



FS Insights

Financial Services Industry Newsletter • Special Edition

Regulatory Reform in the United States — New Rules, Many Questions

On March 26, 2009, U.S. Secretary of the Treasury Timothy Geithner, in testimony before the House Committee on Financial Services, outlined the Obama administration's plans for regulatory reform of the financial services industry, indicating that it was based on the following four principles:

- Reducing systemic risk in the financial system
- Protecting consumers and investors by providing “clear rules of the road that prevent manipulation and abuse”
- Eliminating gaps in regulatory oversight that allow regulatory arbitrage and ineffective or uneven regulation of financial products and activities
- Fostering international coordination because risk does not stop at national borders

The Secretary prefaced his remarks by saying that what is needed are “... not modest repairs at the margin, but new rules of the game.” He further indicated that these rules must be simpler, more effectively enforced and adaptable to changes in the financial markets.

After 17 months over which myriad proposals were proffered and debated, regulatory reform legislation – the Dodd/Frank Act of 2010 – has been signed into law. Enactment of the law leads us to ask the following:

- Does the reform legislation accomplish what the Administration had hoped?
- How did the financial services industry fare at the end of the debate?
- Are financial services industry customers better off because of the legislation?
- Who's going to pay for all of this?
- Will the Dodd/Frank Act prevent the next crisis?

Before trying to answer these questions, it is important to note that the law includes thousands of pages of text and 14 separate titles with more than 1,400 sections. Further, according to the U.S. Chamber of Commerce, the law requires regulatory agencies to pass 350 rules, conduct 47 studies and issue 74 reports.¹ We

¹“U.S. Chamber Denounces Flawed Financial Reform Bill,” U.S. Chamber of Commerce Press Release, June 25, 2010, available at <http://library.uschamber.com/press/releases/2010/june/us-chamber-denounces-flawed-financial-reform-bill>.

would add that, based on our review, the act also requires at least seven new bodies or departments, some with specifically designated offices, to oversee implementation and enforce the law. In short, therefore, it will be some time before the questions posed above can be answered definitively, but we can offer some initial views based on information currently available.

A Closer Look at the Reform Bill: Does it Meet the Objectives?

The Administration's platform for identifying and mitigating systemic risk initially called for:

1. Establishing a single regulatory body with responsibility over “systemically important” companies and over payment and settlement activities
2. Setting higher standards for capital and risk management for systemically important companies
3. Requiring all hedge funds above a certain size to register with the U.S. Securities and Exchange Commission (SEC)
4. Establishing a comprehensive framework for oversight of the over-the-counter (OTC) derivatives market
5. Establishing requirements to protect against the rapid withdrawal of money market funds

On these points, the reform legislation receives mixed grades after having gone through much debate and compromise to become something that could be enacted. With respect to the oversight of systemically important companies, the approach finally approved is more complicated than what was initially contemplated. Instead of a single regulatory body with responsibility over “systemically important” companies, we will have a Financial Stability Oversight Council (FSOC), which will be composed of 10 voting members and five non-voting members,² and an Office of Financial Research to support the

²Voting members include: the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Director of the Consumer Protection Bureau, the Chair of the U.S. Securities and Exchange Commission, the Chair of the Federal Deposit Insurance Corporation, the Chair of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chair of the National Credit Union Administration Board, and an independent member with insurance experience who will be appointed by the President and approved by the Senate; non-voting members include: the Director of the Office of Financial Research, the Director of the Federal Insurance Office, a State Insurance Commissioner, a State Banking Commissioner, and a State Securities Commissioner, each to be selected by his/her peers.

FSOC with information gathering and analysis. The FSOC will be responsible for identifying and addressing systemic risk and for recommending more stringent prudential standards for systemically important institutions, defined generally as institutions that meet an asset threshold of \$50 billion or otherwise present risks of a level deemed appropriate by the FSOC.

In an effort to curb risk in the industry, the law also includes the Volcker Rule, named for former Federal Reserve Chairman Paul A. Volcker. The Volcker Rule, with certain exclusions, prohibits any insured bank or thrift or holding company (collectively referred to as “banking entities”) that controls any insured bank or thrift from engaging in proprietary trading for itself or any systemically significant nonbank entity. It further prohibits banking entities from acquiring or retaining any ownership interest in, or sponsoring, any hedge fund or private equity fund, subject to certain exclusions, including a *de minimis* provision of not more than 3 percent of the banking entity’s Tier 1 capital.

Advisers to private and hedge funds with more than \$150 million in assets under management will be required to register with the SEC. The law also provides that both the FSOC and the SEC may impose reporting requirements on advisers of private funds, including the disclosure of the “identity, investments or affairs” of their clients.

The Commodity Futures Trading Commission (CFTC) and SEC are authorized to write rules for the swaps and security-based swaps markets, register market participants, and approve new products. They also are given enforcement authority except for banks and branches/agencies of foreign banks, where enforcement will remain with the bank regulators. Rules are expected to address mandatory clearing of swaps, mandatory clearing on an exchange, public trade reporting, capital and margin requirements, and prohibitions against market manipulation. Under the so-called Swap Pushout Rule, the law also precludes providing federal assistance (e.g., federal deposit insurance or access to the Federal Reserve discount window or Federal Reserve credit facilities) to swaps and security-based swaps entities. An exception does exist for insured depositories if they limit their swap activity to hedging or swaps involving reference assets in which national banks are permitted to invest. Insured depositories are permitted to have affiliates that are swap entities.

There does not appear to be any mention in the act regarding actions related to preventing withdrawals of money market funds. In January 2010, however, the SEC adopted rules designed to afford better protection to investors and increase the resilience of money market funds during periods of economic stress.

The act includes several provisions aimed at protecting investors and consumers. These include, but are not limited to:

- Formation of a Bureau of Consumer Financial Protection within the Federal Reserve
- Formation of an Office of Investor Advocate within the SEC
- New mortgage lending requirements and restrictions, including a requirement that lenders will no longer be able to make a loan without verifying that the borrower can repay it, and “skin in the game” risk retention requirements for originators and securitizers of certain types of mortgage loans
- Regulation of consumer remittances
- Changes to the long-standing principle of federal pre-emption
- Myriad studies

The new Consumer Financial Protection Bureau, a lynchpin of the legislation, will have rulemaking and some enforcement powers. It will examine and enforce regulations for: all mortgage-related businesses; banks and credit unions with assets of more than \$10 billion; and payday lenders, check cashers and certain other nonbank financial firms. Whether these provisions result in the “clear rules of the road” that Secretary Geithner was envisioning will not be evident until the bureau is established, new rules are written and study results are considered.

In an effort to close the gaps in regulatory oversight that may have exacerbated the financial crisis, the law introduces new requirements for, among others, hedge funds, credit rating agencies, municipal securities, and mortgage lenders and other nonbank providers of financial services. In addition, as previously noted, it adds many new regulatory bodies and departments to share responsibility for supervisory oversight and consumer protection.

Unfortunately, barring a few studies, the law does not really address what tools and resources will be provided to any of the new regulatory bodies, nor those that existed pre-Dodd/Frank Act. As an aside, it is worth noting here (though likely not surprising to students of regulatory reform) that the Federal Reserve, which at various points during the debate was assigned partial blame for the crisis, could be the big winner among the bank regulatory agencies. On the flip side, the Office of Thrift Supervision will be eliminated, though the thrift charter will survive, at least on paper. However, some will question the practical longer-term viability of the charter following the failure of many of the largest thrifts and the lack of a dedicated thrift regulator going forward.

Secretary Geithner's fourth and final principle is intended to ensure international coordination. The law does include provisions related to the sharing of information cross-border and recognition of home country regulation, and in some instances is fashioned along the same lines as requirements being considered and/or imposed on financial institutions in other jurisdictions. However, it is not clear how much international coordination has influenced U.S. legislation or, for that matter, legislation/regulatory changes in many of the major financial services markets. Recent comments by BNP Paribas Chairman Michel Pebereau highlight the issue: "At this period of time, it is clear we have a different situation if we compare the U.S. and Europe. The priorities are not the same."³ Over time, more commonality may emerge, driven by regulators rather than legislators. If not, regulatory arbitrage opportunities will surely exist for those companies that operate multinationally.

Industry Assessment

The reactions of trade associations such as the American Bankers Association (ABA) and the Securities Industry and Financial Markets Association (SIFMA) are likely good proxies for how the financial services industry believes it has fared. The ABA is already marshalling the industry to start talking to Congress about "fixing the problems." SIFMA President and CEO Tim Ryan, who has previously expressed concerns about unintended consequences of the legislation, said, "... this is a tough law that will also have profound effects on the operations and cost structure of most financial services companies and financial markets."⁴

While lobbyists and industry associations were able to get some concessions, overall the final reform legislation is viewed as a disappointment by many in the industry.

Customer View

There are, no doubt, many customers of financial services companies that applaud the passage of the Dodd/Frank Act because it includes all types of new consumer and investor protections. Given the complexity of the legislation and the unanswered questions that remain, this may be shortsighted. There is still considerable work to be done to achieve true regulatory reform. There are a great many unknowns, starting with the costs of reform legislation and the question of who picks up the tab.

Who's Paying?

The law includes certain provisions for funding the costs of new requirements, such as Title XIII – the Pay It Back Act, which ends the Troubled Asset Relief Program (TARP) three months early and saves approximately \$11 billion of the projected \$19 billion of the government's cost of the reform over a 10-year period. Other funding mechanisms may include an increase in deposit insurance premiums for institutions larger than \$10 billion in total assets.⁵ These costs, however, don't include actual costs to the industry of implementing legislative and regulatory reform.

The real answer to "Who will pay?" comes from Bob McTeer, former president of the Federal Reserve Bank of Dallas and current Protiviti Advisory Board member, whose simple answer is, "You." Explaining his answer, McTeer stated that we "... should not forget a couple of basics: (1) the imposition of massive new regulations on the banking and financial system will raise costs that may not be called taxes, but will have a similar effect; (2) the incidence of that cost-tax probably won't be what was intended. Banks, like other businesses, will likely pass most of the additional cost onto their customers."⁶

Are We Protected from the Next Crisis?

Most likely, the answer is "no." In fact, as noted in a recent Forbes.com article, one of the certainties we can count on is that "No matter what the rules are, the financial industry will figure out how to innovate around them."⁷ The truth is that, historically, the financial services industry experiences a crisis every seven to 10 years. The best we can hope for is that everyone who contributed to the latest crisis – legislators, regulators, bankers, credit rating agencies, consumers – has learned some valuable lessons that will at least make the next crisis less cataclysmic.

For anyone thinking of breathing a sigh of relief that regulatory reform in the United States is at least behind us, keep in mind that the Financial Crisis Inquiry Commission's report, which will likely recommend additional changes, is still to come. It is due in December 2010. There is also the battle over the future of Fannie Mae and Freddie Mac.

Summary

Our goal for financial services reform was better, not just more, regulation. We are skeptical that goal has been achieved.

³ "BNP Paribas Says Europe Should Be Ready to Break from U.S. Over Bank Rules," Bloomberg.com, July 6, 2010, available at <http://www.businessweek.com/news/2010-07-06/bnp-says-europe-should-be-ready-to-break-from-u-s-over-rules.html>.

⁴ SIFMA Statement on Conclusion of Conference, June 25, 2010, available at <http://www.sifma.org/news/news.aspx?id=17458>.

⁵ "Joint panel agrees to end TARP early to help pay for financial reform," Puzanghera, Jim and Mascaro, Lisa, *Los Angeles Times*, June 30, 2010, available at <http://articles.latimes.com/2010/jun/30/business/la-fi-financial-reform-20100630>.

⁶ "Who Will Pay for Financial Reform? You," StreetTalk blog, Forbes.com, July 6, 2010, available at <http://blogs.forbes.com/streettalk/2010/07/06/who-will-pay-for-financial-reform-you>.

⁷ "The Dumbest Financial Laws of All Time," Farrell, Maureen and Nelson, Brett, Forbes.com, July 3, 2010, available at www.abcnews.go.com/print?id=11067496.

For More Information...

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