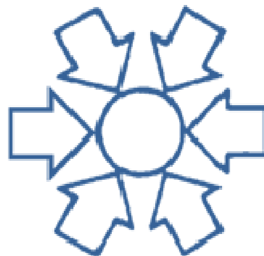
Seeing the Forest, Not the Trees: What the Sum Total Impact of All the New Rules Means For the Industry and Financial-System Stability



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It is an honor to be here today and follow Chairman Greenspan and SIFMA's leadership on a program focused squarely on the critical challenge facing financial-services firms: the still-incomplete and increasingly-complex regulatory framework that, more than any market or management factor, now defines each firm's success or failure.

Five years after the start of the global financial crisis, I would have thought we would be talking together about your strategic plans based on final regulations that resolutely addressed the global market collapse. But, reforms are, at best, incomplete, creating the worst of both worlds: prudent firms are frozen in place and risky practices are still often left unregulated.

Indeed, over a year ago, Chairman Bernanke admitted that he didn't know the combined impact of all the rules being issued even though, as he readily acknowledged, this is a vital question.

Recognizing this, Tim Ryan charged my firm with a challenge: define the sum total impact of all of the significant prudential rules confronting SIFMA's membership.

The result of this analysis is three studies that show that while some regulations that were sorely needed after the financial crisis of 2008 were needed, and regulators have gotten important pieces right, many more are unfinished and unable to be fully synchronized with each other.

This afternoon, I will summarize each of the three studies SIFMA requested and, then, turn to their combined findings. Each of you has, I believe, been given the studies – and, I hope a rolling carry-bag to take them home. I'm sorry the landscape piece of the analytical survey is particularly long, but I hope you will find the individual pages on each key rule instructive on each of these critical policy actions, even as the study as a whole pulls all of the surveyed rules together to assess their sum-total impact. Importantly, all of these studies are as objective as we could make them, with the landscape on each rule detailing its desired impact and an array of possible – but by no means certain – unintended results. There may be much to argue with on each page, but I think the sum-total impact is inescapable.

The first study goes through each major prudential rule identified as a strategic industry concern. We then map out each rule's intended effect, deriving these from a read of the rule to see what the agencies and, where applicable, Congress and Group of Twenty heads of state said are the rule's objectives. Then, we looked at an array of industry, consumer-group, academic and industry comments to analyze how each rule meets its purported goals and where the rules collide. I'll talk about "bumper cars" in a minute, but we found a lot of them strewed across the regulatory landscape.

The second study catalogues what I call "operational impediments" to effective regulation. Whatever a rule may intend to do and how much one likes or dislikes that, certain fundamental building-blocks are essential for effective rulemaking. For example, one may well want the Basel III rules to apply across borders, but they can do so, at best, only imperfectly if national accounting standards define critical elements of the rule – "capital" for instance – in very different ways. And, of course, there are all the U.S. rules that Congress told as many as six regulators harmoniously to finalize, despite the very different entities the agencies regulate, the statutory goals each agency is to meet and all the other rules on each agencies' plate.

Finally, the third study looks at bumper cars that are 18-wheelers: the contradiction between all the rules premised on the continued too-big-to-fail status of behemoth banks and the orderly-liquidation regime established in Dodd-Frank to bar future bail-outs. Critics have argued that the Dodd-Frank resolution regime is insufficiently robust, so we took a hard look at the law and implementing rules. Evaluating these and arguments levelled against them, the study concludes that the U.S. systemic-resolution regime is, while incomplete and untested, a meaningful barrier to too-big-to-fail, especially when analyzed in concert with the other prudential rules under way to govern large financial-services firms.

Let me now turn to each of the studies to present their results to you in more detail.

Bumper Cars on the Go

First, we were asked to identify prudential rules with strategic impact for financial institutions and markets.

Given the scope of U.S., European Union and global standards, this survey could have taken us from the front of this hotel across the Hudson and back again without necessarily capturing each rule that matters to each of you. So, our first task was to select the most significant strategic standards, which we did by surveying our own prior analyses and consulting SIFMA to ensure that any missing issues were reflected in the landscape. From this, we mapped a wide array of rules – capital, liquidity, single-counterparty limits, Volcker, ring-fencing, derivatives reforms and new mortgage and asset-securitization standards among them. In each case, we analyzed the rule or proposal, checked the law as needed and then detailed key provisions, the rule's desired goal and, then, the unintended effects and even perverse consequences possible as each rule is considered in light of all of the others.

As I said, we found a lot of bumper cars – vehicles intended for the high road instead running head-on into those headed in the opposite direction in search of the same, high road. One collision – between systemic rules premised on too-big-to-fail and the U.S. resolution regime meant to end it – was so compelling as to warrant its own analysis.

Other major interactions with unintended impact we found include:

- Reforming Derivatives: The collision between the raft of pending reforms to over-the-counter derivatives with other high-priority global and U.S. initiatives is a major set of careening bumper cars. For example, we find that the capital rules may well make it far more difficult to establish the central counterparties (CCPs) heads of state have determined are needed to stabilize and regulate OTC practice. The proposed U.S. single-counterparty credit-exposure limits may have the same impact on CCPs, and the new margin requirements contradict in key respects not just the capital and credit-exposure standards, but also new liquidity rules that want banks to hold lots more of the same highly-liquid assets needed for margins.

- Capital vs. Liquidity: The capital rules want banks to add or subtract unrealized gains or losses to calculate capital. Maybe a good thing on the downside, but for sure risky on the up since banks would seem unduly capitalized due to evanescent gains. Up or down, capital becomes a lot more volatile and, quite possibly, pro-cyclical – a direct contradiction to the broad effort in many rules to make capital counter-cyclical. Counting unrealized gains and losses also runs head-on into the liquidity rules because benchmark assets needed for liquidity purposes are subject to frequent mark-to-markets that drive gains and losses on the balance sheet.

- To Hedge or Not to Hedge: In general, regulators want banks to hedge exposures because, of course, doing so reduces risk. But, an array of rules aimed at other issues may well make it hard for banks to undertake effective hedging. The Volcker Rule poses this problem, as do pending ring-fencing, liquidity, single-counterparty and capital rules. The U.S. standards that set floors on regulatory capital are intended to address model and similar risk, but may undermine risk-reduction with regard to hedging and numerous other factors.

- Private Capital for Mortgage Finance: Regulators have repeatedly said they want to spur the return of private capital to residential finance, reducing the virtually total dependence now on taxpayer-backed securitization. But, the pending risk-retention rules will make this, at best, difficult, especially taking the new capital and liquidity rules into account. If proprietary trading in agency debt and MBS is not protected in the Volcker Rule, this will not only adversely affect hedging, but also the broader market liquidity necessary for there to be a TBA market.

Many of the rules described in this study are understandably intended to be as tough as possible – the financial crisis cost trillions in lost wealth and millions of people lost their jobs. But, almost all of them are focused only on banks.

As a result, all of these bank-centric rules could drive risk into "shadow" sectors. Regulators readily acknowledge this risk and are working on some fixes to it, but ironically most of these are based on curtailing bank interactions with "shadow" firms, a strategy that could have little or even perverse effect if, as some suggest, non-bank entities can readily access capital markets without relying on regulated banks. The shadow standards will, at the least, take years to finalize, meaning potentially significant shifts in market share unless or until these are both complete and robust.

Impediments to Effective Rules

But, let's assume for the moment that none of these perverse or unintended effects will occur. Can all of the rules proceed as planned? Our second study turned to this question and found that the answer is, despite the need for many reforms, an emphatic no.

I think it's irrefutable that effective rules must be transparent and, when applicable across industry sectors or borders, comparable. Without this transparency and comparability, rules

cannot govern their intended subjects, sanctions miss their targets, and accountability – for regulators, not just financial-services firms – will be difficult to assign. Even worse, rules without transparency, comparability and accountability may well create their own systemic risk: an undue faith in "false science" reflected in sweeping, fancy rules that cannot in fact be implemented as planned or enforced as needed.

Some of the key impediments we found to effective rulemaking are:

- Regulatory Coordination: There's not a lot of this because agencies operate under different mandates, different objectives and thus often can't agree even on desirable policy objectives, let alone all the details in their complicated rules. This not only delays rulemaking, but leads to widely differing rules within the U.S. that dramatically affect planning and compliance in diversified firms and exacerbate regulatory arbitrage. Take the U.S. framework and compare it to differences dividing EU regulators and the impediment to a functional regulatory framework becomes still more profound.

- Global Implementation: The Basel framework and much else is premised on comparable global implementation and enforcement. However, as recent peer-reviews by the Basel Committee make clear, this remains far more hope than reality. Top-down global standards not in fact honored in key markets create serious regulatory-arbitrage and competitiveness risks. Efforts to impose rules on an extraterritorial basis show the fraying nature of global cooperation without creating a transparent, comparable regulatory rulebook.

- Supervisory Capacity: New rules are in many areas extremely complex. This not only complicates implementation and accountability at banks, but also undermines the basic ability of regulators to determine if financial firms are playing by the rules. Some have suggested that complex rules should be eliminated in favor of seemingly simple supervisory discretion, but marketplace realities and political inevitabilities mean, I think, that supervisors will always lag problematic industry or institution practice. After-the-fact enforcement is cold comfort even when or if it occurs with vigor.

Let me make clear, the identification of operational impediments to effective regulation is not intended to say that all rules must be deferred until all of these impediments are cleared away. To do so would delay regulatory reform too long and worsen the uncertainty dampening economic recovery.

It is, however, important that rules be finalized not only with a clear understanding of their cross-cutting impact, but also with realistic recognition of any of the missing building blocks needed to ensure transparent, comparable and accountable regulation.

Incremental steps – not sweeping rewrites – should be advanced unless or until these impediments are removed. Seemingly far-reaching rewrites that rest on weak under-pinnings are, in many cases, worse than no reform at all. The more regulators, investors, depositors and

counterparties think they are protected without an enforceable rulebook that ensures they are, the more vulnerable financial markets become to sudden shock and, thus, even worse systemic risk.

Is Orderly Liquidation Meaningful Resolution?

Key to real reform is a transparent framework in which every financial-institution counterparty that can reasonably be expected to understand his or her risk has the information in hand with which to assess it and the broader market has the bulwarks in place to prevent harm to innocent bystanders. Do U.S. law and rule protect the innocent and punish those who could reasonably be expected to protect themselves? If not, then regulation premised on taxpayer bail-outs is warranted; if too-big-to-fail is terminated, financial firms need not be swaddled in unduly protective regulation.

Because this question is critical, our third study takes it on. Here, we were asked by SIFMA to analyze the orderly-liquidation authority (OLA) established in Title II of the Dodd-Frank Act to see if it in fact creates the barrier to bail-outs Congress demanded.

In short, I think it does, especially in the context of the changes wrought in Title I of the Act that stipulate numerous structural and regulatory reforms.

Key to these are the recovery and resolution plans – "living wills" – required of large banking organizations and, upon designation systemic nonbanks. The fact that U.S. law creates a framework for nonbank systemic regulation and resolution is unique. No other nation has yet done so nor has any other regime erected a resolution framework without implicit or explicit taxpayer bail-outs. One need look only to the EU to see not only banks too big to fail, but those also so large that their sovereigns cannot save them without severe harm to national markets and economic systems.

Is Title I done? No. Is the Title II regime stipulating OLA complete? No, although it's been substantively enacted in a series of sweeping and disciplined FDIC rules assessed in our study. More are in the works, including important answers to the question of how a complex banking organization under solvency stress would be resolved and the manner in which cross-border failures are handled.

Could the FDIC back down? Maybe, although the law still doesn't let it, Treasury or anyone else bail out a big bank. Might Congress lose its nerve and intervene in a future systemic situation? Perhaps, but it's inappropriate to decide that a law is defective because someone someday might repeal it. Policy is most meaningfully judged on its face to see how well it accomplishes identified goals and whether work is under way to resolve unanswered questions.

By these criteria – the right ones by which to measure OLA, I believe – the U.S. has a meaningful answer to too-big-to-fail. Regulation should recognize this to reinforce it, not seek to backstop it by rules that lead markets to anticipate bail-outs that, under law and rule, cannot occur.

Conclusion

All too often, financial institutions – big banks most of all – are lambasted because they are said to oppose all reform. The studies SIFMA asked my firm to do are evidence that one group of major financial-services firms wants to play a constructive role in erecting a disciplined and effective framework that recognizes the havoc wreaked in the financial crisis. I am grateful for the opportunity to conduct this research on your behalf and I look forward to answering your questions on it.