Chapter 1

Summaries

Chapter 2 – The architecture of financial regulation. Assuming the financial architecture will continue to be dominated by institutions imposing high levels of systemic risk, the creation of a new systemic risk regulator is a central component of post-crisis financial reform. This new regulator would supervise the growing cohort of financial conglomerates and through a regulatory council work in tandem with the Federal Reserve and three reconfigured functional regulators to both macro-prudential and micro-prudential responsibilities. This task will be facilitated if risk is priced more appropriately and as a result institutions are encouraged to follow more specialized business strategies.

Chapter 3 – The Independence of the Fed. Pending legislative proposals to alter the functioning of the Federal Reserve would compromise its independence, politicize its role and hamper its ability to react swiftly in the event of a crisis. These proposals, in our view, may actually work against their stated goals of strengthening the U.S. financial system and making monetary policy more effective.

Chapter 4 – Measuring Systemic Risk. Before systemic risk can be contained, regulators must first be able to identify systemically important institutions and then to quantify that risk in an organized manner. The House and Senate bills rely largely on simple systemic risk criteria, such as size, leverage and interconnectedness; we believe that market-based measures, which are more continuously variable, would be extremely useful in the process, as well.

Chapter 5 – Managing Systemic Risk. Both the House and Senate proposals that deal with managing systemic risk recognize that systemic institutions must be subject to higher standards, and ultimately, they must be charged for the implicit guarantees that they enjoy. Yet given that risk, leverage and interconnectedness can never be measured perfectly, other remedies, such as forcing systemic firms to separate out those activities that expose taxpayers to excessive risk, may also be warranted.

Chapter 6 – Taxing Too-Big-To-Fail. Current House and Senate proposals call for the establishment of a risk-based systemic fund that would guarantee obligations of certain financial institutions in the event of a crisis. The capital in the fund would be paid for by systemic institutions based on some measure of their complexity. The House bill is flawed in that it focuses more on a firm's size than its systemic risk profile, and the legislation fails to address the appropriate level of assessment on financial institutions.

Chapter 7 – Capital and Liquidity Requirements. The current House and Senate proposals call for stricter standards to be imposed on systemically risky institutions in the form of capital requirements, leverage limits and liquidity requirements. While the legislation correctly focuses on these issues, it fails to define these requirements. We believe that major capital loopholes should be closed and that there should be less reliance on rating agencies.

Chapter 8 – Breaking Up Too-Big-To-Fail. Current proposals before the House and the Senate do not call for the breakup of massive financial conglomerates, but they do set forth standards that would cap credit exposure. We do not favor breaking up complex financial institutions based on size considerations, but we do find merit in some such breaking up based on activities.

Chapter 9 – Contingent Capital. Both the House and Senate bills call for the issuance of contingent capital to be a potential additional standard to face systemically important institutions. We believe this is a sound idea, but as proposed, it does not go far enough. In addition to contingent capital and resolution plans, an explicit fee should be charged to banks in good times, based on their expected losses and contribution to systemic risk.

Chapter 10 – Financial Institutions Subject to the Bankruptcy Code. The House and Senate bills both try to create a mechanism to unwind failing systemically significant financial companies in an orderly way through receivership. The positive aspect of the bill is that it gives legal authority to deal with large complex financial institutions that are not just depository institutions, but the legislation does not go far enough to reduce the uncertainty surrounding bankruptcy.

Chapter 11 – Money Market Funds. In response to the financial crisis, and to avoid the type of run on money market funds that occurred in September 2008, the SEC has proposed several changes to the way money market funds are regulated. While we believe that these amendments are sensible and would increase the general safety of the money market fund sector, they do not adequately address the issue of likely government guarantees in future financial crises.

Chapter 12 – Hedge Funds. Hedge funds and mutual funds did not cause, or even materially contribute to, the recent financial crisis. Nevertheless, there may be circumstances under which they might impose externalities on the financial system by generating systemic risk in future crises. The House bill recognizes this possibility by making them eligible to be taxed when they likely are generating systemic risk, just like other large financial institutions. Significant implementation issues remain.

Chapter 13 – Government-Sponsored Enterprises. The collapse of Freddie Mac and Fannie Mae during the 2008 financial crisis raises questions about how these GSEs should be structured going forward. Financial legislation must address these issues – most importantly, eliminating the proprietary trading function of the GSEs.

Chapter 14 – Insurance Industry. We support the creation of the National Insurance Office. However, we recommend that the legislation go further and create a National Insurance Regulator and an optional or even mandatory federal charter for financial institutions with a significant presence in the insurance industry. There is hardly any discussion in either bill about specific regulation of insurance companies relating to their systemic risk.

Chapter 15 – Credit Rating Agencies. Credit rating agencies -- central players in the subprime residential mortgage crisis -- are now being examined in current legislation before the House and Senate. The goals of the proposals are to strengthen regulation, to keep rating agencies accountable, and to ensure that the agencies produce high-quality information on the risks of the securities they rate. The legislation, however, does little to prevent issuers from "shopping" for the best rating.

Chapter 16 – OTC Derivative Reforms. The House Financial Services Committee has approved a bill to regulate the massive OTC derivatives business. The proposed legislation calls for sweeping changes in the structure of the OTC marketplace and its regulation, requiring most standardized derivatives to be traded on a newly defined entity called a Swaps Exchange Facility or an electronic exchange. We believe that many of these proposed changes have the potential to stabilize the derivatives markets and improve their functioning and their regulation.

Chapter 17 – Securitization. Securitization created serious systemic problems that played a major role in the financial crisis. Current proposals before Congress call for securitizers to have "skin-in-the-game" and for more transparency, but fall short on three dimensions: (i) they adopt a "a one-size-fits-all" approach to the retention of risk that should be maintained by securitizers; (ii) they are too sweeping in their disclosure requirements, while not specifying the risk implications in any detail; and, most importantly, (iii) they fail to address the critical regulatory loopholes in capital adequacy regulations that led to the systemic problems, while imposing large accounting and regulatory compliance costs that would impede efficient intermediation.

Chapter 18 – Consumer Finance Protection Agency. In response to the financial crisis and to address growing concern about consumers' lack of financial knowledge and vulnerability in light of the complex financial products they face, Congress has proposed the creation of the Consumer Financial Protection Agency. The CFPA would unify the supervision and enforcement of existing consumer protection laws – a role that is currently spread across at least 11 agencies. While we support the creation of such an entity, we suggest changes to the House and Senate proposals that close loopholes, encourage innovation, and extend the authority of the agency to intervene prudently.

Chapter 19 – Compensation and Governance. Outrage about the large bonuses paid to employees of financial institutions that received federal bailout money has spurred Congress and the Federal Reserve to review and suggest changes to financial firms' compensation policies. While we welcome many of the proposed reforms that focus on reducing shareholder/regulator and manager/shareholder conflict, we believe that the prohibition of "excessive" compensation at financial firms is problematic.

Chapter 20 – Independence of Accounting Boards. The financial crisis has focused a spotlight on the setting of accounting standards – notably on making GAAP more amenable to the goals of bank regulation. We believe that bank regulators should have no significant power over GAAP and that if politicians want to allow bank regulators to exercise regulatory forbearance, modifications should be made to regulatory accounting principles, not GAAP.

Chapter 21 – Banks' Loan Loss Reserving. Various parties have proposed changes to the way that banks reserve for loan losses, contending that using the "incurred loss model" exacerbates the cyclicality of the financial system. We believe that an "expected" loss approach – not "dynamic" -- is more consistent with fair value accounting. Furthermore, we believe that encouraging banks to build up capital during periods of economic strength is a worthy goal, but that it must not be accomplished by compromising the consistency of GAAP.

Chapter 22 –Market Illiquidity and Fair Value Measurement. There are practical problems that arise when measuring fair value in illiquid markets. We favor exit value over amortized cost as the preferred measurement basis for banks' financial instruments and also believe that increased disclosure is imperative.