

GETTING THE BEST OF BOTH BILLS

MIKE KONCZAL, FELLOW | THE ROOSEVELT INSTITUTE

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There is little time left in financial reform. Small changes made during the conference committee will have major consequences for developing a 21st century financial sector. The reformed sector should work to grow, nurture and build the real economy, create a broad-based prosperity, and shine as an example for the developing world of how to have a financial sector that works.

With the Senate Bill as a baseline and pieces of the House Bill up for vote, financial reformers can get the best of both bills. There are many places to focus on where changes can make a difference,

and this document focuses on four specific ones. Resolution authority is an untested solution for a financial crisis, so reforms that make it more credible are crucial. Capital is essential for the stability of our financial sector, so banks must be made to hold more and better capital. And bringing the over-the-counter derivative market into the sunlight of exchanges and clearing, as well as carrying out an audit of the Federal Reserve's lending during the previous crisis, will allow transparency to do its job.

MIKE KONCZAL is a Fellow at the Roosevelt Institute. He can be reached at mkonczal@rooseveltinstitute.org

	WHAT PROVIDES A GOOD BASELINE IN THE SENATE, BUT IS AT RISK?	WHAT FROM THE HOUSE, NOT CURRENTLY INCLUDED, COULD MAKE IT EVEN BETTER?	NOTES
MAKING RESOLUTION AUTHORITY CREDIBLE	Sect. 716, the swap spin-out, & the Merkley-Levin Amendment, hard wiring the Volcker Rule into the bill.	Prefunding, which fixes the broken funding mechanism, and the Miller-Moore amendment, to write-down secured creditors.	Resolution authority is an untested solution to a crisis; making it credible should be a top priority.
GETTING OUR BANKS CAPITALIZED	The Collins Amendment requires banks to hold quality capital and bank holding companies to have requirements that are as strict as their bank subsidies.	The Spiers Amendment requires that banks hold a minimum amount of leverage through a leverage cap of 15:1 that regulators can't ignore.	One doesn't work without the other. Banks need to hold quality capital, and a solid baseline amount of it.
BRINGING DERIVATIVES INTO THE SUNLIGHT	The language is strong, though a loophole for illegal swaps needs to be closed.	The Lynch Amendment would help with ownership conflicts in clearinghouses and exchanges to make sure the market remains transparent.	Watch for the loopholes from the House to be introduced, and for radical last minute changes.
AUDITING THE FEDERAL RESERVE	The Senate language is strong, as it makes the audit available for public scrutiny, though it is a one-time audit.	The House bill allows for continuing audits.	The final bill could have continuing audits of the Senate's quality. To stop another crisis, we need to know what happened.

GETTING THE BEST OF BOTH BILLS

On December 11th, 2009, the House passed H.R. 4173, “The Wall Street Reform and Consumer Protection Act of 2009.” And on May 20th, 2010, the U.S. Senate passed, 59-39, the “Restoring American Financial Stability Act of 2010.” Both bills are the regulatory response to the financial crisis that wrecked the U.S. economy in 2008.¹

The bills are similar in many ways. They both reflect the initial approach outlined by the Obama administration in its June 2009 financial reform white paper. However, each also reflects the nature of the political realities that they faced when they were debated and passed. The House Bill started off similar to the white paper. During the debate, the bill’s resolution authority grew stronger, while it grew weaker from having large carve-outs and loopholes inserted in the derivatives and consumer protection areas. The Senate Bill’s derivative regulation started off strong, riding political momentum after the passage of health care reform, but resolution authority did not have the same strong amendments added to it during the debate process.²

Starting next week, a conference committee will be held to determine what the final bill will look like. The baseline will be the Senate Bill, with items from the House Bill up for debate. With this in mind, financial reformers should be in a good position to pick from the best of both bills. By using the House Bill to supplement the weak points of the Senate Bill, while also keeping the best parts of the Senate Bill that are at risk, it is possible to end up with a financial reform bill that will guide the real economy well into the 21st century and help mitigate a future crisis.

MAKING RESOLUTION AUTHORITY CREDIBLE

Resolution authority is the ability to unwind a systemically important financial firm through means other than the bankruptcy code. During the financial crisis of Fall 2008, regulators lacked the legal authority they needed to wind down financial institutions.

This bill places a lot of weight on being able to carry out the untested solution of an FDIC-style resolu-

tion on a large, interconnected, failing financial firm. Regulators need to be able to detect systemically important financial firms that are going to fail beforehand, and use the financial sector’s regulatory powers to push them back on a stable path. So resolution isn’t just about failing a firm; it’s about telling a firm that it must take action to become safer before it is resolved.³

Markets participants are currently conflicted as to whether or not resolution authority is credible. Notably, Moody’s Investor Service wrote, “[A] key issue that challenges the feasibility of the proposed legislation is that it would not fully eliminate the issue of interconnectedness, nor is it likely that resolution authority could fully eliminate the systemic implications of allowing a large and/or highly interconnected firm to default, especially with respect to large international groups, and it certainly would not eliminate the risk of contagion.”⁴

There are many ways to go about making resolution authority more credible. The two largest components in the Senate Bill are Section 716 and the Merkley-Levin amendment.

Section 716: This part of the reform bill, passed out of the Senate, would remove the ability of banking entities to engage in swap dealing. This would limit the interconnectedness of bank entities and return commercial banks to the business of commercial banking. Swap dealers need to be collateralized, but we don’t want them to use their access to the discount window to provide that collateral. Removing this interconnectedness of the banks will make resolution authority work better, as it would simplify the business model, making a credible detection of the problem easier. As the major banks would participate in the market as a consumer of derivative products for their own hedging needs, their size and power would be redirected to serve as a first line of market discipline on the dealers.

Merkley-Levin: In addition to this, providing a hard line between proprietary trading and commercial banking (the “Volcker Rule” and in the bill the Merkley-Levin amendment) would go a long way toward a financial sector in which resolution authority can

work. Merkley-Levin would keep the regulators from giving exemptions and overruling this distinction between business lines. We should not expect a regulator to avoid the temptation of giving exemptions to friends or dismantling the rules in the middle of a bubble, and writing it clearly into the law without an override mechanism will help make resolution authority more credible.

The House bill has several additional elements that were added that makes resolution authority much more credible. Neither of these are in the Senate bill.

Prefunded Resolution Fund: The first is a prefunded resolution fund. This is in no way a “slush fund” or a bailout fund.⁵

With prefunding, the results are counter-cyclical; firms will save money in good times to pay off in bad, which is good risk management. It discourages firms from growing in size and risk at the margins and becoming systemically risky; it is a real penalty they would have to pay. And it is unlikely that the government would put a large liability on the balance sheet of other large firms in the middle of a crisis, at which point the fee would become revealed. Prefunding takes this all off the table, and makes resolution more credible. It is for these reasons and others that Shelia Bair, the chairman of FDIC, supports a prefund mechanism, and why Congressman Gutierrez included it in the House Bill.⁶

Miller-Moore Amendment: The second amendment that is in the House but does not have an equivalent in the Senate is the Miller-Moore Amendment. This amendment allows the FDIC to give haircuts to secured creditors. Secured creditors are treated as unsecured creditors past the first 80% of their money. This gives the FDIC greater ability to protect taxpayers from losses, and this ability will be credible to the market, preventing firms from ballooning on the assumption that creditors will never actually take a haircut.⁷

By defending the strong parts of the Senate Bill, while also adding the best parts of the House Bill,

the resolution mechanism can become more credible, and as such, deter the next financial crisis.

GETTING OUR BANKS CAPITALIZED

Having well-capitalized banks is essential to keeping the possibility and damage of another financial crisis low. Capital is the cushion that banks use to weather the downturns. Regulators face perverse incentives to let banks become pro-cyclical. When times are good and a bubble is increasing, regulators are under extreme pressure to let firms hold less capital. And they also face pressure to let banks become extremely ‘innovative’ with what constitutes capital.⁸

Collins Amendment: There are elements in both the Senate and House Bill that tackle each of these perverse incentives. The Senate Bill has the Collins Amendment. This amendment requires bank holding companies to have requirements that are as strict as their bank subsidiaries. It would re-emphasize the fact that tangible common equity, the best kind of capital, is the type of capital we want our bank holding companies to carry. And it would guide regulators to, when in doubt, require banks to hold more capital when they engage in riskier activities.⁹

Though it passed the Senate, it is considered to be a likely target for removal by Treasury and the Federal Reserve.¹⁰ This would be a mistake. Forcing bank holding companies to be more secure in terms of capital, and especially in the types of capital they hold, must be a major goal of this reform. As Shelia Bair said in a letter defending the Collins amendment to the Institute of International Bankers, “As we saw during the crisis, the source of strength doctrine was turned on its head as insured banks often had to come to the aid of their holding companies – holding companies that in too many cases also required federal support.” This upside-down world of how our banks are supposed to work can’t be allowed to continue.¹¹

Spiers Amendment: The House Bill, through the Spiers Amendment, has a hard 15:1 leverage cap for systemically risky firms. One of the reasons this recession is so deep, why so many millions of Ameri-

cans are currently unemployed, is that in 2004 the SEC gave a leverage and capital exemption to five firms: Goldman Sachs, Merrill Lynch, Lehman Brothers, Bear Stearns, and Morgan Stanley. For the previous 30 years, broker dealers' capital ratio had to be 12-to-1, but after this exemption these five banks leveraged up well over 20 or 30 to 1.¹²

We must always realize our regulators, though they have on-the-ground knowledge and expertise, are human beings. It will be difficult for a risk-averse government agent to challenge a handful of very powerful and politically connected firms asking for discretion to be used to allow massive gambling.

Notice how each of these amendments complements each other. A leverage requirement doesn't do anyone any good if garbage qualifies as capital. And having great quality capital doesn't do you any good if you only have a little bit of it. Taken together, these amendments still allow officials to use their knowledge and expertise in regulating banks, but also provide a hard fence around how much leverage the largest and riskiest banks can have.

BRINGING DERIVATIVES INTO THE SUNLIGHT

In any story of the financial crisis, the over-the-counter derivatives market plays a major role. And bringing the derivatives market into the sunlight of clearinghouses and exchanges has been one of the centerpieces of financial reform from the beginning.¹³ And Senator Lincoln's current language, passed out of the Senate, provides a strong baseline.

Closing the No Penalty Loophole: Under the current language in the Senate bill, there is no penalty for anybody who fails to centrally clear a derivatives trade, even though the bill lists this activity as illegal. What is worse is that this trade is still valid, even though the activity is illegal.¹⁴

Maria Cantwell has proposed an amendment to close this unfortunate loophole in the bill, though it did not come up for a vote in the Senate. Conference committee would be an appropriate place to close this loophole and any others that are found.

Lynch Amendment: The House Bill has the Lynch

Amendment, which would prevent a swap dealer or major swap participant from controlling more than 20% of a clearinghouse, exchange or swap execution facility. Much of the governance of these institutions will determine how well sunlight is let into the over-the-counter market, and we want to make sure that they don't have a conflict of interest.

Since the major players want to keep as much of the derivatives market in the shadows as possible, if they are allowed to run the clearinghouses and exchanges they will run them in such a manner that prevents transparency from coming into play.¹⁵

Dividing this ownership structure, and in particular not having it grandfathered in, would be a major benefit for bringing transparency to one of the most opaque financial markets.

AUDIT THE FED

As a result of the lack of transparency in both the Federal Reserve as a whole, and in particular the way the 2008 bailouts were conducted when the Federal Reserve lent money to firms that weren't banks, there's been a push for the financial reform effort to audit the Federal Reserve.¹⁶

Both the House and the Senate have provisions to have the GAO audit the Federal Reserve. The Senate Bill is a one-time audit whose full results will be available to the public. Thus the analysis can also be conducted by the public, and experts with a wide range of backgrounds can find specifics and tell a more complete story of what happened in 2008 and 2009.

The House Bill has a weaker audit in the sense that the full details aren't required to be released to the public, though it is an ongoing audit. The best way to combine both of these features is to keep the Senate's audit and disclosure mechanism and bring in the ongoing language from the House.¹⁷

CONCLUSION

There are many other features of the bill that could have last minute surprises and could be beefed up at the margins. Though for many of them, including such items as the cronyism of auto dealer exemp-

tion for the Consumer Financial Protection Agency,¹⁸ the language is currently well targeted in the Senate bill and the administration shows no sign of wanting it weakened.

This is not true of all parts of the bill. Amendments and language that would make resolution authority, the centerpiece of the bill, more credible and more likely to work are either at risk to be removed or could be supplemented by amendments and language in the House Bill. This is also true of the crucial capital requirements and derivatives reform.

There is little time left for financial reform. Small changes made in the next few weeks will have major consequences for developing a 21st century financial sector that works to grow, nurture and build the real economy, that creates a broad-based prosperity and that will shine as an example to the developing world on how to have a financial sector that works. By taking the best of the two bills and using them to make a better bill, we will be further along this journey.

MIKE KONCZAL, a Fellow with the Roosevelt Institute, works on financial reform, structural unemployment, consumer access to financial services, and inequality. He blogs for New Deal 2.0 and the Rortybomb, and his work has appeared at *The Atlantic Monthly's* Business Channel, NPR's Planet Money, the Baseline Scenario, Huffington Post, and *The Nation*. He was formerly a financial engineer and mathematical analyst. Konczal holds a MS in Finance and a BS in Mathematics from the University of Illinois at Urbana-Champaign.

The views and opinions expressed in this paper are those of the author and do not necessarily represent the views of the Roosevelt Institute, its officers, or its directors.

To contact Mike, email
mkonczal@rooseveltinstitute.org

ENDNOTES

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