Influential Think Tank Recommends Tame Reform of Financial Services

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On January 15, 2009, the Group of Thirty published its recommendations for Regulatory Reform for Financial Services. The Group of Thirty is a Washington think tank headed by Paul Volcker, who was Chairman of the Fed during the Reagan administration. The Group of Thirty's recommendations made the front pages of the financial press because Paul Volcker is one of President Obama's leading economic advisors.

The Group of Thirty's report purports to present recommendations for global reform. However, the Financial Reform Working Group, which authored the report, is composed of twelve prominent financial leaders, eight of whom are Americans. So, while the report uses terms like "prudential regulation and supervision by a single regulator," it has a decidedly US focus. The recommendations really amount to proposals to reform the US financial system. European policy makers are likely to find these proposals useful only as more or less pressing analogies.

Equity traders will be happy to hear that nothing in the report is directed at their business. I would like to think that after a decade or so of market structure tinkering culminating in Reg NMS, policy makers now have other fish to fry.

The report contains eighteen recommendations. Along the way, it takes a swipe at the regulation of banks, insurance companies, broker-dealers, money market funds, hedge funds, asset-backed securities, government sponsored mortgage financing agencies (such as, Fannie Mae) and rating agencies.

Many of the report's recommendations amount to useless platitudes. So, we are told that the quality of regulation must be improved. In light of recent events, this pronouncement is hardly controversial. We are told that regulatory structures should be reevaluated to eliminate overlaps and gaps in coverage and complexity. Yes, and children should eat their vegetables.

In other cases, the recommendations are blessed with the perspectives of twenty-twenty hindsight. So, the Group of Thirty seems to favors a return to Glass-Steagall principles, when banks were not permitted to engage in certain financial activities. In the 1930's, Congress thought that banks should not underwrite securities because bank underwriting activities were believed to be one of the causes of the Great Depression. In the Panic of 2008, bank organized mortgage pools seem to be the root of all evil. So, the Group of Thirty would limit these activities and

require banks that create "collective debt instruments" to retain a meaningful part of the credit risk.

I have heard this sort of proposal from a number of sources, but its logic escapes me. Banks created mortgage pools in order to free their balance sheets up so they could make more loans. They have no reason to create the pools unless they can also offload the risk.

Unsurprisingly, the report does not approve of Fannie Mae and Freddie Mac, euphemistically referred to as "Government-Sponsored Enterprises." The report thinks that if the government wishes to support the mortgage market, it should do it with a government agency, rather than a public-private hybrid. The Group of Thirty would prefer to spin these outfits off to the private sector and presumably not buck them up with taxpayer money.

The Group of Thirty also doesn't approve of the way money market mutual funds are being supported by the Fed. The report would require most money market funds to organize as special purpose banks. Other funds would not be allowed to offer "bank-like" services, such as checking accounts and assurances of stable net asset values (not breaking the buck). This is one of those proposals where the devil is in the details. Is there any oxygen between the current money market funds, which were supposed to be uninsured, and regular commercial banks, who are generally hungry for deposits? And, what about the commercial paper market? Without money market funds, the commercial paper market will lose its main habitat and is likely to go the way of the dinosaur. The Group of Thirty refrains from exploring the ramification of their proposals.

Other recommendations are so careful not to offend that they are reduced to meaninglessness. My personal favorite is the recommendation that legislators do a cost benefit analysis to determine if more transparency in financial products would be a good idea. The benefit cited in the report would be greater confidence in the markets. The costs would be the privacy of financial services firms. In the first place, privacy for financial services firms is not a value that in itself should be protected. Businesses that want to play in this area have long understood that the price of admission is opening their kimono. We permit privacy to the extent that it will encourage competition and innovation. So the real question is whether more transparency will injure competition and reduce innovation.

Even if we think there is some merit to the transparency versus privacy question, I defy anyone to produce an acceptable method to evaluate the relevant costs and benefits. Among other things, the cost benefit analysis would be a moving target, and dynamic analysis is very difficult to get right. Two years or so ago, when financial services firms were lauded for launching a new era of global financial prosperity, we would have done anything not to disturb the magic of secretive financial engineering. Now, in the wake of government bailouts and Madoff, privacy appears to be little more than a blind for fraud and rapacious behavior.

The greatest weakness of the report is that it generally proposes tune-ups of existing regulation, rather than regulatory reformation. So, it proposes that managers of hedge funds that are highly leveraged should be required to register and provide regulatory reports and public disclosures regarding the size, investment style, borrowing and performance of funds under management. The report would not require all managers of hedge funds or any private equity funds to register. At most, this proposal would require a modest amendment to the Investment Advisers Act. Similarly tame, the report would impose capital requirements on funds that are judged to be "systemically significant." Categorizing these funds as broker-dealers should do the job, again a relatively small adjustment to existing legislation.

The distinction between hedge funds and private equity funds is not crystal clear. We have seen a lot of crossover activity in recent years. And how is a regulator to know whether a manager is "highly leveraged" unless all managers are registering with it? How will the regulators determine when a private fund has become "systemically significant," unless all funds are required to make reports under a consistent system of regulation. Does it make sense to leave all of this in the hands of two separate regulators, particularly if the issue is one of systemic significance? If we are going to have the systemically important funds provide reports to one regulator, the reports should go to the same regulator that supervises banks. But, that would involve a sea change to existing law, rather than the modest adjustments advocated by the Group of Thirty.

Current regulations have failed because they create separate categories for businesses that perform the same functions, some of which are not regulated or lightly regulated while others are highly regulated. This sort of bucket regulation incentivizes evasion and makes it difficult for regulators to determine which institutions are dangerous to the system or to evaluate the collective impact of widespread investment practices. We need to regulate functions, not entities. If someone manages other people's money, they should report their activities to a single regulator, whether they are called a bank, an insurance company, a broker-dealer or an investment manager, regardless of the size of operations.

At the end of the day, the proposals of the Group of Thirty argue in favor of the status quo. This is hardly surprising. The Group of Thirty is composed largely of people who spent their careers at financial institutions that profited from the existing regulatory structure. The lawyers advising the Group made fortunes designing the exotic securities products at the root of the current crisis. It is natural for them to hope things will gradually change until they stay about the way they are.

As it happens, events have already rendered the report antique. We are at the point of seriously considering nationalization of banks. The taxpayer is increasingly becoming a shareholder in commercial enterprises. Nothing like this

is discussed in the Group of Thirty's report, probably because it is unprecedented and our system of law and regulation doesn't contemplate it.

The recent governmental interventions into the private sphere may be imperative. The alternatives are depressing. Nonetheless, the fact is that our current lurch toward nationalization of commerce is changing the fundamentals of our markets and altering the way business is done. Getting it back on a private track at this point would mean further restructuring with all of the nasty consequences of more business failures at an otherwise difficult time. I don't see it happening any time soon.

For this reason, I suspect the system of financial regulation that will emerge when the Panic of 2008 has run its course will look much different than the modest proposals of the Group of Thirty.

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