

The rules establishing the regulatory oversight for the U.S. financial system were put in place after the market crash of 1929 and were designed to protect investors and the financial system. Yet, over the past two decades, the growth in the complexity of securities, financial transactions and financial firms has far outpaced both domestic regulatory and supervisory capabilities. After the repeal of the Glass-Steagall Act in 1999, banks were allowed to place more of their capital at risk in the hopes of earning higher returns. The result was the polluting of the capital markets with toxic assets and oversized leverage that ultimately curtailed the flow of credit and put the entire financial system at risk of collapse in 2008.

Now, the most extensive rewrite of those regulations has passed through Congress's reconciliation process. The compromise Bill is set for a vote this week and is expected to be signed into law before July 4<sup>th</sup>. Our analysis of the Bill and initial conclusions are discussed in this article.

## What Changes did the Financial Reform Bill Address?

The Bill was intended to address the causes of the Financial Crisis of 2008 and the subsequent bailouts of financial institutions that followed. To that end, the Bill includes several provisions designed to reduce the risk of a future financial catastrophe.

### Regulatory Oversight

The Bill reestablishes the Federal Reserve as the primary regulator for community banks but expands their oversight to many complex financial companies. At the same time, the legislation eliminates the Office of Thrift Supervision. The Bill establishes a specific entity, a council consisting of 10 members, to oversee systemic risk in the capital markets and financial system. The Bill attempts to provide a more direct path to liquidating troubled financial firms by providing the authority to regulators to seize and break up troubled financial firms and specifically setting up a process for liquidating troubled banks under the FDIC. In a rebuke to the TARP and other emergency programs implemented in 2008 and hastily put in front of Congress, the Bill limits the Fed's emergency lending authority and mandates a one-time audit of the Fed's emergency lending programs.

### Banks and other Financial Firms

One of the most controversial aspects of the legislation concerned limiting the reach of banks in other "non-bank" activities including the ability for banks to trade with their own capital, invest in hedge funds and trade derivatives. This initiative became known as the "Volker Rule" which was named after retired Fed Chairman Paul Volker who recently chaired the Group of 30 authored the recommendations designed to constrain the activities of banks. As a result, the legislation bars the largest banks from trading their own capital and limits their investments in hedge funds and private equity to 3% or less of a bank's capital.

Further, the Bill requires banks to spin off their derivatives operations into a separately capitalized subsidiary of the bank holding company and imposes specific capital, margin and reporting requirements on the new company. However, the Bill carves out the ability for a bank to retain certain derivatives operations within the bank for interest rate swaps, foreign exchange swaps and certain commodities trading.

The legislation creates an office within the Treasury Department called the Federal Insurance Office specifically to monitor the insurance industry which, up until now, has had no federal oversight. The FIO will have no regulatory authority, but it will have the power to monitor all activities related to the business of insurance (except for health and long term care). In addition, hedge funds and private equity funds will now be required to register with the Securities and Exchange Commission and disclose information on trades.

### The Rating Agencies

The legislation gives the SEC specific oversight authorities to penalize a rating agency (which is classified as a Nationally Recognized Statistical Rating Organization – NRSRO) for poor ratings and the powers to deregister an NRSRO for giving too many bad ratings over time. In addition, the legislation allows for an NRSRO to lawsuits for negligence, effectively removing them from their First Amendment defense which they've been hiding behind.

### Investment Advice by Broker-Dealers

We have written extensively about the problems of having two different *standards of care* with the investment industry. The typical individual investor and endowment/foundation board does not understand that the broker-dealer standard of care of *suitability* is lower than the registered investment advisor's *fiduciary* standard of care. The Bill provides the authority to the SEC to raise the standard of care for broker-dealers providing investment advice. The legislation delegates the authority to the SEC to hold broker-dealers to the fiduciary standard of care.

### Consumer Protection Agency

The Bill establishes a consumer protection agency called the Consumer Financial Protection Bureau within the Federal Reserve which will help review financial products and establish rules and enforce regulations over banks and other financial firms. This initiative was a result of many poorly structured mortgage loan products that banks and credit unions pushed on consumers from 2002 to 2007. As a result, the CFPB has the authority to examine and enforce regulations for all mortgage related businesses with assets over \$10 billion, as well as payday lenders, check cashers and other non-bank financial firms.

### Mortgage Lending

The legislation requires the mortgage lender to ensure that the borrower has the capacity to repay a home loan by verifying their income, credit history and job status. In other words, Congress has just told the mortgage companies how to do their job. The Bill also prohibits payments to brokers for steering borrowers to high priced loans (which the newly formed CFPB is supposed to oversee).

## Does the Financial Reform Bill Address the Problems in our Financial System?

The answer is both yes and no. The Bill expands the regulatory powers of the Federal Reserve and other agencies to fill in the gaps that grew wider over the past several years. It addresses important issues of identifying systemic risk in the financial system and winding down firms that fail. Further, it attempts to address other weaknesses in the capital markets such as securitizations, better oversight of the credit rating agencies, and limiting the activities of the banks. However, we believe that the Regulatory Reform Bill is a step in the right direction; however, we expect two major themes will rise to the top.

First, there will be confusion over the definition of terms and what agency has jurisdiction over specific companies and products. For example, terms like "derivative" and what is considered "proprietary trading" will need to be defined with better clarity. In addition, we will move into an environment where more regulation will be the norm and responding to the mountain of requests of different regulators will be the fodder of Op-Ed articles in the New York Times and Wall Street Journal and everything that was wrong with the Financial Regulatory Reform Bill.

Second, there is a difference between regulation and oversight. Much of the breakdown in the financial system was the result of inadequate oversight by the regulators. This will require hiring quality people, training them well and providing them with the resources to maintain a high skill level in order to evaluate the next toxic product or trade that a Wall Street firm pushes into the market.

Unfortunately, the legislation ignores several important problems that still exist but remain unaddressed. These include the instability of Fannie Mae and Freddie Mac which were nationalized in 2008 in order to keep the home mortgage business going. Also, while the Bill provides for some new wind down processes and oversight for financial institutions, it doesn't specifically address the issue of "too big to fail." The 10 largest banks represent over \$10 trillion in assets which is over 70% of our current GDP. If one of these banks were to have even the perception of failing, it would create a domino effect that would again impale our financial system and freeze our credit markets. Short of reinstating the Glass-Steagall Act, this is the best we have right now.

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