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Statement of the Shadow Financial Regulatory Committee

Beyond Dodd-Frank

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The Dodd-Frank Act created a heavy workload for financial regulators. Regulatory agencies are now researching and drafting over one hundred reports mandated under the Act, and writing the specific language to implement the regulatory details of a long agenda of mandated financial reforms. As the new Congress considers those reports and the various possibilities for improving regulation, there will be many opportunities for fine tuning. We provide a brief list of some of the issues worth addressing first.

Housing reform: Focus on limiting leverage

Fannie Mae and Freddie Mac are in conservatorship, and the losses on subprime mortgages held by Fannie, Freddie, and FHA already have reached hundreds of billions of dollars. The key flaw in the US mortgage market, which permitted so many other mistakes to occur, was the subsidization of high leverage by the government. Government-induced increases in mortgage leverage were a key factor in promoting the housing bubble, and turning the subsequent housing price decline into a financial crisis. For example, no-docs subprime lending would not have happened if homeowners had been required to put a minimum 20 percent stake into their homes, as was generally required in the 1980s, and still is in many other countries. And the price declines would not have created financial system collapse if homeowners had borne the first 20 percent of those declines. An obvious answer is to mandate a phased-in increase in minimum down-payment requirements for mortgages. Gradually increasing the minimum down-payment on a mortgage by 2 percent a year (beginning at 3% today, and rising to 20% in about eight years) would restore sanity to the mortgage market and prevent a repeat of the housing disaster, without disrupting the market. To the extent that the government wishes to subsidize low-income homeownership, it should do so transparently, on-budget, and in a manner that does not promote financial system instability. Winding down Fannie and Freddie, and replacing FHA's high-leverage loans with a homeownership program that subsidizes down-payments for low-income families on a matching basis would be one alternative worth considering.

Consumer protection and due process

The new Consumer Financial Protection Bureau (CFPB) created by Dodd-Frank is taking shape, but under a highly politicized and inappropriate form of direct White House control. The CFPB has a broad mandate, budgetary independence, and no clear guidelines for deciding how to weigh the advantages and disadvantages of imposing limitations on the menu of financial products available to consumers. New consumer protections may make sense in many cases, but they should be considered under appropriate due process by properly constituted regulatory agencies, and implemented transparently and as a matter of explicit law and regulation, not on a discretionary and hidden basis. Furthermore, before regulatory policies discourage or prohibit products or practices from the marketplace, there should be an open debate in which the merits and problems of the product can be aired and considered in the light of day. We encourage the new Congress to conduct wide-ranging hearings and set guidelines for the process under which new consumer protection regulations are being formulated.

NRSROs: Quantification of ratings and consequences for errors

The Dodd-Frank Act enjoins regulators to discontinue the regulatory use of ratings by Nationally Recognized Statistical Rating Organizations (NRSROs). The Committee believes there is much merit to the view that the regulatory use of ratings encouraged ratings inflation, and there is substantial evidence that structured debt ratings have been unreliable indicators of risk. Nevertheless, there are legitimate arguments for retaining the regulatory use of ratings for a limited period of time, while more reliable methods of measuring financial risks are developed. In the meantime, it may be desirable to reform, rather than prohibit the regulatory use of ratings. One approach would be to require ratings to have objective meaning in terms of the probability of default, and hold rating agencies accountable for egregious understatement of that probability, for example, by suspending their NRSRO status for a period of time after observing such egregious understatements.

Derivatives clearing

The focus of Dodd-Frank Act upon exchange-based clearing of derivatives reflects the important role of derivatives obligations in the financial crisis. Among the important goals of policy with respect to the handling of derivatives clearing and trading are to ensure the adequacy of collateral to make sure that the central clearing counterparty is bullet-proof, to create limits to the generation of systemic risk and to enhance price transparency, while not retarding innovation in the markets. However, the prospective implementation of these goals leaves many observers wondering whether there is "less than meets the eye." At least some of the goals reflect the derivatives fiasco at AIG, but many of the exotic instruments that it issued would not be likely candidates for clearing on an exchange. Furthermore, the degree to which changes in clearing practices are achievable by the statutory implementation deadline of September 15, 2011 is very much an open question due to a number of rational concerns. A new market structure must be built and designed along with a newly developed legal and regulatory framework. For example, with respect to the new reporting requirements, the highly specialized nature of derivatives trading is likely to necessitate the introduction of significant reporting delays for large positions. Indeed, the tight statutory deadline creates the potential for a foreseeable train wreck on September 15th, disrupting derivatives markets.

An important complication confronting the central clearing counterparty that was not contemplated by the Dodd-Frank Act will be the potential difficulty in setting suitable margin requirements for credit-default swaps. The payoff pattern on credit-default swaps reflects significant downward jumps due to the nature of default insurance. Because of the substantial correlations in default among the underlying corporate bonds, it is difficult to set margins or collateral requirements to protect the insurer and the clearinghouse based solely upon an actuarially determined expected number of defaults. That difficulty is not confined to markets with a central counterparty and would also arise for collateral setting in over-the-counter derivatives trading. Indeed, while the inadequacy in the provision of collateral by AIG is widely recognized, at least in small part this reflected the conceptual issue described above.

It would be desirable for Congress to anticipate the above problems and explicitly permit reasonable delays in implementing reforms to forestall market disruptions.

<u>Whistleblowers, then and now</u>

The Sarbanes Oxley Act of 2002 (SOX), adopted after the Enron and World Com accounting scandals, sought to strengthen internal controls over corporate financial records and reporting. As part of that effort, SOX encouraged corporate employees, as well as counsel and auditors, to inform company audit committees and legal and compliance officers of suspected fraud and other wrongdoing. Companies were to establish confidential hotline numbers to protect sources, and retaliation against whistleblowers was prohibited.

The Dodd-Frank Act undercuts that effort by creating incentives for employees to ignore company internal governance and self-correction, and instead go directly and immediately to the SEC or CFTC. Dodd-Frank creates bounties – 10% to 30% of sanctions that are greater than $1 million – for the first person to report independent knowledge of a potential securities low violation to the Commission. The remedies for retaliation are also enlarged (e.g., two times back pay and a much longer statute of limitations), but only for those reporting to the SEC, not those reporting internally.

The SEC in its rule proposal (75 Fed. Reg. 70,488 – 3 November, 2010) requested comments on whether a whistleblower should be required to make reasonable use of internal compliance procedures. The Committee believes that the answer should be in the affirmative.