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Change we can believe in?

American financial regulation after the crisis

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Dissatisfied citizens in the United States started a movement called "Occupy Wall Street" on Sep 17, 2011 to express their growing concern over the role of the financial sector in the global economic downturn. Protests began with an encampment in the financial district of New York City, but soon spread to other American cities. President Barack Obama said demonstrations reflected the broad-based frustration of Americans about how the financial system works. Indeed, the financial sector seems to be returning to the same abusive practices that led to the most severe economic recession since the Great Depression.

When Obama became president, he had an ambitious plan to overhaul regulation of the whole U.S. financial system in order to prevent future crises resulting from loopholes in the regulatory framework. His aspirations were translated into the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed on July 21, 2010 after long months of political wrangling. Obama and numerous experts have characterized the bill as an historic achievement. But if we examine the Dodd-Frank Act that was finally signed by the president, we notice that the original aims of a sweeping, deep reform were significantly modified.

The five key points of the legislation are as follows:

∗ A too-big-to-fail (TBTF) circuit breaker

The state spent a large amount of taxpayers' money on saving and recapitalizing systemically important financial institutions that were too big to fail (TBTF). If they had in fact failed, they could have endangered the operation of the whole financial system. But state intervention resulted in growing government debts. The Dodd-Frank Act suggests some basic amendments in TBTF regulation, but the original TBTF proposal would have changed the financial industry's basic model and would have prevented financial institutions from becoming too complex.

The final version of the bill only contains a prescription about a council of regulators with the right to monitor the operation of TBTFs, and a plan that banks will have to put aside enough capital to use if they go bankrupt (thus avoiding further taxpayer-financed bailouts). Since the Dodd-Frank Act does not limit the size of financial institutions and thus does not solve the original problem, the treatment is symptomatic.

∗ The "Volcker Rule"

The crisis made people realize that several financial institutions were using clients' money to indulge in risky investments on the bank's behalf. The Volcker rule, bearing the name of former United States Federal Reserve Chairman Paul Volcker, originally proposed to prohibit banks, or institutions that own banks, from engaging in proprietary trading that is not behalf of its clients and from owning or investing in a hedge fund or private equity fund, as well as limiting the liabilities the largest banks can hold. In the final version of the Dodd-Frank Act, banks are allowed to own or invest up to 3 percent of their capital in a hedge or private equity fund.

Although three percent is a negligible amount, the reader should recall that the first efforts to loosen the previous Glass-Steagall restrictions started in the same way. The Glass-Steagall Act was introduced after the Great Crash of 1929 in order to separate investment and commercial banking, thus limiting the conflicts of interest created when commercial banks are permitted to engage in brokerage activities. From the 1960's, a whole lobbying subculture emerged around Glass-Steagall and, by 1986, lobbyists had achieved considerable results: commercial banks were allowed gross revenues of up to 5 percent from investment banking activities. In 1989, the limit was raised to 10 percent and then in 1996 to 25 percent, effectively rendering the Act obsolete.

Considering that, according to a 2010 report, the six largest U.S. banks spent 200 million dollars in 2009 to block bank reform measures in Congress, history may well repeat itself and the Volcker 3 percent threshold Rule will soon be increased.

∗ Transparency reforms

The regulation of over the counter swap markets includes regulating credit default swaps as well as credit derivatives that were the subject of several bank failures at the beginning of the crisis. Bringing light to the $600 trillion derivatives market might truly regulate a corner of the securities market that has long functioned

in the shadows. The bill requires standardized derivatives contracts to be traded on an open exchange, with prices and volumes reported publicly. The contracts must also be cleared through a third party, an intermediary, who guarantees that if one party defaults, the investor holding the other side of the trade will still be paid. The bill also requires securities firms to maintain certain minimal levels of capital and banks to segregate derivative operations from their commercial banking business.

But the original tough derivatives propositions that would have forced banks to spin off all swap trading operations have been watered down so that banks are allowed to engage in swap trades like interest-rate swaps, foreign exchange swaps and gold and silver swaps. They only have to spin off their riskiest swaps, such as those for agriculture, metals, and energy. So the regulation leaves around 80 percent of the swap trade business with the banks. Apart from increased transparency, the Dodd-Frank Act leaves the derivatives industry largely unchanged.

∗ **Consumer protection**

The crisis was in large part due to ignorance on the part of consumers. They trusted financial institutions and brokers excessively and often signed contracts without being aware of hidden fees or additional risks. Different actors on the financial market took advantage of consumer trust and placed their own interest ahead of that of the clients.

The Dodd-Frank financial regulatory reform established the Bureau of Consumer Financial Protection to financially educate consumers and to promote financial literacy. Before the crisis, the Federal Reserve was responsible for both consumer protection and the safety of national financial institutions, often putting the emphasis on the latter. The new agency has the right to regulate credit counselling, payday loans, mortgages, credit cards and other bank products. The Bureau would in theory shield consumers from abuses involving mortgages, credit cards, lending and other financial services.

The Bureau itself is a good proposal that could prevent abuses resulting from consumer financial illiteracy. But its successful operation is still pending since it has become the focal point of continued Republican opposition to the financial overhaul law and Republicans are trying to obstruct and slow down its operation.

∗ **”Say-on-pay”**

Before the crisis, several financial institution managers received huge bonuses for short-term results and were not held responsible in case of bankruptcy (typically landing with golden parachutes). To end this vicious circle of excessive compensation that led to risky investments, Obama’s original proposal aimed at limiting huge compensation packages. However, in the final version of Dodd-Frank, nothing but a “say-on-pay” passage was finally included.

Say-on-pay means that, in their annual proxy statement, public companies are required to provide for a non-binding shareholder vote approving executive compensation. The non-binding shareholder vote on this proposal does not overwrite board decisions, but does determine the frequency of the “say-on-pay” proposal (i.e., every year, every two years, or every three years). In addition to the say-on-pay proposal, whenever shareholders are asked to approve an acquisition, merger, consolidation or sale at a meeting, the company or the person soliciting proxies must disclose any agreements or understandings concerning compensation payable to the named executive officers as a result of such transaction, and shareholders are granted a separate non-binding vote to approve such payments. The results of this vote do not override board action. Since all these amendments bring about a voting system with non-binding results, it will certainly not be enough to stop excessive compensation of top managers.

All-in-all, the Dodd-Frank reform is not an adequate reply to the questions posed by the financial crisis. It does not treat the root causes of the problems that caused the crisis. Dodd-Frank does not address adequately the problem of breaking TBTF institutions up into smaller entities. And although they did play a big role in driving Wall Street towards hazardous short-term investments, compensation packages have not been radically changed either. The law also fails to put an end to banks getting involved in dubious investments using their clients’ money. Nor does it reduce securitization and high leverages that set the world on the course to financial meltdown.

Even minor modifications to the current financial system are very hard to implement. More than a year after passing the bill, only 38 of the some 400 new rules have been finalized, reflecting considerable efforts by banking industry allies to prevent regulators from realizing their original aims and achieving the spirit of the legislation.

Since the core problems that led to the global financial crisis have not or have only partially been solved by the 2010 financial overhaul legislation, it is more than probable that American financial markets will have to face new, more severe crises. Movements such as ”Occupy Wall Street” underline growing consumer concern and the need for change in which both the markets and the average American can believe.

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