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ECONOMIC TALKING POINTS

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FINREG: The Re-Shaping of Financial Institutions…In a Credit Starved Economy

There is a noticeable irony in the completion of the financial regulatory bill overnight.

The legislation takes concrete steps to rein in excessive risk taking by Wall Street firms. It seeks to restrain major financial institutions from over leveraging and works to protect taxpayers so they are never again forced to be in a position to bail out banks from their folly. The disturbing irony is that these days banks are shunning risks altogether. The pendulum of risk taking by lenders has swung to the side of excessive caution.

By dramatically cutting back loans to consumers and small business, financial institutions have hampered the ability of the economy to fully bounce back from the most severe recession since the Great Depression. This morning the government reported the economy grew at a far slower pace in the first three months of 2010 than first thought. GDP expanded just 2.7% in the first quarter, less than half the pace of the fourth, and the lack of credit availability from banks was a factor behind this weakness.

Therein lies a policy dilemma:

There can be no normal recovery unless the banks are willing to help finance it --- and

that will not come until lenders understand how the changing regulatory regime will affect them. At the same time, comprehensive reform of the financial regulatory system was necessary given the increasingly reckless behavior of banks and other institutions since the repeal of Glass Steagall two decades ago. Excessive speculation with risky derivative securities, the opaqueness and profound lack of understanding how to value such instruments, the dismal failure of regulatory oversight, the absence of any clearinghouse that would make such securities more transparent, the arrogance by many financial institutions that they were too big too fail, plus outright fraud and misrepresentation --- all together ended up causing the greatest financial meltdown in the nation's history. So major reforms were absolutely crucial, and we got them.

• Under the bill, bank proprietary trading has been limited. For example, banks can continue to invest in hedge funds and private equity firms, but no more than 3% of their Tier 1 capital. (By the way, that was softened from an earlier version that sought to limit such investments to 3% of tangible common equity, the highest quality of bank capital).

• Most over the counter derivative trades will be conducted via clearinghouses, that is through regulated exchanges or on open electronic systems. This will help investors better track and price such securities.

• A new consumer protection bureau will be established and reside within the Federal Reserve to protect consumers from abuses by credit card issuers and mortgage lenders. (The consumer protection proposals also got watered down. Auto dealers, which provide loans and leases to car buyers, were able to get an exemption from the additional scrutiny.)

• The bill also creates a Financial Stability Oversight Council that will closely monitor large financial firms for early warning signs of an emerging systemic risk.

• Some bank holding companies will also be forced to raise additional capital under the bill.

• The Federal Reserve will now be subject to an audit of its emergency loans and eventually have to make public those firms that have received such special assistance.

There are hundreds of other provisions in this 2,000-page bill and it will take weeks to go through them all.

The overriding question, of course, is will it work? The goals are to strengthen the banks, reduce risks to the financial markets and improve the confidence of investors who purchase securities sold by lenders, brokers and insurers. Yes, the reforms will work to clamp down some excessive risk-taking. But if history is any guide, Wall Street will over time find new ways to maximize profits by seeking out loopholes and finding ways to cleverly circumvent some of the new rules. After all, what followed the repeal of Glass Steagall was an ongoing cat and mouse game among financial firms, regulators and legislators. It may sound cynical but we suspect that game will start anew.

Still, we have to return to the more immediate threat to the economy which is that

banks are still too risk aversive by keeping their lending windows shut. While historic regulatory reform was necessary, the timing may be less than ideal. US bank executives, already unnerved by what's going on in Europe, will now have to examine the immediate and longer term implications of this sweeping overhaul of the financial industry. Yet the urgent question for now is how do we get these institutions to finally loosen up and provide fresh credit to a credit starved economy.

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