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A change of pace on Wall Street

Tough times call for tough measures and the United States Congress has finally passed a financial reform bill which will have far-reaching effects on the way financial institutions in the United States operate. Some believe it is too severe while others believe it is not severe enough but regardless of the arguments of its opponents or the applause from its supporters, everyone agrees that something had to be done.

The bill has its genesis in the financial crisis of 2008. The crisis, for those of us who might not have noticed, resulted in the collapse of the U.S. banking system. It all began when firms on Wall Street began creating and trading increasingly complicated securities which, while very profitable, were very risky. The securities in question were based on risky loans (like home mortgages and credit cards), commonly referred to as “sub-prime loans”. When borrowers began to default on these loans, the system began to unwind. Financial institutions were unsure which asset-backed securities were tainted by the bad “sub-prime loans” and which were not. As a result banks were hesitant to lend money to anyone as they did not know what quality of collateral they would receive in return. With no lending, the credit supply dried up and with no credit the United States banking system ground to a halt.

Fast forward to the present and regulators are adamant that this must never be allowed to happen again. Enter the new U.S. financial reform bill and at just under 2,300 pages the bill is not the sort of thing you would want to read over breakfast. However it will result in some serious changes to the U.S. banking system and anyone with an interest in finance should have a look. In a nutshell, the bill proposes a series of measures to restore stability to the banking sector and reinforce the regulatory bodies that oversee it.

The biggest change will be the limitations placed on proprietary trading. Proprietary trading includes a wide range of financial activities through which a firm uses its own money to generate a profit for itself. Because of the temptation to go after bigger risks in pursuit of bigger profits (it was standard practice that portfolio managers were compensated in accordance to how much money their portfolios made) proprietary trading could place the entire firm in danger when these trading strategies resulted in losses. The bill proposes that a bank be limited to providing no more than 3% of a private-equity or hedge fund’s capital with the additional stipulation that banks do not invest more than 3% of their Tier 1 capital in these funds.

The second biggest change relates to a firm’s derivative trading operations. A derivative is a security in which a particular payoff is linked to a secondary event which can be almost anything - grain prices, stock prices or ice cream prices. Firms profit from this by gambling on an outcome. Needless to say this is a high risk activity. However the original intention of derivative trading was in fact to protect against risk. For example, a firm (Firm 1) could enter into an agreement with another firm (Firm 2) to hedge its ice-cream sales against a drop in average temperature (assuming a lower temperature is bad for ice cream sales). If the average temperature was lower in 1 year, Firm 2 would have to pay a sum of money to Firm 1. If average temperatures were higher on the other hand, Firm 1 would pay Firm 2 (but with higher temperatures Firm 1 would sell more ice cream and recover the loss). It is this sort of derivative trading that the bill allows for as it encourages survivability and includes interest rate and foreign exchange rate swaps among others. Derivative trading solely for profit making however has to be transferred to a subsidiary of the company where, if derivative trades went bad, it would not jeopardize the entire firm and ultimately would not require bailouts at the expense of taxpayers. And if a firm knows it is no longer likely to be bailed out, chances it will engage in risky trades. Additionally some types of derivative trades will have to be conducted on third-party clearinghouses and onto regulated exchanges or similar electronic systems which, although more expensive, will make it easier for the market and regulators to track the trades.

And just who are these regulators? The bill proposes the formation of a new committee as well as the reinforcement and streamlining of existing regulators. Chief among them is the new Financial Stability Oversight Council (FSOC) which will have the resources to adequately monitor financial institutions and mechanisms in order to identify and respond to emerging systemic risks which, thanks to the interconnectivity of modern finance, threaten the entire system. The FSOC will also monitor firms as they grow and will make recommendations concerning capital, leverage, liquidity, risk management and other requirements to the Federal Reserve. As a last resort, regulators will even be able to have worrisome non-bank financial firms submit to Federal Reserve supervision or have a large firm divest some of its holding if it poses a significant threat to the rest of the banking system.

As mentioned before, firms are limited to the extent in which they can invest in hedge funds. The bill goes further by mandating hedge funds that manages over $100 million in assets will now be required to register as investment advisers with the Securities and Exchange Commission (SEC) and disclose all relevant financial information. The SEC itself will be given the financial and technical resources to better protect investors in securities.

The bill also seeks to address consumer protection with the creation of a centralized regulator, the Consumer Financial Protection Bureau (CFPB), which would be able to examine and enforce regulations for banks and credit unions with assets of over $10 billion as well as mortgage-related and large non-bank financial companies. The CFPB will write consumer protection rules for all entities offering consumer financial services or products including credit-cards, loans and debt collectors.

Not only will consumers be better protected but now the consumers (at least those with share holdings) will have the ability to vote on the nomination of directors and vote on issues regarding executive compensation. To further bridge the gap between big business and the everyday investors, financial institutions that offer risky products (like the mortgage-backed securities that led to the crisis) will now have to hold some of the risky securities themselves (as much as 5%). This ensures that the interests of both the company and consumer are brought in alignment

However, no matter how much investors are brought into the loop, they will never be able to keep on top of all the information coming out of Wall Street. Even the large banks would find it difficult to do so. Credit ratings agencies have traditionally done the research for them. These agencies provide unbiased analyses on the credit worthiness of institutions and the majority of financial institutions trust the information that they provide. During the financial crisis this trust was severely shaken as it became evident that the credit rating agencies had failed to inform investors about the true extent of the risk posed by the asset-backed securities. The failure resulted, among other reasons, from a lack of regulatory oversight and from conflicts of interest. Proposals to correct theses shortcomings include the creation of the Office of Credit Ratings Agencies which will oversee the regulation of credit agencies and promises to introduce new rules, procedures and penalties in the industry.

In the event a solvent firm finds itself in trouble, the Federal Deposit Insurance Corporation (FDIC) is able to provide a limited debt guarantee to prevent a run on the institution once the firm is insured (with the FDIC) and it meets a series of requirements. Finally if a firm does fail the bill requires companies to have a documented plan for the organized liquidation and of the company.

The bill went before the Senate on 15 July having already been passed in the House of Representatives and brought to an end an almost year long debate on the matter. It will now go before President Obama and once he signs, the bill will become law in the United States of America.

FINANCIAL & ECONOMIC INDICATORS

As at 15 July, 2010

Exchange Rate/US$	Closing Value	Previous Week
Yen	87.40	88.36
Euro	1.30	1.27
Jamaica	86.32	85.55
Guyana	203.9	204.20

Commodity Prices	Closing Value	Previous Week
Crude oil (US$/bbl)	76.62	75.44
Natural Gas (US$/mmbtu)	4.41	4.61
Gold (US$/Troy Ounce)	1,208.25	1,198.10

Eurobond Indices (As at 15-July-10)

JP Morgan EMBI+ (Basis points)	310
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	N/A

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0.25	0.25
Euro Zone	1.00	1.00
Japan	0.10	0.10
Brazil	10.16	10.16
Trinidad	5.00	5.00
Jamaica	9.00	9.00
Barbados	2.50	2.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.15	0.15
US 10-Yr Treasury	3.00	3.03
3-month UK Libor	0.73	0.73
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	10.90	10.90
TT 90-day T-Bill	1.00	1.00
Jamaica 90-day T-Bill	8.52	8.52
Barbados 90-day T-Bill	3.26	3.26

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com