Group of Thirty Issues Roadmap for Financial Reforms

On January 15, the Group of Thirty (G30) issued a report entitled *Financial Reform: A Framework for Financial Stability*. The report recommends a massive, globally coordinated restructuring of the legislative and regulatory system that governs the financial services industry. Viewed in the context of the momentum created by other recent proposals, it is clear that the G30 report presents a roadmap for pending legislative and regulatory reforms and will likely play a significant role in shaping the financial reform agenda in the United States and internationally.

The G30 Working Group on Financial Reform that issued the report is chaired by former Federal Reserve Chairman Paul Volcker, one of President Obama’s economic advisors and Chairman of the President’s Economic Recovery Advisory Board. Mr. Volcker has stated that he will make the recommendations to President Obama and that the report is “a reasonable indication of the direction in which we might go.” Although many of those with official responsibilities recused themselves from participating in the report, it is believed that there was general support among G30 members for the report’s recommendations. The private international group’s prominent membership includes Timothy Geithner, U.S. Treasury Secretary Nominee; Lawrence Summers, Chairman of the U.S. National Economic Council; Jean-Claude Trichet, President of the European Central Bank; Mervyn King, Governor of the Bank of England; and Zhou Xiaochuan, Governor of the People’s Bank of China.

The report provides recommendations that would significantly increase government oversight over most aspects of the financial services industry. Although the recommendations have a U.S. focus, they are aimed at all countries and call for international coordination. The report’s significant recommendations include:

Core Recommendation 1: Require that all systematically significant financial institutions be subject to prudential oversight. [Note, prudential regulation generally refers to collaborative problem solving with the regulated entity as opposed to strict enforcement of rigid rules].

- Bank supervision should be consolidated under one prudential regulator.
- Systematically important banks should be closely supervised, meet common international standards, and be prohibited from engaging in high-risk activities.
- Consolidated, national-level prudential regulators should be established to supervise different categories of non-bank financial institutions, such as investment banks, broker-dealers, and large internationally active insurance companies.
- Money market mutual funds offering bank-like services should be regulated as banks. Remaining money market mutual funds should offer only conservative investments.

- A national prudential regulator should be established to oversee managers of private pools of capital, including hedge funds and perhaps private equity funds. The regulator should have the authority to require registration, periodic reports and public disclosure and to establish appropriate capital, liquidity, and risk management standards for systematically significant funds. The regulatory framework should be applied on an internationally consistent basis.

- There should be clearer separation between government and private sector functions in the mortgage market, and the roles of and the degree of public support for Fannie Mae and Freddie Mac should be expressly defined.

Core Recommendation 2: Improve the effectiveness of prudential regulation by increasing international coordination and enhancing resources available to regulators and central banks.

- Regulatory structures should be modified to eliminate overlaps and gaps in coverage.

- The central bank should regulate financial stability and have a strong role in prudential regulation. Central bank emergency lending authority should be preserved, and eligibility for such credit should be expanded to include non-bank institutions. However, central bank liquidity support operations should not involve high-risk assets and would be more appropriately performed by directly accountable government entities.

- National regulators should enhance international coordination to (1) supervise international banks, (2) modify material national differences in standards, (3) raise standards related to offshore banking centers, and (4) develop processes for joint consideration of systemic risks.

Core Recommendation 3: Strengthen institutional policies and standards, with a particular focus on governance, risk management, capital, liquidity, credit and counterparty exposure, and leverage.

- Regulatory standards for governance and risk management should be raised. In particular, these standards should govern boards’ oversight of compensation and risk management policies.

- Capital requirements should be adjusted to limit their current tendency to be pro-cyclical.

- Liquidity standards should include norms for maintaining a diversified mix of long-term funding and liquid assets.

- Fair value accounting principles and standards should be modified to better reflect the business model and regulatory requirements of financial institutions. Accounting standards setters should coordinate fair value standards with prudential regulators, who should review these standards to ensure the safety and soundness of financial institutions.

Core Recommendation 4: Increase transparency and realign risks associated with financial markets and products.

- Markets for securitized products, structured products, and derivatives should be subject to regulatory regimes similar to those for public securities markets. Financial institutions should be required to retain a portion of the credit risk packaged into such products.

- Credit rating agencies should be reformed, preferably on an internationally coordinated basis, including modification of the issuer-pays system.

- Legislation should be enacted to establish a formal system of regulation over credit default swaps (CDS) and over-the-counter (OTC) markets. The regulatory framework should be internationally consistent.

- A process should be established to require early warnings, take corrective actions, and implement orderly closings of banks and systematically significant financial institutions.

- The disclosure and dissemination regime for asset-backed and other structured financial products should be enhanced.
The G30 report is not only important because of the ties of its primary author, Mr. Volcker, to the Obama Administration. The report is particularly significant when considered in the context of other recent efforts aimed at addressing the financial markets. Through these efforts, momentum has been building for consolidation, increased oversight, and international coordination of the legal and regulatory framework that governs the financial industry. The G30 report differs from many of the prior U.S.-based efforts, however, in its unabashedly pro-regulatory agenda, representing a shift in thinking by policymakers in Washington. Fundamentally, the G30 report translates these objectives into a clear roadmap, setting the stage for the most comprehensive review of financial services law and regulation since the New Deal.

Released in March 2008, the Department of Treasury Blueprint for a Modernized Financial Regulatory Structure is one significant reform proposal. Previous reports, such as the U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century Report and the Bloomberg/Schumer Sustaining New York’s and the US’ Global Financial Services Leadership Report, had recommended some level of modernization to address the overlaps and gaps in the current financial markets regulatory system. These efforts have been complemented by ongoing empirical research provided by the Committee on Capital Markets Regulation.

Building on these efforts and consistent with the recommendations in the G30 report, the Blueprint proposes the development of an objectives-based regulatory structure to increase oversight of the financial markets. The proposed structure consists of a market stability regulator to address overall financial stability, a prudential financial regulator to address limited market discipline caused by government guarantees, and a business conduct regulator to address standards for business practices and consumer protection. The Blueprint also recommends merging the CFTC and SEC, as well as creating an optional federal charter for insurance.

In November 2008, the Group of Twenty (G20) held its Summit on Financial Markets and the World Economy, adding international harmonization to the financial markets reform agenda. The Summit Declaration states, “Our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability.” G20 members committed to implementing policies to strengthen financial market transparency, including enhancing required disclosure on complex financial products; strengthen regulatory regimes, prudential oversight, and risk management; and reinforce international cooperation to formulate regulations in a consistent manner.

In January 2009, the Government Accountability Office (GAO) released a report, A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System. As denoted in the title, the report sets out a framework by which to evaluate reform proposals. Similar to the approach in the G30 report, the GAO report recommends that (1) regulatory reforms comprehensively address all activities that pose risks, (2) include mechanisms for identifying, monitoring, and managing risks to the financial system regardless of source, (3) eliminate overlapping federal regulatory missions, and (4) regulate similar institutions, products, and risks consistently.

U.S. reform efforts will further crystallize in the coming months. The House Financial Services Committee and the Senate Banking Committee are expected to adopt oversight plans as early as February. Legal and regulatory reform of the financial industry will undoubtedly be a centerpiece in each of the plans. High priorities will likely be developing regulatory regimes for hedge funds and private equity funds as well as for derivatives. The mortgage industry may also be a core focus, with a probable emphasis on mortgage modifications and GSE reform. In addition, both Committees are likely to have a strong focus on consumer and investor issues such as mortgage origination and securitization practices, credit card lending, shareholder rights, corporate governance, and executive compensation.
The G30 report also reflects the political and regulatory mood in the UK and Europe. Some parts of the report appear to address particular U.S. issues, but much of it highlights issues that are at the top of the agendas of European regulators such as the UK Financial Services Authority (FSA). Certain parts of the report appear to be suggesting a regulatory system not unlike that already established in the UK. For example, the UK already has a single prudential regulator for banks and insurance companies, the FSA, and all managers of private pools of capital (i.e. hedge funds, private equity funds) in the UK are required to be FSA authorized. In some areas, however, Europe is in the process of catching up with the United States. For example, while the United States already has a mandatory regulatory and registration regime for credit rating agencies, Europe is set to acquire one in 2009.

Much of the report, however, recommends an agenda that is relevant and timely in the UK and Europe. Many European politicians and regulators will warm to the theme of an international approach to systemic risk, and there is not likely to be any shortage of European political and regulatory support for proposals such as enhanced governance and prudential standards for financial institutions. In the UK, the FSA has already set about reforming capital and liquidity standards for financial institutions, and there is much more to come in this area. One report recommendation that stands out from a UK perspective is the suggestion that hedge funds established offshore should be subject to prudential regulation by the onshore regulator of the fund’s manager, coupled with increased disclosure of fund activities. If this is pursued, it can be expected to trigger an energetic response both from the hedge fund industry and the offshore jurisdictions concerned.

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