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White House's financial reform plan targets derivatives

By Agri-Pulse Staff

As released by the *Washington Post* Tuesday, more details are available on the Obama administration's plan for a comprehensive overhaul of the nation's financial regulatory system. An 85-page administration white paper specifying proposed changes is scheduled for release Wednesday and Treasury Secretary Timothy Geithner will testify in back-to-back Senate Banking Committee and House Financial Services Committee hearings on Thursday to answer questions about the reform proposals.

The details, background and justification for sweeping reforms covered in a draft of the 85-page white paper include:

- "The current financial crisis occurred after a long and remarkable period of growth and innovation in our financial markets. New financial instruments allowed credit risks to be spread widely, enabling investors to diversify their portfolios in new ways and enabling banks to shed exposures that had once stayed on their balance sheets.
- "Through securitization, mortgages and other loans could be aggregated with similar loans and sold in tranches to a large and diverse pool of new investors with different risk preferences.
- "Through credit derivatives, banks could transfer much of their credit exposure to third parties without selling the underlying loans. This distribution of risk was widely perceived to reduce systemic risk, to promote efficiency, and to contribute to a better allocation of resources.
- "However, instead of appropriately distributing risks, this process often concentrated risk in opaque and complex ways. Innovations occurred too rapidly for many financial institutions' risk management systems; for the market infrastructure, which consists of payment, clearing and settlement systems; and for the nation's financial supervisors.
- "Securitization, by breaking down the traditional relationship between borrowers and lenders, created conflicts of interest that market discipline failed to correct. Loan originators failed to require sufficient documentation of income and ability to pay. Securitizers failed to set high standards for the loans they were willing to buy, encouraging underwriting standards to decline. Investors were overly reliant on credit rating agencies. Credit ratings often failed to accurately describe the risk

of rated products. In each case, lack of transparency prevented market participants from understanding the full nature of the risks they were taking.

- "The build-up of risk in the over-the-counter (OTC) derivatives markets, which were thought to disperse risk to those most able to bear it, became a major source of contagion through the financial sector during the crisis.
- "We propose to bring the markets for all OTC derivatives and asset-backed securities into a coherent and coordinated regulatory framework that requires transparency and improves market discipline. Our proposal would impose record keeping and reporting requirements on all OCT derivatives. We also propose to strengthen the prudential regulation of all dealers in the OTC derivatives markets and to reduce systemic risk in these markets by requiring all standardized OTC derivative transactions to be executive in regulated and transparent venues and cleared through regulated central counterparties.
- "We propose to enhance the Federal Reserve's authority over market infrastructure to reduce the potential for contagion among financial firms and markets.
- "Finally, we propose to harmonize the statutory and regulatory regimes for futures and securities. While differences exist between securities and futures markets, many differences in regulation between the markets may no longer be justified. In particular, the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the CFTC and SEC.

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- "All OTC derivatives markets, including CDS markets, should be subject to comprehensive regulation that addresses relevant public policy objectives:
    1. preventing activities in those markets from posing risk to the financial system;
    2. promoting the efficiency and transparency of those markets;
    3. preventing market manipulation, fraud and other market abuses; and,
    4. ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

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- "We urge national authorities to promote the standardization and improved oversight of credit derivative and other OTC derivative markets, in particular through the use of central counterparties, along the lines of the C-20 commitment, and to advance these goals through international coordination and cooperation.

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- "We recommend that the CFTC and the SEC complete a report to Congress by September 30, 2009 that identifies all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explains why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or makes recommendations for changes to statutes and regulations that would eliminate the differences."

To read the White House's 85-page draft plan for financial industry reforms, to go:
http://media.washingtonpost.com/wp-srv/politics/pdf/nearfinaldraft_061709.pdf

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