US Project Meeting Note

CHATHAM HOUSE
The Royal Institute of International Affairs

Regulatory Reform in the United States

29 April 2015

On 29 April 2015, Chatham House's US Project hosted a breakfast discussion with **Paul Volcker**, former chairman of the Federal Reserve (1979–87), on **'Regulatory reform in the United States'**. This is part of an ongoing project, sponsored by Bank of America Merrill Lynch, which brings together senior representatives from multiple sectors to discuss US and European perspectives on common economic challenges.

The principal points from the discussion included:

• Over the past 70 years, the United States has repeatedly tried and failed to reform its system for regulating financial institutions. Since the end of the Second World War and the Hoover Commission, there have been 20–25 official efforts to address this issue, none of which have resulted in significant improvements. Consequently, the system for regulating financial institutions in the United States is fragmented, outdated and ineffective. Although redesign of the regulatory structure and alignment of regulatory agencies are required, the intricate involvement of lawyers in financial activities has made both of these objectives highly unlikely.

• In the 1980s, banks accounted for the majority of the financial system, with a small minority of other financial institutions existing outside that group. The regulatory system was structured accordingly. The dominant philosophy at the time was that if banks were regulated and protected, the rest of the market would regulate itself and that too much regulation would restrict market growth. However, today banks only represent a minority of the financial system; the majority of institutions exist outside banking in the so-called shadow banking sector.

• It is important that hedge, equity and venture capital funds are adequately controlled through banks and regulations. Under the current system, these institutions hold securities and use them as collateral for loans, which means they have significant amounts of leverage. As a result, they are taking on more risk, a trend aided by low interest rates. This market development may require an overall rule limiting leverage.

• Another challenge is how to regulate asset managers outside the banking sector. Attempting to regulate institutions in the present circumstances is very difficult. This challenge is compounded by the fact that regulators are never able to catch up with market developments – particularly in an age of rapid technological advances and a slow bureaucratic regulatory system.

• Around the world people want more stringent capital requirements and risk-based capital standards. If the US government heavily regulates banks, it will force more businesses to operate in the shadow banking sector.

• Banks in the US are expending huge amounts of effort to comply with federal money-laundering and counterterrorism regulations. This has little to do with financial regulatory functions, and undermines banks' competitiveness by deterring customers.

• One issue that has hindered regulatory structural reform is the lack of motivation for Congress to pursue reform. Although there is a political interest in reforming the regulatory structure, few US politicians are willing to act because such reform is not a priority for many voters. There is no major constituency to be accommodated or political capital to be gained by concentrating on reform for most members of Congress.

• In 2010, President Barack Obama signed into law the Dodd-Frank Act, which established the Financial Stability Oversight Council (FSOC). The FSOC included 15 pre-existing federal agencies and is chaired by the secretary of the Treasury. The idea was to create one coordinating agency that could provide surveillance of the financial system and potential regulatory oversight. The FSOC is conceptually reasonable but not functionally effective because its fragmented structure inhibits inter-agency cooperation.

• Before the 2008 financial crisis, countries in the developing world had US$6 trillion in debt. Today that figure is closer to US$9 trillion, and increasing. The fact that much of this debt has to be serviced in US dollars, the value of which has appreciated against emerging-market currencies, makes repayment costlier for borrowers in the developing world. The negative impact on highly indebted developing countries could reverberate throughout financial markets and the global economy.

• Many trade agreements are driven by the regulatory needs of US firms and their desire to liberalize foreign regulations, or to extend proprietary protections. There is a possibility of regulatory harmonization between the US and EU through trade agreements such as the Transatlantic Trade and Investment Partnership (TTIP).