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Ready or Not: Big Rule Changes Coming for Financial Industry

Within a year…a whole new way to police the nation's banks, brokers, insurers, mutual funds and anyone else trading in financial products.

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An overhaul of the U.S. financial regulatory system is coming. By early 2010, Congress will cobble together a package of structural changes and policy directives intended to reduce the threat of future financial meltdowns.

Elected politicians are determined to act, convinced that American voters demand change. They are rushing out proposals months before committees set up to study the crisis have reported back. "We ought to take some time and determine what went wrong before we legislate solutions," says William Isaac, chairman at LECG and former head of the Federal Deposit Insurance Corporation. "If you had all these reforms in place years ago, I'm not sure that this crisis would have been averted."

Financial industry officials are resigned to new rules of the road and are even supportive of some moves. They'll fight against some proposals they see as just too damaging, but recognize that the juggernaut can't be stopped. "Changes are certainly needed, but the pros and cons and unintended consequences must be carefully evaluated before dramatic changes affecting the entire structure of financial regulation are enacted," said Edward Yingling, head of the American Bankers' Association before a House panel on regulatory reform.

There's a chance that the changes will do more harm than good. "Legislation passed in haste in an emotional period is seldom the right legislation," says Isaac.

Paperwork requirements will grow. Costs of borrowing will rise as profit margins decline. Some customers are likely to find their access to credit is curbed as banks are compelled to be more cautious. Some talented executives may desert the U.S. for countries where government rules won't inhibit compensation. And innovation may be stifled, curbing not only risk, but the development of beneficial new services as well.

Much will depend not on legislation passed, but on the specific rules regulators come up with to implement it. Some analysts worry about that. "It's the same folks that will still be regulating the system," says Mark Calabria, director of financial regulation studies at the libertarian Cato Institute. "But they missed the boat the first time -- where is the argument that they will get it right the next time?"

The key components we expect to see:

- A consumer protection watchdog, charged both with preventing fraud and abuse in mortgages, credit cards and the like, and with ensuring that underserved communities have access to financial services. Banks particularly object to this last mission, fearing that regulators will push them into risky loans, undermining bank safety. But they'll have to live with the guardians. "I definitely think that a consumer protection agency would have an adverse impact on the development of new products," says Chris

Cole, senior regulatory counsel at the Independent Community Bankers' Association. "We see this agency as being full of examiners coming out to banks and making them offer certain products to certain people." But they'll have to live with the guardians.

- A mechanism for overseeing systemwide risk, the kinds of cascading failures that threatened when insurance giant AIG teetered in 2008. Despite lawmakers' worries about giving more authority to the Federal Reserve, which some say muffed the job of regulating bank holding companies last year, the central bank will take the lead. There's simply no other agency as well equipped to keep its thumb on the spectrum of public and private firms of not only banks but also insurers, hedge funds, private equity firms and others that pack a financial wallop. Still, it's a good bet that it won't be a solo act, but that the Fed will lead a council made up of several agencies. "No one had the responsibility to oversee whole range of activities before, but now a regulator will be able to look at everything the institution does in terms of credit risk," says Jean-Francois Tremblay, a vice president at Moody's. "We see it generally as making regulated financial institutions safer and that's beneficial to creditors."
- New rules creating a brighter regulatory floodlight. Derivatives will come under a regime of rules and standards. Target, Toyota and others operating nonbank banks, called industrial lending companies, will see stricter banking regulations. And agencies will require more disclosure about the financial deals and positions of all players, including big hedge funds. Plus banks will be forced to hold onto larger capital reserves for a stronger safety net. For their part, shareholders will help provide more built-in checks on risky deals getting a bigger voice on both compensation issues and on how much risk is OK.

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