AMERICAN BANKER®
THE FINANCIAL SERVICES DAILY

*Tuesday August 27, 2013*

BANKTHINK

# How Regulation Can Save Financial Innovation

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The financial crisis has obscured the role U.S. financial institutions have had in the development of the global economy. America's system of community banking is virtually unique and supportive of local communities, consumers and small businesses and farms. Regional and money center financial institutions each play important roles in larger stage financings, which produce jobs and opportunities. Our capital markets and other financial and near-financial firms – rating agencies, data companies and financial media – have been pioneers.

The cornerstone of this success has been innovation—and not only in finance, but in financial regulation. The most successful inventions are accompanied by inventive, pragmatic regulation. A common set of time zones, agreed upon by the major railroad companies, eased the way to interstate travel and commerce. A common set of production and testing standards in the Pure Food and Drug Act gave researchers a safe, trusted way to bring medical inventions to market.

Finance is no exception. The national banking system, deposit insurance, securities regulation and the financial holding company all emerged in response to particular market developments. They were often regarded as unfamiliar, unwelcome, even disruptive elements, but they ultimately restored confidence in the regulated activities and provided a strong foundation for the evolution of the regulated institutions. A critical element in policymakers' success is pragmatism, an effort to improve the underlying industries without ossifying them.

History tells us that we should expect this pattern to hold for Dodd-Frank and other post-crisis regulatory changes as well. Implemented properly, with pragmatism and balance, not excess, proposed regulatory changes will strengthen the marketplace and consolidate the financial innovation that took place prior to the crisis, allowing the private sector to prosper and grow.

Take, for example, rating agencies. Over the last century, they became a critical tool for institutional and retail investors, and a mechanism for institutions themselves to evaluate the credit they offered. The crisis revealed weaknesses in both ratings and ratings oversight. But much stronger rules from the Securities and Exchange Commission and structural changes in Dodd-Frank have set a higher bar for the rating institutions.

These regulatory changes are extensive and have been painful for the industry to adopt. But Congress and the SEC have constructed the changes to give both rating agencies and investors a brighter future.

For example, while ratings are no longer mandatory for many credit evaluations, they remain important tools in the credit evaluation process. Single issuer ratings have been a reliable source of credit information for many years, and with more rigorous processes and procedures at the rating agencies, the same can be true for ratings of more complex financial products. In sum, the reforms will lead to much greater confidence in the rating agencies, ratings governance, and ultimately, the ratings themselves. This will preserve an important source of credit information that supports the efficient allocation of credit across the economy and more open markets.

The resolution and recovery mechanism in Dodd-Frank is another case in point. Global financial institutions emerged during the 1980s and 1990s, when a wave of mergers and acquisitions swept through the banking sector. They offered convenience and efficiency for many global corporate customers, but the crisis left significant doubt about the risk of complex financial entities, consisting of dozens or even hundreds of legal entities. By mandating recovery plans, Dodd-Frank offered these firms an opportunity to review and more fully understand their own structure, making them safer, better-run and trusted to survive a crisis without government support.

A final example of thoughtful regulation has begun to emerge in the home mortgage area. There, efforts to craft new rules got off to a rocky start, and many potentially sound borrowers could have been frozen out of the home mortgage system. However, by listening to comments from the industry, experts and consumer advocates, regulators are moving towards a much better picture.

The final Basel III capital rulemaking eschewed a risk-weighting system for mortgages that, combined with ability-to-repay and risk-retention rules, might have unnecessarily clamped down on certain categories of affordable home loans. Regulators may do the same with the Qualified Mortgage and Qualified Residential Mortgage rules, where initial limitations could have had a disproportionately negative impact on minority borrowers. The willingness of regulators to modify initial drafts and craft tough but sensible rules benefits both financial institutions and their customers, and reflects well on the regulatory process.

We are a long way from finishing the post-crisis regulatory reforms. There are many rules to write and even more to interpret and enforce. History tells us that, in the end, these reforms should increase confidence but still allow regulated entities to innovate and prosper, all in support of a stronger economy. We are at an inflection point, and we must avoid doctrinaire, overly complex and rigid rulemakings that could set America back

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