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# Republicans' Financial Regulatory Reform Plan a Good Start

*David C. John*

House Republicans on the Financial Services Committee have released a comprehensive financial regulatory reform plan.[1] The plan has several key features that are unfortunately likely to be missing from the coming Obama plan.

The proposal focuses on preventing future bailouts, consolidating regulators, and gradually eliminating such entities as Fannie Mae and Freddie Mac. While details on the individual parts of the plan are lacking so far, its basic framework is sound and deserves careful consideration.

**Bankruptcy, Not Bailouts.** The plan substitutes a form of enhanced bankruptcy for the workout authority proposed by the Obama Administration for troubled non-bank financial institutions that could pose a systemic risk to the economy. While details will be especially important here, such a move would prevent most future bailouts, in part by discouraging companies from risky behavior. Such a proposal would be far less troublesome than giving a government agency the ability to take over a large financial institution and operating it.

Of course, it may well be that a receiver appointed by the bankruptcy court has to oversee the operations of some portions of a problem financial institution. But by operating under the supervision of a court with the eventual goal of liquidation, the impact on the rest of the industry is likely to be less than with a regulatory takeover.

Similarly, the proposal to create a council of regulators to monitor systemic risk is far superior to creating a new super-regulator. Systemic risk will be very difficult to accurately diagnose in advance and even more difficult to prevent.[2] At best, proposals to create either new regulators or a council with wider powers will result only in false hopes that cannot be met. At worst, they would create an all-powerful new regulator that could further destabilize the financial industry.

**Merging Financial Regulators.** Similarly, the Republicans' plan would consolidate certain existing bank regulators, something that the Obama Administration initially appeared to support but now seem to have backed off of.

The current system of many regulators reflects the financial industry of the 1930s, not today's reality. Merging the functions of the Office of Thrift Supervision and the Office of the Comptroller of the Currency—along with the supervisory functions of the Federal Deposit Insurance Corporation and the Federal Reserve, as proposed by the Republican plan—is a good start toward a more efficient and less burdensome financial regulatory structure.

However, the Republican plan does not go far enough. It should also merge the Commodities Futures Trading Commission (CFTC) into the Secu-

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(202) 546-4400 • heritage.org



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rities and Exchange Commission (SEC). While the CFTC was once focused on agricultural futures, today those products make up only about 15 percent of its regulatory activities. The main stumbling block is that the CFTC is under Congress's agriculture committees, while the SEC falls under the financial services committees. This is yet another obsolete arrangement that should be modernized.

**Eliminating Fannie Mae and Freddie Mac.** For decades before their takeover last year, the government-created Freddie Mac and Fannie Mae dominated and distorted the housing finance market. Ultimately, their business model distributed profits to shareholders while sharing losses with the taxpayers.

Now that they have been seized by regulators, it is time to gradually eliminate their ties to government, reduce their size, and eventually allow them to compete on an equal basis with private companies. The Republican plan recognizes this necessity and makes it a priority.

**Limits on the Federal Reserve's Emergency Authority.** The proposal would also require the Fed to get the advance approval of the Treasury secretary before taking any action under its emergency authority. It would also give Congress the chance to disapprove such action within 90 days. (Congressional disapproval would come after the emergency action; if they disapprove, the Fed would have to wind up the action within 90 days.) Both of these requirements are improvements over the current situation.

However, the Republican plan would also completely ban the Fed from any intervention on behalf of a specific financial institution. While any such intervention should be rare, there are cases—such as the failure of Long Term Capital Management in 1998—where it can reduce the possibility that a problem could infect the entire sector.

Requiring the advance approval of the Treasury secretary and giving Congress the opportunity to disapprove would reduce the chance of abuse of the Fed's emergency authority, but completely eliminating it for individual financial institutions would be unwise, and it would increase risk.

**Poorly Considered Consumer Provisions.** In an apparent response to Administration and certain legislators' plans to create a Financial Products Safety Commission, House Republicans propose to turn the Treasury's Financial Literacy and Education Commission into some sort of consumer protection agency.

This is very poorly considered and betrays a serious misunderstanding of both the existing role of the Financial Literacy and Education Commission and the need for such a consumer help entity in the first place.

First, neither the proposed safety commission nor the Republicans' proposed additional mission for the existing Treasury commission are needed. The financial regulators can much more effectively protect consumers than any new entity, especially if some of them are consolidated. There is no need for an additional agency to add yet another regulatory layer on top of that which already exists. The only result is likely to be a stifling of innovative products that could provide better value for consumers.

Second, Americans desperately need expanded access to financial literacy training now. Such information is critically needed to improve savings, retirement preparation, and other types of asset building. Diverting the existing commission into a completely different role—for which it is completely unprepared and lacks sufficient resources to meet—is both unwise and shortsighted. Both this part of the Republican plan and the proposed financial products safety commission should be reconsidered.

**Avoiding Just More Regulation without Reform.** The worst outcome to the coming debate on financial regulatory reform would be for Congress to just add more layers of regulation without

1. Financial Services Committee Republican Plan for Reforming the Financial Regulatory System, at *http://republicans.financialservices.house.gov/images/stories/fscrepregreformplan.pdf* (June 14, 2009).
2. David C. John, "Financial Systemic Risk Regulators: Congress Is Asking the Wrong Questions," Heritage Foundation *Webmemo* No. 2472, June 8, 2009, at *http://www.heritage.org/Research/Regulation/wm2471.cfm.*



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making any major changes in the regulatory structure or addressing any of the other serious questions that have arisen from the last 18 months.

These include creation of a financial products safety commission (which would just duplicate the role of existing regulators) and further attempts to micro-manage financial services firms. But despite its limitations, the House Republican plan contains a number of key provisions that Congress should carefully consider in the coming weeks.

*—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*