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The Obama Financial Regulatory Reform Plan: Poor Policy and Missed Opportunities

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The recent financial regulatory reform plan issued by the Treasury Department[1] is a detailed mixture of overreaching policy mistakes, missed chances for real reform, blanks that will be filled in later after studies, and a few good ideas.

One key concern is the almost unlimited power given to several agencies in order to pursue goals that are fuzzy at best. Some proposals, such as making the Federal Reserve the systemic risk regulator and creating a Consumer Financial Protection Agency, should be rejected immediately. Others, such as merging the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) should be expanded to create a financial regulatory system that better mirrors today's realities instead of those of 70 years ago.

As with many recent Treasury proposals, this is a white paper rather than a legislative proposal, and it shows signs of being released before it was really completed. The overall proposal has serious weaknesses, and Congress should not be rushed into passing anything without serious and complete consideration. Certain parts can be salvaged, but much of the Treasury plan should be discarded.

The Federal Reserve as Systemic Risk Regulator. One key error in the Treasury paper is that it creates a new and extremely powerful systemic risk regulator that is charged with reducing risks to the entire financial system before they reach a critical stage. It assigns that role to the Federal Reserve. The new responsibilities would be in addition to the Fed's current responsibilities.

Charging a single entity with reducing systemic risk is likely to raise false expectations. It is very doubtful that any systemic regulator will be able to successfully fill this role unless it has almost unlimited powers,[2] and the Treasury proposal reinforces this concern.

For instance, the proposal allows any regulatory body to recommend to the Fed that a company be designated as posing systemic risk to the system regardless of whether it is currently regulated. The Fed's criteria for making such a determination are worded broadly enough to include just about any firm of a sufficient size.

In fact, the proposal even states that the Fed should be allowed not only to take other unspecified factors into consideration but also to "exercise discretion" in applying those factors to specific institutions. This type of open-ended power would be difficult to constrain and should be resisted.

Similarly, the white paper notes that the Fed would "also have to develop new supervisory approaches for activities that to date have not been significant activities" for most bank holding companies, but the proposal fails to define this any further. It then goes on to describe in very broad, general

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www.heritage.org/Research/Regulation/wm2545.cfm

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terms ways for the Fed to reduce systemic risk, but it is very uncertain how such regulation would work in practice or even if those approaches are the best ways to approach the problem.

Finally, adding such a mission to the Fed would reduce its ability to focus on monetary policy—its key role—and expose it to even more political pressure than it now faces.

If such a regulator is actually needed, it would be far better to assign it to the new Financial Services Oversight Council, a grouping of the heads of all of the federal financial regulatory agencies. Successfully containing systemic risk is far more likely to happen if there are concerted actions from all of the involved regulators after a public recommendation of action than if it becomes the exclusive responsibility of one agency.

In addition, such a regulatory council should have strictly limited powers that do not include the ability to force financial institutions to come under its supervision without the explicit advance approval of Congress.

Unfortunately, any systemic regulator is likely to be hindered even during good economic times by political interference. The Treasury paper fails to address this issue at all. Past history, however, shows that even if such a regulator had tried to act against the housing bubble in 2006 or 2007, it would almost certainly have been blocked by the combined opposition of the realtors, homebuilders, low-income housing advocates, lenders, Fannie Mae and Freddie Mac, and many others.

Systemic risk is certainly a concern, and realistic solutions need to be considered, but if Congress simply passes legislation and assumes that all is well, it is only setting itself and the taxpayers up for serious future trouble.

Creating a Consumer Financial Protection Agency. Treasury proposes to consolidate existing consumer regulators into a new and very powerful Consumer Financial Protection Agency.[3] This is the single biggest policy mistake in the Treasury plan.

This approach is superficially attractive as a way to emphasize the Administration's concern for this area. However, the proposal assumes that consumers are unable to understand any financial products other than the most simple, basic versions even with detailed disclosures in advance of purchase. This basic contempt for the intelligence of consumers would extend to requiring them to refuse certain basic products before they would be allowed to purchase anything else.

The new agency would more likely stifle innovation instead of actually helping consumers. Separating the oversight of consumer products from an overall understanding of financial institution operations and financial strengths and weaknesses is likely to result in decisions that decrease the attractiveness of products, causing many that could be attractive to consumers to be withdrawn or offered only to select groups.

In addition, the proposed law does not even set out a single national standard that consumer financial products would have to meet to be acceptable. Instead, it explicitly encourages states to come up with stricter standards that would substitute for the federal ones. National firms could face up to 51 separate consumer regulatory regimes, complete with disputes about whether the applicable standard is the one where consumers live or have moved to subsequently, where the firm is located, or where the Internet site that was used is based. This provision alone is enough reason to oppose the proposal.

Resolution Authority for "Too Big to Fail" Financial Firms. Dealing with failing financial companies that could cause risk to the financial system is a valid concern, but the Administration's approach seems more geared toward facilitating future bailouts and justifying additional intervention.

1. U.S. Department of the Treasury, "Financial Regulatory Reform: A New Foundation," at *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf* (July 15, 2009).
2. See David C. John, "Financial Systemic Risk Regulators: Congress Is Asking the Wrong Questions," Heritage Foundation *WebMemo* No. 2471, June 8, 2009, at *http://www.heritage.org/Research/Regulation/wm2471.cfm.*
3. A Treasury Department fact sheet on the new agency is available at *http://www.financialstability.gov/docs/regulatoryreform/strengthening_consumer_protection.pdf* (July 15, 2009).

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Over the past 18 months, policymakers found that while they had the ability to close failing banks, the only way they could close bank holding companies, insurance companies, and similar firms was to essentially buy them from shareholders. This left taxpayers in the unenviable position of having to repeatedly bail out companies like AIG.

Closing down multi-national financial firms is not easy. The collapse of Lehman Brothers resulted in about 92 subsidiaries going into bankruptcy, only 20 of which were located in the U.S. and came under American jurisdiction. Clearly, a receiver/conservator that can operate at least certain subsidiaries until they can be sold or orderly closed is necessary in order to maximize returns to debtors. But the Treasury plan assumes that the Federal Deposit Insurance Corporation (FDIC) should handle this role rather than allowing the courts to determine a receiver and then supervise it. While the FDIC has broad experience with resolving failed banks, it has no experience with the broader financial activities almost certainly to be part of failing large financials.

A better approach is to modify U.S. bankruptcy law to accommodate the special problems of resolving these firms and also allow the courts to appoint receivers with the specialized knowledge necessary to best deal with their failure.[4]

Merging the OCC and the OTS. While merging the OCC and the OTS makes sense, failing to merge several other financial regulatory agencies at the same time is a major missed opportunity. For instance, the bank regulatory activities of the FDIC and the bank holding company oversight by the Federal Reserve should also be merged into the combined entity to create a true banking regulator. Similarly, the Commodity Futures Trading Commission should be merged into the Securities and Exchange Commission. But the Treasury plan merely calls for "harmonized regulation" of futures products and securities.

While the Obama Administration had discussed additional mergers of existing regulators, it appears to have backed off to avoid conflict with those who support one regulator over another. This is a major missed opportunity, and House Financial Services Committee Chairman Barney Frank's (D–MA) decision to delay even the OCC–OTS merger underlines the Treasury plan's failure to really modernize financial regulation.

Increasing International Cooperation. A significant section of the Treasury report[5] covers the "need" to raise international regulatory standards and "improve international cooperation." While much of this section may just be an effort to placate demands from overseas, it is disturbing that all of the sections call for increasing international supervision and expanding the scope of regulation.

Events over the last year reinforce the fact that the financial services industry is international and that the activities of one firm could affect the entire world. However, the much more extreme regulatory regimes such as those in the European Union were no more successful in avoiding financial institution problems.

The U.S. regulatory system should meet the needs and risks facing *American* financial institutions. Since the pressure from most other countries will be for tighter restrictions rather than for simplified commonsense regulations, Congress should treat this section with the deep suspicion that it deserves.

More Details to Come. Major vital parts of the Treasury plan are missing until the completion of studies that will recommend further action. These include:

- A working group examining regulatory capital requirements for banks, bank holding companies, and other "too big to fail" firms (due December 31);
- A fundamental reassessment of the supervision of bank and bank holding companies (due December 31);
- Reducing money market mutual funds' susceptibility to runs (date uncertain); and

4. See David C. John, "Republicans' Financial Regulatory Reform Plan a Good Start," Heritage Foundation *WebMemo* No. 2484, June 15, 2009 at *http://www.heritage.org/Research/Regulation/wm2484.cfm*.
5. A Treasury Department fact sheet on this section is available at *http://www.financialstability.gov/docs/regulatoryreform/improving_internatl_reg_standards_co-op.pdf* (July 15, 2009).

- The future role of Fannie Mae and Freddie Mac (due in the 2011 budget).

All of these are important fundamental questions, and Congress should delay its consideration of financial services regulatory changes until those reports are received.

Slow Down and Do It Right. The complexity of the Treasury plan, combined with Secretary Tim Geithner and others' requests for quick action, is a warning signal that Congress should instead slow down and carefully consider each individual element before acting. Financial regulation is very complex, and even small mistakes can have huge consequences. Doing it right is far superior to quick action that results in mistakes that have to be corrected later.

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