WebMemo

Published by The Heritage Foundation

No. 2942
June 28, 2010

Financial Reform in Congress: A Disorderly Failure

David C. John and James L. Gattuso

After weeks of negotiations, a congressional conference committee has finally come to an agreement on a financial regulation bill. Weighing in at close to 2,000 pages, the legislation represents the largest expansion of Washington's role in the financial industry since the Great Depression. Final votes are expected in the House and Senate next week.

The goal of the legislation is clear: to minimize the chances that another financial crisis—and subsequent bailouts—will occur. The objective is a good one. Unfortunately, the massive bill on the whole would hurt consumers and the economy, and rather than decrease the chances of another crisis or bailout, it would make them more likely to occur.

Failing Financial Firms. The lack of a broadly accepted process for closing down large financial institutions helped lead to the massive bailouts of 2008 and 2009, as regulators feared the economic consequences of "disorderly" failures. The legislation adopted by the House and Senate addresses this problem by creating an "orderly liquidation" process by which regulators are empowered to seize financial institutions that they believe are in danger of failing and liquidate them.

The House version of the bill provided for a $150 billion "orderly liquidation fund" to facilitate this process. Pre-funded by fees on large institutions, this account would be used in part to pay creditors of failing institutions, shielding them from full losses. This was, in effect, a pre-funded mechanism for future bailouts.

To its credit, the conference committee took out this provision, replacing it with language from the Senate bill requiring that the costs of liquidation be paid for with the assets of the closed institution and limiting creditors to receiving what they would have received in bankruptcy.

However, the liquidation process is still problematic. Federal regulators are granted broad powers to seize private firms they feel are in danger of default, and these powers are subject to insufficient judicial review. Such governmental discretion to seize private property is constitutionally troubling.

There is, of course, an alternative mechanism for closing institutions: bankruptcy. For most industries, the bankruptcy laws have long provided a way for failing firms to reorganize or liquidate under established rules of law and with independent, nonpolitical supervision by courts. There is no reason that (with perhaps a few modifications to take into account the special characteristics of large financial firms) it cannot work here as well.

Systemic Risk. The legislation establishes a new 10-member Financial Stability Oversight Council composed of regulators that would be responsible for monitoring and addressing system-wide risks to

This paper, in its entirety, can be found at:
http://report.heritage.org/wm2942

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

the financial system. Among other things, the council would recommend that the Federal Reserve establish stricter capital, leverage, and other rules for large, complex financial firms. This council would also have almost unlimited powers to draft financial firms into the regulatory system and even force them to sell off or close pieces of themselves.

Unfortunately, it is extremely difficult to detect systemic risk before a crisis has occurred, and the council would serve mainly as a group to blame for failing at an almost impossible task. On the other hand, its huge powers are much more likely to destabilize the financial system by stifling innovative products while failing to detect dangers posed by existing ones.

Bureau of Consumer Financial Protection. The bill also creates a new Bureau of Consumer Financial Protection with broad powers to regulate the financial products and services that can be offered to consumers. The intended purpose is to protect consumers from unfair, deceptive, and "abusive" practices, but the effect would be to reduce available choices, even in cases where a consumer fully understands and accepts the costs and risks. For many consumers, this would make credit more expensive and harder to get.

The new agency would nominally be part of the Federal Reserve System, but it would have extraordinary autonomy. This autonomy would impede the efforts of existing regulators to ensure the safety and soundness of financial firms, as rules imposed by the new agency would conflict with that goal.

The Volcker Rule. The final version includes a form of the "Volcker rule," which would largely prohibit any bank or other institution with FDIC-insured deposits from undertaking proprietary trading—that is, trading for the banks' own behalf rather than for the benefit of a client—or from owning or sponsoring hedge funds or private equity funds. This rule would allow regulators to micromanage financial institutions but would do nothing to reduce systemic risk.

The conference committee did reject the near-total ban on such investments, allowing banks to take minor stakes in hedge funds and private equity funds. However, the new rules still present problems. For instance, the difference between legitimate and traditional activities and those the Volcker rule seeks to ban would be difficult, if not impossible, to determine. Attempting to do so would require an intrusive, expensive regulatory compliance system that by its nature would micromanage day-to-day activities.

Derivatives. One of the most complex sections deals with the regulation of derivatives, a financial instrument that one party to the transaction can use to reduce risk while the other assumes that risk in return for a potential gain. These instruments can substantially reduce the risk of financial transactions.

The legislation comprehensively regulates most derivatives, traders, and issuers. Dealers would be subject to new capital, reporting, and margin standards and would have to trade routine derivatives on exchanges. As with the Volcker rule, the conference stopped short of the Senate's complete ban on bank investments in derivatives, but the new regime will still increase the cost of derivatives and limit their benefits.

Debit Card Fees. The bill would also eliminate part of the fees paid by retailers to credit card companies for the use of debit cards. The part that is being eliminated goes to the financial institution that issues the card, and the loss of this income may cause certain issuers to either drop their cards or limit their availability. This fee applies only to large banks, with fees going to smaller financial institutions, state governments that use debit cards to pay certain types of benefits, and certain other card issuers still being allowed.

Capital Standards. A good portion of the conference agreement would set new size- and risk-based capital standards for financial institutions. Capital, composed of retained earnings and shareholder equity, is the first line of defense when a financial institution runs into trouble, as it can absorb losses.

Unfortunately, the bill limits its impact by prohibiting larger holding companies from using one popular form of existing capital, trust-preferred securities (a financial instrument having characteristics of both equity and debt), as Tier 1 capital. This

will force larger banks to replace existing capital when they should be building additional capital.

Fannie Mae and Freddie Mac. Despite much rhetoric about ending bailouts, the bill does nothing to address Fannie Mae and Freddie Mac, two of the largest recipients of federal bailout money. These two government-sponsored enterprises, now in federal receivership, helped fuel the housing bubble. When it popped, taxpayers found themselves on the hook for some $150 billion in bailout money.

The failure to address their future is a serious error and shows just how hollow are claims that this agreement will prevent future crises.

Devil in the Details. The above is by no means a comprehensive list of problematic provisions in this massive bill. There are many others, including major legislative moves to extend Washington's control of compensation, revise federal deposit insurance, regulate credit reporting agencies, and alter corporate governance rules.

In addition, the bill includes small but significant changes hidden in other sections that have not yet surfaced. As in any bill of this size, these "hidden" provisions of all kinds will inevitably come to light in the coming weeks—after the scheduled final vote.

Making Things Worse. This legislation is the wrong approach to fixing the financial industry. Rather than end the "too big to fail" mindset, it reinforces it. Rather than end bailouts, it ignores the ongoing bailout of Fannie Mae and Freddie Mac. Rather than make the financial system safer, it reduces firms' ability to handle risk. And rather than help consumers, it raises their costs, reduces their choices, and hinders the capital formation necessary to make them more prosperous. Congress should consider these problems carefully before rushing into final passage next week.

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