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Administration Proposes Financial Regulation Reform

On June 17, the Obama Administration published its long-awaited Financial Regulation Reform proposal. The proposal would recast many aspects of US financial regulation and provide for more centralization and coordination of regulatory oversight. The proposal does not, however, create a single, European style, regulator of all financial services businesses as had apparently been considered by the Administration during its development of the reform proposal.

In essence, the main part of the proposal is to greatly expand the jurisdiction and authority of the Federal Reserve to supervise, regulate, and impose capital requirements on any type of financial institution that the Federal Reserve determines to be systemically significant, and impose a federal receivership process for systemically significant financial institutions. The Federal Reserve would have broad leeway to determine what types of firms (apparently including industrial firms such as General Motors (GM), which was deemed to be such in order to receive federal assistance earlier this year) are "financial institutions" and, if they are deemed to be systemically significant based on size, interconnectedness, leverage, reliance on short-term funding, connection to payment, clearance and settlement systems, and the potential impact of their insolvency on the financial system as a whole, to regulate them as "Tier 1 Financial Holding Companies" in much the same way that bank holding companies currently are regulated under the Bank Holding Company Act. The Federal Reserve would be guided in this effort by a new "Financial Services Oversight Council" made up of representatives from the Securities and Exchange Commission (SEC), Commodities Futures Trading Commission (CFTC), federal banking agencies, Federal Housing Finance Agency, and the new Consumer Financial Protection Agency, and have a permanent staff from the Treasury Department.

These Tier 1 Financial Companies would be given five years to divest non-financial activities. One wonders what impact this may have on a company such as GM, or on any private equity, merchant banking or venture capital firm unlucky enough to be designated as a Tier 1 Financial Company. Management compensation structures of Tier 1 Financial Companies would be subject to regulation. Tier 1 Financial Companies would be required to have contingency plans for their rapid resolution in the event of financial distress, develop sophisticated risk management systems, and maintain liquidity and capital levels higher than those that would otherwise apply. Tier 1 Financial Companies, apparently, also would be subject to administrative enforcement actions and FDIC receivership.

Obviously, many financial firms will seek to structure (or restructure) their balance sheets and operations in order to avoid being designated as Tier 1 Financial Companies. Limiting size, leverage and reliance on short-term funding, counterparty open position exposure, and eschewing a significant role in intermediating payment, settlement and clearance systems, would be ways that firms may explore to avoid this designation. Presumably, such steps to avoid regulation would serve the purposes of the Administration's proposal just as well as regulating them, by reducing the systemic risk posed by these firms.

In addition, under the Administration proposal, the federal role in the supervision of specific types of financial institutions, including hedge funds and their advisers (with the SEC granted jurisdiction), insurance companies (with a new federal insurance regulator in an area previously regulated only by the states, within the Treasury Department to be called the Office of National Insurance), and the owners of various "nonbank banks," would be expanded. Other parts of the proposal include revamping the requirements applicable to money market mutual funds, over-the-counter derivatives such as swaps, and securitizations, harmonization of futures and securities regulation, creating the Consumer Financial Protection Agency as a new regulator for consumer financial products, scaling back federal preemption, prohibiting arbitration clauses in retail financial services contracts, and replacing the Office of the Comptroller of the Currency (OCC) (which charters and regulates national banks) and the Office of Thrift Supervision (OTS) (which charters federal savings associations and regulates state and federally chartered savings associations) with a single "National Bank Supervisor."

The Administration proposal was delivered in the form of a Treasury Department Report or "white paper" rather than as specific legislative text. In July, however, the Administration published drafts of legislative language to implement most aspects of the proposal. Previously, drafts of legislation were circulated that would subject systemically significant financial institutions to FDIC receivership. ["Treasury Proposes Legislation for Resolution Authority," US Treasury Press Release tg-70 (Mar. 25, 2009); "Treasury Outlines Framework For Regulatory Reform," US Treasury Press Release tg-72 (Mar. 26, 2009).] In addition, various other legislative proposals have been introduced that are similar to various aspects of the Administration proposal (including regulation of over-the-counter derivatives, and regulation of hedge fund managers), and the SEC has proposed to significantly revise and tighten Rule 2a-7 governing money market mutual funds. Senate Banking Committee Chair Christopher Dodd has indicated that the Committee will not take up consideration of significant reforms for financial services regulation until the Fall of 2009.

In the Report, and in an op-ed piece in the Washington Post by Treasury Secretary Timothy Geithner and Economic Council Chair Lawrence Summers two days before its release, the Administration provides a pithy summary of the events and forces that led to the current economic crises. We put on too much debt, and took on too many poorly understood risks, in financial products ranging from swaps to home mortgages to consumer debt to securitized assets, and in the financial institutions that created, sold, and invested in them. There is blame enough for all. Blame for the regulators who did not appreciate or understand the risks involved and who have been unable to coordinate among rival branches of government. Blame for financial institutions for creating, selling, trading, and investing in risky products and deals. Blame for consumers for incurring too much debt and investors for investing blindly in foolish deals.

There is, however, something of a disconnect between the causes of the problem and the regulatory restructuring solutions contained in the Administration proposal. If the problem is too much leverage, would it not be simpler to more directly limit use of debt and leverage by increasing margin requirements, down-payment requirements for home mortgages, and the degree of embedded leverage permitted in asset securitizations acquired by pension plans, mutual funds, banks and insurance companies, and increase capital standards for regulated institutions? Those are simple rules to write and administer, and do not require any new federal agencies or the expansion of any agency's jurisdiction. The old "KISS" rule of thumb has been forgotten.

To be fair, raising capital requirements, like raising taxes, serves as a brake on the economy. If fully implemented now, such a move would prolong the current recession and mute the next period of economic growth. But it would also likely forestall future recessions and minimize their impact. To address this contradiction, the Administration proposal appears designed to create an even more elaborate regulatory system in order to keep things chugging along with more controls seeking to manage risk, but not enough capital to absorb the potential losses that come with risk-taking.

Other questions arise from the proposal. Are consumers really benefited by use of slow and expensive litigation rather than quick and inexpensive arbitration for resolving their disputes over financial services agreements? Or for that matter, do families really want to give up their stable net asset value money market mutual funds, when only two have ever "broken the buck" in the nearly 40-year history of the product?

Perhaps most fundamentally, in view of the fact that the unregulated portions of the financial services industry, such as private investment funds, were not the source of the problem and have held up far better than heavily-regulated government-sponsored enterprises, banks, insurance companies and broker-dealers, at no cost to the public, is there a basis for thinking that extending Federal Reserve jurisdiction over them will make things better, rather than worse? The problem was not the absence of regulation, but the failure of an elaborate and oppressive regulatory structure to prevent the insolvency of very heavily regulated institutions.

The Administration proposal also contains some internal inconsistencies. One stated goal is to simplify a complex maze of overlapping agencies with jurisdiction over banks. Yet the proposal creates more agencies than it does away with, and the jurisdiction of the new agencies overlaps with existing regulators. The patchwork of regulation of banks and other financial firms is made more complex by the proposal.

There are many complex issues, policy considerations and turf disputes that will need to be resolved before legislation can move forward on financial regulatory restructuring. There are opponents on both sides of the aisle to many aspects of the proposal, and lingering concerns in many quarters about concentration of power in the Federal Reserve. When Congress takes up these issues in the Fall, it is likely that whatever may result will be different from what has been proposed by the Administration.