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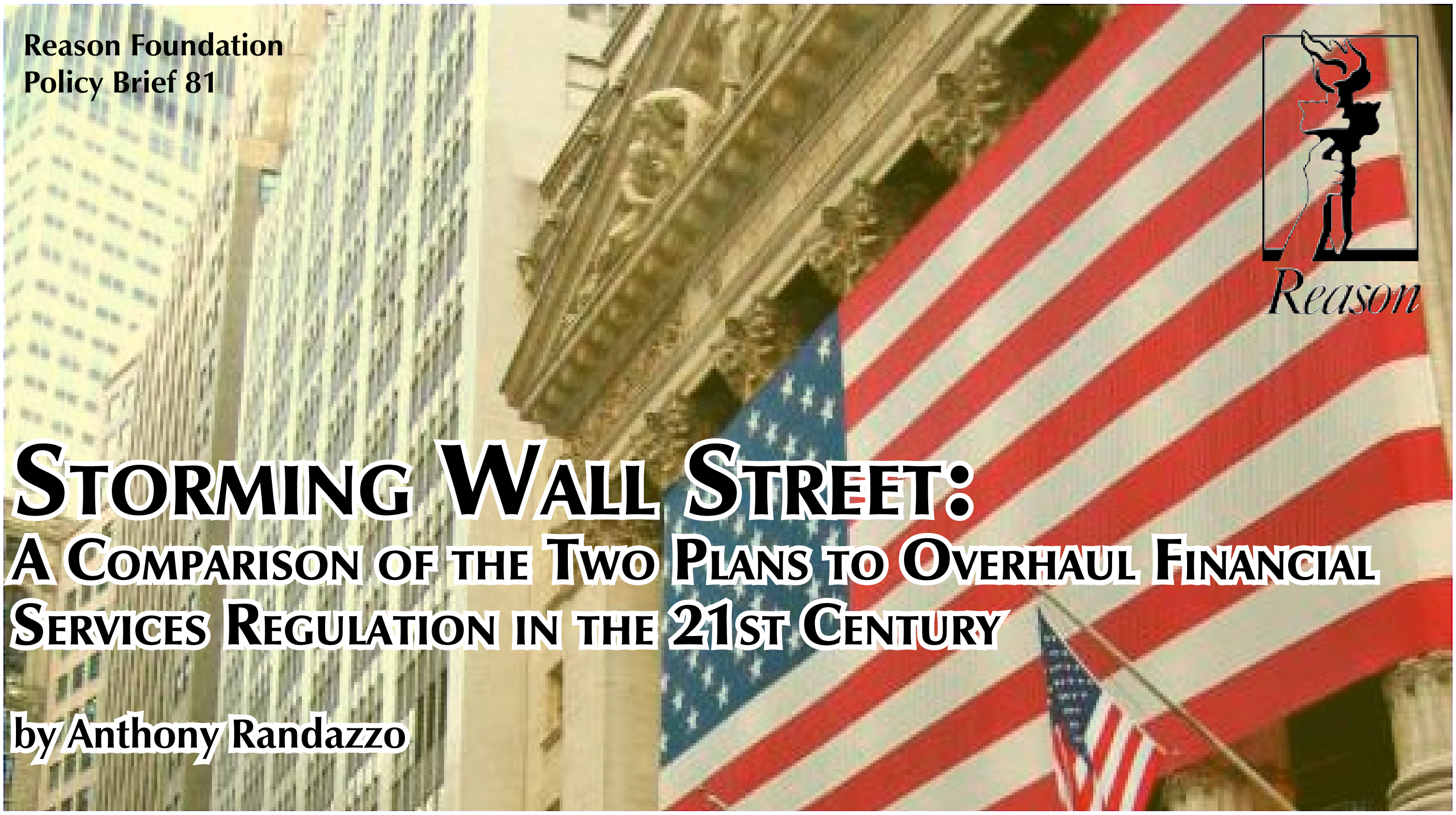

Storming Wall Street:
A Comparison of the Two Plans to Overhaul Financial Services Regulation in the 21st Century

by Anthony Randazzo

INTRODUCTION

The role regulation played in the creation and evolution of the recession and financial crisis is a very hot topic. Undoubtedly, regulators helped create the mess, though how and to what degree remains undecided. But everyone agrees that some changes need to be made to the financial sector's regulatory structure.

President Barack Obama unveiled his proposal to fix Wall Street regulation on June 17, 2009. If enacted, the plan—written with the help of Federal Reserve Chairman Ben Bernanke and Treasury Secretary Tim Geithner—would be the biggest expansion of federal regulation of the financial sector since the Great Depression. The proposal dramatically increases the authority and scope of the Federal Reserve, while also creating a system that codifies the concept of "too big to fail." That part of the plan would ensure plenty of future bailouts. Still, President Obama's plan does go a long way toward consolidating complicated layers of oversight in the banking and insurance industries.

Congressional Republicans offered a counter plan on July 23, 2009. Their alternate proposal includes several similar provisions, including establishing a board to oversee systemic risk, reducing Federal Reserve independence, and consolidating banking regulation. The GOP's plan overreaches in bank regulation reform, takes a weak position against government-sponsored enterprises, ignores federal insurance reform completely, and unfortunately expands the role of the Securities and Exchange Commission (SEC). However, the Republicans focused chiefly on ending the policy of "too big to fail" and, despite supporting bailouts under President George W. Bush, are now opposed to future bailouts.

Unfortunately, neither plan will be perfect. We know Congress is going to pass a bill overhauling financial services regulation. Given that some reform is going to happen, and is probably necessary, there are aspects of each plan that can be mixed and matched to prevent the government from expanding its reach into every corner of the financial market and instead simplify regulations to ensure taxpayer money does not wind up supporting failing financial institutions in the future. To that end, we have provided a condensed comparison of the two plans, what they propose, and what should be done.

COMPARING REGULATION REFORM IDEAS

Oversight for Systemic Risk

Obama Plan: Establishes the Financial Services Oversight Council that will monitor the financial markets and determine if firms should be placed under newly designed "Tier 1" regulations; gives power to the Federal Reserve to enforce Council decisions and be responsible for stopping firms from becoming systemic risks.
GOP Plan: Establishes the Market Stability and Capital Adequacy Board to monitor the financial markets for potential systemic risks; only individual regulators would be authorized to act on a concern from the Board.

Both proposals establish an oversight authority—the difference is how much power that body will have. Both would be looking for systemic risks and pointing them out, but the Obama plan would explicitly classify firms as "too big to fail," codifying one of the ambiguities that partly created the crisis. Firms identified by the Council as "Tier 1" would be at the top of a three-tiered system for financial institutions, based in part on how likely their failure would negatively impact the whole financial system. These firms, pre-qualified for bailouts, would permanently put taxpayers on the hook to bail out failing firms. The GOP's Adequacy Board could still create problems by singling out firms as systemic risk and subjecting them to increased regulation. However, the Board is better because it has less teeth and authority. The less authority a systemic risk monitor has, the less likely it can influence the market and the more responsible firms are for their own risk and investment choices.

What Happens to Firms "Too Big to Fail"?

Obama Plan: Creates a resolution authority to nationalize failing non-bank financial institutions in order to prevent systemic damage; funding for the resolution authority is yet to be determined by Congress; failing banks will still be protected by the FDIC.
GOP Plan: Amends bankruptcy laws to create new Chapter 14 bankruptcy proceedings for non-bank financial institutions that would build on Chapter 11 bankruptcy by expediting the hearing process; failing banks will still be protected by the FDIC.

The real debate here is whether firms should be considered too big or interconnected to fail. The Obama plan asserts that letting large, interconnected firms file for bankruptcy is an unacceptable policy position given the aftermath of the Lehman Brothers bankruptcy, and seeks to create an FDIC-styled system to handle non-bank firms that might need bailouts. This authority would have been used for AIG, Bear Stearns or Morgan Stanley had they technically failed. The Chapter 14 proposal from the GOP believes that firms should be allowed to fail and then get resolved through the bankruptcy system. In a summary document about the proposed new legislation the GOP wrote that continuing a too-big-to-fail policy through a resolution authority "could place politics over sound regulation and give firms the incentive to grow even bigger" in order to achieve bailout protection.

Recently, small business lender CIT, the largest loan originator for local businesses in the country, was denied a bailout from Washington on the grounds that its failure would be too small to impact the market. In the wake of CIT's crisis many suggested that if the lender had taken on just a little more risk in the past year, it could have grown its size and risk portfolio enough to qualify as "too big to fail." While some firms may constrain themselves (destroying economic value) in order to avoid the tougher, Tier 1 regulations, there is a very real threat that a too-big-to-fail policy will create perverse incentives for higher risk-taking.

Authority to Bail Out Financial Institutions

Obama Plan: Allows the Fed to lend to financial institutions in extreme economic conditions with written permission from the Treasury Department.
GOP Plan: Repeals the Fed's authority to lend to specific firms; distressed financial institutions would either be taken over by the FDIC or required to enter Chapter 14 bankruptcy.

This is one of the starkest differences between the two plans. The Fed has spent, lent or committed over $7.8 trillion since the start of the crisis, an excessive abuse of its authority. This money is financing the purchase of commercial paper and term asset-backed facilities, supporting mutual funds and propping up failing financial institutions, among other things. While the Obama plan does make the positive step of requiring the Treasury to authorize future bailouts, taxpayers could still wind up supporting Wall Street's failures. The GOP plan, in setting up Chapter 14 bankruptcy, sends a signal to the financial sector that it is much less likely that firms will be bailed out in the future.

Federal Reserve Reform

Obama Plan: Gives the Federal Reserve oversight authority over firms considered a systemic risk; transfers its banking oversight responsibilities to a national bank regulator; requires Treasury authorization before bailing out a financial institution.
GOP Plan: Takes away virtually all responsibility except for managing monetary policy; grants the Government Accountability Office the authority to audit the Fed; requires the Federal Open Market Committee (FOMC) to establish an explicit inflation target.

The Obama plan wants to reform the Federal Reserve, but only in hopes of expanding its authority. The biggest expansion would be giving the Fed regulator authority over all the too-interconnected-to-fail Tier 1 financial institutions. The GOP's proposal doesn't expand the Fed, but the FOMC requirement could be a strike at reducing Federal Reserve independence by problematically mixing more politics with monetary policy. What the GOP's plan does do positively is reduce the Fed to a central bank that only does monetary policy, with banking and consumer oversight transferred to other agencies.

Capital Requirements

Obama Plan: Makes capital requirements and reserve ratios a part of the new tiered risk structure rules, with Tier 1 firms having the highest capital requirements; creates systems to adjust requirements and ratios based on economic conditions, redesigns that models calculate risk-based reserve measurements to include off-balance sheet liabilities and derivative exposure.
GOP Plan: Makes capital requirements unnecessary because of the elimination of bailouts and too-big-to-fail policy.

The Obama plan's reserve proposals are largely sensible, aside from the tiered structure, given the current regulatory structure. One area that banks were able to game the system was with improper use of off-balance sheet accounting tactics that weren't adequately calculated in determining reserve rates, and the Obama plan addresses this well. Still, it may not be as necessary to adjust capital requirements and reserve ratios after the April 2009 change in mark-to-market (MTM) rules made accounting more flexible in economic crisis. Some firms would have benefited from higher capital requirements, becoming so over-leveraged that they were insolvent. But others simply didn't have the cash to match the MTM requirements when asset prices dropped suddenly and would have survived if those rules had been flexible in extreme conditions (as the rules were changed to say after the fact). If the policy of too-big-to-fail were eliminated, reserve ratios would be less necessary because firms would have to manage their own risk. Self-determined capital requirements could also become a competitive advantage for firms seeking to attract investors looking for safe and stable institutions.

Banking Institution Reform

Obama Plan: Establishes the office of National Bank Supervisor, consolidating all federal banking regulation into the new agency; ends federal chartering of thrifts; removes restrictions on interstate banking.
GOP Plan: Establishes a Financial Institutions Regulator for all federal and state deposit-bearing institutions, consolidating all banking supervision powers of the Fed, National Credit Union Administration, Office of Thrift Supervision, and Office of the Comptroller of the Currency.

One thing is for sure: the Office of Thrift Supervision (OTS), which is the regulator for all federal and some state savings and loan banks, will be dissolved. Both plans offer reforms that could be beneficial, but what both need to keep in mind is that one-size-fits-all regulation of banks has the potential to create problems. By consolidating all banking regulation in one house, the temptation to issue standardized rules may have unintended consequences since what is best for a federal bank may not be helpful to a state bank. Still, the Obama plan has two positive aspects the GOP plan doesn't: first it largely leaves state banking regulation alone, and second it allows state-chartered banks more freedom to expand business.

Consumer Protection

Obama Plan: Establishes the Consumer Financial Protection Agency (CFPA) to regulate financial products, including mortgages and credit cards; the stand alone agency will have the power to set standards for those same product types and be able to reject products that are deemed too complicated or dangerous for other reasons.	
GOP Plan: Increases Securities and Exchange Commission authority resources to prosecute financial sector misconduct; reauthorizes the Financial Crimes Enforcement Network to detect financial fraud.	

Nearly every financial industry group has lined up in opposition to the proposed Consumer Financial Protection Agency—and most of their complaints have merit. The recent Credit Card Responsibility Accountability and Disclosure Act (CARD) is an example of what kind of regulations might come out of a CFPA. The CARD bill tries to protect consumers by restricting the way companies can charge interest, requires simpler contract language and restricts the types of fees lenders can use. The unintended consequence of this is that the regulations could very well increase the cost of credit, and limit it to others, since firms can no longer charge market rates. The CFPA could do a similar thing on other types of financial products.

Another problem with the CFPA is that it will have the power to design "plain vanilla" versions of financial products and force firms to offer them in addition to their self-designed products. The CFPA may even ban certain products and require that firms offer the CFPA's "safer" alternative alone. The agency would also have independent power to restrict products it deems harmful instead of letting consumers make choices for themselves.

There is also merit for the Federal Reserve's argument that banking regulation and consumer protection regulation are complementary activities, and one informs the other. The GOP's approach is to simply help the SEC do its job better by increasing is authority and resources. It may not be necessary to give the SEC more power, but it is a much better approach to ensuring consumer protection than a CFPA.

Money Market Mutual Funds

Obama Plan: Allows mutual funds to suspend payouts in extraordinary economic situations; increases liquidity requirements and SEC oversight.
GOP Plan: Nothing.

The GOP didn't touch this issue, but what they should have proposed is letting money market mutual funds establish their own, internal rules for avoiding bank runs and allowing those policies to be a competitive advantage. The Obama plan unnecessarily regulates an industry that is already showing positive signs of self-correcting mistakes and of putting money market mutual fund management companies in a place to bear the risk for their own activities.

Hedge Funds

Obama Plan: Requires hedge funds and private equity groups to register with the SEC; has the systemic risk Council determine if any hedge funds pose a systemic risk and subjects them to Tier 1 regulations.
GOP Plan: Makes the regulation of hedge funds unnecessary because of the elimination of bailouts and too-big-to-fail policy.

Requiring the largest hedge funds to register with the SEC is not necessarily problematic, and many of them are already reporting if they trade commodities. However, requiring small hedge funds to register and report to the SEC may create enough compliance costs that many of them will have to shut down or pass the costs onto consumers.

OTC Derivatives and Securities Reform

Obama Plan: Establishes an open exchange for derivatives, futures contracts and securities; encourages the standardization of contracts; creates a central authority to clear trades to provide more transparency; increases margin requirements for customized derivative contracts; requires all securities originators maintain at least a 5% interest in the security.
GOP Plan: Makes the regulation of derivatives unnecessary because of the elimination of bailouts and too-big-to-fail policy.

In a regulatory structure that considers certain firms too big to fail, an open derivative exchange isn't a bad idea. However, it should not reduce the potential for customized, unique financial products to be developed, and it should be allowed to evolve as the market comes to value more stability and transparency with derivatives. Additionally, standardizing all derivatives would be extremely detrimental to the innovation process and hurt economic development where unique derivatives can create wealth. The Obama proposal to require some skin in the game is not all bad, but it won't stop all securities from losing value.

Credit Rating Agency Reform

Obama Plan: Nothing.
GOP Plan: Eliminates all references to credit rating agencies in federal law.

This is one of the GOP's best ideas and yet it was ignored by the president's proposal.

The existence of credit ratings is perfectly legitimate and beneficial, however, they should not be turned into a federally supported oligopoly. U.S. law refers to credit ratings as a tool for setting capital reserve requirements, restricting investments and guiding the use of taxpayer money in the marketplace. However, this has reduced the need for money managers to perform proper due diligence. The proposal, which the SEC is also considering doing on its own, would increase fiduciary responsibility.

Insurance Reform

Obama Plan: Establishes the Office of National Insurance to regulate all aspects of the insurance industry; places large insurance companies under Tier 1 regulation to prevent systemic risk.
GOP Plan: Nothing.

The Obama plan appropriately addresses the need for insurance industry reform, though it did not propose a federal charter, giving insurance firms the option of a national, uniform set of regulations instead of having to adapt to the wide range of laws state-by-state. While Tier 1 status for an insurance company would put taxpayers on the hook for a potential future bailout like AIG, the plan does make a good first step toward streamlining the complicated web of insurance regulation.

Government-Sponsored Enterprise Reform

Obama Plan: Nothing.
GOP Plan: Requires that the currently nationalized government-sponsored enterprise (GSEs) be released within two years; creates a 13-year timetable for ending the federal charter of GSEs and privatizing their assets.

This is a significant weakness of the Obama plan. The role of GSEs, such as Freddie Mac and Fannie Mae, in creating the crisis should not be downplayed. The GOP appropriately wants to take steps to get rid of them. However, the GOP does not go nearly far enough, allowing GSEs another 13 years of access to taxpayer dollars if necessary. The ideal plan would wind down the GSEs by the time the stimulus and bailout programs are ended within the next 18 months.

International Cooperation

Obama Plan: Commits to work with other nations to coordinate reforms for Basel II requirements, international bank oversight, executive compensation and derivatives; extends information-sharing agreements between central banks and regulators; suggests expanding the tiered risk structure to foreign banks.
GOP Plan: Nothing.

The Obama plan is partially on target with these suggestions. Regulation reform could make firms in America less competitive in the global market if there is no coordination between countries on how to modernize laws and oversight authority. Broadly speaking it is a good idea for the world to work together on the reform movement. However, extending bad ideas for the American financial sector across the globe, such as the tiered risk structure, would not be helpful.

Executive Compensation

Obama Plan: Requires all executive compensation packages be subject to a non-binding vote from shareholders.
GOP Plan: Nothing.

This law is largely harmless by itself, though there are costs, such as simple things like mailing out notices to shareholders, associated with conducting these votes that can be a deterrent. However, there is a significant worry that this will open the door to other, more invasive attempts at regulating compensation. Congress is currently considering several pieces of legislation that would set membership restrictions on corporate governance boards and give the Treasury Department the power to set wages at financial institutions. Furthermore, the measure seems unnecessary since shareholders can offer a vote of no confidence anytime they want to by just selling their shares.

CONCLUSION

Both plans have good and bad. President Obama's reform proposal falls short of addressing the most important problem with the current regulatory system: taxpayer protection for private sector failure. The codification of bailouts and the too-big-to-fail policy extends some of the very problems that contributed to the financial crisis and recession. The private sector should be put on notice: there will be no more bailouts.

The Republican plan also has some failings, but largely gets it right on "too big to fail." The use of bankruptcy law is a much better option than resolution authority that will have to be funded by taxpayer dollars or inequitable fees charged to all Tier 1 firms or perhaps the whole industry. It will be important, though, for the bankruptcy process to be transparent, unlike the Obama administration's recent plan for General Motors, which prepackaged a deal irrespective of the rights of bondholders and forced it through court proceedings.

Neither of the plans properly addresses the Federal Reserve, though the shortcomings are in different areas. The GOP's plan misses on many of the nuances of reform that will be addressed when Congress debates this issue in the fall of 2009. The Obama plan makes the right steps, though not perfect, in many of these areas, specifically regarding banking and insurance reform.

Ultimately, when designing new regulations and guidelines for the financial services sector, lawmakers must ensure they do not create conditions for the next crisis. This means signaling to companies that they will not be bailed out with taxpayer money if they fail and considering the vast number of unintended consequences these congressional actions may prompt. Regulations should also avoid, as much as possible, limiting the wealth creation process. The fastest way out of this recession and onto economic recovery is a fully functioning, vibrant financial market that is driving growth in every sector of the American economy.

ABOUT THE AUTHOR

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