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JUDGMENT CALL

Principled approach?

Paulson's proposal raises fundamental questions about government's role in the financial system

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In an ambitious effort calculated to establish the boundaries of a long-term national debate on financial regulation, Treasury Secretary Henry Paulson proposed reforms to substantially restructure every aspect of the federal financial regulatory system.

The reforms include proposals to make the Federal Reserve the guardian of market stability and extend comprehensive federal regulation to the insurance industry, payments systems and mortgage market participants. Nothing in the proposal is effective until legislation is enacted, and—as with a fine wine—it will take years before its time arrives.

Perhaps the most significant part of the proposal may be its intention to federally regulate broker-dealers and various investment vehicles and funds, including hedge funds, private equity funds, mutual funds and venture capital funds. This could have the largest impact on the way the markets function today, particularly to the extent that the net result is the application of fundamental regulatory controls such as leverage limitations and systemic safety net powers.

Treasury suggests that the current regulatory structure, which was largely in place by 1934, is obsolete. No one can dispute that the U.S. economy, the capital markets and financial services looked very different in 1934. The revolution in the past 20 years in structured finance, synthetic and alternative securities and derivatives, swaps and hybrid mortgages appears to be driving the impetus for additional regulation of what amounts to a shadow economy.

The risks of a globalizing economy have put pressure on the government to provide the regulatory controls required to prevent and resolve modern systemic market dislocations.

Parenthetically, it should be noted that market changes do not necessarily mean traditional regulatory systems no longer work. Indeed, many may argue that the current regulatory structure has worked well through many economic cycles and has demonstrated unparalleled resiliency. There is no form of regulation that can guarantee that our economy will not see future excesses and periods of economic turmoil. Therefore, an analysis of evidence describing when and how the system has failed would seem to be an important starting point in order to identify the improvements required and avoid the imposition of overcompensating regulation.

The Treasury's blueprint boils down to several fundamental changes to the regulatory structure.

1. The new regulatory system would be based on principles rather than function. Similar financial lines of business, no matter who owned them and in what financial charter they were housed, would be regulated by the same agency applying the same rules. The Treasury's proposal would entirely replace the current federal regulatory system with a variety of agencies responsible for (i) market stability, (ii) prudential and (iii) business conduct regulation. There would be a single federal charter for banks, thrift institutions and credit unions; the Securities and Exchange Commission and the Commodities Futures Trading Commission would be merged; the Office of the Thrift Supervision and the thrift charter eliminated; the Treasury would regulate international insurance issues and a new federal insurance charter; and unregulated mortgage lending would become subject to federal licensing and oversight. The Federal Deposit Insurance Corp. would become solely a deposit insurer and lose its bank examination and regulation authorities.

2. A principles-based regulatory structure would be indifferent to the identity of the owners of federally regulated financial licenses and eliminate the final vestiges of the separation of banking and commerce imposed by the Glass-Steagall Act in 1933 and partially removed in the Gramm-Leach-Bliley Act in 1999. Retailers and manufacturers, for example, would be permitted to own banks, securities firms, insurance companies, hedge funds and vice versa.

3. Securities firms and a wide range of investment vehicles, as

well as banks and insurance companies, would be regulated both by a corporate conduct agency and a conduct-of-business regulator on securities and disclosure issues and consumer protection, respectively.

However, those businesses would, in return, be able to borrow from the Federal Reserve discount window under certain circumstances. But the expansion of federal regulation raises the question of what additional federal privileges or obligations would be made applicable to financial firms. For example, would federal bank conservatorship and receivership principles be made applicable to them, and could financial firms apply for membership in the Federal Home Loan Bank System to have further access to federally sponsored liquidity sources?

4. State regulation of financial firms appears to be disfavored in the Treasury proposal, and the inference is that the dual system of banking would be phased out or become irrelevant. The privilege of deposit insurance and other government guarantees appears to be both the carrot and the stick to migrate state-chartered institutions to the federal charter.

5. The Federal Reserve would lose its bank holding company and its state member bank oversight authority, but it would keep its monetary policy oversight and powers and gain broad umbrella authority to obtain information from institutional borrowers at the discount window, oversee payments systems and mortgage lenders, examine depository and nondepository institutions under limited circumstances and require corrective action from financial firms to reduce systemic risk.

Obviously, the details of this proposal, which will take years to develop, are critical to any meaningful analysis of it. But there are fundamental questions that are already on the table.

Will private equity and hedge funds be required to adopt bank-like capital and leverage requirements? Will acquisitions and investments of or by newly licensed financial firms be subject to federal change in control limitations and approvals, as are banks today? Will investment activities and operations of financial firms be limited by capital, and will capital requirements be adjustable based on risk or other quantifiable measurements? Will affiliate transaction limitations, such as those that are applicable to banks and bank holding companies, be imposed on a wider range on financial firms? What financial products will be federally insured, and will an expansion of federal guarantees impact the role of the federal government in the market place? How will federal regulation of a major portion of the economy that is currently unregulated impact the health, safety, soundness and vitality of the economy?

These questions are likely to be among those debated for the foreseeable future. In that regard, financial firms of all kinds should keep themselves well-educated on the evolution of this process in order to be in the best position to protect their economic interests in the long legislative process that will ensue. ■

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