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Obama: Government's role is to unleash creativity in markets

Proposal gets mixed reviews from regulatory observers, think tanks

By Ronald D. Orol, MarketWatch

WASHINGTON (MarketWatch) -- President Barack Obama on Wednesday proposed a sweeping revamp of the U.S. financial regulatory system which rivals the reform that was enacted in the aftermath of the Great Depression in the 1930s.

Obama argued that the financial regulatory reform proposal he is introducing will empower the free market to be more creative, bringing prosperity to the U.S.

"In these efforts, we seek a careful balance," Obama said. "I have always been a strong believer in the power of the free market. I believe that our role is not to disparage wealth, but to expand its reach; not to stifle the market, but to strengthen its ability to unleash the creativity and innovation that still make this nation the envy of the world."

Key aspects of the Obama administration's financial regulatory reform proposals:

- Fed as systemic risk regulator for entire financial system
- Multi-agency council to identify emerging risks in firms and market activities
- Set up process to unwind failed big financial institutions
- Consumer Products Safety Commission to approve or reject mortgage products
- Issuers of complex mortgage products must maintain 5% stake in securities they sell
- Treasury working group to do study on regulatory capital by Dec. 31, 2009

To avoid another economic collapse, the President has said that financial regulatory reform was necessary to ensure that another credit crisis does not occur again.

"A culture of irresponsibility took root from Wall Street to Washington to Main Street. And a regulatory regime basically crafted in the wake of a 20th century economic crisis -- the Great Depression -- was overwhelmed by the speed, scope, and sophistication of a 21st century global economy," Obama said.

The plan would empower the Federal Reserve and make it the supervisor of large, systemically vital financial institutions, granting it the authority to be a lender of last resort in "unusual and exigent circumstances," to mega-banks if the department first receives approval from the Treasury Department. See full story.

Big financial institutions will need to have greater capital on hand, less leverage and they will be scrutinized more thoroughly by the central bank, according to the administration plan.

The 85-page proposal will begin to be scrutinized Thursday with hearings in both the House and Senate. Lawmakers are expected to draft legislation reforming the bank regulatory system by the end of the year, with the House expected to approve a bill before the Senate.

The proposal also calls for the elimination of the Office of Thrift Supervision and the Federal Thrift Charter, subsuming the agency into a new "National Bank Supervisor," agency based on the Office of Comptroller of the Currency that will supervise all federally chartered depository institutions.

It calls for the creation of an eight-member, multi-agency financial services oversight council that would seek to identify potential risks with large financial institutions and problematic investment products.

The proposal also seeks to set up a process to help unwind insolvent large systemically significant financial institutions so their failure does not cause extended damage to the markets. Obama did not specify which agency would be responsible for this so called "resolution authority," however he pointed out that the Federal Deposit Insurance Corp. already has a process for dismantling traditional savings and loan banks. The FDIC collects funds from banks to fill its deposit insurance fund that goes to pay depositors of a failed bank.

However, the FDIC's deposit insurance pool is under-funded and has recently obtained the authority to borrow up to $500 billion from the Treasury over the next two years.

"Think about this: if a bank fails, we have a process through the FDIC that protects depositors and maintains confidence in the banking system," Obama said. "This process was created during Great Depression when the failure of one bank led to runs on other banks, which in turn threatened wider turmoil. And it works. Yet we do not have any effective system in place to contain the failure of an AIG and the largest and most interconnected financial firms in our country."

A Treasury working group will be set up to study whether changes need to be made to the regulatory capital requirements of banks, with a report due Dec. 31, 2009.

Reaction

So far the reaction to the proposal has been mixed.

Regulatory observers argue that the Obama plan is negative for banks and other financial firms. Jaret Seiberg, a policy analyst at Concept Capital in Washington, explains that the proposal's call for higher capital standards and lower leverage limits for large systemically vital financial institutions will reduce the profitability of these banks and financial firms.

'I have always been a strong believer in the power of the free market.'

President Obama

He also points out that one aspect of the proposal, which limits transactions between a bank and its affiliate, could make it more expensive to do business with an affiliate.

Another aspect of the proposal seeks to have issuers of complex mortgage products maintain a 5% stake in securities they sell, unless those home loan products are simple fixed rate mortgages. Seiberg added that such an approach would limit availability of variable rate mortgages and reduce mortgage innovation.

The Brookings Institute argues the proposal does not go far enough. In a statement, the think tank argues that political constraints have caused the administration to "stop short of a full solution in certain areas."

Brookings Fellow Douglas Elliott argues that the proposal should have taken further steps to consolidate regulatory functions into fewer hands. He contends that the council of regulators the administration proposed will make it difficult for the Fed to effectively respond to systemic risk.

"The need to win a consensus across all the regulators, with their different views, constituencies, and institutional interests is likely to make it excessively hard to achieve the desired systemic safety," Elliott said.

Mark Calabria **, director of financial regulation studies at the Cato Institute said he was shocked that the reform proposal doesn't seek to make regulatory changes to Fannie Mae and Freddie Mac, two giant mortgage entities that the government put into government "conservatorship" last year as they teetered on the edge of collapsing.**

Calabria argues that the costs to taxpayers to bailout Fannie Mae and Freddie Mac will ultimately be greater than a $700 billion government program to inject capital into banks known as the Troubled Asset Relief Program, or TARP.

"These two entities were the single largest source of liquidity for the sub-prime market during its height," Calabria said. "In all likelihood, their ultimate cost to the taxpayer will exceed that of TARP, once TARP repayments have begun. Any reform plan that leaves out Fannie and Freddie does not merit being taken seriously."

Len Blum, managing director at New York-based Westwood Capital, said the proposal is an "exceptionally well thought out policy document that aims to do exactly what is necessary to reverse the mistakes of the past quarter century."

Blum agreed with the proposal's basic notion that it would be less efficient and far more costly to strip apart all of the existing financial industry regulatory structure in the U.S. in favor of a single super-regulator. With this proposal, Len said the Fed is given sufficient additional responsibility and authority. "We believe this will prove to be a highly successful alternative," Len said.

The American Bankers Association said they are opposed to the proposal that would eliminate the Office of Thrift Supervision and the charter for thrift banks, arguing it will hurt banks.

"It needlessly rips apart all the existing regulatory agencies, eliminates charter choices and creates a new agency with powers to mandate loans and services that go well beyond consumer protection," the ABA said.

Labor union Services Employees International Union Secretary-Treasurer Anna Burger said the proposal is a significant first step, however she said expects a big fight with the financial industry and its lobbyists as legislation is drafted on Capitol Hill.

"Despite this strong move by the White House, we must be on guard for a big fight with the financial industry and its lobbyists, who continue to try to dilute and nullify real financial reform," Burger said.

Opposition on Capitol Hill

GOP lawmakers are expected to criticize the proposal as too weak, while some Democratic lawmakers, including Sen. Byron Dorgan, D-N.D., will argue it isn't stringent enough.

GOP lawmakers last week released their regulatory reform proposal, which unlike the Obama measure, would not create a new process for unwinding systemically significant financial institutions.

Republican leadership in the House argue that regulators should rely on the bankruptcy process to unwind large systemically significant financial institutions. They argue that the system Obama proposes would ultimately encourage the use of government bailout dollars to help resolve insolvent mega-financial institutions.

"No nation can bailout, borrow itself out of prosperity," said Jeb Henserling, R-Texas.

Obama's proposal is likely to give one agency the authority to collect fees and possibly use taxpayer dollars to pay off creditors and counterparties of an insolvent mega-institution as an approach that would seek to quickly limit the collateral damage a collapsing mega-institution would have on the markets. However, GOP lawmakers argue that the fees would not be enough and the government would use taxpayer dollars to pay off creditors and counterparties of insolvent financial institutions, picking winners and losers.