Bloomberg Businessweek Friday July 16, 2010

Available on the iPad

Bloomberg

New Finance Rules Become Real With Emanuel Saying ‘Just Do It’

July 16, 2010, 12:03 AM EDT

July 16 (Bloomberg) -- Three days after U.S. lawmakers completed negotiations on the financial-overhaul bill last month, Rahm Emanuel called an emergency meeting of top administration officials in the White House’s Roosevelt Room.

The deal was unraveling as three Senate Republicans whose votes were needed for passage were balking at a $19 billion bank fee. Emanuel, President Barack Obama’s chief of staff, needed a new way to help pay for the legislation. Among the options offered by Treasury Secretary Timothy Geithner: wind down the bank-bailout fund Congress set up in 2008, to save billions of dollars and end a program unpopular with voters.

“I don’t want to hear anything else,” Emanuel said, according to people in the room. “That’s it. Just do it.”

The finance bill that’s awaiting Obama’s signature benefited from key elements lacking in the yearlong health-care debate. Among them: A more active White House role, and two Democratic lawmakers with a combined 65 years in Congress who steered the bill through with little Republican backing.

The effort was also boosted by public anger, stoked at a crucial moment by a government lawsuit against Goldman Sachs Group Inc., that overcame an industry lobbying blitz.

“Public opinion kicked big money’s ass,” said House Financial Services Committee Chairman Barney Frank, one of the two main legislative architects of the bill, along with Senate Banking Committee Chairman Christopher Dodd.

Toughest Rules

As a result, the toughest set of market rules in seven decades will soon become law, with Senate passage yesterday of the legislation. The package is in response to an economic crisis that pushed the banking industry to the brink of collapse, froze credit markets, and led to $700 billion in taxpayer bailouts to firms such as Citigroup Inc., Bank of America Corp. and American International Group Inc.

Goldman Sachs yesterday agreed to pay $550 million and change its business practices to settle U.S. regulatory claims that it misled investors in collateralized debt obligations linked to subprime mortgages.

The legislation mirrors a plan Obama proposed in June 2009, based on a 90-page white paper drawn up by White House and Treasury officials. It creates a consumer financial protection bureau with independent authority to write and enforce rules for banks, sets up a council of regulators to police companies, and establishes a mechanism to wind down failing firms whose collapse would roil markets.

White House Setbacks

In addition to finding an alternative to the bank fee, the administration helped salvage a proposal to strengthen oversight of derivatives, incorporate a plan to limit proprietary trading at banks, and defend the Federal Reserve against efforts to reduce its power, according to lawmakers, congressional aides and government officials.

The White House suffered setbacks, such as when auto dealers were exempted from consumer agency supervision.

“Nobody here is happy about that,” said Diana Farrell, deputy director of the White House National Economic Council.

Bankers and banking analysts also say the legislation won’t fundamentally reshape Wall Street’s biggest firms. Obama’s white paper grew to a 2,300-page bill packed with heavily lobbied provisions that industry leaders say might dilute the impact on their practices.

The overhaul won’t shrink banks deemed too big to fail, and it leaves largely intact a financial industry dominated by six banks with more than $9 trillion of combined assets.

Public Not Impressed

It does little to solve the danger posed by debt-financed lending and trading firms that rely on markets for funding, which can evaporate in a panic like the one that spread in late 2008. And rather than prohibit federally insured banks from trading derivatives or investing in hedge funds and private equity funds, the law just imposes limits on such activity.

Lenders including JPMorgan Chase & Co. and Citigroup will be required to move less than 10 percent of the derivatives in their deposit-taking banks to a broker-dealer division during the next two years.

The bill strengthens oversight on financial advisers to state and local governments in the municipal bond market. Still, it postpones any immediate challenge to a 1975 law that prevents the Securities and Exchange Commission from imposing corporate- disclosure rules on local government borrowers.

A Bloomberg National Poll shows most Americans harbor doubts that the new regulations will prevent a future crisis.

Expecting More

“Given the severity of the economic crisis caused by past regulatory failures, the public had the right to expect much more extensive reform,” Dean Baker, co-director of the Center for Economic and Policy Research in Washington, said yesterday in a statement.

The overhaul gives Obama an opportunity to make the case as November’s congressional elections approach that he took on an industry that brought the economy to the verge of collapse, aides said.

“Congress has now passed a Wall Street reform bill that will bring greater economic security to families and businesses across the country,” Obama said yesterday at the White House. He called it “reform that would never again put taxpayers on the hook for Wall Street’s mistakes.”

Other key players shaped the bill. Dodd, a Connecticut Democrat, singled out Federal Deposit Insurance Corp. Chairman Sheila Bair. Bair, who has clashed with the administration, pressed for new FDIC authority to liquidate “systemically important” financial firms and collaborated with Republican Senator Susan Collins of Maine on an amendment to require big banks to meet stricter capital standards.

Watching Basketball

“Sheila Bair has been very good all the way through,” Dodd said in a telephone interview.

At the staff level, Farrell and Deputy Treasury Secretary Neal Wolin were among the administration’s top negotiators, according to lawmakers.

Throughout the process, White House officials took a hands- on approach with lawmakers. As House and Senate negotiators went into conference last month, Emanuel, Dodd and aides met in Frank’s Capitol Hill office to set priorities for the talks, with game seven of the National Basketball Association finals airing on a flat screen TV in the background.

With the game still going on and the meeting over, Emanuel and Dodd headed to Tunnicliff’s Tavern nearby, where they watched the Los Angeles Lakers rally to defeat the Boston Celtics and win the title.

Central Role

It was Obama whose role was often central. On March 24, the day after he signed the core of the health-care overhaul, the president met at the White House with Dodd, Frank and other officials to determine how strongly Republicans would oppose the finance bill.

The legislation, which the House approved in December, had just emerged from the Senate Banking Committee without Republican support, and the policymakers were concerned they would have to make “all kinds of compromises,” Frank, a Massachusetts Democrat, said in a July 12 interview.

Obama, relaying a recent conversation with a Senate Republican leader, allayed those concerns, according to a person familiar with the discussion. While the Republican leader would oppose the Democrats’ efforts, he wouldn’t fight as hard as with health care to try to block it, Obama said, according to the person.

‘Bataan Death March’

Dodd reflected that newfound confidence after the meeting: “The outcome there, I think, has strengthened our hand in reaching out to people who would like to be part of the solution,” he told reporters.

In some ways, the hard-fought victory on health care made this debate less daunting, said White House senior adviser David Axelrod.

“Once you’ve gone through the Bataan Death March of health reform, every other fight seems a little less tumultuous,” said Axelrod.

The health-care campaign also made White House officials appreciate the need to forcefully respond to critics.

In April, Republicans attacked a Dodd proposal to create a $50 billion industry-supported fund the government would use to cover the cost of liquidating a failing financial firm whose collapse would threaten the economy. They said the fund would institutionalize bailouts by taxpayers -- echoing a central theme of a memo written by Republican pollster Frank Luntz earlier in the year to party members.

No Death Panels

Obama’s aides grew concerned the criticism would take hold. They recalled the previous summer, when some Republicans almost derailed the health-care legislation by accusing Democrats of wanting to set up “death panels” to ration care.

“If this false perception had caught on, it would have been damaging for the bill,” said Austan Goolsbee, a White House economic adviser. “We were not going to get death-paneled on this thing.”

To push back, Axelrod, White House Communications Director Dan Pfeiffer and Press Secretary Robert Gibbs started a media campaign, using Obama’s April 17 weekly radio address to focus on regulations and sending advisers, including National Economic Council Director Lawrence Summers, to the airwaves.

The timing coincided with the SEC’s April 16 announcement of the lawsuit accusing Goldman Sachs of fraud tied to CDOs. When news of the suit broke that day, Axelrod ran out of his West Wing office and down the hall to Pfeiffer’s desk to ask if anyone in the press operation was aware of the action. Nobody was, he said.

‘Shocking Development’

“It was really a shocking development for us,” Axelrod said.

Goldman Sachs’s settlement announced yesterday is the largest ever levied by the SEC against a Wall Street firm, the agency said in a statement. Under the deal, the firm acknowledged it made a “mistake” and that marketing materials for the debt instruments had “incomplete information,” the SEC said.

Democrats tried to capitalize on the momentum when the suit was announced. Obama gave a speech in New York on financial regulations. With Goldman

Sachs Chief Executive Officer Lloyd Blankfein in the audience, the president called on the industry to back his efforts.

"The president was instrumental in painting this as, 'if you vote against the bill, you're voting to coddle Wall Street,'" said Mark Calabria, a former Republican Senate Banking Committee aide who directs financial-regulation studies at the Cato Institute, a Washington-based libertarian research group.

Wearing on Republicans

The pressure began to wear on Republicans, who had been holding off Democrats' attempts to begin considering the bill on the Senate floor. In late April, Collins told her colleagues in a meeting that she couldn't keep voting against efforts to start debate, according to a Senate Republican aide.

That cleared the way for Dodd and banking panel counterpart Richard Shelby, an Alabama Republican, to reach a deal on May 5 to remove the fund from the bill, which allowed lawmakers to begin amending the legislation.

Legislators later agreed to add to the bill a variation of the resolution fund -- the $19 billion bank fee. Yet the fee also sparked objections from Republicans who had voted for an earlier Senate version of the bill: Senators Scott Brown of Massachusetts, Collins and Olympia Snowe, also of Maine. Their opposition forced Emanuel to call the June 28 meeting.

In a rare move, House-Senate negotiators, led by Frank and Dodd, met to reopen the talks on June 29 to remove the levy and add language ending the bank-bailout fund -- the Troubled Asset Relief Program -- an option that Treasury counselor Gene Sperling had joined Geithner in laying out for Emanuel the day before. The plan would also include raising the fee banks pay to support the deposit-insurance fund.

Consumer Protection

The administration played a hand in designing another element of the bill: the consumer protection bureau. The idea was the centerpiece of Obama's overhaul and had drawn fire from Republicans and the banking industry.

While the House had approved a stand-alone agency in its bill, Dodd succumbed to Republican pressure and placed it within the Fed. In a victory for Obama, Dodd preserved the agency's power to write its own rules.

Derivatives, contracts whose value is derived from stocks, bonds, loans, currencies and commodities, also assumed a central role in the debate after losing bets on swaps tied to mortgage- backed securities forced AIG close to bankruptcy.

As the Obama administration pushed for stronger rules on derivatives, a Democratic lawmaker sought even tougher ones, creating one of the biggest problems surrounding the bill.

Derivatives Language

Senator Blanche Lincoln, the Arkansas Democrat who heads the Agriculture Committee, sent an outline of her proposed bipartisan derivatives language to the Treasury on April 8, an administration official said. The measure was so strong that it threatened to hurt the bottom line of banks like JPMorgan by requiring that federally insured banks place their swaps-trading operations in subsidiaries.

Obama's aides hadn't been informed of the plan.

Lincoln's staff and the White House were stalemated, as Fed Chairman Ben S. Bernanke and Bair argued for the plan's removal. Gary Gensler, chairman of the Commodity Futures Trading Commission, who advocated for market deregulation in the 1990s and once worked at Goldman Sachs, sided with Lincoln.

In the end, the White House pressed Lincoln to meet with House Democrats, who were threatening to vote against the bill if the provision was kept. Minnesota Democrat Collin Peterson, head of the House Agriculture Committee, then announced a Treasury-crafted compromise. Lincoln reluctantly signed off.

Volcker Rule

One of the final issues hammered out last month was a measure that even administration officials initially said had little chance of surviving: the so-called Volcker rule in Dodd's bill, which banned proprietary trading at banks and restricted their investments in private-equity and hedge funds.

As the rule, named after former Federal Reserve Chairman Paul Volcker, was debated in the House-Senate conference, Dodd and Frank presented various options to the 82-year-old economist. While disappointed, Volcker ultimately endorsed the changes, which allow banks to invest up to 3 percent of their capital in private equity and hedge funds.

"Nobody ever thought we were going to get it," Emanuel said of the rule. "When we first introduced it, everybody said this would just be a symbolic gesture."

On June 25, the day Dodd and Frank completed an all-night session to finish merging the bill's two versions, Volcker sent them a letter saying the Dodd-Frank legislation was the modern- day Glass-Steagall Act, which separated commercial and investment banking before its repeal a decade ago.

--With assistance from Phil Mattingly in Washington and Christine Harper in New York. Editors: Mark McQuillan, Don Frederick

To contact the reporters on this story: Julianna Goldman in Washington at jgoldman6@bloomberg.net. Alison Vekshin in Washington at avekshin@bloomberg.net.

To contact the editor responsible for this story: Mark Silva at Msilva34@bloomberg.net.

Bloomberg