For Fed and Council, Two Is a Crowd

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Cheyenne Hopkins

How to oversee systemically important financial companies is one of the toughest questions facing policymakers trying to reform the regulatory regime.

The Obama administration has proposed concentrating this authority in the Federal Reserve Board, while Senate Banking Committee Chairman Chris Dodd wants to hand the job to a council of regulators.

House Financial Services Committee Chairman Barney Frank tried to find a middle ground and legislation the panel expects to pass next week would split the power: an interagency council would recommend standards for firms that pose a risk to the financial system, and the Fed would write and enforce them.

But that hybrid approach is being panned by critics who argue it sets up a confusing system that won't work. They said the bill does not lay out how the Fed and the council should interact or what happens if they don't agree.

"It's a mess," said William Isaac, chairman of LECG Global Financial Services and a former chairman of the Federal Deposit Insurance Corp. "It is very unclear who is going to do what. We have too much confusion now and this just makes more of it."

Under the Frank bill, the systemic-risk council, which includes the heads of the Fed, FDIC, Securities and Exchange Commission, Office of the Comptroller of the Currency and Commodity Futures Trading Commission, would be able to designate which companies are systemically important, make binding decisions to decide disputes among regulators on the council, offer recommendations on systemic risk and report to Congress periodically on the issue. Under an amendment passed last week, it would also have the power to break up institutions that it determines are a threat to the system.

But many observers said the council is still too weak, especially compared with the Fed.

Though it could make recommendations to the Fed on rules for systemic risk, it would still be up to the central bank to decide if it would adopt those rules, and how to do so.

One of the council's strongest powers appears to be its ability to decide which institutions are systemic.

Once that identification is made, however, the Fed would regulate the company and the council would have little power over any individual institution.

Many observers said the lines of power are not clear enough. While the council, for example, could break up an institution it considers a systemic risk, the Fed, too, could use its own authority to break apart a financial services company's proprietary trading unit if it poses a threat to the safety and soundness of the company or the stability of the country.

"It doesn't seem as though the Fed and the council have well-defined responsibilities," said Gil Schwartz, a partner at Schwartz & Ballen LLP and a former Fed lawyer. "It sounds like the Fed is supposed to take advice from the council and the council is supposed to take advice from the Fed. It sounds like a hodgepodge of responsibilities."

Observers also said the Fed would have the upper hand because it has a seat on the interagency council.

"The Fed is not just an implementer; it's a member of the council," said Doug Landy, a partner in Allen & Overy LLP and formerly a lawyer at the New York Fed.

If the council tried to stop a Fed action, "what's likely is the Fed would object, then the action would just stall," Landy said.

Kevin Jacques, Boynton D. Murch chair in finance at Baldwin-Wallace College and a former Treasury official, said that systemic-risk regulation would ultimately rest with the Fed.

"When you take the SEC, OCC, FDIC, CFTC and Fed in a room, the fact of the matter is the Fed is going to lead that discussion anyway," Jacques said. "When you bring the agencies together, the Fed is viewed as the most powerful and having the most intellectual firepower."

Jaret Seiberg, an analyst with Washington Research Group, a division of Concept Capital, said that unless the members of the council assert a clear role early on, it would be inefficient.

"Any time you create a council you have the risk of paralysis, so the entity that can fill the breach always has the advantage, and in this case that's the Federal Reserve," Seiberg said.

Because the council would be headed and staffed by the Treasury Department, the Fed would at a minimum share some systemic-risk responsibilities with the Treasury.

"If Treasury puts enough of its political strength and connections behind its representation on that committee, then you have the possibility of the Fed and Treasury working together, but then I don't know that you accomplish a whole lot by having the other regulators there," Jacques said. "They will be minor players at best."

The bill also does not outline what happens if the Fed and the other members of the council disagree.

"Who wins?" Isaac asked. "It appears the Fed, but it's not clear. If it is true, why not just state it? And then why have the other agencies? If you want to move to a single agency, then let's do it."

Some said the central bank is likely to tread lightly, and will not buck the council.

"Making recommendations to the Fed is a powerful tool," said Ernest Patrikis, a lawyer at White & Case LLP. "If you are the Fed and this group makes a recommendation to you, you are going to be hard put to ignore it. And if you do, you are to blame, so it's not just toothless."

But others said the Fed could go its own way.

"In terms of forcing conversations it has a value, but I don't think it's going to solve a lot of issues," said Mark Calabria, director of Financial Regulations Studies at the Cato Institute and a former Republican Senate Banking Committee staffer. "For one it doesn't have the power to solve a lot of issues. It's a value, but it's not a cure-all. If the Fed doesn't think it's an issue, the council can't push it. The council is going to have to rely on the moral suasions of its members."

Several observers suggested the House should pick a side rather than giving some power to both the Fed and some to the council. In the Senate, Dodd's bill would not give the Fed any systemic-risk authority, but would vest it all in an independent council (which would include the central bank among many other agencies.)

Isaac said the Dodd bill is a better solution because it clearly defines roles.

"I don't think you satisfy everyone," he said. "Let's just be clear what we are doing. That's what I like about the Dodd proposal. It's very clear what's going on."

Others agreed Congress should settle on one solution.

"Somebody is going to have to make a decision," said Oliver Ireland, a partner at Morrison & Foerster and a former Fed lawyer. "This particular combo is very confusing. This seems like it is going to create a lot of friction along the way."

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