Paulson plan begins battle over how to police market

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The Bush administration's plan to remodel the patchwork system of U.S. financial regulation, built piecemeal since the Civil War, is the biggest salvo in what will be a long-running debate about the role of government in financial markets.

In a sweeping proposal circulated over the weekend, Treasury Secretary Henry Paulson slaughtered a number of Washington's sacred cows, proposing to merge or eliminate institutions of long standing including the Securities and Exchange Commission, and to create a controversial new role of supercop for the Federal Reserve. Mr. Paulson will formally outline the plan -- originally undertaken last spring to streamline bureaucracy, not respond to the current credit crisis -- on Monday.

In an interview, Mr. Paulson said the regulatory system is broken, a growing sentiment in recent months in Washington as each of the nation's financial watchdogs failed in a different way to prevent the foreclosure crisis and credit-market turmoil from spreading. "We need regulation, but if we have it, it should be just structured in a way that it has some way of being more effective," he said. "Everywhere I look, I see the plumbing hasn't changed to meet the realities."

Little is likely to happen this year, amid the fierce presidential and congressional election races, even on fixes that Treasury has designated as short-term items. That means a new Congress and president will determine the ultimate shape of any regulatory overhaul.

But the battle lines were already forming over the weekend, and they stem from both ideology and turf.

The Bush administration has long been working on reducing regulation that, it argues, has hurt U.S. financial institutions in competition with overseas centers such as London and Hong Kong. The final plan is a sometimes uneasy balance of ideas: Some planks attempt to streamline the fundamental regulatory process, while others more directly address issues that regulators are now scrambling to contain, such as mortgage-risk problems and supervision of investment banks.

Congressional Democrats and others say the current crisis is the result of too little regulation, not too much. "It takes a certain chutzpah to say the appropriate response to a financial crisis is to loosen regulation," said Barbara Roper of the Consumer Federation of America, a consumer-advocacy group. "Wall Street [in the plan] generally looks to me like they didn't get hit with anything they don't want."

Bankers See Benefits

Reaction from financial firms was cautiously optimistic. "Anything that moves the current fragmented regulatory system forward to more coordinated structure is good," said Thomas Russo, chief legal officer and vice chairman at Lehman Brothers Holdings Inc. Bankers saw

benefits to be won in the possibility of lighter, more streamlined regulation. But they also worried that rules designed to make the financial system safer could cut into profits.

The attempted redrawing of the regulatory map already has sparked some fierce responses from the agencies involved. Even before the Treasury document became public Friday night, Office of Thrift Supervision Director John Reich, whose agency regulates federal savings and loans, or thrifts, sent a memo to employees Friday arguing this isn't the right time to consider revamping the rules. Under the plan, OTS would be merged out of existence.

It's not clear that the Fed, which could accumulate a lot of new powers, is fully in accord with the proposal. The central bank's greatest concern is that it gets its new responsibility for overseeing market stability with little explicit authority to enforce it.

Big crises, from the Panic of 1907 to the Great Depression to the 1987 stock-market crash, tend to give impetus to perennial efforts to reform U.S. financial oversight. The current system has developed over more than a century, and critics have long complained that too many agencies have overlapping jurisdictions and leave too many areas exposed.

The Hallmark

Even if only parts of the Treasury plan see the light of day, they could reshape how the government interacts with Wall Street banks, Main Street banks, insurance companies, hedge funds and other institutions that grease the wheels of the nation's economy. While the Fed would gain power, the Securities and Exchange Commission could lose some or even all of its authority. Regulators at the federal level would significantly increase their clout at the expense of state regulators.

The blueprint, whose drafting was led by Treasury Assistant Secretary David Nason, bears the hallmark of Mr. Paulson, a former co-chief executive of Goldman Sachs Group Inc. In the late 1990s and early 2000s while at Goldman, Mr. Paulson pushed hard to consolidate the disparate marketplaces and regulatory agencies that he felt hindered the firm's ability to operate efficiently.

Shortly after becoming Treasury Secretary in June 2006, he made it a priority to address the regulation and litigation he felt burdened the U.S. financial industry. In a speech that November, Mr. Paulson cited the decline in the U.S.'s share of global initial public offerings of stock as a reason to worry about the burden.

Mr. Paulson said the plan wouldn't necessarily prevent future financial crises. "I don't think any regulatory system is going to change that. I think we rely very, very heavily on market discipline. Having said that, I still think we need a system that is more efficient and gives us a better chance, gives us more tools to try to solve problems."

Rep. Barney Frank of Massachusetts, the Democrat who chairs the House Financial Services committee, said he found the plan encouraging. But he said that for the rest of this year, lawmakers need to devote all their energy to stabilizing the mortgage-market turmoil rather than determining broader fixes. "It's too close to an election and it's a very major thing," he said.

Indeed, one of the biggest risks of launching this plan now is that Mr. Paulson could stand accused of disrupting the work of the nation's regulators in the midst of a crisis. That's especially true of agencies in the midst of the financial mess -- such as the banking regulators -- which have already warned of a spike in insolvent institutions this year.

"It's probably a bad idea to spend too much time debating the organization of the fire department while the fire is still burning and no independent investigation of the cause of the fire has yet been completed," says former Clinton Treasury Secretary Lawrence Summers, who is now a managing director at hedge fund D.E. Shaw Group.

Widespread Consensus

There's widespread consensus that the current patchwork regulatory system doesn't work. One problem is that overlapping jurisdictions lead regulators to court the regulated. A year ago, for instance, at a Honolulu hotel, the heads of three federal regulatory agencies charged with guarding the soundness of America's banks addressed 3,000 community bankers and delivered this message: We're the ones you want regulating you.

"I'm not telling you anything you don't already know," the OTS's Mr. Reich told the conventioneers. "I just want you to know there's a federal bank regulator in Washington, D.C., who knows it too, and who wants to do everything possible to preserve the institution of community banking in this country." Each agency -- OTS, the Federal Deposit Insurance Corp. and the Comptroller of the Currency -- implied it would be more pleasant to deal with than the others on the stage.

"It's not a good idea to have people competing with each other, particularly if they're competing in laxity," says Hal S. Scott, professor of international financial systems at Harvard Law School.

One other problem: The regulatory system left important pockets largely unwatched, such as mortgage brokers who aren't part of regular banks. With narrowly focused agencies looking after discrete areas of the finance world, there were major lapses in coordination as financial market innovation outpaced regulators' ability to keep up.

Bank regulation has never been one of Washington's more glamorous topics and -- until recently -- rarely spilled into the broader public dialogue. The credit market turmoil changed that, with questions about the supervision of financial institutions overtaking the town, and even rivaling the war in Iraq as a hotly debated topic on the campaign trail.

Crisis Mentality

While policymakers are more likely to take action during a crisis, some economists caution that the crisis mentality itself can lead to rash decisions and costly mistakes. R. Glenn Hubbard, former chairman of President Bush's Council of Economic Advisers, says that's exactly what happened with the Sarbanes-Oxley law, which tightened standards over a host of ways companies operate, such as accounting. Adopted as a reaction to the Enron scandal and others,

the measure has had some positive effects, he says. But he doubts that lawmakers adequately considered the balance of costs and benefits.

Mr. Paulson's plan calls for changes in three distinct phases -- over the short, intermediate and long-term.

Among the short-term recommendations, he advocates the creation of a Mortgage Origination Commission, which would monitor the adequacy of each state's supervision of mortgage lending. He argues that this could give states the incentive to improve oversight, as investors would avoid securities backed by mortgages from poorly regulated areas.

Over the intermediate-term, the proposal recommends merging the SEC with the Commodity Futures Trading Commission, reflecting the blurred lines between securities and commodities. While the agencies cover very similar terrain, they also represent extremely territorial and powerful constituencies. Commissioner Bart Chilton of the CFTC is already cautioning against any hasty moves.

"I think most Americans would prefer that government do our jobs and that means doing everything possible to cauterize the subprime mess before performing major surgery on a regulatory system, parts of which are still very healthy," he said.

Over the long term, Mr. Paulson advocates a new, and instantly controversial, role for the Federal Reserve. Mr. Paulson sees the central bank eventually taking on the role of a "market stability" sheriff. This would move the Fed away from direct bank supervision, something the central bank has always argued is vitally important. A new entity would take that over. Instead, the Fed would use a broad authority to monitor any company or any business line that could destabilize financial markets.

"They would have broad powers so they could go anywhere in the system they needed to go," Mr. Paulson said. That would detract from the SEC, which is supposed to perform part of that role today. Indeed, in the Treasury's dream scenario, the SEC is effectively eliminated and its responsibilities divided up between a series of new agencies.

A roving oversight role could ultimately leave the Fed as sole supervisor of nothing while being potentially liable for everything. Fed officials are in a delicate position over the plan. They do not want to explicitly endorse a report with which they have some important misgivings. They have argued they needed the authority, if they found a firm or firms acting in a way that endangered the system, to take firm measures to correct it, such as imposing a capital surcharge. The report does not explicitly give the Fed that power, but it does give it the power to take "corrective actions" in consultation with the other regulators.

But the Fed didn't want to break ranks with Treasury. The united front the two have maintained in the recent crisis -- such as the bailout of Bear Stearns Cos. -- has been important to restoring confidence in financial markets, officials feel. Like other agencies, the Fed also sees little point in getting into a fight over a blueprint that is unlikely to be implemented any time soon, if at all.

Mr. Summers, the former Treasury Secretary, says the Fed in any case might not be up to the task. "It's not realistic to think that career civil servants are going to foresee bubbles that are about to burst in ways that are better than those who have their large fortunes on the line," he said.

Another fundamental change is Treasury's recommendation of a federal charter for insurance companies. Unlike in banking, where companies can choose between a state and national charter, insurance companies have been regulated by states. That means big companies have to comply with many different supervisors, something the industry has complained about for years.

"A state-based regulatory system creates increasing tensions in such a global marketplace, both in the ability of U.S. based firms to compete abroad and in allowing greater participation of foreign firms in U.S. markets," Treasury said in a document summarizing its proposal.

The proposed creation of a federal regulator will spark howls of protest from state officials and also from smaller insurance companies who prefer to be supervised locally. It also represents a dramatic power grab by the federal government.

"The Treasury Department has not recognized the fact that the current insurance regulatory system has functioned effectively to protect consumers and the safety and soundness of the industry," said Bob Rusbuldt, president and CEO of the Independent Insurance Agents & Brokers of America, a trade group.

Whether Treasury's plan would have addressed the causes of the current mess isn't clear. In the mortgage arena, the blueprint calls for better coordination among the multitude of federal and state agencies that oversee home-mortgage lending. But there would still be no single agency in charge.

States' Role

With regulation split between the feds and the states, some local regulators were able to crack down on abuses. But enforcement was inconsistent because the divisions of responsibility were rarely clear.

There is very little chance that Mr. Paulson's most ambitious plans will be fully debated -- much less enacted -- during President Bush's final months in office. However, the secretary hopes it will form the basis of discussions in the next administration, regardless of who controls the White House. "With very few exceptions, most of this blueprint should not and will not be implemented until after the present market difficulties are past..." Mr. Paulson said. "But we've got a chance of getting people to look at it more broadly now. In that way, I think the timing is great."