

Will it fly?

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Hank Paulson kicks off what promises to be a long and bruising debate about how best to police America's financial firms

BIRD-WATCHING is high on the list of Hank Paulson's leisure pursuits. This week America's Treasury Secretary made it quite clear which avian creature his country's system of financial regulation most resembled: the albatross. His "blueprint" for change, presented on March 31st, is the boldest attempt to overhaul the rulebook since the Depression, when much of it was written. Most of the proposals are long-term, and will thus be pulled around by the next administration and Congress. But the plan marks an important first step in a much-needed facelift for an outdated regime. "He's teed it up in a way that can't be ignored," says James Lockhart, director of the Office of Federal Housing Enterprise Oversight, which regulates America's quasi-official mortgage giants, Fannie Mae and Freddie Mac.

Though the proposals are entwined with the credit crisis, they predate it: the original impetus, a year ago, was fear over America's waning capital-markets competitiveness. The finished product is thus an odd mix of streamlining and tougher regulation, such as a new oversight body for mortgage markets. The timing struck some as odd too, but the Treasury says it wants to provoke debate, not distract from market woes. The report may also have been timed to head off what one official calls "very silly" new banking rules threatening to emanate from Congress.

Political pressure had been growing to revamp regulation, after bank supervisors were deemed to have been asleep at the switch as the credit bubble inflated. Mr Paulson's motivation was broader: he has long argued, correctly, that the present set-up is Balkanised and inefficient. None of the half-dozen federal regulators, which sit atop hundreds of state rulemakers, sees the whole map. Supervision has not always been divided up for the best reasons: the Securities and Exchange Commission (SEC), for instance, won oversight of big investment banks four years ago, not because it was best placed to do so, but as part of a compromise following legal changes in Europe.

The Treasury plan envisages several phases of reform. Short-term goals include the expansion of the President's Working Group (PWG), now a club for only select large regulators, and the creation of a federal Mortgage Origination Commission. This would consolidate oversight of a process that has wreaked havoc on balance sheets. It is also seen as a partial solution to the problem of dodgy securitisation, as the commission would grade the underwriting of loans going into pools. Critics point out, however, that it would create another layer of bureaucracy, since regulation of mortgage brokers and many lenders would stay with the states.

In the long run, say between two to eight years, Mr Paulson hopes to see a new regulatory architecture, with today's hotch-potch folded into three "objectives-based" agencies that some see as similar to the Australian system. That means a remodelled Federal Reserve with an eye on overall market stability; a prudential regulator for banks and thrifts, which would mean the

demise of the Office of Thrift Supervision (OTS); and a business-conduct agency, taking in much of the SEC's oversight of disclosure and the like.

The eagle-eyed Fed (and its blind spot)

The first of these is the most important—and most controversial. Though the Fed would lose long-cherished supervisory authority over big banks such as Citigroup and JPMorgan Chase, its overall power would be greatly expanded. The role, which the Fed rehearsed with its rescue of Bear Stearns, would allow it to hunt anywhere for systemic risk, including among the entangled roots of hedge funds and investment banks.

Some at the Fed worry this may be a poisoned chalice. Spotting crises in advance is not easy—witness the central bank's own failure to ring alarm bells as house prices soared. One pundit, inspired by scandals in New York politics, likens its proposed role to “putting Eliot Spitzer in charge of a morals division”.

Now that the Fed has extended emergency funding to investment banks, they can expect tougher regulation. But the Treasury plan stops short of proposing that this arrangement be made permanent. As for the new regulation, it calls for further consideration by the PWG, which is taking a lead in a host of other areas, including reform of credit ratings and the derivatives-trading infrastructure.

Nor does the plan deal with regulation of Fannie and Freddie, where vast portfolios of mortgage-backed securities have soured, leaving them short of capital. However, Mr Paulson can reasonably argue that this crucial issue is already close to resolution. A bill to strengthen oversight of the two unwieldy enterprises has passed through the House and should soon be heard in the Senate.

You may think a plan this sweeping would be welcomed at a time when the old order had been found so wanting. But, this being an election year, and regulation being as emotive as it is arcane in America, it is being attacked from all sides. No wonder Mr Paulson talks of an “almighty battle” ahead.

Some on the right think it is not radical enough. The Treasury resisted the temptation to propose a single super-regulator along the lines of Britain's Financial Services Authority, leaving itself open to criticism that turf wars will persist. Admirers of the FSA's broad, principles-based approach to regulation contrast it with the lawyer-stuffed SEC, which values strongly enforced rules over guidelines. But the Northern Rock fiasco has tarnished the British agency's image. Moreover, regulatory competition is not always bad, says Allan Meltzer of Carnegie Mellon University. The Fed has been coaxed forward by more proactive agencies many times over the years, for instance.

Those on the left, meanwhile, attack the plan on two fronts. They complain that it does little to alleviate the crisis—even though that was not the intention—or to tighten the rules. Christopher Dodd, head of the Senate's banking committee, dismissed the reforms as “a wild pitch...not even close to the strike zone.” Others gripe that it is too kind to Wall Street: Mr Paulson, a former

head of Goldman Sachs, included its biggest firms in the crafting of the plan. Not so, say the investment banks, which could well face higher capital requirements to redress their follies.

Super-regulated out of existence

Then there are the regulators and constituencies who fear losing out. The plan to merge the OTS out of existence prompted its head, John Reich, to write to employees declaring his opposition—though Christopher Cox, head of the SEC, which faces the same fate, has reacted more equivocally. State insurance regulators, which would be scrapped in favour of a federal regulator within the Treasury, are hopping mad. Small financial firms, such as credit unions and community banks, are none too pleased either, fearing that their voices will be drowned out under the new prudential regulator. Associations such as the Independent Community Bankers of America pack plenty of lobbying clout and could cause mischief.

One form of attack will be to point out that we have been here before: a number of the reforms, including both the federal-insurance charter and the dissolution of the OTS, have been discussed and rejected over the years. Reducing the power of the states could also prove incendiary. During the last boom, state regulators alerted the Fed to shenanigans in the subprime-mortgage market but were rebuffed.

Pro-regulation critics say Mr Paulson is cheekily trying to push through a largely deregulating package in disguise. He rejects such “simplistic bumper stickers”. The problem is not too much or too little regulation, he says, but the clumsiness of the system's design, which means rules are not applied effectively. With industry regulators obsessed with patrolling their own turf, for instance, important bits of the market have been missed at the edges. Think of mortgage brokers.

Still, the political mood increasingly favours more regulation, and many expect the reforms to be tugged in that direction. Hal Scott of Harvard Law School, director of an independent commission on capital-markets regulation, fears a repeat of Sarbanes-Oxley, the corporate-governance act rushed through in the wake of the Enron and WorldCom collapses, amid a similar “something must be done” atmosphere. Parts of that law put an intolerable burden on auditors and managers. They have since been pared back.

Frank Partnoy of the University of San Diego notes that Washington has a tendency to produce rules in fits and starts, especially after crises, and that these “often grow into monsters”. This is not a purely American thing, to be sure. The governments of Britain, Germany and others hard hit by the credit crisis are pushing for an urgent overhaul of banking regulations. However, the Financial Stability Forum, a group of global regulators which is due to issue a report to the G7 finance ministers on April 11th, is mindful that regulating too zealously does more harm than good.

Indeed, no regulatory regime is perfect. However sensible the rules, the market is always a step ahead of those who police it. As Mr Paulson concedes, better regulation is no guarantee against blow-ups “every five or ten years”. At which point, there will be a new clamour for change.