

Paulson's Financial Reform Plan Gets Mixed Response

By David J. Lynch, Sue Kirchhoff and Adam Shell

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USA Today – The Federal Reserve's role in monitoring the health of financial institutions would dramatically expand under a plan the Bush administration unveiled Monday to overhaul regulatory oversight.

The plan — which critics said was sure to be modified by Congress — capped a year-long process that began with a desire to help U.S. financial players compete globally by streamlining their oversight and ended amid fear of a meltdown fed by lax regulation.

Treasury Secretary Henry Paulson, who unveiled the 218-page blueprint for reform, acknowledged that the far-reaching proposal represents just the start of a long political process.

He also fired back at critics who complained that the plan would do nothing to address regulatory failures that led to the current crisis.

"The overhaul of our financial and regulatory system is inevitable," Paulson said in an interview with USA TODAY. "This is going to take time — a lot of time — but we have a responsibility to begin this discussion now."

The Treasury Department plan, the product of consultations with financial market participants, academics and former government officials, takes aim at what it calls an outdated regulatory structure that financial innovation has left behind.

The blueprint would:

- Replace a welter of federal agencies with three main regulators charged with ensuring stable markets, safeguarding federally guaranteed institutions such as banks and protecting consumers.
- Introduce federal regulation of the insurance industry with the creation of an optional federal charter to supplement the state-level system that's been in place for 135 years.
- Create a Mortgage Origination Commission to pass judgment on state oversight of the mortgage industry.
- Merge agencies that oversee securities and futures trading — the biggest change for the Securities and Exchange Commission since its creation in 1934.

On Capitol Hill, Paulson's proposal drew a cool reception from the majority Democrats.

Even those who welcomed it said they don't see it passing in an election year.

Rep. Barney Frank, D-Mass., who chairs the House Financial Services Committee, called it "a constructive step forward (in) a profound national discussion that cannot be concluded in the months before the election."

Senate Majority Leader Harry Reid, D-Nev., and Senate Banking Committee Chairman Chris Dodd, D-Conn., told reporters that they are focused on passing a bill to address the rising number of home foreclosures, a crisis that the administration's proposal would not address.

That bill, which Republican lawmakers are blocking, would let bankruptcy judges rewrite the terms of mortgages.

"I would call this the wild pitch," Dodd said of the Bush administration plan in a conference call with reporters. "It's not even close to the strike zone. ... Clearly, this has nothing to do with the current problems we're facing."

The verdict was harsher on the presidential campaign trail, where Sens. Hillary Rodham Clinton, D-N.Y., and Barack Obama, D-Ill., both took shots at the administration's game plan.

In a statement, Clinton derided the blueprint, saying it "comes late and falls short."

Even as he introduced the sweeping proposal, Paulson took pains to stress that it had been in the works for a year and was not a response to the current financial crisis.

Asked how much the plan had been affected by the recent turmoil in credit markets, he replied, "Not much."

The Treasury secretary, a former CEO of investment bank Goldman Sachs, suggested that the economy is destined to tumble into a crisis "every five to 10 years," no matter what regulatory structure is adopted.

Still, if enacted, the administration's proposal would drastically reshape the way Washington controls several major elements of the U.S. economy.

Here's a look at the plan's likely impact if it were adopted:

Federal Reserve: Central bank gains power, responsibility

The greatest impact would be felt at the marbled headquarters of the nation's central bank, where the Federal Reserve would gain broad new responsibility for preventing financial problems from developing into crises. Along with its traditional role of promoting economic stability, the Fed would acquire new power to review the books of investment banks, hedge funds, commodity trading institutions and other firms.

It's unclear, though, whether the central bank would continue its role of overseeing national bank holding companies, or whether that power would be shifted to a new federal bank regulator. And critics questioned whether the central bank would gain enough new authority to match its new responsibilities.

"They give (the Fed) everything they need but only limit it to periods when we're in big trouble," complains former Fed governor Lyle Gramley. "There's a lot of clarification that needs to be done."

Paulson insisted, though, that the Fed would have sufficient power to act as needed. A onetime Dartmouth College football standout, Paulson likened the central bank's new role to that of a "free safety," roaming the field.

Others, including Senate Banking Committee Chairman Dodd, say the Fed helped sow the seeds of the current crisis by being slow to recognize problems in the housing sector and too reluctant to use its existing authority to clamp down on unsafe practices.

Augustine Faucher of Economy.com said it's unclear whether the Fed, or anyone, can detect latent threats in financial markets. "Presumably, the firms themselves have the greatest knowledge of the risks they undertake," Faucher wrote in a research note. "Yet during this crisis, the players clearly misjudged the risks in mortgage-related holdings. Could the Fed be expected to do better?"

Insurance industry: States could lose power to regulate

In the insurance arena, the blueprint recommends revising the historic state-by-state regulatory network by giving insurance companies the option of seeking a federal charter and Washington oversight. Long sought by the insurance industry, the proposal mirrors an option already available to banks.

The plan calls for creating an Office of National Insurance, led by a federal commissioner, within the Treasury Department. That agency would be subject to congressional oversight.

Such sweeping changes would likely involve lengthy Washington debate. But the Treasury blueprint says some issues, such as international regulatory agreements, need immediate action. It says the nation should have an easily identified "lead negotiator in the promotion of international insurance policy."

Insurers hailed the plan, while state regulators and consumer advocates argued that it would reduce protection for policyholders. Marc Racicot, president of the American Insurance Association and a former Republican national chairman, said the current state-by-state approval of some insurance products can take more than two years, compared with less than two months for similar offerings from competing industries.

Those lengthy reviews also increase costs, which are passed on to consumers, Racicot argues. A 2007 study conducted for the American Council of Life Insurers concluded that switching to a single regulator could save \$5.7 billion in annual life insurance costs. Consumers would benefit with lower premiums, said Frank Keating, the former Oklahoma governor who heads the council.

But Sandy Praeger of the National Association of Insurance Commissioners said, "We want to get products into the marketplace quickly, but we also believe scrutiny of those products is important."

Banks: Oversight spread among 3 regulators

The Treasury Department's blueprint would revamp a banking system under which a patchwork of five federal regulators, along with state agencies, supervise depository institutions.

Overall, it's a "step forward," says Richard Sylla, a financial historian at New York University's business school, but it doesn't "add a lot of regulatory teeth" to overseeing the commercial banking industry.

Investment banks would face tighter regulation, which could bring benefits and drawbacks. "The reason this is good for them is that, in a sense, this will constrain future crises," says David Beim, a professor at Columbia University's business school. "But the cost is some constraint on how they do business."

One regulator, the Federal Reserve, would be charged with ensuring market stability. Another federal regulator would be charged with consumer protection. A third would oversee the safety and soundness of all institutions that are covered by federal deposit insurance.

Now, banks can seek to be primarily regulated by state or federal regulators, depending partly on the charter they seek. A long-term goal of the Treasury plan is to require all institutions covered by deposit insurance to have federal charters and, thus, federal regulation.

Consumer groups say they fear the plan would end states' enforcement authority over insurance, securities and other financial products, while offering little guarantee of strong consumer protection at the federal level. The plan, says Barbara Roper of the Consumer Federation of America, has "kernels of good ideas surrounded by a lot of bad ideas."

"If you just create a new agency flow chart, and you don't address the underlying cause of regulatory failure, you're not doing anything meaningful to benefit consumers," Roper says.

Mortgages: Agency would focus on predatory lending

A linchpin of the plan is the creation of a federal Mortgage Origination Commission, a powerful and first-of-a-kind entity whose purpose, in part, would be to prevent predatory lending or deceptive disclosure to home buyers.

The commission would be made up of a director appointed by the president and representatives from the states and federal banking regulators.

It would have broad authority to evaluate each state's handling of standards for mortgage brokers. The goal: to avoid problems such as the granting of toxic subprime mortgages that originated from state-regulated firms.

Still, the proposal could pose troubling implications for home buyers, warns Houman Shadab, senior research fellow at the Mercatus Center at George Mason University.

States now set their own standards for mortgage brokers, a duty the proposal would hand to the feds.

If those standards become overly restrictive, Shadab says, they could eliminate some good brokers along with the bad ones.

Richard Smith, CEO of Realogy, parent company of Century 21, Coldwell Banker, ERA and Sotheby's International Realty, argues that the government needs to address other mortgage-related problems. Among them: the widespread availability, in the run-up to the current crisis, of "liar loans," which let consumers obtain loans without demonstrating sufficient income needed to repay them.

Some economists say the proposal may sound good at first blush, but there are still a host of unanswered questions.

Home buyers, for example, often sign mortgages without a clear understanding of how much they are borrowing and how their payments could rise over time, notes Joel Naroff of Naroff Economic Advisors.

Wall Street: Experts see changes as demotion for SEC

On Wall Street, the Treasury secretary's initiative was generally viewed as a necessary step to restore investor confidence.

"The financial services industry had a chance to police themselves, and instead they threw caution to the wind," says Gary Kaltbaum, president of Kaltbaum & Associates. "Wall Street shirked all their responsibilities because of greed for the past three years. And, in my opinion, the regulators have been missing in action."

With the blueprint granting greater powers to the nation's central bank, Wall Street's current top cop, the Securities and Exchange Commission, would face a demotion.

Paulson has proposed that the SEC be combined with the Commodity Futures Trading Commission. Experts say they expect that its enforcement duties would be marginalized. **"This is definitely a demotion for the SEC," says Mark Maddox, a securities lawyer at Maddox Hargett & Caruso and former Indiana securities commissioner. "There is a new bigger watchdog on the beat: the Fed."**

But Anthony Sabino, a business professor at St. John's University, says the Fed's expanded role would be a negative for investors. "If you take the SEC's power away, Wall Street will become the Wild, Wild West," he said.

Under the new proposals, the Fed would gain greater freedom to inspect the books of investment banks, hedge funds and private-equity funds. That doesn't necessarily mean more red tape for Wall Street's finest, says Daniel Clifton, head of policy research at Strategas Research Partners.

"Paulson is trying to seek a balance by streamlining regulation, while also designating areas of the market that need to be regulated more," Clifton says. "It is not necessarily more regulation. It is more sensible regulation."

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