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## Obama's Financial Plan, Round One

The combatants are set to battle over Obama's proposals for the Fed, how to regulate products like mortgages and credit cards, and much more

By Theo Francis and Jane Sasseen

Let the battles begin.

Now that President Barack Obama has unveiled his sweeping proposal to remake financial regulation in the U.S., attorneys and lobbyists for nearly every facet of the financial-services industry are poring over it, determining where to fold, where to compromise—and where to fight tooth and nail.

They've got plenty to choose from. In his brief White House address—which was accompanied by a detailed 88-page white paper outlining the changes he would make—the President made clear the ambitious scope of his agenda.

"That's our goal—to restore markets in which we reward hard work and responsibility and innovation, not recklessness and greed; in which honest, vigorous competition...in the system is prized, and those who game the system are thwarted," Obama said on June 17 to an East Room crowd of dozens of top regulators and congressional leaders, along with representatives from business, labor, and consumer groups. "With the reforms we're proposing today, we seek to put in place rules that will allow our markets to promote innovation while discouraging abuse."

### BUSINESS'S CONCERNS

Sounds good in theory, and few would disagree with those aims. In fact, few did. Financial-services representatives and other business groups were quick to laud the broad ideas the President laid out, even as they lambasted the details they didn't like.

"While the Administration has made several positive recommendations, we're concerned that overall the proposal simply adds to the layering of the system without addressing the underlying and fundamental problems," said David Hirschmann, president and CEO of the U.S. Chamber of Commerce's Center for Capital Markets. "We can't simply insert new regulatory agencies and hope that we've covered our bases."

No surprise there: Should the Administration succeed in pushing its plans through Congress, profits and growth could be significantly diminished throughout much of the financial sector, as could financing for other industries.

The debate now moves to Capitol Hill, where it is likely to continue through yearend, if not longer. Of course, as trade groups and lobbyists target elements large and small, they won't be working in a vacuum. Public anger over the financial crisis and bailouts, along with a Congress that largely shares the Administration's goals, leave them facing an uphill struggle in many cases. Consumer advocates and other groups are also gearing up for the fight: On June 16, some 200 organizations that support most of Obama's financial agenda threw their collective weight into a newly created organization, Americans for Financial Reform.

"Business had it the way they wanted it for a very long time—little or no regulation, the ability to offer a lot of funny-money products that didn't necessarily help consumers but made the companies a lot of money," says John Taylor, chief executive of the National Community Reinvestment Coalition, which advocates for lower-income households.

"Now let's try it the way the rest of the world does it—you actually have a free market and consumer protections that bring the rule of law into the marketplace."

### "SEASON OF REGULATION"

With so many interests—and so much money—at stake, the fight will be neither short nor sweet. Longtime Democratic political strategist Bob Shrum, now a senior fellow at New York University's Wagner School of Public Service, predicts a three- to five-year "season of regulation" for financial firms similar to President Franklin Delano Roosevelt's push for workplace and securities-market reforms from 1935 to 1938. While any delay in the enactment of Obama's proposals probably falls in the favor of business, Shrum warns that financial companies could pay a price if they simply try to stonewall.

"Business has a lot of capacity to influence this as the process will move along—already has influenced it, and will influence it more in Congress," Shrum told a gathering of financial-company representatives Wednesday morning. "In this environment, I think the risk of not being at the table is very high."

So which issues are likely to be the most contentious? Here are four:

## **CONSUMER PROTECTION**

Perhaps the boldest stroke is the Administration's call for a new Consumer Financial Protection Agency. The new entity would take over the regulation of credit, debit, and gift cards and mortgages, as well as such things as the oversight of overdraft protection on bank accounts. The goal: to improve and simplify disclosure so that consumers don't end up trapped in products with high prices or hidden fees they didn't properly understand.

The Administration aims to use such a shift to push the industry to create more standardized versions of loans and other products that would allow consumers to comparison-shop more easily.

Supporters argue that the result will be more than a safer financial marketplace for consumers—it will be a safer financial system, period. They trace the roots of the financial crisis to failed consumer protection and a system that allowed mortgage brokers to sell toxic loans to homeowners who were already dealing with too much credit-card debt and deceptive bank fees.

"This crisis started with one household at a time; one lousy mortgage at a time," says Elizabeth Warren, the Harvard University law professor who is chairwoman of a congressional panel supervising the federal financial bailout. She first proposed the new consumer agency.

Eliminate many of those bad loans and the risks they entail on the front end of the mortgage chain, she told *BusinessWeek*, "and that gives you the capacity to deal with systemic risk at the back end."

The new agency—which many believe Warren would head if the proposal makes it through Congress—is the one element of the plan almost universally loathed by financial interests. They argue that the simplified products would make it tougher for financial firms to specialize or differentiate themselves, as consumers would gravitate toward offerings seen to have a government seal of approval. "Everything would be compared to the government's basic product," says Don Ogilvie, independent chairman of Deloitte & Touche USA's Center for Banking Solutions.

Others worry that the unbridled power of the proposed new agency could stifle innovation in financial products—many of which, for all the recent problems, have been good for consumers and economic growth alike. "Far more really good products were developed over the past couple decades than bad," says Jared Seiberg, a financial policy analyst for the Washington Research Group. He adds that if too much is done to make a loan safe, it may no longer be profitable for financial companies to offer.

"There's no such thing as a 100% safe loan, and thank God. If there was, very few people would get credit. And the fewer loans made, the less the economy would grow."

## **SECURITIZATION**

Obama's proposals would also require companies that originate and securitize mortgages and other assets to retain a 5% stake.

That idea parallels a proposal made earlier by House Financial Services Committee Chairman Barney Frank (D-Mass.). Some are pushing for requiring a bigger stake—including George Soros, who in a *Financial Times* op-ed on Wednesday called for a 10% "minimum requirement."

The goal is to rein in the "originate to distribute" business model, under which thinly capitalized firms would write home loans and then immediately package and resell them, using the proceeds to write new loans. Critics say the fat profits and limited risks the model created gave originators a huge incentive to push borrowers to take on too much debt or to lend too much to people with lousy credit, since they didn't suffer any consequences if the borrowers eventually defaulted.

By forcing originators and distributors to keep "skin in the game," the President is aiming to permanently alter that skewed incentive. "It's a game-changer," says Brian Gardner, a policy analyst for Keefe Bruyette & Woods (KBW), a brokerage firm specializing in the financial sector. But while the originate-to-distribute model is credited with laying the groundwork for the current crisis, hanging on to an equity stake doesn't necessarily help. Gardner notes that one reason many thrifts failed during the savings and loan crisis in the

1980s and 1990s was precisely because they made bad loans and held onto them.

The Administration's proposed rule would create an exception for fixed-rate mortgages that meet certain conditions run-of-the-mill 30-year loans, essentially. But WRG's Seiberg warns that alone could dry up financing for variable-rate loans and other alternative mortgages.

## **SYSTEMIC RISK AND THE FED**

Then there's the big kahuna: the Administration's proposed plan to anoint the Federal Reserve as its new systemic-risk regulator.

The shift would vest enormous new powers in the Fed, though it would be backed by a council of other regulators, chaired by the Treasury. Here, the fight may wind up being between banking industry players that have grown to appreciate the Fed's familiarity with their issues and lawmakers with a deep-seated distrust of an independent agency over which they have no control.

Even as it has been integral in managing the government's financial-crisis response, the Fed has taken some knocks from both Democratic and Republican lawmakers in recent months. Some of them distrust the New York Federal Reserve Bank's cozy relationship with major financial institutions (which pick most of its board). Moreover, critics—including the powerful head of the Senate Banking Committee, Christopher Dodd (D-Conn.)—argue that the Fed has done a poor job balancing monetary policy and bank regulation, with the latter getting short shrift. Moreover, some worry that the Fed lacks the expertise it will need to supervise not only commercial banks, but the investment banks that came under its wing last fall, big hedge funds, private equity funds, and other financial institutions.

"Does the Fed have the right kind of experience to regulate that kind of entity?" asks Harry Rowen, president of Starmont Asset Management in San Ramon, Calif., who worked on Capitol Hill in the 1970s and served as a Securities & Exchange Commission attorney.

Whatever the criticisms, however, the Administration is likely to prevail, if only because there are few options for overseeing the economy and the financial system as a whole. Policymakers are skeptical that the other leading possibility—vesting the power in a collective of regulators—would work, given the diffusion of responsibility. "We looked at a range of alternatives very carefully," says

Treasury Secretary Timothy Geithner. "I do not believe there is a plausible alternative."

Adds Larry Summers, head of the President's National Economic Council: "Experience in financial regulation, in government, and in life more generally suggest that collective responsibility is too often no responsibility." In return for the new powers, however, the Fed would give up some of its independence. Under Obama's proposal, for example, the Treasury would get some oversight of the Fed's emergency lending actions. To win backing from Dodd and other skeptics in Congress, other compromises may prove necessary. "As the Fed grows in power," Gardner adds, other counterbalancing will take place to keep it "in check."

## **DERIVATIVES**

Another, perhaps less-public, fight is likely to take place over how to rein in the excesses of the once-lucrative derivatives market.

While it's less likely to engage the interest of Congress, the outcome has huge implications for restoring the safety of the financial markets.

One of the fundamental failings that the crisis has revealed over the past year is the dangers inherent in the enormous, virtually unregulated markets for credit default swaps and other derivatives. AIG (AIG) alone has soaked up more than \$100 billion in taxpayer investment and Federal Reserve guarantees because it lacked the capital to back up its failed bets in that market.

And its position is hardly unique. Billions in derivatives trades are scattered over the books of U.S. firms, but those trades don't go through any central clearinghouse or exchange. That means no federal regulator—not to mention the average counterparty on the other side of a given trade—has a strong grasp of how much risk exists or what money could be lost if trades go bad. Nor do derivatives traders face consistent capital standards requiring them to ensure that they have the funds to back up their bets.

The Administration has proposed imposing new capital and margin standards on all derivatives; those with more risk might have to set aside more capital, for example. In doing so, policymakers want to bring down the excessive

leverage that has made the derivatives market so dangerous. They also want to ensure that most derivatives begin to trade openly under new regulatory scrutiny. By requiring more disclosure—and backing it up with an audit trail to police suspicious trades—regulators would gain much greater ability to monitor and manage risk. "We need to bring everything, all such products, into more transparent exchanges where trades will be seen by regulators," says Gary Gensler, the head of the Commodity Futures Trading Commission, which regulates derivatives.

Such shifts could cut sharply into traders' fortunes, however. An industry long used to secrecy is expected to fight to keep much of that profitable opacity intact, though financial-industry officials and lobbyists say they are open to reforms generally.

There's another potential problem: Derivatives are commonly broken into standardized products, which are much the same no matter who holds them and could be traded in a like manner through a clearinghouse, and nonstandard deals, which tend to be complex trades designed to hedge a specific risk for an individual trader. Gensler says that by raising capital standards and forcing disclosure, the new regulations would provide strong oversight even for such individualized deals.

**But some market participants are skeptical. Those one-off derivatives are a huge source of profits. "There will be push-back on the derivatives side if [the Administration] actually starts to go at customized credit default swaps," says Daniel Alpert, managing director of Westwood Capital. They will also be hugely difficult to regulate. "When you start looking at individual CDSs, it would take an army to parse the terms and conditions," says Alpert. His worry? That the Administration "will move aggressively to get standardized stuff traded through clearinghouses, declare victory, and move on." If traders are able to do lucrative customized deals with less scrutiny, that's where many of the trades will flow, he says.**

And if that happens, many of the risks now embedded in the derivatives market will remain, 88-page white paper or not.