RSC Republican Study Committee
Financial Services Working Group
Congressman Scott Garrett (R-NJ), Chairman
Congressman Tom Price (R-GA), RSC Chairman

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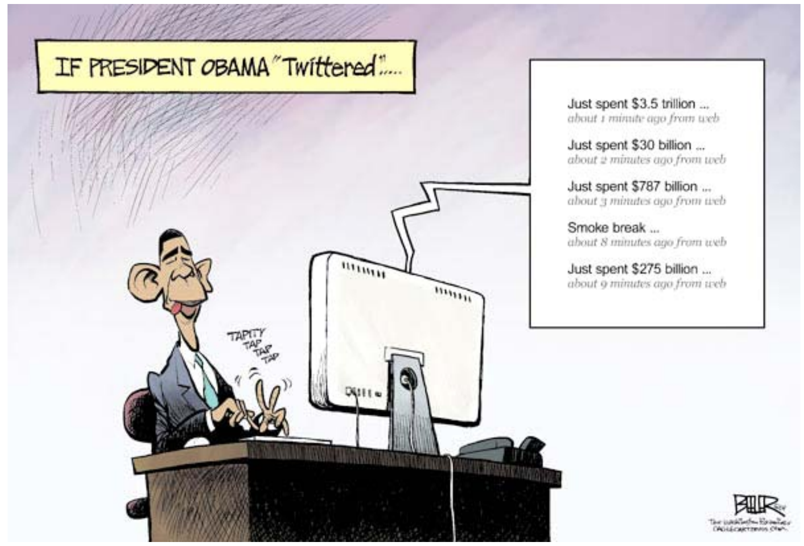
### Over-the-Counter Derivatives




Derivatives have proved to be effective tools for helping American companies manage their financial risks, even though poor practices have allowed some companies to use derivatives in a way which harmed their own financial health. In this debate it is important to preserve and protect the important benefits these financial contracts provide for American businesses while proceeding with reform of a broken and outdated financial services regulatory structure. Derivative products provide firms the ability to minimize risk and benefit individual consumers. The use of these products spans multiple industries such as agribusiness firms and energy users; in doing so, these products provide consumers protection against energy and food price spikes. Good risk management reduces costs for consumers, increases economic growth, and creates more jobs.

### Chairman Frank's Derivatives Bill

While there are some improvements over the Administration's initial derivatives proposal, the Frank draft still represents characteristics of so many Democrat proposals over the last several months – intrusive government over-reach into yet another sector, marked by cumbersome, unnecessary and counterproductive layers of regulation (up to 2-3 additional new layers), and "solutions" that don't address the actual problems that caused the financial crisis. The legislation's goal of forcing much of the OTC derivatives market onto an exchange or through central clearing facilities and to impose capital and margin requirements will do more harm than good – making it too expensive for many companies to enter into prudent risk management.

- **This will kill jobs and raise food and energy prices**
- **Proposed capital and margin regime will reduce, rather than increase competition in the dealer community, further concentrating the market with the largest dealers and thus exacerbating systemic risk.**
- **Other provisions could have the effect of sending more of these markets overseas**

## On the Horizon

### Derivatives and Consumer Financial Protection Agency Legislation Mark-Up Next Week

The Financial Services Committee will be marking up Chairman Frank's derivatives legislation, as well as his legislation for a new Consumer Financial Protection Agency, next week.

A Consumer Financial Protection Agency (CFPA) has the potential to reduce consumer choice, and limit innovation and credit availability by establishing a new bureaucracy to regulate individual financial products and services, from credit cards to annuities, and gives government bureaucrats the job of deciding which financial products are suitable for sale to the public.

Ultimately, it could damage the financial system and consumer well-being by separating consumer protection from supervisory functions, ensuring that consumer protection is undertaken in a regulatory vacuum.

The CFPA could lead to the extinction of many widely used financial products such as home equity lines of credit, adjustable rate mortgages, ATM cards, and certain debit card services offered by community banks.

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**How the Fed Can Avoid the Next Bubble**
By IAN BREM MER AND NOURIEL ROUBINI

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WSJ.com

Ben Bernanke and the Federal Reserve face a number of very difficult challenges in the years ahead. They include:
• Resisting pressure to monetize deficits, which would eventually cause high inflation.
• Implementing an exit strategy from the massive monetary easing of the past year.
• Maintaining the Fed's independence, which has been compromised by the direct and indirect bailout of financial institutions and congressional attempts to micromanage the central bank.
• Properly calculating asset prices and the risk of asset bubbles according to the Taylor rule, an important guideline central banks use to set interest rates.
• Supervising and regulating the financial system more effectively, particularly in the role of "systemic risk" regulator.

The first two tasks are closely related. In order to prevent a persistent monetization of deficits that would lead to inflation, the Fed must implement an exit strategy from the unconventional monetary easing that began in late 2008. If the fiscal and monetary stimulus is taken away too soon, there is the risk of relapsing into deflation. If it is taken away too late, we may eventually face a fiscal crisis and an inflationary recession, or stagflation.

The Fed does not control fiscal policy. But to avoid a game of chicken wherein loose fiscal policy forces the Fed to monetize deficits to prevent a spike in bond yields, the Fed needs to pre-emptively state it won't be buying more Treasury bills.

As for the exit from monetary easing, the Fed must learn from the fateful mistake it made after the 2001 recession. Then, the central bank cut the federal-funds rate too much and kept it too low for too long. It also moved far too slowly when the normalization occurred—in small increments of 0.25% from summer 2004 until the summer of 2006, when it peaked at 5.25%. Normalization took two full years. It was in that period of slow normalization that the housing, mortgage and credit bubbles spiraled out of control. The lesson learned: When you normalize, move rapidly, or prepare for another dangerous bubble.

Of course, this is easier said than done. From 2002 to 2006, the Fed moved slowly because the recovery appeared anemic and because of significant deflationary pressures. This time around, the recession is more severe—unemployment is at 9.8% and is expected to peak above 10%, and we are experiencing actual deflation. Therefore, the incentive not to exit too soon will be greater and the risk of creating another bubble is greater. Indeed, the sharp increase in the stock market and commodities, and narrowing of credit spreads since March, are partly due to a wall of global liquidity chasing assets and already causing asset inflation.

If the conflict between economic growth and financial stability requires that monetary policy remain loose, then it is critical that the supervisors and regulators of the banking sector move aggressively to prevent another bubble from emerging. Thus they should quickly adopt the regulatory reforms agreed to by the G-20—including a new insolvency regime for financial institutions deemed "too big to fail," a serious approach to limiting "systemic risk," and appropriate rules governing incentives and compensation for bankers and traders.

It won't be easy to define systemic regulation and too-big-to-fail. There is a significant risk that doing so will provide an implicit guarantee for large and complex financial institutions. There is also a longer-term risk that actions taken by congressional and regulatory agencies will distort global financial markets. Western financial institutions now depend heavily on state financial backing, and several governments have tweaked rules and regulations to support the large financial institutions that are now at least partially taxpayer-owned. Further, governments could increasingly require domestic financial institutions to lend more at home, which will curtail their foreign operations. Creating a system of effective financial regulation—while resisting the impulse to favor domestic institutions—will be a real challenge for most countries, including the U.S.

Over time, once the fed-funds rate is normalized, incorporating asset prices into monetary policy making is also necessary to ensure financial stability. While it is correct that the fed-funds rates may not be the most effective instrument at controlling asset and credit bubbles, excessively cheap money is always a source of such bubbles. So faster normalization of the fed-funds rate will eventually be important.

The Fed's involvement in quasi-fiscal operations creates other challenges. As long as the Fed remains involved in maintaining financial stability and in preventing other episodes of systemic risk, it will be hard to eliminate the perception that the Fed will be involved as a lender of last resort for too-big-to-fail firms. So far, this Pandora's Box remains open.

The way to prevent future moral-hazard distortions is to create a regulatory regime where too-big-to-fail institutions have much higher capital requirements: a greater liquidity buffer, lower leverage, and lower involvement in risky and illiquid investments if they are depository banks. They should be supervised internationally and must be able to be closed down in an orderly fashion should failure loom.

The Fed is currently resisting a Treasury-led effort to review how it is organized out of concern it might forfeit its independence. Yet the governance structure of the New York and other regional Federal Reserve banks left them effectively controlled by large financial institutions last year, so such a review is necessary. While congressional interference in the Fed's jurisdiction is a danger, the recent quasi-fiscal activities of the Fed bear a review.

The Fed also needs a greater regulatory backbone. The Fed had the power to regulate mortgage markets but failed to use this power out of a misplaced deference to laissez-faire attitudes and Wall Street. Regulating mortgage markets requires a careful balance: short-term regulatory forbearance to avoid a greater credit crunch, along with medium-term countercyclical supervisory actions in order to prevent the emergence of further asset and credit bubbles.

Establishing financial stability—in addition to price stability and growth—is the essential role of the central bank. Achieving this goal in a way that avoids moral-hazard distortions, as with the too-big-to-fail finance institutions, and prevents another bubble in the next years will surely be one of the greatest challenges ever faced by the Fed.
—Mr. Bremmer, president of Eurasia Group, is co-author of the "The Fat Tail: The Power of Political Knowledge for Strategic Investing" (Oxford University Press, 2009). Mr. Roubini is a professor of economics at New York University's Stern School of Business and chairman of RGE Monitor.

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