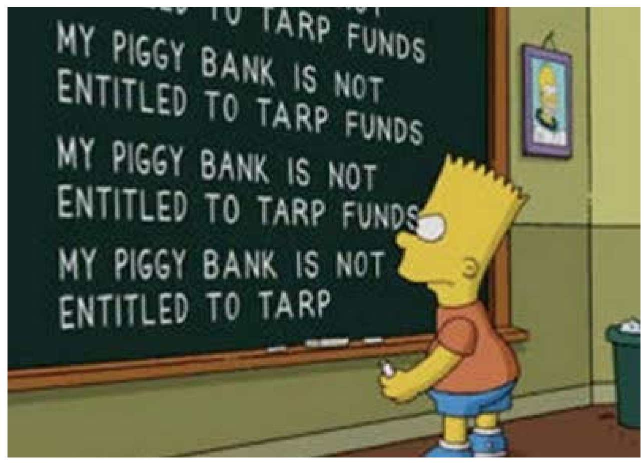
June 30, 2010

Financial Services Regulatory Reform: The Final Countdown

The financial services regulatory reform legislation (H.R. 4173) is expected to be up for a vote on the House floor TODAY. The legislation is being called the "Frank-Dodd" bill. We were trying to think of a more catchy title for it. Remember **Sarbanes-Oxley**? It was called **"SOX."** Using the same logic, we think **Frank-Dodd should be "FRODD" – as in fraud.** Seems like it might be appropriate…

This legislation promises to be a job-killer for our economy. Here are some highlights:

TARP Rescue for Wall Street - AGAIN. Rather than ending the $700 billion TARP program, and using the remaining money to pay off the deficit, as originally promised, H.R. 4173 includes the so-called "Pay It Back Act," which allows the government to purchase Wall Street's toxic assets with taxpayer dollars if there is an immediate and substantial threat to the financial system. Under the provision, the Secretary of the Treasury, with concurrence from the Chairman of the Federal Reserve, has the authority to reuse TARP funds that have been repaid for purchasing toxic assets. ***FRODD makes bailouts permanent by granting the government unlimited bailout authority that lets regulators pay off the creditors of firms they deem "too big to fail."***



Punishes Farmers Trying to Keep the Cost of Food Down. The final bill includes a hastily rewritten derivatives provision that has the potential to do more lasting harm to the U.S. economy than perhaps anything else in this 2,315-page legislation. It punishes end-users of derivatives by applying overly burdensome and punitive regulation to derivatives trading, even to small businesses that in no way caused the crisis. By pushing these activities out of heavily regulated banks and into the shadow banking system, this proposal would lead to less transparency and more risk in the financial sector. ***FRODD will also have the effect of driving derivatives activities offshore, which may mean massive job losses for the United States, just as our country is experiencing record levels of unemployment.***

Empowers Bureaucrats to Snoop Through Our Personal Financial Records. The final bill includes a Senate provision to create an Office of Financial Research and the Consumer Financial Protection Bureau – two brand new federal agencies that will have unprecedented power to track the financial activities of all Americans. Buying a new car? The feds want to know. Switching credit cards? They'll follow that, too. ***Under the FRODD bill, information about all consumer transactions will be gathered –without citizens' approval - and monitored by unelected bureaucrats with few constraints over how and when the information will be used.***

Fails to Reform Fannie Mae and Freddie Mac. Fannie & Freddie have received $145 billion already and CBO predicts they will ultimately cost taxpayers $380 billion – the biggest taxpayer bailout of all. The federal government now owns 80 percent of Fannie & Freddie and guarantees more than $1.7 trillion of their debt. ***Without real reforms to Fannie Mae and Freddie Mac – the root cause of the housing meltdown and financial crisis – FRODD is a sham and will fail to protect taxpayers from further bailouts.***

Fails to Demand Accountability from Regulators Who Missed the Crisis in the First Place. The bill creates an Office of Financial Research and the Consumer Financial Protection Bureau – two brand new federal agencies that will give unelected bureaucrats unprecedented power to track financial activities - without citizens' approval - with few constraints over how and when the information will be used. ***FRODD expands the role of the Federal Reserve and regulators who failed to see the crisis coming, and rewards their failure with more power to pursue "Too Big to Fail" policies at taxpayer expense.***

$8 Trillion Taxpayer Liability. To pay off the creditors of a "too big to fail" financial institution, among other things, the bill confers upon the FDIC the authority to borrow an amount equal to the assets of the firm being liquidated. For the largest firms, such as JP Morgan Chase, Citigroup, and Goldman Sachs, this amount would be $2 *trillion* dollars or more; for the six largest firms combined, this amount would be more than $8 *trillion*. ***FRODD opens the floodgates for endless Wall Street bailouts, permanently putting taxpayers on the hook rather than demanding financial institutions appropriately manage their own risk.***

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Triumph of the Regulators

The Dodd-Frank financial reform bill doubles down on the same system that failed.

President Obama hailed the financial bill that House-Senate negotiators finally vouchsafed at 5:40 a.m. Friday, and no wonder. The bill represents the triumph of the very regulators and Congressmen who did so much to foment the financial panic, giving them vast new discretion over every corner of American financial markets.

Chris Dodd and Barney Frank, those Fannie Mae cheerleaders, played the largest role in writing the bill. Congressman Paul Kanjorski even offered a motion to memorialize it as the Dodd-Frank Act. It's as if Tony Hayward of BP were allowed to write new rules on deep water drilling.

The Federal Reserve, which promoted the housing mania and failed utterly in its core mission of monitoring Citigroup, will now have more power to regulate more financial institutions and more ability to dictate the allocation of credit.

The Treasury, which bailed out institutions willy-nilly without consistent rules, will now lead the Financial Stability Oversight Council that will have the arbitrary power to define which financial companies pose a "systemic risk" and which can be shut down without recourse to bankruptcy. Willy-nilly will now be the law.

And the SEC, which created the credit-ratings oligopoly and missed Bernie Madoff, will get new powers to decide how easy it should be for union pension funds to get their candidates on corporate proxy ballots.

Oh, and Fannie Mae and Freddie Mac? They aren't touched at all, even as they continue to lose billions of taxpayer dollars each quarter.

In other words, our Washington rulers have taken 2,000 or so pages to double and triple down on the old system that failed.

Perhaps the most striking irony is that even in 2,000 pages Congress isn't precisely defining new bank powers. That task will be left to the regulators in the coming weeks and months, a reality that some in the media are finally figuring out. They are now reporting, with notable alarm, that this means bank lobbyists will be able to influence those rules behind the scenes. What did reporters think would happen in a system built not around clear parameters of what institutions can and cannot do, but instead entirely on regulator discretion?

Take the Volcker Rule, which proscribes banks that accept insured deposits from engaging in the riskiest kinds of trading. This makes sense in theory but the rule's execution will depend on how regulators define and enforce it. It's hardly reassuring when the Davis Polk & Wardwell law firm has to write a seven-page memo, as it did on Friday, explaining how this rule-making will proceed. The Volcker Rule may work in restraining excessive risk-taking. Or it may merely drive that risk-taking into other institutions that will attract the best and brightest drawn to the higher profits such trading can gain.

Consider as well the doctrine of "too big to fail," which FDIC Chair Sheila Bair says this bill will end. It is true that, thanks mainly to Ms. Bair and Alabama Republican Richard Shelby, Dodd-Frank puts more constraints on bailouts than Treasury Secretary Tim Geithner or Fed Chairman Ben Bernanke wanted.

But the Fed (with the consent of the Treasury Secretary) can still use its emergency lending authority to rescue a firm as long as it also provides loans to similar institutions at the same time. The bill also gives access to the Fed discount window to the new clearinghouses that are supposed to handle most derivatives trades. So the same exchanges that are supposed to reduce the riskiness of derivatives trades will know the feds will bail them out if they get into trouble.

Meanwhile, the FDIC Chairman will be free to choose which creditors to rescue and which to punish when a company goes into "resolution," even discriminating among creditors who bought the same bond issue. Expect union pension funds to fare better than other creditors when the feds roll up a bank in the future.

In the same way, Congress also added a last-minute, dead-of-night $19 billion tax on some financial institutions to pay for the implementation of these vast new regulatory powers. Who will pay this tax? Whoever the council of regulators decides should pay. The tax can hit any financial firm with more than $50 billion in assets (excluding banks that have deposit insurance, and Fannie and Freddie or any government-sponsored enterprise) and hedge funds that manage more than $10 billion.

This will take $19 billion out of financial firms that supply capital to growing companies, and it will punish precisely the firms that have attracted the most capital because of their better-than-average performance. This is only one of many new ways that Dodd-Frank will reduce the supply and raise the cost of credit across the economy. Think of how last year's limits on credit card fees have already reduced the supply of consumer credit and are leading to the end of free checking for all but wealthy bank customers.

We could go on, but perhaps the best summary is to hail Dodd-Frank as the crowning achievement of the Obama "reform" method. In the name of responding to a crisis, the bill greatly increases the power of politicians and regulators without addressing the real causes of that crisis. It makes credit more expensive and punishes business without reducing the chances of a future panic or bailouts.

The only certain result is that when the next mania and panic arrive, and they will, Congress and the regulators will claim they were all someone else's fault.