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Analysis

Paulson Proposes Sweeping Reforms for Regulating the Financial System

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Seeking to streamline an increasingly outdated and convoluted regulatory system, the Bush Administration on Monday proposed the most sweeping changes to oversight of the nation's sprawling financial services industry since the Great Depression.

Businesses as varied as Wall Street's biggest investment banks and neighborhood mortgage brokers would be affected by the plan.

Click here to read more about the 218-page plan to revamp the financial regulatory system

Treasury Secretary Henry Paulson introduced the proposal and noted that none of the recommendations are likely to be in place any time soon.

Instead, the plan unveiled Monday is intended to spur debate over how the current regulatory system can be improved and made more efficient. Most of the bigger changes would require Congressional approval, something not likely to happen overnight.

"This is a complex subject deserving serious attention," Paulson said.

Paulson said the recommendations have been in the works for months, and that the proposal is not in response to the current global credit crunch brought on by the collapse of the U.S. housing market.

Nevertheless, the Treasury Secretary said innovations included in the proposal could help prevent a similar crisis from happening again.

Response was mixed, although most analysts agree some reform is needed to update the existing system, some of whose parts date back to the Civil War.

"I'm in favor of simplification as long as it doesn't stifle innovation and jeopardize America's standing as a leader in global financial markets," said financial services expert Jay G. Baris, a partner with the New York law firm Kramer Levin Naftalis & Frankel.

Baris explained that as financial services companies have expanded the products they offer, the lines of distinction that once separated say an insurance company from a stock broker have blurred. Consumers can now get a checking account with their stock brokerage firm and buy investment securities from their local bank, he noted.

This overlapping of services has led to the patchwork of regulatory agencies that now exists, he said.

Paulson said that patchwork is "duplicative" in places and has left room for potential abuse and instances in which a lack of oversight was allowed to "fall through the cracks."

An important element of the plan would be to give the Federal Reserve more power to protect the stability of the entire financial system. Day-to-day bank supervision, meanwhile, would be merged into one agency, down from five at present.

Analysts noted that the administration's proposal would increase the reach of an entity -- the Fed -- already operating outside established lines of Washington authority and accountability.

"The Fed is independent with all the good and bad that comes with it," said Axel Merk, manager of the $400 million Merk Hard Currency Fund. "The Fed is a private institution with a license to print money. All commercial banks are required to keep a deposit with the Fed, and the Fed sets interest rates. It's a great business model, especially since they have a monopoly."

Merk noted that few Americans currently understand how the Fed sets monetary policy, but that the central bank's independence allows it to address problems quickly.

Paulson is seeking to strengthen that aspect of the Fed's authority.

Still, Merk questioned the true independence of any Washington-based federal entity.

In Congress, House Financial Services Committee Chairman Barney Frank, who is working on his own regulatory revamp, called Paulson's proposal a "constructive step forward" but said it wouldn't give the Fed enough authority to carry out its expanded job to police the stability of the entire financial system, according to the Associated Press.

The Bush Administration’s plan would also create one super agency in charge of business conduct and consumer protection, performing many of the functions of the current Securities and Exchange Commission.

In addition, it recommends eliminating the Office of Thrift Supervision and the Commodity Futures Trading Commission and merging their functions into other agencies.

It would also ask Congress to establish a federal Mortgage Origination Commission to set recommended minimum licensing standards for mortgage brokers, many of whom now operate outside of federal regulation, and it would take a first step toward federal regulation of the insurance industry by asking Congress to establish an Office of Insurance Oversight inside the Treasury Department.

Paulson defended current regulators against charges that they were asleep at the wheel while the housing bubble expanded and the mortgage industry joined forces with Wall Street to capitalize on the boom.

“I do not believe it is fair or accurate to blame our regulatory structure for the current market turmoil,” he said. “I am not suggesting that more regulation is the answer or even that more effective regulation can prevent the periods of financial market stress that seem to occur every five to 10 years.”

Banking groups raised strong objections to the plan. “Dismantling the thrift charter and crippling state banking charters will weaken banking in America,” Edward Yingling, president of the American Bankers Association, told the Associated Press.

The proposal arrives amid the worst credit crisis in two decades, one that has resulted in billions of dollars of losses for big banks and investment houses and the near-collapse of Bear Stearns, the country's fifth-largest investment bank.

Consumers and businesses have found it harder to get credit, further weighing on an economy struggling with a prolonged housing slump and soaring energy prices. Many economists believe the country is already in a recession.