Treasury's Blueprint: Regulatory Efficiency or More Red Tape?

*By John Shu**

On March 31, 2008, the U.S. Department of the Treasury issued its "Blueprint for a Modernized Financial Regulatory Structure," the largest proposed revamping of federal financial regulation and oversight since the Great Depression.[1] Although released in the middle of a national financial crisis, the Blueprint is not designed to be a quick fix for the current economic situation. Instead, it proposes significant changes that will greatly affect financial institutions—and the entities with which they conduct business—for many years to come.

The Treasury Department developed its proposal over the past year, with some of the ideas already existing for many years and/or previously proposed. Divided into short, intermediate, and long-term plans, the Blueprint proposes to expand the Fed's responsibilities and to streamline the regulatory plan for depository institutions, securities firms, hedge funds, mortgage originators, and the insurance industry.[2] But despite this stated intent to streamline the regulatory framework, the Treasury's proposals call for the creation of several new regulatory agencies, such as "Mortgage Origination Commission," "Office of National Insurance," "Office of Insurance Oversight," "Mortgage Stability Council," "Federal Insurance Guarantee Corporation" (with a "Federal Insurance Guarantee Fund"), "Prudential Financial Regulatory Agency," and a "Conduct of Business Regulatory Agency."[3]

Mortgages

While practically every American is painfully aware of the current mortgage and housing sector difficulties, the Treasury Department's proposal is not specifically designed to address the nation's immediate real estate or financial problems. One may wonder, then, why the Department of the Treasury is getting involved with mortgages. Unlike 1933, mortgages today are deeply intertwined not only with Wall Street, but also the global economy. In fact, investors exposed to subprime mortgages that do not comply with state and federal consumer protection laws face the risk that the mortgages supporting some of their investments may not be enforceable, which would lead to extensive litigation. Thus, the Federal Reserve has long-held rulemaking power regarding the Truth in Lending Act, including the Home Ownership and Equity Protection Act.[4]

As an important part of its short-term planning, the Treasury Department, recognizing the importance of mortgages to the national and global economies, recommends creating a Mortgage Origination Commission (MOC) to "evaluate, rate and report on the adequacy of each state's system for licensing and regulating participants" (e.g., brokers and lenders) in the mortgage origination process. Presumably this would include creating licensing standards for state-regulated mortgage companies and oversee how states oversee mortgage origination. The MOC's board would have representatives from the Federal Reserve, the Office of the Comptroller of the Currency (OCC), Office of the Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Conference of State Bank Supervisors (CSBS). Because each state currently sets its own minimum qualification standards, a certain number of mortgage brokers and lenders do not fall under federal regulation and instead are subject to varying degrees of state oversight.[5] These state-regulated entities are responsible for more than half of the subprime mortgages in the United States. The MOC would not replace the states' regulation of mortgage origination but, rather, would add an additional regulatory layer and provide the marketplace with information regarding each state's mortgage compliance standards.[6] The MOC, similar to the OTS, would be funded through assessments on mortgage originators that would be required to register through the National Mortgage Licensing System & Registry.

One problem with the Treasury Department's proposal is that the state agencies would certainly balk at having to operate under a federal minimum standard, instead of having the autonomy to create their own. Also, a substantial number of the troublesome subprime mortgages issued from federally regulated entities, not state-regulated ones.[7] Additionally, because of regulatory fragmentation, it remains unclear which regulatory agency would have oversight and enforcement of mortgage originators who are independent participants (i.e., unaffiliated with depository institutions), and those which are affiliates, not subsidiaries, or depository institutions. The Blueprint notes that state supervisory agencies must be given the clear authority to enforce federal mortgage lending standards, along with the appropriate federal regulator, and calls for federal legislation either to set uniform minimum licensing qualification standards for state mortgage market participant licensing systems or to give the MOC the power to develop and implement them.

The Federal Reserve

The Blueprint not only advocates that the Fed continue to have rulemaking authority over the Truth in Lending Act and the Homeowners Equity Protection Act, it proposes expanding the Fed's power and responsibilities. For the short term, the Treasury Department suggests clarifying and enhancing liquidity provisioning by the Federal Reserve and allowing the Fed to conduct on-site examinations of non-depository institutions under certain circumstances, presumably in conjunction with the U.S. Securities & Exchange Commission (SEC) and/or the U.S. Commodity Futures Trading Commission (CFTC). This is partially an acknowledgement of what the Fed has already done this year, e.g., opening up the discount window to non-depository institutions, establishing the Term Securities Lending Facility, and facilitating JPMorganChase's buyout of Bear Stearns.

For the intermediate and long-term, the Treasury Department envisions the Fed acting as a "market stability regulator," with broad authority to monitor risks and take

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** John Shu is an attorney at Stradling Yocca Carlson & Rauth in Newport Beach (CA). He served as a law clerk to the Hon. Paul H. Roney, U.S. Court of Appeals for the Eleventh Circuit.*

"corrective action" under certain circumstances across the financial system, including investment banks, hedge funds and commodity operators—not just the financial holding companies, bank holding companies, and certain chartered banks it already monitors. In order to do so, the Fed presumably would want to be able to take "corrective action" sooner rather than later, and would be required to evaluate the capital, liquidity, and margin practices across the entire financial system, (not just with depository institutions), as well as to analyze the potential impact on overall financial stability. The Blueprint, however, does not define at what point the Fed would be able to step in and take "corrective action." Part of this vision, however, is the creation of a "Market Stability Council" which would serve as a check on the Fed, and would have the Fed oversee state-chartered banks and payment and settlement systems.[8]

Skeptics argue that the Fed already failed to properly regulate those banks already within its jurisdiction. A number of banks have had to write off billions of dollars in subprime mortgage losses. There is some question whether the Fed could handle expanded regulatory responsibilities (although the Fed, unlike federal agencies such as the SEC, does not depend on Congress for funding staffing increases). Further, the Treasury Department's proposal does not make clear what authority the Fed would have to intervene or enforce existing regulations. For example, if the Fed were to intervene only in times of "extreme market stress," then Congress or perhaps the Fed's Board of Governors would have to define the term and provide clear guidance as to not only the insertion point(s) but also the procedures that the Fed would take once it determined that it had to take action.

Insurance

Insurance, like banking, is a sector which permeates every aspect of American life. The subprime fallout adversely affected insurers. For example, bond insurers such as Ambac and MBIA suffered heavy losses as a result of their forays into the Collateralized Debt Obligation (CDO) world, affecting municipalities and investors across the country.

Recognizing this, the Treasury Department proposed an intermediate-term plan to establish a federal insurance regulatory structure, presumably with federal preemptive powers. Traditionally, insurance regulation is left to the states. As a result of the insurance industry's increasing national and international focus, the Treasury Department believes that the current state-based regulatory framework is too cumbersome for efficiently developing nationwide products and competing abroad.

The Treasury Department's proposed federal structure would require creating an optional federal charter similar to the current dual-charter banking system and would require a new regulator: the Office of National Insurance. There is some question as to how strict the federal regulatory structure would be. There is also some question as to whether it is appropriate to, in effect, nationalize a structure which traditionally has been within the role of the several states. The Blueprint also urges Congress to immediately establish an Office of Insurance Oversight (OIO) within the Department of the Treasury. The OIO would address international regulatory issues such as reinsurance and serve as the lead regulatory voice in promoting American international insurance regulatory policies and ensuring that the state insurance regulators achieve a uniform implementation of declared U.S. international insurance policy goals.

Agency Streamlining

Perhaps the most widely reported feature of the Blueprint is the Treasury Department's proposal to merge the CFTC with the SEC and the OTS with the OCC. These proposed mergers are part of the Blueprint's intermediate-term plan. Futures trading is no longer limited to agricultural commodities and the Treasury Department believes that product and market participant convergence, market linkages, and globalization warrant unifying the CFTC and the SEC. To maintain some of the CFTC's charter, the Treasury Department recommends that the SEC adopt core principles for exchanges and clearing agencies, expedite the SRO rule approval process, and provide a general exception under the Investment Company Act of 1940 for already actively traded exempted products such as Exchange-Traded Funds.[9]

Harmonizing the two agencies' regulatory philosophies and the many differences between securities and futures regulation will be a daunting task. The SEC and CFTC have separate, and sometimes disparate, rules regarding numerous issues, such as margin, segregation, insider trading, insurance coverage for broker-dealer insolvency, customer suitability, short sales, SRO mergers, implied private rights of action, portfolio managing, and the SRO rulemaking approval process. For example, "margin" in the securities context refers to the minimum amount of equity that must be put down in order to purchase securities on credit, whereas in the futures context "margin" means a risk-based performance bond system which acts like a security deposit.

The suggested SEC–CFTC merger is not new, and has drawn opposition from various trade associations, the CFTC, the states, and within Congress. For example, commodities, due to their agricultural history, fall under the jurisdiction of the House and Senate Agricultural Committees. Those committees would be reluctant to cede oversight power should the CFTC and SEC merge. Notably, the futures markets have always been known as more of a "Wild West" environment than the securities markets, and the SEC has fallen under repeated criticism for its failures to catch and stop behaviors ranging from stock option backdating to Enron to the current subprime fiasco. Critics point out that a combined agency which would be SEC-heavy would fail to properly regulate the already chaotic futures markets. Furthermore, state regulators, whose "blue-sky" laws regulating securities have already been somewhat eclipsed by the SEC and CFTC, may justifiably view this proposed consolidation as a further infringement of their regulatory authority.

Prudential Financial Regulatory Agency

For the long-term, the Treasury Department envisions a single "Prudential Financial Regulatory Agency" to focus on financial institutions with some type of explicit government guarantee associated with their business operations, capital

adequacy requirements, investment limits, activity limits, and direct on-site risk management supervision. As an intermediate step to that ultimate vision, the Treasury Department proposed combining the Office of Thrift Supervision (the primary federal regulator of saving associations and savings and loan companies) with the Office of the Comptroller of the Currency (the national bank regulator). Part of the Treasury Department's reasoning is that U.S. consumers have sufficient access to residential mortgage loans and that thrifts and banks are nearly indistinguishable in the modern day. The proposed combined agency would oversee the safety and soundness of firms with federal guarantees, while having authority to deal with affiliate relationship issues.

Industry groups and the OTS have screamed foul. In fact, the OTS has suggested that its authority ought to be *expanded* in order to provide nationwide uniformity in regulating mortgage bankers and mortgage brokers. The OTS-OCC merger proposal, like the proposed SEC-CFTC merger, is also an old idea. Thrifts have historically focused more on mortgage lending, but they also offer various financial products. OTS's budget comes from assessments it levies on the more than 800 savings and loans it supervises. In a direct challenge to Treasury's proposal, OTS has suggested that it its role be expanded to include supervisory powers over mortgage brokers, a task for which Treasury proposed creating the Mortgage Origination Commission.

Business Conduct Regulatory Agency

For the long-term, the Treasury Department ultimately envisions combining a number of agencies, including the SEC, CFTC, and perhaps even the Federal Trade Commission (FTC) into a single "business conduct regulator" to protect consumers and investors. This agency would presumably have authority over disclosures, rule writing, business practices, and chartering/licensing. The future agency would subsume most of the roles of the SEC and CFTC, as well as the consumer protection and enforcement roles of insurance and banking regulators, with authority over mortgage disclosures. It is unclear as to whether Treasury envisions the SEC, CFTC, and other agencies to still exist, or to which agencies the non-subsumed duties would go.

CONCLUSION

It is interesting that the Treasury Department, and thus Secretary Henry M. Paulson, is the public face of the proposed changes, rather than the President. The Administration was bold in revealing the Blueprint, most of which, in principle, would help government regulators keep up with rapidly changing financial innovation. The devil, however, is in the details. Beyond the political difficulties of turning any of the Blueprint's proposals into law, many are skeptical that a new regulatory regime would be any better than the current one in terms of protecting consumers and the overall market. If anything, the nation's current political mood appears to want more government regulation, rather than less. There is also a structural disconnect between the nationalization, and globalization, of financial products and our federalist system of government. Individual state regulators and state legislatures may decide to flex their own political muscles in trying to maintain or even expand their powers and responsibilities.[10]

The irony of the Treasury Department's Blueprint is that it does not appear to streamline the regulatory environment all that much. Even if the SEC/CFTC and OTS/OCC mergers occurred, the Blueprint still proposes at least seven new entities, and would require multiple new charters. As noted earlier, the Blueprint also fails to adequately address several procedural and enforcement questions.

Very little in the Blueprint can happen without congressional action in the forms of legislation and appropriations. Interested or potentially affected parties already have attacked the Blueprint. Additionally, the political realities of an administration in its last months, combined with a Congress which is unlikely to be able to take any substantive action regarding the Blueprint in a presidential election year, means that, at minimum, the current regulatory structure will survive well into the latter half of 2009. Further, global economic difficulties related to the various subprime and exotic mortgage-backed instruments have led many observers to believe that more, not less, regulation and enforcement could have prevented those difficulties. While politically the Blueprint has forced Congress to take some action (e.g., holding hearings), Congress has often demonstrated a real lack of courage and thoughtfulness in tackling pressing issues. Should Congress pass new legislation as a result of the Blueprint, the affected administrative agencies would still have to engage in extensive rulemaking to satisfy the attendant administrative law requirements and to fill in any legislative gaps. Even without any new legislation, it is reasonably likely that certain agencies, the Fed, or even the several states will take preemptive steps to either maintain or expand their power and jurisdiction. Financial sector companies would be wise to monitor Congress and the relevant agencies to see what storm might be coming. Regardless of the final form of the legislation, there will certainly be significant debate, and litigation, in this arena for years to come.

Endnotes

1 The Blueprint is available at http://www.treas.gov/press/releases/reports/Blueprint.pdf.

2 The current financial regulatory structure includes five federal depository institution regulators, state-based regulators, separate federal securities and federal futures regulators, self-regulatory organizations, and state-based insurance regulators.

3 The Treasury proposal leaves in place the many Self-Regulatory Organizations (SRO's) and, in certain cases, enhances their powers.

4 The Fed's authority exists independent of Congress, which is currently debating bills regarding mortgage standards. The Fed has been sharply criticized for its perceived failures to better regulate the mortgage lending industry. Approximately four months ago, the Fed proposed new standards for exotic mortgages and for high-fee or high-cost loans to borrowers with lower credit scores. The Fed's proposal would require mortgage lenders to disclose hidden fees and mortgage companies to show that their customers could realistically afford their mortgages, and prohibit misleading advertising. The Fed was planning to issue final rules sometime this summer, but the Fed now appears to be leaning towards limiting the scope of its proposed rules in response to mortgage industry comments. Consumer protection groups,

Congress, and even some agencies such as the FDIC have publicly expressed their concerns about the Fed's seeming response to the various mortgage, home builders, and realty trade associations.

5 Only seven states actively participate in the National Mortgage Licensing System & Registry (NMLSR), which provides information regarding mortgage market participants' background, expertise and disciplinary history.

6 In proposing the Mortgage Origination Commission, Treasury borrowed certain aspects from the mission of the Federal Financial Institutions Examination Council (FFIEC), a formal interagency body created in 1979 which prescribes uniform principles, standards, and report forms for the federal examination of financial institutions and makes recommendations to promote supervisory uniformity. The FFIEC facilitates public access to data that depository institutions must disclose under the Home Mortgage Disclosure Act of 1975.

7 The Blueprint also does very little, if anything, to address the current and upcoming waves of mortgage and/or subprime-related litigation. Already there are a significant number of lawsuits, including large class actions, against almost every type of entity which is part of the mortgage lending process or residential real estate, including the investment banks. The litigation claims are diverse, but include categories such as inadequate disclosure, fraud and securities fraud, commercial contract, and bankruptcy cases.

8 Payment and settlement systems are the mechanisms used to transfer funds and financial instruments between financial institutions, and between financial institutions and their customers to discharge certain obligations. On a typical business day, U.S. payment and settlement systems settle transactions with a value of more than $13 trillion.

9 An Exchange-Traded Fund (ETF) is an investment vehicle traded on stock exchanges, much like stocks or bonds. An ETF represents a collection or "basket" of assets such as stocks, bonds, or futures.

10 In certain areas, federal regulatory requirements tend to be less restrictive than those of certain states, *e.g.,* consumer privacy.