

FINANCIAL SERVICES COMMITTEE REPUBLICAN PLAN FOR REFORMING THE FINANCIAL REGULATORY SYSTEM

Overarching principles:

- The Republican plan will be designed to ensure that (1) the government stops rewarding failure and picking winners and losers; (2) taxpayers are never again asked to pick up the tab for bad bets on Wall Street while some creditors and counterparties of failed firms are made whole; and (3) market discipline is restored so that financial firms will no longer expect the government to rescue them from the consequences of imprudent business decisions. The Republican plan seeks to return our regulatory system to one in which government policies do not promote moral hazard, and insolvent financial firms are permitted to fail rather than become wards of the state.
- Chairman Frank and the Obama administration have insisted that the financial crisis was caused by a lack of regulation and a failed free market philosophy, requiring government intervention on the scale of the New Deal to “re-regulate” finance. The Republican plan is premised upon a belief that it was misguided government policies to allocate credit (GSEs, CRA) and government intervention to prop up failed financial institutions that helped precipitate, and later exacerbate, the crisis, which suggests that what is needed is smarter – not more – regulation. Republicans will resist the command-and-control approach that has characterized the Obama administration’s and congressional Democrats’ stewardship of the economy.
- Republicans will oppose plans to empower the Federal Reserve as a new “systemic risk super-regulator,” while at the same time offering solutions to modernize our outdated financial regulatory structure by consolidating agencies with overlapping missions and eliminating gaps that can be exploited by firms seeking to avoid regulatory scrutiny. Rather than massively expanding the Federal Reserve’s mission and further enshrining a failed government policy of rescuing “too big to fail” institutions, Republicans support scaling back the Fed’s authorities so that it can focus on conducting monetary policy and unwinding the trillions of dollars in obligations it has amassed during the financial crisis. When combined with the Obama administration’s reckless “borrow-and-spend” fiscal policy, the vast expansion of the Fed’s balance sheet in recent months arguably represents a far more significant source of “systemic risk” to our nation’s economy than the failure of any specific financial institution.

Specific policy proposals:

1. **Resolving Large, Complex Non-bank Financial Institutions: Bankruptcy, not More Bailouts.** The guiding principle of the Republican alternative can be summed up in one sentence: no more bailouts. By putting an end to ad hoc, improvised and unprincipled bailouts designed to spare big Wall Street firms and their creditors from the consequences of their mistakes, Republicans are offering a clear alternative to the limitless and unconstrained

“bailout authority” that Democrats want to confer upon those very regulators that failed to anticipate the current crisis that almost wrecked our financial system. The Democrats want to hide the consequences of regulatory and private sector mistakes by giving regulators the authority to bail out large financial institutions, their creditors, and their counterparties, without any accountability whatsoever. Even worse, the Democrats have not yet figured out who is going to pay for this limitless bailout authority, administered by bureaucrats for the benefit of a handful of large financial institution.

Republicans also reject the Democrats’ call for a government-run economy that depends upon the omniscience and omnipotence of government regulators who have shown themselves unable to anticipate crises, let alone do anything to prevent them. Republicans believe that the financial system works best when individual participants are free to keep the gains yielded by their efforts, but are forced to bear the costs of their failure. By adhering to the principle that no firm is “too big to fail,” Republicans will ensure that responsibility for monitoring the stability of the financial system is placed exactly where it needs to be: with the individual market participants who have the self-interest and the expertise to monitor their exposure to the financial system, and who are in the best position to take the necessary action to protect themselves, their investors, and their creditors from the risks that are endemic to the financial system.

Rather than asking government to act as a fairy godmother who will ensure the safety of the financial system or spare participants from the consequences of their mistakes by imposing those costs on others, Republicans call for the resolution of insolvent non-bank institutions — no matter how large or systemically important — through the bankruptcy system.

The key to making bankruptcy work as an alternative is to make credible and clear the government’s commitment to restructuring, re-organizing, or liquidating troubled financial institutions at the expense of their creditors and counterparties. This commitment requires a firm rejection of the current status quo, in which the decision whether to rescue a specific firm and insulate its creditors and counterparties from losses is left to the discretion of regulators accountable to no one but themselves. This commitment also requires the rejection of the possibility of *any* bailout, no matter how that bailout is described. Without this firm commitment to ending bailouts, too-big-to-fail financial institutions and those who do business with them have every incentive to pursue short term gains, knowing that the costs will ultimately be borne by others if things go wrong. By making credible the government’s policy that losses will be borne by those responsible, the government makes the financial system stronger by encouraging creditors to be more vigilant in assessing the creditworthiness and business practices of the parties to whom they are extending credit. And by making clear that the government will not step in to bail out a failing institution or its creditors, the government can remove the uncertainty and confusion that roiled the markets last September when market participants could not anticipate the government’s actions. Markets may be unpredictable. But the mere possibility that government may — or may not — intervene turns that unpredictability into chaos.

The relatively smooth bankruptcies of Drexel Burnham Lambert, Enron, and WorldCom demonstrate that the bankruptcy system is more than capable of resolving and liquidating large, complex institutions. The failure of Lehman Brothers last September is often cited by proponents of a new systemic risk resolution authority as an example of why bankruptcy “won’t work.” In truth, the shock to the markets from Lehman’s collapse was the result of dashed expectations of market participants that the government would ride to Lehman’s rescue just as it had in the earlier Bear Stearns and GSE episodes, **not** of any inadequacies in the bankruptcy process. Nevertheless, Republicans believe that bankruptcy **can** be made more efficient and better tailored to resolving large non-bank financial institutions. Republicans are therefore proposing a new chapter to the Bankruptcy Code to deal with the unique characteristics of financial institutions that will make “orderly failure” a practical solution for resolving troubled firms. Among other things, this new chapter will provide for better coordination between the regulators of these institutions and the bankruptcy system, so that regulators can provide technical assistance and specialized expertise about financial institutions. In addition, this new chapter will give bankruptcy judges the power to stay claims by creditors and counterparties to prevent runs on troubled institutions, thereby helping to alleviate the panic that could strike the financial system if a large institution finds itself facing difficulties.

2. **Market Stability and Capital Adequacy Board.** Rather than establishing the Federal Reserve as the “systemic risk regulator,” as Chairman Frank and Secretary Geithner have previously suggested, and identifying in advance those firms that are systemically significant (i.e., “too big to fail”), the Republican plan would create a Market Stability and Capital Adequacy Board, chaired by the Secretary of the Treasury and comprised of outside experts as well as representatives from the financial regulatory agencies responsible for supervising large, complex firms. This panel would be charged with monitoring the interactions of various sectors of the financial system, and identifying risks that could endanger the stability and soundness of the system. The panel’s mandate would include reviewing financial industry data collected from the appropriate functional regulators; monitoring government policies and initiatives; reviewing risk management practices within financial regulatory agencies; reviewing capital standards set by the appropriate functional regulators and making recommendations to ensure capital and leverage ratios match risks regulated entities are taking on; reviewing transparency and regulatory understanding of risk exposures in the over-the-counter derivatives markets and making recommendations regarding the appropriate clearing of trades in those markets through central counterparties; and making recommendations regarding any government or industry policies and practices that are exacerbating systemic risk. In order to address current regulatory gaps, each functional regulator would be required to assess the effects of their regulated entities’ activities on macroeconomic stability and review how entities under their regulatory purview interact with entities outside their purview. This panel would not have independent enforcement or supervisory authority over individual firms, but would instead meet on at least a quarterly basis and periodically report its findings to Congress and the relevant functional regulators (the cops on the beat) so that policymakers and regulators could act upon them to contain risks posed by specific firms, industry practices, activities and interactions of entities under different regulatory regimes, or government policies.

3. Consumer Protection and Regulatory Restructuring. To modernize the financial regulatory structure, the Republican plan would streamline the current framework of overlapping and redundant Federal financial regulatory agencies by centralizing supervision of deposit-taking entities in one agency while preserving charter choice (e.g., credit unions and State charters) as well as the dual banking system (the regulator would have two divisions -- one would oversee federally chartered banks and thrifts, and one would serve as the primary federal regulator of state-chartered, state-supervised banks). The Republican plan would immediately combine the OCC and OTS into one agency and shift the supervisory functions of the Federal Reserve and FDIC to that agency, including responsibility for overseeing bank and financial holding companies. The plan establishes an Office of Consumer Protection within the new agency to streamline in one place responsibility for rule promulgating and enforcing the Federal consumer protection laws applicable to depository institutions, eliminating the confusion created by the existence of five different Federal regulatory agencies which currently share consumer protection responsibilities. Consumer protection rules will be reviewed and updated regularly with rule promulgation consisting of extensive consumer testing. In addition, Republicans will provide the Office of Consumer Protection with the authority to redesign and improve consumer disclosures so that they are transparent to all interested parties and written in plain language to enhance understanding by all consumers and investors.

Republicans will simplify and streamline the complaint process for consumers and investors who believe they have been wronged by abusive industry practices, by establishing a single, toll-free number and website – to be administered by the Office of Consumer Protection – to field consumer inquiries and direct them to the appropriate regulatory or enforcement agency.

The Republican plan ensures that institutions engaged in similar activities and serving similar functions will be regulated similarly, limiting the potential for competitive distortions and a “race to the bottom” among firms seeking the most lenient regulatory treatment. It promotes simplicity and consistent enforcement. It guarantees accountability and transparency. And it enables the Federal Reserve and the FDIC to concentrate on their most important responsibilities: formulating monetary policy and protecting the deposit insurance fund, respectively.

4. Fundamental Reform of the Federal Reserve. The extraordinary market interventions conducted by the Federal Reserve since the onset of the financial crisis have added trillions of dollars to the government’s balance sheet and taken it far afield from its core mission of conducting the nation’s monetary policy. The Republican plan would re-focus the Fed on its monetary policy mandate by relieving it of current regulatory and supervisory responsibilities, reassigning them to other agencies. Reallocating these duties will eliminate the Fed’s current incentive to prop up the economy through an accommodative monetary policy to prevent firms under its regulatory purview from failing. The Republican plan would make the Federal Reserve more transparent and accountable to taxpayers by enabling the Government Accountability Office to conduct more extensive audits of the central bank.

In addition, to send clear signals to markets, the plan would require the Fed to have an explicit inflation target, and would narrow the Fed's authority under section 13(3) of the Federal Reserve Act, which currently provides the Fed with nearly unlimited powers during periods the Board of Governors deems "unusual and exigent," as follows: (1) require the Secretary of the Treasury to officially sign off on all actions taken by the Federal Reserve pursuant to section 13(3); (2) allow Congress to block any Federal Reserve action undertaken pursuant to its section 13(3) authority within 90 days of such action by passing a congressional resolution of disapproval, in which case the Fed would have 90 additional days to unwind the relevant facility; (3) place all expenditures to date pursuant to section 13(3), and those taken in the future, on Treasury's balance sheet; and (4) eliminate the Federal Reserve's ability to use its 13(3) authority to intervene on behalf of a specific institution, allowing the powers to only be used to create liquidity facilities that would be broadly available to a market sector.

5. **GSE Reform.** Fannie Mae and Freddie Mac's government-subsidized model has cost taxpayers tens of billions of dollars. The Republican plan would phase out taxpayer subsidies of Fannie Mae and Freddie Mac over a number of years and end the current model of privatized profits and socialized losses. Republicans would sunset the current GSE conservatorship by a date certain, placing Fannie and Freddie in receivership if they are not financially viable at that time. If they are viable, once the housing market has stabilized, the plan would initiate the process of cutting their ties to the government by winding down the federal subsidies granted through their charters and transitioning Fannie and Freddie into non-government backed entities that compete on a level playing field with other private firms. In making reforms, Republicans will address reducing Fannie and Freddie's portfolios, re-focusing Fannie and Freddie on promoting housing affordability, and requiring SEC registration and the payment of taxes.
6. **Credit Rating Agency Reform.** To restore market discipline and promote greater investor due diligence, the Republican plan will discourage blind reliance on ratings supplied by the major credit rating agencies that has had such disastrous consequences for investors and the economy as a whole. For too long, the government has adopted policies that bestowed a "Good Housekeeping" seal of approval on the rating agencies and their products, which perpetuated a rating agency duopoly that contributed significantly to a mispricing of risk and a subsequent collapse in market confidence. Designating certain agencies as Nationally Recognized Statistical Rating Organizations (NRSROs) and hard-wiring references to their ratings into numerous Federal statutes and regulations are the two most egregious examples of this implied government blessing. The Republican plan will address these market distortions by changing the NRSRO designation to "nationally *registered* statistical rating organizations" and removing all references to ratings throughout Federal law and regulation. These changes will promote greater competition among rating agencies and less reliance on their ratings among investors. To further mitigate over-reliance on third-party credit analysis, functional regulators should be required to more thoroughly examine governance, risk management and enterprise management policies and procedures.

7. **Strengthening Anti-Fraud Enforcement.** To restore investor and consumer confidence and better protect financial markets, the Republican plan will enhance the ability of the financial regulatory agencies to enforce Federal consumer protection and securities laws. Regulators need more tools in their arsenal to proceed administratively and judicially against alleged violators. Republicans will propose reforms to increase civil money penalties in government enforcement actions; maximize restitution to victims of fraud; improve surveillance of bad actors who exploit gaps in the current regulatory regime to continue preying upon innocent consumers; and reauthorize the Financial Crimes Enforcement Network (FinCEN), authorizing an additional \$15 million to combat financial fraud.