

Rocky Mountain News

The Paulson Plan

By Rocky Mountain News finance editor David Milstead

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Monday, I e-mailed attorneys, regulators, financial-service folks like investment advisers, bankers and credit union executives to ask what they thought of Treasury Secretary "Hank" Paulson's plan to overhaul federal financial regulation.

We asked them to consider these questions. Some addressed them one-by-one; others sent their overall thoughts.

- * Is this necessary? Was the current system really broken?
- * Will it be more effective than the current system?
- * Is it "too easy" on Wall Street, as some critics have said? Who is being protected in this proposed system?
- * What are the perils and pluses of moving, in some cases, away from state regulation to federal regulation?
- * Should regulators be competing to be the 'regulator of choice' for the subjects of regulation?
- * Is it too early in the current problem environment to try to craft an overhaul plan?

A small sample made it into the paper; here are the complete musings.

Raymond Friedlob, attorney, McKenna Long & Aldridge LLP:

Since I deal with this so much I could take pages and hours to answer but will only relate a few top of mind observations. First, the system was not broken but this was a failure of federal regulators to police the credit markets in the banks. They were not even doing credit checks but had a risk manager who dealt in probabilities. These people should have been in Las Vegas because they were packaging paper which was not creditworthy and passing the package to the investment banks. Everyone was chasing yield. The bank regulators could have stopped these practices because as a result of their looks at banks disclosed the poor quality of the paper. The investment banks merely put their faith in the risk managers report that only a small number of defaults would occur-they failed and

put junk into the system for yield. The SEC does not have a broad enough statute to put an investment bank on notice as long as they maintain net capital ratios. The commercial banks were just conduits for product and they were out of the picture took their rake off and went on to the next. The rating agencies misused their franchise and were as guilty as the banks, investment and commercial. They do not have the high level rating people to make the tough decisions.

The state regulators do not have the expertise to regulate financial markets. But the new legislation should require some risk retention by everyone because it is fear of defaults and bad paper which will cause everyone to be more careful.

Finally, the beg players sitting on the sidelines with cash are bottom fishers and once they invest the crisis is over quickly. But they are gaming the system trying for every last dollar-like Fortress Fund. Hedge funds are not regulated and 10B-5 should be extended to cover them.

At the heart of it all is Greenspan who kept the rates too low for too long to cause housing to lure people into houses that they could not afford.

In summary, there are many culprits but the largest are the regulators of commercial banks who see the bad credit decisions. Next are investment bank heads who just grab for the yield and are too focused on action and not the quality of what they are selling. This must be stopped at the federal level because these practices are too complicated for many to understand. Note the Fannie and Freddie scandals where again the Feds didn't stop them.

Aaron Azari, Vice Chairman, Colorado State Bank and Trust:

I do not think that anybody would disagree that some kind of reform in the Federal or States regulatory and oversight process is warranted. Spending billions of taxpayer dollars directly (and indirectly) in an attempt unlock frozen credit markets, and arrange for the orderly liquidation of securities firms, simply cannot go unanswered.

Whether Mr. Paulson's proposal is a reaction or an appropriate response is debatable. Most financial institutions (Federal or State chartered) are audited, regulated and reviewed routinely. Most executives will argue that such oversight is more than sufficient to maintain the interests of depositors, account holders and other interested parties.

The proposal to extend oversight into areas which have uneven, spotty or have no oversight is appropriate. This initiative not only requires an assessment of who should be regulated, but also a review of current oversight capability and quality of that oversight; who provides it, how is it provided and how effective is it at achieving the public policy intent.

I don't believe that it is "too easy" on Wall Street – financial products have become complicated - as a society we have not invested the regulatory resources in an effort to adequately understand the business as it has evolved. Wall Street has always been about capital formation and destruction. Theoretically, in some cases it might be best to let firms fail.

However, as a society we have decided (through regulation) to "cushion" the societal effect of financial failure and disruption with government regulation – and in extreme cases, intervention. As long as the public believes that regulation and intervention are necessary; having a rational, deliberate and unified process of oversight is much preferred to the current fractured system of multiple regulators and jurisdictions. It is appropriate to start having an overhaul discussion – with all parties (including those that would be regulated) at the table. In fact it has been appropriate and needed for many years.

Jeff M. Wilson, president, Wilson Advisory Group:

Regulatory overhaul is desperately needed. The current system has its origins from the Civil War, and is neither comprehensive enough, nor properly suited to the 21st century. As we see from periodic breakdowns, most recently the S & L crisis, the Internet Bubble, and the current Subprime Tsunami led Credit Collapse, the regulators don't prevent problems. At best, they manage them, and in some cases, they actually manufacture them.

Unfortunately, given the past performance of regulatory reform, it is likely that whatever is finalized, will sow the seeds for the next crisis. Unless a mechanism is built into the process to identify problems before they are problems, there will be little benefit. For example, the growth of securitization of mortgages and debt should have immediately been met with analysis and identification of fraud, inadequate underwriting, or even no underwriting. Open discussion of problems, and perhaps precautionary regulatory action, could have limited the enormous impact, now \$200 billion in losses and growing. Instead, the regulators are involved in cleaning up the mess, and in the case of the Fed, keeping the system from "freezing up."

There are pluses and minuses to state versus federal regulation. The regulated should NEVER be able to choose their regulator. There should be objective criteria used to determine the regulator. That said, the "diversification" of state regulation serves as a "testing ground" for new ideas, and limits the national impact of bad ideas or systemic failures.

It will take years to develop, and the sooner we start, the better. It is unlikely that anything developed from the current discussion will be in place in time to impact our current crisis.

Taylor Kirkpatrick, vice president, W.G. Nielsen & Co.

Recognizing that we as investment bankers are inherently conflicted about the restrictions that a stiffer regulatory environment would create, it is our opinion that Paulson's Blueprint for Regulatory Reform or some iteration of it is a necessary step to ensure that the ultimate goal of "a sound and competitive financial services industry grounded in robust consumer protection and stable and innovative markets," as the report states, is intact.

This plan as drafted is a gargantuan undertaking, and seems to focus on myriad regulatory proposals to streamline through realignment and renaming of agencies; further, and of paramount importance, there are clearer lines of responsibility and accountability. Although it was not clear that the reorganization would strengthen certain agencies (and in fact may remove some SEC functions with industry self-regulation), the plan creates a new Mortgage Origination Commission (MOC) which sets uniform standards and "minimum educational requirements" for mortgage lenders and presumably protects prospective homebuyers. Additionally, the plan calls for a federal takeover of insurance regulation now carried out by the states through creation of an Office of Insurance Oversight (OIO).

The plans concerning the Federal Reserve change its role to "a market stability regulator...conducted through the implementation of monetary policy and the provision of liquidity to the financial system. In addition, the Federal Reserve should be provided with a different, yet critically important regulatory role and broad powers focusing on the overall financial system...In terms of its recast regulatory role focusing on systemic risk, the Federal Reserve should have the responsibility and authority to gather appropriate information, disclose information, collaborate with the other regulators on rule writing, and take corrective actions when necessary in the interest of overall financial market stability."

This is a role that the Fed has been taking - investment banks and broker dealers borrowed more than \$30 billion a day from the Federal Reserve's discount window this past week, and the impending failure of Bear Stearns pushed the Fed to open up its discount window lending facility to the primary dealers as well. It should be an expectation that borrowers be subjected to additional scrutiny and regulatory hurdles in order to manage overall risk and not jeopardize the US markets to any undue threat to financial system stability.

In sum, recent events have evidenced the need for an integrated, holistic approach to regulation and accountability to create a better mousetrap of checks and balances. It is never too early to propose innovative ways to foster robust consumer protection and stable markets, and we applaud Mr. Paulson for taking that critical first step.

Philip A. Feigin, attorney at Rothgerber Johnson & Lyons and former Colorado securities commissioner:

I have certainly not had the time to digest the whole report. From what I have reviewed, it is very short on the details on exactly what is intended. Nonetheless, I have some general observations on where they are coming from and the potential impact of at least some of the approaches.

There is much about American government that is inconvenient, clumsy, complicated and confusing. We all know that things began with 13 separate colonies that evolved into states. Do we really need state distinctions and governments in today's age of air travel, the Internet, telephones, highways and television? Do we really need Rhode Island? Wouldn't it make more sense if Vermont and New Hampshire merged, so you wouldn't have to remember which one's on the left and which is on the right?

From the perspective of our national government, these questions are very real. States and their laws and governments don't make much sense. Those in Washington attempt to govern a national system. It is hard enough given the complexities of the nation's business, and even harder when they must consider dealing with 50 different subdivisions. This is made even more frustrating when they interact with their international counterparts, who control it all, without localized interference.

The U.S. system of financial regulation is a mishmash of historical evolution, much like a camel is a horse designed by a committee. As amusing as that saying may be, who wouldn't be happy to have a camel to cross the desert?

I have a hard time believing this proposal will go anywhere. We are too far down the road. Some significant pruning and tweaking may be in order, but not the fundamental redesign intended. It would be like adopting a national code of state law, so that the criminal and civil codes of each state were identical to each other state's law. We would not have local police forces; just local posts of the national police. All nice and uniform. But it would never work. We're just too big. It would all start out at the same place, but it would only take a month or two for the whole thing to fall apart. The guys in Alabama would seek to imprison someone for something when the cops in Montana let a similar guy go with a warning. The proponents of a national system might say that there would be a national clearing house to make sure that didn't happen. Can you even imagine the enormity of the infrastructure to run that national system would be?

I fear that uniformity is a pipe dream for people who have never worked in the trenches. The people in Washington imagine the financial world as populated by Merrill Lynch and Bank of America and Travelers and Countrywide. They do not see the interaction between a rep and customer.

As a matter of principle, I find several of the overall proposals appealing, but they tend to be in areas where I do not spend a lot of time. For instance, I see no reason why the OTS should not be consumed by the OCC. (Although not among the proposals, I believe credit unions should be regulated as banks, but others will chime in on that, I am sure.) The CFTC and the SEC can be merged without much turmoil, it is just that the people in the commodities industry will have to learn to live with more invasive and less “cooperative” regulators. My sense is that most of the insurance regulation provided at the state level is provided by a few highly sophisticated states, like New York, California, Connecticut, to name a few. To shift that centralization to a federal agency might be achieved without significant disruption.

However, I find it highly unlikely that the insurance piece is likely to happen any time soon. The state legislatures will rise up as one to defend not only their jurisdiction but also the state revenues regulating insurance produces. The insurance companies like being able to influence important state legislatures, a task that might be more difficult were the focus to shift to Congress.

I’ll close with some comments on state securities regulation. The report is rather vague as to what is intended here. Blue sky regulation has continued to adapt with the times, although more slowly and unevenly as some would like. At times, state involvement with what appear to be national enforcement cases can be frustrating and overkill. Even so, no model will be without its problems. In my view, the system that has and will work the best is a partnership between national and local regulators. A true partnership between equals. At times, the SEC has simply let the investing public down, providing a laissez faire regulatory environment driven by politics and buzz words. The states were there to act as a check and balance on ideas that would have led to disaster. The same is likely true in other areas of overlapping state and federal regulation.

There is no perfect system. There is not likely a better system. A plus here, a minus there. Has the Secretary delineated how the new system, were it in place five years ago would have averted the current mortgage problems? Or the dot.com/Enron collapse? It is not the system but the people who enforce it that make all the difference. Pay those who regulate like those who they regulate and see what happens. Show us this sea change would have made any difference, or will in the future.

David A. Peterson, Principal, Peak Capital Investment Services:

Is this necessary? Was the current system really broken?

Response: It is probably time for some changes, since many of these regulatory institutions have been in place since the Great Depression. The current system has a difficult time in dealing with the complexity and innovation that has taken

place from new financial products, integrated financial institutions and the globalization of the financial marketplace.

Will it be more effective than the current system?

Response: It has the potential to streamline the regulatory process considerably by creating fewer regulators. This could be particularly advantageous for those in the insurance industry that have to deal with 50 separate state regulators.

Is it “too easy” on Wall Street, as some critics have said? Who is being protected in this proposed system?

Response: I do not see this as either increasing or decreasing protections for any specific groups. The primary goal, it appears, is to streamline the regulatory system and improve the coordination of regulators and to better grasp the scope of potential financial problems that now all fall under the responsibility of the Fed.

What are the perils and pluses of moving, in some cases, away from state regulation to federal regulation?

Response: The biggest potential perils are that there will be less regulatory customization to meet states’ specific needs and that enforcement will move to the federal level. However, this seems a very small price to pay when you consider that in order to do business on a national basis, firms have to deal with fifty different state regulators.

Should regulators be competing to be the ‘regulator of choice’ for the subjects of regulation?

Response: If they are, then that is probably the cause of the problems we have today. It is very difficult to take these regulators pleas seriously when it appears that they are more concerned with protecting their turf than fulfilling their public service roles.

Is it too early in the current problem environment to try to craft an overhaul plan?

Response: The changes that are being proposed are much more long-term in scope than just a knee-jerk reaction to the current housing slump and associated credit crisis. The current environment makes this an ideal time to initiate some of these changes. The only reason to wait would be to see if things get worse before they get better. Even if that is the case, the new regulations would not help us.

Richard Fulkerson, Colorado Bank Commissioner:

- Is this necessary? Was the current system really broken?

I don't believe that the current system is broken, however; I do think there are gaps in the regulatory structure and that too many players in the financial markets are largely unregulated. Treasury Secretary Paulson's plan is a first step in developing a comprehensive regulatory structure, but it is important to set aside regulatory turf battles, avoid politicizing the process, and not arbitrarily discard components of the existing structure that are effective for the sake of change.

- Will it be more effective than the current system?

I don't think it is possible to predict at this point if the proposed revamp would be more effective than the current structure, particularly given the likely differences between the proposed structural changes and what actually emerges.

- Is it "too easy" on Wall Street, as some critics have said? Who is being protected in this proposed system?

I have no basis to comment.

- What are the perils and pluses of moving, in some cases, away from state regulation to federal regulation?

I am obviously a little biased in this area, but strongly support the dual banking system and believe that the benefits far outweigh the inefficiencies of the current structure. The choice between state and federal charter provides a check against a concentration of power in a single regulatory agency and preserves the right of individual states to craft consumer protections and bank policies appropriate to local economic needs and conditions. The beauty of the U.S. banking system is its stability, diversity, and ability to adapt to changing market conditions through the development of new products and services. Any regulatory structure that results in greater consolidation of the industry will lead to greater concentration of risk and a reduction in consumer choices.

- Should regulators be competing to be the 'regulator of choice' for the subjects of regulation?

The imposition of a semblance of market discipline on regulatory agencies promotes efficiency and responsiveness - provided there is a backstop to prevent a lowering of standards. Currently the FDIC, as the guardian of the insurance fund, serves in that capacity. Regulatory agencies must permit financial institutions to develop, within reasonable risk parameters, new products and services, experiment with alternative delivery channels, and respond to market needs, i.e. ATMs, online banking, and debit cards. A single regulatory agency may be so risk averse as to inhibit such innovation.

- Is it too early in the current problem environment to try to craft an overhaul plan?

It is not too early to start a meaningful dialogue on the regulatory structure, but it must be a long term process. The current credit and foreclosure crisis has

focused sufficient attention on the issue to effect long term change, but a knee jerk reaction must be avoided and due consideration given to the law of unintended consequences. I believe that it is imperative that consideration be given to appropriate regulation of all financial service providers, from payday lenders to investment banks, and that revisions to the current structure not diminish the authority of state legislatures, and/or preempt consumer protections.

Don A. Childears, Colorado Bankers Association President/CEO:

- Is this necessary? Was the current system really broken? There are problems that need to be addressed – mortgage originations by inadequately supervised brokers, Fed access by those not regulated by the Fed, insufficient credit union regulation, etc. – but they don't justify this proposal. It needs much work.

- Will it be more effective than the current system? Yes in some ways by addressing the above issues, but it also damages the highly valuable dual banking system (both state and federal bank chartering and regulation), and may discard benefits from the existing thrift charter.

- Is it "too easy" on Wall Street, as some critics have said? Who is being protected in this proposed system? The result needs to include effectively enforced uniform and universal mortgage standards for all parties.

- What are the perils and pluses of moving, in some cases, away from state regulation to federal regulation? The peril is losing the state level which is responsible for many of the innovations in banking and which is more local and accessible regulation attuned to local conditions. There is benefit to addressing issues like mortgage origination and equal regulation of all financial institutions on a national level – much like the U.S. government set minimum standards for appraisals after the S&L crisis of the 1980s.

- Should regulators be competing to be the 'regulator of choice' for the subjects of regulation? Ideally no, but that is a reality.

- Is it too early in the current problem environment to try to craft an overhaul plan? It's not too early to address our most pressing issues related to housing, but I would put this regulatory restructuring in a longer time frame. Despite some merit to the proposals I can't see anything passing in the next year – due to a GOP President negotiating with Democrats in Congress (who think they will have the White House in a year), and regulated entities having differing views among their ranks and with regulators who also are jockeying for position.

Larry Martin, Bank Strategies LLC:

The current system was designed seventy-five years ago and is increasingly obsolete. The sub-prime mortgage debacle and associated fall out are clear indicators of problems with the current system. A newer system will be more effective, how much so will depend on how well it is designed and implemented.

Doug Ferraro:

I'm Doug Ferraro, President/CEO of Bellco Credit Union. I am also Vice Chairman of the Board of the Colorado Division of Financial Services, the regulator for state chartered S&Ls and credit unions. I am bothered by this proposal in both roles.

This reactionary proposal is like cleaning a bug off your windshield with a fire hose. It is an entirely misplaced attempt to fix a real issue by creating 100 bigger problems.

The proposal seeks to eliminate the charters of savings and loans and credit unions entirely, and to eliminate the federal and state regulators of such institutions. The Office of Thrift Supervision, the National Credit Union Administration and the Colorado Division of Financial Services and the institutions they regulate in Colorado did not cause the mortgage crisis, and they don't need to be fixed or eliminated.

The debate between dual charters and dual regulations is one of state's rights. To suggest elimination of dual chartering is a serious threat to state rights that has long been resolved in favor of consumers. Today, every institution has an option to select one of six charters; bank, savings and loan or credit union, federal or state. Each of those charters is unique with different powers and responsibilities. Each institution selects the charter of choice on how to uniquely fulfill their mission in their communities. This effectively eliminates choices and requires institutions to ignore the differentiation that has been so important in their heritage. There are structural and cultural differences in institutions that should be preserved for the benefit of all consumers, not destroyed by the ill thought out whims of federal bureaucrats.

This proposal appears to be a conspiracy developed between the largest banks and opportunistic politicians to eliminate the unique role and competition offered by alternative charters and smaller institutions. It would be the demise of small community institutions and put consumers at the mercy of the largest institutions, the same institutions that contributed to the real problem at hand today. Credit unions and local thrifts have long been the small thorn in the side of big banks to force more competition in favor of consumers. This idea would substantially eliminate competition.

Finally, anyone who has ever worked in a regulated financial institution knows we don't need more regulation, we need less. We are already burdened by so many

laws and regulations adopted over the years, while we are never provided relief from those already in existence, no matter how obsolete. The result of regulations is higher cost of credit and financial services to consumers. Making it harder to provide mortgage loans to consumers will hurt Americans, the economy and the country.

Gregory Anderson, CEO, GRAnderson Wealth Management Group

U.S. Treasury Secretary Hank Paulson' plan is too late and too extreme. The government currently has tools in place to regulate the capital markets and any additional intervention would be duplication. For example, the Securities and Exchange Commission (SEC) has repeatedly asked hedge funds to be more transparent in their investment policies and activities. The result has been voluntary compliance. Hedge funds, like other pooled investment funds, should provide the same disclosures. Another area in which the SEC could and should be more active is regulation of insurance rating agencies. How could so many debt related securities warrant "investment grade" rating?

Frank Birgfeld, the St. Croix Group and former head of the NASD's Denver office:

A substantial reorganization of the financial sectors is long overdue. The present scheme is a patchwork of rules and concerns, most of which were created by situations long gone and which were fabricated at a time when stock brokers, banks, and insurance companies had there own unique products and did not stray into each other's space. With the present financial supermarket environment, those old days are gone but the regulatory scheme continues to labor as if they remain.

While words leading to modernizing the financial regulatory apparatus are applauded, my bet is this, like other past efforts, never gets far down the road. Since really changing things presents opportunities for one entity to gain advantages, this will be fertile ground for competing lobbyists who will have plenty over funds to press into the hands of willing politicians. There will be turf battles as regulatory staffs seek to enhance or save their careers. And melding the present agencies will be a monumental undertaking considering that the very basic philosophies under which they approach their tasks are so markedly different. Whereas securities regulators operate for fair dealing with customers, the bank regulators want the public to retain confidence in the financial integrity of its institutions, a throwback to the Depression. To make the point, security regulators routinely publicize sanctioning brokerage firms and their individual brokers. Can anyone remember like treatment of a bank or an insurance company? Are there no bad apples in those barrels?