M E M O

To: Republican Leader John Boehner
From: Larry Lindsey, The Lindsey Group
Date: April 16, 2010
RE: Financial Regulation Reform: Unintended Consequences and Some Intended Bad Ones

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The Financial Regulation reform bill is being rushed to the Senate floor, possibly as early as next week. Formal bipartisan negotiations on a number of issues were ended, reportedly at the request of the White House, although informal conversations are still proceeding. <u>The bill weighs in at 1408 pages.</u> Like health care, the bill has a lot of sections that have not been thoroughly considered and will likely cause adverse consequences for both the financial services industry and the economy at large if it is enacted.

To date, public attention has focused on whether the bill is a "bailout" bill that will keep "too big to fail" alive. You be the judge. <u>First, the bill contains a $50 billion fund for resolution of systemically risky institutions.</u> The bill allows a 2/3 vote of the Financial Stability Oversight Council to deem any firm (financial or non-financial) as coming under its rubric and then authorizes the FDIC and Treasury Secretary to treat each of the firm's shareholders and creditors as they choose, without regard to bankruptcy law. <u>Second, the bill gives the Treasury and the FDIC authority to grant an unlimited number of loan guarantees to systemically risky institutions.</u> No Congressional authorization or appropriation is required. <u>Third, the bill gives the Fed the authority to fund any "program" to assist these institutions accepting as collateral anything it deems appropriate.</u> So perhaps too big to *fail* is dead. How could any firm actually *fail* when all of its debt could be guaranteed by the Treasury, the Fed could print money to assist it, and just in case, there was $50 billion sitting around to reassure nervous creditors that they would be repaid regardless what contract or bankruptcy law said? <u>Needless to say, the large Wall Street firms aren't complaining; they will permanently benefit from having lower borrowing costs thanks to these provisions, the same way Fannie Mae and Freddie Mac enjoyed implicit guarantees.</u>

<u>The soon-to-be-released Derivatives section requires virtually all derivatives trading to be channeled through exchanges</u>. While appropriate for some contracts, a lot of Derivative contracts are fairly esoteric, and like highly specialized corporate bond issues, unlikely to face a liquid market. That is why they are traded over the counter. It is important to note that some over the counter derivatives transactions, like corporate bond transactions, can be cleared safely while others are appropriately done bilaterally.

<u>The legislation mandates a six-month study of the Volcker rule by the Financial Stability Oversight Council followed by a nine-month period for the regulatory agencies to implement the results of the study.</u> No Congressional review – the regulatory agencies' interpretation of the committee findings are implemented directly through the Administrative Law process.

The 1408 pages also contain lots of one-off benefits to politically powerful groups. Labor gets "Proxy Access" to bring its agenda items before shareholders as well as annual "say on pay" for executives. Consumer activists get a brand new agency funded directly out of the seignorage the Fed earns. No oversight by the Federal Reserve Board or by the Congress on how the money is spent. This is the first known Congressional raid on Fed cash flow to fund projects without oversight. <u>The politics of the rush-to-passage are clear: to prevent the development of public awareness of the myriad special provisions in the bill.</u> It also allows anyone trying to block quick passage of being pro-Wall Street. Ironically, Wall Street contributed roughly 2-1 to the Democrats in the last two campaign cycles. One can only wonder whether this is what they thought they were getting.