BUSINESS

Finding a gatekeeper in world of finance

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Congress is weighing the most significant regulatory overhaul of the financial system since the 1930s. But the intense focus on health care and the rebounding stock and bond markets have diverted public attention from the effort, which could affect everything from payday loans to bank regulation to derivatives trading.

The Denver Post assembled a panel of four experts to discuss regulatory reform efforts.

ON THE PANEL: (From left) Sanjai Bhagat, professor of finance at the University of Colorado at Boulder Leeds School of Business; Jennifer Waller, senior vice president with the Colorado Bankers Association; Gary Merenstein, a Boulder consumer attorney; and Fred Joseph, the state securities commissioner and interim banking commissioner.

What role did regulation or the absence of regulation play in the financial crisis?

Bhagat: Earlier regulations required homeowners to make some kind of down payment. Mortgages were then issued without any sort of a down payment, the notion being that home ownership is a good idea. Well, home ownership is a good idea, but if you have only debt and zero equity, where's the ownership? Confidence in the credit-rating agencies was misplaced. They were co-opted because of the significantly large fees that they were collecting by rating these mortgage bonds. The antidote for that is to essentially remove all regulations that require them to rate bonds. Investment banks had a central role to play, and I think it's ironic in this day when you see Goldman Sachs claiming so much earnings. Incentive compensation was terribly misaligned, not only for the shareholders but also for the interest of the economy.

Joseph: This is a question that always seems to come up when there is a financial crisis of some sort. If you go back to the 1980s, the same question was asked, "Where were the regulators?" If I had to put it in two different words, I would say leverage and transparency. Investment banks could leverage debt to capital 40 to one. And transparency. Some of this stuff is hidden in hedge funds, dark pools and the like. I would say deregulation also plays a role. Glass-Steagall (a law separating commercial banking from investment banking) was repealed back in 1999.

Waller: One thing we feel pretty passionately about is that there should have been consistent regulation for all financial-service providers, including the AIG and Lehman Brothers of the world, who were not regulated to the same stringent standards that banks were. There was a huge difference between Wall Street banking and Main Street banking.

Joseph: The investment bankers are basically allowed to voluntarily police themselves and, in essence, set their own capital ratios. The SEC allowed this voluntary program, but it turned

out to be an abject failure.

Bhagat: Investment banks were highly leveraged, and they were allowed to manage their own financial leverage, if you will. And we saw very high leverage levels. So, if you want to play the free market, play the free market all the way to bankruptcy and beyond. That's where the big mistakes were made by former Treasury Secretary (Henry) Paulson and the last administration and continuing on into this administration.

Post: One of the key proposals is for a Consumer Financial Protection Agency, which would oversee payday loans, mortgages and many other consumer products. Are we overdue for that, or are we opening up a Pandora's box?

Waller: It's well-intentioned, but it absolutely misses the mark in that most of the abuses suffered by consumers were not created by regulated banking institutions. The last draft I saw exempts almost all of those non-bank entities. It's a very dangerous precedent to try and separate consumer protection from the safety and soundness of a lender. To have a viable long-term financial establishment, you have to have those two functions going hand in hand.

Merenstein: Well, there are existing laws that oversee unfair trade practices by creditors and debt-collection abuses by debt collectors. So as far as regulating those two areas, there already is a safeguard. These laws could be strengthened and expanded. I like the general idea (of a consumer protection agency), though.

Joseph: State banking, securities and insurance regulators, as well as state attorney generals, favor the creation of this entity. There would be a pretty broad oversight over a lot of things — mortgage loans, payday loans, credit cards, student loans, that sort of thing. And obviously it gets down to the devil in the details and what does it look like at the end of the day.

Bhagat: It sounds like a good idea because consumer protection, who can be against that; you know it protects the average consumer out there. But then you think about . . .

Merenstein: It is as American as apple pie.

Bhagat: So, you have a consumer that goes to a bank, nobody is forcing them, to get a loan and these banks compete fairly actively. If we pass a bill that requires the banks to behave a certain way or be more forgiving of consumers, are we going to preclude some consumers from getting loans? The bank can merely stop lending to those consumers. By trying to protect the consumer, you end up hurting many consumers who cannot then get the loan.

The vast majority of people know exactly what they are getting into. They are living beyond their means, and then they get into a problem and say it's the bank's fault. Maybe we need to talk about how people cannot act like adults. If they know they cannot afford a $1 million home, maybe a $300,000 home will be just fine. So, a little bit of telling people to behave responsibly might go much further.

Merenstein: It goes without saying that consumers should act with fiscal responsibility. But these consumer financial devices were created by the merchants and creditors. Consumers are actively encouraged by advertising to take advantage of those.

When somebody goes to approve a loan, they pull a person's credit score and look at whether

they are working. Down the road, somebody could lose their job or they don't have health insurance and could incur major medical debt. They are going to fall into trouble. It has nothing to do with fiscal irresponsibility. Actual deadbeats, those who can pay and don't, are a very small percentage.

Bhagat: The vast majority of citizens are behaving responsibly. They pay off their debt, they pay their mortgages on time and many have no mortgages. So, every time you want to bail out those that have behaved irresponsibly, those that behave responsibly have to pay for it. Now, what kind of incentive does that send? We have the incentives in the country the wrong way.

Post: Fred, hedge funds and private capital pools will have to register, and securitization markets will have to face tighter rules. Do proposals go far enough or is more needed?

Joseph: I believe the proposed legislation addresses the issue, and I'm encouraged in the direction that's heading. Transparency is key here, and there hasn't been any. One of the biggest things that keeps me up at night is some firm out there over- leveraging and no one knows it until it blows up.

Post: The reform package seeks to create one national banking regulator instead of the half-dozen we have now and to do away with the federal thrift charter. Where do bankers stand on that, Jennifer?

Waller: One-size regulation we feel would simply not work. We feel that the regulatory power now is concentrated in Washington. If you had just one regulator, it would favor those entities and programs that are controlled and sponsored by Washington. We feel that eliminating most federal regulators eventually would lead to the elimination of state banking regulators, who have a better feel for the environment of their state, who know their market.

Post: Many consumers don't realize they are in a financial trap until it is too late. Gary, how can regulators better manage how debt and delinquencies are handled in this country?

Merenstein: One of the biggest things these days are debt buyers. Some of these companies are publicly traded, and they'll go and buy millions of dollars' worth of outstanding debt from creditors for pennies on the dollar. And when they get these large portfolios of outstanding debt, they typically don't receive proof that the consumer owes the debt. They are taking up a large percentage of the dockets on county courts all over Colorado, seeking default judgments. And so when a consumer does show up in court and disputes the debt, collectors who are now the creditors are unable to prove their case. A possible reform would be to make the debt collector certify in their compliance that they file that they are already in possession of evidence to prove their case.

Post: What's more important at this point, health care reform or financial reform?

Joseph: The markets have improved the last six months. There seems to be stabilization and it's kind of moved off the front page, whereas health care reform is right there in front of everybody.

Merenstein: I would note that if everybody were insured, not as many people would be behind on their debt, which relates to financial reforms at least in regard to debt collection.

Bhagat: Health care reform is at some level a financial issue. The level of expenditures that are required from the taxpayers is mind-boggling. And we sort of believe that we can keep spending and there will be no long-term implications. No nation has ever remained great by becoming indebted to other nations, so I don't know why we think we will somehow get around this.

Post: One of the criticisms of regulatory reforms are that they tend to deal with yesterday's problems, what already happened. What reforms are needed that aren't being addressed?

Bhagat: If you have an entity considered too large to fail, they need to have a living will or plan approved by regulators in all the countries they operate about getting through the bankruptcy process. Investment banks must have sufficient equity. They should have capital requirements.

Waller: The (proposed) systemic risk regulator would be charged with both identifying, monitoring and addressing risk. They would see risks coming, and not only just for banks but for any financial institution that has any impact on the overall system, even due to the nature of the business, their size or their interconnectedness. That will help address the situation of regulation predominately being reactive instead of proactive.

One area where regulators have been proactive is in commercial real estate. They've been identifying that as a problem for years, and banks have been encouraged to slow down commercial real estate lending. There is a consensus that we haven't seen the full impact of the downturn on commercial real estate yet, but regulators have limited lending in that area.

Joseph: I don't know whether I see much right now addressing those institutions that are too big to fail. What do we do with them to lessen the moral hazard, whether capital levels, compensation, whatever you have. I'm not saying bring Glass- Steagall back, but it seemed to work for 60 years and look where we are at today after they repealed it. Just the too-big-to-fail concept, I think, is left hanging out there and it's not fully addressed.

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Sweeping proposals

Congress is considering legislation to reshape financial-industry regulation. Below are some of the major components.

Consumer Financial Protec-tion Agency: This new regulator would supervise the design, terms, practices and disclosures surrounding a wide array of consumer financial products.

Financial Services Oversight Council: Made up of existing regulators, this council would track and identify risks that threaten the entire financial system.

Systemic Risk Regulator: The Federal Reserve would be granted authority to supervise all companies that pose a threat to financial stability, including non-banks.

National Bank Supervisor: Several banking regulators would be folded into one entity, and the federal thrift charter would be eliminated.

Hedge funds and private capital pools would be required to register.

Over-the-counter derivatives and the debt securitization markets would come under tighter regulatory control.

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