Go slow on overhauling financial regulations

by The Detroit News

A spokeswoman for President George W. Bush said quick action is needed on the major overhaul of the federal financial regulatory system unveiled by Treasury Secretary Henry Paulson Monday - but Paulson correctly called for long and careful deliberation on it.

The most troubling aspect of his proposal is that the Federal Reserve System, the nation's central bank, could be divested of its direct power to regulate commercial banks and given more authority to regulate investment houses. Commercial banks accept deposits and make direct loans, such as home mortgages and auto loans. Investment houses package and trade securities.

Shareholders of investment houses and buyers of securities assume much more risk than bank depositors. For this assumption of risk, they expect a generally greater return than bank depositors. This is called the "risk premium." But if investors and operators of investment houses expect to reap such a premium, they must also be prepared to accept the losses associated with risk.

Recently, the Federal Reserve shepherded the sale of a large investment house, Bear Stearns, to the larger financial conglomerate of J.P. Morgan Chase rather than let it go into bankruptcy. Shareholders were initially to receive only $2 per share for their stock; the price has since gone up to $10.

To facilitate the sale, the Fed guaranteed to back $30 billion in mortgage-backed securities held by Bear Stearns so Morgan could more safely assimilate the company.

The Fed also agreed to begin lending to other investment houses as well as commercial banks. Paulson's plan anticipates such loans in the future and states they must be "transparent" and come with lending standards and the ability of the Fed to examine the books of the investment houses.

A new agency could assume the bank-examining role now held by the Fed. The Fed would be given broad new responsibilities to maintain the overall stability of all financial markets.

But two top Harvard economists interviewed by the Wall Street Journal, former Reagan economic adviser Martin Feldstein and Clinton-era Treasury Secretary Lawrence Summers, wondered whether Fed regulators would have the expertise to stay on top of something as volatile as the financial market, compared with the more staid world of commercial banking.

Justin Moran, a local bank consultant, said that if the Fed is to lend money to investment houses, it has to have the same power to examine them that it now has with commercial banks - to make sure they have enough capital reserves and quality assets to sustain themselves.

But should the Fed assume this role, and back it with the power to put taxpayer funds at risk by guaranteeing questionable loans, as it did with Bear Stearns? That is a formula for continuing financial problems.

Federal lending to investment houses ought to be a rare emergency event, not something that is routinized through regulations.

The immediate problem confronting the financial markets is the existence of a large number of securities backed by poor-quality mortgages. Paulson would create a special commission to examine and rate state mortgage-lending rules. Michigan regulators and honest mortgage brokers have proposed tougher licensing, education and background checks for mortgage brokers, which is in line with new federal regulations proposed by Paulson. This makes sense.

But the best way to deal with the mortgage securities problem is to let the investment houses that are holding them take a hit. Sheltering the financial market from the consequences of bad decisions could lead to a long period of slow growth and inflation.

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