



Financial regulation in the Obama Administration; what to look for

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President Obama comes to office in the midst of the largest financial crisis the US and the world has faced since the Great Depression. Like President Franklin Roosevelt in 1933, he starts with enormous personal popularity and only sketchy ideas for how to get out of the current mess. Like Roosevelt he was elected because he conveyed hope and confidence and a break with the past. Great things are expected of him. Can he deliver?

Although the Obama Administration faces many challenges, its first priority will be to address the financial meltdown. Many causes are given for the crisis — greed, a climate of laissez faire and deregulation, subprime mortgage madness — but a main culprit, according to most commentators, is the failure of regulators to do their job. There is widespread agreement that throwing money at the problem — even huge amounts of money on an unprecedented scale — will not be enough; there will also have to be regulatory reform.

But what kind of reform? How extensive will it be? What will it mean for the federal agencies that currently regulate banks and securities? For the state agencies that currently regulate insurance?

This is a moving target. New plans are proposed by the Obama team and Members of Congress every day and the final shape of regulatory reform has not yet emerged. Nevertheless, some possible outcomes are more probable than others.

1. There is little doubt that the regulatory environment will be strengthened, with new government powers and greatly heightened enforcement under existing authority. The Republican mantra that free markets will take care of themselves is no longer in favor in Washington.

2. The new regulatory regime, however, is likely to be based in most instances on existing institutions and responsibilities. A wholesale break with past practices or the creation of major new regulatory agencies is not in the cards.

3. In particular, the prospect for the enactment of legislation creating an optional federal charter for insurers does not look bright. It was recently reported that Sheila Bair, the head of the Federal Deposit Insurance Corporation who will likely be reappointed to that position by President Obama when her current term is up, told an insurance trade association that the creation of a federal insurance regulator is unlikely and that plans to create an Optional Federal Charter may fall by the wayside. She said the Obama Administration would seek to consolidate regulatory agencies, not create new ones. Nonetheless, major components of the US insurance industry will continue to press for federal charter legislation.

4. What is likely is that additional authority will be given to a federal agency, probably the Federal Reserve Board, to gather data on major financial firms, including insurers, in order to assess systemic risk and provide early warning of impending trouble in the markets. Representative Barney Frank, Chairman of the House Financial Services Committee, recently said a consensus is emerging that the Federal Reserve Board be given this new authority and that he will schedule hearings on the idea for April. It is not clear, however, that any new regulatory authority will go with this role.

5. Instead the current regulatory agencies will continue to exercise much of the authority they have today, although likely with more resources, greater energy and more attention to enforcement. That is, the Office of the Controller of the Currency and the Federal Deposit Insurance Corporation will continue to regulate federally chartered banks, the Securities and Exchange Commission and the Commodity Futures Trading Commission will continue to regulate trading activities, and state insurance regulators will continue to regulate insurance. Some elements of the authority of federal regulators may be combined or consolidated so that, for example, credit default swaps might be considered futures and therefore subject to the CFTC, but the basic functions of the major regulatory agencies are likely to remain very much as they are today.

6. The Federal Government will probably play a larger role in international insurance regulatory activities in the future, perhaps through the creation of an Office of Insurance Information in the Treasury Department. But again, this will likely be a coordinating and information gathering role, not a regulatory function.

7. There will be an attempt to bring under regulatory control by existing agencies all financial market activities, including some, such as hedge funds and derivatives, that currently are largely unregulated, and to sort out which agencies are responsible for such hybrid products as credit default swaps and variable annuities.

This assessment is based on a couple of key principles that often play a role in the American political process:

- The US political system retains a fundamental aversion to the consolidation of power. Just as President Bush tried but ultimately failed to strengthen the executive power of the White House in the face of the unprecedented threat of terrorism, so efforts to consolidate regulation over the entire financial sector in one place are not likely to succeed, even in the face of the current financial crisis. Americans prefer divided authority, even when it is inefficient and costly. There will be no rush to repeal the federal McCarran-Ferguson Act, which delegates the regulation of the business of insurance to the states and precludes the application of federal antitrust laws to insurers that are state regulated. And there is unlikely to be a radical consolidation of regulatory authority at the federal level.
- However costly and overlapping the current regulatory system is, there are constituents for it. Congress will want to make as few changes as possible in the existing regulatory framework in order to avoid unwelcome political problems. If state insurance regulation works — and there have been far fewer problems with insurers than with banks and other federally-regulated financial institutions — it will not likely be changed. No one is predicting the creation of an American counterpart of the UK's Financial Services Authority. Congress may create a new superstructure with authority to monitor the "big picture," but real regulatory authority will most likely remain essentially where it is today.

Does the advent of the Obama Administration, then, mean business as usual? Not at all. The great loss of wealth and, especially, the loss of jobs will spur the newly empowered Democrats to take innovative

measures on an unprecedented scale. The Democrats are not afraid to use the power of government to bring about desired change. That is a philosophical difference they have with Republicans, who believe — at least in theory — that government should be small and have limited authority. There will be a new emphasis in the Obama Administration on the regulation of financial markets, new support for enforcement activities, perhaps new laws to extend the reach of regulation over activities that are currently unregulated.

The public outrage over the financial meltdown, and the vast amount of taxpayer money involved in the bailout, will spur the President and the Congress to push for stronger regulation of the financial industry. When the dust clears, however, the current regulatory structure, with all its faults and redundancies, may well remain essentially unchanged.

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