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Statement of the Shadow Financial Regulatory Committee

On

**Statement on Financial Services Agenda for the Second Bush Administration
(An Open Letter to President George W. Bush and the Congress)**

December 6, 2004

The Shadow Financial Regulatory Committee believes that the items below will be on the agenda for consideration in the next four years and makes the following recommendations for action.

1. Regulation NMS (national market system).

According to press reports, the latest draft of the SEC's Regulation NMS will include an extension of the trade-through rule to all markets. The trade-through rule attempts to give price protection to limit orders by prohibiting bypassing or "trading-through" a better priced limit order. The Committee has always supported competition in markets, and in the absence of compelling evidence of market failure or a demonstration that the securities markets are a natural monopoly—or that the new SEC draft otherwise improves upon competition—the Committee believes that the Administration should support the complete elimination of the trade-through rule.

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2. Liberalizing International Financial Services

International financial services liberalization has been on the Administration's agenda as part of the WTO Doha Round and in the negotiation of regional free trade agreements. Even after the completion of the Doha Round, the Administration should keep such liberalization at the forefront of its priorities. A solid body of economic research suggests that improvement in financial arrangements precedes and contributes to economic performance, not just in developed countries but also in developing countries, and thereby contributes to worldwide economic growth. Financial liberalization should extend not just to banking, securities, and insurance, but also to asset management, credit cards, venture capital, and private equity. As a part of the Administration's liberalization policy international organizations should be encouraged to harness public and private efforts to identify international best practices in insurance, securities and banking regulation, clearing and settlement systems, disclosure (and transparency), and accounting and auditing standards.

3. Realizing the Full Potential of the Gramm-Leach-Bliley Act

The potential of the Gramm-Leach-Bliley Act of 1999 (GLBA) to bring about meaningful financial modernization has been frustrated by the rigid restrictions the Act imposes on the nonfinancial activities of financial holding companies (FHCs). These limitations have significantly deterred insurance and securities firms from becoming full competitors for depository institutions. Moreover, while GLBA permits joint rulemaking by the Federal Reserve and the Treasury to add activities to the list of those financial activities permissible for FHCs, the fierce battle precipitated by their proposal to add real estate brokerage to the list strongly suggests that any statutory scheme providing for case-by-case determination of those activities that are "financial" in nature has the potential to be converted into pure turf warfare among potentially competing industries, to the detriment of consumers. The Administration should seek to have GLBA revisited to eliminate those restrictions that impede its potential for achieving real financial modernization.

4. Privatization of Fannie Mae and Freddie Mac.

The Committee has in the past endorsed the privatization of Fannie Mae and Freddie Mac. Recent events at Fannie Mae have emphasized the importance of this step in reducing or eliminating taxpayer risks, and increased the likelihood that privatization will be considered during the administration's second term. Although the Committee has not made a particular privatization proposal, it believes any privatization

proposal developed or endorsed by the Administration should be designed to increase competition in the secondary mortgage market.*

* John D. Hawke, Jr. took no part in the consideration or preparation of this paragraph.

5. Extension of Terrorism Risk Insurance Act

The Committee has opined that the arguments for extending the Terrorism Risk Insurance Act (TRIA) beyond 2005 are unpersuasive (Statement No.207, May 24, 2004). If the Congress, however, decides to extend TRIA, the program's scope should not be expanded, and the amount of losses that the private sector must bear before federal assistance kicks in should increase annually over the duration of any extension. Regardless of whether TRIA is extended, the Congress should focus on reforming policies that inhibit private sector capacity to provide insurance and reinsurance for terrorism losses at premiums that many businesses would find acceptable. Serious consideration, for example, should be given to whether modifications in the corporate income tax code are desirable as a means of reducing insurers' and reinsurers' costs of holding the large amounts of capital required to provide coverage, thereby increasing supply, reducing premiums, and reducing demands for any federal backstop program.

6. Deposit Insurance Coverage Limits

Congress is likely to be asked to increase the deposit coverage on FDIC insurance from the current ceiling of \$100,000. There is little need to do so as the average deposit is less than \$20,000. Moreover, by reducing the number of depositors who have incentives to monitor the condition of their banks, raising coverage limits will increase the risk of bank failure, as occurred in the banking and thrift crises of the late 1980s at high cost to the taxpayer.

7. Protecting Federal Preemption for National Banks and Federal Thrifts

The next session of Congress is likely to see a renewal of the attack on federal preemption of state laws that serve to regulate the exercise of banking powers conferred by Congress on national banks and federally chartered thrifts. The Administration should oppose any effort to curtail preemption or to limit the ability of federal chartering agencies to make preemption determinations.

The banking business is increasingly a multi-jurisdictional, if not nationwide, business. Consumers of banking services have the ability to choose among a wide variety of providers, whose location is frequently

irrelevant to their choice. In an earlier time, when the banking business was predominantly local in nature, there may have been some force to the notion that issues of consumer protection in the area of financial institutions should be left to local lawmakers and enforcers. However, in today's marketplace subjecting providers of banking products and services to the varying laws and regulations of a multitude of state and local jurisdictions can only serve to generate inconsistencies and to impose needless costs that will inevitably be passed on to consumers. Rather than permitting the clock to be turned back on preemption, the Administration should support the development of uniform national standards in those areas that need to be addressed.

8. Pension Benefit Guaranty Corporation

The Pension Benefit Guaranty Corporation (PBGC) has announced a \$23.3 billion deficit on its balance sheet in its most recent fiscal year. It is unlikely that this deficit will be substantially reduced in the future, as additional firms with defined benefit plans are likely to declare bankruptcy and abandon their pension funds to the PBGC. At the same time, higher premiums on solvent firms will encourage them to switch to defined contribution plans. Thus, to protect the current pension beneficiaries the government should officially recognize its implied liability for the PBGC and take action to close the Corporation to future coverage. (See Statement No. 213 for additional detail)

9. Personal Retirement Accounts

If the Administration pursues personal retirement accounts in social security reform, the Committee believes that there are a number of important implementation issues that should be addressed. A guiding principle should be to avoid a situation similar to what happened with the savings and loan associations and is happening with the Pension Benefit Guaranty Corporation, namely a taxpayer bailout of investments that perform poorly. This principle should guide the decision about the number and types of investment choices available to individuals for personal retirement accounts. For example, individuals might be allowed to choose from a limited number of different stock and bond index and broadly diversified funds. Competition among portfolio management firms to be chosen for the approved list, as well as the reopening of the approved list from time to time, would be desirable. Some functions, such as record keeping, could be centralized in the government in order to hold down costs and assure continuity. Portfolio management however, should be carried out by private professional firms.