Washington Post: "Plan to Expand Financial Oversight May Add New Risks"

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The Obama administration's plan for a sweeping expansion of financial regulations could have unintended consequences that increase the very hazards that these changes are meant to prevent.

Financial experts say the perception that the government will backstop certain losses will actually encourage some firms to take on even greater risks and grow perilously large. While some financial instruments will come under tighter control, others will remain only loosely regulated, creating what some experts say are new loopholes. Still others say the regulation could drive money into questionable investments, shadowy new markets and lightly regulated corners of the globe.

And a shortage of manpower raises questions about the government's ability to keep up with the vast and complex financial markets.

In congressional testimony last month, Treasury Secretary Timothy F. Geithner laid out the principles of the administration's proposals. He called in part for designating a federal agency that would be responsible for identifying financial companies whose failure could endanger the wider economy and for giving the government greater authority to wind down troubled financial firms. He also proposed new regulations for hedge funds, venture capital funds and private-equity funds, as well as for complex financial instruments known as derivatives.

These plans seek to mitigate some of the dangers exposed by the financial crisis. But while weak regulation is partly responsible for the current turmoil, the unintended consequences of government action over past decades also played a role.

At the top of the Obama administration's agenda is the creation of a regulator that can peer into any corner of the economy to root out threats that could shatter financial markets.

But some experts warn that such a "systemic risk regulator" could unleash new hazards if it can identify certain companies as being too large to fail. This could create an incentive for firms to grow dangerously big so they can win a government guarantee against failure. If a company has the promise of government protection, its creditors might be willing to lend it money at below-market rates because of the reduced probability the company will collapse and they won't get paid back.

The danger of this incentive is twofold. For one, a firm may be willing to take on more unreasonable risks. Second, if a company gets access to unusually cheap financing, its rivals are at a competitive disadvantage.

"If these entities are now perceived to be too big to fail within the protective net, then they get an advantage vis-à-vis other institutions that are not so perceived," said Lawrence White, an economics professor at New York University. "The creditors to these guys become even less inclined to monitoring and more inclined to say, ‘Hey, let the government do it.'"

In the view of many financial experts, that is exactly what happened to mortgage-finance companies Fannie Mae and Freddie Mac before the government seized them last year. Congress chartered both companies to provide financing to lenders to make home mortgages. Their debt didn't carry the official backing of the U.S. government, but many creditors assumed the government would step in if the companies faltered.

That meant the interest rates Fannie Mae and Freddie Mac had to pay to borrow were just slightly higher than what the U.S. government had to pay. With access to cheap financing, the firms borrowed hundreds of billions of dollars and bought or guaranteed trillions of dollars in mortgages. Some of these went bad in recent years. Last fall, the companies nearly collapsed as a result, prompting the government takeover.

Geithner's proposals for hedge funds and derivatives also drew concerns from some financial experts. Geithner proposed that hedge funds register with the Securities and Exchange Commission and disclose information about their operations.

But some who closely track the industry warn that may encourage more investors to put their money into hedge funds without actually protecting against fraud and risky investment practices.

"The government is going to be more hands-on, and that's going to imply to people the government is vetting the risks relevant to a hedge fund," said Jason Scharfman, managing director of Corgentum, a firm that evaluates whether hedge funds have proper safe internal procedures. "It exposes investors to a false sense of security that they don't need to perform adequate due diligence on the hedge funds they're investing with."

The SEC and other agencies may not have the manpower to adequately oversee new markets.

In recent months, the SEC has disclosed that the number of agency staffers available to police the market has stagnated even as the size and complexity of the market has grown far greater. For instance, only one in 10 investment advisers -- the designation under which most hedge funds register -- is examined every year by the SEC.

Meanwhile, the special inspector general overseeing the Treasury Department's financial recovery plan has just 30 employees. The inspector general's chief of staff recently said that his operation would need an agency the size of the FBI -- which has nearly 30,000 employees -- "to truly cover this by ourselves."

In his testimony on the future of regulation, Geithner also said that most derivatives should be regulated. Of particular concern are credit-default swaps, which are essentially insurance contracts between two parties to cover losses should a bond default. These swaps were behind the near-collapse of American International Group. And because trillions of dollars of swap agreements were made over recent years, it was difficult for the government to determine the extent to which they posed a threat to the entire financial system when the crisis escalated last fall.

Geithner proposed that swaps be traded through a central clearinghouse, allowing regulators to keep an eye on the derivatives market and give investors more confidence that their partners are legitimate. This would apply to standard swaps -- for instance, one to protect against a General Electric bond going bad.

But others would be exempt. This would include nonstandard swaps, such as one to protect against the default of a multilayered security composed of residential and commercial mortgages.

Several experts cautioned that leaving any room for exemptions could be devastating.

"It could give incentives for parties to issue less standardized or very customized contracts which would not be required to be cleared," said Houman Shadab, senior research fellow at the Mercatus Center at George Mason University.

There could be a rush to use nonstandard swaps if there's an opportunity to get around a clearinghouse, which would impose additional costs.

Michael Greenberg, a University of Maryland law professor and former top official at the Commodity Futures Trading Commission, said "any fissure in this regulatory structure will lead to a race to the bottom."

The Obama administration's initiative also poses a risk that financial firms will move their activities offshore to avoid heightened regulation. Last week big industrial nations met in London to work on international regulatory reform, and some European countries want even tighter regulation than does the United States. But that doesn't solve the problem of lightly regulated island regimes such as the Cayman Islands or Netherlands Antilles, or developing financial centers in Asia and the Middle East.

"More regulation here will undoubtedly lead to more money flowing to places with a less heavy regulatory framework, in an effort to keep costs down," Andrew P. Morriss, a professor who studies regulation at the University of Illinois at Urbana-Champaign, said in an e-mail.

Morriss warned that money currently flowing into the United States from international investors could go elsewhere, such as China, "if we try to make it hard to come here."

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