Bailout Plan Puts All Eyes on the Fed

By Sudeep Reddy

The Federal Reserve's emergency weekend action putting the nation's last two independent investment banks under its direct oversight is bound to intensify scrutiny of the Fed and its performance as a regulator.

The Fed late Sunday approved requests by **Goldman Sachs Group** Inc. and **Morgan Stanley** to become bank holding companies overseen by the Fed. The move, after the collapse or sale of three other investment banks in recent months, effectively sidesteps a regulatory debate—brewing since the Fed extended direct loans to Wall Street firms in March—over which government agency should oversee investment houses.

"The Fed now becomes the über regulator," said Robert Litan, a senior fellow at the Brookings Institution.

A Treasury Department proposal earlier this year ultimately would have removed direct banking supervision from the Fed and left the central bank almost as a backstop for the overall safety of the financial system. Instead, "it's becoming the defensive line, the linebacker and the safety all together—the whole team," Mr. Litan said.

A separate bank regulator, the Office of the Comptroller of the Currency, would oversee the commercial banks for Morgan Stanley and Goldman. But the Fed will be the key oversight agency for the two firms' overall capital levels and soundness. The central bank already oversees other major bank holding companies, such as the parents of Citibank and Bank of America.

Revamping the U.S. financial system's regulatory structure is expected to be at the top of the next Congress's to-do list. Officials in the Bush administration, Congress and independent agencies such as the Fed and the Securities and Exchange Commission have acknowledged flaws in the current approach.

Treasury Secretary Henry Paulson has said in recent days that the system will need to be revamped—but only after the current crisis passes. Mr. Paulson, Fed Chairman Ben Bernanke and SEC Chairman Christopher Cox will be among the officials testifying before lawmakers Tuesday about the crisis.

"When we get through this difficult period, which we will, our next task must be to improve the financial regulatory structure so that these past excesses do not recur," Mr. Paulson said last week while announcing the outlines of his plan. "This crisis demonstrates in vivid terms that our financial regulatory structure is suboptimal, duplicative and outdated."

The crisis has exposed failures across numerous agencies. The SEC, for instance, has been the lead oversight agency of Wall Street firms while two major investment banks—Bear Stearns Cos. and Lehman Brothers Holdings Inc.—collapsed. Merrill Lynch & Co. sold itself to Bank of America Corp. this month to avoid a similar fate.

The Fed also has faced criticism on the regulatory front. Critics say its consumer-protection rules fell short during the housing boom and contributed to the current crisis.

Fed officials have been accused of misjudging the ramifications of the subprime-lending crisis, planning for significant losses but not anticipating the broader breakdown in credit markets.

At the same time, it has watched banks write down the value of assets—particularly risky mortgage securities—by billions of dollars, contributing to the current crisis. Fed Vice Chairman Donald Kohn acknowledged earlier this year that the central bank "did not perform flawlessly" in supervising financial institutions. "I don't know that we fully appreciated all the risks out there," he told Senate lawmakers in March. "I'm not sure anybody did, to be perfectly honest."

The Fed's key short-term task now will be converting Goldman and Morgan, two highly leveraged investment banks, into less-risky institutions.

Investment banks can operate in large part through short-term borrowing, allowing them to invest substantially more than the actual funds they hold for that purpose. Commercial banks must hold more capital, and by taking customer deposits they have a deeper cushion in case of a breakdown in short-term funding markets, as is occurring now.

The Fed has had its staff inside major investment banks since March, when it opened its short-term lending window to the firms. That provided officials with a clearer view of the firms' conditions before taking the radical step—even waiving a waiting period—of allowing Goldman and Morgan Stanley to become bank holding companies.

The firms will be limited in some of their activities. But the law provides two years for them to conform to the law on nonbanking investments and activities, with the possibility of three one-year extensions after that.