

Geithner calls for new risk watchdog

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WASHINGTON (Fortune) -- Treasury Secretary Tim Geithner called for new rules Thursday that would allow regulators to police the darkest corners of the financial markets, including big hedge funds and derivatives trading.

The U.S. also needs a single regulator to oversee the biggest financial firms, Geithner told the House Financial Services Committee in prepared testimony.

Treasury Secretary Tim Geithner called the current system 'fragile' in prepared testimony.

The comments came as Geithner testified before the congressional panel on the need for a sweeping overhaul of financial regulation in the wake of the deepest financial crisis since the Great Depression.

"Our system failed in basic fundamental ways," Geithner said in written testimony released Thursday morning by the panel, which is chaired by Rep. Barney Frank, D-Mass. "The system proved too unstable and fragile, subject to significant crises every few years, periodic booms in real estate markets and in credit, followed by busts and contraction."

Geithner also called for "substantially more conservative capital requirements" for big firms and consistent standards for executive pay.

Policymakers led by Geithner and Federal Reserve Chairman Ben Bernanke have spent the past week making the case on Capitol Hill that they need sweeping new powers to regulate financial institutions in order to prevent a repeat of the current banking industry crisis.

On Monday, Geithner called for new legislation that would allow regulators to take over big financial firms that fall outside the purview of the main banking regulator, the Federal Deposit Insurance Corp.

Regulators have been calling for the authority to wind down so-called too-big-to-fail institutions because of the problems they have encountered over the past year dealing with troubles at Bear Stearns, Lehman Brothers, AIG (AIG, Fortune 500), Citigroup (C, Fortune 500) and Bank of America (BAC, Fortune 500).

Geithner made clear that his proposals have been shaped in large measure by policymakers' struggle to contain the damage caused by derivatives speculation at AIG, the insurer that was near collapse last September before the Federal Reserve Bank of New York extended it an \$85 billion emergency loan.

Despite that massive infusion of aid, the company has continued to hemorrhage cash, in part because of losses tied to its massive portfolio of unregulated derivatives known as credit default swaps. After repeated return trips to the taxpayer trough, AIG is now in hock to taxpayers to the tune of \$182 billion.

"Let me be clear: the days when a major insurance company could bet the house on credit default swaps with no one watching and no credible backing to protect the company or taxpayers from losses must end," Geithner said in his prepared testimony.

In response, he proposed that swap dealers face tougher regulation as too-big-to-fail firms. Geithner also said regulators would "strengthen participant eligibility requirements and, where appropriate, introduce disclosure or suitability requirements" - potentially limiting who can buy or sell these instruments.

The trade group representing the big banks that handle the lion's share of over-the-counter derivatives trades said it has been reforming market practices, and is eager to continue to do so.

"We look forward to working with the Obama administration and Congress to develop a regulatory regime which more accurately accommodates 21st century products and markets," said Robert Pickel, executive director of the International Swaps and Derivatives Association. AIG backlash continues

Despite Geithner's pledge to fix the regulatory problems that allowed AIG to build up huge unhedged liabilities, the bailout sideshow took a new twist Thursday.

Rep. Spencer Bachus, R-Ala., said he sent a letter to Frank demanding an investigation of allegations that AIG is forcing U.S. banks that lent to it to take steep haircuts on the debts it owes them.

Bachus said this claim highlights the differing treatment of domestic and foreign creditors of AIG, in the light of the federal

decision last fall to pay some off holders of credit default swaps in full.

AIG made clear earlier this month that the payoff of AIG's swap counterparties benefited numerous domestic and foreign banks, including Goldman Sachs (GS, Fortune 500) and the Merrill Lynch brokerage now owned by Bank of America as well as Germany's Deutsche Bank (DB) and France's Societe Generale.

The domestic banks Bachus was referring to in his letter wasn't clear. He added later in the hearing that he was referring to "secured loans" extended to an AIG subsidiary by federally insured U.S. banks.

Bachus' office didn't immediately respond to a request for further comment, and AIG didn't immediately return a call seeking comment. Many big U.S. financial firms have done business with AIG, however.

In the aftermath of the initial bailout of AIG last fall, BofA chief Ken Lewis said, "I don't know of a major bank that doesn't have some significant exposure to AIG."

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