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For now Obama's regulatory proposals are just proposals -- but they're another step away from economic dynamism.

We don't think that yesterday's announcement of the Obama administration's proposals for financial regulatory reform has any particular immediate implications for markets. But let us not take that too casually, because having no implications is itself an important implication. Just over three months ago, markets were destabilized to the point of free-fall by a runaway train of legislative and regulatory "change" in the name of "emergency" (see "Obama: '...today does mark the beginning of the end'" February 20, 2009). Markets have stabilized since then in large part because that runaway train has been considerably slowed down (see "Wolf in the Fold" May 18, 2009), and yesterday's proposals are no exception. That is, they are only proposals -- in a way, little more than a statement of principles or even just a wish-list. There is very little in them can be implemented without congressional legislation, or at least extensive regulatory rule-making processes. And we don't see any urgent momentum to make anything large-scale happen in Congress. We face nothing like the 2002 rush to judgment that resulted in Sarbanes Oxley.

Update to strategic view

US FINANCIAL STOCKS: The Obama administration's financial regulatory proposals are of no immediate impact. But they are a salient reminder of the threat that overhangs the financial sector, and will inhibit the innovation and risk-taking necessary to rehabilitate the sector's broken earnings growth model -- already struggling to deliver a return on a diluted equity base.

[see Investment Strategy Dashboard]

Key documents

Financial Regulatory Reform: A New Foundation
US Treasury, June 17, 2009

Fact sheets:
- Strong supervision
- Strong financial core
- New tools
- Consumer protection
- International regulation

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All that said, these proposals are a reminder of the long-term anti-growth policy threat that overhangs the financial sector. We remain confident that the authorities have finally found a way to draw a firm line under the banking sector's solvency crisis (see "The Stress Tests' Hidden Mickey" May 4, 2009), we remain equally confident that the financial sector comes out of that crisis without a viable earnings growth model, and likely to be inhibited by regulation from ever coming up with a new one (see "All's Not Wells" April 13, 2009).

One notable feature of the proposals is the elevation of the Fed's supervisory power to include "authority over market infrastructure to reduce the potential for contagion among financial firms and markets." At the same time, the proposals curtail the Fed's current considerable powers by calling for Treasury approval of Fed loans under the emergency powers now granted in section 13.3 of the Federal Reserve Act. It may be that the Bernanke Fed is somewhat ambivalent about all this. Bernanke didn't make a statement in support of the proposals, though other regulators did, and such statements have become somewhat customary for the Fed. And Tuesday, just one day before the proposals were made public, Federal Reserve Board Governor Kevin Warsh, a Bernanke protégé who has emerged as one of the Fed's most thoughtful and far-sighted spokesmen, gave a speech delivering the heretical message that financial stability might come at the price of growth. Warsh said,

Recommended reading
Kevin Warsh's Greatest Hits "Defining Deviancy" June 17, 2009 "The Promise and Peril of the New Financial Architecture" November 6, 2008 "Market Liquidity: Definitions and Implications" March 5, 2007
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> Long after panic conditions have ended, stability threatens to displace economic growth as the primary macroeconomic policy objective. But we must recognize that the singular pursuit of stability, however well intentioned, may end up making our economy less productive, less adaptive, and less self-correcting--and in so doing, less able to deliver on its alluring promise.

It's not hard to see what Warsh means when browsing the Obama administration's proposals. Two entirely new regulatory agencies, arbitrary requirements on retention of securitized product, and restriction on non-banks owning banks -- to pick just three items among many -- are sure to punish innovation. But for that, they are not sure at all to deliver on the promise of stability.

BOTTOM LINE: The Obama administration's financial regulatory proposals are of no immediate impact. But they are a salient reminder of the threat that overhangs the financial sector, and will inhibit the innovation and risk-taking necessary to rehabilitate the sector's broken earnings growth model -- already struggling to deliver a return on a diluted equity base.