

APRIL 5, 2010, 2:08 AM

Krugman: Fool-Resistant Finance Reform

The White House is confident that a financial regulatory reform bill will soon pass the Senate. I'm not so sure, given the opposition of Republican leaders to any real reform, Paul Krugman writes in an Op-Ed column in The New York Times. But in any case, how good is the legislation on the table, the bill put together by Senator Chris Dodd of Connecticut?

Not good enough. It's a good-faith effort to do what needs to be done, but it would create a system highly dependent on the wisdom and good intentions of government officials. And as the history of the last decade demonstrates, trusting in the quality of officials can be dangerous to the economy's health.

Now, it's impossible to devise a truly foolproof regulatory regime — anyone who believes otherwise is underestimating the power of foolishness. But you can try to create a system that's relatively fool-resistant. Unfortunately, the Dodd bill doesn't do that.

As I argued in my last column, while the problem of "too big to fail" has gotten most of the attention — and while big banks deserve all the opprobrium they're getting — the core problem with our financial system isn't the size of the largest financial institutions. It is, instead, the fact that the current system doesn't limit risky behavior by "shadow banks," institutions — like **Lehman Brothers** — that carry out banking functions, that are perfectly capable of creating a banking crisis, but, because they issue debt rather than taking deposits, face minimal oversight.

The Dodd bill tries to fill this gaping hole in the system by letting federal regulators impose "strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity." It also gives regulators the power to seize troubled financial firms — and it requires that large, complex firms submit "funeral plans" that make it relatively easy to shut them down.

That's all good. In effect, it gives shadow banking something like the regulatory regime we already have for conventional banking.

But what will actually be in those "strict rules" for capital, liquidity, and so on? The bill doesn't say. Instead, everything is left at the discretion of the Financial Stability Oversight Council, a sort of interagency task force including the chairman of the **Federal Reserve**, the **Treasury** secretary, the comptroller of the currency and the heads of five other federal agencies.

Mike Konczal of the Roosevelt Institute, whose blog has become essential reading for anyone interested in financial reform, has pointed out what's wrong with this: just consider who would have been on that council in 2005, which was probably the peak year for irresponsible lending.

Well, in 2005 the chairman of the Fed was Alan Greenspan, who dismissed warnings about the housing bubble — and who asserted in October 2005 that "increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system."

Meanwhile, the secretary of the Treasury was John Snow, who ... actually, I don't think anyone remembers anything about Mr. Snow, other than the fact that Karl Rove treated him like an errand boy.

The comptroller of the currency was John Dugan, who still holds the office. He was recently the subject of a profile in The Times, which noted his habit of blocking efforts by states to crack down on abusive consumer

lending, on the grounds that he, not the states, has authority over national banks — except that he himself almost never acts to protect consumers.

Oh, and on the subject of consumer protection: the Dodd bill creates a more or less independent agency to protect consumers against abusive lending, albeit one housed at the Fed. That's a good thing. But it gives the oversight council the ability to override the agency's recommendations.

The point is that the Dodd bill would give an administration determined to rein in runaway finance the tools it needs to do the job. But it wouldn't do much to stiffen the spine of a less determined administration. On the contrary, it would make it easy for future regulators to look the other way as another bubble inflated.

So what the legislation needs are explicit rules, rules that would force action even by regulators who don't especially want to do their jobs. There should, for example, be a preset maximum level of allowable leverage — the financial reform that has already passed the House sets this at 15 to 1, and the Senate should follow suit. There should be hard rules determining when regulators have to seize a troubled financial firm. There should be no-exception rules requiring that complex financial derivatives be traded transparently. And so on.

I know that getting such things into the bill would be hard politically: as financial reform legislation moves to the floor of the Senate, there will be pressure to make it weaker, not stronger, in the hope of attracting Republican votes. But I would urge Senate leaders and the Obama administration not to settle for a weak bill, just so that they can claim to have passed financial reform. We need reform with a fighting chance of actually working.

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