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The Politics Of Regulatory Reform

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In a historic moment last week President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Do you think it makes the financial system safer and reins in the risky behavior of Wall Street financial institutions? Judging by the reaction of markets it is not much more than a blip on the radar of the Wall Street giants. For Goldman Sachs, Citigroup, JPMorgan Chase, Bank of America and others it will be pretty much business as usual going forward, with a few more government regulators looking over their shoulders. Of course, there will be changes in the regulatory environment that will make them a little less profitable for a while, but this is nothing like the sweeping overhauls of the 1930s.

The issues the Act covers in its 2,300 pages were informed by many of the failures of our financial architecture in the crisis. Those failures were catastrophic, and they had the potential to be far more devastating to the economies of the world than they actually were. The awareness of how close we came to paralyzing the financial system created an opportunity to do something truly significant to make the system safer and more in tune with the needs of our economy. Sadly, because all things in Washington are political, we fumbled the ball.

The Act is already being denounced by some for not going far enough to curb the risky behavior of financial institutions, and denounced by others for going too far and hampering innovation and efficiency in financial markets. The Act does make some important improvements in the oversight of the financial system and addresses some of the causes of the crisis, but whether it will be effective depends on the 243 rules yet to be written, the 67-plus studies yet to be undertaken, and the subsequent implementation and enforcement. It took a long time to get into the pickle that brought our economy to its knees, so we shouldn't be too impatient about the lengthy process. What makes a fellow dubious, however, are the cynical political calculations that are evident throughout this legislation.

Consider some examples. The most important cause of the financial crisis was the accumulation of systemic risk in the banking system because so many firms had made the same stupid one-way bet on housing. This created a big externality: The actions taken at any one firm had consequences, not just for that firm and the parties to its transactions, but for the entire financial commons. There was an enormous buildup of systemic risk in the financial system, specifically the risk that a large number of financial firms funded with short-term debt would fail all at once if there was a correction in the housing market.

Broadly speaking there are two ways to tackle problems like this. The first is a market-based solution that taxes the firms that create this risk, thereby discouraging firms from creating it. Such taxes are usually the least invasive way to remedy a market failure because they don't require heavy-handed government intervention into the specific decisions made by households and firms. In the context of the financial crisis, these would take the form of taxes on financial firms that rise with their systemic risk contributions. They would also raise revenue that the government can use to reduce other taxes or employ to improve the infrastructure of financial markets or cover the costs of sorting out systemic failures.

The second approach is direct government intervention: It addresses the same problem of risk with heavy monitoring by government bureaucrats and restrictions on the activities of banks.

Can both approaches succeed? Yes, of course. Which is more likely to be effective? Well, the agencies and institutions entrusted to do the monitoring are the same ones who missed the build up to the financial crisis of 2007-09. They are government regulators who are paid far less than the bankers they are regulating. Bankers who tend to be very proficient at finding ways to sidestep regulations, making requirements less binding and so on.

Here is another example of the cynical politics: the Bureau of Consumer Financial Protection. I won't get into the debate over whether we should even have one or whether it should be integrated with existing consumer protection agencies like the Federal Trade Commission. What they decided in the end was a head-shaking solution. It is to be located within the Federal Reserve, funded by the Federal Reserve, otherwise independent of the Fed and with a head appointed by the president. Huh?

Well, there is a twisted logic to it: The solution keeps the Bureau firmly under the political control of the executive branch. Keep in mind that this is in the interest of politicians, not necessarily consumers. Also since the Bureau is to be funded by the Fed, the funds for creating and running this large new bureaucracy do not have to be requested from Congress and become an acknowledged part of the budget. The taxpayers still foot the bill because these funds will come out of money earned by the Fed that would otherwise be paid by the Fed to the Treasury. The Treasury is using the Fed as its own little special purpose funding vehicle.

One more brief example: It is without question that among the worst, most inept contributors to the financial crisis were the government-sponsored enterprises Fannie Mae and Freddie Mac. These two institutions hold or guarantee more than $5 trillion worth of mortgages. To date their blunders have cost us close to $150 billion, and conservative estimates by the Congressional Budget Office as of last January were that the mispriced government guarantees of these mortgages will eventually cost taxpayers roughly $389 billion.

How can a major financial reform effort not deal with a problem of that magnitude? The official answer is that they didn't address it because they don't want to rattle housing markets in the midst of a shaky recovery. A more cynical guess is that the politicians don't want to acknowledge these liabilities on our balance sheet and don't want to give up control of housing policy.

The common theme in these examples is that those running the political process are always willing to trade off doing what is best and wisest for the safety and soundness of our economy for the preservation of political control over economic institutions. They are continually creating the case for more government. It is no wonder Americans are frustrated with their government: The political calculus always wins out over common sense.

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