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March 25, 2010 4:00 A.M.

Getting Financial Reform Right
What should we make of the Dodd bill?

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Earlier this week, the Senate Banking Committee endorsed regulatory-reform legislation that would (among other things) launch a Financial Stability Oversight Council to monitor and tackle systemic risk, establish a new consumer-protection agency in the Federal Reserve, boost shareholder rights through proxy access, and implement a watered-down version of the "Volcker rule" on proprietary trading. The measure, sponsored by Democratic committee chairman Chris Dodd, won approval by a party-line vote of 13 to 10.

Is it the watershed bill that many had expected? Not quite. In some ways, "Dodd is codifying the status quo," says Cato Institute economist Mark Calabria, who worked for GOP ranking member Richard Shelby on the Banking Committee from 2003 to 2009. Though the five-term Connecticut senator, who is not seeking reelection this year, insists that his plan would effectively solve the problem of "too big to fail" (TBTF) financial institutions, Calabria predicts it would lead to more "ad-hoc bailouts" of the type we saw during the Wall Street turmoil of 2008 and 2009.

Others agree that it would perpetuate, rather than end, TBTF. "Under the Dodd plan," writes *National Journal* columnist Clive Crook, "many big financial firms would indeed be declared too big to fail." Encima Global economist David Malpass has argued that creating a massive liquidation fund (starting size: $50 billion) supported by the biggest financial companies, as Dodd proposes, would only exacerbate the TBTF dilemma. Meanwhile, Carnegie Mellon economist and Fed historian Allan Meltzer has noted that "systemic risk" remains a murky concept that is tough to define in practice. He contends that forming a Financial Stability Oversight Council "is just another way to pick the public's purse." (Meltzer suggests revamping banker and shareholder incentives through new capital requirements: After the size of a bank passes some minimum threshold, the bank should be forced to maintain a higher level of capital relative to its assets. This would combat the excessive leveraging that preceded the recent financial implosion.)

On the other hand, no less a free-market enthusiast than CNBC host and NR contributing editor Larry Kudlow has praised the Dodd bill for providing "strict language on bankruptcy judges and shutdowns," and for "stating that most large failed financial firms are expected to be resolved through the normal bankruptcy process." It is conceivable, in his view, that Dodd "may have opened the door to ending TBTF and bailout nation." But Kudlow also objects to key elements of the legislation, including those related to consumer protection and proxy access.

In December, the House of Representatives passed its own financial-reform package, which would create a fully independent Consumer Financial Protection Agency with authority to regulate credit cards, mortgages, student loans, and other products. Republicans unanimously opposed the House bill, so Dodd was forced to pursue a compromise. During his talks with GOP senator Bob Corker, he agreed to jettison the independent-agency idea and put the new consumer unit in the Fed, thereby angering many liberal Democrats. (House Financial Services Committee chief Barney Frank told the *Boston Globe* that housing it in the central bank would be "crazy.") But according to Corker, the Consumer Financial Protection Bureau (CFPB) outlined in Dodd's legislation does not reflect "the balance that we were trying to achieve in our negotiations," referring to the balance between enhancing consumer safeguards and ensuring financial stability. To prevent the CFPB from running amok, says Corker, prudential regulators should have the power to veto any rules that "would undermine the safety and soundness of our financial system." He worries that the accountability mechanisms in the Dodd bill are insufficient.

As Calabria observes, Dodd's CFPB "is essentially independent of the Fed." It would have an independent director (appointed by the White House), an independent budget, independent rule-writing ability, and enforcement authority. Though regulators would be allowed to appeal its rules, the CFPB would wield enormous clout.

But is it really necessary? Put another way: Was the absence of such a consumer watchdog truly central to the financial meltdown? "I don't see consumer protection as being at all part of the problem we're trying to fix," says University of Chicago economist and financial expert John Cochrane. Unfortunately, it has taken on disproportionate significance in the current debate.

Another hot-button issue is proxy access for shareholders. In late February, activists representing 17 different center-right groups sent a letter to Dodd and Shelby warning that proxy access — which the Dodd bill mandates — would "benefit special interests with political agendas at the expense of ordinary shareholders."

As for derivative regulation, Sens. Jack Reed (D., R.I.) and Judd Gregg (R., N.H.) have teamed up to draft an amendment. Even if they can find common ground on that subject, Democrats and Republicans will continue bickering over the proposal championed by former Fed boss and Obama economic adviser Paul Volcker — that Washington should outlaw proprietary trading by banks and bank holding companies. The trouble with the Volcker rule is that prop trading, like systemic risk, is hard to define. At a Senate Banking Committee hearing on February 2, Volcker said of excessive trading, "It's like pornography: You know it when you see it" (an allusion to the famous Potter Stewart quote). So much for offering concrete guidance.

Dodd's bill contains a version of the Volcker rule; but as Calabria points out, the language "is full of holes." So are Dodd's TBTF provisions. Back in the summer of 2008, the Connecticut Democrat explicitly characterized government-backed mortgage giants Fannie Mae and Freddie Mac as TBTF. Yet his legislation does not address their ongoing threat to the financial system. That is a rather glaring omission.

Before their talks collapsed, Dodd and Corker had made considerable progress toward a bipartisan deal. They might even have succeeded, says Corker, if not for the bitter wrangling over health-care reform. On resolution authority, the Dodd bill largely reflects the substance of their collaboration. "There were some loopholes added," Corker explains. "It needs to be tightened up."

Indeed, one thing seems certain: Dodd's legislation will not pass the Senate without first undergoing major revisions.

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