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A Dubious Way to Prevent Fiscal Crisis

By JOE NOCERA

So where were we?

Last November, when I took a temporary powder, the subject du jour — at least in this little corner — was [financial regulatory reform](#). Today, eight months later (ouch!), as I return from my hiatus, the subject du jour is financial regulatory reform.

Back then, the question was whether Congress could muster the votes to even pass a reform bill. Health care dominated the body politic. Financial lobbyists were swarming. Senate Republicans were doing their foot-dragging thing. And so on.

Today, the question is a different one. Very soon, possibly as early as next week, House and Senate conferees will begin meeting to hammer out the compromises necessary to turn the bills they wound up passing in the interim into something [President Obama](#) can sign into law. There are plenty of differences between the House bill, which passed in December, and the Senate version that passed a few weeks ago, and there will be lots to haggle over in the conference committee. But broadly speaking, they're not that different. They both contain a new consumer protection agency, and they both take the same general approach to everything from systemic risk to the ratings agencies.

And thus it's not too early to ask: Will the bill that emerges from this conference do what it is intended to do? Will it prevent another crisis? Will it put an end to government bailouts? The painful answer is: probably not.

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In the first place, there is nothing even remotely radical about anything in these bills. Nobody is suggesting setting up a new [Securities and Exchange Commission](#), which reshaped Wall Street regulation when it was formed in 1934. Nobody is talking about breaking up banks the way they did in the 1930s with the passage of the [Glass-Steagall Act](#). Nobody is even talking about a wholesale revamping of a regulatory system that so clearly failed in this crisis. “They are trying to attack the symptoms, instead of the basic issues,” said Christopher Whalen, managing director of the Institutional Risk Analyst. There is something oh-so-reasonable about these bills, as if Congress was worried that they might do something that would — heaven forbid! — upset the banking industry.

Credit [derivatives](#)? Banks will still be able to trade them, and peddle the most dangerous ones without using an open exchange. Credit rating agencies? Their wings are barely clipped. The consumer agency? It has potential, but it’s not nearly as strong as it should be. Too big to fail? Under the new regime, the banks will remain as big, and as interconnected, as ever. And just because the country is going to have a systemic risk council — consisting of the [Treasury](#) secretary and the top financial regulators — doesn’t mean the bills do anything to reduce systemic risk. They don’t.

If you drill down with me on a few provisions, you’ll see what I mean.

THE RATINGS AGENCIES Does anyone doubt that the willingness of the big three ratings agencies — [Moody’s](#), [Standard & Poor’s](#) and [Fitch](#) — to slap AAA ratings on subprime junk played a huge role in the [financial crisis](#)? The shocking charges leveled this week at the [Financial Crisis Inquiry Commission](#) hearing by former Moody’s employees only reinforced the point. Moody’s analysts, they said, had knowingly handed out flawed ratings because top executives were pushing them to complete deals as fast as they could. They sold their souls for market share.

To solve this problem, Senator [Al Franken](#) of Minnesota inserted an amendment in the Senate bill that would end the practice of banks picking the agency to rate their securities; rather, an agency would be chosen at random, and the bank would be forced to accept its rating. But that is not the only problem — or even the primary one.

Ratings agencies are understaffed and underpaid. The best rating agency employees quickly gravitate to Wall Street. And the agencies have a long history of getting it wrong. [Enron](#), WorldCom, Penn Central — the ratings agencies always seem to be a day late and a dollar short. Yet since the 1970s, the ratings agencies have been imbued with a special government status — Nationally Recognized Statistical Rating Organizations, they're called — and a whole body of regulation has been written that revolves around ratings. [Mutual funds](#), to cite one example, can hold only securities that have the highest investment-grade ratings.

The solution should be obvious, shouldn't it? Just get rid of that special government status — and stop writing regulations that revolve around ratings. Believe it or not, S.& P. is in favor of such a solution. So why isn't it in the bill? Because all those money market and pension funds much prefer the crutch provided by the ratings — that way, if anything goes wrong they can simply say “It was the rating agency's fault.” And they're the ones Congress listened to.

CONSUMER PROTECTION AGENCY The good news is that it hasn't been completely gutted, despite the efforts of the Chamber of Commerce. The bad news is that it is a lot weaker than it ought to be. The “plain vanilla” option — showing consumers, for example, a 30-year-fixed mortgage alongside an option adjustable-rate mortgage — was tossed overboard long ago. A committee of bank regulators can veto any decision by the consumer agency. An astounding 98 percent of the nation's banks — every bank with assets under \$10 billion — are exempt.

And get this: the bill gives the [Office of the Comptroller of the Currency](#) the right to pre-empt state laws aimed at stopping predatory practices. This is the same regulator that used its pre-emption powers to moot laws passed by cities and states aimed at curbing the worst subprime excesses during the bubble. Not exactly confidence-inspiring.

“The consumer agency has some dings in it right now,” said [Elizabeth Warren](#), the chairwoman of the Congressional Oversight Panel, who first broached the idea for the agency in an article she wrote as a law professor. “I think it still has what it needs to succeed, but it's right at the edge,” she added. “If it is weakened any further, then it becomes a waste of time.”

DERIVATIVE REGULATION You've no doubt heard that the vast majority of derivatives will wind up on

an exchange, where everyone can see their price and the risks can be toted up out in the open. Don't get too excited. Most such derivatives will be products like interest rate swaps, which had no role in the crisis. **Credit-default swaps**, which played a major role in the crisis, are another story. In particular, the most complicated, one-of-a-kind — and most profitable — credit-default swaps will most likely stay in the shadows, which is exactly where the big banks want them to be. The profits the big banks make on these credit derivatives would drop substantially if these swaps were traded openly and, well, we can't have that, can we? The banks actually argue that credit will be constrained if they are forced to put these swaps on an exchange. It's like saying, if I can't gouge you, I won't lend to you. Nice little business model they've got there.

The bills try to come at these complex derivatives in other ways, primarily by clamping down on credit speculation and proprietary trading by banks. (That's what the Volcker Rule is all about.) But I'm skeptical that the Volcker Rule will be effective, even if it becomes law, which appears likely. The line between what constitutes trading for one's own account — proprietary trading — and what constitutes trading for one's client, which would still be legal, is extremely murky. It is easy to imagine the banks classifying all sorts of activities as "servicing clients," even if they happen to put lots of money in their own pockets.

Because credit-default swaps are a form of insurance — insuring against a default — they ought to be regulated like an insurance product, which would include walling them off from the rest of the bank and requiring that large amounts of capital be set aside to cover big potential payouts. But because that would inflict actual pain, it won't happen. (The amendment introduced by Senator **Blanche Lincoln** of Arkansas into the Senate bill, which would have walled off derivative operations from the rest of the bank, has no chance of making it into the final bill.)

Perhaps the most troubling fact of all is that the bill will do very little to reduce systemic risk. Derivatives will still be a means of creating unacknowledged leverage in the system. Hedging activities between counterparties will still create immense interconnectedness. Capital — the greatest cushion of all against systemic risk — is barely mentioned in the bills; Congress is leaving that to an international body in Basel, Switzerland, that sets international capital standards — and didn't exactly cover itself with glory with the rules it set prior to the financial crisis.

The bills' supporters say that the new resolution authority will give regulators the tools to prevent future taxpayer bailouts. But let's be honest: if a giant bank like **Citigroup**, with tentacles all over the world, most out

of reach of United States regulators, were to become insolvent, you don't think the Treasury Department would rush to bail it out? I do.

"When they say this is the greatest reform package since the 1930s, that is literally true," said Simon Johnson, the co-author of "13 Bankers" and one of the leading critics of the United States response to the crisis. "But that tells you nothing. There haven't been any reforms since the 1930s."

Indeed, watching Congress struggle just to pass even these timid reforms gives one a greater appreciation for what Congress accomplished during [the Great Depression](#). The current bills tinker with the status quo. The reforms in the 1930s actually forced banks to divest their investment banking divisions and outlawed all sorts of practices that were as common as selling credit-default swaps are today. No doubt the bank lobby of that era complained that their business would be ruined. But Congress went ahead and did it anyway.

I guess it's easier to have a spine when you're living through a Great Depression, and not just a Great Recession.

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