



October 25, 2009

Fair Game

Wall Street Follies: The Next Act

By [GRETCHEN MORGENSON](#)

It certainly sounded good.

Hoping, perhaps, to persuade a dubious public that curbing reckless business practices is indeed a Washington priority, the Obama administration and Congress produced a hat trick of financial reforms last week. The outlines of a consumer financial protection agency emerged from the House Financial Services Committee. The House Agriculture Committee spelled out ways to regulate risky derivatives trading, and the [United States Treasury's](#) compensation czar announced his plan to rein in runaway [executive pay](#) at seven companies that, in total, have received hundreds of billions of dollars in taxpayer help within the past year.

Not to be outdone, the [Federal Reserve](#) announced plans late Thursday to review pay practices at the nation's largest banks. It all left the question, would it make Wall Street safe for America?

For all the apparent action in Washington, some acute observers say that it was much ado about little. Last week's moves, they say, were tinkering around the edges and did nothing to prevent another disaster like the one that unfolded a year ago.

The white-hot focus on pay, for example, looks like a way for the government to reassure an angry public that they are making genuine changes. But compensation is a trifling matter compared to, say, true reform of derivatives trading.

"The American public understands the immorality of paying people huge bonuses for failures that damaged the economy," said Michael Greenberger, a law professor at the [University of Maryland](#) and a former commodities regulator. "What they don't understand is that those payments are only a small fraction of the irregularities that took place and that, in essence, the compensation problems, as bad as they are, are a sideshow to the

casino-like nature of the economy as it existed, pre-[Lehman Brothers](#), and as it exists today.”

It is difficult enough for seasoned regulators or market professionals to assess whether various reform proposals will close pernicious loopholes and make the financial system safer. But for a crisis-weary public, such an analysis is almost impossible. Much easier to grasp are the cuts to executive pay announced by [Kenneth R. Feinberg](#), the Treasury official in charge of setting compensation at bailed-out companies.

Mr. Feinberg reduced compensation across the board at [American International Group](#), [Citigroup](#), [Bank of America](#), [Chrysler](#), [General Motors](#), [GMAC](#) and Chrysler Financial, the companies that received the most government help. He cut average cash payments by more than 90 percent and overall pay by around 50 percent. Trying to discourage the instant-gratification mindset that permeates trading desks and executive suites, Mr. Feinberg also required that the majority of the salaries he oversees be paid in stock that must be held for the long term.

It is certainly worthwhile to reduce outsize pay at companies receiving taxpayer support. But regulating derivatives is far more important to those interested in eliminating the possibility of future billion-dollar bailouts. These financial instruments, which trade privately and beyond the prying eyes of regulators, are central to the interconnectedness among companies that required some of the costliest rescues. American International Group, for example, had to be rescued to cover the costs of insurance it had written for customers intending to protect their mortgage holdings from default. The insurance is a derivative called a [credit-default swap](#). The company has received \$170 billion in taxpayer aid.

But the derivatives bill generated by the House Agriculture Committee contains a sizable loophole. It is designed to push the trading of these opaque instruments onto exchanges or clearinghouses where regulators and participants can better assess who is at risk. But the bill would let transactions remain private if they involve nonfinancial companies that are trying to protect against fluctuations in their costs of doing business, a practice known as hedging. For example, when Exxon buys or sells derivatives to hedge against shifts in the price of oil, those transactions would be exempt from having to be traded on an exchange or clearinghouse. Thus, many derivatives would not trade in the light of day.

Such companies argue that trading on an exchange will make their costs rise. But critics of the exemption say

that if protecting the system from a meltdown costs participants a bit more, so be it. This last go-round has certainly been expensive for taxpayers, after all.

The consumer financial protection agency moving through Congress would also carve out an exemption that disturbs advocates for borrowers. It means that the agency will not oversee loans provided by auto dealerships.

Travis Plunkett, legislative director at the Consumer Federation of America, said this is akin to exempting mortgage brokers from oversight in real estate finance. "It's crazy to us not to cover the people who are offering the loans, who benefit from the loans and who sometimes have been found to participate in unfair lending," he said.

None of this, mind you, addresses the most significant issue of all: how to make sure that companies do not grow to a point where they become too big or interconnected to be allowed to fail. The man with a plan to resolve that crucial problem is [Paul A. Volcker](#), the former chairman of the Federal Reserve who is revered for crushing the ruinous inflation of the early 1980s.

In an interview last week with The New York Times, Mr. Volcker said the nation's commercial banks should not be allowed to hold and trade risky securities, a practice that generated deep losses for many of them in the credit crunch. The governor of the [Bank of England](#) made the same point last week. Separating these operations was the response the United States government took after the Crash of 1929, but today, the administration says it has no plan to break up the banks again in the manner Mr. Volcker suggests.

The former Fed chairman is certainly not alone in his fears about the threat that large institutions still pose. Neil Barofsky, special inspector general of Treasury's [Troubled Asset Relief Program](#), was asked last Wednesday by CNN about the changes being made to ensure that a disaster like the one starting last year would not recur.

"I think actually what's changed is in the other direction," the refreshingly candid Mr. Barofsky said. "These banks that were too big to fail, are now bigger. Government has sponsored and supported several mergers that made them larger. And that guaranteed that implicit guarantee of moral hazard. The idea that the government is not going to let these banks fail, which was implicit a year ago, its now explicit."

Then he added, “So, if anything, not only have there not been any meaningful [regulatory reform](#) to make it less likely, in a lot of ways, the governments have made such problems more likely. Potentially, we could be in more danger now than we were a year ago.”

[Copyright 2009 The New York Times Company](#)

[Privacy Policy](#)[Terms of Service](#)[Search](#)[Corrections](#)[RSS](#)[First Look](#)[Help](#)[Contact Us](#)[Work for Us](#)[Site Map](#)