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Health Care Strangles Bank Reform!

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The Senate takes up financial reform this week, but after a bruising battle over Obamacare, nobody's up for a fight. Jeffrey E. Garten on why a milquetoast bill is the best we can hope for.

Richard Drew / AP Photo

The Senate returns this week to take up Sen. Christopher Dodd's Banking Committee's bill on financial reform. The House has already passed its own bill. In the same way that TV commentators call the results of a big election before all the votes are in, I'm ready to predict the final outcome, which I believe will come this summer.

Here's what we have to look forward to: We will have a 2,000-plus page bill that President Obama will readily sign. It will still require reams of implementing regulations and years of legal interpretation. The legislation will have something to say on all the headline issues, including derivates, consumer protection, comprehensive oversight of heretofore unregulated firms such as hedge funds, and ways to avoid future tax-payer bailouts. Our political leaders will hail the bill as containing the most far-reaching changes in banking regulations since the 1930s. And, after all that, very little of importance will change on the ground.

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We'll have fewer big banks but those left standing will be mega-banks, having swallowed the others the way JP Morgan absorbed Bear Stearns or Bank of America subsumed Merrill Lynch. Another financial crisis will still be possible, because even the optimists know that booms and busts are a permanent feature of capitalist economies. And when push comes to shove, there will be no choice but to bail out the mega-banks.

A few regulatory agencies may disappear but a few more, such as a council of regulators to sit atop of all the others, will be established. The power balance between Washington and Wall Street may shift in the near term towards the former, but in a global market where regulation stops at the border's edge, it won't stay that way for long.

In addition, new laws are likely to mandate that derivatives be listed and traded on exchanges, where prices can be transparent. But there will be a number of important loopholes for customized derivatives – potentially a large category. There will be a Consumer Protection Agency, but it will be placed within the Federal Reserve or hamstrung in several other ways, rather than be made independent and powerful enough to combat the onslaught from regulatory agencies with other agendas and Wall Street lobbyists. Nothing will yet have been done with regard to mortgage giants Fannie Mae or Freddie Mac. The all-important issue of bank reserves will have been left for international agencies to determine months if not a year or more from now. And so it goes.

A number of forces will be responsible for a Herculean effort that produced a mouse.

To begin with, the legislation will have been a massive political compromise among many powerful constituencies: between congressional Democrats from the right and those on the left; between Democrats and Republicans; between Congress and the administration; between some regulators, like the Fed, against others, like the FDIC; and between Washington and Wall Street. The result will be provisions that are watered down or loopholes that vitiate key provisions altogether.

The main reason why these compromises could be made at all was that everyone was appalled at the devastation that bankers caused (and that goes for many on Wall Street itself, although few will say so publicly.) In addition, as I found out on a recent week-long trip to Washington—during which I met off the record with senior members of the administration, top regulators, key congressional staff, and heads of industry trade associations—there is little appetite in any quarter to drag out reform. Most everyone is weary after months of effort. Indeed, health care exhausted much of the appetite for battles that need to be waged for the kind of government intervention that would be required for real transformational change. For its part, financial community thinks the deal its getting isn't that bad; they'd like to draw a line under this black period of history—now.

Another reason for a milquetoast bill is that once the administration stabilized the banks and a total meltdown was no longer imminent, two contradictory forces were at play—the understandable pressure to punish the banks and the recognition that the smooth operations these same banks were essential in the face of slow growth and unconscionable unemployment. And as economic recovery started to gather steam—last week, the Dow breached 11,000—many forgot the dark and scary days of 2009 when a financial disaster and a depression seemed all too likely.

In a global financial system with powerful, highly innovative financial institutions, moreover, money finds a way around regulations as water flows around a rock. Exhibit A is the extensive set of corporate governance regulations called Sarbanes Oxley that was enacted after the Enron and WorldCom fiascos in 2002 and designed to improve risk management and accountability. Five years on, they didn't seem to help much when it came to Bear Stearns, Lehman, AIG, Merrill Lynch, Countrywide and others.

I believe that both Wall Street and Washington have been guilty of egregious malpractice. I feel that more bankers and regulators should have been held directly accountable. I would liked to have seen some far-reaching structural reforms, such as Paul Volcker's proposal to separate deposit taking institutions from firms that make more risky investments. It is also a good idea, in my view, to limit the size and the interconnectedness of banks. I support a new, orderly bankruptcy process for closing down big, complex firms like Lehman Brothers without causing enormous collateral damage. The fact is, however, that no one has been able to come up with pragmatic ways to implement these kinds of policies. Example: how big is too big in a hypercompetitive global market when neither Europe and China have no intention of shrinking their own financial behemoths? How can we measure "interconnectedness" when its very complexity still eludes our ability to understand its extent?

Truth is, maybe this is the best we can do, all things considered. And maybe it's time to focus more on rebuilding the economy for the long term, pumping investment into new industries and new technologies to expand job opportunities and American competitiveness, and coming to grips with the excruciating fiscal policies problems ahead. If I were advising President Obama, I would suggest that when the legislation gets to him, he should hold his nose, sign the bill, resist the rhetoric of how he socked it to the banks, and just move on.

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