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Financial reform in America

A decent start

A somewhat clumsy bill is hardly a panacea, though it fixes some impor things

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IT IS touted as the biggest overhaul of American finance since the Great Depression. Th 2,319-page Dodd-Frank Wall Street Reform and Consumer Protection Act, now nearing t its odyssey through Congress, tackles almost every aspect of American finance from mu bonds to executive pay. Its success, however, rests on a simple question: does it make crisis significantly less likely?

The reform does make progress in three critical areas: regulatory oversight, derivatives dealing with troubled banks that are too big to fail. Yet by itself, this bill, whose passag Senate is still not quite secure, is an incomplete remedy (see article). Much depends on American regulators implement its provisions. Congress left several meaty matters for l including the crippled mortgage giants, Fannie Mae and Freddie Mac. And even more is how the Basel club of international banking supervisors compel banks to raise their buff capital and liquidity.

Start with what the bill gets right. Though the financial crisis was global, it originated in uniquely fragmented financial system, overseen by a patchwork of federal and state reg Dodd-Frank missed its chance to eliminate that patchwork, but offers decent alternative creates a council to advise regulators on emerging threats. It consolidates oversight of financial products, from mortgages to credit cards, in a single agency. And big financial aren't banks can be yanked into the embrace of the Federal Reserve.

Though a secondary player in the crisis, derivatives are a perennial candidate for causin one because they add opacity and leverage to the financial system. Most derivatives tha trade dealer-to-dealer will be traded on public exchanges. That will lessen the risk that dealer's failure brings down others. An extreme proposal to stop banks trading derivativ been mercifully scaled back. (The Volcker rule, limiting banks' ability to trade on their o account, also seems likely to hurt Wall Street profits less than some feared.)

The most important provision is the resolution authority under which federal regulators any financial company whose failure threatens the financial system, and quickly pay off creditors while imposing losses on shareholders and unsecured creditors. This is an imp on the status quo. Such resolution authority already exists for banks, but for other comp Lehman Brothers and American International Group, regulators face a dreadful choice of bailing out the company and its creditors or letting it go bankrupt. Yet in its zeal to prot taxpayers, Congress has made the resolution process so similar to bankruptcy that coun and lenders may still choose to abandon a troubled firm to avoid losses. Other steps are needed: for example, regulators should create a new ring-fenced group of creditors who exposed to losses in resolution. But the horrible truth is that the effectiveness of any su will be discovered only when a real crisis occurs.

Meanwhile there are two other ways to mitigate the risks flowing from banks that are se big to fail. One is to claw back the subsidy such firms enjoy in their borrowing, both to e them to shrink and to pay for the clean-up when they fail. Barack Obama has proposed a that would serve the purpose. Despite the failure of the G20 to agree on such a tax last America (and other countries) should press ahead. The other is to force financial institut have more capital and liquidity to make collapses less likely in the first place. Negotiatio Basel have slowed as Europeans fret that stiffening standards may slow lending and hin economic recovery. Implementation should indeed not be rushed. Yet in the longer term buffers are essential.

Still a work in progress

In America Dodd-Frank's actual impact will depend greatly on how regulators like the Fe new consumer agency enforce its provisions. The risks cut two ways. Banks and their lo may persuade regulators to interpret the new rules in the friendliest possible way to Wa as they did before the crunch: the treatment of the ratings agencies, which seem to live life, will be a good test. In the opposite direction, regulators may overreach—stifling inn which, for all its recent excesses, has over time been a force for good.

At the G20 Mr Obama boasted of "leading by example" on financial reform. In fact, Dodd too idiosyncratically American and too incomplete to be a true template for others. And that it would keep a financial crisis like the one the world just went through "from ever h again" is bound to prove wrong. Yet imperfect though it is, the reform is proof that even government as fractious as America's can move with impressive speed when the motiva there.

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