WebMemo
Published by The Heritage Foundation

No. 2738
December 17, 2009

Financial Reform: Dodd's Even Bigger Government Solution to Financial Risk

David C. John

Senate Banking Committee Chairman Chris Dodd's (D–CT) draft financial reform package is so filled with bad policies that it is hard to decide where to start. Rather than trying to break up the financial regulatory reform proposed by the Obama Administration into six or seven smaller chunks like his House counterparts have done, he introduced it all in one big, 1,000-plus-page package.

But size is the least of the problems. The proposal, being circulated at the moment as a "discussion draft," includes big government solutions to virtually every problem that it seeks to address, including in many cases even more government intervention and new government agencies than the House legislation.

Bad Policies. Senate Banking Committee Members from both parties balked, and at Dodd's request, bipartisan pairs are looking at each of the major parts of his draft with the expectation that they will propose language that will be more acceptable to the committee as a whole. However, this does not mean that Dodd's draft is dead but merely that it could be revised as the legislative process continues.

Dodd's plan consists of many different parts covering a wide array of financial regulatory issues including the following.

- *A New Consumer Agency.* Like the House effort, Dodd would create a new Consumer Financial Protection Agency by pulling the consumer regulatory functions out of the existing financial regulators and merging them into a big new agency designed to micromanage consumer financial products.[1] Although intended to help consumers, the net result of such a move would be to stifle the innovations that would bring them improved, lower-cost financial products.
- *A New Mission for the FDIC.* Dodd's plan would also give the FDIC an extensive new role in resolving troubled large financial services firms.[2] Under the plan, the FDIC would take charge of any failing financial institution that could pose a risk to the overall financial system. Once in charge, the agency could change its management, take steps to preserve the firm's assets and liquidity, and provide it with additional financing during the process of closing it or selling it off in whole or in part.

  This would for the first time extend FDIC's authority beyond the banks that it directly insures. The new FDIC authority is also quite broad, raising questions about which institutions can be taken over and at what point. And, unlike current bankruptcy processes, there would be little recourse to courts.

  While the FDIC has done a fairly good job resolving smaller banks, it lacks the expertise and resources to handle a very complex multi-

This paper, in its entirety, can be found at:
www.heritage.org/Research/Regulation/wm2738.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation
LEADERSHIP FOR AMERICA

national financial institution. Bankruptcy courts, on the other hand, have both expertise and experience with complex corporations and, with revisions to the bankruptcy law, could more effectively handle financial institutions.

- *A New Systemic Risk Agency.* Dodd would also create another new Agency for Financial Stability that would have virtually unlimited powers to monitor systemic risk.[3] It could essentially draft any financial firm into the federal financial regulatory system and subject it to a wide variety of restrictions that could include compelling large financial firms to sell off portions of themselves, drop lines of business, break up, or otherwise reduce the "risk" that the regulators believe they may impose on the financial system.

  Together with the expanded FDIC role and a plan to create a new resolution fund to pay some of the costs of dealing with large problem financial institutions, this new bureaucracy would almost guarantee more big bank bailouts costing taxpayers untold billions of dollars. The new regulators could declare any problem with a major financial institution to be a potential systemic risk and tap into the fund to bail it out.

- *Creation of a New Super Banking Regulator.* One of the biggest policy mistakes is Dodd's proposal to merge the regulatory functions of the four agencies that now share it—Federal Reserve, FDIC, Office of Thrift Supervision (OTS), and Comptroller of the Currency—into a new Financial Institutions Regulatory Administration. (The comptroller's office and OTS would be eliminated entirely.)

  There is certainly a good argument for making substantial changes to the existing patchwork system of financial regulators. One of the best is that the current system better mirrors the financial industry of 50–75 years ago than the industry that exists today, but Dodd's piecemeal proposal makes little policy sense.

  It is hard to justify taking away the regulatory powers of the Federal Reserve and (to a lesser extent) the FDIC if the result is a system where both agencies still have the responsibility for dealing with any crises that come down the road. Dodd's approach would take away those agencies' ability to analyze market activities so that they could better anticipate problems and—even more importantly—place those that develop into context so they can decide what (if any) action to take. As long as these agencies retain underlying roles in the system, this would greatly increase the chance that a relatively small problem could develop into a catastrophe.

  This is not to say that either agency is untouchable in a more comprehensive, better considered merger of financial regulators. However, the Dodd package is certainly not that proposal. In addition to merging the OTS into the Comptroller of the Currency, Dodd should eliminate agencies like the Commodities Futures Trading Commission, whose mission duplicates that of the Securities and Exchange Commission. He should then propose to realign the remaining agencies so that their missions do not overlap and that the whole regime covers today's financial products with the flexibility to meet future industry developments.

- *More Bad Ideas.* Dodd's package also deals with a number of other issues, including regulating derivatives, municipal securities, hedge funds, and credit rating agencies. In addition, it would place restrictions on executive compensation, change corporate governance rules, increase investor

1. For a more complete discussion of this issue, see David C. John, "How to Protect Consumers in the Financial Marketplace: An Alternate Approach," Heritage Foundation *Backgrounder* No. 2314, September 8, 2009, at *http://www.heritage.org/Research/Regulation/bg2314.cfm.*
2. For a discussion of how to resolve "too big to fail" financial institutions, see David C. John, "Using Bankruptcy and Capital Standards to Address Financial Institutions That Are 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2343, November 24, 2009, at *http://www.heritage.org/Research/Regulation/bg2343.cfm*.
3. For a discussion of systemic risk, see David C. John, "Financial Systemic Risk Regulators: Congress Is Asking the Wrong Questions," Heritage Foundation *WebMemo* No. 2471, June 8, 2009, at *http://www.heritage.org/Research/Regulation/wm2471.cfm.*

protections, and change securitization rules. In each case, his plan would increase regulatory burden and attempt to micromanage these areas.

Bigger Is Not Better. A good rule of thumb is that the quality of a financial reform package is usually inverse to its size and complexity. This is certainly true of the Dodd package, which is filled with poor policies and outright mistakes that should be quietly dropped as the Banking Committee develops alternatives. As the legislative process continues, the Dodd draft will be mainly useful as a guide of what not to do.

—*David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*