Journal of Banking & Finance 36 (2012) 654–661

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Missing elements in US financial reform: A Kübler-Ross interpretation of the inadequacy of the Dodd-Frank Act

Edward J. Kane *

Boston College, Carroll School of Management, Chestnut Hill, MA 02467, United States

ARTICLE INFO

Article history:
Available online 1 June 2011

JEL classification:
G21
G28

Keywords:
Dodd-Frank Act
Financial reform
Safety-net subsidies
Financial crises
Regulatory capture

ABSTRACT

The success of any treatment plan depends on how completely the problems it targets have been diagnosed. The precrisis bubble in securitization can be traced to incentive conflict that allows national safety nets to subsidize leveraged risk-taking. Safety-net subsidies encouraged regulation-induced innovations that enabled firms to take hard-to-monitor risks and to make themselves politically, administratively, and economically difficult for government officials to fail and unwind.

This paper summarizes the incentive conflicts that led creditors and internal and external supervisors to short-cut and outsource due diligence. The Dodd-Frank strategy of reform does not adequately acknowledge or address these conflicts. The key step needed is to develop an effective statistical metric for measuring the ex ante value of safety-net support in the aggregate and at individual institutions. To accomplish this, government and industry need to rethink the informational obligations that insured financial institutions and their regulators owe to taxpayers *as de facto investors* and to change the way that information on industry balance sheets and risk exposures is reported, verified, and used. Without reforms in the practical duties imposed on industry and governmental officials and in the way these duties are enforced, financial safety nets will continue to expand and their expansion will undermine financial stability by generating large rewards for creative and aggressive risk-takers that are smart enough to cash in their share of safety-net benefits before they evaporate.

1. Introduction

In signing the massive Dodd-Frank Wall Street Reform and Consumer Protection Act (henceforth the Dodd-Frank Act), President Barack Obama issued a seemingly straightforward prediction about the effectiveness of the Wall Street Reform section of the Act:

> "The American people will never again be asked to foot the bill for Wall Street's mistakes. There will be no more taxpayer-funded bailouts. Period" (McGrane, 2010).

In 1766, Voltaire famously opined that "Men use thought only to justify their wrongdoings, and speech only to conceal their thoughts." This is another way of saying that no one should expect private or government officials either to tell the truth or to accept blame when it is due. Riffing on this theme, comedian Steven Colbert characterizes official explanations of adverse developments as "truthy" cover stories. Officials tell us what they *want the facts to be* as opposed to either what the facts are or what realistic analysis can support.

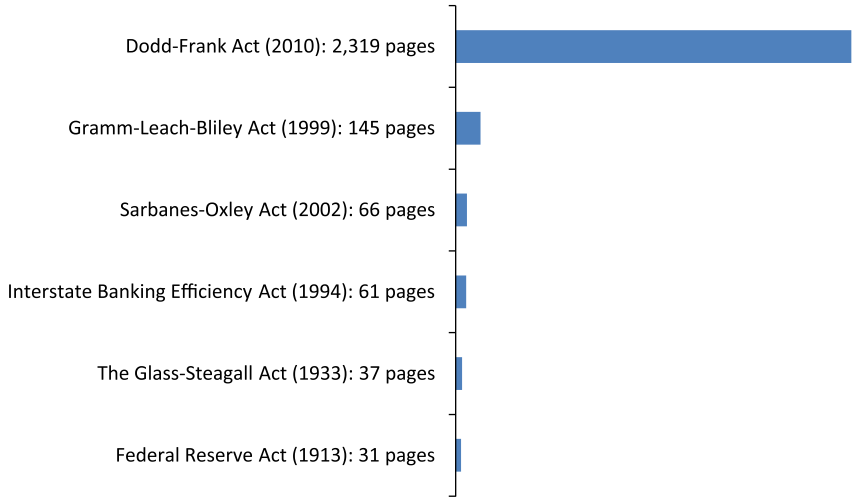
When government officials misinform the public about the reasons for – or probable effectiveness of – one or another economic policy, they violate a duty of accountability that every public servant owes to citizens of his or her country. This is because the right to protect high officials from painful criticism that government spokespersons implicitly invoke is trumped by duties of disclosure, loyalty and care that, as agents, high officials owe to other members of society. The integrity of representative democracy turns on these duties. For this reason, governmental or media deceptiveness poses a professional and ethical challenge to conscientious newspersons and academic economists to uncover the spin and explain the deception to citizens who might be harmed by it. This paper takes up this challenge with respect to the Dodd-Frank Act. It seeks to explain that ignoring the mechanisms of regulatory capture renders the Act deceitful at its core. Without changes in the ethical obligations accepted by managers of regulated institutions and regulatory agencies and new limits on how both groups interact with Congress, genuine and lasting financial reform is impossible.

* Address: 2325 E Calle los Altos, Tucson, AZ 85718, United States. Tel.: +1 520 299 5066.

E-mail address: edward.kane@bc.edu

0378-4266/$ - see front matter © 2011 Elsevier B.V. All rights reserved.
doi:10.1016/j.jbankfin.2011.05.020

Table 1
The expanding relative size of financial reeform legislation in the United States.



2. Why we cannot trust the President's statement

One way to establish the truthiness of the President's prediction is to expose mental reservations that could in principle explain its deceptiveness. The President was careful not to include "mistakes made by Congress or by incentive-conflicted managers of federal agencies and government-sponsored enterprises (GSEs)" in his first sentence. His second sentence reassures taxpayers, but neglects lower-income categories of "American people" that are apt to be harmed by crises in different ways. Finally, the President did not clarify whether he meant to exclude indirect "taxpayer funding" such as guarantees. Whether or not he had such reservations in mind, the one-word third sentence is an indefensible rhetorical flourish that strongly suggests an intention to mislead.

The Act puts responsibility for avoiding future crises squarely on the competence and good intentions of future regulators. The presumption that regulators can succeed year after year in this task – in the face of perverse Congressional pressures and recruitment procedures – is a wishful element that could account for the President's rosy forecast. Table 1 shows that – at 2319 typed pages – the Dodd-Frank Act is orders of magnitude longer than previous financial legislation. Despite its length, the Act allows GSEs to continue their loss-making ways and offers numerous opportunities for the regulatory community to misread its authority or otherwise miss its marks. In particular, the Act encompasses lengthy phase-in periods for most of the changes it mandates and leaves to federal financial regulatory agencies the hard work of specifying and implementing crucial details of the proposed new regulatory structure. By one count, federal regulators' incremental workload is to "complete 243 rules, largely during the next 2 years, along with 67 one-time reports or studies (including one on GSEs) and 22 periodic reports" (Kaper, 2010).

Although most moralists regard scapegoating and truthy "spinning" of facts as slippery slopes (Bok, 1999; Strudler, 2010), inviting listeners or readers to misinterpret shrewdly worded legislation is definitely more elegant than lying. Moreover, our legal system conditions us to accept (and even to admire) the use of clever evasions. Like producers of shoddy goods, producers of artfully framed words routinely defend themselves by blaming their victims for swallowing the bait. They can and do argue that listeners ought to realize that they are in a position of *caveat emptor* and act accordingly. From this captious perspective, verbal sleight of hand is acceptable because it offers its audience an opportunity to reason their way through the deception. However, the more officials use such techniques, the clearer this opportunity becomes and the smaller the percentage of a country's population that misdirection can fool.

A Bloomberg National Poll conducted during the week before the signing suggests that Presidential and Congressional misdirection has failed to sell the public on the effectiveness of the Act's legislative thrusts. Only 21% of respondents believed that the Act "will require big Wall Street Banks to make major changes in the way they do business" (Miller, 2010). In a *Risk* magazine survey conducted on its website about a week later (Table 2), only 12% of its presumably more-expert respondents thought regulators "are ready for new regulations."

To explain the divergence in expectations between the US political establishment and ordinary citizens, we can make use of the Kübler-Ross model of how people work through the emotional pain generated by personal and societal crises (Kübler-Ross, 1969). In recent years, her model has been expanded from five to seven stages: shock, denial, anger, fruitless bargaining for an easy way out, depression [i.e., realizing things (e.g., mortgage availability) will never be the same], examining realistic solutions, and settling on a satisfactory way to move forward. The model recognizes that people may easily become trapped in one of the passive early stages of denial, fruitless bargaining, and depression or cycle back to one of these stages in frustration when realistic solutions seem unreachable.

This paper advances the hypothesis that federal authorities are cycling between the stages of denial and superficial political bargaining, while the public is cycling between anger and depression. Although authorities refuse to admit it, Congress has ignored or undertreated what are easily perceived to be fundamental causes of the crisis: the regulation-induced "shadow" banking system (Gorton, 2010); the SEC's lax oversight of securities, credit-rating, and investment-management firms (as exemplified by the Madoff scandal); the *de facto* corruption of regulatory capture (accomplished through bargaining for campaign contributions and postgovernment job opportunities); and subsidies to leveraged risk-taking offered in derivatives markets and mortgage finance. The Bloomberg and *Risk* Polls suggest that these undertreatments and omissions have led a large percentage of the citizenry to lose faith in the ability of the US financial and regulatory systems to confess and amend their weaknesses.