

Heading Off the Next Financial Crisis



Damon Winter/The New York Times

ON THE CARPET The Federal Reserve chairman, Ben Bernanke, left, in the office of Treasury Secretary Timothy Geithner last month. Even critics credit their intellectual heft, but both overlooked ominous signs of excess over the past decade.

By [DAVID LEONHARDT](#)

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[I. Why We Need Regulation]

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Damon Winter/The New York Times

REGULATORY MAN Treasury Secretary Timothy Geithner after a meeting with business, university and elected officials at Research Triangle Park in North Carolina in February.

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A public good is something that the free market tends not to provide on its own, to the detriment of society. Pollution laws and police departments are classic examples. In the case of finance — and of the crisis of the past two years — this missing good has been strong regulation. A weak system of regulation allowed Wall Street firms to take on enormous debt. Those debts let the firms make more and riskier investments than they otherwise could have, lifting their profits. But when the value of the investments began falling, the firms had little margin for error. They were like home buyers who made a tiny down payment and soon found themselves underwater.

It was tempting to let the banks fail. They certainly deserved it. But big bank failures often cause [terrible damage](#). Credit dries up, and the economy can enter a vicious cycle of falling asset prices and job losses. That is what began to happen in 2008. To get credit flowing again, the federal government came to the rescue with billions of taxpayer dollars. It was a maddening story line: the government helped the banks get rich by looking the other way during good times and saved them from collapse during bad times. Just as an oil company can profit from pollution, Wall Street profited from weak regulation, at the expense of society.

If there has been a theme to the Obama administration's disparate domestic policies, it has been to invest more in public goods. The administration has increased spending on schools, highways and scientific research and tried to play a more active role in energy policy and health care. "They're all a necessary part of the network of what makes market economies work," [Timothy F. Geithner](#), the [Treasury](#) secretary, told me recently, "and we have not been good enough about doing them in recent years." A big part of that network, Geithner added, is financial re-regulation.

To reduce the odds of a future crisis, the Obama plan would take three basic steps. First, regulators would receive more authority to monitor everything from mortgages to complex securities. This is meant to keep future financial time bombs, like the no-documentation loans and [collateralized debt obligations](#) of the past decade, from becoming rife. Second — and most important — financial firms would be forced to reduce the debt they take on and to hold more capital in reserve. This is the equivalent of requiring home buyers to make larger down payments: more capital will give firms a bigger cushion when investments start to go bad. Finally, if that cushion proves insufficient, the government would be allowed to seize a collapsing financial firm, much as it can already do with a traditional bank. Regulators would then keep the firm operating long enough to prevent a panic and slowly sell off its pieces.

Will this work? It is difficult to know. No one can be sure where the next bubble or crisis will come from or, as a result, how to prevent it. You can make a plausible argument for many different forms of regulation, and there has been plenty of debate over the various details of re-regulation. How should derivatives be regulated? Should a consumer-protection watchdog be an independent agency or part of the [Federal Reserve](#)? Which agency should be responsible for seizing a failing firm?

With that being said, the Obama plan has a lot to recommend it. It would close many of the most obvious holes in the regulatory net. Congress could conceivably overcome its partisan divisions and pass an important bill this summer. If it does, the biggest reason to be nervous about the plan will not be any one of those details that has received so much attention in recent months. It will be something more fundamental. Whatever the regulatory apparatus, it will still be operated by regulators. Regulators will have to set [capital requirements](#), decide when to close a struggling firm and find a balance between protecting consumers and still letting them make choices. The legislation does not spell out many of these details, and neither [President Obama](#) nor [Ben Bernanke](#), the Fed chairman, has been especially clear about them. They have not offered much guiding philosophy beyond promising us that regulators will do better next time.

In a way, this issue is more about human nature than about politics. By definition, the next period of financial excess will appear to have recent history on its side. Asset prices will have been rising, and whatever new financial instrument that comes along will look as if it is safe. “When things are going well,” [Paul A. Volcker](#), the former Fed chairman, says, “it’s very hard to conduct a disciplined regulation, because everyone’s against you.” Sure enough, both Bernanke and Geithner, along with dozens of other regulators, [overlooked many signs of excess](#) over the past decade.

One way to deal with regulator fallibility is to implement clear, sweeping rules that limit people’s ability to persuade themselves that the next bubble is different — upfront capital requirements, for example, that banks cannot alter. Thus far, the White House, the Fed and Congress have mostly steered clear of such rules.

So it is worth asking whether the current re-regulation plan has enough of a backstop. Even if Wall Street stays one step ahead of Washington, even if future regulators allow too many loopholes in the capital requirements, even if the government does not seize the next [Lehman Brothers](#) until too late, can re-regulation still serve the public good?

[II. How We Got Here]

For more than a half-century starting after [the Great Depression](#), the United States enjoyed what the economist Gary Gorton calls [the quiet period of banking](#). Before the Depression, financial panics were a regular part of life. They occurred about once a decade. People would get nervous about the health of their bank and, en masse, begin withdrawing their money. The bank, however, had lent the money to other families and businesses and did not have anywhere near enough cash to allow the withdrawals.

In the wake of the bank panics of the early 1930s, the Roosevelt administration and Congress passed two crucial reforms as part of the [Glass-Steagall Act](#). In one, the federal government set up a new agency, the [Federal Deposit Insurance Corporation](#), that would insure deposits and guarantee that savers would get their money back even if their bank went bust. In the other, banks were restricted to traditional lending. They could not use their deposits to speculate in stocks and were no longer allowed to underwrite securities. Together, the two rules shored up the two sides of a bank’s business — its relationships with savers and with borrowers — and reduced the odds that a bank would go under. The quiet period was born.

It began to end in the 1980s. Banks started facing new competition for both savers and borrowers. Households could put their money in [mutual funds](#) like those offered by Fidelity and Vanguard, which offered better returns than savings accounts and sometimes with little risk. Meanwhile, companies, which had once relied on bank loans for financing, could more easily borrow from bond markets.

These changes clearly brought some benefits. As Daniel K. Tarullo, a Fed governor appointed by Obama, [has said](#), the New Deal regulations “fostered a banking system that was, for the better part of 40 years, quite stable and reasonably profitable, though not particularly innovative in meeting the needs of depositors and borrowers.” In the more competitive new system, borrowing costs fell. Credit cards, debit cards, A.T.M.’s and online banking brought convenience to consumers. The relatively high returns of the stock market became available to a [wider group](#) of people than before. Venture-capital firms turned ideas into companies.

But there was a fatal flaw in the new system. The banks’ new competitors received scant oversight. They were not directly bound by Roosevelt’s restrictions. “We had this entire system of outside banks that had no meaningful constraints on capital and leverage,” Geithner says. Investment banks like Lehman Brothers were able to make big profits in part by leveraging themselves more than traditional banks. To use the down-payment analogy again, it was as if Lehman were allowed to put down only 3 percent of a house’s purchase price while traditional banks were still making larger down payments. When the house’s value then rose by just 3 percent, Lehman doubled its investment. [A.I.G.](#), similarly, created a highly leveraged derivatives business that regulators essentially ignored.

In response, the traditional banks started advocating for deregulation, so they, too, could plunge into mutual funds and help companies sell stock. In 1999, the Clinton administration and a Republican Congress [repealed](#) most of Glass-Steagall, officially allowing traditional banks to engage in other, more risky investments. Even so, the banks’ new competitors — investment banks, insurers, hedge funds and other firms that collectively became known as shadow banks — continued to face less scrutiny and to grow rapidly. Thanks to their leverage, they could make enormous profits by being just a step ahead of ordinary investors or simply by riding a bull market. “The profits these firms make are so out of proportion with any contribution they make to the economy,” Volcker told me not long ago.

Eventually, so-called shadow banking made up roughly half of the American financial system. It also helped recreate the same preconditions for a panic that existed before the 1930s. The highly leveraged firms were vulnerable to panics. This time, the panic would come not from individual depositors — who were still insured by the F.D.I.C. — but from other financial firms. A central part of modern finance is something called the repo market, in which firms lend one another huge sums of money every day. If traders suddenly begin to worry that a second firm borrowing from their firm is in trouble, they immediately demand more collateral on the loan. Once one lender begins asking for more collateral, others get nervous and do the same. It is much like a bank run, this time conducted by phone and computer rather than at a bank’s front door. In September 2008, [JP Morgan Chase](#) and [Citigroup](#) did this to Lehman, effectively dooming it. Lehman’s collapse then set off a panic around the world.

The deregulation of the last few decades has come in for a lot of blame for the current [financial crisis](#). It deserves some blame, too. If Citigroup and [Bank of America](#) were still operating under the New Deal rules, they might not have flirted with bankruptcy. But take a minute to think about which firms [had the biggest problems](#). They were the shadow banks: stand-alone investment banks like Lehman, [Bear Stearns](#) and [Merrill Lynch](#); and other firms, like A.I.G., that were not banks at all. They were never fully covered by the New Deal regulation, and they were not the ones most affected by the deregulation.

The root of the crisis, then, came not so much from the laws that were changed. Finance evolved, and Washington did not keep up. So the creation of another quiet period probably cannot revolve around restoring old rules. It almost certainly depends on new rules, whether they are of the sweeping variety or the more nuanced.

[III. Protect Consumers]

In 1988, Congress created the [Schumer box](#). Named for Senator [Charles Schumer](#) of New York, then a member of the House, the box became a required part of credit-card solicitations, listing the interest rate, the annual fee and other basic numbers. The box serves a useful purpose. Among other things, anyone who does not want to pay an annual fee can quickly toss aside any credit-card offer that includes one. But over time, banks figured out how to charge new fees that were not covered by the Schumer box. They added new billing tricks to credit cards and made millions on overdraft fees in debit cards. Once again, Wall Street remained a step ahead of Washington.

It would be foolish to imagine that we could come up with just the right mix of rules and regulations to prevent this from happening again. If regulators are entirely bound by rules and the private sector remains flexible, regulators will never be able to keep up. This is why some amount of discretion is a vital part of re-regulation.

With this in mind, the Obama administration has proposed a new agency — the Financial Product Safety Commission — that would allow regulators to rely on their judgment more than they have been able to in the past. They would not simply be enforcing rules. They would have the ability to monitor the marketplace in real time. If banks were [hiding debit-card fees](#) or persuading millions of people to take out mortgages their incomes could not support — practices that brought huge profits over the past decade — the commission could issue a public warning or even prohibit a practice. Its powers would be similar to that of the [Consumer Product Safety Commission](#), which monitors toy safety and other issues. Today, there is effectively no equivalent for consumer finance.

The agency has become the most contentious part of the regulation debate, much as the public option was to the health care debate. [Richard C. Shelby](#), the lead Republican senator on the Banking Committee, has made clear that he opposes a free-standing consumer agency. In part, the Republican opposition reflects the banks' views. But it also stems from a concern that regulators could stifle innovation or, going the other way, push banks to take unwise risks in the name of consumers. That is what happened with [Fannie Mae](#) and [Freddie Mac](#), the government-sponsored agencies that helped support the growth of subprime lending.

In recent weeks, senators have been discussing whether some version of the agency — housed inside the Fed, perhaps — might be able to win Republican support. The Fed, however, has a long history of poor consumer protection. For this reason, [Christopher J. Dodd](#), the chairman of the Senate Banking Committee, has proposed giving the agency a dedicated budget and having its director appointed by the president.

More important, though, than where the oversight function is housed is how it approaches regulation. In this regard, the administration is on to something. The agency may be the most politically assertive part of Obama's plan, but it also reflects his — and his advisers' — fondness for policies based on empirical research. The word they like to use is “pragmatic.” As White House and Treasury officials imagine the new agency, it would be an outgrowth of behavioral economics, a discipline that combines psychology and economics to study how people really behave, rather than how they say they will or how academic models predict they will behave. The agency would even be able to run experiments, in which social scientists could study how consumers respond to different financial offers.

Geithner's assistant secretary for financial institutions is [Michael S. Barr](#), who is on leave from the [University of Michigan](#) Law School, where he has studied consumer finance. One of Barr's research collaborators — [Sendhil Mullainathan](#), a Harvard professor and MacArthur “genius grant” winner — spent last year working for the Treasury and the [Office of Management and Budget](#), focusing in part on the design of the consumer agency.

Mullainathan likes to say that in many areas of life, the profit motive promotes consumer welfare. People can understand what makes for a good shoe or mobile phone, and companies compete based on quality and price. In other areas, though, consumers are not able to distinguish a good product from a bad one. The issues are too complex. They involve interest rates, for example, or compound returns. Companies could theoretically try to educate customers about these subjects. But this is an uphill battle. It is far easier to appeal to instincts that people already have. So companies selling complex products often do not compete on quality and price. They compete with slick advertising or too-good-to-be-true offers, like those for low initial interest rates.

“A lot of people think, Companies are trying to subvert what's good for me,” Mullainathan told me. “But think of the guy in charge of a credit-card division. He's doing his job. All he has to work with is the demand curve.” And the demand curve is based on the factors that actually influence consumer demand, not the ones we might wish influenced it. People really do sign up for mortgages with low initial payments even when they have no realistic hope of making the later payments.

The only reliable solution to this problem is regulation. Government regulators make sure airplanes are safe, because consumers cannot monitor the workings of aircraft engines. The airlines then compete on things consumers can evaluate, like price, legroom, route convenience and in-flight television. The goal of the consumer-finance agency, Mullainathan says, would be to “take the powerful river of competition and make it flow in a direction that benefits people.”

Barr recently showed me a mock-up of a credit-card bill created by a graphic designer — a new take on the Schumer box that could be updated over time. Even if the box did not become mandatory, banks could be given incentives to use it. Private groups might more easily be able to identify the banks that were hiding fees. Barr also mentioned the idea of replacing the stacks of paper that home buyers receive at a house closing with a simple mortgage-disclosure form. The form could highlight the most relevant information, and, unlike the mass of documents most people now sign, many might actually read it.

By itself, the consumer-protection agency would be unlikely to prevent the next crisis. Modern financial crises tend to have many of their roots deep inside Wall Street, with complex securities that consumers never see. But the same idea behind the agency exists in other parts of re-regulation, too. In the Senate bill, a council of regulators, presided over by the Treasury secretary, would work with the Fed to monitor risks in the financial system as they developed. Crucially, the council would be able to monitor both traditional banks and shadow banks.

[IV. Cushion the Blow]

All of this new regulation depends on the wisdom of regulators, who are, of course, human beings with the potential to be swept up in the enthusiasm of a bubble. And Obama administration officials — especially Geithner, the main architect of re-regulation — are sensitive to the idea that they are asking too much of human discretion. Their solution is to depend on capital requirements to prevent another financial crash. They refer to these requirements as cushioning or foam on the runway. So long as a firm has enough hard assets — and can get access to their cash value — it can survive a lot of bad investments and a lot of ineffective oversight.

“We don’t know where the next crisis is going to come from,” Geithner told me. “We won’t be able to foresee it. We’re not going to pre-empt all future bubbles. So we want to build a much bigger cushion into the system against those basic human limitations. I don’t want a system that depends on clairvoyance or bravery.” He added, “The top three things to get done are capital, capital and capital.”

Many others share this broad view. Shelby has talked about the importance of capital. So has [Sheila Bair](#), the chairwoman of the F.D.I.C., who has occasionally clashed with Obama’s economic advisers.

One good way to understand the importance of capital is to look at the fate of firms that entered the crisis with relatively thick cushions. In 2007, commercial banks had an average leverage ratio of about 12 to 1, according to a [recent report](#) by McKinsey & Company. This means the banks had a dollar in assets for every \$12 in debt. That was enough for many of them, like [Bank of New York](#), to survive the bust in decent shape. In Canada, financial firms had an average ratio of about 18 to 1, and Canada endured the crisis better than perhaps any other rich country.

By contrast, the five big investment banks in this country — Bear Stearns, [Goldman Sachs](#), Lehman, Merrill Lynch and [Morgan Stanley](#) — were close to or exceeding a ratio of 30 to 1. Of

the five investment banks, Lehman collapsed, Bear and Merrill were sold at cut-rate prices and Goldman and Morgan Stanley might not have survived without government aid.

The crisis has made Wall Street much more conservative. But this will not last. It never does. Left to their own devices, financial firms will again take on big debts and big risks. They have a lot of incentive to do so. A Wall Street Journal [analysis](#) found that if one set of stricter leverage standards had been in place during the five years before the crisis, it would have reduced the biggest firms' profitability by almost 25 percent.

The model for setting future capital rules is the [stress tests](#) that the Fed conducted last year to gauge the strength of individual banks. Geithner convinced Obama to make those tests a core part of the financial-rescue strategy, and they ended up being something of a turning point in the crisis. Banks in the United States are healthier today than in many other countries, and the economy is growing more rapidly. Perhaps most striking, the rescue is on course to cost far less than the average clean-up from a financial crisis, according to [International Monetary Fund](#) statistics.

Beyond the immediate crisis, Geithner saw the stress tests as a way to show what the Fed could accomplish when it had authority over all parts of the financial system, including the shadow banks. Moreover, the tests would be proof that the Fed now believed in regulation after decades of mostly ignoring it. In the new regulatory framework, the Fed — a repository of well-trained, nonpolitical economists and bank experts — would be given a vastly bigger role than in the past.

But there is reason to wonder whether the capital cushions, at least in their current form, will be enough to overcome human limitations. The administration and Congress have been deliberately vague about what the capital ratios will be. They have not given out numbers or explained a myriad of details: how the ratios will vary by firm size, for instance, or how they will deal with so-called off-balance-sheet assets. Their approach has the advantage of keeping technicalities free of Capitol Hill horse-trading, much as setting interest rates is a process left to the Fed, not Congress. Vagueness also allows American regulators more freedom to coordinate with regulators in other countries. On the other hand, by remaining out of the public eye, capital requirements become yet another issue that will ultimately depend on discretion. Wall Street firms will have a chance to persuade the Fed that maybe they do not need as much capital as people first thought. No doubt, the firms will offer some highly sophisticated mathematical models to make their case.

The stress tests, remember, were conducted when banks were financially and politically weak. When times were good over the previous decade, Fed officials — and not just [Alan Greenspan](#) — neglected to use the powers they did have. They came to believe the bubble rationales that Wall Street offered. It is not hard to see how that could happen again. The most telling case study may be Geithner himself.

Despite the criticism that Geithner has faced for being too close to Wall Street, he has never worked there. He is a lifelong civil servant. When the Clinton administration was winding down, his mentor, [Robert Rubin](#), told him he could get a plum job on Wall Street. Geithner instead chose a low-profile job at the I.M.F. And as the president of the [New York Fed](#), he raised more

alarms than many regulators did. He pushed his staff and bank executives to think about how much capital banks had and how much they needed. He warned that periods of calm often led to unanticipated crises and that once confidence started to slip, it could quickly vanish. Intellectually, he understood how things *could* go wrong.

What he missed, however, was the fact that things *were* going wrong in some of the very institutions he was overseeing. “Financial innovation has improved the capacity to measure and manage risk,” [Geithner said in a speech](#) at a Fed conference in Georgia in May 2007. Large firms, he added, “are generally stronger in terms of capital relative to risk.” Bernanke, who may have years as Fed chairman ahead of him, made statements that [look even worse](#) in retrospect. He did not merely say that bubbles were hard to identify. He actively denied that there was a housing bubble.

Might future versions of Bernanke and Geithner do better? Maybe. But that does not seem like a great bet. Both men spent their careers studying and working on financial crises. Even some of their critics agree they are unusually bright. By all rights, they should have been the ones to come down with regulatory force, and they didn’t.

What is the alternative? Canada offers another telling lesson. It relies more on blunt rules than the United States does. Canada requires any mortgage with a less than 20 percent down payment to be insured, and those mortgages are much less common there. It also sets a standard leverage ratio of no more than 20. As Julie Dickson, the chief financial regulator in Canada, told me, “We become nasty when banks get close to it.”

Blunt rules inevitably have their problems. But they also send signals that can outlast a given administration or a given moment in the business cycle. In Canada, the well-publicized conservative capital rule not only restrained Canadian banks, but it also served as an immutable reminder to regulators and kept them from falling under the sway of bubble thinking.

Five days before Geithner gave that speech in Georgia, [Dickson gave a speech](#) of her own in Ontario. She began by discussing “Bewitched,” the 1960s television show. Dickson reminded her audience that Samantha, the lead character, had magical powers and, among other things, could turn sows’ ears into silk purses. “Today,” Dickson continued, “markets seem to be producing triple-A instruments from instruments that are not rated triple-A.” The sow’s ears, in her telling, were subprime mortgages that Wall Street repackaged into triple-A, supposedly risk-free securities that were touted as silk purses.

[V. Put a Tax on Finance]

The blunt, sweeping rule that has received the most attention over the past year is the Volcker Rule. Named for the former Fed chairman and Obama adviser who has been pushing it, the rule would, among other things, prohibit traditional banks from engaging in proprietary trading — the buying and selling of stocks or other investments for a bank’s own profit, rather than as a service to clients. On its face, the rule sounds like a reinstatement of Glass-Steagall. When Obama added it to his regulation plan in January, he seemed to be making a major shift.

But if you listen to the rule's main advocates — like Volcker or [Austan Goolsbee](#), a White House economist — you come to realize that it is often misunderstood. Its goal is narrower: to eliminate one of the subsidies that Washington now bestows on Wall Street. Traditional banks have access to cheap government loans to encourage them to lend freely and also to serve as a backstop during a panic. When banks turn around and use these low-interest loans to make investments they are essentially receiving a government subsidy for stock trading. This subsidy has helped Goldman Sachs and other firms reap big profits over the last year. “It’s just not appropriate for banks to get money subsidized by the taxpayer and use it for their own speculative investments that have nothing to do with their clients,” Goolsbee says.

Yet the subsidy is not what caused the crisis. With or without it, a firm can bring down the financial system. Lehman nearly did, and it was not a traditional bank.

So long as Congress can adequately define proprietary trading — which will take a little work, but is not as hard as Wall Street has suggested — some version of the rule seems like a sensible part of re-regulation. But it is not a reform that will serve as a reliable backstop to regulator failure.

The boldest proposal along these lines would be to break up the banks. Some outsiders, like [Simon Johnson](#), a former chief economist at the International Monetary Fund, argue that today’s huge banks are powerful enough to resist any effort at strong regulation. Their size alone could make it especially hard for the government to seize a troubled bank and wind it down in an orderly fashion. One middle-ground option would be to give regulators the authority to split up a big bank that began to have problems well before it would need to be seized.

The flaw in this approach is that size is not the same as risk. Lehman and A.I.G. were not the country’s largest financial firms. The well-regulated Canadian financial sector is far more concentrated than the underregulated American financial sector. Canada has 4 of the 50 biggest banks in the world. The United States, with an economy 10 times as large as Canada’s, has 5 of the top 50.

What may be more worrisome than the size of any individual bank is the size of the entire sector. It accounted for about 30 percent of all corporate profits in the decade before the crisis, up from 16 percent in the 1970s and 1980s. Some of that growth no doubt reflected innovations that improved people’s lives, [like the A.T.M.](#) But a significant portion probably did not. It reflected, among other things, Wall Street’s ability to make huge profits in good times and to be bailed out in bad times. It was what some economists have called the privatization of profit and socialization of risk. Wall Street was benefiting at the expense of society.

There is a commonly accepted strategy for dealing with activities that impose costs on society. [You tax them.](#) A tax discourages the harmful activity. It also raises revenue that can help cover the associated costs. Economists refer to such taxes — on alcohol or pollution, for example — as externality taxes.

The regulation [blueprint](#) that the Treasury Department released last spring did not include a tax on banks. But Obama has [since proposed](#) a tax that would allow the government to recoup any

losses from the \$700 billion bailout fund — the [Troubled Asset Relief Program](#), or TARP — that was passed in 2008. The ideal regulation plan would create a permanent tax along these lines. Such a tax would acknowledge that banks serve a vital function in a market economy but that they also have a habit of taking unwise risks. No matter how hard regulators try and how smart they are, they often cannot keep on top of those risks. Taxpayers are then left to pay the bill, to keep a financial crisis from turning into a depression. A bank tax would force banks to share that cost.

Obama's TARP tax would be temporary, expiring as early as 2020. But Congress often extends tax provisions that began with a time limit, and the Obama administration seems quite comfortable with the idea of the tax becoming permanent. "Financial crises cause a huge amount of damage to the revenue base over time," Geithner said. "So there is a very good argument you should put a tax on finance, like a tax on pollution."

If you add up the major parts of the Obama plan, you can see how it is meant to replicate Roosevelt's regulatory successes, albeit for a very different banking system. The consumer-safety agency is today's answer to the [Securities and Exchange Commission](#), which was created in 1934 to protect investors. Expanding the regulatory net to cover shadow banking is an attempt to reduce risk taking, just as Glass-Steagall was. Higher capital ratios are meant to make panics less likely. Giving the government the authority to take over dying investment banks simply extends the New Deal law allowing it to take over traditional banks.

Still, there is a big thematic difference between the Roosevelt approach and the Obama approach. Roosevelt relied on the kind of sweeping ideas that this White House has largely eschewed. Roosevelt guaranteed bank deposits, separated commercial banking from investment banking and banned misinformation about stocks. Obama would hold banks to as-yet-undefined capital and liquidity standards commensurate with how big and how connected to other firms they are.

It is a crucial step, as are many of the other new regulations in the plan. But it would be easier to have confidence in them if the administration and Congress took a few steps away from discretion and toward clarity. "Rule-based regimes," Kevin M. Warsh, a Fed governor, [said in a recent speech](#), "are inevitably crude and imperfect." But Warsh suggested that they may be better than a system in which banks accept micromanagement under the assumption that they will be able to co-opt their micromanagers.

To avoid this, the bank tax could move from being a sideshow in the regulation debate to the center of it. Regulators could also forge ahead with tough, well-publicized capital rules. The specific numbers do not need to be included in legislation, but the Fed — which will have the power to set the rules — does not need to wait for what may be an [elusive global consensus](#). And, at the very least, the rules should be straightforward enough to be widely understood. "This whole idea of ultrasophistication — we're just kidding ourselves," Robert C. Pozen, an investment manager and author of a [recent book](#) on re-regulation, says. As the crisis showed, intricate mathematical models can too easily produce the answer that their handlers want to hear.

Whatever their imperfections, simple rules have the advantage of sending signals that can outlast a given administration or a given moment in the business cycle. That is one of the lessons of the Roosevelt reforms and of the quiet period in banking that followed.

The obvious reason to re-regulate finance is to prevent the next crisis or at least to make it less damaging. But there are other potential benefits to reform. Consider what has happened to the American economy over the last three decades. Highly leveraged financial firms became a dominant part of the economy. Their profits allowed the firms to recruit many of the country's most sought-after employees — mathematicians, scientists, top college graduates and top former government officials. Yet many of those profits turned out to be ephemeral. So some of the best minds were devoted to devising ever-more-complex means of creating money out of thin air, the proceeds of which then drew in even more talent.

A more serious approach to regulation could, if indirectly, have a big impact on this situation. By reducing financial firms' profits, it could reduce the industry to a smaller and arguably more natural size. Re-regulation could remove some of the subsidies that Wall Street now receives. The cottage industry of hidden fees, ballooning interest rates and other misleading practices could be brought under control. Higher capital requirements and a bank tax could force financial firms to experience the bad times as well as the good. Above all, re-regulation could acknowledge that modern finance brings both benefits and risks.

It is worth remembering that Wall Street's long boom has not exactly been shared by much of the rest of the American economy. Wage growth for most workers has been painfully slow over the past three decades. Economic growth over the last decade was [slower](#) than in any decade since World War II. Surely, one goal of re-regulation should be to loosen Wall Street's grip on the country's resources, both financial and human, in the hope that they might be put to more productive use.

David Leonhardt is an economics columnist for The Times and a staff writer for the magazine.

This article has been revised to reflect the following correction:

Correction: March 27, 2010

An article on Page 36 this weekend about ways to prevent the next [financial crisis](#) misstates the amount of the TARP bailout fund established in 2008. It was \$700 billion — not \$787 billion, which was the size of the stimulus package approved in 2009.