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Dodd-Frank Revisited: The Vatican and Paul Volcker Call for Additional Financial Reforms*

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The reforms adopted in the aftermath of the financial crisis have yet to be fully implemented in the U.S. or the E.U. Nonetheless, the Vatican and Paul Volcker are calling for additional reforms. The Vatican, through the Pontifical Council for Justice and Peace, has published a note on financial reform entitled "The International Financial and Monetary Systems in the Context of Global Public Authority." Separately, Paul Volcker has authored an essay in the latest issue of the New York Review of Books that is entitled "Financial Reform: Unfinished Business."

There are some notable differences in the scope and substance of the reforms proposed in these two papers. At the same time, the authors have very similar views on the causes of the crisis and their proposed reforms are based upon an international approach to regulating financial markets. This article takes a closer look at these two papers.

The Causes of the Crisis

Mr. Volcker and the Vatican offer a strikingly similar assessment of the causes of the financial crisis. Both acknowledge that the financial crisis was not simply a failure of financial firms and financial markets, but also a result of broader economic conditions and capital flows around the world. According to Mr. Volcker, the crisis was due, in part, to "the culmination of years of growing, and ultimately unsustainable, imbalances between and within national economies," which was the result of "decisions on taxing, spending, and exchange rates... not a reflection of the characteristics of the financial market." Likewise, the Vatican notes that "Since the 1990's, we have seen that money and credit instruments worldwide have grown more rapidly than revenue," and "from this came pockets of excessive liquidity

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and speculative bubbles which later turned into a series of solvency and confidence crises..."

Both papers also attribute the crisis to an overreliance by policymakers on market forces. Mr. Volcker states that "It should be clear that among the causes of the recent financial crisis was an unjustified faith in rational expectations, market efficiencies, and the techniques of modern finance." He further notes that this "new financial zeitgeist" generated a "relaxed approach by regulators and legislators" that failed to appreciate and regulate the growing "shadow banking" system.

The Vatican calls this overreliance on market forces a "liberalist" approach, which is "unsympathetic towards public intervention in the markets" and "spurns rules and controls." The paper cites the decision of U.S. regulators to allow Lehman to fail as evidence of this approach, noting that while regulators assumed that Lehman's bankruptcy would "contain the crisis and its effects," it actually "spawned a widespread lack of confidence."

Finally, both papers note that technology contributed to the overreliance on market forces to control excessive risk. Mr. Volcker cites the "seeming mathematical precision" that was brought to investment decisions and "complicated" new products that were intended to minimize risk, but had the opposite effect. The Vatican warns of the "dangers of the technocracy ideology," which fails to take into consideration ethical and cultural factors.

Despite these failures in economic policy and financial regulation, both papers express a respect for free markets over controlled markets. In other words, they call for better regulation, not overregulation. The Vatican acknowledges that the process of globalization "is at the root of the world's great development in the twentieth century," and advocates regulation that respects "efficient and effective monetary and financial systems." This means "free and stable markets overseen by a suitable legal framework, well-functioning in support of sustainable development and social progress for all..." Mr. Volcker, in turn, cautions against a regulatory regime that seeks to fully eliminate market forces: "We cannot, and should not, contemplate a financial world so constrained by capital requirements and regulation that all failures are avoided and innovation and risk-taking are lost."

An International Approach

In addition to their similar assessments of the causes of the financial crisis, both the Vatican and Mr. Volcker have similar views on the need for a global approach to financial reform. The Vatican paper concludes that the International Monetary Fund has lost its effectiveness, and calls for the creation of global "world Authority," which, among other responsibilities, would develop rules for the global financial market. Mr. Volcker's vision is less sweeping, but nonetheless global. He notes "the absence of a disciplined international monetary system" and sees a need for international coordination beyond the accepted need for common capital standards. He states that: "Success will be dependent upon complementary approaches in major markets. . . "

Specific Recommendations

The two papers diverge when it comes to specific recommendations for reform. The Vatican recommends just three "concrete" reforms: (1) a financial transactions tax with rates that vary based upon the complexity of a transaction; (2) the recapitalization of banks with public funds that is conditioned upon "virtuous" behaviors aimed at developing the real economy; and (3) a clear definition of the domains of ordinary credit and investment banking, which would allow for more effective management of "shadow markets." The revenue from transaction tax could be placed into a "world reserve fund to support the economies of countries hit by crisis as well as the recovery of their monetary and financial system."

Mr. Volcker does not endorse a transaction tax or any further public capitalization of banks. On the other hand, he does support a clear separation between traditional banking and investment banking activities. He is the intellectual force behind the provision in the Dodd-Frank Act that places limitations on proprietary trading and equity investments by banks and their affiliates. He believes that the combination of banking and investment banking activities within the same organizational structure leads to a culture that is willing to engage in excessive risk-taking: "At its root, the case for restriction on trading is a matter of the culture of banking institutions."

In his essay, Mr. Volcker also calls for: (1) agreement on international accounting standards; (2) a system of truly independent auditors who approach their responsibilities with skepticism; (3) competent in-house credit determination to reduce reliance on credit rating agencies; (4) bank-like regulation on money market funds (e.g., capital requirements, government insurance, stronger surveillance of their investment practices); (5) structural reforms that eliminate the risks associated with firms that are "too big to fail" (e.g., reductions in the size of institutions, in the interconnections between institutions, and in the activities of institutions); and (6) reform of Fannie Mae and Freddie Mac.

A Call For Action

Each of the papers ends with a call for action on financial reform. Not surprisingly, the authors speak to different audiences. Mr. Volcker sees reform as a challenge for governments and regulators:

> One thing is sure: we have passed beyond the stage in which we can expect officials of central banks, regulatory authorities, and treasuries to rely on ad hoc responses in dealing with what have become increasingly frequent, complex, and dangerous financial breakdowns. Structural change is necessary. As it stands, the reform effort is incomplete. It needs fresh impetus. I challenge governments and central banks to take up the unfinished agenda.

In contrast, the Vatican's call is to humanity as a whole:

> Only a spirit of concord that rises above divisions and conflicts will allow humanity to be authentically one family and to conceive of a new world with the creation of a world public Authority at the service of the common good.

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