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OP-ED COLUMNIST

Out of the Shadows

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Would the Obama administration's plan for financial reform do what has to be done? Yes and no.

Yes, the plan would plug some big holes in regulation. But as described, it wouldn't end the skewed incentives that made the current crisis inevitable.

Let's start with the good news.

Our current system of financial regulation dates back to a time when everything that functioned as a bank looked like a bank. As long as you regulated big marble buildings with rows of tellers, you pretty much had things nailed down.

But today you don't have to look like a bank to be a bank. As Tim Geithner, the Treasury secretary, put it in a widely cited speech last summer, banking is anything that involves financing "long-term risky and relatively illiquid assets" with "very short-term liabilities." Cases in point: Bear Stearns and Lehman, both of which financed large investments in risky securities primarily with short-term borrowing.

And as Mr. Geithner pointed out, by 2007 more than half of America's banking, in this sense, was being handled by a "parallel financial system" — others call it "shadow banking" — of largely unregulated institutions. These non-bank banks, he ruefully noted, were "vulnerable to a classic type of run, but without the protections such as deposit insurance that the banking system has in place to reduce such risks."

When Lehman fell, we learned just how vulnerable shadow banking was: a global run on the system brought the world economy to its knees.

One thing financial reform must do, then, is bring non-bank banking out of the shadows.

The Obama plan does this by giving the Federal Reserve the power to regulate any large financial institution it deems "systemically important" — that is, able to create havoc if it fails — whether or not that institution is a traditional bank. Such institutions would be required to hold relatively large amounts of capital to cover possible losses, relatively large amounts of cash to cover possible demands from creditors, and so on.

And the government would have the authority to seize such institutions if they appear insolvent — the kind of power that the Federal Deposit Insurance Corporation already has with regard to traditional banks, but that has been lacking with regard to institutions like Lehman or A.I.G.

Good stuff. But what about the broader problem of financial excess?

President Obama's speech outlining the financial plan described the underlying problem very well. Wall Street developed a "culture of irresponsibility," the president said. Lenders didn't hold on to their loans, but instead sold them off to be repackaged into securities, which in turn were sold to investors who didn't understand what they were buying. "Meanwhile," he said, "executive compensation — unmoored from long-term performance or even reality — rewarded recklessness rather than responsibility."

Unfortunately, the plan as released doesn't live up to the diagnosis.

True, the proposed new Consumer Financial Protection Agency would help control abusive lending. And the proposal that lenders be required to hold on to 5 percent of their loans, rather than selling everything off to be repackaged, would provide some incentive to lend responsibly.

But 5 percent isn't enough to deter much risky lending, given the huge rewards to financial executives who book short-term profits. So what should be done about those rewards?

Tellingly, the administration's executive summary of its proposals highlights "compensation practices" as a key cause of the crisis, but then fails to say anything about addressing those practices. The long-form version says more, but what it says — "Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value" — is a description of what should happen, rather than a plan to make it happen.

Furthermore, the plan says very little of substance about reforming the rating agencies, whose willingness to give a seal of approval to dubious securities played an important role in creating the mess we're in.

In short, Mr. Obama has a clear vision of what went wrong, but aside from regulating shadow banking — no small thing, to be sure — his plan basically punts on the question of how to keep it from happening all over again, pushing the hard decisions off to future regulators.

I'm aware of the political realities: getting financial reform through Congress won't be easy. And even as it stands the Obama plan would be a lot better than nothing.

But to live up to its own analysis, the Obama administration needs to come down harder on the rating agencies and, even more important, get much more specific about reforming the way bankers are paid.