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A Master Achievement

BY JOHN M. BERRY

A vigorous defense of Dodd-Frank.

Four years ago, a sharply divided Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, and its critics still abound. Some argue that it didn't do enough to rein in the financial cowboys whose heedless actions ruined some large commercial and investment banks and threatened to destroy the world's financial system. Others maintain the legislation was misguided, too complex, and so burdensome to financial institutions that it is a key reason the recovery from the deep recession spawned by the financial crisis has been so weak.

Certainly Dodd-Frank has plenty of flaws and its implementation thus far has hardly been perfect. Still, it has greatly reduced the likelihood of another financial crisis by forcing major financial institutions to double their loss-absorbing capital, and it has imposed much stricter oversight of their operations. As Stanley Fischer, the Federal Reserve's new vice chairman who successfully guided the Bank of Israel though the crisis, said recently, "We should recognize that despite some imperfections, the Dodd-Frank Act is a major achievement."

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Nevertheless, the financial services industry rails at the new burdens the act has placed on it, including the power of the Consumer Financial Protection Bureau whose rules regarding items such as bank overdraft fees have reduced profits. So do many Republicans in Congress who tried to stymie the agency's actions by refusing for months to confirm appointment of its director.

Dodd-Frank has greatly reduced the likelihood of another financial crisis.

Meanwhile, regulators have been slow in drafting many of the rules because of their sheer complexity and determined opposition from financial institutions and some members of Congress. For example, only last month did the Securities and Exchange Commission finally approve new rules for the money market mutual fund industry focused on making such funds less likely to be hit by runs of shareholder withdrawals that were stopped during the crisis by federal guarantees. Some officials at other regulatory agencies, including the Federal Reserve, think the rules are inadequate.

There are justified complaints that the Commodities Futures Trading Commission didn't go far enough in limiting trading in derivatives when it set new rules as required by Dodd-Frank. "The still-too-opaque marketing of derivatives allows banks to hide enormous risk from investors and regulators," Anat R. Admati of Stanford University's Graduate School of Business said in congressional testimony a few weeks ago. Not surprisingly, the big banks that dominate derivatives trading argue the rules go too far.

It's easy to conclude, as Fischer said, that the 2,300-page Dodd-Frank Act is far from perfect. There is general agreement, too, that all the new regulations have not conclusively ended all possibility that a too-big-to-fail, or TBTF, institution might someday require a bailout using tens of billions of taxpayer money to prevent a potential systemic collapse.

As with the Affordable Care Act, aka Obamacare, sharp partisan disagreements mean most of the Dodd-Frank imperfections stand little chance of being fixed. In the case of TBTF, the rules are truly still a work in progress. The very large systemically important financial institutions, known as SIFIs, are required to develop so-called living wills—effectively plans under which they could go out of business. At the same time, regulators are supposed to create a method for the orderly liquidation of a failing SIFI. Neither of these Dodd-Frank requirements is close to completion, and some observers, including Admati, doubt they ever will be.

Too-big-to-fail, though, is altogether an inappropriate litmus test for the success or failure of Dodd-Frank. That fixation is an example of a wish for a guarantee getting in the way of acceptance of a work-in-progress that is already pretty good. In a lecture last month to economists at the National Bureau of Economic Research, Fischer said that TBTF isn't going to go away, probably ever. "A great deal of progress has been made in dealing with the TBTF

Dodd-Frank's Greatest Critic

AEI's **Peter Wallison**

Peter J. Wallison of the American Enterprise Institute maintains that the broad increase in regulation has been pointless because it was federal efforts to expand homeownership that led to a collapse in home mortgage underwriting standards that caused a housing boom and bust and the financial crisis. In a *Wall Street Journal* op-ed piece last month, he wrote that over the past four years Dodd-Frank's "pernicious" effects have "overwhelmed the regulatory system, stifled the financial industry, and impaired economic growth." He implied that the below-average growth during the recovery from the crisis-caused recession has been due to uncertainties, costs, and restrictions of Dodd-Frank that "have sapped the willingness or ability of the financial industry to take the prudent risks that economic growth requires."

—J. Berry

problem. While we must continue to work toward ending TBTF or the need for government financial intervention in crises, we should never allow ourselves the complacency to believe that we have put an end to TBTF," he said. Many of Dodd-Frank's critics chose to ignore that progress.

There were lots of different, interrelated actions that produced the financial crisis, but ultimately they boiled down to one: big losses at many financial institutions that did not have enough capital to absorb them. In most cases, even solvent institutions were not able to fund themselves because investors and counterparties had no way of telling for sure whether they were still creditworthy. The short-term money normally used to make longer-term loans and investments dried up and liquidity became a major issue. In short, the money markets froze.

"At one level, the story on capital and liquidity ratios is very simple," Fischer said. "From the viewpoint of the stability of the financial system, more of each is better." And under Dodd-Frank and an international agreement negotiated through the Basel Committee on Banking Supervision, "more" is now the order of the day. For the biggest banks and other types of systemically important financial institutions, or SIFIs—read potentially dangerous to the financial system if they failed—the capital requirements are substantially higher than they were seven years ago.

Last month the Fed's semi-annual monetary policy report to Congress noted that bank holding companies have increased their regulatory capital ratios significantly: "The sector's aggregate Tier 1 common equity ratio, which compares high-quality capital to risk-weighted assets for all bank holding companies, has more than doubled, from 5.5 percent in the fourth quarter of 2008 to 11.7 percent in the first quarter of 2014. In addition, all of the domestic systemically important banking organizations met their minimum Tier 1 common equity ratios, including the capital surcharge, required under Basel III rules."

Under Dodd-Frank, bank holding companies with more than $50 billion assets have to undergo annual "stress tests" to determine whether they could meet their financial obligations and keep lending even in times of economic difficulty. The thirty bank holding companies in this group had a combined $13.5 trillion in assets, roughly four-fifths of all U.S. bank holding company assets. All thirty passed the tests based on "severely adverse" conditions, the report said. Based on the stress test results, the Fed has the power to approve or disapprove the capital formation plans of the big bank holding companies, including plans to issue or buy back stock or pay dividends. Only one bank holding company failed to have its plan okayed.

Nevertheless, in testimony before a Senate Banking subcommittee last month, Stanford's Admati questioned whether the capital requirements are nearly high enough. Fed Governor Daniel K. Tarullo, the lead Fed Board member on banking regulation, has indicated he, too, would like to see them higher. And they are gradually still being raised. For instance, for SIFIs that actively trade in financial markets, a new market risk surcharge has been added, and additional capital surcharges for SIFIs are being considered including a "countercyclical" one. The latter could be imposed when credit expansion appeared to be excessive enough to threaten the financial system.

There are legitimate concerns about the cost of compliance with Dodd-Frank rules, especially for small so-called community banks.

Meanwhile, new rules are also in the works for assuring that adequate liquidity will be available over a twelve-month horizon even if severe market stress were to develop.

None of those steps mollify critics such as Peter J. Wallison of the American Enterprise Institute. Wallison maintains that the broad increase in regulation has been pointless because it was federal efforts to expand homeownership that led to a collapse in home mortgage underwriting standards that caused a housing boom and bust and the financial crisis. In a *Wall Street Journal* op-ed piece last month, he wrote that over the past four years Dodd-Frank's "pernicious" effects have "overwhelmed the regulatory system, stifled the financial industry, and impaired economic growth." He implied that the below-average growth during the recovery from the crisis-caused recession has been due to uncertainties, costs, and restrictions of Dodd-Frank that "have sapped the willingness or ability of the financial industry to take the prudent risks that economic growth requires."

That's quite a reach. Of course, regulations have costs, but so did the balance sheet burdens of bad loans and a lack of capital that caused banks to curtail lending during and after the crisis. Many households had their own balance sheet problems as home prices and stock market values tumbled and millions of workers lost their jobs leaving them in a deep financial hole. And during and after the deep recession, when normally federal spending would have increased to help spur economic activity, conservatives in Congress forced such spending to decline. Wallison ignores all that.

An analysis done in 2011 by economists at the Organization for Economic Cooperation and Development—which was cited approvingly by one of Wallison's AEI colleagues in congressional testimony—concluded that when fully implemented, the higher capital standards called for in the international Basel III proposals might raise lending spreads by about half a percentage point if banks passed on to their customers all the rise in their funding costs. That in turn might trim between 0.05 and 0.15 percentage points from GDP growth, the economists concluded. However, once growth had recovered to the point that central bank interest rates were no longer stuck at very low levels, the "impact on economic output could be offset by a reduction (or delayed increase) in monetary policy rates by about 30 to 80 basis points," the report said.

Such analysis suggests the implausibility of Wallison's rhetoric. Higher capital standards didn't even begin to bite until the recovery was three years old and won't be fully in force for several more years. Some other standards, such as minimum required down payments on home purchases, have still not been finalized. Mortgage money clearly was hard to come by, but it's more likely that was more due to the weak economy and the huge overhang of unsold properties after the housing boom burst than to the rules and uncertainties generated by Dodd-Frank.

Large institutions, the SIFIs, are far more well capitalized and, with the annual stress tests, far more adequately supervised than before 2007.

Jeb Hensarling, the extremely conservative Texas Republican who is chairman of the House Financial Services Committee, nevertheless has bought into Wallison's view that Dodd-Frank has hurt the economy badly. When the legislation was passed, Hensarling said last month, "We were told it would 'lift the economy,' 'end too big to fail,' 'end bailouts,' 'increase financial stability' and increase investment and entrepreneurship.'

Most analysts believe the TBTF label allows larger institutions to fund themselves more cheaply than smaller institutions.

"And instead, what have we learned? We have learned that it is now official that we are in the slowest, weakest recovery in the history of the nation. Tens of millions of our countrymen now unemployed… Business startups at a twenty-year low. One out of seven dependent upon food stamps," Hensarling said as his committee continued to churn out "regulatory relief" bills related to Dodd-Frank. None has become law.

There are legitimate concerns about the cost of compliance with Dodd-Frank rules, especially for small so-called community banks, and regulators need to be very conscious of that. Most such institutions readily meet the new capital requirements and the surcharges being applied to the SIFIs do not affect them at all. Over time, some legislative changes that have broad support could be useful—so long as the extremely well-funded lobbying power of the financial services industry doesn't turn them into efforts to gut key Dodd-Frank provisions.

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Currently one such effort is near success. Dodd-Frank language basically requires that the same rules governing bank SIFIs be applied to others, such as very large insurance groups, including MetLife and American International Group. But insurance companies are not banks, and the Senate unanimously—unanimously, mind you—passed a bill to give the Fed more flexibility in dealing with them. The Obama administration has no objection and Fed Chair Janet L. Yellen also said the Fed would welcome such flexibility. The bill has significant support in the House, where the key question is whether Hensarling's committee will attempt to add more controversial changes to Dodd-Frank, which the Senate likely wouldn't accept.

Aside from the danger posed for the financial system by a SIFI failure, and thus the likely need for a federal bailout again, most analysts believe the TBTF label allows larger institutions to fund themselves more cheaply than smaller institutions. The size of this implicit public subsidy is extremely hard to measure and it likely changes over time. The Government Accountability Office attempted this year to measure this subsidy and came up with uncertain results.

In the report issued last month, GAO said that among market participants interviewed, "many believed that recent regulatory reforms have reduced but not eliminated the likelihood the federal government would prevent the failure of one of the largest bank holding companies." The authority under Dodd-Frank to close a failing institution in an orderly way and the higher capital requirements had caused two of the three largest credit rating agencies to reduce their credit ratings of the eight largest bank holding companies. Ratings on some large regional bank holding companies have also been reduced and there may be further reductions ahead, the report said.

Those actions on ratings are a strong vote of confidence that Dodd-Frank is working.

More generally, GAO was not able to pin down the value of the possible subsidy related to TBTF. It used forty-two different econometric models to test the proposition. "All forty-two models found that larger bank holding companies had lower bond funding costs than smaller ones in 2008 and 2009, while more than half the models found that larger bank holding companies had higher bond funding costs than smaller ones in 2011 through 2013, given the average level of credit risk each year," the report said.

Mary J. Miller, undersecretary of Treasury for domestic finance, told GAO, "We believe these results reflect increased market recognition of what should now be evident—Dodd-Frank ended 'too big to fail' as a matter of law."

Former Congressman Barney Frank, whose name is on the law, agrees with Miller, for a specific reason: In testimony last month before Hensarling's committee, Frank said the act specifically forbids the use of federal money to bail out any financial institution. The provision of the Federal Reserve Act that allowed the Fed to extend an enormous amount of credit to American Insurance Group was repealed, he said, and the other funds provided under the Troubled Asset Relief Program required a specific authorization from Congress. Would Congress do that again "to save a large, indebted and very unpopular bank?" he asked.

Instead, under the law, a failing institution can be liquidated, with its board of directors and executives fired and the entity put into receivership by the Federal Deposit Insurance Corporation. The FDIC can use all its assets to wind it down. "If those assets are insufficient, the FDIC's only recourse is to draw from the Orderly Liquidation Fund the law established, which consists entirely of money raised from other large financial institutions," Frank explained.

In the case of TBTF, the rules are truly still a work in progress.

After the GAO report came out, Senator Sherrod Brown, an Ohio Democrat who is sponsoring legislation to break up some of the largest banks, called a hearing to discuss it. All four of the witnesses, including Admati, disagreed completely with Miller's view.
In a *Washington Post* interview last year, Brown said that under his bill, "No bank could have non-deposit liabilities valued greater than 2 percent of U.S. GDP, and no investment bank could have non-deposit liabilities exceeding 3 percent of GDP. This would only affect the six largest megabanks, which would be given three years to comply by drawing up their own proposals to meet this goal."

The six biggest banks would have about approximately \$1.2 trillion in combined liabilities, which would reduce their combined size from about 64 percent of U.S. GDP to about 34 percent of GDP, as they were in 2001, he said.

Regulators have been slow in drafting many of the rules because of their sheer complexity.

Fischer is not convinced. "Would breaking up the largest banks end the need for future bailouts?" he asked in his lecture. "That is not clear, for Lehman Brothers, although a large financial institution, was not one of the giants—except that it was connected with a very large number of other banks and financial institutions.

"Similarly, the savings and loan crisis of the 1980s and 1990s was not a TBTF crisis but rather a failure involving many small firms that were behaving unwisely, and in some cases illegally. This case is consistent with the phrase, "too many to fail." Financial panics can be caused by herding and by contagion, as well as by big banks getting into trouble.

"In short, actively breaking up the largest banks would be a very complex task, with uncertain payoff," Fischer said.

The same could be said of Dodd-Frank—a very complex task, with uncertain payoff. It is still possible that it could be improved legislatively without ruining the parts that clearly are working well. Consumers are better protected than they were before the CFPB was created. The rules for over-the-counter derivative trading are somewhat better. Big shadow banking firms are being supervised far more closely than they were before the crisis. Above all, large institutions, the SIFIs, are far more well capitalized and, with the annual stress tests, far more adequately supervised than before 2007 when the crisis began. As Fischer said, Dodd-Frank is a major achievement. ◆