Little to Celebrate on Dodd-Frank’s Birthday

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America’s Dodd-Frank act is one year old on Thursday. The act made some useful corrections in the regulation of American financial markets, but it has failed to respond effectively to the root causes of the financial crisis and its impact on the global financial system. In the short term, it has hindered economic recovery. Worse, in the longer term, it has actually made future crises more likely, while potentially damaging the international competitiveness of America’s financial institutions.

The crisis resulted from a housing bubble fuelled by loose monetary policy and excessive risky lending by over leveraged banks, encouraged by pro-housing financial regulation. Yet Dodd-Frank did not rectify the low underwriting standards of Fannie Mae and Freddie Mac, and failed to reverse the low levels of capital that Basel has required banks to hold for mortgages. Its creation of a Financial Stability Oversight Council to monitor systemic risk – a ten-headed hydra of largely independent agencies – will not be effective.

As the crisis developed, plunging housing prices created a contagious liquidity problem, only headed off by heroic policies of the Federal Reserve, the Federal Deposit Insurance Corporation and the US Treasury. Yet Dodd-Frank has now crippled the ability of these same agencies to respond in the same way to future crises. The Fed can no longer lend to individual companies, as it did to AIG. More importantly it can no longer establish emergency liquidity facilities without the written agreement of the secretary of the Treasury, who may in the future be a hostage to America’s new “anti-bail-out” consensus.

The FDIC, meanwhile, can no longer guarantee deposits above a new $250,000 limit after the end of 2012, or guarantee senior debt, without a joint resolution of Congress. Due to earlier legislation relating to the financial crisis, the Treasury also can no longer use its economic stabilisation fund to guarantee money market funds. As a result, at a whiff of a new crisis, liquidity will dry up in a flash.

Dodd-Frank did at least insist that systemically important financial institutions hold more capital, while banks hold at least as much capital as required under the original Basel I requirements. Yet the most important reforms on increased capital were left to the Basel Committee, whose record is weak. While Basel III has required more capital, there remains the more difficult (if not impossible job) of setting accurate risk weights against which to measure this capital.

One of the great myths of Dodd-Frank is that the new orderly liquidation authority of the FDIC to resolve non-banks will avert future crises. But if important financial institutions are taken over by the FDIC, it is already too late – runs will already be in progress; at best losses can be minimised in resolution. Worse, Dodd-Frank takes away from FDIC its previous power to keep troubled banks alive through open-bank assistance and makes it difficult to preference short-term creditors in any resolution, powers that may be needed to curb runs.
Dodd-Frank does make some needed corrections in regulation by requiring central clearing of over-the-counter derivatives, more disclosure to investors in securitised loans, more transparency about rating agency methodology and more emphasis on consumer protection. Yet the introduction of these so-called Volcker rules were in truth uncalled for. The crisis had nothing to do with proprietary trading or investment in private funds. Prohibiting these activities deprives US banks of diversification opportunities, and makes them uncompetitive with foreign banks.

This massive revamp of American regulation creates uncertainty for now, and, with Basel III, significant costs in the future, with uncertain benefit. The political debate that produced it was shaped by the popular desire to avoid bail-outs of irresponsible financial institutions. The record shows, however, that these bail-outs worked, and were profitable for taxpayers. Any future shortfalls could be met by taxes on financial institutions or, in the case of deposit insurance, by an increase in premiums. Taxpayers need not be put at risk. In the future bubble-induced crises will, unfortunately, continue. Yet, following the new rules introduced a year ago, containing them will sadly now be more difficult than ever.