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Despite Dodd-Frank Law, 'Too Big To Fail' Lives On

By: Nicole Gelinas – December 10, 2013

ObamaCare is only one of the president's crumbling initiatives. Five years ago this September, the Lehman Bros. investment bank collapsed. Markets around the world froze until Western governments devised a massive bailout plan that kept investors from pulling trillions out of the global financial system and precipitating a worldwide depression.

The financial crisis helped propel Barack Obama to the presidency. In his inaugural address, Obama said the crisis was a reminder that "without a watchful eye, the market can spin out of control."

After the February 2009 stimulus law and the March 2010 ObamaCare health insurance overhaul, the Dodd-Frank financial reform act of July 2010 -- meant to sharpen the vision of that "watchful eye" -- became Obama's third signature legislative victory.

"The American people will never again be asked to foot the bill for Wall Street's mistakes," Obama said as he signed the bill into law. "There will be no more tax-funded bailouts -- period." To applause, he added that "there will be new rules to make clear that no firm is somehow protected because it is "too big to fail.' "

But three years later, "too big to fail" lives on.

"There's a growing bipartisan consensus that the Dodd-Frank Act regrettably did not end the "too big to fail' phenomenon or its consequent bailouts," Texas Congressman Jeb Hensarling, head of the House Financial Services Committee, said just before Dodd-Frank's third anniversary this summer.

Republicans aren't the only ones saying so. Elizabeth Warren, the new Democratic senator from Massachusetts, recently introduced her own "end too big to fail" bill, implicitly suggesting that Dodd-Frank did not fix the problem.

What went wrong with Dodd-Frank, and how can the problems be fixed?

Dodd-Frank's biggest failure is to have perpetuated "too big to fail." The cataclysm of 2008 proved that Washington was terrified to let large or complex financial firms go bankrupt. But bankruptcy is a natural, healthy occurrence in a capitalist system.

The goal should have been to figure out how to allow these firms to go under.

Dodd-Frank's approach, by contrast, was to make the world safe from bankruptcies, not for them. "Dodd-Frank kills the capitalist system," Harvey Rosenblum, former director of research at the Federal Reserve Bank of Dallas, says bluntly.

Dodd-Frank's command-and-control ethos is epitomized by the Financial Stability Oversight Council, a 10-member regulatory group that will "identify risks to the financial stability of the United States," "promote market discipline" and "respond to emerging threats to the stability of the U.S. financial system."

But these three things don't go together. The FSOC's work in monitoring the nation's largest financial institutions contravenes its mandate to ensure market discipline.

Why should investors monitor big firms if the government is already doing it for them?

"As soon as a financial institution is designated as systemically important" by the FSOC, Dallas Fed President Richard Fisher told the House Financial Services Committee this June, "it is viewed by the market as being the first to be saved." The SIFIs -- the law's "systemically important financial institutions" -- thus "occupy a privileged space," Fisher added.

Such privilege makes it exceedingly difficult for free markets to reverse a decades-long trend. In 1990, Fisher notes, the nation's four biggest banks had $519 billion in assets, or 9% of gross domestic product. By 2011, they had $7.5 trillion, or 50% of GDP.

"We have a structure that is not a free-market structure," concurs Thomas Hoenig, vice chairman of the FDIC. "It is heavily subsidized" -- at least $83 billion annually in artificially cheap borrowing costs, according to a Bloomberg View analysis.

Further, if the FSOC misses a big risk and a firm fails because of this oversight, whose fault is that? Congress has ensured that it is the government's fault just as much as the firm's -- hardly a blow for market discipline.

In vesting regulators with the power to chase moving threats, Congress and the president have also sowed uncertainty in the financial system, making it hard for financial firms to plan ahead and thus hampering economic recovery.

As Louise C. Bennetts, associate director of financial regulation studies at the Cato Institute, notes, the law has awarded overlapping jurisdiction to regulators, "making it challenging for the private sector to know exactly which agencies they are answerable to and why."

Hester Peirce, senior research fellow at George Mason University's Mercatus Center, concurs. "I'm most concerned that (regulators) get to pick their own jurisdiction," she says.

Dodd-Frank did create a way for a large financial firm to fail in the unlikely event that the nation's all-knowing overseers miss something -- but under the law's Orderly Liquidation Authority, the firm would not declare insolvency. Instead, the FDIC would take it over.

As Fisher said in his June testimony, the OLA process bears little resemblance to bankruptcy. In a real bankruptcy, a neutral judge (one hopes) applies a consistent body of law to creditors and debtors alike.

In orderly liquidation, regulators could use Treasury funds to favor specific institutions, injecting money from the Orderly Liquidation Fund into them and keeping them going.

"Failed companies (can be) artificially kept alive . . . for up to five years," said Fisher.

"To us, this looks, sounds and tastes like a taxpayer bailout," he observed.

Five years is enough time for a firm that should have failed to resuscitate itself, especially with taxpayer life support. Five years after Lehman, companies such as AIG, Citigroup and even Fannie Mae have become profitable again.

The government could take over a large firm and wait out an economic cycle, with help from government-controlled low interest rates.

And though Dodd-Frank constrains regulators' ability to treat some creditors better than others, it makes room for exceptions. The FDIC could favor one creditor over another if it thought that doing so would improve all creditors' recovery -- likely meaning that the FDIC would protect short-term creditors to prevent them from fleeing.

Because Dodd-Frank enshrined "too big to fail," the law's good provisions are less effective than they might be. Regulators have spent the past few years reducing the amount of money that financial firms can borrow and warning financial institutions about their reliance on short-term funding -- both good developments. Regulators have also put in place better derivatives-markets rules.

But rules can't do everything. It's investors who must pull back from short-term lending to large financial institutions.

They have little motive to do so, though, when they know that the large financial institutions into which they pour their money are still permanent wards of the state.

Listen carefully, and the people who have studied this law the closest seem skeptical about it, or worse. Perhaps most damningly, former Fed Chairman Paul Volcker complained publicly in May that "it shouldn't take three years to make a regulation."

In August, Obama held a private meeting with key financial regulators from the Fed, the Treasury and other agencies to urge faster implementation.

All this uncertainty was unnecessary. The nation did not need a sweeping new financial regime; it needed incremental change to fix the specific things that went wrong before 2008.

First, Obama should have asked Congress to repeal the 2000 law that prohibited regulation of new derivatives markets, so that authorities could impose debt and reporting requirements on them.

Second, he should have directed the Federal Reserve, the FDIC and other regulators to impose higher capital requirements on financial institutions and to do so more consistently -- that is, without undue favoritism to mortgage and government securities -- so that the financial system would not get itself in trouble again, thanks to government directives on what was "safe" and what wasn't.

Third, regulators could have used capital and liquidity requirements to wean financial firms from their dependence on short-term investors, reducing the risk that such investors would all flee in a crisis.

Fourth, Congress could have eased the risk of destabilizing bankruptcies by revising the bankruptcy law so that derivatives counterparties couldn't pull all their money out of a bankrupt firm, as no other creditors could do.

Congress could have completed financial reform by making clear to the financial industry that it would support regulatory agencies when they enforced existing laws, even in the face of industry opposition.

The Dallas Fed's Rosenblum thinks that it will take another "disaster" -- and perhaps another decade -- before the public realizes that Dodd-Frank hasn't worked and Congress finally "gets around to trying to get it right." To that end, Rosenblum and his boss, Fisher, have proposed an alternative plan.

Fisher is seeking a congressional sponsor for a five-page bill that would cut off any government guarantee or subsidy -- including the ability to borrow from the Federal Reserve in a crisis -- from all but the bread-and-butter commercial-banking operations of a financial firm.

The reform would make "the counterparties to other parts" of the financial institution "simply sign an agreement that the government will never, ever rescue us," he told Congress.

Sen. Warren has teamed up with John McCain and four other middle-of-the-road senators to propose a modern-day Glass-Steagall bill to separate investment banking from commercial banking; the bill currently runs just 30 pages.

Sen. David Vitter, R-La., has introduced a bill to beef up capital requirements substantially for the biggest banks. More members of Congress are learning that it's not political suicide to point out that today's financial industry escapes free-market discipline.

In a political sense, it's the Democrats who should worry this time around.

As late as 2012, a plurality of voters still blamed former President George W. Bush and Wall Street for the financial crisis and its recessionary aftermath. Fair enough.

Next time, though, the world will remember that it was Obama and his party who promised to end "too big to fail" -- and didn't.

Gelinas is a contributing editor to the Manhattan Institute's City Journal. This article is adapted from a longer essay appearing in the autumn issue.