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Dodd-Frank Guarantees Too Big to Fail

By Mark Calabria
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It's been a year since President Barack Obama signed the Dodd-Frank Wall Street bill, yet little has changed for the better in our financial markets — and much has changed for the worse.

Dodd-Frank promised the American public an end to the notion of "too big to fail." Though the act offers government the tools to resolve failing firms without cost to the taxpayer, it leaves regulators the option of not liquidating those firms or doing so while protecting bondholders and charging the red ink to the taxpayer or to the rest of the financial services industry.

Not only has Dodd-Frank failed to end too big to fail; it has extended the federal safety net. The much-heralded derivatives provisions actually, for the first time, set up a process where clearinghouses can access the Federal Reserve's discount window.

Instead of reducing risk in the derivatives market, the act aggregates that risk into a few entities, then wraps an implicit guarantee around those same entities.

In addition, the more than doubling of the ceiling for insured bank deposits grossly reduces market discipline, while putting the taxpayer further on the hook for any Federal Deposit Insurance Corp. losses.

Uncertainty has clearly been a drag on business confidence and economic growth. The passage of Dodd-Frank, however, has greatly added to that uncertainty. A year after enactment, we still do not know which firms are going to be labeled "systemically important;" which nonbanks are going to be regulated at the federal level or which derivatives are going to require centralized clearing. Only a small portion of Dodd-Frank's required 385 regulations have been finalized.

Rather than actually legislating, Congress vested most decision-making power under Dodd-Frank in unelected bureaucrats. Meanwhile, proponents of the act are now predictably howling that those bureaucrats would be doing a splendid job if they only had more funding.

A basic principle of good government should be the ability to read a statute and have some guess as to whether you are in compliance or not. That's impossible to do under Dodd-Frank.

The act states that taxpayer funds cannot be used for bailouts. But consider that the law said the same for Fannie Mae and Freddie Mac. Taxpayers are still out more than $150 billion for their rescue.

Perhaps the simplest way to gauge whether Dodd-Frank's "no bailout" provisions are credible is to examine the funding costs of those companies deemed too big to fail. Prior to the crisis, the largest banks had to pay more to borrow than smaller banks. At the height of the crisis, when bailouts were dispensed like Halloween candy, the largest banks gained a substantial funding advantage. Since then, that advantage has shrunk but still remains substantial. Creditors are clearly acting as if they believe they are going to be rescued if more troubles hit.

One purpose of the act was to restore the public's confidence in the financial system. Yet the public's faith in our system has steadily declined since Dodd-Frank's passage, as the University of Chicago's Financial Trust Index reveals. While some of that decline is due to the actions of banks, a portion is also because of public skepticism about Dodd-Frank.

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Only 12 percent of the public was satisfied with Dodd-Frank, the FTI reports, with 54 percent dissatisfied. A large majority (66 percent) believes the act is insufficient to protect against future bailouts. Whatever its promises, the American public is not buying what Dodd-Frank is trying to sell.

Credit is the lifeblood of an economy, facilitating both investment and consumption. While the economy faces several headwinds, the unavailability of credit is a major problem. Rather than fix our financial plumbing, Dodd-Frank has largely clogged up the channels of credit further. The new Consumer Financial Protection Bureau could likely represent a massive litigation risk for lending. The result is both a higher cost of credit for consumers and reduced availability. Hardly a recipe for economic recovery.

Our financial system is now more concentrated and more vulnerable than before 2008. Dodd-Frank was a missed opportunity to address the public's demand to end bailouts, while also providing a more rational system of financial regulation.

Given Obama's devotion to the act, repair of its defects is unlikely anytime soon. Congress can, however, undertake an in-depth inquiry of the causes of the crisis, fulfilling the responsibilities it has thus far chosen to delegate to bureaucracy.

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