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Congress' Dodd-Frank fix is no fix at all

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Congress is looking to make changes to the post-financial crisis regulatory system, but it's not going to "roll back" Dodd-Frank. Don't take it from me, but from one of the former congressmen after whom the Obama-era financial regulation is named. Barney Frank has expressed opposition to S. 2155, the banking reform bill slated to be passed this week with Republican and minority Democratic support. But he doesn't believe the bill will "make a serious dent" in post-crisis financial rulemaking.

Frank may view this as a good thing, but the bill's timidity is precisely its chief weakness. Many of the measures it contains are certainly welcome. It will lower regulatory requirements on less risky mortgage contracts for which banks are willing to bear part of the risk. It eases supervision, which had led to ballooning compliance costs after 2008, on all but the largest banks.

The bill also exempts small banks, whose trading operations are generally marginal and do not pose a threat to the stability of the financial system, from having to prove continuously that the trading they do conduct is not for their own account.

In all of these ways, S. 2155 will help to reduce the regulatory burden on financial institutions that didn't cause the previous crash and are unlikely to cause the next one, as and when it occurs.

Yet for a financial system that had seen steady growth in regulationbefore 2008 and has had 27,000 additional rules imposed since then, this bill will provide only small relief. Banks today face a regulatory mire that is impossible for any single individual to navigate. This complicates effective evaluation of the costs and benefits of new rules. It also makes it harder to hold lawmakers and regulators accountable.

Most people view banks primarily as credit providers, enabling people to earn a return on their savings, make payments, borrow for auto, home and other purchases, and store emergency funds.

That is indeed banks' main profit-making activity. But they have also increasingly been forced to take on myriad other functions mandated by politicians. The typical bank today is responsible for ensuring that you are who you say you are; that your money was legitimately acquired and will be used for lawful purposes; that you are under all foreseeable circumstances able to repayyour loans; and that the bank's suppliers and contractors are liquid and solvent. These obligations, of course, come on top of the bank's own internal risk management requirements.

One might object that such due diligence (knowing who you're dealing with and whether they're creditworthy) should be performed by sound banks anyway. But then it is pointless to mandate the practice as a matter of law.

The current rules, on the other hand, may do more than what they set out to achieve, and not in a good way. For example, they could make it harder for people of modest means or those with little credit history to use banking services. It's worth recalling that 30 million households, or around a quarter of the total, still have limited or no access to banking.

Regulations might also raise the cost of borrowing for small businesses, harming job creation and investment. Evidence suggests this is just precisely what happened in the aftermath of 2008. Well-meaning regulation can have real negative effects on economic well-being, particularly of those least prepared to weather a hit.

Another problem with profuse financial regulation is that it instills a false sense of confidence. Banking and finance were among the most tightly regulated industries before the last crisis. Indeed, many of the rules in place today were enacted more than eighty years ago. The narrative of a pre-2008 Wild West of risk-taking is simply false.

Yet the 2008 crash still happened even with all the rules and personnel aimed at keeping the financial system safe and sound.

Indeed, many of the practices that made the crisis worse, such as subprime mortgage lending and trading in opaque financial instruments, were encouraged by regulation. Other policies, such as mandatory deposit insurance, made bank customers less likely to inform themselves about the practices of their bank. Can you think of any sector in which the duty to inform oneself of a provider's credentials is so routinely neglected?

These structural weaknesses afflicted large parts of the financial system a decade ago. They were largely unaddressed by Dodd-Frank, which instead has added new layers of micromanagement of every bank's daily activities. The bill that Congress will vote on this week constitutes only a modest effort to redress the recent increase in regulatory burdens.

But those who claim that the next financial crisis will happen because Dodd-Frank was weakened are doubly mistaken: Neither have post-crisis rules been fundamentally altered, nor will regulation prevent the next crash so long as it refuses to deal with the root causes of financial instability.

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