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Restoring accountability to the business of banking

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On May 24, President Trump signed the Economic Growth, Regulatory Relief, and Consumer Protection Act — the first significant financial regulatory reform bill to become law since the crisis-era Dodd-Frank Act.

Although some may claim this represents an undoing of Dodd-Frank, what the president enacted is far from the anticipated overhaul. Instead, the changes primarily give community banks relief from regulations — which makes sense since they weren’t the drivers of the financial crisis and are crucial for economic growth.

If small businesses are engines of economic growth in the U.S., community banks have long specialized in providing much of their fuel.

Community banks, building on their direct personal relationships with customers and deep understanding of their local economies, are able to provide small-business loans, home mortgages and other forms of consumer credit. Their on-the-ground perspective gives them detailed knowledge of each loan’s risks and rewards, and the risks their borrowers face.

Dodd-Frank made many banks’ relationship-based loans impossible, as regulators favored check-the-box loans that met their own definitions of “safe.”

Two especially harmful regulations are the Qualified Mortgage rule and the Ability-to-Repay rule. Combined, they push banks to primarily issue mortgages that meet standards established by the government-sponsored enterprises, Fannie Mae and Freddie Mac. Besides making it nearly impossible for a bank to adjust mortgage terms according to a homebuyer’s needs, the rules, in conjunction with myriad reporting requirements, have added hundreds of pages of paperwork to mortgage applications and make it difficult for consumers to qualify for mortgages.

These mortgage regulations have had a chilling effect: From 2015 to 2016, when the Qualified Mortgage rule took full effect, relationship-based mortgages fell from 14 percent to just 9 percent of a typical bank's mortgage lending.

Perhaps the costs would be warranted if the return is safety. But the evidence suggests that community banks are good at making sound mortgage loans, with their relationship-based loans outperforming even the highest quality fixed-rate and prime mortgages. Whether Fannie and Freddie standards make for safe mortgages, the subprime crisis leaves little confidence.

In the post-crisis world, community banks are also subject to more stringent prudential regulatory standards.

Prudential regulations are meant to make the financial system less prone to failure. In reality, they substitute the banker's risk judgments with the regulator's — and make riskier options seem cheaper. While arguably needed for larger and "systematically important" banks, they make little sense for small banks.

International risk-weighted capital standards are one example. If a bank holds mortgage-backed securities or sovereign debt, regulators count those assets as being less risky and, therefore, allow the bank to hold less capital against them. If a bank makes a small-business loan, that's considered more risky and regulators require more capital. It doesn't matter if an inventory loan the bank has made for 30 years to a local music store owner gets repaid every year, Greek debt is still considered less risky by their regulators and, therefore, is less costly for the bank to have on its books.

The new law gives community banks, those with less than $10 billion in assets, a regulatory off-ramp option. In exchange for holding higher capital, small banks gain relief from some of the most ill-suited prudential capital rules. As banks bear more of the costs for their mistakes — as more of their capital is on the line — they are incentivized to behave more prudently. In turn, the regulatory relief they achieve enables them to tailor their products to serve the lending needs in their communities.

The new law also gives community banks a safe harbor for their relationship-based mortgages instead of forcing mortgages into the Qualified Mortgage mold. It also reduces enhanced mortgage reporting requirements that have nothing to do with safety and soundness. And it exempts small banks from the poorly constructed Volcker rule, which makes banks riskier by preventing them from holding diverse investments on their books.

Of course, Dodd-Frank provisions that undermine the stability of our financial system remain.

Dodd-Frank's Orderly Liquidation Authority continues to make bailouts the law of the land, signaling to banks and shareholders they won't pay for mismanaging their banks. The Financial Stability Oversight Council's Systemically Important Financial Institution designations give large financial institutions a too-big-to-fail seal of approval, essentially guaranteeing they will be bailed out. And the Federal Reserve still has the authority to bail out financial institutions mostly at its discretion.

Provisions like these, which make the government and the taxpayer the backstop for bad decisions, undermine accountability and discourage prudent behavior by banks.

Despite leaving out other needed reforms, the regulatory relief now signed into law is an improvement, reducing stifling regulations that don't improve system safety. Achieving a truly robust, accountable, pro-growth financial system will take more work, but it's off to a good start, especially with the regulatory off-ramp option that puts banks more on the hook for their own risks while allowing them to serve their communities' needs.

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