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Toward Accountability To The Banking Business

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Last Thursday, 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.

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.

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 rules.

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 that they won't pay for mismanaging their 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.

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