Dodd-Frank: Five Years Later and What Do You Get? A Lot of Days Older and Deeper in Doubt

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With Congress and even the Presidential election embroiled in battles over what Dodd-Frank did and how much of it must be preserved as is, the fifth anniversary of the post-crisis landmark law is not just an historcal event, but also a critical policy junction. Many believe that the largest banks and other big financial institutions remain both too big to fail and jail five years on, trying to rewrite the law to rewrite or just repeal the systemic regulatory and resolution standards. Others agree that big banks are still ungoverned behemoths, but instead propose to make Dodd-Frank still tougher and go still further by also resurrecting the Glass-Steagall Act. Outside the administration and some of the federal financial agencies, almost no one believes the law is working as it should. Here, I assess why this is and what now could be done about it.

Dodd-Frank was supposed to make the largest U.S. financial-services firms safer and ensure that those that still falter could no longer topple the financial system. Despite progress on both the regulation and resolution fronts, I do not believe either of these goals are met. Big banks are indeed more stringently regulated, but non-banks remain largely as before. Resolution protocols for big banks are also advanced, but none are final nor do any handle cross-border resolutions or those of large non-banking organizations. Importantly, this asymmetric regulatory framework has now created new systemic risks, risks for which policy-makers are as ill-prepared as they were for the 2007-2008 debacle. I below analyze:

- why Dodd-Frank's rules are so long in coming;
- how the financial-regulatory framework is now constructed; and
- what should now quickly be done to meet Dodd-Frank's most critical goal – a U.S. financial system that can be reliably counted upon to discipline itself so that no firm's failure requires taxpayer bail-out to avert disaster.

Why So Long and So Hard?

Websites are replete with tables showing the thousand or so rules Dodd-Frank demands and how many have yet to be finalized. The formidable task of Dodd-Frank build-out demonstrated by these charts has led regulators often to argue that, given what Congress told them to do, they aren't really doing all that badly. I don't agree.

Sure, the law demanded a lot, failed to set priorities, and is all too often contradictory. The law also requires formal notice-and-comment proceedings that take time, as well as cumbersome cost-benefit analyses that slow them down still more.

But, the rule of law does not mean a descent into endless footnote-chasing, detail perfecting, and countless hours of unproductive negotiating among fractious regulators with competing jurisdictions – or it shouldn't. Dodd-Frank's rules have been so slow in coming and so complex upon arrival because:

- the Financial Stability Oversight Council, charged with organizing and prioritizing the systemic regulatory roll-out, was moribund until 2013 and only somewhat more effective since;
- lawyers and economists have so controlled the rule-writing process that major regulations are often sidelined for smaller projects that are easier to handle. When complex issues are tackled, often largely in the absence of clear instruction from top-level officials, endless

research is all too often undertaken to validate every assertion upside down and backward; and

- the most critical planks of the Dodd-Frank framework – systemic regulation and resolution – are often left for last. Sometimes, this is due to statutory deadlines that force attention to other priorities, but all too often it results from a lack of policy guidance from the top, and it takes more time to write rules that read more like doctoral dissertations or law-review articles than directives for real-world financial-services firms.

How Risky is U.S. Finance Now?

As Secretary Lew and others have said, Dodd-Frank can best be judged by its results. They thus argue that it's working reasonably well because:

- big banks are holding lots more capital and liquidity than before the crisis;
- the resolution framework is being developed; and
- nothing really bad has happened since 2010 despite a couple of near-disaster brushes with systemic risk.

All of this too is true, but unpersuasive if one asks the hard questions about what Dodd-Frank was supposed to do: make the U.S. financial system stronger and safer. Much in the law addresses these issues, but the architectural supports of the entire Dodd-Frank edifice are to be found in the law's first two titles, each of which headlines its purpose to be "financial stability." Title I establishes the systemic-designation and regulatory process, laying out the FSOC's structure, the rules to govern designated firms, the types of activity-and-practice rules that could also be mandated, and how large bank holding companies and designated non-banks are to ensure they can be shuttered under operation of the U.S. Bankruptcy Code. Title II defines the orderly liquidation authority (OLA) to be kept on hand in the event sweeping financial shocks overwhelm the tightly-regulated firms and market-resolution protocols mandated by Title I.

If this works, everything else in Dodd-Frank is commentary. Useful commentary in many cases, but commentary nonetheless because each of the risks now so evident from the partial build-out of other Dodd-Frank requirements – e.g., central clearing – would be forestalled by prior regulatory-and-resolution requirements. Further, the all-too-evident market distortions resulting from disproportionate regulation for like-kind financial products would be far better addressed in a more consistent and fairer regulatory burden applied where needed instead of where the word "bank" is found in a firm's charter.

Would it have been hard to fashion a more consistent and more equitable regulatory framework far faster? Of course. Would much of Dodd-Frank have stymied policy-makers had they tried to prioritize the objectives of like-kind regulation and effective resolution? To be sure. Are either of these valid excuses for inaction for so long? Only if events do not trump the all-to-fragile framework being so hesitantly and carefully constructed.

Now What?

As evidenced by the final Federal Reserve rules enacted on July 20 for the largest U.S. BHCs and for at least one designated non-bank, the long march continues. Upon taking office, Secretary Lew announced

a major effort to revitalize FSOC and, to some extent, he did. The Treasury-led committee cudgeled the Volcker Rule out of five contentious agencies, did the same for the risk-retention rule (this time forcing six agencies to settle on something), named a new more systemically-important non-bank, and tried its hand at activity-and-practice regulation.

However, the latter ended badly, at least as far as Treasury and the FRB were concerned. Many other rules languish, and the designation process is mired in controversy. Is there a better way?

I think so, but it's even harder than Dodd-Frank efforts to date because it takes something each regulatory agency has so far been unwilling to give: ground. This is ground for final rules that are good, but not perfect, ground for inter-agency compromises that are fair, if not necessarily the final word, and ground most importantly for the most urgent regulatory matters that, if left longer undone, will foster another systemic risk. Key priorities are:

- identification of which activities and practices affect financial-market infrastructure to such an extent and in such a way as to pose systemic risk regardless of what type of financial-services firm offers or relies on the activity;
- final prudential standards and resolution protocols suitable for bankruptcy resolution across the spectrum of U.S. financial-services firms, and
- a clear understanding of what the rules to date have cost whom so that, where these costs are undue, they are reduced. Where these costs are due, but unfairly applied only to some financial institutions, they should be shared through cross-sectoral regulation. Where this cannot be done due to cross-border limitations and/or statutory restrictions, then alternative solutions should be determined to offset market distortions resulting principally from differential regulatory-cost drivers.

Some of this work has been done in policy statements and it's often advocated in speeches from senior U.S. officials. But, if anything of substance has been done on any of these priorities, it's not yet been made public.

As a result, financial-services firms are doing what privately-held financial-services firms are supposed to do: plan for the future. When their differential regulatory costs are fully taken into account on a forward-looking basis, the business of the largest U.S. BHCs is clearly being wholly redesigned. The goal may be to make these BHCs smaller, but how this will be done without a still more rapid shift to a non-bank financial system appears ill-considered. Indeed, where thought is given to market reconfiguration, it is largely at the Federal Reserve, which is increasingly of the view that it can no longer just be a lender of last resort to U.S. banks. Now, it may need to be a "market-maker of last resort" for all comers because monetary policy and financial stability increasingly depend on non-banks.

Many readily acknowledge that spreading a central-bank safety net beneath these non-banks will stoke the fires of regulatory arbitrage, as well as incite still more moral hazard in a new class of too-big-to-fail financial behemoths. But, scared of new-style systemic risk, no one quite knows what else to do.

A market-maker of last resort at the Federal Reserve is a tarp over a gaping hole in the construct of the U.S. financial regulatory and resolution framework. It may cover a multitude of incomplete rules and ducked decisions, but not for long. It's true that, since 2010 there hasn't been a repeat of a global financial crisis. There have, though, been several near-misses. These increasingly appear to be the result of Dodd-Frank driven regulatory reconfiguration, as well as new financial practices spawned both

by these rules and the continued march of technology to design new ways to deliver products across the range of wholesale and retail customers.

The problems of 2010 are only partially fixed in 2015, and many of these half-fixes are causing problems of their own. Still focused on the 2010 framework, U.S. policy-makers are leaving those already evident in 2015 for later. Later, though, is now – a combination of old-style rules with new-style safety nets in a high-speed market governed at key points by less and less regulation cannot stand firm for long.