OPINION

The Dodd-Frank Financial Fiasco

By John B. Taylor

The sheer complexity of the 2,319-page Dodd-Frank financial reform bill is certainly a threat to future economic growth. But if ou sift through the many sections nd subsections, you find much ıore than complexity to worry bout.

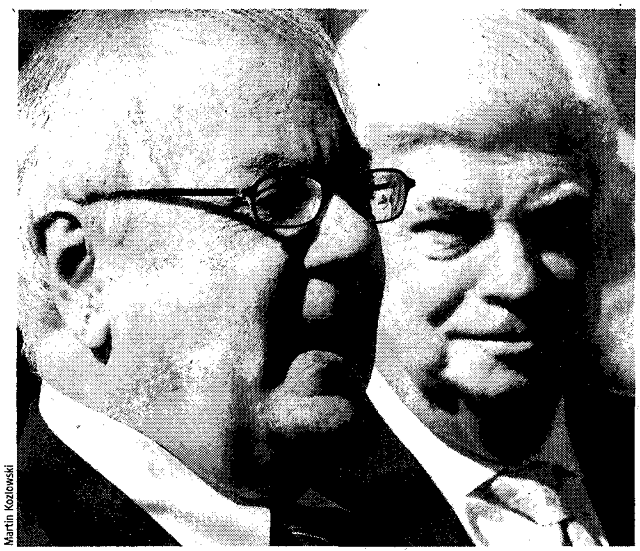
The main problem with the bill is ıat it is based on a misdiagnosis of ıe causes of the financial crisis, hich is not surprising since the bill as rolled out before the congresonally mandated Financial Crisis ıquiry Commission finished its di;nosis.

The bill all but guarantees bailouts as far as the eye can see, while failing to address real problems like Fan and Fred and our outdated bankruptcy code.

The biggest misdiagnosis is the sumption that the government not have enough power to avoid crisis. But the Federal Reserve the power to avoid the monetary esses that accelerated the housboom that went bust in 2007. New York Fed had the power to) Citigroup's questionable lendand trading decisions and, with dreds of regulators on the premises of such large banks, should have had the information to do so. The Securities and Exchange Commission (SEC) could have insisted on reasonable liquidity rules to prevent investment banks from relying so much on short-term borrowing through repurchase agreements to fund long-term investments. And the Treasury working with the Fed had the power to intervene with troubled financial firms, and in fact used this power in a highly discretionary way to create an on-again off-again bailout policy that spooked the markets and led to the panic in the fall of 2008.

But instead of trying to make implementation of existing government regulations more effective, the bill vastly increases the power of government in ways that are unrelated to the recent crisis and may even encourage future crises.

The bill creates a new resolution, or "orderly liquidation," authority in which the Federal Deposit Insurance Corporation (FDIC) can intervene between any complex financial institution and its creditors in any way it wants to. Effectively the bill institutionalizes the harmful bailout process by giving the government more discretionary power to intervene. The FDIC does not have the capability to take over large, complex financial institutions without causing disruption, so such firms and their creditors are likely to be bailed out again. The problem of "too big to fail" remains, and any cozy relationship between certain large financial institutions and the government that existed before the crisis will continue.



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Another false remedy is a new Bureau of Consumer Financial Protection housed at, and financed by, the Fed. The new bureau will write rules for every type of financial service, most of which (such as payday loans) have no conceivable connection with the crisis. Yet another false remedy is a new Office of Financial Research at the Treasury that will look into systemic risk. The unrealistic hope here is that it will somehow do a better job than the Fed, which already had that responsibility leading up to the crisis.

The bill does reduce the power of the Fed to intervene to bail out the creditors of a single financial institution, as the Fed did in the case of Bear Stearns and AIG. But at the same time it authorizes bailouts if the financial institution is a "participant in any program or facility with broad-based eligibility" that the Fed has established for emergency purposes, which hardly is a constraint on bailouts in an interconnected financial system. It also gives complete discretion to the Fed and the Treasury to determine "the policies and procedures governing emergency lending."

Yet another false remedy is a new regulation for nonfinancial firms that use financial instruments to reduce risks of interest-rate or exchange-rate volatility. The bill gives the Commodity Futures Trading Corporation (CFTC) authority to place margin requirements, which call for higher collateral on risk-reducing instruments, on such firms even though they had nothing to do with the crisis; their customers and employees will be penalized by the increased costs. And while the bill sensibly merges the Office of Thrift Supervision into the Office of the Comptroller of the Currency, it creates more regulatory ambiguity by assigning both the SEC and the CFTC the new job of regulating over-the-counter derivatives with imprecise guidance on who does what.

Other innocent bystanders hit by the legislation are the stockholders of firms that had nothing to do with the crisis. The bill gives the SEC the explicit authority to impose "proxy access" provisions empowering shareholders to run their own candidates for boards. Research by David Larcker of Stanford Business School shows that stock prices react negatively to proxy access regulations.

Some claim that corporate governance problems were a cause of the crisis because corporate boards of large complex banks did not prevent risky lending practices. But those who make this argument did not do so before the crisis, and they do not mention that hundreds of government regulators at these banks on a daily basis also failed to deal with the problem.

By far the most significant error of omission in the bill is the failure to reform Fannie Mae and Freddie Mac, the government sponsored enterprises that encouraged the origination of risky mortgages in the first place by purchasing them with the support of many in Congress. Some excuse this omission by saying that it can be handled later. But the purpose of "comprehensive reform" is to balance competing political interests and reach compromise; that will be much harder to do if the Frank-Dodd bill becomes law. For example, many of the same activists who supported proxy-access provisions are those that also favor the Fannie and Freddie subsidies.

Another serious error of omission is reform of the bankruptcy code to allow large complex financial firms to go through a predictable, rules-based Chapter 11 process without financial disruption and without bailouts—a far better alternative than the highly discretionary resolution authority in the bill. Without this orderly bankruptcy alternative, the too-big-to-fail problem will not go away. At least Section 216 of the bill calls for a study of the matter, but this is obviously no substitute for action.

The continuing debate over the Dodd-Frank bill in the days since it emerged from conference is good news. People may be waking up to the fact that the bill does not do what its supporters claim. It does not prevent future financial crises. Rather, it makes them more likely and in the meantime impedes economic growth.

Mr. Taylor, a professor of economics at Stanford and a senior fellow at the Hoover Institution, is the author of "Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis" (Hoover Press, 2009).