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Keep Dodd-Frank, or face the consequences

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President Barack Obama signs the Dodd Frank-Wall Street Reform and Consumer Protection Act in a ceremony in Washington in July 2010. (AP Photo/Pablo Martinez Monsivais)

by **Mark Zandi**

The noise out of Washington is deafening. Contributing to the cacophony are President Trump's problems over the Russian election-meddling probe, congressional Republicans' efforts to repeal and replace Obamacare, and mounting debate over tax cuts and reform.

Getting lost in it all are the president's efforts to do "a big number" on Dodd-Frank — the massive legislative remake of the financial system passed in the wake of the economic crisis. After Obamacare is resolved, Dodd-Frank is the next Obama-era achievement in the political crosshairs.

Though some of Dodd-Frank’s many moving parts work better than others, on the whole it has put our financial system on much sounder ground. The odds of another crisis on the scale of the recent calamity are much lower. And while the financial system will surely stumble again, it is much less likely to be an existential threat to the economy.

Doing a big number on Dodd-Frank would be a big mistake.

Its most significant success: It addresses the too-big-to-fail problem. The financial crisis was cataclysmic, in part because the nation’s largest financial institutions took on too much risk, believing that, if push came to shove, taxpayers would bail them out.

And we did. The government limited the losses of owners of institutions including Bear Stearns, Fannie Mae, Freddie Mac, Citigroup, and AIG. Indeed, nearly the entire banking system was ultimately propped up by taxpayers.

To ensure that never happens again, Dodd-Frank establishes a process known as Orderly Liquidation Authority for gracefully resolving failing institutions. It gives the Federal Deposit Insurance Corp. — which has insured bank deposits since the Great Depression — authority to temporarily use public funds to keep an institution from collapsing and wind it down.

But those funds, plus interest, would be repaid from sales of the institution’s assets. And if that wasn’t sufficient to repay taxpayers, the entire financial industry would pay fees to cover it.

As a result of Dodd-Frank, owners of financial institutions now know there will be no taxpayer bailouts. They have a big incentive to make sure their institutions don’t take risks that put themselves and the rest of us in harm’s way.

Allowing regulators to identify certain financial institutions as systemically important is another vital tool provided by Dodd-Frank. These institutions are deemed to be so large, complex, and integral to the financial system that, if they failed, they would take the system with them. As such, they have a much higher regulatory bar to clear.

Doing away with Dodd-Frank would also mean scaling way back on the stress testing that major banks now must do. This testing determines whether banks have the capital necessary to survive Great Recession scenarios. Capital is the financial cushion that banks are required to hold to absorb the losses they would suffer on their loans and other holdings in bad economic times.

Because of annual stress testing, banks have almost doubled the size of their capital cushion since before the crisis, and are financially prepared for almost any economic scenario. Which means they will be able to continue lending to us in the toughest times, helping to ensure those times won’t be as tough.

To be sure, parts of Dodd-Frank need a good reworking. The so-called Volcker rule comes to mind. This provision — named after former Federal Reserve Chairman Paul Volcker, the rule's most vocal advocate — requires the biggest banks to largely stop buying and selling financial securities.

It sounds intuitive that this could be a very risky activity, and thus something we don't want our banks to do. But the reality is it isn't necessarily all that risky, and certainly wasn't a contributing factor to the financial crisis. Moreover, it served a critical role in providing much-needed liquidity to the financial system.

Liquidity is the grease, so to speak, that ensures financial markets are stable. Less liquid markets mean prices for stocks, bonds, and other financial instruments are more prone to big ups and downs. That's not a big deal when times are good, but it could be a serious problem when things aren't going so well.

Having said that, it's impossible to imagine going through something as harrowing as the financial crisis and not fundamentally changing the way our financial system works.

The system failed us, colossally. Dodd-Frank has reshaped it for the better. Doing a number on the law will only sow the seeds for the next financial crisis.

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