Dodd-Frank regulations strangling economy: ‘Too big to fail’ has got to go

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Mitt Romney decried the Dodd-Frank Act as “the biggest kiss that’s been given to New York banks I’ve ever seen.” Since its passage, 122 community banks have closed. If the election had turned out differently, there would have been a prospect of repealing Dodd-Frank. There still may be grounds for a modicum of reform, particularly of “too big to fail” (TBTF) banks and doctrine.

Dodd-Frank was falsely sold by President Obama, Sen. Christopher J. Dodd and Rep. Barney Frank as critical to preventing another financial crisis. In truth, the legislation did not address any of the primary causes of the financial crisis. The Federal Reserve’s reckless, easy money, coupled with government systematically weakening and politicizing mortgage credit standards through Fannie Mae, Freddie Mac and the Community Reinvestment Act, fueled an unprecedented housing bubble, the mortgage implosion, the financial crisis and the Great Recession.

Dodd-Frank, however, did impose a suffocating regulatory burden on the financial system, further politicizing the system. It enshrined TBTF and consequently put a damper on economic growth. A vibrant financial-services industry is vital to robust economic growth.

Regulators didn’t foresee the most recent financial crisis, the savings and loan debacle or the Great Depression, and they will be blindsided by the next crisis. Banks shepherded by Washington mandarins will follow the same risk-avoidance strategies, magnifying systemic risk.

During the crisis, the idea gained widespread currency that some financial institutions were so big and interconnected that their failure, even managed as part of an orderly bankruptcy or liquidation, would pose a systematic risk to the financial system. This warranted bailouts.

While arguably no U.S. financial institution actually meets this criterion, politicians, regulators, management and the market believe and will act otherwise. Dodd-Frank put a seal of approval on, and even ratcheted up, incestuous corporatism between Washington and America's financial Goliaths.

These large institutions enjoy cheaper capital than community banks because of government's implicit guarantee. According to Dallas Federal Reserve Bank economist Harvey Rosenblum, they get perhaps a 1 percentage point advantage or more. Additionally, financial giants have legions of lawyers, compliance staff and lobbyists to cope with and influence regulation to their advantage relative to smaller and nontraditional competitors. The greater the state's power over industry, the greater the risk of regulatory "capture," in economist George Stigler's words.

Notwithstanding less stringent capital requirements and an exemption from debit-fee price controls, Dodd-Frank sounds the death knell for many community banks.

A handful of behemoth banks managed as virtual public utilities suits the corporatist sentiment of Mr. Obama, Treasury Secretary Timothy F. Geithner and Federal Reserve Chairman Ben S. Bernanke better than the creative froth of thousands of independent financial institutions vigorously competing, whose value and management are judged continuously and ruthlessly by the market, not Washington overlords.

Politicians and regulators make a great show of lamenting TBTF, yet with their active complicity, the financial-services industry became more concentrated. Economist Simon Johnson notes that from 1995 to 2009, the assets of the six largest banks increased from 18 percent to 68 percent of gross domestic product (GDP). Washington encouraged Chase's acquisition of Washington Mutual and Bear Stearns, Bank of America's purchase of Merrill Lynch and Countrywide, and Wells Fargo's scooping up of Wachovia.

The left is hugely suspicious of gargantuan banks. In 2010, Sen. Sherrod Brown's Safe Banking Act proposed capping their size — limiting deposits to 10 percent of the market and nondeposit liabilities to 2 percent of GDP (3 percent of GDP for non-bank institutions) and mandating minimum capital ratios. The act received 33 mostly Democratic votes, including from Senate Majority Leader Harry Reid and Sen. Richard J. Durbin, as well as the Banking Committee's ranking Republican, Sen. Richard C. Shelby and Club for Growth heartthrob Sen. Tom Coburn.

In 2012, Sen. David Vitter and Rep. Scott Garrett, both Republicans, took a more limited stab at curbing TBTF, proposing that the Financial Stability Oversight Council no longer be able to designate non-banks as systematically important.

Not all central bankers and regulators are wedded to the corporatist status quo. Bank of England governor Mervyn King warned, "If some banks are thought to be too big to fail then they are simply too big." Former Kansas City Federal Reserve Bank president and current FDIC Director Thomas M. Hoenig said he "couldn't agree more." Dallas Federal Reserve Bank President Richard W. Fisher similarly calls for curbing TBTF banks.

TBTF financial institutions need to be broken up into pieces, each small enough to be permitted to prosper or fail. For mammoths such as Bank of America, Chase and Citi, diseconomies of scale and complexity likely obtain, and value would be created. If, however, value not attributable to government guarantees were destroyed, shareholders would need to be compensated.

In a world where no bank is deemed systematically important, the rationale for heavy regulation is FDIC insurance. If the state guarantees deposits, it has an interest in the riskiness of how they're deployed.

The Cato Institute’s Mark A. Calabria observes the high correlation between state deposit insurance and thousands of banks going belly-up in the 1920s. Yet even at the peak of the Great Depression’s 1933 bank failure, just 2 percent of deposits were lost.

Franklin D. Roosevelt opposed FDIC insurance, arguing it was “quite dangerous” and would “lead to laxity in bank management and carelessness on the part of both banker and depositor.” He was right.

While eliminating FDIC insurance might be a political bridge too far, it should at least be limited. The FDIC insures deposits up to $250,000 and since the end of 2010 has provided unlimited coverage for non-interest-bearing consumer and business accounts.

If all financial institutions were free to compete and to fail, serving shareholders and customers rather than Washington overlords, it would spur innovation and economic growth and curb systematic risk.

It ought to be possible to cobble together a political coalition of right and left willing to drive a stake through the heart of TBTF.

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