Unfinished Business

BY KARTIK ATHREYA

The Dodd-Frank Wall Street Reform and Consumer Protection Act, better known as the Dodd-Frank Act, became law a little more than 10 years ago, in July 2010. Immense in scope, the act created new regulatory institutions and conferred substantial new powers on those already in place. Heavily contested since its inception, it has been modified by subsequent legislation, executive action, and court rulings. More recently, the Dodd-Frank Act has arguably played an important role during the coronavirus crisis. It's a good time to take another look.

Enacted in response to the 2007-2008 global financial crisis, the law reflected widespread views about the root causes of the crisis and the reforms most likely to avert its repetition. One area of agreement was that the non-traditional or "shadow" banking sector had been a major flashpoint. By 2007, investment banks such as Bear Stearns and Lehman Brothers had become highly leveraged by historical standards, and their balance sheets carried substantial maturity and liquidity mismatches. A second area of agreement was that, despite the Basel framework for bank capital adequacy that had been in place at the time, the traditional banking system had been inadequately capitalized to handle the crisis without extraordinary official assistance.

The Dodd-Frank Act's capital adequacy and stress testing requirements were designed to improve the resiliency of the traditional banking sector, and by many accounts they have been a success. As a general matter, traditional banks were strongly capitalized coming into the coronavirus pandemic and thus have been well positioned to assist their customers' loan forbearance and liquidity needs. Indeed, some observers have credited the act for the resiliency the banking system has shown so far during the pandemic.

Yet some scholars and policymakers, including Fed Gov. Lael Brainard, have contended that the Dodd-Frank Act's bank regulatory provisions have not been implemented with sufficient rigor. In March 2019, she dissented from the Fed's decision not to activate the countercyclical capital buffers for large banks that are authorized by the law. Brainard voiced additional differences with Fed policy in June 2020, after the Fed released the results of stress tests based on COVID-19-inspired scenarios. Although the Fed barred more than 30 banks from buying back their own stock and limited the size of their dividends, as authorized by the Dodd-Frank Act, she objected to allowing banks to issue any dividends at all in the context of the crisis.

Moreover, the Dodd-Frank Act's measures to address risks posed by the shadow banking sector have proven to be inadequate in the eyes of many observers. The most noteworthy measure was the establishment of the Financial Stability Oversight Council (FSOC), which was given the power to identify systemically important *nonbank* financial institutions and put them under Fed supervision. The FSOC has been cautious in exercising this power, designating only four firms. In late 2019, the FSOC issued guidance that signaled a strong reluctance to make any future designations.

Former Fed Chair Janet Yellen recently argued that the FSOC has not sufficiently expanded supervision to account for the risks posed by nontraditional banks operating in the "perimeter." According to her, "the pandemic showed that the risks were very real and serious." When market volatility increased in March, highly leveraged hedge funds faced margin calls and sold off massive quantities of Treasuries. Had the Fed not intervened on a massive scale, "we probably would have had another Long-Term Capital Management type episode," she said, referring to a major financial market disruption in 1998 that led to Fed intervention.

Modifications to the Dodd-Frank Act have also been aimed at banks in particular. In 2018, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act, which exempted banks with assets below $250 billion from the Dodd-Frank Act's most rigorous regulatory standards.

While deregulation of financial intermediation may well carry benefits, specific proposals should be considered in the broad context of the overall financial safety net in place, either explicitly, as with deposit insurance, or implicitly, as with expectations of emergency lending by central banks. The Dodd-Frank Act certainly moved the bar on explicit insurance: It more than doubled the cap on deposit insurance to $250,000. This level of insurance may be warranted for a variety of reasons, some of them possibly consistent with improving overall economic performance. But as the financial crisis recedes from memory and leaves us increasingly focused on the burdens of regulation, we would do well to heed the warning of banking scholar John Kareken many years ago: Lighter regulation in the face of constant or increased protection of creditors may be putting the cart before the horse. For the variety of changes ushered in by the act, we can ask, at the 10-year mark, has their net effect been to throw an ever-wider safety net on the creditors of financial intermediaries? If so, lowering regulatory burdens — attractive at the present moment for many reasons — *without* simultaneously paring back the safety net in a decisive way risks a more fragile financial system. **EF**

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