Reforming Wall Street: What Dodd-Frank failed to

By **David W. Smith** - July 25, 2014

The Dodd-Frank Act was supposed to stave off another financial crisis by introducir raft of regulations. But the lobbying of the Big Six banks has ensured that the most important measures, including limiting the size of banks, have been left out. David V Smith reports

The Dodd-Frank Act of 2012 is an impressive-looking tome. It weighs in at 2,000 pages and is not even counting the hundreds of pages in supplementary documents interpreting the op legal jargon. Then there are all the amendments to the Act. The new Volcker Rule, which tri restrict speculative investments, adds another 1,000 pages to the pile.

The density of the regulations can give the impression that the Obama administration has clamped down strongly on banking power. But this is false, or at least an over-simplification. rules and interpretations were written with the "kindly" assistance of lobbyist lawyers from t Big Six banks. Independent economists were not invited to the debate. The banks made son concessions, although they concealed them in a mountain of obfuscation. Most importantly, did not agree to be shrunk to a safer size and remain too-big-to fail.

Simon Johnson is one of America's leading experts on banking reform, but Congress failed t invite the British-born former chief economist of the IMF to help formulate the regulations. I likely that the uncomfortable truths told about the US Government and bankers in Johnson's book 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown made him unwelcome at the seat of power.

In short, the bankers wanted to protect the system which has allowed them to grow so fat fi critical scrutiny. "The essence of the business model is that the bankers have the Governmeı behind them. This is not a left-wing perspective. It is shared by right-wing economists like University of Chicago's Eugene Fama and left-wing economists like Joseph Stiglitz," said Johı "Both camps agree that what we are looking at is not a market but a subsidy scheme. The intellectual right and left get it, but not the political right or left."

Johnson says the US banks "regulatory capture" of US Government policy has been largely untouched by the crisis. "The biggest banks were put back on their feet with no strings attac in 2008 by President Obama. The 13 bankers were called into the White House in March 200 and saved, including their jobs, pensions and boards of directors. Everything about how they the world was intact," he said.

Having restored the banks' power, Obama then promised financial reform. "But once they we back on their feet, with the bonus structure and all the rest of it intact, they could plough th money into lobbying to prevent reforms," said Johnson.

The absurdity of the situation prompted Treasury Deputy Secretary Neal Wolin to deliver an angry speech to the US Chamber of Commerce in 2010. Wolin accused the Chamber's lobby of holding back reform by spending US$1.4 a day funding four lobbyists per member of cong "Wolin told the Chamber it had to stop, but why would they? They like the system the way it said Johnson. "It lets them take on risk, and let's them cash out when the times are good."

The irony of the Dodd-Frank reforms is that their byzantine complexity conceals their limitat Having preached the need to be free of regulatory constraints in the run up to the 2008 crisi the banks conceded the need for more regulations. But they have influenced the wording ev step of the way.

Bob Ivry, author of The Seven Sins of Wall Street: Big Banks, Their Washington Lackeys, An Next Financial Crisis, is disillusioned with the scope of Dodd-Frank. He says the same Big Six banks at the core of the crisis are bigger and badder than ever. "Dodd-Frank has changed lit the Big Six could hop on a bubble tomorrow they would. What the Government created with bailouts we live with today, which is moral hazard – the belief that if I make money it's mine if I lose it it's yours," he said.

A major problem with Dodd-Frank, Ivry said, was its over-reliance on regulators to police th banking sector. "Regulators stink at their jobs. Although they're hard-working and earnest, t aren't enough of them and they aren't well-paid considering how much they have to do. The is their track record is lousy and any reform that relies on them to pinpoint problems before happen is doomed to fail," he said.

Ivry believes the single most effective measure would be to cap the size of the banks. "Too-l to-fail banks are anti-competitive and antidemocratic. If you make a rule that the biggest financial institutions have to be restricted to US$500 billion in assets, then if they got into trouble, the taxpayer would be off the hook. The shareholders would suffer, the creditors wo suffer, the customers and employees might suffer, but not the taxpayer."

A capping solution would work well because of its simplicity. "You could allow them to do anything they liked within the law and it wouldn't be necessary to layer on regulations. If th screwed up, they would be hurt and not the rest of us. It would be the best way to prevent dangerous risk-taking by the big banks because they would have to suffer the consequences Ivry said.

The capture of the American political establishment by the Big Six US banks involved the gra removal of regulatory restrictions. What Johnson refers to as the "weakening of the levees" began in the 1970s, picked up pace in the 1980s during Ronald Regan's presidency and reall took off in the 1990s. In 1993, Wall Street gained even greater influence over the Democrat economic policy when Robert Rubin became President Clinton's Treasury Secretary after spe 26 formative years with Goldman Sachs.

> *'DODD-FRANK HAS CHANGED LITTLE. IF THE BIG SIX COULD HOP ON A BUBBLE TOMORROW THEY WOULD. WHAT THE GOVERNMENT CREATED WITH THE BAILOUTS WE LIVE WITH TODAY, WHICH IS MORAL HAZARD – THE BELIEF THAT IF I MAKE MONEY IT'S MINE BUT IF I LOSE IT IT'S YOURS,' BOB IVRY*

“The Government was won over during this period by the ideology of finance,” said Johnson. true that there was a revolving door between the Government and Wall Street, but the real ability of the banks to get what they wanted was all about ideology. They convinced themsel and many others in politics and academia, that finance was good, that unregulated finance better, but completely unfettered, large financial institutions were best. They created a set o financial firms that cannot be allowed to fail.”

The biggest bank not to be bailed out following the 2008 crash was CIT Group, which had m than US$60 billion in finance and leasing assets. It was not enough to qualify for federal aid whereas Goldman Sachs’s US$1.1 trillion accounts and Citigroup’s US$2.2 trillion in assets p them in the too-big-to-fail bracket.

The ongoing guarantee of Government support gives the Big Six banks an unfair competitive advantage. According to a recent International Monetary Fund (IMF) report, security against failure provides a guarantee to creditors which lowers funding costs by about 100 basis poin one percentage point. The IMF says these implicit subsidies are worth up to US$70 billion pe year for the US banks, and as much as US$300 billion for eurozone banks.

The IMF chief Christine Lagarde told an audience in London recently that banks were still resisting reform and focused on excessive risk-taking to secure their bonuses. “The behavio the financial sector has not changed fundamentally in a number of dimensions since the cris The industry still prizes short-term profit over long-term prudence, today’s bonus over tomorrow’s relationship.”

She added: “The bad news is that progress is too slow, and the finish line is still too far off. of this arises from the sheer complexity of the task at hand. Yet, we must acknowledge that also stems from fierce industry pushback, and from the fatigue that is bound to set in at thi point in a long race.”

> *‘THE REAL ABILITY OF THE BANKS TO GET WHAT THEY WANTED WAS ALL ABOUT IDEOLOGY. THEY CONVINCED THEMSELVES, AND MANY OTHERS IN POLITICS AND ACADEMIA, THAT FINANCE WAS GOOD, THAT UNREGULATED FINANCE WAS BETTER, BUT*

COMPLETELY UNFETTERED, LARGE FINANCIAL INSTITUTIONS WERE BEST,' SIMON JOHNSON

Simon Johnson agrees that much more needs to be done. "There's been progress with Dodd Frank, but it's not been fully implemented yet and there's still a lot of fighting about very important details. The game is still on and it's not even half-time," he said.

Johnson says that if the reforms were to stop now, there is a danger the next crisis could be even bigger. One of the greatest flaws of the system is that there is no cross-border resoluti mechanism in place to wind down banks. Although Dodd-Frank mandates the creation of a resolution authority, it would not be able to control inherently global US banks.

"That's a big loophole as four of the six largest US banks are inherently global – JP Morgan Chase, Morgan Stanley, Citigroup and Goldman Sachs. We would need a cross-border resolu authority and prior agreement between all governments involved over who gets assets in th event of failure. Without it, you cannot have the orderly liquidation of a bank like JP Morgan Chase," he said.

Just as important would be insisting on more equity in the financial system, he says, so that banks are not running highly leveraged operations. More equity gives them far more loss absorption capacity. Before the crisis, the Big Six banks had about 2% equity and 98% debt the liability side of the balance sheet, meaning they were leveraged 50:1.

The new regulations have improved the situation slightly. The Volcker Rule places some limitations on risk-taking and the recently adopted Basel III framework has raised equity requirements. But Johnson says the measures do not go far enough. Right now, the big ban have on average 3% equity and 97% debt and the latest leverage rules will improve this to equity and 95% debt for the largest eight banks by 2018. Whilst a ratio of 20:1 is a great improvement, Johnson a higher ratio is needed to ensure financial stability.

Johnson agrees with Bob Ivry that a major weakness of the Dodd-Frank act was not restricti the size of banks. The Brown-Kaufmann amendment to Dodd-Frank would have capped ther but it was voted down by 61 votes to 33 in the Senate in 2010. Johnson said there was no necessity for big banks. The US achieved prosperity without such gargantuan financial institutions. "My concern is that next time we could have an even worse crisis. If we have th same incentives towards massive risk-taking, the banks could scale up. This is what they ar paid to do," he said.

Please share your experiences and views in the comment section

Related posts

Triodos grows as investors flee big banks

Umpqua: Is this the world's nicest bank?

Get me out of the Apple economy

Disrupting Finance: Better Banking

Nils Elmark: Saving 10 Million Casualties of Modern British Banking

Economy of Hours – a growing Echo from a flourishing community

« **Previous** **Next**

David W. Smith

An editor with a passion for social justice and the environment, David has been a journalist f 20 years. He began learning the trade on a local paper in Lincolnshire and worked his way u to the national papers in London.