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OPINION | COMMENTARY

Four Principles for Replacing Dodd-Frank

First, address incentives: Banks want to avoid costs and regulators tend toward the politically expedient.

House Financial Services Committee Chairman Rep. Jeb Hensarling at a hearing on Capitol Hill, March 22. PHOTO: ASSOCIATED PRESS

By Charles W. Calomiris
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The effort to repeal the 2010 Dodd-Frank Act and reform American financial regulation seems to be losing traction. Although the House voted 233-186 last week to pass Rep. Jeb Hensarling's ambitious and substantive Financial Choice Act, it is unlikely to come to a vote in the Senate soon. The Treasury this week released the first installment of its own blueprint for reform, another good step. But the urgency of action has been lost as the Trump administration struggles to find its footing on tax cuts, health care and the budget.

Unfortunately, delay is damaging. Financial regulation since 2009 has been a trifecta of failure: It has not achieved its stated objectives, yet has imposed enormous costs on banks and the economy, while creating Kafkaesque procedures that deform democracy by undermining the rule of law. With respect to missed targets, consider a few examples:

• The 2009 CARD Act sought to protect risky credit-card borrowers from high bank charges. Instead the law has pushed these borrowers into the shadow consumer-finance system.

• Dodd-Frank was supposed to limit mortgage risk through standards for qualified mortgages and qualified residential mortgages. But these requirements have been ineffectual because mortgage transactions by Fannie Mae and Freddie Mac are exempt. Even Barney Frank has publicly recognized the problem. In 2015 he said that regulators had "let the loophole eat up the rule." As a result of relaxed underwriting standards at Fannie and Freddie, mortgage risk has been rising steadily for the past four years.

• Title II of Dodd-Frank was advertised as a way to prevent bailouts of too-big-to-fail banks by offering them a means of orderly liquidation. But it is unworkable and will not produce neat resolution in practice. The path of least resistance remains bailouts, the procedures for which were codified by Dodd-Frank.

• The Durbin Amendment, which limited debit-card fees, failed to help consumers because banks simply raised other fees, such as those on overdrafts. The share of banks offering free checking accounts fell from 75% before Dodd-Frank to 37% in 2015.

• Dodd-Frank's Financial Stability Oversight Council was supposed to establish a credible means for measuring or controlling systemic risk, but it has failed to do so. The FSOC's one high-profile foray into so-called macroprudential policy was to limit banks' leveraged lending—an initiative designed to deprive private-equity firms of certain types of loans. This was completely ineffectual, since leveraged lending by shadow banks increased dollar-for-dollar.

• Dodd-Frank and its implementing rules have increased banks' minimum capital ratios, but there is little reason to believe that today's prudential regulations—which use complex models of risk and liquidity to require minimum amounts of bank capital or cash—will prove more reliable during the next crisis than they were in the last one. Recall that Citigroup 's regulatory Basel capital ratio was 12% at the end of 2008. The current goal seems to be to make all banks just as sound as Citi was at that time.

Despite these regulations' ineffectiveness, the compliance costs paid by customers and stockholders are large. Small banks face high regulatory overhead as a fraction of assets—so much so that virtually no new banks have been started since Dodd-Frank was passed. Midsize banks often avoid profitable growth or acquisitions because they want to avoid an increased regulatory burden. Large banks bear unique compliance costs, such as stress testing based on highly questionable criteria, which probably does little to limit systemic risk but crimps the credit supply.

Even more troubling is the adoption of processes inconsistent with the rule of law. Regulators increasingly issue "guidance" rather than go through formal rule making, with little regard for predictability, transparency or accountability. The criteria employed in stress testing are secret and therefore unaccountable. The standards for considering which nonbanks present a systemic threat are arbitrary.

The Consumer Financial Protection Bureau's new outcome-based theories of lending discrimination are radical. The very structure of the CFPB, as a three-judge panel at the U.S. Circuit Court of Appeals for the District of Columbia ruled last fall, "violated bedrock due process principles" by giving the bureau's director "more unilateral authority than any other officer in any of the three branches of the U.S. government, other than the president."

With unchecked power comes predictable abuse, but some cases challenge the imagination. For instance, in "Operation Choke Point," the Obama administration, working through financial regulators, warned banks against doing business with industries that the government deemed undesirable—gun dealers, tobacco purveyors and payday lenders, among others.

Why did Dodd-Frank and the rest of the crisis-induced rules fail? Because they did not recognize the core principles of successful regulation. I would emphasize four:

First, effective regulation must address incentives. Banks and financial firms want to avoid regulatory costs. Regulators tend toward what's politically expedient. Good rules take this into account. For instance, using market-based measures of risk and capital alongside accounting measures would make regulatory arbitrage less likely.

Second, consumer protections should help people make informed choices instead of attempting to dictate choices with prohibitive rules.

Third, macroprudential policy should focus first and foremost on real-estate risk, especially where subsidized and promoted by the government. The primary threat to financial stability remains subsidized risk-taking in the mortgage market, which is growing once again to worrying levels.

Fourth, regulation should conform to the rule of law—which means ending the reliance on "guidance" and the delegation of excessive discretionary authority to politicized actors such as the FSOC and the

CFPB. Financial rules and their enforcement must be transparent, so that regulators are accountable to the public.

The Financial Choice Act is a good start, but there's no time to waste. The longer the Senate waits to take up Mr. Hensarling's bill, the more harm the current regulations will do to America's financial system, the economy and the rule of law.

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