Dodd-Frank and Obamacare: Different problems, same illusory solution
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Dodd-Frank may be unconstitutional. There's a more practical problem with it, too, though, that even we non-constitutional non-scholars can grasp. The law just doesn't work, in that it will never do what it was supposed to do: end too big to fail. Moreover, it was *designed* not to work. That's the problem, indeed, with both of President Barack Obama's signature laws. The other one, of course, is the 2010 Affordable Care Act, or Obamacare, signed into law three months before Dodd-Frank (the 2009 stimulus law, by contrast, was temporary). Indeed, Dodd-Frank is just as flawed in its own way as Obamacare is, although we don't pay as much attention to Dodd-Frank because it's harder to see the flaws. It has a similar potential to harm ordinary Americans, though. And the failures have similar origins.

The two laws have several things in common. For starters, both bills are too long and too complex. Obamacare clocks in at 906 pages. Dodd-Frank is 849 pages. By contrast, the 1965 act creating Medicare ran 138 pages, and the Securities Act of 1933—a cornerstone of financial regulation that helped prevent meltdowns for five decades —ran just 93 pages. The Glass-Steagall Act, another 1933 law that separated long-term commercial banking from shorter-term investment banking, ensuring that the risk of one activity didn't infect the other, totaled 53 pages. And even after decades' worth of amendments, the Securities Exchange Act of 1934 adds up to only 371 pages.

But the length of the law itself understates the case. Dodd-Frank was not really a law, but a set of mandates for regulators, as Louise Bennetts of the Cato Institute often says. The law directed regulators to write 398 separate rules, many as complex as the law itself. The rule-making undertaking for Dodd-Frank has so far produced—or rather, consumed—18,789 pages of text, containing 15 million words, according to a report that the Davis Polk law firm prepared for its clients on Dodd-Frank's third anniversary.

Yet rule-makers, missing deadline after deadline, are only 40 percent complete. As Davis Polk notes, of the 280 now-expired deadlines that Congress set, regulators have failed to meet 172. They haven't even announced proposals for another 64. Treasury officials insist that the work is accelerating, but the slow pace "has been remarkably consistent," Davis Polk observes. Even the rule-making isn't the end of it. To enforce new rules, Congress created 17 new bureaucracies to do everything from achieving "financial stability" to winding down failing firms through an "orderly liquidation authority" to regulating derivatives as well as mortgages. Almost as an afterthought, the law creates an enormous new bureaucracy, the Bureau of Consumer Financial Protection. The CFPB, as it's commonly known, is so potentially consequential that its sponsors should have introduced it as a separate piece of legislation.

Dodd-Frank also creates 17 smaller bureaucracies. Just read through the acronyms that didn't exist before to get an idea of the new office space needed. There's the the Financial Stability Oversight Council (FSOC); the Office of Financial Research (OFR); the Investor Advisory Committee (IAC); the Research and Analysis Center (RAC); the Financial Research Fund (FRF); the Orderly Liquidation Authority (OLA); the Orderly Liquidation Fund (OLF); the Office of Minority and Women Inclusion (OMWI); the Federal Insurance Office (FIO); the Office of Credit Ratings (OCR); the Office of Municipal Securities (OMS); the Office of Fair Lending and Equal Opportunity (OFLEO); the Office of Financial Education (OFE); the Office of Service Member Affairs (OSMA); the Office of Financial Protection for Older Americans (OFPOA); the Consumer Advisory Board (CAB); and the Private

Education Loan Ombudsman (PELO).

This complexity isn't merely an inconvenience – or bad for the environment as regulators and analysts print out page after page to figure out what it says. A brick of a law that directs regulators to write more bricks of rules means that neither lawmakers nor the president know exactly what's in the law. Nor do they know how each part of the law eventually will work with – or against – other parts.

Obamacare has run into the same complexity problem. The law has been on the books for more than three years, just as Dodd Frank has. But regulators have delayed implementation of key parts of it, including the requirement for employers to provide health care for their workers, and the parts that *are* taking effect right now are not working as advertised, as well all know.

Take the president's repeated—and false--promise that any American who wanted to keep his or her health plan could do so. He appears to have genuinely not understood that the voluminous law would lay the groundwork for what we are seeing now: widespread cancellation notices to insured Americans.

It's harder to grasp Dodd-Frank's failure. But it's equally simple: a promise made and not kept. In his inaugural address in 2009, Obama said that the crisis was a reminder that "without a watchful eye, the market can spin out of control." In signing Dodd-Frank, Obama pledged that "the American people will never again be asked to foot the bill for Wall Street's mistakes. … There will be no more tax-funded bailouts—period."To applause, he added that "there will be new rules to make clear that no firm is somehow protected because it is 'too big to fail.' "

Just this past May, though, Treasury Secretary Jacob Lew told Congress that "getting Dodd-Frank implemented is still a fair amount of work." On the procedures that are supposed to allow financial firms to fail in an orderly fashion, he said: "I think the challenge is now to make sure that we know that those can work. . . . The operational issues are not insignificant." Somewhat obliquely, Lew concluded that we're "still determining how to set the levels in various areas" so that "in the end we'll be able to say that too big to fail has ended."

Indeed, "there's a growing bipartisan consensus that the Dodd-Frank Act regrettably did not end the 'too-big-to-fail' phenomenon or its consequent bailouts," Texas congressman Jeb Hensarling, head of the House financial-services committee, said just before Dodd-Frank's third anniversary this summer. Republicans aren't the only ones saying so. Elizabeth Warren, the new Democratic senator from Massachusetts, recently introduced her own "end too big to fail" bill, implicitly suggesting that Dodd-Frank did not fix the problem. At nearly a dozen Congressional hearings this year, independent expert witnesses from various Federal Reserve districts, particularly Dick Fisher of the Dallas Fed, have admitted that there is still no structure in place that would allow large financial institutions to go under without risking an economic meltdown.

What's the hold-up? Just as with Obamacare, it's easy to blame the complexity itself. But the solution to "too-big-to-fail" was always pretty easy: prevent financial firms from borrowing too much. How do you do that? The same way that the government prevents drivers from driving too fast. Set a clear, simple speed limit – and enforce it. Similarly, set a clear simple rule governing how much financial institutions can borrow for a given amount of non-borrowed "capital" – and enforce it.

Why would such a rule work? Three main reasons. First, right now, the government allows large financial institutions to borrow far more money if they borrow that money to do what the government wants them to do: lend the money through homeowners via mortgages, or to the government itself via

Treasury bonds. This way of doing things would be akin to the government telling everyone that it must use the same highway out of several competing highways because that highway is safer. What would happen? The highway would grow too clogged – and have far more crashes – than if everyone followed simple speed rules on different roads.

Second, such a rule would allow financial firms to go bankrupt without endangering the rest of the economy. Why? If every financial institutions were making different mistakes at different times rather than the same mistake all at once, they wouldn't fail at the same time, as they largely did during 2008. The economy can withstand separate failures for separate reasons at separate times, but it cannot handle the same failures all at once. To switch metaphors, this would be like if the government mandated that all restaurants serve only sushi. That works – until sushi falls out of favor.

The third reason is really the combination of the first two reasons. If investors knew that financial firms could fail without taking down the rest of the economy, investors really and truly would believe that the government would not bail out these institutions. Only then would investors stop lending money to large financial institutions at artificially low rates. And only then will we have ended too big to fail.

Implementing consistent capital requirements wouldn't be that complex. It would require, perhaps, 30 pages of legislation, indeed, in Congress, on the left and the right respectively, Senators Warren as well as David Vitter have introduced bills that would restore some market discipline to Dodd-Frank within this page limit.

Instead, look what has happened with the government's approach. Let's take just two signature initiatives. First, consumer protection. To protect people from borrowing too much to purchase a home, and thus leaving themselves vulnerable to foreclosure, Dodd-Frank directed the new CFPB to tell banks that they must assess consumers' "ability to pay" back mortgages before approving them.

That sounds reasonable. But how did they define ability to pay? The regulators decided that an individual can borrow up to 43 percent of his income—highly inadvisable for almost anyone. Borrowing this heavily leaves little room for a spouse to lose a job, say.

Regulators should have established a requirement for a mortgage down payment, big enough to provide home borrowers with a large cushion of non-borrowed money invested in their homes should they run into trouble. Americans followed such guidelines informally until the 1980s, when affordable-housing goals, as well as a desire for larger profits on the part of federally guaranteed housing agencies Fannie Mae and Freddie Mac, eroded the standards. Worse, the mortgage rule has important exceptions. Small banks in rural areas can still issue risky "balloon" mortgages, which require a huge payment at the end of their term, rather than amortizing steadily over years.

The mortgage rule is riddled with loopholes that undermine its purpose: to protect people from borrowing too much. Congress wants to look tough on mortgage lenders while continuing to let easy credit prop up the economy; regulators have obliged.

Next, let's look at the Volcker Rule. Regulators have spent nearly three and a half years trying to write the Volcker Rule, a provision that Obama once billed as the centerpiece of his financial-reform effort. The rule itself, championed by the former Federal Reserve chief, is straightforward. Banks that enjoy implicit taxpayer subsidies in the form of federally insured customer deposits and being able to borrow from the Federal Reserve in a crisis should not be permitted to make large, speculative, short-term bets in financial markets. Instead, they should confine themselves mostly to long-term lending activities and to traditional investment-banking practices, such as managing people's money for a fee.

Volcker has criticized regulators for the delay in finalizing the rule, rather than blaming lawmakers for assigning them an impossible task. Congress specifically directed regulators to carve out an exception to the rule's main premise, so that financial firms can "hedge" long-term lending activities. That is, if a bank's officers think that a recession could cause borrowers to default, the bank could offset that risk by purchasing an investment that would perform well in a high-default environment. But regulators cannot readily determine what kinds of activities constitute hedging and what kinds constitute speculation. If a bank holds $1 billion in long-term farm loans and then decides to short-sell corn futures—in the expectation that corn prices would drop and that its borrowers would begin defaulting on their loans—is that hedging, or is it speculation? Another problem is the sheer number of agencies that must coordinate on the Volcker Rule (and on others).

Why, then, didn't the government simply take this approach? Before he was elected, in fact, Obama seemed to understand what he needed to do. In a speech at Cooper Union college in New York in March of 2008 before an audience that included Mayor Michael R. Bloomberg and former Federal Reserve chairman Paul Volcker, Obama suggested more robust bank supervision, higher capital requirements, and increased transparency. He also said that he would "streamline" many "overlapping and competing regulatory agencies."

Just like with Obamacare, the complexity is a symptom of a simple problem: the unwillingness of either party to level with voters. Ending too-big-to-fail for real would require ending decades of implicit government subsidies for financial firms. Bank have been able to borrow cheaply since the early '80s because their investors know the banks will receive government help in a crisis. If banks can't expect such help, they'll have to pay more to borrow in accordance with the higher risk. Then, the banks will have to charge people higher interest rates for mortgages and other loans. That's a good thing in the long term. Part of the reason the country is still in so much trouble economically is because people were able to borrow way too much way too cheaply for too many years.

In the short term, though, ending the era of "too big to fail" would be bad for banks and bad for consumers. Just think of what would happen to the housing market, for example. Without the ability to borrow well below five percent a year over 30 years, Americans couldn't refinance their existing mortgages or raise money to buy new homes. Home prices would fall. People would consider the president an economic failure, and would not have reelected him last year. That's why the government wrote hundreds of pages pretending to solve the problem without doing so.

Likewise, making sure everyone has health insurance isn't all that difficult. Some people will pay more – either in insurance costs or taxes -- so that others can pay less. Young, healthy people will pay higher rates so that older, sick people can at least afford some insurance. But Obama never really explained this – so people are surprised. He should have said: you may know your wife's not going to get pregnant again because you had a vasectomy. But getting insurance for your own health care means you pay for others' care, including their pregnancy care, so you can't pick a plan that doesn't cover pregnancies anymore.

With healthcare, Obama didn't dare touch popular aspects of the status quo, even though they were at the heart of the issue. If you get health insurance through your employer, for example, you enjoy a huge tax subsidy, one that keeps healthcare costs artificially high for everyone. But that subsidy was viewed as untouchable. The same concept held with Dodd-Frank. Neither Obama nor Congress dared to "reform" Fannie Mae and Freddie Mac, two deeply flawed entities that have given many Americans a government benefit in the form of a cheap mortgage.

Big chunks of the existing healthcare industry, too, have a stake in keeping things largely as they are. Healthcare in America is more expensive than it is in other Western countries, partly because insurers and providers have benefited from an opaque marketplace with costs borne by third parties. (If you have to pay $315 for a ten-minute visit, you don't care because your insurance company pays – but someone without insurance has a headache wriggling out of a similarly inflated bill.)

Dodd-Frank and Obamacare have similar problems, as seen above – but there's a difference. If American healthcare keeps failing, people will be able to tell before there is one big catastrophe; it is a gradually unfolding problem. They may not be able to do much about it, but at least they'll know. If financial regulation keeps failing, few people will know until the next financial crisis – one that likely would cost millions of jobs, just as the last one did.

Financial-regulatory failure, though, does have a real economic effect now. What is that effect? Because large financial firms can still borrow too cheaply thanks to the artificial subsidies that come with too big to fail, these firms compete with the real economy rather than support it. Think about where people and businesses put their capital. They put far too much of it in the housing market rather than in riskier ventures that might create better jobs. This decreases the effect, say, or tax cuts on capital. That capital is going to distorted markets.

Failure to hold financial firms to free-market discipline also helps these firms to distort asset markets. Why is property so expensive in the world's capital cities? The entire world wants to put their wealth in property in New York and London. This isn't because of free-market economics. It's because zero-percent interest rates – another way of maintaing the power of too-big-to-fail financial institutions, which goes hand in hand with Dodd-Frank – leave the world's wealthy with no rational markets in which to invest their capital.

When will people notice the failures of Dodd-Frank? Most likely, the next time we need a large financial-firm bailout. And we will – because Dodd-Frank further obliterated market discipline rather than restored it. Dodd-Frank's command-and-control ethos is exemplified by the Financial Stability Oversight Authority, a ten-member regulatory group that will "identify risks to the financial stability of the United States," "promote market discipline," and "respond to emerging threats to the stability of the U.S. financial system."

But these three things don't go together. The FSOC's work in monitoring the nation's largest financial institutions contravenes its mandate to ensure market discipline. Why should investors monitor big firms if the government is already doing it for them? "As soon as a financial institution is designated as systemically important" by the FSOC, Dallas Fed president Richard Fisher told the House financial-services committee this June, "it is viewed by the market as being the first to be saved." The SIFIs—the law's "systemically important financial institutions"—thus "occupy a privileged space," Fisher added.

Such privilege makes it exceedingly difficult for free markets to reverse a decades-long trend. In 1990, Fisher notes, the nation's four biggest banks had $519 billion in assets, or 9 percent of gross domestic product. By 2011, they had $7.5 trillion, or 50 percent of GDP. "We have a structure that is not a free-market structure," concurs Thomas Hoenig, vice chairman of the FDIC. "It is heavily subsidized"—at least $83 billion annually in artificially cheap borrowing costs, according to a Bloomberg View analysis. Further, if the FSOC misses a big risk and a firm fails because of this oversight, whose fault is that? Congress has ensured that it is the government's fault just as much as the firm's—hardly a blow for market discipline.

When a firm does fail, it is unlikely that Dodd-Frank's new mechanism for such failure will work. Dodd-Frank did create a way for a large financial firm to fail in the unlikely event that the nation's all-knowing overseers miss something—but under the law's Orderly Liquidation Authority, the firm would not declare insolvency. Instead, the FDIC would take it over. As Fisher said in his June testimony, the OLA process bears little resemblance to bankruptcy. In a real bankruptcy, a neutral judge (one hopes) applies a consistent body of law to creditors and debtors alike. In orderly liquidation, regulators could use Treasury funds to favor specific institutions, injecting money from the Orderly Liquidation Fund into them and keeping them going. "Failed companies [can be] artificially kept alive . . . for up to five years," said Fisher. "To us, this looks, sounds, and tastes like a taxpayer bailout," he observed.

Why is that? Five years is enough time for a firm that should have failed to resuscitate itself, especially with taxpayer life support. Five years after Lehman, companies such as AIG, Citigroup, and even Fannie Mae have become profitable again. Creditors, in particular, know this. OLA provides them little incentive to lend more carefully. The government could take over a large firm and wait out an economic cycle, with help from government-controlled low interest rates.

And though Dodd-Frank constrains regulators' ability to treat some creditors better than others, it makes room for exceptions. The FDIC could favor one creditor over another if it thought that doing so would improve all creditors' recovery—likely meaning that the FDIC would protect short-term creditors to prevent them from fleeing.

Dodd-Frank's supporters claim that the OLA mechanism isn't a bailout because the financial industry, not taxpayers, would repay any money advanced by the OLF. Indeed, all large financial firms would have to help repay a government bailout of a failed financial firm. But collectivizing losses throughout an industry hardly promotes market discipline. Perhaps this is why investors have shrugged off findings that Chase misled its board about the extent of the losses it suffered last year on its infamous "London Whale" bet a year ago. They know that in a crisis, the government and Chase's rivals will be there to help out.

Moreover, because Dodd-Frank is so densely written and relies on regulators' moment-to-moment discretion rather than clear rules, the unpredictability its real-time application could create could induce a panic in a future period of financial turmoil. Thomas Hoenig, vice chairman of the FDIC, told Congress this summer that the OLA was "designed for an idiosyncratic event." He warned: "If you have a systemic meltdown, I feel pretty confident" that regulators would have to come back to Congress for another law, just as Congress had to pass the Troubled Asset Relief Program (TARP) under emergency conditions in October 2008. As New Jersey congressman Scott Garrett, a Republican, said at the summer hearing, "You can't on the one hand say that banks are no longer too big to fail and then on the other hand bemoan the fact that they still are."

What force could finally restore market discipline to the financial system? It won't be the politicians – at least not voluntarily. As we see with Obamacare, most people don't concern themselves with theoretical problems. They only care when they see the real results. Only now are Democrats talking about some minor fixes to Obamacare.

The same may be true with Dodd-Frank. It won't be fixed until we have public outcry. And that public outcry may not come until a financial crisis – when one political party or the other sees that it would be toxic for them to approve new bailouts. It may be the Democrats who should worry this time around. As late as 2012, a plurality of voters still blamed former president George W. Bush and Wall Street for the financial crisis and its recessionary aftermath. Fair enough. Next time, though, the voters may remember that it was Obama and his party who promised to end too big to fail—and didn't.

For further reading, please see "Too Convoluted to Succeed," City Journal *magazine, Autumn 2013, and "How Financial Reform Became a Fiasco,"* Research *magazine, August 2013.*