Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Did Dodd-Frank Solve or Create Problems?*

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The Dodd-Frank Act is a young statute in many respects, so it's still early to determine whether it has met the intentions of the Congress by solving problems that created the environment for the Recession of the 00s without creating other pernicious complications. We will need more time to pass and more difficult economic and social conditions to develop before fully understanding whether it solved the problems it was intended to solve, and if in doing so it avoided creating other serious issues. Some conclusions are beginning to form, however.

It appears things are safer, though perhaps too much so.

In the one economic area that seemed to be blamed the most for the 00 Recession — housing — it seems that the Act and the implementing rules have made it more difficult for borrowers who are unable to repay a loan to borrow in the first place. Said another way (depending upon one's mindset), it has made it more difficult for the high flying subprime lenders of Orange County to entice borrowers into loans that they had no realistic chance of repaying. That was certainly the driving force behind the passage of Title XIV of the Act, and to a lesser extent, Title X.

Numbers of delinquencies have fallen, foreclosure rates are once again moving toward traditional levels, deceptive or potentially very dangerous products have nearly disappeared, and floods of foreign money are not entering the system and driving prices through the roof. A system has been constructed in which borrowers are limited to those with a reasonable ability to repay, and, once in the system as a borrower, they have access to various ways to try to resolve their debt problems while remaining in their homes.

That is the accepted story. It's a nice question whether that is the full story.

A recent study by Wharton professors[1] concludes that the recession was more a recession of defaults in the prime market, not the subprime market, and that subprime loans that were entered

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] Frederick Ferreira and Joseip Gyourko, "A New Look At the U.S. Foreclosure Crisis: Panel Data Evidence of Prime and Subprime Borrowers from 1997 to 2012," NBER Working Paper No. 21261.

into in the early 00s seemed to have done all right. In other words, it was the decline in housing prices, not the products or terms of the mortgages that determined if a loan would default. When that is combined with the fact that in the worst part of the crisis more than 75% of the subprime loans continued to pay regularly, legitimate issues can be raised about the wisdom of the solutions to the housing crisis created by the DFA and its implementing regulations.

The percentage of homeowners has fallen below pre-crisis levels to around 63 — 64%, now being fairly close to the level it was 50 years ago. It remains unevenly distributed by race, a fact that was true during the height of the Recession of the 00s. Nothing dramatic has changed on distribution among the races since the housing market broke. It does appear likely, however, that there has been a decline in housing credit made available to those with less wealth or with bad credit ratings. It is not clear that those individuals would have defaulted at a higher rate based on the data that the Wharton professors found in their study, just as long as the price of housing didn't precipitously decline.[2]

Looking beyond mortgages, we are probably safer now because the amount of capital that regulated institutions must retain is higher than it was before DFA, by quite a bit, and some of the more exotic definitions of capital have now been abandoned. If banks face a downturn in the economy, they are now likely to have greater resources upon which to draw before becoming a candidate for failure.

Greater capital can be a bit of a trap, of course. The FDIC has studied bank failures in the past, and the number of institutions that had what regulators would call adequate capital shortly before they failed is always surprising. Most observers agree that Lehman Brothers had capital when it failed; it failed because it couldn't fund itself in the market place. Capital regulations have addressed liquidity, capacity and risk, and while there remain comments that the largest institutions should have even greater levels of capital, the capital layering seems to have neared its peak. Of course, if the regulators are trying to downsize the biggest banks through capital increases, we may not have seen the end of the increased requirements.

Are the banks safer now? Most assuredly they have more capital and capital of different kinds that should permit them to withstand large losses or difficulties in reaching the market for funding. To assume that they have sufficient capital to withstand losses caused by black swan disasters would be fooling ourselves. That raises the question whether increased capital levels is a good substitute for assistance in catastrophic circumstances. Only time will tell whether it is.

Are our trading markets safer? Flash trading has created potential problems not yet handled, but on a more mundane level, the Volcker rule has reduced the amount of risk that bankers can accept in trading insured deposit money. There remain problems associated with the way rating agencies are paid, notwithstanding DFA, so there will be a lingering concern about the objectivity of the ratings. What is the prevailing philosophy that drives the trader — simply to make more money? That, of course, is the kind of problem not well suited to legislative fence building — traders are simply too clever to accept the restraints. If they are driven mainly by making money, then customer relationships and satisfaction may be secondary and that can continue to lead to problems.

[2] Of course, it does regularly precipitously decline. In doing so, the Wharton study seems to suggest that all are caught up in the problem, good credits or not.

More important, are there unintended consequences of adopting the most reasonable solution to an existing problem.[3] It is unlikely that the goals of Congress included reducing housing credit to Black and Hispanic borrowers, yet that seems to have been the case as a direct result of the adoption of the ability to repay rules compounded by the increase in penalties for violation of those rules. Similarly, it is unlikely that the goals of Congress and the CFPB could have been to reduce the percentage of home ownership to a level comparable to what it was fifty years ago, but that seems to be the result.

Liquidity in the market place generally seems to have been reduced and increased capital costs have led to higher prices for borrowers, strengthened underwriting, and less remuneration for the lenders. That has to have led to a general drag on the growth of the economy which probably is felt most immediately by those in the lower rungs of the economy and in industries that are less capable of competing in a global economy or without alternative funding opportunities. There is, of course, the possibility that capital costs to lenders who have lost an implicit subsidy from the government with the passage of various titles of the Act (for example, I, II and XI) will increase. It is not at all clear that unencumbered global capital would target large U.S. banks as the best of many available investment opportunities at this time, and it would be unusual if that result had been the goal of Congress and the regulators as they passed the statute and implementing regulations. As important is the theory that generally the tendency is for those who feel safer to take more risks,[4] a result, if true, that would suggest that banks with greater capital will take additional risks until they again reach a risk tolerance consistent with their desires.[5]

As for Too Big To Fail, that debate continues and will probably continue until another economic or financial crisis occurs and we all discover whether the largest banks cause a problem and, if so, whether they are deemed essential to the continued operation of the economy. If they are not, the alternatives that exist in the statute will be implemented, and we will all see what those dislocations will do to the economy of both the U.S. and the world. When faced with a tradeoff between short-term and long-term desirable actions when they are in conflict, most officials operating in a political system choose the short-term actions, even if they are in conflict with what is perceived as the better but distant long-term goals.

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[3]See a discussion of this in the book Foolproof by Greg Ip. Ip uses examples of football helmets mandated to stop skull fractures only to see more brain concussions; fire retarding practices of the National Park Service that has resulted in an increase in major forest fires; rebuilding of homes in flood plains as levees are constructed — homes that will, in turn, be destroyed as the levees either break or are topped in the future, etc.

[4]Ip op cit.

[5]That increased risk may account for the Marx, Mills, Schumpeter and Keynes view of excess capital accumulation leading to economic downturns; it's probably a question of the need for greater and greater risk taking to pay the investors.