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Real Clear Markets

Opinion | June 17, 2014

It's Time to Recalibrate Financial Reform

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It's time to reassess the global and national reforms of the financial system and to recalibrate the specific regulatory and legislative measures, five years on from the first efforts. Overall, the reforms are a strongly positive set of actions to make the financial system and our economy safer and more effective. However, with the benefit of experience and further analysis, there are a few areas where actions have likely been counterproductive and more where the cost has been too high for the additional safety that has been gained. In yet other areas, risks are developing that were not foreseen nor have not been adequately addressed.

Leaders of the 20 key economies in the world will be meeting in Brisbane in October with an agenda that includes such a comprehensive reassessment. We ought to encourage this and to take that review seriously. This includes correcting some clear mistakes in the Dodd-Frank Act, the main U.S. financial reform law that was passed four years ago. The U.S. has been caught in a damaging stasis, where Democrats have felt compelled to block any changes to Dodd-Frank because they believe that Republicans would use the opening to reverse important new protections for the financial system. We are in the unfortunate situation where Republicans are calling for wholesale repeal or radical amendment of Dodd-Frank and Democrats feel the need to effectively act as if everything in it is perfect. It's time for a compromise where Republicans accept that Dodd-Frank will remain the law of the land, unless and until they win the Presidency and achieve a filibuster-proof majority in the Senate, and Democrats admit that revisions are necessary. Dodd-Frank is a long and complex piece of legislation that substantially alters regulation of a huge and complex part of our economy. It should be no surprise that it can be improved now that we know more and have thought about it longer.

One example of a mistake in Dodd-Frank is in the regulation of financial institutions, other than banks, that are determined to be systemically important. Once so designated, as has happened with Prudential and AIG, a set of additional requirements click in to ensure they are operated more safely. This is good in principle, but the requirements were put together without sufficient consideration and treat insurers and other non-banks too much like banks. As a result, the Federal Reserve, the new systemic risk regulator, has made clear that they believe they would have to apply a set of bank-like capital requirements to these institutions, due to the "Collins Amendment," a part of Dodd-Frank. Doing this would be quite damaging to these insurers, and any others that are designated in the future, without any public benefit. Many argue that there are ways to work around this within the confines of the law, but the Fed insists it cannot do so and it would clearly be better in any case to simply clarify the law.

We are also part of many global reform initiatives, such as those undertaken by the Basel Committee on Banking Supervision and the Financial Stability Board. These have established important common rules on bank capital and liquidity requirements, as well as the new rules governing derivatives markets and certain other reforms. The U.S. has substantial influence on the shape of these rules and their application and we should help ensure that they are appropriately calibrated to optimize the balance of safety and economic efficiency.

In some areas, it appears that the global rules may be too harsh and may limit the availability of credit provision through banks or their affiliates, either making such credit harder to get or more expensive, or pushing the business into the so-called "shadow banking" sector, where it may be more dangerous to the financial system. (Some of this should move to markets or non-bank credit channels. The concern is about regulatory arbitrage where some business moves to where it is less safely and effectively controlled.) Concerns have been raised, for example, about infrastructure financing, loans to small and medium sized enterprises, and government debt of emerging market economies, which are important drivers of global growth.

On the other hand, there are risks to the financial system that have yet to be adequately addressed, especially in the shadow banking sector, but also including the central counterparties (CCP's) that have been mandated to be at the heart of the reformed structure of derivatives markets. Greater use of CCP's is a good thing, but they also bring risks for which global regulators have yet to find sufficiently good protections.

These are all very complicated topics that cannot be adequately addressed here, but the key point is a simple one. A comprehensive reassessment is needed and we must be open to recalibrating and fixing the reforms to ensure that we address all relevant risks and that we have the right balance of safety and efficiency. However dull this may seem to the public and most policymakers, the choices that are being made have substantial effects on the economy. It would be a serious mistake to either pretend that everything is being done perfectly or that there is no point in making revisions short of a wholesale restructuring of the reforms.

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