Making Dodd-Frank Worse

December 22, 2014 - The financial reform bill known as Dodd-Frank was Congress's knee-jerk reaction to the collapse in housing prices and subsequent bank bail outs. As with anything knee-jerk, it was poorly written, driven by a panic to show the voting public that Congress was doing something, and full of unintended but easily predictable consequences. A good analogy would be that Dodd-Frank is to banking what Obamacare is to health insurersâ€¦ a real mess. That's why we were somewhat surprised last week when Congress passed a funding bill that actually makes Dodd-Frank worse than it was before.

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In the lead up to passage of Dodd-Frank we warned our readers repeatedly that the bill would lead to new bank fees, the end of free checking accounts and increased fees for credit card usage. But Congress passed this so-called consumer protection bill anyway. Since then, all of our predictions about the effects of the bill have come to fruition.

But something that Congress did get partially correct in Dodd-Frank was trading regulations on banking derivatives known as "credit default swaps". These derivatives caused a number of financial services companies to ask for government bailouts at taxpayer expense.

Under Dodd-Frank though, banks that wanted to engage in the trade of credit default swaps had to conduct their trades through affiliated companies which had to have larger cash reserves. This kept these trading activities completely insulated from the portion of the banks' business that is driven by deposits. In financial circles, this was called the "push out rule".

The reason that we say that Congress got this "partially correct" is that they didn't simply outlaw the trading of credit default swaps. These derivatives serve no useful purpose but they can leave the companies that trade them exposed to huge financial losses.

In fact, credit default swaps were illegal in 49 states prior to the year 2000 and were regulated under state gambling laws known as "bucket shop laws". In 2000, the Congress and the Clinton administration passed a banking reform law that specifically forbid the states from enforcing these anti-gambling laws on financial derivatives. This allow banks to engage in the direct trading of credit default swaps and played a major role in the 2008 financial collapse.

Once Dodd-Frank became law, banks still had the ability to engage in these trades but under the new structure, taxpayers were supposed to be assured that in any future failures, taxpayer money wouldn't be at risk and no government bailouts would be forthcoming.

Last week, Congress passed a bill to fund most of the federal government through September of 2015. Buried in that bill was a repeal of the "push out rule". This means that banks can once again directly trade credit default swaps. And that means that if they get into financial trouble again, taxpayers are likely to be asked to bail them out. It is an absolutely horrible decision which is likely to lead to another set of entirely foreseeable unintended consequences.
byJim Malmberg
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