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## Repealing Dodd–Frank and Ending "Too Big to Fail"

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**Abstract**

*The financial crisis of 2008 led to the "Great Recession" from which the nation is still recovering. Despite the slow economic rebound, and in the face of contradictory historical evidence, many critics still try to blame these events on the supposed failure of the free market. They claim that a lack of regulation caused the crisis and that the federal response vindicates government's role in the economy. But government bailouts designed to preserve a few irresponsible and overextended companies came at the expense of the taxpayer, and with the consequence of punishing other banks and financial institutions with egregious regulations that only increase the danger of financial crises. Yet Fannie Mae and Freddie Mac, the very institutions that played a central role in the 2008 crisis, are virtually untouched by any corrective regulation or action from Congress and enjoy the government's continued favor. Congress can and should ensure that taxpayers will never again bail out large institutions or their creditors. Financial institutions that fail should be allowed to wind down through an orderly bankruptcy process. Government corporations Fannie Mae and Freddie Mac should be shut down and the housing market made more stable by relying on private financial firms that are not backstopped by taxpayers.*

### Key Points

- The mere existence of the Financial Stability Oversight Council (FSOC) is wholly incompatible with the functioning of a dynamic private capital market. Short of a full repeal of the Dodd–Frank Act, the preferred solution, Congress should eliminate the FSOC.
- There has not been any sort of substantive deregulation of financial markets in the past century. In fact, the evidence suggests that the massive federal regulatory framework contributed to the crisis.
- When Congress responded to the crisis with the Dodd–Frank Act, Fannie and Freddie remained largely untouched and to this day pose a threat to taxpayers.
- Given the development and current sophistication of financial markets, there is even less reason to allow the central bank to serve as a lender of last resort now than there was in 1913. There is, in fact, no clear economic rationale for the Fed to provide direct loans to private firms.

The financial crisis of 2008 led to the "Great Recession" from which the nation is still recovering. Despite the slow economic rebound, and in the face of contradictory historical evidence, many critics are still trying to blame these events on the supposed failure of the free market. They claim that a lack of regulation caused the crisis *and* that the federal response vindicates government's role in the economy. It was the unbridled capitalism of the George W. Bush

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years, they say, that crashed the economy, and it was the heroic application of federal power via emergency bailouts, massive stimulus, and new regulations that spurred the economy to recovery.

A more accurate reading of history tells a very different story of favoritism for some, at the expense of opportunity for many. Government bailouts designed to preserve a few irresponsible and overextended companies came at the expense of the taxpayer and with the consequence of punishing other banks and financial institutions with egregious regulations that only increase the danger of financial crises. Yet the two institutions that played a central role in the 2008 crisis, Fannie Mae and Freddie Mac, are virtually untouched by any corrective regulation or action from Congress and enjoy the government's continued favor.

## Why "Too Big to Fail" Is Dangerous

The notion that there has been any sort of substantive deregulation of financial markets in the past century is completely wrong. In fact, the evidence suggests that the massive federal regulatory framework *contributed* to the crisis. Policies and regulations that existed long before 2008 solidified the belief that large financially troubled firms would be supported with government money—the so-called too-big-to-fail doctrine. This doctrine, that the federal government should support large firms rather than allowing them to go bankrupt has a long history in the U.S., and the government's actions in the wake of the recent crisis have mainly served to enshrine "too big to fail" into law. Collectively, these actions have reinforced and possibly expanded incentives for risky financial behavior, thus increasing the likelihood of future bailouts.

When mortgage lenders, large banks, and other financial firms got into trouble, U.S. citizens were forced to pay for their life support. Such is the privilege of favored institutions deemed too big to fail. But while some companies, such as Bear Sterns and General Motors were bailed out, other large companies, such as Lehman Brothers, did not get special treatment from the government and were allowed to go under.

Creating an environment in which certain large firms expect to be supported with taxpayer dollars, or in which various market participants expect such support, is dangerous for several reasons. First, this process ultimately allows government officials to decide which firms survive and which companies fail. Providing government authorities with this sort of power all but ensures less economically beneficial activity precisely because inefficient and unprofitable firms are the ones most likely to fail. Furthermore, socializing financial firms' costs while leaving profits mainly private makes it more likely that managers will take on too much risk and that creditors will provide too much credit.

**Now that bad actors know that bailouts, subsidies, and government partnerships are the rewards for failure, they have more incentive to take risks that endanger taxpayers again.**

Now that bad actors know that bailouts, subsidies, and government partnerships are the rewards for failure, they have more incentive to take risks that endanger taxpayers again. The measures enacted in the wake of the crisis to ensure a sound financial sector stand only as a grim monument to the consequences of panicked action by legislators. Since 2008, the government's main response has been to either regulate completely unrelated issues or to create vast new powers for itself while protecting some of the very institutions that contributed to the crisis.

This process stands to generate new opportunities for incompetent firm management, corruption, and unprecedented intrusion into the private affairs of American citizens. Rather than ending too big to fail, the Dodd–Frank Wall Street Reform and Consumer Protection Act has enshrined it into law. Managers and creditors have every reason to make more risky bets when an expectation of bailouts exists. The best way to ensure that firms do not take undue risks is to credibly state that owners and creditors—not taxpayers—will be responsible for financial losses.

## Enabling the Bailout: The Fed's Emergency Lending Authority

During the 2008 crisis the supposedly independent Federal Reserve worked closely with the U.S. Treasury Department to provide loans to various financial companies, including banks and securities

firms that may have otherwise filed for bankruptcy. The government even forced some banks to take money against their objections.[1] In particular, the Fed facilitated bailouts to financially weak firms and their creditors by invoking its so-called emergency lending authority.

This emergency lending authority exists because the Fed has historically been viewed as the nation's lender of last resort (LLR), but it now serves mainly as a way to enable too-big-to-fail policies. An LLR is supposed to provide credit when funds are not available from any other source, but the essence of a true LLR is to avoid lending to financially troubled firms. Whenever possible, the LLR should avoid lending to specific institutions and, instead, ensure the system-wide flow of credit. Overall, the Fed has rarely acted as the LLR it was designed to be. Throughout its history, the Federal Reserve has given special treatment to some by lending to financially troubled firms, thus jeopardizing the independence of its monetary policy decisions and putting taxpayers at risk.

During the 2008 financial crisis, the Fed allocated credit directly to several firms, as well as indirectly through various broad-based lending programs. For instance, the Fed provided a $13 billion loan to Bear Sterns, one of the Fed's largest primary dealers, on March 14, 2008. The loan was repaid in days, but then the Fed provided a $30 billion loan to facilitate J. P. Morgan Chase's Acquisition of Bear Sterns (via a special-purpose vehicle named Maiden Lane, LLC). Shortly after this deal was completed, former Fed chairman Paul Volcker remarked that this loan was "at the very edge" of the Fed's legal authority.[2] Then, on March 17, 2008, the Fed's primary dealer credit facility (PDCF) provided overnight cash loans to primary dealers against "eligible collateral," as defined by the Fed. Nearly $9 trillion was loaned through the PDCF by 2010.

Overall, the U.S. Government Accountability Office (GAO) estimates that the Federal Reserve lent financial firms more than $16 trillion through its broad-based emergency programs.[3] To put this figure in perspective, annual gross domestic product (GDP) reached $16.8 trillion in 2013, an all-time high for non-inflation-adjusted GDP in the U.S. During the crisis, the Fed created more than a dozen special lending programs by invoking its emergency authority under Section 13(3) of the Federal Reserve Act. The Dodd–Frank Act amended this authority after the 2008 crisis, but even if these changes had been in place before, the Fed would still have been able to conduct roughly half of those lending programs.

## A Free Ride for Fannie Mae and Freddie Mac

Meanwhile, some of the very institutions that triggered the financial crisis enjoyed the government's continued protection. The operations of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac were a key cause of the financial crisis and are the poster children for the too-big-to-fail doctrine. The fact that these companies were "sponsored" by the government alludes to one of the worst-kept secrets in the history of the U.S.—taxpayers would be forced to bail these companies out if they ever became insolvent. In 2008, that is precisely what happened.

The details center around the GSEs' operations, particularly the guarantees that they provide. These companies buy mortgages from banks, bundle them, and then sell the repackaged mortgages as mortgage-backed securities (MBS). The GSEs guarantee the interest and principal payments on their MBS,

1. James Gattuso, "Paulson and the Banks: What an Offer You Can't Refuse Looks Like," The Daily Signal, May 15, 2009, http://dailysignal.com/2009/05/15/paulson-and-the-banks-what-an-offer-you-can%E2%80%99t-refuse-looks-like/; Nina Easton, "How the Bailout Bashed the Banks," CNN Money, June 22, 2009, http://money.cnn.com/2009/06/19/news/economy/trouble_with_tarp_bailout.fortune/index.htm?postversion=2009062107 (accessed June 11, 2014); and John A. Allison, *The Financial Crisis and the Free Market Cure: Why Pure Capitalism Is the World Economy's Only Hope* (New York: McGraw Hill, 2013), pp. 170–171.
2. J. Brinsley and A. Massucci, "Volcker Says Fed's Bear Loan Stretches Legal Power," Bloomberg News, April 8, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPDZWKWhz21c (accessed July 8, 2014). Later, the Fed created two additional Maiden Lane, LLCs to complete the American International Group (AIG) bailout. The combined net holdings of the three Maiden Lane entities are currently more than $1.7 billion, and nearly the entire total rests in the original LLC.
3. These loans were made from December 1, 2007, through July 21, 2010. U.S. Government Accountability Office, "Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance," GAO–11–696, July 2011, p. 131, http://www.gao.gov/new.items/d11696.pdf (accessed July 3, 2014).

ostensibly turning mortgages into a great investment. But the fact that the GSEs guarantee their MBS does not make mortgage risk disappear. When mortgage holders default, for example, someone still has to pay the investors. That's where the guarantee kicks in.

The GSE guarantee has always ensured that MBS investors would be made whole if too many mortgages defaulted, and it has also meant that taxpayers would have to pay if the companies ever failed. In 2008, the two GSEs could not meet their obligations, so the U.S. taxpayers started doing it for them. This arrangement is the key to understanding the housing finance reform debate: Investors want taxpayers to guarantee MBS cash flows. This debate, in other words, is about investments, not about homeowners. When Congress responded to the crisis with the Dodd–Frank Act, Fannie and Freddie remained largely untouched and to this day pose a threat to taxpayers. In fact, the two companies—now essentially government controlled—are an even bigger player in the mortgage markets than before the crisis.

## Federal Regulatory Framework Perpetuates "Too Big to Fail"

Many critics blame "Wall Street" and "the banking industry" for taking excessive risks that caused the recent meltdown. But risk is inherent to all financial transactions; it is the process of socializing the costs of risky behavior that motivates firm managers to take on too much risk. In other words, government policies that support the too-big-to-fail doctrine create systemic risk. The massive federal regulatory framework contributes to this problem, and too few have acknowledged that regulators watched as the financial crisis unfolded—and largely did nothing to stop these activities.

The implementation of the Basel capital requirements in 1988, for instance, produced more of the activities that caused the crisis 20 years later. The Basel accords were regulators' attempt to improve capital standards by better matching the riskiness of assets with the amount of capital held against the assets. In reality, the Basel accords induced banks to buy Fannie Mae and Freddie Mac securities to lower their capital, thus having the opposite effect of the stated intentions. These were the very same (taxpayer-backed) securities that contributed to the 2008 meltdown, and many more of them existed partly because the Basel rules encouraged (and even sanctioned) these purchases. Since 1992, Fannie Mae and Freddie Mac issued these securities under the eye of the Office of Federal Housing Enterprise Oversight, an independent regulator with the Department of Housing and Urban Development.

The Federal Reserve also carries responsibility for these (and other) key regulatory failures. The Fed, which has been the primary regulator of bank-holding companies since 1956, had embedded resident examiners in some of the largest firms that failed or nearly failed during the crisis. Furthermore, the minutes of the Fed's Open Market Committee meetings in 2008 show that the Fed did not fully understand the magnitude of the crisis as it was happening. Despite these facts, the Basel rules are still in place, financial firms now face more federal regulations, and the Fed's regulatory role has been increased. There is no clear economic logic behind mitigating financial crises in this manner, much less to solving the too-big-to-fail problem with more of the same policies that clearly do not work. Nonetheless, that is essentially the approach enshrined in the 2010 Dodd–Frank Act.

Further, even the nonbank financial companies that did not previously fall under risk-based capital requirements were, in most cases, regulated in some way before the crisis. For instance, life, property/casualty, and health insurance companies have been required to insure for losses (reinsurance) and hold reserves against estimated future losses since at least the 1940s, even though there was no federal mandate. In addition to reserve and reinsurance requirements, many states had adopted risk-based capital standards for insurance companies operating under their jurisdiction prior to 2008.[4]

In fact, the only large *insurance* company at the center of the 2008 crisis was a federally regulated

4. National Association of Insurance Commissioners, "Risk-Based Capital: General Overview," July 15, 2009, http://www.naic.org/documents/committees_e_capad_RBCoverview.pdf (accessed March 18, 2014), and National Association of Insurance Commissioners, "The United States Insurance Financial Solvency Framework," 2010, http://www.naic.org/documents/committees_e_us_solvency_framework.pdf (accessed March 18, 2014). For historical mortality tables used to estimate future life insurance claims, see Society of Actuaries, "Mortality and Other Rate Tables," http://mort.soa.org/ (accessed January 27, 2014).

company. The American International Group (AIG) was regulated by the Office of Thrift Supervision because it was a holding company that owned savings and loan institutions.

If deregulation really had caused the crisis, as some argue, Congress would have simply needed to restore those rules. Dodd–Frank did not mandate restoration of rules because there was nothing to restore. Given that Dodd–Frank expands financial market regulation with newer versions of the same rules and regulations that have been in place for years, there is little reason to expect less economic turmoil in the future. In fact, many of the private financial firms that had nothing to do with the 2008 meltdown now face expensive regulations that fail to address the original problems.

**The FSOC Identifies Too-Big-to-Fail Firms.** The Dodd–Frank Act greatly expanded the federal government's reach into financial markets through the Financial Stability Oversight Council (FSOC), a multi-regulator council that is supposed to constantly monitor and improve U.S. financial stability. The FSOC enshrines the too-big-to-fail problem because it identifies firms whose failure regulators believe would be catastrophic to the U.S. economy. The FSOC's very existence increases the likelihood of future financial crises and bailouts.

If history is any guide, the fact that the council expands regulations over financial markets should not inspire confidence that future crises will be mitigated. Less regulation, not more, gives firms the flexibility to learn and adapt in order to avoid repeating past mistakes. Furthermore, adhering to the rules and regulations provides the false notion that firms have not taken on too much risk.

In practice, the FSOC will lower competition, increase financial risks, and cost consumers money. The FSOC has a broad, ill-defined mandate through which it designates certain "systemically important" financial companies for special regulations under the Federal Reserve. These designations effectively identify the firms whose failure regulators would consider catastrophic to the U.S. economy—that is, the firms considered too big to fail.

Aside from the authority to make these special designations, the FSOC can ultimately require new regulations for any financial company for virtually any stability-related reason. The FSOC framework assures that the Federal Reserve will regulate even nonbank sectors of financial markets more extensively than ever before. In general, the process of imposing these regulations in the future can evolve largely in the absence of further congressional action. The mere existence of the FSOC is wholly incompatible with the functioning of a dynamic private capital market.

The operations of Fannie Mae and Freddie Mac were a key cause of the financial crisis, and are the poster children for the too-big-to-fail doctrine.

**Dodd–Frank's Orderly Liquidation Authority Provides New Federal Backstop.** One of Dodd–Frank's most troubling aspects is the creation of seizure authority—politely called "orderly liquidation authority"—for certain firms that regulators perceive to be failing. While orderly liquidation sounds pleasant, Title II of Dodd–Frank achieves it by allowing federal regulators to seize troubled financial firms—with minimal judicial review—and close down their affairs. Title II also authorizes the Federal Deposit Insurance Corporation (FDIC) to hold taxpayers responsible for the most worthless assets on a company's books. The time-tested bankruptcy system, with its legal protections and judicial supervision, is a far better system.

Dodd–Frank's proponents argue that Title II will prevent taxpayers from being forced to bail out shareholders and creditors of failing institutions. In practice, though, there is little hope that Title II will end bailouts. In an orderly liquidation under Title II, the FDIC acts as the receiver of the firm's parent holding company and, as such, transfers the parent's assets, derivatives, and short-term obligations to a newly created "bridge" company. The bridge company, which is exempt from paying all federal, state, and local taxes, recapitalizes the subsidiaries as the FDIC deems necessary.

Theoretically, these actions *could* be supported through private borrowing, but a firm can be forced into a Title II proceeding only after the FDIC and the Fed certify that there are no private-sector options for saving the company from default. Dodd–Frank supporters also point out that the bridge company can be supported by the "Orderly Liquidation Fund,"

thus avoiding taxpayer support. This fund, however, is analogous to the FDIC deposit insurance fund in that it contains the proceeds of *obligations* issued by the FDIC and purchased by the Treasury Department. In other words, taxpayers are ultimately responsible for the fund.

The mere existence of the Financial Stability Oversight Council is wholly incompatible with the functioning of a dynamic private capital market.

Another main problem with the orderly liquidation process is that it is specifically designed to allow the firm's operating subsidiaries to continue functioning. As a result, the managers of the subsidiaries—as well as the firm's creditors—all know they have a federal backstop for their activities. This backstop prevents the market from disciplining private actors and effectively ensures that there will be even more risky lending.

## What Congress Should Do

The notion that there has been any sort of substantive deregulation of financial markets in the past century is completely wrong. If anything, the constant expansion of the massive federal regulatory framework *contributed* to the crisis. It follows that most of the so-called solutions offered since then—virtually all of which involved increasing regulations—will fail to make the financial markets any safer. In order to reduce the risk of future bailouts and financial crises, Congress should:

- **Repeal Dodd–Frank.** The 2010 Dodd–Frank Act's answer to the financial crisis was to institute more federal regulation and oversight, despite the fact that this approach has repeatedly failed in the past. Worse, many of the act's components did virtually nothing to address the root causes of the financial crisis and simply expanded the federal safety net for financial firms. This approach has only further socialized the cost of financial risk-taking and, therefore, has increased the likelihood of future financial crises and bailouts.

- **Amend bankruptcy laws to establish an orderly resolution process for large institutions.** There is clearly a need to fix this process and, short of repealing Dodd–Frank, the preferred solution, eliminating Title II of the law would be a good start. Amending the bankruptcy laws so that a credible resolution process exists for large financial firms is a key component to ending the too-big-to-fail problem.

- **End the Fed's broken lender-of-last-resort function.** Congress should prohibit the Fed from making emergency loans under Section 13(3) of the Federal Reserve Act and via the discount window. There is, in fact, no clear economic rationale for the Fed to provide direct loans to private firms. Given the development and current sophistication of financial markets, there is even less reason to allow the central bank to serve as an LLR now than there was in 1913. Congress should help to minimize the chances of future too-big-to-fail-style bailouts by revoking the Federal Reserve's emergency lending authority and closing the discount window.

- **Permanently shut down Fannie and Freddie.** Government-sponsored corporations Fannie Mae and Freddie Mac should be eliminated altogether and the housing market made more stable by relying on private financial firms that are not backstopped by taxpayers.

- **Eliminate the Financial Stability Oversight Council.** In the near term, Congress should fix the most glaring weaknesses in the process that the FSOC uses to designate firms for heightened supervision under the Fed. In particular, Congress should force the FSOC to be more transparent and should lift Dodd–Frank's restrictions on legal challenges to the FSOC's designations. However, Congress should be careful that these types of improvements do not lead to the impression that Dodd–Frank should not be repealed or that the FSOC should survive. The mere existence of the FSOC is wholly incompatible with the functioning of a dynamic private capital market. Short of a full repeal of Dodd–Frank, the preferred solution, Congress should eliminate the FSOC. Any other FSOC reforms should be viewed as temporary fixes.

## Conclusion

Congress can still act to ensure that history does not repeat itself. Conservatives can and should ensure that taxpayers will never again bail out large institutions. Large financial institutions that fail should be allowed to wind down through an orderly bankruptcy process. Government-sponsored corporations Fannie Mae and Freddie Mac should be eliminated altogether and the housing market made more stable by relying on private financial firms that are not backstopped by taxpayers. Lastly, Congress should undertake a major reform of the Federal Reserve, an institution that bears little resemblance to the central bank that was created in 1913.

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