The Ruling Class

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The Dodd-Frank law misses the primary causes of the financial crisis.

The landmark Dodd-Frank Act transformed the U.S. banking industry into a public utility, increasingly dominated by financial Gargantuas presumed too big to fail. The act and the presumption make the next financial crisis more likely, and that puts a damper on economic growth.

The prevailing false narrative for the financial crisis painted banks, greed on Wall Street, and insufficient regulation as the causes, and wrote Dodd-Frank as the solution. Never mind that Wall Street greed was as old as Wall Street; that onerous regulation increased before the crisis, with the Privacy Act, Patriot Act, and Sarbanes-Oxley; and that hedge funds weathered the storm best despite their relatively light regulation.

The financial-services industry allocates the economy's lifeblood—capital—and provides payments. In the new era of crony capitalism, the assets remain in private hands, but the supervisors and allocators of capital are Washington mandarins.

While Dodd-Frank batters the industry with suffocating regulation, it doesn't address the principal causes of the financial crisis: the Fed's easy credit and government's politicized mortgage-credit standards.

A Blizzard of Paper

Law firm Davis Polk counted 398 new rules that regulators must promulgate under Dodd-Frank. About a third of them have resulted in final rules; another third are finished, but not yet approved; and for the final third, there is not yet a draft rule proposed.

Though many find the 2,300 pages of Dodd-Frank too much, there's more to read now. The Fed's debit-interchange-price-control-and-routing rule is

307 pages, the Consumer Financial Protection Bureau's qualified-mortgage rule is 804 pages, and its mortgage-servicing rule is 753 pages. The CFPB also can rule without writing rules. It can define any consumer financial product as abusive and move against its sponsors.

Regulators didn't anticipate the Great Depression, the savings-and-loan crisis of the 1980s, or the 2008 financial debacle. The herd of like-thinking regulators probably will miss the next crisis, or even bring it closer, just as it did the last time.

Washington's "affordable housing" goals for Fannie Mae and Freddie Mac created fierce competition throughout the banking system to find riskier borrowers to satisfy them. Consequently, by 2008 there were 28 million subprime or otherwise high-risk mortgages, three-quarters of which were held or guaranteed by Fannie, Freddie, and the Federal Housing Administration. With the CFPB joining forces with them to define qualified mortgages, government remains the U.S.' chief mortgage underwriter. Political pressure to degrade credit standards, prop up housing prices, and promote home ownership will sow the seeds of another crisis.

In our brave new world, financial services are critical to prosperity. In 1870, bank assets were 20% of U.S. gross domestic product. By 2011, they had mushroomed to 117% of GDP, and assets of nonbank financial institutions were another 220% of GDP.

Quest for Value

Dodd-Frank constipates and politicizes capital allocation and financial-services innovation vital to healthy, sustainable economic growth. The creative ferment of thousands of competing financial institutions, each permitted to prosper, innovate, and fail, would more ruthlessly and effectively manage risk than the savviest regulators. Competition would continuously allocate capital away from underperforming financial institutions to those delivering greater value for consumers and businesses.

Former Sen. Chris Dodd and former Rep. Barney Frank assured the country that their law ended the policy of too-big-to-fail. Instead, under Dodd-Frank's Orwellian regime, all banks are equal, but some are more equal than others. Dodd-Frank labels 38 bank holding companies with more than $50 billion in assets as "systemically important." Management

and markets see them as government-sponsored enterprises that are too big to fail.

The Financial Stability Oversight Council can designate nonbanks as systemically important also, and it can make financial institutions that provide clearing, settlement, or payment activities eligible for Fed bailouts. This makes state support of the largest U.S. financial institutions very clear, if not explicit. The FSOC has designated eight clearinghouses as systemically important, each with access to Fed credit. Since regulators are hard-wired to extend their turf, it's a safe bet that the council will tag large insurance carriers, hedge funds, mutual funds, and finance companies as systemically important.

Meanwhile, the banks that are too big to fail are getting bigger. From 1995 to 2009, assets of the six largest banks increased from 18% of GDP to 68%. During the financial crisis, the top 10 banks increased their share of industry assets from 68% to 77%. At regulators' urging, Bank of America scooped up Countrywide and Merrill Lynch, Chase acquired Bear Stearns and Washington Mutual, and Wells Fargo absorbed Wachovia. None of the acquiring banks are better off for the experience, but consolidation means that regulators can direct a handful of Goliaths, instead of thousands of vigorously competing smaller institutions.

Middle Ground

Nobody suggests that government isn't needed. But Washington should play the role of night watchman and lender of last resort to otherwise sound financial institutions strapped for liquidity because of a panic. It should not be the central planner of banking.

With Democrats controlling the White House and Senate, the chances of repealing Dodd-Frank are bleak. Ending the implicit policy of too-big-to-fail may be possible, if lawmakers of both parties can recognize advantages.

Many Democrats are hostile to big financial institutions and don't want to give them bailouts. Most Republicans don't want Washington picking winners and losers, and also oppose bailouts. With bipartisan leadership, a coalition could be forged to drive a stake through the heart of too-big-to-fail.

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