U.S. Dodd-Frank overhaul plan seen increasing risk in financial system – NYU report

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While U.S. Congressional efforts to curb some burdens of Dodd-Frank are welcome, several aspects of the House Republican “CHOICE Act” puts the financial system at greater risk in the event of a future crisis, says a new publication by New York University’s Stern School of Business.

The book, a compilation of research by several of the school’s leading academics, argues that a major benefit of Dodd-Frank’s sweeping reforms was to put the U.S. financial system on a stronger footing than those in other regions.

"The evidence clearly points not only to much lower systemic risk in the U.S. financial system today relative to the crisis, but also relative to other regions in the world, especially the large countries (and their financial systems) in Europe and Asia," the study, published this week, said.

However, while the post-crisis reforms may have made the U.S. system safer, the authors argue Dodd-Frank did not go far enough in addressing a "full-blown onset of systemic risk, suggesting the need to rethink the legislation."

When placed against this objective, the Financial CHOICE Act, a bill sponsored by House Republican Jeb Hensarling, chair of the Financial Services Committee, would make the U.S. system even less safe, the study found.

"In the end, one has to evaluate the CHOICE Act by asking whether the future of the financial system would be safe and more stable under it or with Dodd-Frank—even in its current form," said professor Kermit Schoenholtz, one of the editors. "We think the CHOICE Act would increase the riskiness of our financial system."

The Financial CHOICE Act is seen by many as the starting point for an overhaul of Dodd-Frank. The bill includes a much higher leverage ratio for banks in return for relief from various requirements under Dodd-Frank such as annual stress tests administered by the Federal Reserve. "Systemically important financial institutions" (SIFIs) would be exempt from such requirements if they met the higher capital hurdles.

"The only true systemic risk assessment tool included in Dodd-Frank is the annual stress test that is applied to SIFIs," the study said. "Since stress tests can reveal what happens to the system when all large banks and other SIFIs are simultaneously under duress, reducing their frequency would make the financial system substantially less safe. Eliminating them could be catastrophic."

The authors also argue that large banks should have credible resolution plans in place in the event of failure, whether under Dodd-Frank's orderly liquidation authority, or the proposed bankruptcy rules by the CHOICE Act.

Repeal of Volcker rule makes sense

Meanwhile, the researchers sided with the CHOICE Act’s plan to repeal the Volcker rule, which bans banks from engaging in proprietary trading, and supported more rigorous cost-benefit analysis of future rules by regulators.

"We share the view that systemic risk reduction resulting from the Volcker Rule does not warrant the costs that it imposes," the authors wrote.

"We argue that a more effective cost benefit approach would be a targeted one that requires such analyses only in specific areas that are most likely to be amenable," they added. "The goal should be to promote a culture of analysis within the agencies rather than to throw sand in the gears of the regulatory system."

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