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The Dodd-Frank Act's Effects on Financial Services Competition

Mr. Chairman, Ranking Member Watt, and members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I was the President and CEO of the Federal Home Loan Bank of Chicago for 13 years, where the customers were about 800 member financial institutions, most of them community banks. In all I spent 35 years working in financial services, and have extensively studied and written on the problems of financial cycles.

After every over-optimistic credit expansion comes the ensuing bust. After every bust, come legislation and expanded regulation to try to prevent the next crisis from happening—but it always happens anyway. For example, after the financial crises of the 1980s, we had the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the FDIC Improvement Act of 1991, and the very ironically named Federal Housing Enterprises Financial Safety and Soundness Act of 1992. It was predicted at the time that this would ensure we would "never again" have a financial crisis—a poor prediction, needless to say, including the fact that Fannie Mae and Freddie Mac proved to be the opposite of safe and sound.

After the corporate accounting scandals of 2001-2002, we had the Sarbanes-Oxley Act, which attempted, among other things, to ensure business risks were controlled by expanded rules and procedures. They obviously were not.

After the great housing bubble and the collapse of 2007-2009, we got the Dodd-Frank Act. It is my view that the greatly increased bureaucracy and regulation mandated by this act will not prevent another crisis—to know whether this is correct we have to await the unknowable future. However, it is certain and universally agreed that Dodd-Frank has and will continue to significantly expand the regulatory burden on financial businesses, including community banks. The disagreement is about whether this expanded burden is worth it or not. About this there are of course conflicting views—my view is that it is not, especially considering the negative effects on overall competition in financial services.

I believe the central question posed by this hearing is excellent--indeed we should be required to ask and answer about every regulation: what are its effects on competition?

Regulatory Burden Falls Disproportionately on Smaller Competitors

As a general principle, if complex, expensive regulatory requirements are placed on all competitors, the burden will be disproportionately heavier for small competitors and large firms will be relatively advantaged. Large firms already have internal bureaucracies accustomed to complicated paperwork, reporting and regulatory relationships, the costs of which they spread over large business volumes. These economies of scale are not available to small competitors.

Congress recognized this general problem in Dodd-Frank itself, when it reduced the burden on small public companies of the notorious bureaucracy of Sarbanes-Oxley's Section 404.

As Tom Hoenig (then President of the Federal Reserve Bank of Kansas City and now a Director of the FDIC) said, "Dodd-Frank has raised the cost of financial transactions in America and that encourages consolidation because it's the only way you can spread the costs over larger assets."

The CEO of M&T Bank, a well-managed regional bank, said last year that the paperwork of Dodd-Frank had so far required 18 full-time employees—that is before implementation of many other regulations now in some stage of development, including whatever the Consumer Financial Protection Bureau mandates, and before the arrival of the complicated new risk-based capital requirements. Compare this to the total staff of the median bank: 37 employees.

The complex new risk-based capital requirements, which are being applied to all banks, large and small, are an interesting case of the problem. Banking consultant Bert Ely concluded that "the highly granular features of many specific provisions in the regulatory capital proposal will mandate a substantial increase in the number of both financial and non-financial data items banks will have to collect on individual assets in order to generate the numbers. Data of the type now generally found in a bank's accounting records will not be sufficient. Inadvertent compliance errors, when calculating capital ratios, will increase." Ely speculates that these costs "could drive [smaller] banks to exit lines of business."

It is not unreasonable to think that Dodd-Frank's effects will impede the ability of small banks to raise capital. "Investors are concerned with a smaller bank's ability to respond to regulatory obligations," wrote the Conference of State Bank Examiners. "As investors vote with their money on the regulatory burden issue, policymakers should take notice that this is a very real issue with a potentially adverse economic impact."

Fletcher School Professor Amar Bhide has published an intriguing discussion of financial reform entitled *A Call for Judgment*. He points out the economic potency of competitive economies in which decentralization gives "many individuals the autonomy to make subjective judgments," and in which they must live with the results of their judgments. "Specifically," he writes, "I propose we reinstate old-fashioned banking, where bankers know their borrowers" and have "case by case local knowledge."

Thus they confront "the unquantifiable uncertainty that is an important feature even of seemingly routine lending decisions."

Obviously, he is describing the competitive advantage of well-run community banks and recommending a system of decentralized credit decision-making and credit risk bearing. Top-down regulatory formulas, for example in mortgage lending, reduce this advantage, while complex, expensive regulations create relative advantages for large institutions.

The Effects of Dodd-Frank on Mortgage Finance

Regulation itself is one of the most important procyclical factors in credit markets—a problem well known to theoreticians of financial regulation. This is especially true in the down cycle, where we still are in housing finance, as the regulatory efflorescence mandated by Dodd-Frank continues. Reflecting each bust, including the most recent one, regulators, afraid of being criticized, seeing the depletion or disappearance of their deposit insurance fund, and reacting to the past mistakes now so apparent in hindsight, clamp down forcefully on banks, including refusing to charter new entrants which would bring unburdened new capital to the sector. This contracts credit further than the crisis already has, as we have once again experienced, this time in the residential mortgage market.

Community banks can be very successful managers of residential mortgage credit to their own customers in their own towns. A healthy, competitive residential mortgage sector, in my opinion, should feature mortgage credit risk widely dispersed among knowledgeable local lenders of the kind Bhide pictures, who also have the ability to share credits among themselves.

What did the American GSE-centric mortgage system create instead? A dupoly system of Fannie and Freddie, with mortgage credit risk concentrated on the banks of the Potomac, a system once claimed in Congressional testimony and elsewhere to be "the envy of the world." The result was that Fannie and Freddie lost every penny of all the profits they had made in the 35 years from 1971 to 2006, plus another $150 billion. They have been transformed in substance from insolvent GSEs to government housing banks, but they are still there and more dominant than before in mortgage finance.

One of the most important competitive effects of Dodd-Frank results from a lack of action: its well-known failure to address the concentrated, duopoly system of Fannie and Freddie in any way. Thus concentration in the mortgage business and mortgage credit risk bearing continues and grows. Indeed, some people are now calling for Fannie and Freddie to be combined into a single mortgage securitizer—to turn their conforming mortgage duopoly into a monopoly. I do not favor this proposal.

In the mean time, all actors in the residential mortgage market, including the community banks, are involved in the continuing complex development of two mortgage regulations in particular, arising from the requirement of Dodd-Frank: the "QM" (Qualified Mortgage) and "QRM" (Qualified Residential Mortgage) rules. By establishing top-down formulas and escalating the legal risks to the lender of making mortgage loans, these regulations will certainly increase the burdens and reduce the role of local judgment in the mortgage business.

The QRM rule will determine whether mortgage competitors are required to retain credit risk in mortgages sold into securitizations—the "skin in the game" idea (the regulations will exempt loans sold to Fannie and Freddie—another boost to concentrating mortgage risk in them). I think having mortgage lenders retain credit risk in the loans they make, when they are paid for so being in the mortgage credit business, is an excellent idea—as long as the risk retention is a voluntary, market transaction. In fact, for a community bank, bearing credit risk in your own loans to your own customers, even if they are being funded by the securitization market, is a logical business. It is the basis of the Mortgage Partnership Finance program which we invented 15 years ago, when I was at the Chicago Federal Home Loan Bank—a program which has had very good credit performance from 1997 to now, and which definitely helps community banks compete in the mortgage business.

The Dodd-Frank idea is not a voluntary market arrangement, but a mandatory and formulaic requirement. The better approach would be to facilitate and encourage mortgage credit risk retention by lenders, but not mandate it.

What's the Difference Between a SIFI and a GSE?

A notable and much-debated provision of Dodd-Frank is the designation of very large financial firms as "SIFIs"—Systemically Important Financial Institutions. What will the competitive effects of this be?

SIFIs will be subject to special regulatory requirements and oversight—a burden. But on the other hand, this will cause them to be perceived as safer. Moreover, they will most probably benefit from being designated as of special interest and significance to the whole financial system and to the government. Having devoted so much special attention to making them safe, the failure of a SIFI would be the obvious failure of the regulators themselves, and a crisis will induce their normal bailout strategy. So in my view, becoming designated as a SIFI effectively makes a competitor a GSE—and we know to what lengths the government will go to protect the creditors of GSEs.

The logical conclusion for a potential creditor, large depositor, or counterparty of any kind, to draw is that they will be safer with a SIFI—all political protestations to the contrary notwithstanding. Remember how various government officials tried to claim that Fannie and Freddie were not guaranteed by the government. But buyers of GSE debt and MBS did not believe such claims, and the investors were right to believe instead that they were guaranteed by the taxpayers. I believe similar beliefs will apply to SIFIs.

So what's the difference between a SIFI and a GSE? Not much.

That means, as has been pointed out by many observers (and contested by others, but incorrectly, in my view) that SIFIs will be even more advantaged in the amount and cost of funding and deposits available to them, and will be preferred counterparties for financial transactions, compared to smaller competitors. This will tend to make the financial markets more consolidated.

An interesting comparison in this contest is the much more concentrated banking system of Canada, which has received a lot of praise over the last few years. Canadian banking is entirely dominated by five big, universal, nationwide banks, all of which are certainly SIFIs. Oligopolies are arguably more stable than competitive markets. Should we trade our 7,000 banks for such an oligopolistic structure? I wouldn't.

Rating Agencies

A pro-competitive provision of Dodd-Frank, one I firmly support, was to prohibit regulatory agencies from making the use of the ratings of credit rating agencies be required by regulation. This helps break up what was previously a government-sponsored duopoly in the credit ratings sector. However, the provision went too far, and has now caused a competitive issue for smaller banks.

Community banks have an advantage in local credit judgments, but a natural disadvantage in credit analysis of nationally-traded securities, as a matter of knowledge and scale. It makes perfect sense to allow them, without requiring them, to use credit ratings for their investment and money market portfolios. The Independent Community Bankers of America have proposed allowing use of external credit ratings, and I have been told that regulators have privately expressed the desire to gain flexibility in this matter by an amendment of the Dodd-Frank Act.

The problem is that Dodd-Frank provides (in Section 939A) that regulators must "remove any reference to or requirement of reliance of credit ratings." The fix is simple: delete the phrase " reference to or." The provision would then read that regulators must "remove any requirement of reliance on credit ratings." In other words, no requirements allowed, but use could be approved in the appropriate circumstances if proposed by the bank—this would remove an unintended competitive disadvantage for smaller banks.

Promoting Entry and Competition

A British Member of Parliament and former banker has recently recommended the following principle: "Regulators must have a specific objective to reduce barriers to entry and promote competition." A good idea. Proposed regulations, including those arising from Dodd-Frank, should specifically take account of their effects on competition among their costs and benefits—just as this hearing is considering.

Thank you again for the opportunity to share these views.