



Dodd and Frank: The Dukes of Moral Hazard

According to the text of the 2010 [Dodd-Frank Wall Street Reform and Consumer Protection Act](#), the law is supposed “to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ [and] to protect the American taxpayer by ending bailouts.”



However, as is usually the case with federal laws, Dodd-Frank does precisely the opposite. “In fact,” reports the *New York Times*’ [Gretchen Morgenson](#),

Dodd-Frank actually widened the federal safety net for big institutions. Under that law, eight more giants were granted the right to tap the Federal Reserve for funding when the next crisis hits. At the same time, those eight may avoid Dodd-Frank measures that govern how we’re supposed to wind down institutions that get into trouble.

In other words, these lucky eight got the best of both worlds: access to the Fed’s money and no penalty for failure.

The eight institutions in question are clearinghouses, which Morgenson describes as “large, powerful institutions that clear or settle options, bond and derivatives trades.” Among them are the Chicago Mercantile Exchange (CME), the Intercontinental Exchange (ICE), and the Options Clearing Corporation (OCC), all of which handle billions of dollars’ worth of transactions a day. They are “lucrative businesses,” Morgenson observes. “Last year, the CME Group, the parent company of the Chicago Mercantile Exchange, generated almost \$3.3 billion in revenue. Its chief executive, Craig S. Donohue, received \$3.9 million in compensation and held an additional \$10 million worth of equity awards outstanding, according to the company’s proxy statement.”

These clearinghouses predate Dodd-Frank; the oldest, the CME, was founded in 1898. But the law has vastly expanded their involvement in the financial system and correspondingly increased taxpayers’ risk, according to [Peter Wallison](#) of the American Enterprise Institute:

The act gives a new, mandatory role to clearinghouses for derivatives and other trades. Trillions of dollars in interest rate, currency and credit default swaps — which were once cleared primarily by hundreds of banks — are now required under Dodd-Frank to be cleared through eight clearinghouses. These institutions will act, in a sense, as guarantors of the performance of the parties in hundreds of thousands of derivatives contracts. In effect, they step into the shoes of the two parties that have agreed to swap a series of payments based on changing market prices.

... In assuming this central role in the financial markets, clearinghouses will now become central to the health of the financial system. If a clearinghouse fails, the U.S. and global economy could grind to a halt as counterparties do not receive expected payments. In other words, Dodd-Frank has *added* to the list of financial institutions that are too big to fail and then created a procedure for bailing them out with taxpayer funds if they fail. [Emphasis in original.]

None of this was an accident. According to Morgenson, Sheila Bair, former head of the Federal Deposit Insurance Corporation (FDIC), wrote recently that “top officials at the Treasury and the Fed, over the



Written by [Michael Tennant](#) on November 8, 2012

objections of the F.D.I.C., pushed to gain access for the clearinghouses to Fed lending.”

The clearinghouses “were drooling at the prospect of having access to loans from the Fed,” she wrote. “I thought it was a terrible precedent and still do. It was the first time in the history of the Fed that any entity besides an insured bank could borrow from the discount window.”

Thus, despite the claims of the Obama administration and its congressional allies that they were trying to eliminate “too big to fail” institutions, behind the scenes they actually sought to expand the number and reach of such institutions. Writes Wallison:

That’s why the administration and the Democrats in Congress provided authority for the Financial Stability Oversight Council (FSOC) — an über-regulator consisting of all the federal financial supervisors and chaired by the treasury secretary — to designate these clearinghouses as systemically important institutions, allowing them to have access to Federal Reserve funding if they ever got into financial trouble. The FSOC obliged, making the designation in July to little public notice. In other words, eight clearinghouses are now anointed as Financial Market Utilities and made eligible for a bailout from the Fed just like Bear Stearns and AIG.

In addition, notes Morgenson, “the CME Group has argued that it should be exempt from the orderly liquidation authority set up under Dodd-Frank” — the one that “is supposed to end the problem of institutions that are too big to be allowed to fail and also to hold their managers accountable.” The FDIC has not officially confirmed that this is the case, but this view “seems to be gaining traction among other regulators,” she reports. “So these large and systemically important financial utilities that together trade and clear trillions of dollars in transactions appear to have won the daily double — access to federal money, without the accountability.”

This is why Wallison argues that Dodd-Frank “makes the failure of a clearinghouse — and its use of taxpayer funds — more likely.” Clearinghouses now face no penalty for failure and will therefore be encouraged to take imprudent risks, which can only result in more failures and consequent bailouts.

Moreover, Wallison points out, while the law supposedly prohibits the Fed from bailing out individual financial firms, it “permits the FSOC to designate *any* financial institution that is engaged in clearing, settlement or payments activities — that is, almost every bank of any size — as eligible for a Federal Reserve bailout if its financial condition might prevent it from performing these functions. So with one hand the act took away bailout authority, but quietly, elsewhere in the act, this authority was fully restored.” [Emphasis in original.]

In short, like practically everything else that comes out of Washington, Dodd-Frank was a lie. In keeping with Ron Paul’s dictum that a law will do exactly the opposite of that which its name implies, the act neither reforms Wall Street nor protects consumers. Instead, it entrenches and encourages existing bad practices, thereby establishing the conditions for more and larger bailouts in the future.

Christopher Dodd retired in 2011, and Barney Frank is set to follow his lead in January. Unfortunately, the law with their names on it — and all the [moral hazard](#) it entails — will remain with us long after they have gone.



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