

Will the review of the Dodd-Frank Act start a regulatory competition with the EU?

blogs.lse.ac.uk/businessreview/2017/03/29/will-the-review-of-the-dodd-frank-act-start-a-regulatory-competition-with-the-eu/

3/29/2017



The US-President has signed an executive order which directs the US Treasury department to revise financial regulation, especially the Dodd-Frank Act. But starting a regulatory competition with the EU will endanger global financial stability.

The Dodd-Frank Wall Street Reform and Consumer Protection Act was initiated under the Obama administration as a response to the Global Financial Crisis. President [Trump argues](#) now that financial regulation is dragging economic growth by restricting banks' ability to lend to businesses and households.

But this argument is misleading. One has to keep in mind that it is in the EU where the debt finance of businesses consists of 80 per cent of bank loans and 20 per cent of bonds, while in the US it's the opposite: 20 per cent of bank loans and 80 per cent of bonds. In contrast to bank loans, corporate bonds can be purchased by other capital market investors, e.g. by insurance firms, pension funds, investment funds or trusts, which are not regulated as banks.

While both the US and the EU toughened bank regulation, funding shortages were significantly higher in the EU compared to the US. The larger funding shortages were to a certain degree based on the different crisis responses in both jurisdictions. While the US banks were obliged to increase their capital ratios, i.e. capital in relation to risk-weighted assets, recapitalisation was mandatory in most European countries. As a result, it was the European banks whose main channel to increase capital ratios was reducing risk-weighted assets, i.e. cutting lending to businesses and households.

Although the argument for reforming Dodd-Frank is not convincing, revising financial regulation is not per se bad – some regulations became too restrictive, while others lack consistency – that is why the regulatory framework has to evolve in time. Revising financial regulation after seven years – Dodd-Frank passed in 2010 – is not atypical. The EU conducted two public consultations during the last two years: one on bank capital regulation and one on the

establishment of a Capital Markets Union. And similar to the US, the EU was concerned over funding shortages. But the problem is that differences in financial regulation between the EU and the US will cause regulation at the global level to become inconsistent. This is what the G20 wanted to prevent when they formulated common objectives for global financial regulation.

The big question is whether the US intends to deviate from the common objectives now. The [President's executive order](#) defines core principles for the regulation of the US financial system and the Secretary of the Treasury should report to what extent existing regulations promote or hinder the core principles. While it is hard to predict the exact recommendations, it can be discussed to what extent inconsistencies at the level of global financial regulation can be expected.

The first principle addresses consumer protection, which was strengthened after the global financial crisis, e.g. through the establishment of the Consumer Financial Protection Bureau, to guard against abusive or misleading retail financial products. Weakening consumer protection might have primarily domestic consequences. But it should not be neglected that the root cause of the crisis was a domestic real estate bubble based on loose lending standards.

The second principle is in line with the international consensus of preventing bailouts to failing banks. But this principle does not rule out that the rules designed to achieve a better resolvability for large banks will not be lightened. And it also does not rule out the abatement of the Volcker rule, which restricts banks' proprietary trading and excessive risk-taking.

The third principle addresses systemic risks. Whether the President will regard risks as large or small depends a lot on the design of the underlying impact analysis. In principle, deregulation could mean a deviation of the US from global rules and standards on which regulators agreed in international forums like the Financial Stability Board (FSB) or the Basel Committee on Bank Supervision (BCBS).

The President's fourth principle wants the American companies to be competitive with foreign firms. This could mean that he wants to get rid of regulations which make it hard for small and mid-sized companies to get financing. But it could also mean, that he wants foreign firms' access to American banks restricted, e.g. through higher risk-weights for loans to foreign companies in bank capital regulation.

The next principle, which says that American interests in international financial regulatory negotiations and meetings should be advanced, smells a lot like protectionism. It would probably mean that the US takes a different view in international forums. If the US wants to lessen standards, barriers for cross-border capital mobility will arise. The question here is also whether the US wants to protect domestic firms from foreign investors.

This point is strengthened with last principle of restoring public accountability within Federal financial regulatory agencies. It can be interpreted as limiting the Federal Reserve Bank's role. Since Fed-chair Janet Yellen has the responsibility for monetary policy as well as for financial supervision and since her appointment has to be renewed next year, there might be a chance for Trump to replace her with someone who shares more his views on financial regulation.

The problem for the EU with revising Dodd-Frank, which likely coincides with the exit of the United Kingdom from the EU, will be that the two countries with the most important global financial centres, New York and London, could start a regulatory competition with the EU in order to attract businesses for their financial centres. The EU could then be tempted to lessen standards, too. Such a race to the bottom in financial regulation will weaken the global financial system and make financial crises more likely.

The EU's response should not be to lessen its standards, but to promote the specialization of its own financial centres in continental Europe, especially in its competencies in financial technology.



Notes:

- This blog post is based on [Is the US starting a regulatory competition with the EU?](#), Cologne Institute for Economic Research, IW Kurzbericht No. 21-2017.
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