THIRD WAY TAKE *Published April 25, 2017 • 5 minute read*

The CHOICE Act Doesn't Prevent Bank Bailouts. Dodd-Frank Does.

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No one wants a bank bailout to happen ever again. But President Trump and Republicans in Congress want to rip up the single most important piece of legislation that helps prevent taxpayer-funded bailouts, Dodd-Frank. And they would replace it with a far weaker bill, the Financial CHOICE Act, that unravels all of the progress we've made to reform Wall Street.

To end bailouts for good, three things need to happen: 1) banks must be stronger financially, 2) regulators must be able to test banks' crisis preparedness on a regular basis, and 3) the legal system must have a way to handle banks whose failure could cause a bigger catastrophe. Dodd-Frank achieves each of these goals through increased equity, improved liquidity, annual stress tests, and Orderly Liquidation Authority. The CHOICE Act would make a huge mistake taking away these tools when the evidence is clear that they work.

Increased equity

Many Americans have a rainy-day fund set aside in case they face a financial setback. A bank's rainy-day fund is

represented by equity—the part of a bank that the shareholders own. Equity acts like a cushion if something happens that causes the value of a bank's assets to drop, and that cushion helps to prevent the bank from defaulting on its liabilities. That's really important, because the vast majority of a bank's liabilities are customer deposits.

There are two ways to determine how much equity a bank needs to cover a potential shortfall. One way is the "simple" leverage ratio, which is just the total value of equity divided by the total value of assets. But the value of some assets, like loans and securities, can be more volatile than the value of assets like cash. The second method—the risk-based capital ratio—makes banks weigh the value of their assets according to different risk categories. Dodd-Frank makes banks do both methods, but with more emphasis on the risk-based version.

Now, U.S. banks have 41% more risk-based capital than they did at the end of 2009. [1] That's major progress, because increasing risk-based capital reduces 1) the chances of a financial crisis, 2) the amount of potential losses in a crisis, and 3) the likelihood of a bailout.

Improved liquidity

What if something happens and you need all of the money in your savings account now? The truth is, your bank does not actually have all of your savings in cash on the premises. Most of it has been lent out to customers for mortgages, car loans, and business loans. Much of the rest of it is held in securities like bonds. The less an asset resembles cash, the more it is considered "illiquid."

Of course, if you only need to withdraw a few hundred bucks, the bank's got you covered. But if everyone showed up at the bank demanding their cash, then there would be a big problem. That's known as a bank run. Today, bank runs look less like a line of customers around the block and more like a bunch of corporate types calling their brokers over millions of dollars tied up in illiquid assets.

To make sure systemically important banks have sufficient liquidity, Dodd-Frank requires them to maintain a certain level of cash and cash-like assets based on the average daily "outflow" of withdrawals. This is called the Liquidity Coverage Ratio.

Improving bank liquidity, like increasing bank equity, does come with tradeoffs. Banks have to scale back lending to a certain degree in order to meet these requirements. But the benefit is that the economy is stronger. The longer that the financial sector can go without a bank run or a liquidity crisis, the more the economy can grow. ***We estimate that the combined benefit of risk-weighted capital and the Liquidity Coverage Ratio increases GDP by $351 billion over 10 years.***

Stress tests

Although we can't predict exactly what a future crisis might look like, we can try to mitigate the potential losses. Stress tests ensure that banks are strong enough to stay standing during a simulated crisis. Banks with at least $10 billion in assets must perform an annual internal test; that's about 100 of the more than 6,000 institutions in the U.S. banking system. Systemically important banks have to do two internal tests and two tests run by the Fed every year.

Naturally, the more that banks practice these fire drills, the better they have become. ***In 2014, five large banks failed. But in the most recent round, only one did.*** By performing these exercises, banks can develop plans for what they would do to avoid a bailout in a future crisis.

Some have criticized the way the Fed handles stress tests, claiming that there is too much secrecy involved. Indeed, the Fed has agreed to pursue some transparency reforms proposed by the GAO. But the element of surprise is still important because it prevents banks from gaming the system in order to pass.

Orderly Liquidation Authority

Dodd-Frank is an anti-bailout law—and to make sure that a bailout won't happen again, there's Title II. Orderly Liquidation Authority (OLA) is a back-up in case there are spillover risks that regular bankruptcy cannot contain. Most importantly, OLA ensures that the losses of a failing financial institution are borne by the private sector, so that taxpayers are never on the hook. OLA is in danger because Dodd-Frank's opponents see it as an opportunity to raise money for tax reform. Taking away OLA funding, as Republicans want to do, would buy the U.S. another recession.

Preventing future bailouts requires all of these parts of Dodd-Frank. Capital and liquidity requirements make banks stronger; stress tests make sure banks can weather a crisis; and OLA contains the potential damage of a bank in distress. Together, these reforms protect Main Street and promote economic growth far more effectively than the repeal agenda in the CHOICE Act.

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1. United States, Federal Deposit Insurance Corporation, "Balance Sheet," QBP Time Series Spreadsheets, Quarterly Banking Profile, December 31, 2016. Accessed March 24, 2017. Available at: https://www.fdic.gov/bank/analytical/qbp/.