Example 12.6
The Wall Street Reform and Consumer Protection Act (The Dodd-Frank Act)

The American public expected the Obama administration and the Democratically controlled Congress to respond to the financial crisis of 2008 with legislation designed to prevent future financial crises, and respond they most surely did. On July 21, 2010, President Obama signed into law the Wall Street Reform and Consumer Protection Act, commonly referred to as the Dodd-Frank Act after its sponsors, Senator Christopher Dodd and Congressman Barney Frank. The Act is truly breathtaking in its scope. 2,319 pages long, it attempts to remedy virtually all the difficulties that were perceived to either cause or contribute to the 2008 financial crisis, essentially by regulating them away.

The Act calls for a massive increase in federal regulation of the U.S. financial sector. It establishes twelve entirely new regulatory agencies that, along with the existing regulatory agencies, are charged with drafting and enforcing literally hundreds of new rules and regulations affecting all segments of the financial industry. The movement to deregulate the U.S. economy that began in President Carter's administration and had continued ever since has taken an abrupt turnaround.

Among the more important goals of the Act are to: ensure that people who take out mortgages to buy houses can reasonably be expected to pay them off; increase the transparency of mortgage backed securities, credit default swaps, and other synthetic derivative assets; continually assess the systemic risk to the overall stability of the financial system; prevent financial firms from becoming too big to fail; establish an orderly way of letting insolvent financial firms die without burdening taxpayers; limit the ability of banks to engage in trading with their own funds and to become involved with hedge funds and private equity firms; ensure that credit rating firms give sound, independently determined ratings of various financial assets; and restrict the Federal Reserve System's ability to make loans to financial firms.

It is impossible in a short example to give anything but a very brief account of how the Dodd-Frank Act attempts to achieve each of these goals.[1]

AFFORDABLE MORTGAGES

The Act creates a new Consumer Financial Protection Bureau (CFPB), housed within and financed by the Fed, and headed by a person appointed by the president. The CFPB has broad authority to write and enforce rules providing protection for consumers for any and all services offered by financial firms. Regarding mortgages, it can prevent lenders from inserting hidden fees, ballooning interest payments, and huge prepayment penalties that locked many borrowers into mortgages they could not afford. It can also examine and enforce all regulations that apply to any firm offering mortgage services. Among these regulations that it will enforce is a separate provision of the Act that requires all firms that issue mortgages to establish that the borrower can reasonably be expected to repay the loan. Firms that fail to do this are subject to stiff penalties.

ASSESSMENT OF SYSTEMIC RISK

A centerpiece of the Act is the creation of a new Financial Stability Oversight Council (FSOC), charged with assessing whether individual financial firms are becoming a threat to the stability of the financial system. It is chaired by the Secretary of the Treasury, and consists of a representative from the Federal Reserve Board, the new CFPB described above, eight of the existing regulatory agencies (including the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), and the Commodities Futures Trading Commission (CFTC), each of which has important responsibilities under the Act, described below), an independent member with expertise in insurance, and five nonvoting members. The FSOC has extremely broad regulatory authority and plays a central role in helping to achieve many of the goals of the Act, some of which are described below. To give one example here, the Fed regulates banks, but not other financial firms. If, however, a nonbank financial firm is perceived to be a risk to the financial system, then the FSOC, with a vote of two-thirds of its members including the Treasury Secretary, can place the firm under the regulatory authority of the Fed. The FSOC also has broad powers to collect and publish data and information from all financial firms that it deems necessary to assess the systemic risk to the financial system.

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[1] For a more complete overview of the Act, see "Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act," available at www.banking.senate.gov. This document is the source of the provisions presented in this example.

In addition to the FSOC, the Act creates a new Office of Financial Research within the Treasury Department to help with the assessment of systemic risk. The new Office is to be staffed in part by academic and industry experts in financial analysis.

TRANSPARENCY OF DERIVATIVES AND OTHER EXOTIC FINANCIAL SERVICES

The Act goes to great lengths to increase the transparency of synthetic derivative assets such as mortgage-backed securities and credit default swaps so that their true market values are easier to determine. A primary reason for the credit freeze in September 2008 was that no one wanted to lend to firms holding these assets because they had no idea what the value of these assets were and therefore whether the firms were solvent and could pay back their loans. The Act also attempts to increase transparency in the so-called shadow economy of hedge funds and private equity firms. Here are some of the more important stipulations of the Act dedicated to these ends:

- All derivative assets that can be cleared must be traded in open exchanges through clearing houses. A clearing house consists of a group of firms trading in a particular asset in which the trades are overseen and settled by the clearing house. The clearing house makes sure that the members have sufficient collateral to back the securities traded should they fail and relies on settlement banks to provide funds to clear trades daily. If a member becomes stressed because the value of its assets decline, the clearing house can provide temporary financial aid to the member from a fund supported by contributions from all the members. The Act also allows the Fed, for the first time, to provide funds to clearing houses to facilitate trades if necessary, and in extreme conditions even provide temporary loans to clearing houses that are themselves threatened with insolvency.
- The FSOC is to collect data from the clearing houses and swap repositories and periodically publish the information collected as part of its assessment of the systemic risk to financial stability.
- All dealers and swap participants, whether operating through clearing houses or not, must demonstrate that they have adequate resources to back the trades that they make.
- The SEC and the CFTC can regulate all over–the-counter derivatives to ensure that they are being traded responsibly and not exposing the financial system to excessive risk.
- Hedge funds and private equity advisors with assets over $100 million must register with the SEC and provide the SEC with sufficient information to determine how risky their investment strategies are.

- Firms that issue mortgage backed securities must retain at least a 5% ownership position in them so that they suffer losses if the securities should decrease in value.

TOO BIG TO FAIL

One of the main responsibilities of the FSOC and the Fed is to guard against firms becoming too big to fail, in the sense that taxpayers would have to bail them out if they did fail. The administration and Congress wanted, perhaps more than anything else, to avoid a future enactment of a TARP to rescue the financial system. To this end, the FSOC can make recommendations to the Fed to increase the requirements for capital, liquidity, equity-to-debt leverage ratios, and other risk management safeguards for any firm under the Fed's authority that is becoming bigger and more complex, especially if it is posing an increasing risk to the overall financial system. In addition, the FSOC, by a two-thirds vote including that of the Treasury Secretary, can permit the Fed to force a large firm under the Fed's regulatory authority to divest itself of some of its assets, if the Fed believes that divestiture is necessary to avoid undue risk to the financial system.

PHASING OUT INSOLVENT FIRMS

The ACT has two main provisions to promote an orderly demise of failed financial firms, assuming that it succeeds in preventing any firm from becoming too big to fail. First, all financial firms must submit a plan for their own funeral, so to speak, by indicating what steps they would take should they become insolvent and fail. Then, the ACT gives the FDIC so-called resolution authority to liquidate insolvent firms in a manner such that the firm's stockholders and creditors assume all the losses. The FDIC can borrow the money necessary to undertake the liquidation, but it then has first call on the sale of the assets of the firm to pay back its loan. If the asset values are insufficient, it can draw from a resolution fund financed by annual assessments on the largest financial firms. Taxpayers must never be asked to support the liquidation of failed firms. In addition, the FDIC has the power to replace the top management of any insolvent firm.

TRADING BY BANKS

The Act seeks to limit trading by banks on their own accounts, so-called proprietary trading, so that they focus more on their main purpose, which is to accept deposits and make loans to households and businesses. The same limitations also apply to nonbank financial firms that are viewed as a risk to financial stability. This provision has been dubbed the Volcker Rule, after former Fed Chairman Paul Volcker who proposed it. The Act also wants to severely restrict banks' investments in, and relationships with, hedge funds and private equity firms. The FSOC is charged with studying these issues and making recommendations to the Fed, but in no case will banks and risky nonbank financial firms be allowed to engage in proprietary trading with more than 3% of their assets.

ACHIEVE BETTER CREDIT RATINGS OF ASSETS

One of the more frustrating features of the financial crisis was that the major credit rating agencies such as Moody's, all of whom are members of the Nationally Recognized Statistical Ratings Organizations (NRSRO), issued their highest AAA ratings to mortgage based assets and other derivative securities that turned out to be far from safe investments. To prevent this from happening again, the Act establishes a new Office of Credit Ratings (OCR) within the SEC to oversee the credit rating agencies. The OCR will examine the credit rating agencies at least once a year and publish its findings. Agencies that continually issue faulty ratings can be deregistered.

RESTRICTIONS ON THE FED

The Act places a number of new restrictions on the Fed. It can no longer make loans available to individual firms as it did to AIG in 2008. Instead, any lending facility that it establishes must apply to a broad class of firms and be pre-approved by the Secretary of the Treasury. The Fed is also more limited in its ability to guarantee the debt of solvent banks. Debt guarantees can be made only if two-thirds of the Federal Reserve Board of Governors and the board members of the FDIC decide that the stability of the financial system is under threat. The Fed is prohibited from making loans to insolvent banks under any circumstances.

ASSESSING THE ACT

The brief accounts above should be sufficient to give a sense of the scope and thrust of this remarkable Act. The question remains as to whether it will work. Can it really prevent another financial crisis? The answer is far from certain, for at least two reasons.

First, the details of the Act matter and they will not be known until such new agencies as the CFPB and FSOC are up and running and all the new rules and regulations envisioned by the Act are in place. This could take a number of years and will undoubtedly be subject to considerable political and industry pressures along the way. To give two examples, the FSOC must issue its recommendations regarding the restrictions on proprietary trading by banks by the end of 2011, but the Fed has until 2023 to implement the FSOC's recommendations. Also, Republicans have been united in their desire to overturn the Act. Its fate likely depends on the outcome of the 2016 Presidential election.

Second, believing that even the massive increase in regulatory oversight required by the Act can contain systemic risk sufficiently to maintain financial stability, prevent another financial crisis, and end taxpayer bailouts may well be wishful thinking. For starters, the history of financial regulation in the United States records numerous episodes of regulatory failure. The Savings and Loans Associations were heavily regulated in the 1980s but the regulators did not prevent many of them from taking on too much risk and failing in 1989, leading to a taxpayer bailout. The story essentially repeated itself in 2007 and 2008, only on a broader scale. Banks are regulated by the Fed and the credit rating agencies supposedly conduct accurate and independent ratings of various securities, yet banks took on too many risks, some of the banks became too big to fail, and the rating agencies badly misrepresented the riskiness of many securities. It hardly inspires confidence that the voting members of the new FSOC, in many ways the lynchpin agency of the Act, come from the same regulatory bodies that either completely missed, or refused to confront, the systemic risk to the financial system that had been building up for some time prior to the crisis in September 2008.

Edward Kane, one of the nation's leading experts on financial regulation, is highly skeptical that the regulatory approach of the Act will succeed. Kane has long held that economists and legislators place far too much faith in financial regulators. In his view, financial regulators suffer from low prestige and low pay, certainly relative to employees with equal educations in the financial firms. Indeed, many federal regulators eventually hope to secure higher paying positions in the very firms they are asked to regulate. As a result they can easily fall prey to what economists call regulatory capture. They have an incentive to worry more about the interests of the firms they are regulating than the interests of the taxpayers that might have to bail out the firms should the firms fail. To make matters even worse, financial regulators are often inadequately trained, to the point that they are almost always a step behind the nimble financiers who find new ways to make exotic and risky bets that expose taxpayers to the possibility of a bailout to save the financial system. Kane speaks of financial firms successfully engaging in regulatory innovation, meaning that they inevitably find ways to circumvent whatever regulatory controls are in place. Kane believes this will always be the expected outcome unless the nation is willing to invest more heavily in its financial regulators, offering them better training, higher pay, and greater prestige. Absent that, we should expect future rounds of regulatory failure and financial crises. A potentially fatal flaw in the Act, in Kane's view, is that it does not address the incentive structure that so often leads to regulatory failure. [2]

Kane may well be too pessimistic—financial regulation on this scale has never been tried before. But the implementation of the Dowd-Frank Act over the next few years should offer a fairly good test of his concerns.

[2] Kane's discussion of the incentives financial regulators operate under, the reforms that he believes are needed to improve regulatory oversight, and other observations on weaknesses in the Act are in E. Kane, "Missing Elements in the US Financial Reform: a Kubler-Ross Interpretation of the Inadequacy of the Dodd-Frank Act," August 24, 2010. Available at SSRN: http://ssrn.com/abstract=1654051.