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Dodd-Frank Act

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BNA INSIGHTS: The Good, the Bad or the Ugly of the Dodd-Frank Act - Part I

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Should government know and consider the impact of new laws before they are enacted? The simple fact is that the benefits and costs of many new laws are not known either before or after enactment. Some of our most significant legislation in recent years has been enacted on a pass-first and evaluate-second basis. It should not be surprising when neither their direct results nor unintended consequences can be anticipated.

The Dodd-Frank Act[1] is an example of this syndrome. It was enacted in 2010 after the Great Recession with the intent of limiting future shocks to the financial system by establishing new and improved regulatory regimes. Almost six years later, with a significant majority of its hundreds of new rules in place, there is essen-

[1] Public Law 111-203; 111th Congress, H.R. 4173, July 21, 2010.

tially no comprehensive empirical analysis by the government that measures how improvements in financial safety and soundness compare to the accompanying costs of and restrictions on delivering financial services to the public.

Those who support Dodd-Frank believe it must be doing what it was supposed to, if for no other reason than it created significant new oversight mechanisms. Those who think Dodd-Frank was an ill-conceived hodgepodge of arbitrary regulatory restrictions untethered to the causes of the crisis contend that it's harming financial companies, the economy and consumers. The truth may lie somewhere in between these two positions.

The presumption that more regulation always results in safer markets and better protection for consumers is overly simplistic. As a matter of historical precedent, there is significant evidence, as explained below, that ill-conceived overregulation can have and has had disastrous financial consequences. While it's too late to argue about the passage of Dodd-Frank, and unrealistic to think that it will be repealed or substantially rolled back, the government should be compiling empirical data on post-enactment costs that can inform policy makers about how to fine-tune Dodd-Frank's continuing regulation of financial institutions and markets.

The reasons are obvious. Every regulatory action is followed by a market reaction. Markets are dynamic, and the more regulation that is put in place, the more companies adjust and adapt their goals, business plans, markets, products and rates in response. This ping-pong never stops. When government policy makers fail to appreciate that and do not measure the economic impact of new laws before or after they are enacted, a disconnect can develop between financial regulation and the functioning of markets. That disconnect reduces the precision of financial regulation to a game of chance and creates potentially harmful unintended consequences.

In his annual letter to shareholders, Robert Wilmers, chairman of M&T Bank, recently identified unintended regulatory consequences that have led to unanticipated costs and impacts harmful to consumers. Wilmers singled out the areas of the secondary mortgage markets dominated by Fannie Mae and Freddie Mac, student lending, small business administration loans and interchange fees.[2] House Financial Services Committee Chairman Jeb Hensarling (R-Texas) labeled Dodd-Frank a failure in a July 2015 *Wall Street Journal* editorial on the five-year anniversary of Dodd-Frank's passage.[3] Hensarling put his finger on what he thought was the real issue: ''It wasn't deregulation that caused the crisis, it was dumb regulation.''[4] That conclusion may not be surprising given that Congress enacted Dodd-Frank in July 2010, long before its own Financial Crisis Inquiry Commission was able to publish its findings and recommendations regarding the causes of the crisis in January 2011.[5]

The Risk of Too Much Regulation

There is no doubt that strong regulation of banks and financial activities has always been and will always be necessary to maintain economic safety and soundness. But U.S. financial history demonstrates that too much or misdirected regulation can also disrupt market forces and, over the long term, create financial disasters and economic dislocations. Experts argue that deficient regulations can have a ''multiplier effect on the regulated sector and are thus a potential source of systemic risk.''[6]

> Financial services regulations aim to overcome or to mitigate market imperfections. However, regulatory actions sometimes cause their own distortions of market structures and market behavior that could even aggravate existing market deficiencies. Well-intentioned regulations could be counterproductive and undermine the very objective they were supposed to attain. Measuring the cost of macroeconomic distortions is difficult (at least in monetary terms). The essential issue is for policy makers to be conscious of the macroeconomic effects that regulatory action could have.[7]

The 1988-94 savings and loan (S&L) crisis, and the role and regulation of Fannie Mae and Freddie Mac are examples of government policies that failed because of too much regulation based on political and social agendas that created dire unintended consequences. I was there for both and know what happened and why.

The S&Ls were caught in the crossfire between regulation and market reality. Deposit interests rates paid by thrifts were capped at 5.5 percent in 1966 in large measure to reduce competition and subsidize home lending. This seemingly innocent and socially progressive act ultimately led to the S&L crisis when interest rate caps were abruptly eliminated in the volatile markets of the early 1980s. At that point, the six-month T-Bill rate was in the range of 15 percent, and S&Ls were essentially compelled to boost the interest that they were paying on deposits overnight to avoid massive disintermediation. This left them hideously mismatched through no fault of their own, having been required by law to make 30-year fixed rate mortgages (but for a few states that allowed variable rate lending) at about 7 percent (consistent with state usury laws). Their average negative spread in 1982 of approximately 400 basis points created an insurmountable operating environment. Between 1982 and 1992, 1,332 U.S. thrift institutions failed.[8]

Similarly, government policies and political expediency inadvertently made Fannie Mae and Freddie Mac principal players in the devastating financial collapse by having them purchase many subprime mortgages to encourage homeownership rates to reach unrealistically high levels. Fannie and Freddie were left susceptible to enormous financial risk as the ultimate guarantors of defective loans that eventually went into foreclo-

[2] Robert Wilmers, Too Many Regulations Are Counterproductive: M&T's Wilmers*American Banker* (Mar. 15, 2016).
[3] Jeb Hensarling, *After Five Years, Dodd-Frank Is a Failure*, The Wall Street Journal (July 19, 2015).
[4] *Id*.
[5] Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report (2011), https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[6] Rolf Nebel, *Regulations as a Source of Systemic Risk: The Need for Economic Impact Analysis*. The Geneva Paper on Risk and Insurance, Vol. 29 No. 2, 281 (April 2004).
[7] *Id*. at 276.
[8] Alex J. Pollock, Don't Forget the 1980s, *Housing Finance International* (March 31, 2015).

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sure when the housing bubble burst.[9] They have been in conservatorship since 2008.

The Economic Costs of Dodd-Frank

Having written my share of federal regulations as a bank regulator, the promulgation of federal rules is at best an exercise in making an educated guess about what might work. When they don't work, Congress and regulators must be willing to recalibrate the restrictions or empowerments that they have created. But very often those recalibrations may not occur because of contrasting public perception, political expediency and industry advocacy.

According to a recent survey of 1,000 Americans on behalf of the progressive nonprofit groups Americans for Financial Reform and the Center for Responsible Lending, 91 percent of voters believe that it is important to regulate financial services to level the playing field for consumers.[10] The study also found that voters would support even more oversight of financial companies by a margin of three to one.[11]

The financial industry's perspective on Dodd-Frank is, not surprisingly, quite different. The industry argues that Dodd-Frank is increasing or will increase operating costs and alter business decisions and the economy in negative ways. The industry contends that regulations regarding capital adequacy, qualified mortgages, risk retention, derivatives, liquidity and the Volcker Rule have all led or will lead to higher compliance costs, fewer profit-generating business opportunities, and less liquidity and lendable funds in the economy.

Recent polling by the American Action Forum suggests that by a margin of 65 percent to 26 percent, surveyed voters say the real cause of the financial collapse was misguided federal policy that encouraged banks to offer loans to people who could not afford to pay them back. Similarly, voters surveyed by the forum agreed 54 percent to 33 percent that an avalanche of new regulations is strangling the economy and killing jobs. Finally, these voters thought that big government rather than big banks had a bigger negative impact on their personal financial situation by 47 percent to 33 percent.[12] A recent article citing the president of the Consumer Bankers Association states that small banks are being ''suffocated with regulation,'' suggesting that one in six community banks will need to merge.[13] If in fact the costs of compliance and capital are increasing because of regulatory demands, they will ultimately be borne by consumers.

The Federal Reserve Bank of Minneapolis also illustrated the financial impacts on community banks. It found that increased staffing needs at community banks could result in a reduction of 14 to 45 basis points in the median profitability among banks with less than $50 million in assets. The study projected that the reduction would result in between 6 percent and 33 percent of those banks becoming unprofitable.[14] A 2014 survey of 200 community banks by the Mercatus Center at George Mason University revealed that customers are seeing the effects of the increased regulatory burden through reduced product and service offerings, particularly mortgage credit availability.[15]

The cost impacts are not limited to smaller institutions. A study by Federal Financial Analytics in 2014 concluded that ''quantifiable'' regulatory costs faced by the six largest banks have doubled since the financial crisis, rising from $34.7 billion in 2007 to $70.2 billion in 2013.[16] The American Action Forum pegged the burden of compliance with Dodd-Frank at roughly $895 billion in reduced gross domestic product, or $3,346 per working-age person between 2016 and 2025.[17] Similarly, Merrill Lynch recently released a report on the volatility in the stock market, noting that ''[s]tricter financial regulation has caused banks to slash holdings in financial assets (dealer inventories currently total 2% of corporate bond fund assets, versus 20% 10 years ago)'' and is ''exacerbating the volatility that normally occurs when the Fed signals its intent to begin raising rates.''[18] JPMorgan Chase's chief of regulatory affairs underscored in a recent speech that banks and regulators are in uncharted waters with regard to market liquidity and a number of structural, economic and participant changes in the market.[19] On Jan. 22, 2016, *American Banker* reported that BankUnited in Florida had decided to ''abruptly pull out of retail mortgage origination and leave the mortgage business'' because as John Kanas, the bank's president and chief executive officer, said, ''[w]e can't make money in the business.''[20]

While this may all be anecdotal evidence that doesn't accurately measure the full benefits and costs of Dodd-Frank, the point is that we simply don't know the comprehensive benefits and costs of the 2010 law.

Richard J. Parsons, the author of ''*Broke: America's Banking System,*'' contends that the impact on the mortgage business is not just anecdotal. He notes that residential mortgage loans are the largest asset sitting on the balance sheets of U.S. banks — comprising 22 percent of all loans, but are the least profitable product. Parsons grouped the 500 U.S. banks with the most residential mortgages relative to their total loans, and compared those institutions with other peer groups and with the industry as a whole. While the nation's roughly 6,000 banks had a median return on equity (ROE) of

[9] Peter Wallison, *The True Origins of This Financial Crisis*, American Spectator (February 2009).

[10] Celinda Lake, et.al., AFR/CFR Poll: National Survey by Lake Research Finds Continued Strong Support for Financial Regulation (Americans for Financial Reform, July 7, 2015).

[11] *Id.*

[12] Douglas Holtz-Eakin, Who's Ready To Throw Out Dodd-Frank? Swing Voters, *American Banker* (Feb. 19, 2016).

[13] Jackie Stewart, One in Six Banks Will Have to Merger: CBA Chief Hunt, *American Banker* (Feb. 12, 2016).

[14] Ron J. Feldman, et al., *Quantifying the Costs of Additional Regulation on Community Banks*, Fed. Res. Bank Minneapolis 13-3 (May 30, 2013).

[15] Hester Peirce, et. al., How Are Small Banks Faring under Dodd-Frank?, Mercatus Center, George Mason University (February 2014).

[16] Saabira Chaudhuri, *The Cost of New Banking Regulation: $70.2 Billion*, Wall St. Journal Moneybeat (July 30, 2014).

[17] Douglas Holtz-Eakin, *The Growth Consequences of Dodd-Frank*, American Action Forum (May. 6, 2015).

[18] CIO Reports Investment Insights, A Market Under Stress – We Believe This, Too, Will Pass, Merrill Lynch Bank of America, Chief Investment Officer (Jan. 19, 2016).

[19] Ian McKendry, *Regulation Only One Factor Hurting Market Liquidity: JPM Exec*, American Banker (Mar. 7, 2016).

[20] Brad Finkelstien and Paul Davis, ''We Can't Make Money'': Why BankUnited Ditched Retail Mortgages,*American Banker* (Jan. 22, 2016).

7.82 percent through the third quarter of 2015, his peer group's median ROE was only 3.5 percent. Meanwhile, the peer group of banks with the *lowest* ratio of residential loans to total loans had a median ROE of 9 percent. He ascribes that result, in part, to the fact that the 500 banks with the most mortgage loans on their books also are burdened with the highest capital ratios in the country. Moreover, the billions the nation's biggest banks paid in legal settlements and fines associated with home mortgages are required to be input as operational losses into their regulatory capital calculations. Thus, they must show sufficient capital going forward to cover 99.9 percent of potential losses based on past experience.[21]

The Government Accountability Office (GAO) has taken some steps to consider cost benefit evidence. In 2013, the GAO noted that while regulators have collected *some* data on these costs, no comprehensive data or analysis exists. Studies have estimated the economic impact of certain of the act's reforms, but their results vary widely and depend on key assumptions.[22] Similarly, in 2014, the GAO noted that although in certain circumstances financial regulators must consider costs and benefits of their rulemakings, they are ***not*** required to make a formal analysis of them.[23]

Most recently, financial regulators met President Barack Obama at the White House to discuss progress in reforming the financial sector, where the president said he decried the ''cynicism'' among the public that nothing has been done since the crisis to improve bank safety. One week later, on March 16, 2016, Federal Reserve Chair Janet Yellen touted the vast improvements to the safety and soundness of the banking sector since the financial crisis, saying the changes — particularly to supervision — represent a ''quantum leap'' from the pre-crisis regulatory regime. She noted that there is ''much more capital, higher quality capital, liquidity in the banking system, and regulators have made ''very meaningful changes in our supervision, for example the stress tests . . . [represent] a quantum leap in terms of the quality of supervision we're providing, especially at the largest firms.''[24] Such assertions may be comforting, but are only a part of the analytical debate.

Precise quantification of the benefits ascribed to the prevention of losses by new rules that make the financial system safer is admittedly a challenging task. But that does not mean that it cannot or should not be done. Frankly, a ''things-are-better-than-they-would-have-been'' argument begins to ring hollow in the face of mounting economic costs and credit constrictions. Moreover, such a defense can theoretically support any legislative effort or implementing regulation, no matter how ill-conceived. That cannot be the best way to run the largest economy in the world.[25]

Fixing the Cost Benefit Disconnect

The cost-benefit disconnect is one that is easily fixable should anyone care to do so. But the government must view cost-benefit analyses as a critical component of both the legislative and regulatory process. Unfortunately, it is not clear that the direct and indirect costs attributable to a piece of legislation, even though required to be calculated and evaluated, is ever controlling or moving the minds of policy makers. While agencies may be required by law to do a cost-benefit analysis or measure the impact of regulations on consumers or small businesses, the analyses rarely change the course of history. Information published pursuant to the Regulatory Flexibility and Paperwork Reduction acts to accompany proposed and final regulations is often not dispositive, and rarely read by anyone but its drafter.

One simple fix would link all agency rulemaking to a requirement to conduct a standardized, rigorous cost-benefit analysis. If the analysis does not empirically demonstrate that the rule's costs were acceptable relative to its overall impact, a court could invalidate it as being arbitrary and capricious. After all, if an agency adopts a rule and does not fully understand whether that rule will ultimately have a positive, negative or neutral impact on the economy, how can that not be an arbitrary decision? That is the gist of a federal district court's recent decision that the designation by the Financial Stability Oversight Council of MetLife, Inc. as a systemically important financial institution was invalid. More on that in Part Two of this article.

So could the rules created by Dodd-Frank to prevent the next financial crisis actually cause it? It is difficult to know without adequate analysis, but just as difficult to argue against that possibility when no one has rigorously quantified the benefits, detriments or most basic impact of Dodd-Frank on financial institutions, consumers or the economy. Next week, Part Two of this article will discuss two regulatory creations of Dodd-Frank systemic prudential regulation and the Volcker Rule — to illustrate the issues and the stakes in this regard.

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[21] Richard J. Parsons, *Do Mortgages Still Have Earnings Potential?,* American Banker (Feb. 2, 2016).

[22] U.S. Gov't Accountability Office, GAO 13-180, Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act (2013).

[23] U.S. Gov't Accountability Office, GAO 15-81, Regulators' Analytical and Coordination Efforts (2014).

[24] John Heltman, Yellen Touts ''Quantum Leap'' of Post-Crisis Banking Rules, *American Banker* (Mar. 17, 2016).

[25] *See* Deloitte Consulting LLP, Global Systemic Risk Regulation Since the Financial Crisis - A Framework for Understanding the Effectiveness, Impacts, and Harmonization of Macroprudential Regulation 20 (2012).

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