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Dodd-Frank Act

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BNA INSIGHTS: The Good, the Bad and the Ugly of Dodd-Frank - Part II

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The 2010 Dodd-Frank Act created the Financial Stability Oversight Council (FSOC) to identify and designate nonbank financial companies as systemically important financial institutions (SIFIs). SIFIs and bank holding companies with more than $50 million in assets are subject to enhanced prudential regulation by the Federal Reserve Board (FRB). In addition, international companies are subject to enhanced systemic regulation by the G-20's Financial Stability Board (FSB) — G-SIBs. The purpose was to create a new and more effective form of global regulation of the risk to ''financial systems'' to prevent future cataclysmic financial crises.

I have seen the FSOC designation process up close while representing a number of companies before the council. Systemic regulation is indeed a laudable goal, but one that is challenging and so far, has been vaguely defined and difficult to implement. Title I of Dodd-Frank requires the members of the FSOC, who are the regulators drafting the underlying regulations, to review their own actions and gauge the aggregate impact that they have from the perspective of national systemic stability.

Systemic Regulation: Costly Placebo or Needed Cure?

How Congress intended systemic regulation to mesh with other global regulatory schemes is also unclear. There were already at least a dozen U.S. federal agencies; 50 state banking, securities, insurance, investment and consumer protection agencies; and 50 state attor-

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neys general directly regulating the activities of financial companies in this country. There is an equal allocation of foreign financial regulatory parties, including the FSB, which also have a role to play. That is a crowded and sometimes competitive regulatory field which is only complicated by the addition of the FSOC's mandate to ensure systemic stability by creating a risk-reducing oversight mechanism that can see around financial corners and allow regulators to steer around future systemic shocks.[1] After nearly six years, it is still unclear whether the FSOC can do what Congress apparently concluded that all the aforementioned federal and state agencies could not or were not doing individually.

In the last six years, the FSOC has designated four large nonbank financial companies as SIFIs. They will be subject to Dodd-Frank's enhanced prudential regulation scheme with 33 large commercial banks.[2] The FSOC's approach to systemic regulation has focused thus far on increased regulation of individual companies, apparently based on the assumption that greater regulation will result in a safer and more stable system.

At the same time, the FRB and the FDIC are re-engineering the vertical regulation of these large financial companies through macroprudential tools, including new capital standards, risk management requirements, liquidity and activities limitations, and single-point-of-entry resolution plans. The theory appears to be that if governments supervise large companies more closely, more restrictively, and require greater reserves of capital and liquidity, then markets will be safer and avert potentially damaging financial collapses. A SIFI designation can result in substantial costs, whether due to the elimination of profitable activities deemed too risky (such as the indirect application of the Volcker Rule which prohibits proprietary trading and investments in covered funds), or increased capital and compliance responsibilities. Those costs will inevitably affect the array and costs of financial services products available to consumers.

In August 2010, just one month after Dodd-Frank was enacted, the Basel Committee on Banking Supervision published a complex and somewhat opaque analysis of the regulation of systemic risk and the attendant benefits and costs.[3] The analysis concludes that, assuming institutions pass on to borrowers the added costs arising from strengthened regulations, the net benefits from reducing the probability of a banking crisis through higher capital and liquidity standards could be measured in terms of "the long-run change in the yearly level of output from its pre-reform path."[4]

> Admittedly, the precise mapping between higher capital levels and stricter liquidity standards, on the one hand, and the reduction in the probability of crises, on the other, is quite uncertain. With this caveat, the sizable gap between benefits and costs for a broad range of assumptions still suggests that in terms of the impact on output, there is considerable room to tighten capital and liquidity requirements while still achieving positive net benefits.[5]

No less of an expert than William Dudley, president of the Federal Reserve Bank of New York, in an October 2015 conference at the Federal Reserve Bank of Boston, said that while "the use of macroprudential tools holds promise, we are a long way from being able to successfully use such tools in the United States."[6] In the same conference, Adam Posen, president of the Peterson Institute for International Economics in Washington, D.C., said that the U.S. institutional framework for preventing crises was "likely to fail" and that FSOC was a "mess."[7]

Perhaps even more instructive is the market's reaction to systemic regulation, which seems to undercut the theory that being too big to fail is an advantage because, among other things, it allows such companies to finance themselves at attractive rates. One of the SIFIs already designated — GE Capital Corporation — has decided to sell a substantial portion of its banking and banklike businesses to scale down and, among other

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[1] *See* William C. Dudley, Federal Reserve Bank of New York, Is the Active Use of Macroprudential Tools Institutionally Realistic? (Oct. 3, 2015).

[2] *See U.S. Dep't of the Treasury, Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.* (July 8, 2013); *see also U.S. Dep't of the Treasury, Basis of the Financial Stability Oversight Council's Final Determination Regarding General Electric Capital Corporation, Inc.* (July 8, 2013); *see also U.S. Dep't of the Treasury, Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.* (Sept. 19, 2013); *see also U.S. Dep't of the Treasury, Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc.* (Dec. 18, 2014).

(A pending challenge to one such designation asserts, among other things, that the government never weighed the measurable costs of increased regulation as a SIFI against the likely economic benefits. The government responds essentially that it did what the law required, and what it could do.)

[3] *See Basel Comm. On Banking Supervision, An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* (August 2010).

[4] *See id.*

[5] *Id. at 2-3.* The study notes that the net benefits of the regulatory reforms are based on the expected yearly output gain associated with the reduction in the frequency and severity of banking crises.

> Using the median estimate of the cumulative discounted costs of crises across all comparable studies, which is around 60 percent, each one-percentage-point reduction in the annual probability of a crisis yields an expected benefit per year equal to 0.6 percent of output when banking crises are allowed to have a permanent effect on real activity. Using the median estimate of losses when crises are seen to have only a temporary effect, which is around 20 percent, each one-percentage-point reduction in the annual probability of a crisis yields an expected benefit per year equal to 0.2 percent of output.

> . . . . each one-percentage-point increase in the capital ratio raises loan spreads by 13 basis points. Second, the additional cost of meeting the liquidity standard amounts to around 25 basis points in lending spreads when risk-weighted assets (RWA) are left unchanged; however, it drops to 14 basis points or less after taking account of the fall in RWA and the corresponding lower regulatory capital needs associated with the higher holdings of low-risk assets.

This calculation relies on realistically estimating the expected discounted cost of a crisis because of stronger capital and liquidity requirements. The analysis does not, however, reflect the fact that Dodd-Frank repealed many of the authorities that the Federal Reserve and the FDIC used to control the collateral damage to the economy in the last crisis.

[6] *See supra* note 29; *see* also Craig Torres, *Dudley Says Work Needed on Tools to Avert Financial Crisis* (Oct. 3, 2015).

[7] *See supra note 34, Torres.*

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things, avoid the more restrictive regulation[8] that accompanies that status[9] and on March 31, 2016, petitioned the government to release it from FRB regulation as a SIFI.[10] That occurred one day after MetLife won its challenge in federal district court to its designation as a SIFI in a stunning defeat for the FSOC and any life that it may have remaining in the current administration.

Admittedly, there are many in and out of government that would consider divestiture and downsizing by these institutions to be a great success because it is a step in the direction of safer, smaller, more supervised financial markets. On the other hand, for those who measure the delicate balance between regulation and free markets, this trend is the proverbial canary in the coal mine.

There are fundamental concerns about how the FSOC and the FSB have proceeded thus far, which raise serious questions about the efficacy of the process and whether related costs can be offset by measurable benefits. First, the regulatory apparatus applied to SIFIs to date and as proposed by the FRB, appears either to be bank-centric[11] or ill-defined. Applying bank capital, liquidity and operational concepts to insurance companies and investment managers, among others, will be problematic given the difference in their business models and risk profiles. Moreover, as the district court's opinion in the MetLife case may indicate, the hypothesis by the FSOC of unsubstantiated risks to which it then tethers a designation effectively requiring companies to shadowbox with fictional risks, is unfair and arbitrary and capricious.[12]

Second, FSOC and FSB analyses have not yet clearly distinguished between large companies that are the creators of market risk, and those that either invest in, absorb or manage that risk. Moreover, if FSOC is successful in lessening the creation of risk in the U.S. economy by designations of nonbank financial companies, a continuously dynamic process, the need to impose additional systemic regulation on other large companies in the market should logically be commensurately lessened over time. Thus, the number and profile of companies needing to be designated should constantly be reevaluated as each designation occurs.

Third, disagreements among FSOC members are a red flag. When some of the more knowledgeable members of the FSOC from the insurance industry dissent on insurance company designations, one wonders what it all means.[13] Similarly, it is not clear how the FSOC's voting members, who are the heads of the constituent agencies — not the agencies themselves — should be and are interacting with their fellow commissioners, board members and staffs.[14]

Fourth, the FSOC and FSB are designating companies for enhanced regulation without clearly identifying a path out of that regulatory status, even though Dodd-Frank requires an annual review of the designation status of each company. If the FSOC does not clearly articulate an empirical basis for designating a company as a SIFI, it remains to be seen whether such a designation is sustainable in the face of a legal challenge. The challenge by MetLife to its designation raised this issue. The failure to identify the precise factors that led to the designation in the record and what a company can do to de-risk and become undesignated means that the designation is effectively permanent, notwithstanding the annual re-evaluation required by the law.[15]

Finally, the costs of this potentially massive global regulatory shift are being undertaken without any empirical data to demonstrate that it will work or not backfire and eventually create the crisis that it is intended to avert.

The Volcker Rule: Risk Mitigation or Economic Albatross?

Perhaps no provision of Dodd-Frank has more potential to have as wide and significant a financial impact on banks, nonbank financial companies, and the U.S. economy than the Volcker Rule.[16] And surprisingly, perhaps no provision of Dodd-Frank had less to do with the direct causes of the last financial crisis, or less analysis about what its effects could be.

The Volcker Rule is ''fundamentally flawed'' and will do considerably ''more harm than good'' for the economy, concludes Brookings Institute Fellow Douglas J. Elliott.[17] He goes on to say that the Volcker Rule tries:

> to eliminate excessive investment risk at our core financial institutions without measuring either the level of investment risk or the capacity of the institutions to handle the risk, which would tell us

[8] Ian Katz and Katherine Chiglinsky, *MetLife CEO Raised Possibility of Breakup in 2014*, Insurance Journal (Jan. 28, 2016).

[9] Matt Levine, *GE Doesn't Want to Be a Big Bank Anymore* (Apr. 10, 2015).

[10] Ian Katz and Katherine Chiglinsky, *MetLife CEO Raised Possibility of Breakup in 2014*, Insurance Journal (Jan. 28, 2016).

[11] ''Application of Enhanced Prudential Standards and Reporting Requirements to General Electric Capital Corporation,'' Docket No. R-1503, 80 FR 44111-44128.

[12] *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) § § 153-154, 12 U.S.C. § § 5343-5344 (2010).

[13] *See, e.g.* Edward J. DeMarco, *views of the Acting Director of the Federal Housing Finance Agency* (Sept. 19, 2013).

[14] Section 120 authorizes the FSOC to recommend heightened regulatory standards to a primary financial regulator, but it is required to consult with that agency (not just the agency head) and conduct a cost/benefit analysis. There are several consultation requirements in Title I of Dodd-Frank, but it appears that differences among commissioners and other principals of various federal and state agencies are not being reflected in the deliberations of the FSOC. *See* Konstantine Kastens, New SEC Commissioner Takes Aim at FSOC on MMF Regulation (2014).

[15] Dodd-Frank, § 113(d), 12 U.S.C.§ 5323(d).

[16] In December 2013, five U.S. regulatory agencies — the FRB, the FDIC, the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) (collectively, Volcker Agencies) — approved a final rule implementing the Volcker Rule enacted in the Dodd-Frank Act. While the Volcker Rule itself comprised a mere 11 pages in the Dodd-Frank Act, the final rule and preamble adopted by the agencies take up 270 pages of the Federal Register. 79 Fed. Reg. No. 21, pgs. 5535–6076, Jan. 31, 2014.

[17] *The Volcker Rule and Its Impact on the U.S. Economy*: Hearing Before the U.S. House Comm. on Fin. Servs., 112th Cong. (2012) (statement of Douglas J. Elliott), transcript available at http://www.brookings.edu/research/testimony/2012/01/18-volcker-rule-elliott.

whether the risk was excessive. Instead, the rule focuses on the intent of the investment rather than its risk characteristics.[18]

Elliott's rationale turns on: (i) the imprecision of regulators measuring investment intent; (ii) the arbitrary definition of ''proprietary investments''; (iii) the creation of an overly complex set of regulations that micromanage banks; and (iv) the likelihood that arbitrary regulatory definitions will miss some of the more excessive risks that banks may actually take.[19] Industry critics argue that the Volcker Rule arbitrarily singles out U.S. financial companies for a form of regulation that will adversely affect market liquidity and job creation.[20]

The Volcker Rule is intended to limit risks to the financial system that Congress believes may be created by: (i) proprietary trading operations of insured depository institutions, foreign banking entities with certain U.S. operations, and the affiliates of the foregoing entities (collectively, banking entities) through a set of ''proprietary trading restrictions''; and (ii) investments and certain relationships between banking entities and private equity and hedge funds (referred to as ''covered funds'') through a set of ''covered fund restrictions.''[21]

Entities that fall within the definition of a ''banking entity'' are covered, and that definition is quite broad, extending far beyond any insured depository institution to include: (i) any company that *controls* an insured depository institution (which could be as little as 10 percent of a company's voting securities); (ii) any foreign bank that maintains a branch or agency in a State; (iii) any company that controls such a foreign bank, as well as any commercial lending company organized under State law that is a subsidiary of a foreign bank or its controlling company under section 8 of the International Banking Act of 1978 (FBO); and (iv) any ''affiliate'' or ''subsidiary'' of any of these foregoing entities.[22] Even where the Volcker Rule permits a banking entity to retain sponsorship of or investment in a covered fund, pursuant to the exemptions discussed above, the banking entity and its affiliates are nevertheless prohibited from entering into certain ''covered transactions'' with those funds.

So if a foreign bank owns 26 percent of the ''voting securities'' or contributes a similar amount of the total capital of a company in the asset management, insurance, fintech or securities business, that company is a banking entity covered by the Volcker Rule. If an asset manager invests money for an unaffiliated entity that is subject to the Volcker Rule, that asset manager may be made subject to the Volcker Rule. Moreover, the reach of Volcker goes beyond U.S. borders to capture foreign affiliates and subsidiaries.

The regulations also draw on the bank affiliate restrictions found in sections 23A and 23B of the Federal Reserve Act.[23] However, whereas Section 23A merely places limits on covered transactions between affiliated entities, the Volcker Rule's so-called ''Super 23A provision'' prohibits such transactions altogether. The regulations' Section 23B provisions require that certain other transactions between a banking entity and a covered fund be substantially the same, or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving unaffiliated companies, or in the absence of comparable transactions, on terms and under circumstances that in good faith would be offered to an unaffiliated party.

The U.S. Chamber of Commerce's Center for Capital Markets released a study in 2012 on the economic consequences of the Volcker Rule. It concluded that it would: (i) have a negative effect on market-making and liquidity; (ii) reduce network benefits of market-making for financial institutions; (iii) lead to higher costs of capital; (iv) make bank risk management less efficient; and (v) harm the ability of businesses to raise capital.[24] In 2014, the OCC estimated that implementation of the Volcker Rule would cost the banks that it supervises between \$413 million and \$4.3 billion.[25] Most of the potential costs could come from the rule's limits on some collateralized loan obligations, with the largest impact on banks with more than \$10 billion in assets. ''The range of [their] cost estimate primarily reflects the uncertainty of the final rule's impact on the market value of banks' investments,'' according to the OCC's report. After Volcker, the market value ''could drop by up to 5.5 percent.'' In view of these governmental conclusions, the absence of an economic cost-benefit analysis is at best troubling.

How to Achieve Regulatory Rationality

How have all of the new regulatory requirements of Dodd-Frank affected the consumer? Perhaps consumers *are* better protected from financial abuses. But how do we know that? The more appropriate question is whether whatever protections that have been gained legitimize, among other things, the increased costs (which institutions will pass along to consumers), or any reduction in the availability of credit.

As we continue to emerge from the ruins left by the financial crisis, cooler-headed and more thoughtful policy makers must begin to re-establish a sense of rationality to the development and implementation of U.S. financial regulation. No matter who is elected president in 2016, it is not reasonable to expect that much of the Dodd-Frank toothpaste would rolled back. However, to ensure that financial services in the U.S. remain a vibrant and growing business, and that credit remains available on the broadest and most efficient bases, some practical changes should be implemented.

First, since markets are so dynamic, every new law and regulation should come with an expiration date and

[18] *Id.*
[19] *Id.*
[20] Trey Garrison, 5 Ways the Volcker Rule Will Destroy Job Creation, HousingWire (Jan. 15, 2014).
[21] Robert H. Ledig et al., *The Volcker Rule: Commentary and Analysis* (ThomsonReuters/Westlaw, 2014).
[22] Entities that are designated as SIFIs by FSOC but are not banking entities are also subject to additional capital charges or other restrictions related to the risks and conflicts of interest that the Volcker Rule is intended to address. SIFIs, however, are not subject to the proprietary trading or covered fund restrictions that apply to banking entities.
[23] 12 U.S.C. § 371c (2010).
[24] Anjan V. Thakor, *The Economic Consequences of the Volcker Rule*, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (2012).
[25] Office of the Comptroller of the Currency, Analysis of 12 CFR Part 44, available at http://www.occ.gov/topics/laws-regulations/legislation-of-interest/volcker-analysis.pdf; Jesse Hamilton, *Volcker Rule Will Cost Banks Up to \$4.3 Billion, OCC Says*, Bloomberg News (Mar. 21, 2014).

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require a meaningful short- and long-term cost-benefit analysis.

Second, FSOC should defer the designation of individual companies until it adopts and understands the impact of the macroprudential tools that it intends to use, and fully evaluates the systemic destabilization that can occur because of obsolete, unnecessary, redundant and poorly constructed systemic rules. In the meantime, it should focus on creating and implementing an early warning system to allow authorities to derail global systemic crises.

Third, Congress should stop enacting detailed financial services laws that resemble punch lists. Financial services laws should allow the regulators to exercise their expert discretion to make finely calibrated decisions about financial safety and soundness.

Fourth, government resources should be focused on getting the best real-time information possible using the most sophisticated tools available to maximize the quality of regulation. Physical examinations should continue, but their limited utility should be understood.

Finally, let's find out if consumers are willing to pay more for fewer financial services in the hope of constructing a financial services system that will be more resistant to or resilient in the next crisis. As a consumer, I would want to know if all this new regulation would avert the next financial crisis before I answered that question.

The most honest answer is that it never has.

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