

# The Impact of the Dodd-Frank Act on Financial Stability and Economic Growth

Martin Neil Baily (Brookings) and Aaron David Klein (Bipartisan Policy Center), presentation to the University of Michigan Conference, October 24, 2014



# A framework for assessing Dodd-Frank

**The goal** of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was to **increase financial stability** to ensure that there would never be a repeat of the crisis of 2007-2009.

**We divide Dodd-Frank's provisions into five sets**, those that have:

- Improved stability with positive impacts on both efficiency and economic growth or with strong impacts on stability with minimal impact on economic growth (**clear wins**)
- Decreased financial stability without benefitting economic growth (**clear losses**)
- Achieved little increase in stability at considerable cost to efficiency and economic growth (**costly trade-offs**)
- Failed to adequately address a stability problem (**didn't go far enough**)
- Created an uncertain trade-off between financial stability and economic growth (**too soon to tell**)



# A framework for assessing Dodd-Frank

## **How regulators can make the most of Dodd-Frank**

In addition to laying out a taxonomy of key Dodd-Frank provisions, the authors suggest actions that could improve regulatory impact. These changes could be made by regulators within the scope of current legal authority.

## **How Congress can make Dodd-Frank better**

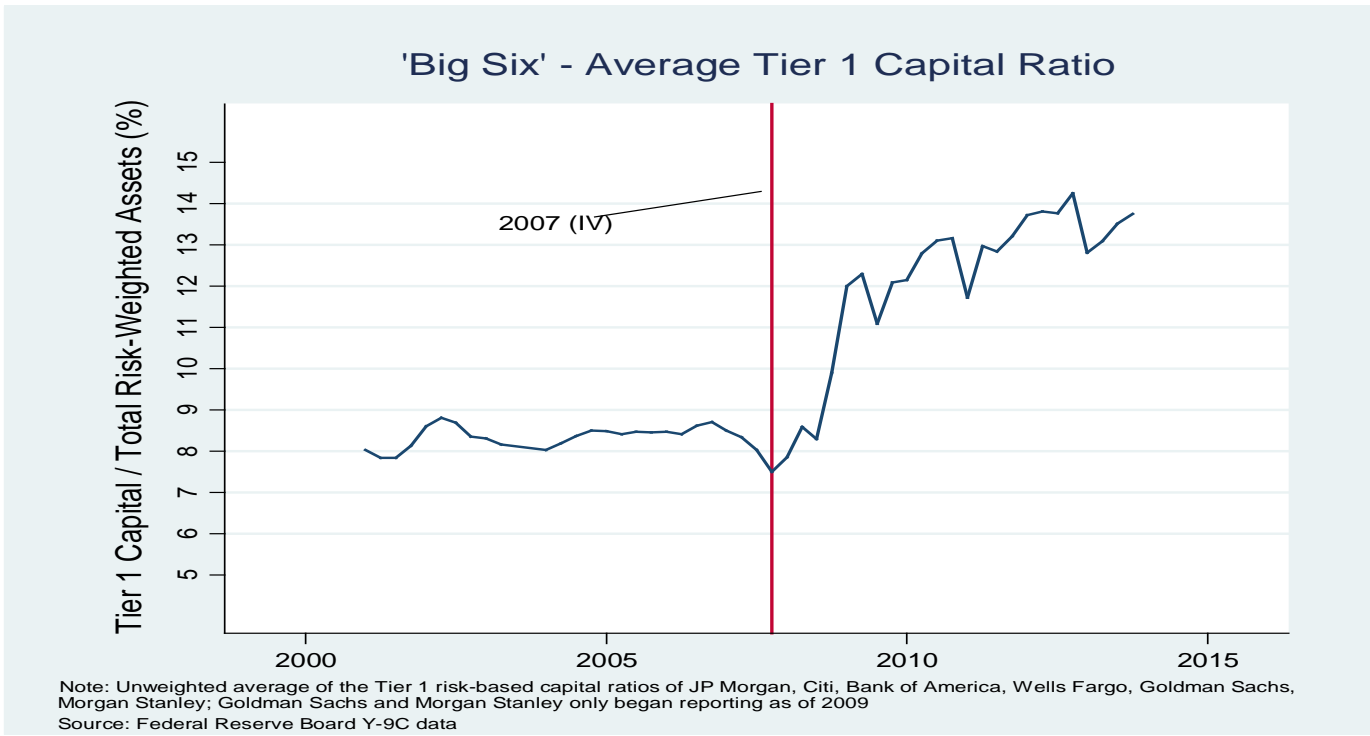
The authors support Dodd-Frank but believe that improvements should be made. There is a danger that re-opening the bill will result in gutting its main provisions, but there is also an opportunity for Congress to work with the president on reforms that both parties can accept. Repeal is neither desirable nor any longer practicable.



# Clear wins: Increased capital

Pre-crisis problem: The largest banks had far too little capital

Solution: Increased capital requirements have led to sharply increased capital levels. Capital increased from DFA but also Basel III and market forces.



# Clear wins: A new resolution process via the FDIC's single-point-of-entry strategy

## **Pre-crisis problem: Bailout or instability**

A major problem in the crisis was that policymakers were faced with the choice of either bailing out large institutions or letting them go under, with serious consequences for financial stability.

## **Solution: Dodd-Frank Title II Resolution Regime as implemented by the FDIC under the single-point-of-entry strategy (SPOE)**

Under SPOE, SIFI banks must create a buffer of equity and long-term unsecured debt at the holding company level. In the event of a failure, the holding company is lifted off while the subsidiaries are placed into a “Newco” (bridge company) and remain in operation.



# Clear wins: A new resolution process via the FDIC's single-point-of-entry strategy

## Benefits of SPOE

- **The costs of failure are borne by the equity and long-term debt holders** of the failing institution. This solves the need for a taxpayer bailout while preserving stability. Newco will be solvent provided the buffer is large enough, but it will require liquidity support from the Fed or the FDIC. The FDIC is granted that authority in Dodd-Frank under Orderly Liquidation Authority while Newco should be able to access the Fed's routine liquidity features (e.g., the discount window).
- **Foreign subsidiaries continue to operate**, making cross-border issues much easier to deal with.
- **The approach has considerable international support**, with cross-border agreements reached with the UK and Canada, and has working relationships with Japan, the EU, Germany, China, and Switzerland. There is some resistance from countries that do not want to allow their large banks to fail.



# Clear wins: Creation of the CFPB

## **Pre-crisis problem: Consumer financial protection took a back seat**

Bifurcated regulatory authority, limited regulatory will, and a lack of legal authority to regulate non-bank consumer products led to substandard consumer protections in many parts of the country. Consumers were abused in the mortgage, credit card, small-dollar lending, and other markets.

## **Solution: Consolidate consumer protection in one agency with expanded jurisdiction to create a level playing field**

The Consumer Financial Protection Bureau (CFPB) was created with a single mission to focus on consumer protection. Authority was realigned and expanded to cover most major consumer products. Independent funding was secured along with very competent senior leadership. The agency was successfully launched and has been actively engaged.



# Clear wins: Creation of the CFPB

## Assessing the Bureau after four years

### **The CFPB quickly established itself as a major financial regulator.**

The Bureau has engaged both bank and non-bank lenders, consumers, and policy makers in tackling a range of critical issues. It is hard to think of any new federal regulatory agency that has had as much impact in its first few years.

### **The new process creates difficulty across regulators.**

The CFPB's product-based examination process challenges traditional bank regulators and institutions who were used to entity based regulation. Bank regulators struggle to integrate CFPB findings into their holistic examination process, while the Bureau is still working to best determine how to close out examinations. Tension at inception is healthy, but regulators must ultimately work cooperatively to avoid regulatory gaps and frictions.





# Clear losses: Restrictions on Fed and FDIC crisis authority

**Problem:** Dodd-Frank eliminated or impeded the use of regulatory tools that were successfully deployed during the financial crisis.

The Fed can no longer make emergency loans to specific non-bank institutions, and the FDIC's ability to provide debt guarantees is subject to a congressional resolution of support, a significant hurdle when time is of the essence.

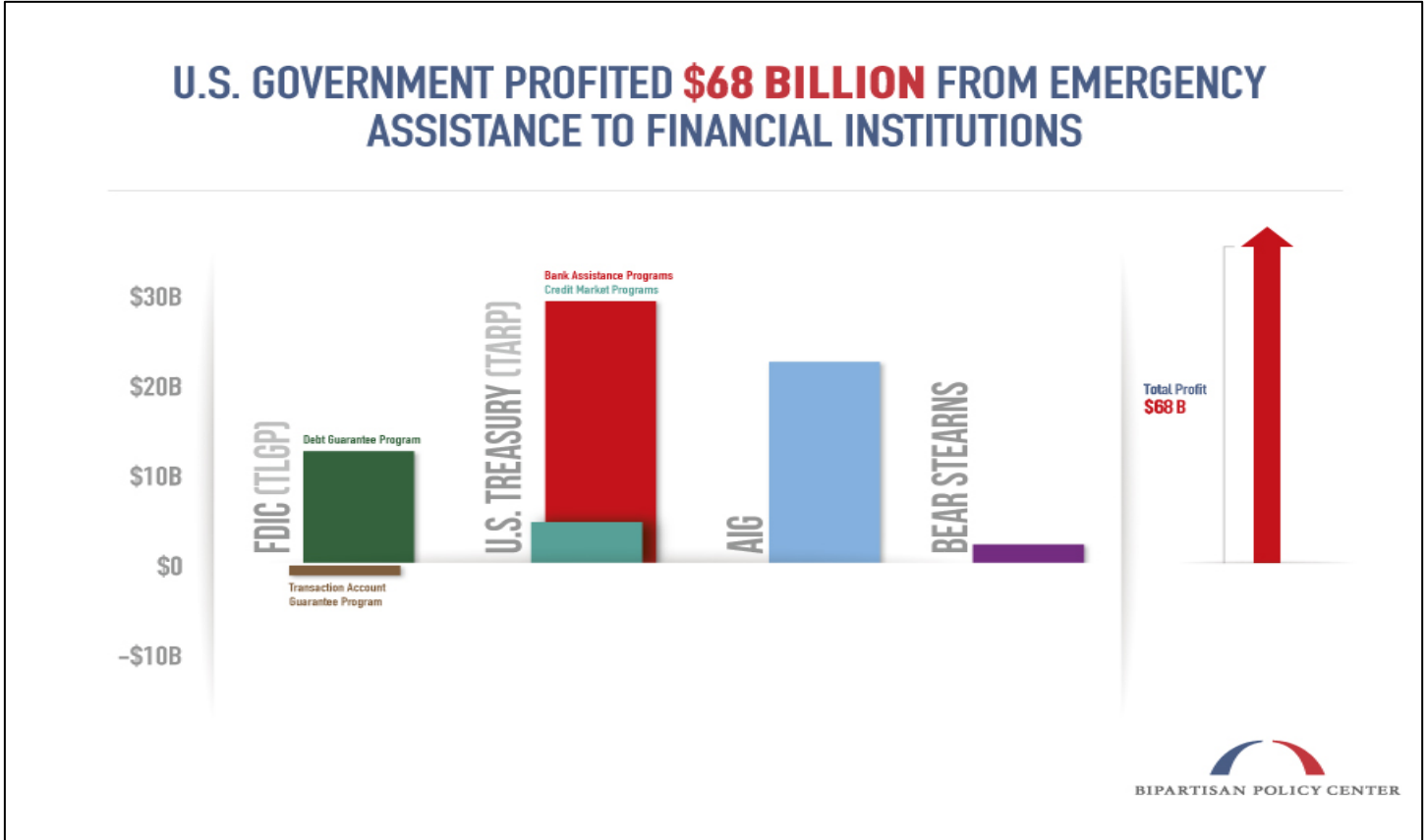
In a crisis, authorities must have the power to act quickly and decisively to restore confidence and prevent a wider collapse. Future crises are inherently unpredictable. Limiting regulatory discretion, particularly to act quickly, is unwise, especially given the success of these programs.

**Solution:** Repeal Dodd-Frank's prohibitions by restoring the Fed's authority and removing the FDIC's need for prior congressional approval.



# Clear losses: Restrictions on Fed and FDIC crisis authority

The Fed stabilized multiple markets and prevented financial contagion. The FDIC guaranteed newly-issued bank debt.



# Costly trade-offs: The Volcker Rule and the Lincoln Amendment

**Pre-crisis problem: Unregulated Derivatives Market with trading by large financial institutions**

**Dodd-Frank's solutions:**

- **Mandatory Clearing:** Many derivatives must use central clearing.
- **Volcker Rule:** U.S banking organizations are prohibited from engaging in proprietary trading or owning hedge funds or private equity funds. Foreign banks are affected for any activity in the United States or with securities offered to U.S. residents. The purpose is to reduce speculation by banks and to eliminate conflicts of interest between banks' profits and the interests of their customers.
- **The Lincoln Amendment:** Insured banks must “push out” their swaps business to nonbank affiliates that are not eligible for deposit insurance or access to the Fed's discount window. The intent is to protect taxpayer funds by barring them from being used to help firms that may have gotten into trouble due to their swaps trading.



# Costly trade-offs: The Volcker Rule and the Lincoln Amendment

- **Mandatory clearing is a clear win.** Centralized clearing should increase efficiency and provide greater stability, although concerns about the exchanges and FMUs merit additional work.
- **Most derivatives are interest rate swaps and foreign exchange swaps that did fine in the crisis.** The problem in the crisis was not so much “trading” as the fact that institutions bought and held risky asset-backed securities. They made “bad loans” and the market and the rating agencies badly mispriced true risk.
- **The Volcker Rule has been hard to implement and may reduce liquidity in financial markets.** There is concern that medium-sized enterprises are finding it harder or more costly to issue debt. Requirement to divest existing assets such as CLOs appears to create market instability for no reason.
- **The Lincoln Amendment addresses the same core concern as the Volcker Rule.** Having both in place is costly and unnecessary.



# Where Dodd-Frank did not go far enough: Regulatory consolidation

## Problem: Lack of Coherent Supervision and Regulation

At the time of the crisis, there were multiple regulatory agencies with overlapping jurisdiction, gaps in the regulatory structure, and no clear mandate for responsibility. Financial institutions often had several teams of regulators in house at once but with no single agency having broad responsibility.

### PRIOR TO DODD-FRANK ACT



DEPOSITORY & LENDING ACTIVITY	FEDERAL RESERVE	OCC	FDIC	OTS	STATE BANKING SUPERVISORS
CONSUMER FINANCIAL PRODUCTS	FEDERAL RESERVE	OCC	FDIC	OTS	STATE BANKING SUPERVISORS
SECURITIES & BOND PRODUCTS	SEC				
DERIVATIVES PRODUCTS EXCHANGE BASED	CFTC				
DERIVATIVES PRODUCTS OVER-THE-COUNTER BASED					
INSURANCE PRODUCTS	STATE INSURANCE REGULATORS				

## FRAGMENTED REGULATORY STRUCTURE WITH GAPS AND OVERLAP.

The complexity and fragmentation of our regulatory system prevented us from recognizing systemic threats that led to the financial crisis.



# Did not go far enough: Regulatory consolidation

## Dodd-Frank's Solution

1. Abolished a failed regulator (OTS), added 3 more (CFPB, OFR, & FSOC)
2. Created the FSOC to oversee the myriad of regulators with new regulator role for Treasury secretary as FSOC chair
3. Provided the Fed with macro-prudential authority as a systemic risk regulator
4. Required more joint regulatory rule writing to enhance coordination

### AFTER DODD-FRANK ACT



DEPOSITORY & LENDING ACTIVITY	FEDERAL RESERVE	OCC	FDIC	STATE BANKING SUPERVISORS
CONSUMER FINANCIAL PRODUCTS	CFPB	STATE BANKING SUPERVISORS		
SECURITIES & BOND PRODUCTS	SEC			
DERIVATIVES PRODUCTS EXCHANGE BASED	CFTC			
DERIVATIVES PRODUCTS OVER-THE-COUNTER BASED	SEC	CFTC		
INSURANCE PRODUCTS	STATE INSURANCE REGULATORS			

### GAPS FILLED, BUT OVERLAP REMAINS.

The Dodd-Frank Act created system-wide oversight and filled gaps, but overlap and fragmentation still exist.

# Did not go far enough: Regulatory consolidation

## Bipartisan Policy Center Initiative supports consolidation

- Create a consolidated exam force with members from all relevant agencies
- Create a single prudential regulator and single capital markets regulator
- Regular joint CFTC-SEC board meetings with both independently funded

### PROPOSED BIPARTISAN SOLUTION



DEPOSITORY & LENDING ACTIVITY	PRA	STATE BANKING SUPERVISORS
CONSUMER FINANCIAL PRODUCTS	CFPB	STATE BANKING SUPERVISORS
SECURITIES, BOND, & DERIVATIVES PRODUCTS	CMA	
INSURANCE PRODUCTS	FIR	STATE INSURANCE REGULATORS



## STREAMLINING REGULATION

BPC's plan consolidates and empowers regulatory agencies with clear lines of jurisdiction. This approach reduces complexity and inefficiency, and ensures a safer financial system.

# Did not go far enough: The FSOC

**Problem:** The FSOC lacks authority to carry out its coordination and systemic risk responsibilities.

- Having all the regulators meet and discuss issues is valuable, but the FSOC lacks authority to force regulators to coordinate and issue joint rules, to require a reluctant regulator to issue regulation, or to issue regulation on an activity that poses a systemic threat.
- The FSOC's major authority is to designate financial institutions as systemically important (SIFIs), which are sent to the Fed for regulation. This process has been contentious and focused mostly on insurance companies.

**Solution:** Empower the FSOC to resolve regulatory gridlock in joint rule makings, reluctant agencies, and activities that threaten financial stability.





# Did not go far enough: The FSOC

**Problem:** The FSOC has lacked transparency in both public and private proceedings. This has undermined the Council's authority, impact, and public perception.

## **Solutions:**

1. The Council should release minutes of its meetings along the lines of the Federal Reserve's Federal Open Market Committee (FOMC), which provides substantial information and insight to the public..
2. The Council should clarify its designation process, notify companies under consideration for designation where they are at all stages in the process, and allow such companies to communicate with all FSOC members throughout the process.



# Did not go far enough: The Office of Financial Research

Dodd-Frank created the OFR with several mandates, including to 1) “look around corners” to find and point out the build-up of risks; 2) improve the quality and standardization of financial data; and 3) support the FSOC.

**Problem:** These mandates have proven to be in conflict in practice. The OFR has chosen to operate more in support of the FSOC as part of Treasury, limiting its ability to “ring the alarm bell” for future crises.

## **Solutions:**

1. The OFR should focus more on its mandate to improve data quality in the short run. This will allow it to operationalize itself, have a meaningful public policy impact, and establish greater independence.
2. Congress should remove the OFR from Treasury and set it up as a separate agency with its own funding. Alternatively, the OFR should exert its own independence like the OCC, which is also within Treasury, has for many years.



# Too soon to tell: Multiple separate capital rules

**Table 1**  
**Minimum Required Ratios**  
**for Most Banking Organizations**  
(Assets Greater Than \$500 Million and Less Than \$250 Billion)

Common Equity Tier 1/RWA	4.5%
Tier 1 Equity/RWA	6.0%
Total Equity/RWA	8.0%
Capital Conservation Buffer	2.5%
Leverage Ratio	4.0%

Source: Federal Reserve Board of Governors

**Table 2**  
**Additional Requirements for Advanced Approaches**  
(Assets of \$250 Billion or More or \$10 Billion in On-Balance-Sheet Foreign Exposure)

Supplemental Leverage Ratio (considers certain off-balance-sheet items)	3.0%
Countercyclical Buffer	0% – 2.5%, if credit quality deteriorates

Source: Federal Reserve Board of Governors

- Minimum level of Tier 1 capital (mostly equity) relative to risk-weighted assets
- Capital buffer
- Leverage ratio requirement (Tier 1 capital divided by un-weighted assets)
- Stress tests to ensure adequate capital for an adverse economic event



# Multiple separate capital rules: Issues

## Complications in stress tests

Stress tests run in early 2009, backed by TARP capital, marked a turning point in the crisis. Since then, stress tests have become a central tool of Federal Reserve supervision. Stress tests have value but complex, annual black-box testing is costly. Stress tests can also fail to predict important gaps or problems, presenting similar issues to inaccurate risk weights.

## Liquidity is hard to predict

Predicting what is a liquid asset in a financial crisis is difficult. US Treasuries are considered a very safe and highly liquid asset, but what if the next crisis is triggered by a US government default? Municipal debt is another example. If liquidity is not properly defined, it can skew demand for both safe and risky assets. And, what is liquid one day can suddenly become illiquid in a crisis.



# Multiple separate capital rules: Issues

## **Bank capital is costly**

Raising bank capital adds to the stability of banks, but it increases bank costs, making borrowing from banks more expensive and/or pushing financial activity offshore or to shadow sector. In theory, increasing bank capital should not raise bank costs by much, but historically the return on equities has exceeded the return on bonds by between 5 and 8 percentage points, a premium so large it is hard to explain within finance models.

## **Adverse incentives in a leverage ratio requirement**

An institution for which the leverage ratio is binding faces an incentive to increase its holdings of risky assets and reduce its holdings of safer assets. Risk weights were a poor guide to actual risks leading up to the crisis, so while the leverage ratio can be a useful guide for regulators, it should not be the binding constraint under normal conditions.



# Too soon to tell: Liquidity requirements

Central banks have traditionally provided liquidity to the banking system in case of runs. Now, banks must hold enough liquid assets (a Liquidity Coverage Ratio, or LCR) to cover their cash needs for a three-week period during which they were unable to access the capital market. And, institutions must meet a net stable funding ratio (NSFR), limiting their ability to use runnable liabilities such as repos.

Basel III Global Liquidity Standard		
1.	<b>Liquidity Coverage Ratio (LCR)</b>  (To be introduced as of January 1, 2015)	<b>Stock of high quality liquid assets must be greater than the Total Net Cash out-flows over next 30 calendar days</b>
2.	<b>Net Stable Funding Ratio (NSFR)</b>  (To be introduced as of January 1, 2018)	<b>Stable funding (deposits, long-term wholesale funding and equity) must be greater than weighted long-term assets</b>

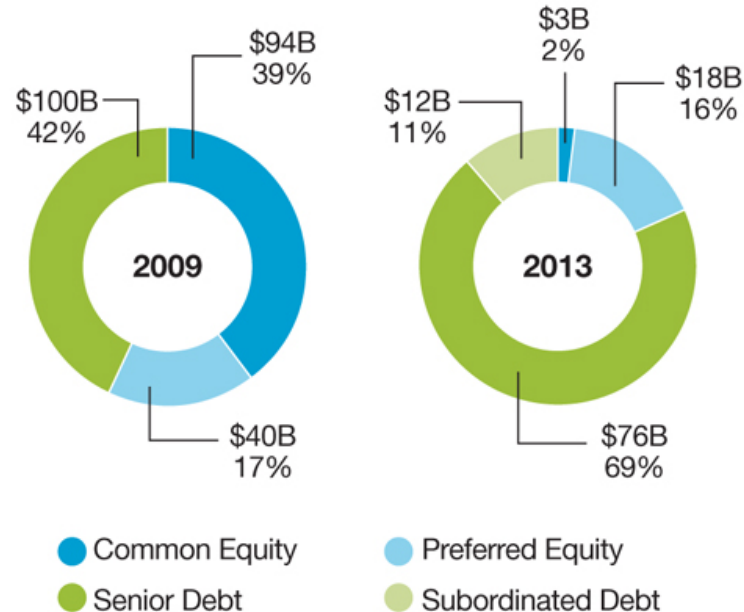


# Too soon to tell: Appropriate size of Long term unsecured debt requirements

In order to satisfy the conditions under the SPOE approach to resolution, banks must hold a yet unspecified buffer of long term debt at the holding company level.

## FUNDING REMIX

*Banks have dramatically changed the way they raise capital over the past five years. In particular, they've shown a growing preference for issuing subordinated debt as investors' appetite for it has recovered*



Note: 2009 subordinated debt is \$0.17B, or 0.1% of capital raises.  
Source: SNL Financial



**Costly Trade-Offs**

**Clear Wins**

Volcker Rule

Lincoln  
Amendment

Resolution  
Process

Increased  
Capital

Mandatory  
Clearing

CFPB

Restrictions  
on Crisis  
Authority

Regulatory  
Consolidation

FSOC

OFR

**Clear Losses**

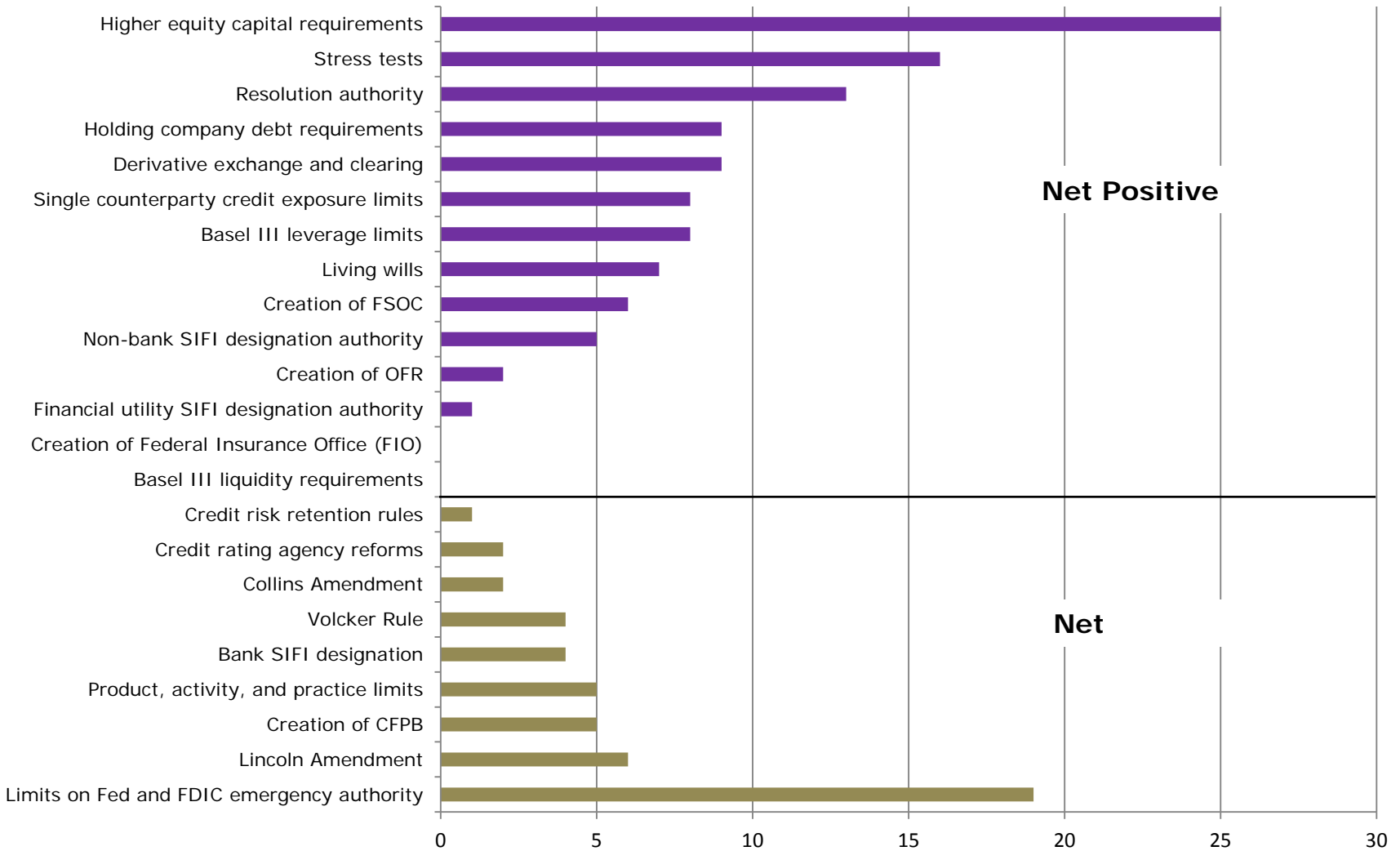
**Did Not Go Far Enough**

**Too soon to tell:**

Combined  
Prudential  
Requirements



# Validity Check: BPC Survey of Thought Leaders on Dodd-Frank Policies to Affect Systemic Risk



Differences in Responses Between More Likely to Decrease Risk and More Likely to Increase Risk

Note: Survey pool was bipartisan thought leaders; not randomly selected or weighted

■ More Likely to Decrease Systemic Risk

■ More Likely to Increase Systemic Risk



# Conclusions

## **The financial sector is much safer today**

Increased capital requirements and stronger regulation and supervision has created a much safer financial sector.

## **There is a clear path to ending TBTF**

The single point of entry strategy has been a breakthrough. It still requires further implementation and progress on cross-border resolution.

## **Economic growth is a vital priority**

The regulatory system should be efficient and not inhibit lending to households and businesses provided risks are being priced and managed correctly. Regulators and supervisors should make sure bank staffs are doing their jobs but should not try to take over those jobs.

## **Try to improve Dodd-Frank or hold the line?**

Most major pieces of legislation are followed by a corrections bill but with Dodd-Frank, political gridlock has made it extraordinarily hard to get anything accomplished.

