CHAPTER 2

UNITED STATES FINANCIAL REGULATION: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT IN CURRENT AND HISTORICAL PERSPECTIVE

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1 INTRODUCTION

This paper presents the major changes in financial regulation in the United States contained in, or mandated by, the 2010 Dodd-Frank Act. It will present the most important changes in legislation designed to prevent a collapse of the financial system similar to the 2007-8 crisis. This evaluation will be based on the analytical framework of financial fragility proposed in the work of Hyman Minsky.

2 BACKGROUND ON THE HISTORY OF PRUDENTIAL REGULATION IN THE UNITED STATES

Financial regulation in the United States has always been unique. It has not followed European examples, as has been the case in many other former European colonies. In particular, as a rebellious colony it rejected British regulation and financial structure. It did not introduce a National Bank or a Central Bank to govern the financial system or act as the financial agent of government until the beginning of the 20th century. Indeed, when something resembling a National Bank was created it had a regionally diversified governance structure that combined federal government and private bankers across 12 regions. It was originally a mechanism to pool bank reserves, rather than something resembling the Bank of England or any European National Bank. In order to understand the recent

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1 The formal name is “An Act To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.” The short title is the “Dodd-Frank Wall Street Reform and Consumer Protection Act”.

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regulatory legislation known as the Dodd-Frank Act, it is thus necessary to review briefly the history of regulation of the financial system.

The US economic system has been driven by the preference of private enterprise over government activity and intervention in the economy. And when government intervention was accepted there has been a preference for intervention at the individual State level, rather than at the level of the Federal government. Thus while the Constitution reserves to the Federal government the right to coin money and engage in debt, it makes no provision for the creation or control of financial institutions such as banks. As a result, private, state chartered, banks tended to dominate the issue of means of payment through unregulated issue of their own notes from the beginning of the Republic.

Prudential regulation was thus initially concentrated on ensuring the redemption value of private bankers’ circulating promissory bank notes. The US had created a Bank of the United States under a temporally limited charter, but without giving it a monopoly of the note issue, or any formal regulatory function. Indeed, its action to improve the stability of the private state banks led to a failure to reconfirm the second Bank of the United States as the National or Central bank of the United States in 1832. The introduction of the Independent Treasury System based on payments by the Federal government in gold specie, relinquished the means of payment function to private sector financial institutions that could only be created under state charter and regulation.

This ushered in a period of “free banking” which lasted from the dissolution of the Second Bank of the United States in 1836 to the issue of the first Federal circulating medium of exchange—the now famous “Greenback”—issued by the Union government to provide finance for the Civil War. When this limited issue proved insufficient for war financing needs the Union government introduced the National Banking System in 1863, accompanied by a regulatory agency, the Office of the Comptroller of the Currency (OCC) responsible for supervision of the issue of national bank notes by the federally chartered National banking associations.
In the free banking period between 1836 and 1863, the means of payment was comprised of private bankers’ notes, in general backed by reserve holdings of the relevant state government securities or by specie. The system of National charter banks required reserve holding of Federal government debt for the issue of National bank notes. In order to ensure dominance of National bank notes, a tax was placed on state banks’ notes. To defend their position, state chartered private banks replaced their bank note issue with deposits subject to check. This extended the need for prudential regulation to bank deposits as well as National bank notes. Since deposits were issued by state banks they were regulated by state governments. This created the dichotomy in U.S. bank regulation, with the state regulators, responsible for prudential regulation of deposit taking by state banks and the OCC for National banks, issuing National bank notes.

The financial system in the United States before the creation of the Federal Reserve was one in which

(…) the four distinct functions of banks (commercial banking, trust and insurance, corporate underwriting, and brokering) each essential to business, and each exercised originally, by a distinct set of men, became united in the investment banker (BRANDEIS, 1933, p. 5–6).

It seemed obvious that such a system would not be conducive to competition:

Can there be real bargaining where the same man is on both sides of the trade? The investment banker, through his controlling influence on the Board of Directors, decides that the corporation shall issue and sell securities, decides the price at which it shall sell them, and decides that it shall sell the securities to himself” (op. cit., 1914, p.11).

Brandeis (1933, p.26) also noted that the large profits that resulted from concentration “led to a revolutionary change in the conduct of our leading banking institutions,” in which banks sought to become investment bankers, leading to their “departure from the legitimate sphere of the banking business, which is the making of temporary loans to business concerns”. However, the main criticism was that the control of bank deposits—other people’s money—was the source of this power of concentration and of the exorbitant profits of investment banks.
Brandeis’ observation concerning the move in the early 1900s to concentration of banking activities in large multi-function investment banks must be seen in the context of the fact that national banks had initially been allowed to engage fully in capital market activities. However, after a challenge by the Comptroller of the Currency of the right of the large New York banks to operate in securities, by 1908 National banks were regulated to only commercial banking activities. National banks thus faced an increasing competitive disadvantage relative to state chartered banks which were usually allowed to operate without restriction in securities markets. To protect their profitability, National banks created State chartered security affiliates that were outside the regulatory writ of the Comptroller. The first such affiliate was formed under state charter by First National City Bank in 1911.

The existence of legal limitations on the maximum issue of greenbacks, and subsequently of national bank notes, meant that the supply of currency was independent of the needs of trade, and there was no means of increasing the supply of notes to meet the frequent loss of confidence in deposits of state banks. In 1875, the limitation on the note issue was removed, but this still did not provide a sufficiently elastic supply of currency. The need for a more elastic currency led to the creation of the Federal Reserve System, composed of twelve District Federal Reserve Banks that could issue Federal Reserve notes. These notes had to be backed 40 percent in gold and 60 percent in discounts on private commercial loans.

The elasticity of the note issue was thus resolved by adopting a form of the “real bills” doctrine that restored the role of the commercial bank—as a deposit taker and lender of short-term funds for commercial purposes—as the central institution in the system. This finally made the means of payment by note issue unique and unified, but retained the diverse quality of deposits issued by individual state and national banks. As a result, the main task of prudential supervision became to ensure the maintenance of convertibility of private bank deposits into Federal Reserve notes.
It was the 1927 Pepper-McFadden Act that finally clarified the range of activities permitted to National banks. In this period national banks that were limited to commercial banking activities suffered from falling profitability. The continued expansion of free banking in many states led to widespread overbanking. At the same time, the 1920s stock market boom brought with it the possibility of national banks’ commercial clients satisfying their short-term financing needs through capital market issues.

Even before the 1929 stock market crash, analysts were predicting the demise of the commercial banks as bank loans extended by national banks continued to decline. Lauchlin Currie, an adviser to the Federal Reserve and the Treasury in the 1930s (CURRIE, 1931, pp. 701–2), notes that over the period 1922–8 there was a tendency for larger, successful firms to reduce their bank borrowing, due to “a realization of the dangers inherent in loans of any description and particularly bank loans” (CURRIE, 1931, p. 708). Whether Currie was right in identifying the cause of the decline in business lending or whether it was simply the fact that firms were encouraged by the banks directing them to their securities affiliates, since the stock market boom made it much cheaper to raise funds as the Fed was putting pressure on interest rates, the end result was a decline in the quality and liquidity of “commercial” bank assets.

The solution to the commercial banks’ dire need for additional sources of revenue was provided by the McFadden Act, which allowed national banks to “buy and sell without recourse marketable obligations in the form of bonds, notes or debentures, commonly known as investment securities ... This did not include the power to buy and sell stocks” (VALENTINE, 1951, p. 400).

Despite the expansion in activities that the Act allowed, National banks went further and side-stepped regulation of their activities by organizing independent securities affiliates under state charters.

Generally speaking it may be said that by 1929 in the field of long-term financing the commercial banks and their affiliates occupied a position comparable to that of private investment bankers from the standpoint of physical facilities, capital employed, and the volume of securities underwritten and distributed (op. cit., 1951, p. 401).
The combination of functions in a single institution, deplored by Brandeis, was thus reconstituted. After the 1929 stock market collapse, conditions facing commercial banks deteriorated rapidly. Currie noted that

If economic progress continues to be associated with the increasing importance of larger corporations having access to the stock and bond markets, there is a strong probability that the commercial loan will continue to decline in the future. The decline in the commercial loan, in other words, appears to be intimately related to the changing structure of business which is bringing about a change in the methods of financing of business (CURRIE, 1934, p. 41).

He suggests that banks will be left with savings deposits as a source of funding individual lending, while other institutions should be expected to emerge to meet any lending demand beyond the ability of these banks (op. cit., 1934, p. 152).

However, the bank holiday in 1933 and the depression produced a strong regulatory response in the form of the Glass-Steagall Act. While the major objective of the Act may be seen as the prudential regulation of banks to ensure the value of public deposits in terms of Federal Reserve notes, it did this by restoring the separation of commercial and investment banking, limiting the activities of deposit-taking commercial banks to short-term commercial lending. It thus followed Brandeis’ recommendation of establishing a direct correspondence between the definition of a regulated institution and its function in providing deposits, excluding investment banks from this activity.

The legislation clearly recognized that the difficulties had been caused by the declining profitability of commercial banks. Thus, effective regulation had to be compatible with a restoration of the profitability of commercial banks. At the time of the new regulations, roughly half of National bank earnings were generated by capital market activities. To substitute these now forbidden sources of earnings it provided a monopoly on deposits and limited over-banking through the Federal Deposit Insurance Corporation (FDIC) provision of deposit insurance against a subsidized premium, and limiting the costs of deposit funds by setting Federal Reserve Act Regulation Q governing interest rates on deposits at zero.

The second objective of the New Deal legislation was to protect individuals from the fraud and malfeasance that had been identified with the activities of the
state regulated securities affiliates of National banks. The regulation of the activities of firms in capital markets thus followed a similar logic to the Banking Act. Under the New Deal securities laws, all other financial firms, such as investment banks and securities firms, were defined as firms engaged in those activities that are excluded from commercial banks—namely securities. Indeed, these investment banks were included in Glass-Steagall 1933 only as an afterthought, because, although their primary activities were as underwriters and capital market intermediaries, they used little capital. However, they did hold substantial amounts of corporate client money on deposit, largely from the proceeds of underwriting for large commercial clients, rather than the general public. Thus, legislative consistency required that they should be treated just as other deposit takers. But this would have prevented them from operating their core business of underwriting and intermediation. Many investment banks thus chose to cease taking deposits, limiting the financing of their activities to borrowing in private capital markets or using partner’s capital.

In contrast to commercial banks, regulation of these “excluded” financial institutions was undertaken in an entirely different way, through the creation of the U. S. Securities and Exchange Commission (SEC). Rather than being based on the definition of the type of institution, regulatory authority was based on the assets dealt in by the financial institution: i.e., they were prohibited transactions deposits, but were allowed dealing in securities. Regulation was thus based on the definition of the product—the type of security, independently of the organization—or on the definition of the firm as a broker, or a dealer, underwriter or primary investor. All institutions undertaking such activities were classified by exclusion as investment banks. This is because the New Deal legislators were more concerned with protecting the individuals investing in securities than in regulating the activities of the firms that traded and sold securities. The major organizing principle of the SEC was thus “sunshine”—providing transparency, rather than providing prudential regulation through capital or loan-loss reserves.

Together the restrictions on permissible activities and protection of those activities were intended to provide support for the two basic functions of the
financial system, providing a safe and secure transactions system by insuring the value of transactions deposits in insured banks and ensuring that financing was available to business borrowers to support their ongoing production operations, leaving the long-term funding of business investments to uninsured financial institutions specializing in capital market activities. This was the famous separation of banking and finance that was the rule in US regulation from 1933 until the 1970s.

3 CHANGES TO THE REGULATORY STRUCTURE BEFORE THE 2007-2008 CRISIS

However, as the crisis of the 1930s faded from memory, economists began to view these protections as creating a monopoly for deposit-taking banks that like other market restrictions would produce economic inefficiencies in the operation of the protected banks themselves, which would eventually render them vulnerable to competition from more efficient non-regulated institutions. Indeed, it was argued that these market restrictions were not only unnecessary to provide financial stability, but that they might produce the opposite result. Characteristic of this position is the statement that

most of the individual proposals focused on increasing bank safety by decreasing competition in a particular area. (...) [thus] the Act, taken as a whole, was blatantly anticompetitive. (...) The commercial banking sector became progressively disadvantaged relative to other sectors that could offer similar products with fewer restrictions. (...) Today, there is general agreement among economists that most, if not all, of the restrictions imposed by the Banking Act no longer are necessary, if they ever were, at least for restricting risk (KAUFMAN 198, p. 184-185).

The result was a movement to remove restrictions on the operations of financial institutions that culminated in the 1999 Gramm-Leach-Bliley Act, which eliminated Glass-Steagall separation and created the possibility of bank holding companies free to operate subsidiaries free to operate in any aspect of financial services. However, by the time the Act was passed most of the 1933 restrictions and limitations had already been removed by administrative decisions of regulators or by appeal to the judicial process. Section 16 of the Act allows to regulated banks “all such incidental powers as shall be necessary to carry on the business of
banking” (KROOSS, ibid.: 2755). Most of the exceptions that allowed commercial banks to meet the innovative competition from non-insured banks and led to the progressive erosion of Glass-Steagall came in interpretations of the phrase “incidental powers”. Already in 1981 a Supreme Court decision affirmed that Sections 16 and 21 apply only to banks and not to bank holding companies. The FDIC thus decided that the prohibitions on securities trading of section 21 of the Glass-Steagall Act should not extend to subsidiaries of insured nonmember banks. But it was the OCC that was most active in extending the operation of member banks to what had been presumed to be prohibited securities activities through liberal interpretation of “incidental powers” to cover activities that are not specifically mentioned as being compatible with the “business of banking” in Section 16. As a result of increased globalization, regulators were concerned not only with the safety and soundness of financial institutions but also with the ability of US banks to compete on a global scale. In the international regulatory environment, Glass-Steagall was an anomaly, and in many countries universal banking—allowing banks to engage in all types of financial services—was the norm. Thus, in conditions of rising US external account deficits, supporting global expansion of US banks became an additional objective of regulation.

Thus at the end of 1999 the Gramm-Leach-Bliley Act (GLB), as it’s commonly known, abolished the segregation of financial institutions by financial activity that had been imposed under Glass-Steagall and instead allowed for the creation of integrated financial holding companies that could provide any combination of financial services. This was the culmination of a long-term initiative orchestrated by the financial services industry to repeal the New Deal legislation. It was based on the argument that there were substantial economies to be achieved by cross-sales of financial services and the resulting possibility to increase the internal cross-hedging of risks within large multifunction financial conglomerates. It was claimed that the symbiosis across different financial services would increase incomes for financial service providers as well as decrease the risks borne by the larger institutions. Thus, the 1999 Act simply ratified changes that had already taken effect in the market place and the courts. This was the regulatory structure
that was in operation at the outset of the crisis with large bank holding companies operating with very little regulation in all aspects of financial services.

The introduction of integrated multifunction financial service corporations had two important consequences. First, it implied that financial holdings companies would be much larger than either commercial deposit-taking banks or noninsured investment banks had been in the past, since expansion would not be limited to the provision of any particular service as had been the case under Glass-Steagall. In the case of investment banks, size had been constrained by the prohibition on raising core deposits and their partnership structure. The latter constraint was removed when investment banks converted to limited-liability public companies to raise capital in equity markets. Until the deregulation of capital markets in the mid 1970s, the NYSE forbade such listing; the move was initiated by the brokerage firm Donaldson, Lufkin & Jenrette, to be followed in the 1980s by the larger investment banks, the last being Goldman Sachs, in preparation for the repeal of Glass-Steagall in 1998.

Second, the economies of scale and risk reduction that resulted from internal cross-hedging of positions meant that risk was more broadly spread across different activities, and thus increased the correlation of risks across different activities. However, as reported by the Senior Supervisors Group, even if this did occur, it appears that there was very little sharing of information concerning exposures in different functions of the conglomerate financial institutions—what has come to be called the “silo” mentality of financial management, in which information remains isolated in each separate activity of the financial institution. The result of cross-hedging and product integration was the creation of financial conglomerates that were both too big and too integrated to allow any of them to be resolved when they became insolvent. Indeed, rather than distributing risk to those most able to bear it, risk was distributed and redistributed until it became impossible to locate who was in fact the counterparty responsible for bearing the

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2 Senior Supervisors Group was formed to assess how weaknesses in risk management and internal controls contributed to industry distress during the financial crisis, and comprised senior supervisors from seven financial agencies: the French Banking Commission, German Federal Financial Supervisory Authority, Swiss Federal Banking Commission, UK Financial Services Authority, and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Federal Reserve. For their joint review, see SSG 2008.
risk. Counterparty risk thus joined the more traditional funding/liquidity and interest rate risks facing financial institutions. It replaced what was initially the most important of bank risks: lending or credit risk.

With respect to the origin of the recent crisis in the supervision of mortgage lending, even before the 1999 Act, bank holding companies had opened mortgage affiliates, or purchased independent consumer finance companies originating subprime mortgages. The Federal Reserve was granted responsibility for the supervision of bank holding companies, but it decided that these mortgage affiliates would not be supervised for compliance federal laws protecting borrowers since they had not been previously subject to regulation. In January 1998 the Board of Governors unanimously decided to formalize a long-standing practice, “to not conduct consumer compliance examinations of, nor to investigate consumer complaints regarding, nonbank subsidiaries of bank holding companies.” This decision was then applied to any nonbank that became the affiliate of a bank holding company. A 1999 report by the General Accounting Office warned that the Fed’s decision created “a lack of regulatory oversight,” because the Fed alone was in a position to supervise the affiliates. Its role as regulator of bank holding companies was strengthened in the GLB Act, but was only exercised for mortgages originated through the deposit-taking banking affiliate of the holding company.

Thus just as banks were moving their capital exposure to mortgage lending off balance sheet through the creation of special purpose entities, they moved these activities outside the purview of regulators by creating and acquiring mortgage affiliates that were technically regulated by the Fed, but that the Fed had declared as being outside the purview of Fed supervision. As a result, around 13 percent of the national total of subprime loans made between 2004 and 2007 by bank affiliates were de facto unregulated even though the Federal Reserve had de jure power to do so. (HOUSING AND URBAN DEVELOPMENT, 2000, p. 29) A 2000 joint report on predatory lending by the Treasury Department and the Department of Housing and Urban Development had noted the failure of the Fed to
use its authority to investigate evidence of abusive lending practices, and urged a policy of targeted examinations, long before the current abuses commenced.

4 URGENT TEMPORARY MEASURES IN RESPONSE TO THE CRISIS

It is not the objective of this paper to explain the advent and development of the crisis. This has already been done elsewhere. However, important to an understanding of the subsequent regulatory response is the range of emergency support measures that were introduced as the crisis evolved and which provide the context for the subsequent Congressional legislative actions.

The response to the crisis has been based on the idea that it was unforeseeable, due to the equivalent of a 500 year flood, to a highly improbable “perfect storm” of factors unlikely to be repeated; once the damage has been brought under control by eliminating the “toxic” mortgage backed assets, the financial system would be restored to health. The idea was to use urgent measures to restore liquidity and restore bank lending to normal. This was the logic behind the initial ‘troubled asset relief program’ (TARP) passed by the US Congress in 2008 to remove the toxic assets from the banks’ balance sheets and provide new capital, and in the actions of the Federal Reserve to extend access to lender of last resort support at its discount window to all financial, and some non-financial institutions, as well as to engage in a ‘zero interest rate policy’ (ZIRP) and ‘quantitative easing’ (QE) to reduce interest rates on medium term government securities. It doubled its balance sheet to over 2 trillion, nearly half of which was mortgage securities. The FDIC also provided lending guarantees amounting to $300 billion to large banks, and the Government Sponsored Enterprises Fannie Mae and Freddie Mac purchased over $100 billion of securitized mortgage obligations. In addition, the Internal Revenue Service provided tax exemptions to banks assuming the assets of failed banks. Estimates of total support including implied guarantees reach $14 trillion (PRINS, 2010).

Graph 1
Composition of Federal Reserve balance sheet
(In billions US$)

Source: Federal Reserve System Statistical Release H.4.1
PS.: Maiden 1: net portfolio holdings of Maiden Lane Limited Liability Companies (LLC);
MMIFL: net portfolio holdings of LLCs funded through the Money Market Investor Funding Facility
TALF: loans extended through Term Asset-Backed Securities Loan Facility;
AIG: sum of credit extended to American International Group, Inc. plus net portfolio holdings of Maiden Lane II and III;
ABCP: loans extended to Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility;
PDCF: loans extended to primary dealer and other broker-dealer credit;
Discount: sum of primary credit, secondary credit, and seasonal credit;
Swaps: central bank liquidity swaps;
CPLF: net portfolio holdings of LLCs funded through the Commercial Paper Funding Facility;
TAC: term auction credit;
MBS: mortgage-backed securities held outright;
RP: repurchase agreements;
Agency: federal agency debt securities held outright;
MISC: sum of float, gold stock, special drawing rights certificate account, and Treasury currency outstanding;
Other FR: Other Federal Reserve assets;
Treasury: U.S. Treasury securities held outright.

However, as can be seen from the accompanying charts (graphs 2 to 4), there has been no increase in bank lending, rather the reverse has been the case. Thus, the urgent measures have succeeded in preventing further insolvency in large financial institutions, but they have done little to return financial markets to normal.
Graph 2
Large bank commercial and industrial (C&I) lending – greater than US$ 10 billion assets sheet

(In billions US$)

Source: Institutional Risk Analytics

Graph 3
Middle/small bank commercial and industrial (C&I) lending - less than US$ 10 billion assets sheet

(In billions US$)

Source: Institutional Risk Analytics
Graph 4
Securities holdings of 25 largest bank holding companies
(In %)

Source: Federal Reserve System Statistical Release H.4.1
PS.: Treasury: US treasury securities held outright;
Agency: US government agency obligations excluding MBS;
Muni: municipal bond - bond issued by an American city or other local government, or their agencies;
Agy Pass: a mortgage-backed pass-through security - created when one or more mortgage holders form a collection (pool) of mortgages, and sells shares or participation certificates in the pool;
CMO: collateralized mortgage obligation from an agency;
1-4 (Family) PMBS: residential 1-4 private mortgage backed securities;
ABS: asset backed securities;
Structured Debt : structured debt instruments, domestic and foreign;
Equities: mutual funds and equity instruments;
CMBS: commercial mortgage backed securities including pass-thru's;
SFP: structured finance products.

5 RECOVERY OF LARGE BANK HOLDING COMPANIES: BUSINESS AS USUAL?

The graph of the securities holding of the 25 largest bank holding companies shows that while there was no increase in lending to finance
construction and industrial activities, these banks did increase their holdings of structured debt and structured finance products. In addition, the largest bank holding companies reported sharp increases in earnings, mainly due to their proprietary trading activities in fixed income, currencies and commodities, and underwriting. Aside from the increase in spreads due to increased concentration in investment banking, this increase was largely due to the ability to access funds at an average of less than 1 per cent. Indeed, one bank reported that it was able to do repo funding at -0.5 per cent.

Graph 5
Quarterly net interest margins
(In %)

Source: FDIC Quarterly Banking Profile, Ratios by Asset Size Group.
Graph 6
Return on average equity for US banks

Source: Federal Reserve Bank of St. Louis.
Nota: ¹ Average assets greater than U$ 15 billion (USG15ROE); between U$ 1 billion and U$ 15 billion (US115ROE); and between U$ 300 million and U$ 1 billion (US$ 31 ROE).
Ps.: shaded areas indicate US recessions.

6 CONGRESS PROPOSES REFORMS: PROTECT THE TAXPAYER

As a result of this recovery in bank performance for large bank holding companies the urgency for radical reform that was present in the Autumn of 2008 largely dissipated. The basic objective behind the reform shifted from restructuring the financial system to ensuring constituent taxpayers that Congress had taken radical steps to ensure that in future financial institutions will be responsible for the costs of failure. Protection of the taxpayer from having to finance financial sector bailouts thus replaced the stability of the financial system as the major objective of the reform process. Since the FIDC has an efficient process for resolving insolvent insured banks of small and medium size, but is thought to be unable to apply this process to large bank holding companies whose bankruptcy may cause systemic disruption, this has meant that the major emphasis has been on the problem of dealing with banks that are too big or too interconnected to fail. Indeed the FDIC has closed over 300 small and medium sized banks since the beginning of 2008 without any loss in insured deposits or creating any market disruption. However,
this process has not been used for the largest insured banks that have received direct financial support from the Treasury TARP program and from the Federal Reserve, the FDIC and the GSEs, as outlined above in the discussion on the recovery in earnings of these banks. In addition, the process does not apply to financial institutions that are not part of the insurance system, such as Bear Stearns, Lehman, American International Group (AIG). Thus the centre piece of the legislation is a procedure for closing down all types of financial institution that are considered as systemically relevant – jargon for too big to fail.

Aside from the major life support measures (TARP, the stimulus bill, ZIRP, and QE), the major response has been that we cannot let “It”—another Great Depression—happen again. Many recognize that radical changes are required in the regulations governing the financial system to make sure that such widespread support measures will never again be necessary to prevent the collapse of the financial system. Congress thus moved rapidly to write and approve a major overhaul of financial market regulations, with the rallying cry that the American taxpayer will never again be required to finance the bailout of Wall Street and Wall Street will never again bring about the collapse of Main Street.

7 HOW TO PREVENT “IT” FROM HAPPENING AGAIN?

The starting point of Hyman Minsky’s approach to financial regulation was the observation that the subject could not be discussed on the basis of a theory in which financial disruption was impossible. Thus the theory could not be one in which instability was a rare or random occurrence: a black swan or a five hundred year flood. Minsky, on the other hand, believed that regulation could only be discussed within a theory that allowed for financial distress as a normal occurrence in the normal development of the economic system. Even in the presence of the perfect operation of complete markets, Minsky’s approach suggested that the financial system would become increasingly exposed to financial disruption and, eventually, a systemic breakdown in the form of a financial crisis. It was to fill this gap in existing theory that he developed the financial instability hypothesis, to
provide a framework for discussing regulation that might provide a more stable, and more equitable, financial system. Despite the formulation of this approach in the 1960s and its continued adaptation and adjustment to evolving conditions in financial markets, it has never been used as the basis for regulation of the financial system. Now that the recent financial meltdown has been dubbed a “Minsky moment,” perhaps it is time to recognize that the greatest contribution of his theory is provision of a basis for the formulation of financial regulation.

8 BACKGROUNDS TO THE CRISIS: MULTIPLE CAUSES

It is widely believed that the recent crisis in the US financial system was caused by difficulties that originated in the sub-prime mortgage market. Lax and/or fraudulent lending standards by mortgage originators, high liquidity levels due to lax Fed monetary policy, underestimates of risk due to conflicts of interest in the credit ratings agencies, lack of due diligence due to inappropriate incentives in financial institutions, ineffective application and gaps in existing regulations and bipartisan political support for generalized home ownership all combined to create an avalanche of mortgage assets whose value depended on continually increasing incomes of mortgage holders and continual increases in the prices of the houses that provided the underlying collateral. The former was never a realistic assumption, and when house prices started to fall, it soon became obvious that the securities collateralized with these mortgages were massively overvalued, if not valueless. The success of the market was thus a “Ponzi” scheme or a “house of cards”. The collapse in the values of housing collateral thus brought a capital loss to both households who had mortgage debt that was greater than the market value of the house it financed, and the value of the securities held by financial institutions who had originated the securities and held them on their books was less than the funds that had been borrowed to purchase them. The result was insolvency for millions of US households as well as for financial institutions. The failure to meet mortgage servicing and widespread default, and repossessions of collateral accelerated the decline in housing prices and the value of the mortgage securities,
leading to a process of debt deflation that soon brought a collapse of demand, and a liquidity crisis that brought a collapse of lending by banks to each other and to the private business sector that combined to produce a sharp decline in real sector activity and rising employment. The result was the deepest US recession and financial crisis in history.

9 REFORM IN THE AFTERMATH OF THE CRISIS: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

The basic objective behind both the House and Senate financial sector reform bills has been to ensure constituent taxpayers that Congress has taken steps to ensure that financial institutions will be responsible for the costs of failure of financial institutions. Protection of the taxpayer from having to finance financial sector bailouts has thus replaced the stability of the financial system at the centre of the reform process. This has meant that the major emphasis has been on the problem of dealing with banks that are too big or too interconnected to fail. In addition, the belief that much of the damage from the sale and securitisation of sub-prime mortgages was due to predatory and/or fraudulent practices of financial institutions has led to the proposal for protection of the taxpayer from predatory business practices in the form of a financial products safety commission. The two major components of the reform are thus the resolution of large banks and the safety commission. The presumption is that the business models and practices of the post-1999 financial system are basically sound if these prophylactic measures are introduced.

The current approach to regulation embodied in the Dodd-Frank legislation continues to be based on the mainstream theoretical framework that sees stability in complete markets, and synergy in the provision and hedging of financial services.\(^3\) It thus accepts that US banks will continue to be large and integrated.

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\(^3\) Reuters notes that “cross-selling between Bank of America and Merrill Lynch, something that many thought would be difficult” improved in 2010; “the wealth management division, mainly Merrill Lynch and US Trust, took in more than 5,300 referrals from other divisions at Bank of America, more than three times the referrals in 2009. The wealth management unit also referred more than 8,000 clients to the commercial and banking and markets divisions, a 71 percent increase over 2009.” Note that this refers primarily to marketing rather than cost efficiency in provision of services or in risk management.
Indeed, Treasury Secretary Geithner has supported the view that the current size of US banks, which has increased substantially as a result of the resolutions undertaken during the crisis, is desired and even necessary if they are to compete in global markets. According to a New Republic interviewer,

[Geithner] told me he subscribes to the view that the world is on the cusp of a major ‘financial deepening’: As developing economies in the most populous countries mature, they will demand more and increasingly sophisticated financial services, the same way they demand cars for their growing middle classes and information technology for their corporations. If that’s true, then we should want US banks positioned to compete abroad. . . . ‘I don’t have any enthusiasm for . . . trying to shrink the relative importance of the financial system in our economy as a test of reform, because we have to think about the fact that we operate in the broader world,’ he said” (SCHEIBER 2011).

Geithner went on: “Now financial firms are different because of the risk, but you can contain that through regulation.” This was the purpose of the recent financial reform, he said.

Thus, the basic theoretical argument that large, integrated financial institutions create synergy in providing a broad range of financial services and reduce risk by pooling is maintained by those who are most influential in “reform,” while the difficulties these institutions caused in the financial crisis will be managed by better regulation and provisions to ensure that if they do collapse, they will be allowed to fail without requiring support from public funds. The two major pillars of the reform package are regulations to better manage the risks undertaken by large, “systemically significant” financial institutions, and the means to force them into bankruptcy liquidation without the need for anything but temporary public assistance. The problems faced in the last crisis are not seen to result from the size of multifunction institutions but from the failure to allow them to fail without

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4 The interview continued: “I asked Geithner if he had a grand vision for the post-crisis landscape—for, say, a less bloated financial sector with a smaller role in the economy—and a map for how to get there. Could he be a figure like George Marshall, who helped win the World War and then remade Europe so that it couldn’t happen again?

“Geithner hunched his shoulders, pressed his knees together, and lifted his heels up off the ground—an almost childlike expression of glee. ‘We’re going, like, existential,’ he said. He told me he subscribes to the view that the world is on the cusp of a major ‘financial deepening’: As developing economies in the most populous countries mature, they will demand more and increasingly sophisticated financial services, the same way they demand cars for their growing middle classes and information technology for their corporations. If that’s true, then we should want U.S. banks positioned to compete abroad.

‘I don’t have any enthusiasm for . . . trying to shrink the relative importance of the financial system in our economy as a test of reform, because we have to think about the fact that we operate in the broader world,’ he said. ‘It’s the same thing for Microsoft or anything else. We want U.S. firms to benefit from that.’ He continued: ‘Now financial firms are different because of the risk, but you can contain that through regulation.’ This was the purpose of the recent financial reform, he said. In effect, Geithner was arguing that we should be as comfortable linking the fate of our economy to Wall Street as to automakers or Silicon Valley.”
public assistance. This is seen as the result of the absence of a formal mechanism for bankruptcy that applies to all bank and nonbank financial institutions. Thus, banks will be allowed to function more or less as before the crisis, within financial holding companies, but to be subject to clear rules on their rapid dissolution rather than their resolution.

Minsky, on the other hand, basing his views on a theory that says financial disruption is a natural consequence of the operation of the system, would have argued that it is impossible to formulate regulations that would ensure the absence of financial disruption. Regulators should thus be concerned, not only by the size of banks, but also by their operations as multifunction financial service providers. Financial innovation will always be driven by regulatory arbitrage, and as a result there can be no assurance that regulations can make large financial institutions safe from crisis. Indeed, the very idea that large banks will be allowed to fail means that banks will continue to become ever larger since a bank that is resolved or wound up will have to have its insured liabilities absorbed by an existing bank or reconstituted under new management. In either case banks will continue to grow in size. The best example of this is the growth in the size of the largest banks as a result of the resolution of failed banks in the recent crisis. The answer to Minsky’s rhetorical question, “Can ‘It’ happen again?” would once again be in the affirmative.

Finally, the approach to reform continues to support the idea that markets provide efficient price discovery. This is the case not only for the pricing of financial assets but also for compensation. While many economists have noted the distorted incentive structure determining compensation for traders as well as management, the response has been proposals to limit compensation. It has not generally been recognized that these are structural difficulties linked to the shift in the business model for financial institutions. The shift in the generation of bank profits from net interest income generated by originating loans and ensuring that they do not default, to the generation of profits from fees, commissions, and trading incomes by originating loans and selling them as rapidly as possible (or taking position and unloading it at a profit as rapidly as possible), produces an incentive to take on
higher risk exposures but reduces the risk of loss for the institution, and eliminates it for management.

This is more than the idea of the private appropriation of profit and the socialization of losses. As long as position taking is financed with external funding there will be a compensation structure with zero risk of loss and only the possibility of profit. In the leveraged buyout period in the 1980s, corporate raiders earned incomes irrespective of losses, which would be the responsibility of the bond or equity holders. Michael Milken also provided a system in which losses were not the responsibility of the junk bond issuers but rather shifted to capital markets. The current expansion of what is now called “shadow banking” functions on the same principle: the originator earns the fees and any short-term profits while capital market investors take the losses. It is the structure of financial transactions that generates the distorted incentives and simple limits, caps, or temporal structures will have little impact on the support this system gives to increased risk taking and financial fragility. This sort of activity is what Minsky identified as “money manager” capitalism, in which the manager of institutional funds earns a return irrespective of results but has an incentive to take higher risks because he does not participate in any losses. Since the current approach to reform leaves the basic business model of finance intact, it also leaves the distortions on incentives intact.

The centerpiece of the Dodd-Frank legislation is the creation of the Financial Stability Oversight Council (FSOC). It has the objective of providing collective accountability for identifying risks and responding to emerging threats to financial stability. The Council has the mandate and authority to identify all systemically important institutions, both financial and nonfinancial, that contribute excessive risk to the operation of the financial system and to avoid the regulatory gaps that existed before the recent crisis, to help minimize the risk of a nonbank financial firm threatening the stability of the financial system. It has the ability to apply additional regulations to them in addition to those stipulated by their applicable regulatory agency. This means that virtually any financial or nonfinancial institution may be designated systemically important allowing the Council to impose conditions to eliminate any threat to financial instability. The FSOC is also mandated to identify
emerging risks to financial stability via direction to, and requests for, data and analyses from the Office of Financial Research, which was also created by the Act.

Despite this charge, Treasury Secretary Geithner, who heads the Council, has stated that in his view it is not possible to create effective, objective criteria for evaluating the risk a financial firm poses to the system. “It depends too much on the state of the world at the time. You won’t be able to make a judgment about what’s systemic and what’s not until you know the nature of the shock.” This would make the identification of systemically important financial and nonfinancial firms difficult and make the identification of emergent risks nearly impossible. Geithner added that lenders would simply “migrate around” whatever objective criteria of emergent risks or significant institutions that policymakers developed in advance.

With reference to the requirement that resolution of insolvent firms should be undertaken without government bailouts or taxpayer support for shareholders or management, Geithner takes the contrary view that “In the future, we may have to do exceptional things again if we face a shock that large. . . . You just don’t know what’s systemic and what’s not until you know the nature of the shock” (SIGTARP 2011).

While the classification and enhanced regulation of systemically important institutions is intended to reduce the moral hazard, it is more likely that this may reinforce the existing perception that they are indeed “too big to fail” and allow for excessive risk-taking on the part of those institutions or their creditors. The idea of identifying specific institutions as systemically significant also seems to miss Minsky’s explanation of the endogenous creation of systemic risk that is not specific to institutions, but rather the result of how the system evolves over time and changes structure in response to regulation and innovation. One of the failures of the Bank for International Settlements (BIS) requirements to prevent crisis is that they function on the principle that if each individual bank can be made to follow commonly accepted standards and codes then none can contaminate any other in the system. The decision on which and how many institutions will be classified as systemically significant is still a matter of debate, but may be significant in generating moral hazard if it creates the perception that the additional regulation
and oversight applied to designated institutions provides some sort of increased guarantee of solvency. The real problem is to identify the endogenous accretion of fragile financing structures, and to recognize their potential impact on systemic stability.

10 VOLCKER RULE

Most of the regulatory actions in the Dodd-Frank Act call for measures to correct difficulties that have emerged from the multifunction banking that was permitted by the 1999 Gramm-Leach-Bliley Modernization of Financial Services Act. The FSOC is responsible for implementing the most important of these measures, the so-called “Volcker rule” provisions set out in section 619 of the Dodd-Frank Act that calls for limitations on the use of proprietary funds for financial speculation by banking entities that benefit from federal insurance, or any explicit or implicit government guarantees. The separation of the use of depositors’ funds for bank business-lending operations and the use of deposits for any operations in securities markets, except those provided as a complement to client services, was the fulcrum of the Glass-Steagall regulations. The intention was to prevent banks from using retail deposit funds, guaranteed by the new government insurance fund, for speculative trading to earn profits on movements in the price of securities. Such activity was to be limited to noninsured investment banks whose partners used their own capital resources to generate income by underwriting and trading in securities. In the 1980s, most investment banks were transformed into limited-liability corporations and eventually became bank holding companies, eliminating the relation between the kind of investment activity and kind of funding in distinct types of financial institution.

Since it is no longer possible under the 1999 Act to separate the use of deposit funds from the proprietary trading financed by bank capital, such trading can produce losses that jeopardize the bank’s ability to repay depositors, thus requiring the Federal Deposit Insurance Corporation (FDIC) to meet the losses entailed in risks that were undertaken and should be borne by the bank’s owners
and managers. The Volcker amendment thus seeks to preclude the use of the capital of the financial institution for the purposes of proprietary trading—that is, trading in which the bank acts as principal—if the bank qualifies for any government support for losses to its depositors.

The intention of the rule is to prevent banks from using any of its deposits or capital funds to take leveraged risks on positions whose value is determined by changes in the price of financial assets, and, in particular, to limit the use of leverage that has been a traditional part of such activities. In general, the leverage that is associated with speculative and arbitrage activities is in noninsured areas such as repo markets and other commercial borrowing, so the rule implicitly seeks to limit the leverage that can be generated by funding proprietary trading in repo markets or in undermargined or nonmargined over-the-counter derivatives structures.

Since the rule would exclude bank activities that provide services to clients, there is also difficulty in determining when such precluded activities are required for supporting client requests for services and when they are simply for the bank’s own activities. For example, a bank providing foreign exchange or interest rate hedging services may find it necessary to warehouse such contracts in order to provide the best execution for clients, and it would be difficult to differentiate such activities from pure proprietary speculation. As noted above, all these difficulties were avoided under Glass-Steagall’s simple proscription on securities trading by insured deposit-taking banks. The difficulties in the interpretation of the Volcker rule would thus seem to stem from an attempt to reintroduce Glass-Steagall separation of activities within the Gramm-Leach-Bliley Act in which they are permitted.

Some of the difficulties raised by the Volcker rule are dealt with in another of the major areas of regulation in the bill: the ability of banks to operate and act as dealers in derivative contracts, and the formal transfer of derivatives clearing and trading to regulated market institutions. The former deals with the so-called “Lincoln amendment” that sought to prohibit banks active in the swaps markets from receiving various forms of “federal assistance,” including federal deposit
insurance and access to the Fed discount window or any Fed credit facility. However, the amendment also created difficulties due to the retention of existing Gramm-Leach-Bliley legislation and emerged with a push-out provision that allowed insured entities to continue their derivatives activities under certain conditions.

The central portion of the regulation forbids federal assistance for a generic category, “swaps entities,” that is defined as “any swap dealer, security-based swap dealer, major swap participant, [or] major security-based swap participant.” In turn, swap dealers and security-based swap dealers are persons or entities that hold themselves out as swap dealers, make markets in swaps, regularly enter into swaps with counterparties as an ordinary course of business for their own accounts, or engage in any activity causing them to be commonly known in the industry as swap dealers or market makers. However, even if an entity is not classified as a “swaps dealer,” it may nonetheless be classified as a “major swap participant” or “major security-based swap participant” subject to the regulation if it maintains “substantial positions” in swaps, or if it possesses outstanding swaps that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets.

Since this provision, which is to come into effect in July 2012, would create substantial difficulties for banks in providing derivatives-based client services, or in using such instruments to hedge their own risks via the use of derivative contracts, the “push out” provision would allow banks to retain Federal insurance and support if their swap activities are carried out through an affiliate. The insured entities could then directly engage in their own and certain client-based hedging activities without being classified as swap dealers. The affiliates may be created by any depository institution that is part of either a bank holding company or savings-and-loan holding company, on condition that the affiliate complies with sections 23A and 23B of the Federal Reserve Act and any other requirements that the Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), and Fed may determine necessary. In effect, this is the equivalent of the section 20
exemption under Glass-Steagall that permitted commercial banks limited securities-market activities.

The activities that can be engaged in by the insured entity itself include acting as principal in swaps with customers in connection with originating loans for those customers; engaging in “de minimis” swaps dealing; entering swap agreements for the purposes of “hedging and other similar risk mitigating activities directly related to the insured depository institution’s activities”; and acting as swaps entities for activities involving rates or reference assets that are permissible for investment by a national bank. Again, these mirror exemptions that had already been approved under Glass-Steagall and did much to undermine its application. Regulations specifying the formal content of these limits and definition are to be formulated by the SEC and CFTC as appropriate.

11 SWAPS AND FUTURES REGULATION

These exemptions do not, however, apply to credit default swaps (CDSs) unless they are cleared through derivatives-clearing regulations that are called for under the Act. The financial industry fought hard to limit reforms on the trading of CDSs to the requirement that they be cleared, arguing that this would be sufficient to ensure safety. However, Greenberger (2010) has argued that, while clearing regulations would help to ensure capital adequacy of trading partners, this alone is not sufficient protection. For example, Greenberger states that the following regulations are necessary as well: transparency of pricing and of the trading party identities, prudential and competency regulation of intermediaries, adequate self-regulation by the industry to help regulators, complete record keeping, prohibitions on fraud and manipulation, full disclosure to regulators and counterparties, and competent private enforcement. This would create a structure similar to stock market rules, regulations, and operating procedures. Exchange trading, strict antifraud requirements that are enforced by state and federal governments, and bans on “abusive” CDSs that are designed to cause economic injury (through
bankruptcy) were seen to be needed to prevent a repeat of the problems that led up to the crisis.

It is interesting that a new market in synthetic collateralized debt obligations is rapidly developing, based on the sharp increase in junk bond issuances that has been stimulated by the low interest rates and spreads in the corporate bond market. The instruments enable investors to take a position on the junk bond market without holding a long position in the underlying instruments. They are created through derivatives on junk bond indices and resemble the instruments that created such difficulty in the mortgage market, while providing exposure similar to a credit default swap. It is not clear that the new regulations will be able to prevent a like collapse in the event of a rapid increase in policy rates, spreads, or junk bond default rates.

The full implementation of the Volcker and Lincoln amendments requires provisions to shift over-the-counter (OTC) trading in derivatives onto federally mandated clearing mechanisms and regulated markets. The Act thus calls for the creation of a comprehensive framework for the regulation, clearing, and exchange trading of OTC derivatives. Now defined as “swap” contracts, federal legislation has always excluded them from similar formal regulations that originated in the initial regulation of futures contracts in 1922. This is due in part to the fact that futures contracts were initially developed in the agricultural sector and thus were subject to commodity futures trading regulation monitored by the CFTC, while other derivatives contracts were primarily financial and therefore under the regulatory rubric of the SEC. Thus, although futures contracts, whether of a financial or commodity nature, could not be legally traded outside of a formally regulated market without a specific exemption, other derivatives were always fully exempt and thus developed in the OTC market. The current regulation thus seeks to apply the exchange and clearing regulations of futures to virtually all standardized swap contracts.

While swaps and futures represent similar “time” contracts, swaps, unlike futures, were customized to the specific commercial hedging needs of businesses
and financial institutions; and, as noted, financial institutions initially acted as intermediaries bringing together swap counterparties in private bilateral negotiations. Since most of these contracts were negotiated without exchange of principal, risk exposure was limited to marginal changes in the market price of the contracts and prescriptive regulation was not considered necessary. As banks began to take on principal positions as counterparties to client requests, they also accepted risk on the nonperformance of counterparties, but this was also considered minimal. The most popular swaps contracts were interest rate and Forex swaps, which were generated by the breakdown of the Bretton Woods system of fixed exchange rates and have since become an integral part of the hedging in the flexible interest and exchange rates in the international financial system. As they increased in volume, the International Swaps and Derivatives Association provided standardized terms and documentation, reducing the need for specific conditions and bilateral negotiation.

The definition of swaps in the Act covers most commonly traded OTC derivatives, including options on interest rates, currencies, commodities, securities, indices, and various other financial or economic interests or property; contracts in which payments and deliveries are dependent on the occurrence or nonoccurrence of certain contingencies (e.g., a credit default swap); and swaps on rates and currencies, total return swaps, and various other common swap transactions.

Due to the parallel development of commodity-based and financial-based contracts, the Act defines and provides for a common approach to “security-based swaps,” which are generally swap transactions involving a single security or loan or a narrow-based security index. In broad terms, these will be regulated by the SEC while “commodity swaps” will be regulated by the CFTC, preserving the historical division of labor between the two agencies.

Another high-volume area of the market that might be considered a prime example of contracts that might benefit from regulated market trading are foreign exchange swaps and forward contracts. These contracts are primarily the domain of banks and are currently exempt from regulatory oversight. They will be subject
to regulation under the Act; however, given the major participation of banks in providing client services and the traditional absence of regulation since the breakdown of the Bretton Woods system, the Act provides the Treasury secretary with the power to exclude them from regulation if the contracts negotiated have not been structured to evade the reach of the legislation. This exemption is expected in the near future.

Banks, dealers, and other financial institutions active in the derivatives markets may be classified as “(security) swap dealers”—that is, any person who holds himself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties as an ordinary course of business for his own account, or engages in any activity causing him to be commonly known in the trade as a dealer or market maker in swaps—and will become subject to registration and record-keeping requirements.

Given the prominent role in providing client services, a number of institutions will be exempt from classification as (security) swap dealers: an insured depository institution, to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer; an entity that buys or sells swaps for such person's own account, either individually or in a fiduciary capacity, and not as “part of a regular business”; and an entity that engages in a “de minimis quantity” of swap dealing in connection with transactions with or on behalf of its customers.

The major obligation of swap dealers will be the application of minimum capital standards and initial and variation margin requirements for swaps that are not cleared as required by the appropriate prudential regulatory agency or commission.

12 TOO BIG TO FAIL: DEALING WITH INSOLVENT INSTITUTIONS

As noted, the major sections of the Act do little to reverse the trend toward larger and larger multifunction bank conglomerates. Indeed, it does not create any limits on their size, interconnectedness, or leverage. Nor does it seek to reverse the increase in the largest financial firms that has occurred as a result of the urgent
measures to deal with the crisis. The ratio of assets to GDP controlled by JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley has risen three fold between 1995 and 2010 to over 60 percent of our nation’s GDP. The share of total deposits controlled by the five largest banks has risen over four fold to over 45 percent.

The Act attempts to deal with the increased risks presented by the continued growth of such institutions by creating a system for the dissolution of such institutions when they become insolvent. Indeed, the overarching theme of the Act is not so much to prevent crises as to preclude the possibility of using public funds in meeting losses or rescuing insolvent institutions. This is understandable considering the criticism of the use of the TARP program to sustain and recapitalize insolvent financial institutions while insolvent households were forced into foreclosure. Congress clearly wanted to wash its hands of any responsibility for the use of public funds in support of financial institutions.

The absence of a common legal framework for dealing with insolvent institutions was one of the main difficulties noted by regulators in responding to the recent crisis. For example, the Federal Reserve has argued that it had no mandate to act in the case of Lehman Brothers, while the Treasury had no mandate to impose bankruptcy on AIG. In the absence of clear FDIC authority to resolve noninsured, nonbank financial institutions, direct government support appeared to be the sole alternative. Title II of the Dodd-Frank Act is meant to meet this difficulty through the creation of an “orderly liquidation authority” (OLA) that gives the FDIC power to seize control of such institutions on the determination by the Treasury secretary that they threaten the financial stability of the United States. It mandates the FDIC to liquidate such designated institutions so as to maximize the value received from the disposition of the company’s assets, minimize any loss, mitigate the potential for serious adverse effects to the financial system, ensure timely and adequate competition, and fair and consistent treatment of bidders on assets and deposits, and prohibit discrimination.
According to the Act, implementing orderly liquidation requires that the FDIC determine that such action is necessary for purposes of the financial stability of the United States, and not for the purpose of preserving the covered financial company; ensure that the shareholders of a covered financial company do not receive payment until after all other claims and the Deposit Insurance Fund are fully paid; ensure that unsecured creditors bear losses in accordance with the priority of claims; ensure that the management and board of directors responsible for the failed condition of the covered financial company are removed (if still present at the time at which the FDIC is appointed receiver); and not take an equity interest in or become a shareholder of any covered financial company or any covered subsidiary.

Another reason for the use of direct government intervention in the recent crisis was the need for rapid action in order to prevent further deterioration of the financial condition of the institutions in difficulty and the risk of contagion. However, under OLA, the determination by the Treasury secretary has to be made on recommendation of certain designated federal regulatory authorities (such as the FSOC) and with an evaluation of why the institution should not be dealt with under the Bankruptcy Code, and after consultation with the president. The Act also requires that before the Treasury secretary can make the determination that the FDIC should be appointed receiver, he must first make a requisite series of specific underlying findings, including that the company is in default or is in danger of default; that should the company so default, the resolution of the company under the otherwise applicable federal or state law would have serious adverse consequences for the financial stability of the United States; that there are no private sector alternatives available that would avoid such adverse consequences; that there are no inappropriate potential effects on the claims or interests of creditors, counterparties, or shareholders that would result from such appointment; and that the seizure of such company under an OLA will prevent or otherwise limit damage to the financial stability of the United States (analysis must consider the effectiveness of such seizure in mitigating the potential adverse effects on the financial system, the cost of such resolution to the general fund of the Treasury,
and the potential of such seizure and resolution for increasing excessive risk taking going forward). The provision also mandates that the financial industry pay (after the fact) for the costs of any such dissolution activity undertaken by the FDIC.

The powers granted to the FDIC as the liquidator are thus very similar to those currently in use for insured institutions, including, where necessary, the ability to continue the operations of a designated institution by means of an unencumbered bridge bank. The Act empowers the FDIC to establish such rules and regulations as it deems necessary or appropriate for implementing an OLA. This is one area in which its operations concerning insured and noninsured designated institutions will differ. In its resolution of normally insured depositary institutions, the FDIC has considered the assets transferred by the institutions to an arm’s-length Special Purpose Vehicle via structured financing securitization, as claimable by secured creditors. However, the FDIC has indicated that it does not intend to apply this procedure in implementing the new OLA, thus protecting assets transferred to a special entity from the liquidation.

One of the difficulties faced by the FDIC in dealing with the resolution of large banks is the limited size of the deposit insurance funds (just like the Federal Savings and Loan Insurance Corporation in the 1980s!). While the ultimate source of funds is the federal government, and thus the Federal Reserve, the idea is that it should be self-financing, based on insurance premia charged to the insured institutions. Given the leitmotif of the Act to eliminate the use of public funds to rescue the financial system, Dodd-Frank mandates measures to increase the size of the insurance fund, as well as measures to adapt the premia to the risk that institutions introduce into the system.

The Act in Section 334 thus raises the minimum designated reserve ratio of fund assets to insured deposits (DRR), which the FDIC must set each year, to 1.35 percent (from the former minimum of 1.15 percent), and removed the upper limit on the DRR (which was formerly capped at 1.5 percent) and therefore on the size of the fund; required that the fund reserve ratio reach 1.35 percent by September 30, 2020 (rather than 1.15 percent by the end of 2016, as formerly stipulated); required
that, in setting assessments, the FDIC offset the effect of (requiring that the reserve ratio reach 1.35 percent by September 30, 2020 rather than 1.15 percent by the end of 2016) on insured depository institutions with total consolidated assets of less than $10,000,000,000; eliminated the requirement that the FDIC provide dividends from the fund when the reserve ratio is between 1.35 percent and 1.5 percent; and maintained the FDIC’s authority to declare dividends when the reserve ratio at the end of a calendar year is at least 1.5 percent, in addition to granting the FDIC sole discretion in determining whether to suspend or limit the declaration or payment of dividends. The FDIC has acted to exceed the requirements of the Act, raising the DRR to 2 percent in 2011.

The Act also requires that the FDIC amend its regulations to redefine the assessment base used for calculating deposit insurance assessments. Under Dodd-Frank, the assessment base must, with some possible exceptions, equal average consolidated total assets minus average tangible equity. The FDIC has proposed eliminating risk categories and the use of long-term debt issuer ratings for large institutions, using a scorecard method to calculate assessment rates for large and highly complex institutions, and retaining the ability to make a limited adjustment after considering information not included in the scorecard. The final rule will define a large institution as an insured depository institution that had assets of $10 billion or more as of December 31, 2006 (unless, by reporting assets of less than $10 billion for four consecutive quarters since then, it has become a small institution); or that had assets of less than $10 billion as of December 31, 2006, but has since held $10 billion or more in total assets for at least four consecutive quarters, whether or not the institution is new. In almost all cases, an insured depository institution that has held $10 billion or more in total assets for four consecutive quarters will have a CAMELS score; however, in the rare event that such an institution has not yet received a CAMELS rating, it will be given a weighted average CAMELS rating of 2 for assessment purposes until actual

5 US Regulators use a rating scale of 1 to 5 based on a series of indicators to assess the soundness of a bank. They include (C) Capital adequacy, (A) Asset quality, (M) Management, (E) Earnings, (L) Liquidity, (S) Sensitivity to market risk.
CAMELS ratings are assigned. An insured branch of a foreign bank is excluded from the definition of a large institution.

On the insurance provided by the Depositors Insurance Fund, the Act calls in the FDIC to fully insure the net amount that any member or depositor at an insured credit union maintains in a noninterest-bearing transaction account. Such amount shall not be taken into account when computing the net amount due to such member or depositor. The normal insurance level remains at $250,000 for each separate, normal interest-bearing account.

Many commentators have suggested that while the FDIC was unwilling to intervene to resolve “too big to fail” institutions, it was certainly able to do so. This position has been made very forcefully by Thomas Hoenig (HOENIG, 2009), president of the Federal Reserve District Bank of Kansas City, on the basis of his experience in dealing with the resolution of Continental Illinois Bank. To facilitate the ability of the FDIC to deal with these very large financial institutions (which, as already noted, Dodd-Frank considers a fact of life), the Act mandates the formulation of so-called “living wills” in the form of the preparation of resolution plans and credit exposure reports. The position has also been supported by Dallas Federal Reserve President Richard Fisher.

Rosner on the other hand notes that

it was neither the failure of Lehman Brothers nor any supposed mortal deficiency of the Bankruptcy Code that necessitated bailouts. Rather ... it was a panicked reaction of regulators who rushed to pay out the creditors of AIG, frightened markets, and exacerbated the crisis. After all, within days of its failure, much of Lehman was sold to Barclays and a relatively orderly bankruptcy process ensued (ROSNER, 2011).

He notes that already in April 1999 in the aftermath of the collapse of Long Term Capital Management,

the President’s Working Group on Financial Markets recognized that the derivatives termination rules in the Bankruptcy Code work well to facilitate the continued functioning of derivatives markets when a financial firm fails, but that in very rare instances, where the failing firm has concentrated a great deal of risk, the rules may not be adequate in mitigating market volatility. The Working Group stressed the need for new bankruptcy rules but it did not, however, recommend an entirely new and overreaching resolution regime (op. cit).
Yet this is precisely what is proposed in Dodd-Frank.

Rosner considers the fact that Dodd-Frank creates two different regimes under which a large financial firm can be wound up: traditional bankruptcy and the OLA as a fundamental flaw in Dodd-Frank’s approach to too big to fail. He notes that

The value of a firm in its ‘going concern’ state is dependent on the resolution process employed when it fails. All non-financial firms and most financial institutions use the Bankruptcy Code; commercial banks use the FDIC; broker-dealers use Securities Investor Protection Corporation. There may be different systems for different types of firms, but there are not, and there should not be, multiple processes for the same firm. In sum, the absolute worst thing that regulators can do is exactly what they’re doing now: signaling to the public and the markets, ex ante, which firms will cause systemic instability and then providing a U.S. Treasury-funded bailout scheme through the Orderly Liquidation Authority. Where investors have great certainty and clarity about the workings of the U.S. bankruptcy process, the Orderly Liquidation Authority’s dangerous subjectivity, increased opacity, preference for short-term creditors, and ambiguity in how it will treat similarly situated creditors will only increase the uncertainty among creditors of a failing institution and cause necessary risk capital to pause at precisely the time their capital is most needed.

13 RESOLUTION PLANS: THE LIVING DEAD

The Act calls upon the Board of Governors of the Fed to require nonbank financial companies and bank holding companies that it supervises to periodically report the plan of such company for rapid and orderly resolution in the event of material financial distress or failure, which shall include: information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company; full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company; identification of the cross-guarantees tied to different securities; identification of major counterparties; and a process for determining to whom the collateral of the company is pledged.

In addition, the Act calls for credit exposure reports covering the nature and extent to which the company has credit exposure to other significant nonbank financial companies and significant bank holding companies, and the nature and
extent to which other significant nonbank financial companies and significant bank holding companies have credit exposure to that company.

The Fed and the FDIC will review these reports, and if, based on their review, the resolution plan of a nonbank financial company supervised by the Board of Governors or a bank holding company is not credible or would not facilitate an orderly resolution of the company, shall notify the company of the deficiencies in the resolution plan; the company shall resubmit the resolution plan within a timeframe determined by the Fed and the FDIC with revisions demonstrating that the plan is credible and would result in an orderly resolution, including any proposed changes in business operations and corporate structure to facilitate implementation of the plan.

The “living will” is thus designed to show ex ante that some firms are too big to fail, and will clearly put the major burden on large multifunction banks with complex global operations, such as Citigroup, Bank of America, JPMorgan Chase, Goldman Sachs, and Morgan Stanley. The head of the FDIC has recently suggested that the inability of a big bank to provide a credible resolution plan would be a condition for requiring that it be broken up by the transformation of its foreign operations into foreign subsidiaries subject to foreign regulators, in order to realign its legal structure and, if necessary, make it easier for regulators to liquidate the bank. “If they can't show they can be resolved in a bankruptcy-like process . . . then they should be downsized now,” said FDIC Chairman Sheila C. Bair. The aim of orderly liquidation is to avoid a repeat of 2008, when the Bush administration bailed out AIG and other firms but not Lehman Brothers. Lehman's bankruptcy virtually froze capital markets.

Minsky always promoted smaller banking institutions as a way to ensure local management and local knowledge could be used in the assessment of creditworthiness. He favored the imposition of the originate-and-hold banking model, which would have incentive structures that promoted financial stability rather than risk taking. Finally, he believed that promotion of small-to-medium-sized financial institutions would be more consistent with a general policy biased
against concentration of economic power—in both the financial and nonfinancial sectors. He would thus have been less willing to emphasize an OLA and resolution plans and more in favor of breaking up the large financial holding companies. It is interesting that under Glass-Steagall, banks were given one year to divest themselves of their securities affiliates and other prohibited activities, and there were no difficulties in meeting this timetable.

14 PROVISION OF LIQUIDITY

The main instrument of Federal Reserve support during the crisis was its authority to open the discount window in urgent and exigent circumstances, as stipulated in section 13(3) of the Federal Reserve Act, to virtually any financial or nonfinancial institution against virtually any type of collateral. As a result of the express desire of Congress to ensure that no support be given to failing financial institutions, the Dodd-Frank Act seeks to ensure that the Fed’s discretion to provide emergency support to insolvent institutions does not circumvent an OLA. The Act thus calls on the Board of Governors,

in consultation with the Secretary of the Treasury, to establish the policies and procedures to ensure that any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, and that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion. The policies and procedures established by the Board shall require that a Federal reserve bank assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan executed by a Federal reserve bank (Section 1101).

In addition, the Act requires the Fed to establish procedures to prohibit borrowing from programs and facilities by insolvent borrowers. Further, it limits the ability of the Board to establish any emergency facility without the prior approval of the Treasury secretary, and, if approval is obtained, to report within seven days to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, providing the justification for the assistance; the identity of the recipients; the date, amount, and form in which the assistance was provided; and complete particulars of the assistance. The particulars include
duration; collateral pledged and the value thereof; all interest, fees, and other revenue or items of value to be received in exchange for the assistance; any requirements imposed on the recipient with respect to employee compensation, distribution of dividends, or any other corporate decision in exchange for the assistance; the expected costs to the taxpayers of such assistance; and similar information be reported every subsequent 30 days, with respect to any outstanding loan or other financial assistance.

And if such reporting were not sufficient, the Act gives the comptroller general of the United States the power to conduct audits, including onsite examinations, of the Board of Governors, a Federal Reserve Bank, or a credit facility, if the comptroller determines that such audits are appropriate, solely for the purpose of assessing, with respect to a credit facility or a covered transaction, the operational integrity, accounting, financial reporting, and internal controls governing the credit facility or covered transaction; the effectiveness of the security and collateral policies established for the facility or covered transaction in mitigating risk to the relevant Federal Reserve Bank and taxpayers; whether the credit facility or the conduct of a covered transaction inappropriately favors one or more specific participants over other institutions eligible to utilize the facility; and the policies governing the use, selection, or payment of third-party contractors by or for any credit facility or to conduct any covered transaction.

From his very early work on the reform of the Fed discount window, Minsky argued that the emergency actions provided by section 13(3) should be made permanent and part of the ordinary operation of the discount window. For Minsky, the reason was quite obvious: there is only one financial institution that does not face a liquidity constraint, and that is the Federal Reserve. As Chairman Bernanke has reiterated, the Fed has the ability to provide liquidity at the push of a computer key. In a complex, layered financial system in which every institution's liabilities must have a higher liquidity premium than its assets, all institutions ultimately rely on the banking system for support in the case of a shortfall of cash inflows and the need to refinance their liabilities. And the banking system relies on the Fed. Thus, limiting discount lending to the banks means allowing a liquidity crisis to morph into
an insolvency crisis in the rest of the financial system before it reaches the banks and access to the discount window becomes an option. Better to lend directly to the institutions facing liquidity difficulties. Indeed, this is what the Fed did in the current crisis, and it is the source of the criticism that the agency was bailing out insolvent institutions. However, the problem was that the Fed extended the reach of the discount window only after a crisis broke out. It provided support only after Bear Stearns was in difficulty, but then extended support to all equivalent institutions. The same was true in the case of Lehman, which was allowed to fail—and then the window was opened to other broker-dealer institutions. For Minsky, it would have been much better to open the window to these institutions as a matter of course, which might have prevented their decline into insolvency. Use of the liquidity facilities early on also could have been made transparent, leaving the Fed less open to the criticism that it was picking winning and losers.

For Minsky, opening the window would have provided the Fed with a “window” into the operations of the institutions seeking support, which would have alerted it much more quickly to the condition of their balance sheets. Instead of continually arguing that the crisis was contained, the Fed, had it been the lender to all financial institutions, would have known much earlier how much the decline in house prices and the markets for securitized structure had impacted all financial institutions.

15 THE FUTURE OF SECURITIZATION: RISK RETENTION

For many, abuse of securitization was at the root of the financial crisis. It was certainly a crucial part of the shift to the originate-and-distribute business model adopted by most large financial institutions and the rise of off balance sheet entities and shadow banks. It also was a source of significant fraudulent activity. It is therefore not surprising that Dodd-Frank Act should propose regulation of these structures. However, the new regulations are not extensive and are limited to the imposition of requirements for credit risk retention requirements of not less than 5 percent for securitizers and, in certain circumstances, originators of asset-backed
securities. Issuers of a Qualified Residential Mortgage (the characteristics of which have yet to be defined by regulators) or the originator of the asset that meets minimum underwriting standards to be determined by the appropriate regulatory agencies will be exempt from the risk retention requirement. This is based on the presumption that if banks had retained some risk, they would have been more diligent in monitoring the quality of the mortgages that they securitized. Yet, in actual fact, one of the causes of the large losses experienced by institutions engaged in securitization was that they had voluntarily retained a substantial amount of investment grade tranches of subprime securitizations. Indeed, in this case, having skin in the game did not lead to greater concern for asset quality, but was a cause of increased instability.

In a study prepared under the mandate in Dodd-Frank, the FSOC (2011) offers several principles and recommendations that should inform the design of a risk-retention framework, so as to strengthen the securitization process and facilitate economic growth by allowing market participants to price credit risk more accurately and allocate capital more efficiently.

The study argues that a risk-retention framework should seek to meet the following objectives: align incentives without changing the basic structure and objectives of securitization transactions; provide for greater certainty and confidence among market participants; promote efficiency of capital allocation; preserve flexibility as markets and circumstances evolve; and allow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner.

A risk-retention framework can be structured in a number of ways to meet these objectives. The form of risk retention, allocation of risk retention to various participants in the securitization chain, amount of risk retention, allowances for risk management, and exemptions from risk retention—all are important variables in the design of any such framework. Although a risk retention framework can help align incentives and improve underwriting standards, the macroeconomic implications of risk retention are complex. A risk-retention framework can incent
better lending decisions and consequently help strengthen the quality of assets underlying a securitization. It may also help mitigate some of the procyclical effects that asset-backed securitization can have on the economy. However, if overly restrictive, risk retention could constrain the formation of credit, which could adversely impact economic growth. The challenge is to design a risk-retention framework that maximizes benefits while minimizing its costs.

It is interesting that the accounting conditions that determine whether or not securitizations can be considered off-balance-sheet nonrecourse sales of assets make no reference to "risk retention," leading to the possibility that the framework will not necessarily make these structures more transparent or better monitored. According to the Federal Reserve’s report to Congress on risk retention (BOARD OF GOVERNORS, 2010), a recourse agreement requiring the originator or holder of assets to absorb a percentage of the credit loss for the assets after sale would not appear to negate any of the conditions required for consolidation on the issuer’s balance sheet. However, it goes on to note that if the risk retention requirements increase the instances of consolidation of the assets and liabilities of an asset-backed security (ABS) entity, the agencies should consider the incentives that such an outcome would create.

This raises a number of issues. First, regulatory capital requirements for banking institutions generally state that consolidated assets must be risk weighted in the same way as assets on the balance sheet that have not been securitized. In addition, if balance-sheet assets are subject to either impairment analysis on a periodic basis or fair-value measurement, this would then apply to securitized assets that do not qualify for exclusion. If these assets require an allowance for credit losses, including loans and leases, this will affect earnings and regulatory capital. Assets measured at fair value, including many securities, also will affect earnings and regulatory capital. The impact on earnings and capital may continue to encourage institutions to engage in deal structuring for the purpose of achieving off-balance-sheet treatment. This may lead to the same arbitrage of activities that plagued Basel I, creating a wedge between economic risk and regulatory risk of the bank portfolio. Under Basel I risk weights, financial institutions were encouraged to
retain the riskiest assets in each category. Instead of solely economic factors determining an appropriate level of credit and liquidity protection necessary for ABS issuances, institutions might desire to retain only the minimum level of risk required by regulation, if the minimum level enabled the institution to avoid consolidation. Similarly, companies may be encouraged as a result of those earnings and capital effects to avoid consolidating assets and liabilities by ceding power over special entities when it is not feasible to limit benefits to an amount that meets regulatory requirements. For example, institutions may cede power over ABS issuance entities—which in some cases results from their ability to manage assets held by the issuance entities—by selling servicing rights or distancing themselves from their customers in order to avoid consolidating the assets and liabilities of the issuance entities. As a result, it is not clear that the de minimis 5 per cent “skin in the game” thresholds included in Dodd-Frank will inhibit the difficulties caused by off-balance-sheet entities in the recent crisis. It is also doubtful that these structures will, in fact, isolate the institutions from the impact of the performance of these assets. Indeed, in the recent crisis, virtually all of the risk of variable-interest entities and other off-balance-sheet activities were eventually subject to recourse and returned to bank balance sheets, further aggravating the crisis. For example, if the fees and trading profits earned by securitizing risky assets is believed by banks to more than offset the risk to capital of retaining a 5 percent share of “skin in the game,” then the rules will not change behavior. And there is the additional danger that, due to off-balance-sheet commitments, the true share could be much higher. Reforms should not be based on the presumption that banks want to avoid risks. Further, perceived risk depends on the operating environment—the “great moderation” lowered perceived risk across the spectrum of assets. That also changed behavior, because the reward for risk fell. This was probably a big impetus to bank activities that appeared to shift risk but in fact did not. Bank activities that appeared to shift risk but in fact did not.

Finally, it should be noted that the SEC had instigated changes in the regulation of securitization before the passage of the Dodd-Frank Act and has continued the process of consultation prior to final rule making in this area.
Securitization has been practiced since the 1970s without incident until the recent crisis. The objective should be to preserve the principle by producing regulation that prevents instability.

16 CAPITAL AND LEVERAGE RATIOS

Some commentators believe that the shift towards securitization was driven by the introduction of risk weighted capital ratios in the Basle requirements which increased the costs of certain types of investments for banks. There are other experts who argue that these requirements have become too detailed and too onerous and should be replaced by simpler traditional ratios of capital to gross assets and traditional liquidity ratios. Despite these criticisms the Act mandates the appropriate Federal banking agencies to establish minimum leverage and risk based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Board of Governors. The minimum leverage capital requirements proposed should not be quantitatively lower than the generally applicable leverage capital requirements that were in effect for insured depository institutions as of the date of enactment of this Act. In addition the Federal banking agencies are mandated to develop capital requirements applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Board of Governors that address the risks that the activities of such institutions pose, not only to the institution engaging in the activity, but to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity. Such rules shall address, at a minimum, the risks arising from significant volumes of activity in derivatives, securitized products purchased and sold, financial guarantees purchased and sold, securities borrowing and lending, and repurchase agreements and reverse repurchase agreements; concentrations in assets for which the values presented in financial reports are based on models rather than historical cost or prices deriving from deep and liquid 2-way markets; and concentrations in market
share for any activity that would substantially disrupt financial markets if the institution is forced to unexpectedly cease the activity.

Given international agreements, the impact of these provisions is to leave the determination of such ratios to the Basel Committee, and its proposals under Basel III, which were not available at the time of drafting the Act.

17 REFORM OF CREDIT RATING AGENCIES

Credit rating agencies and, in particular, nationally recognized statistical rating organizations (NRSROs) have been thought by many to be at the center of much of what went on in the market crisis, especially in the area of structured products. The agencies have come under significant criticism for their methodologies, lack of procedures, and conflicts of interest. Attempts to reform the role of credit rating agencies have been ongoing, reinforced with each financial crisis that breaks out without any prior indication of credit weakness appearing in the ratings issued. These regulatory changes have sought to provide an avenue for an increase in the number of NRSROs and to remove their role in regulation, but regulations have not been provided for the NRSROs themselves. For example, on September 17, 2009, the SEC moved to eliminate references to NRSROs in the “References in Rules and Forms” under the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Exchange Act, the Securities Act, the Investment Company Act, and the Investment Advisers Act.

Title IX of the Dodd-Frank Act breaks with the hands-off treatment and calls for the creation of an Office of Credit Rating with the authority to fine credit rating agencies, to administer the rules of the SEC regarding the practices of NRSROs. The Office will examine all NRSROs at least annually, with each examination to review the following: the NRSROs’ established procedures for assigning ratings, whether conflicts of interest are effectively managed, the NRSROs’ ethics policy, NRSRO corporate governance procedures; and the processing of complaints. The Office of Credit Rating will publish annual reports summarizing the findings of the examinations of the NRSROs.
All NRSROs will be required to establish, maintain, enforce, and document an effective internal control structure for determining credit ratings. They must submit annual internal controls reports, attested to by the CEO, to the SEC that describe management’s responsibility to establish and maintain effective internal controls for determining credit ratings. NRSRO compliance officers must prepare certified annual reports and submit those reports to management and the SEC. All NRSROs must disclose information on each initial credit rating assigned and on any subsequent changes to a credit rating. This information must be prepared to allow users of the credit rating to evaluate the accuracy of ratings and to compare the performance ratings of NRSROs. Further, NRSROs will have to disclose their use of third parties for due diligence efforts, and if an NRSRO is made aware of credible and significant information from other sources, it must consider that information in assigning a rating.

The Act also requires the removal of all references to credit ratings in various other statutory schemes—among them, the Federal Deposit Insurance Act, the Federal Housing Enterprises Financial Safety and Soundness Act, the Investment Company Act, and the Exchange Act—in order to eliminate overreliance on credit ratings. All Federal agencies must substitute references in regulations to credit ratings with other standards of creditworthiness.

In addition, the SEC must commission a study regarding the feasibility or desirability of standardizing credit ratings for all NRSROs, standardizing stress testing, requiring a quantitative correspondence between credit ratings and a range of default probabilities, and standardizing credit rating terminology; and the Government Accountability Office must conduct a study to evaluate different methods for compensating NRSROs in order to create more incentives for providing accurate ratings, as well as a study on the feasibility and desirability of creating an independent professional organization for rating NRSRO analysts. Thus, major reform of the operation and role of NRSROs remains to be determined after the completion of the mandated studies.
A key part of the new provisions deals with the structure of the rating agencies. Each NRSRO is required to have a board of directors, at least half of whom are independent. The board is charged with overseeing the implementation of internal controls regarding policies and procedures for determining ratings, as well as compensation and promotions within the organization. It is also responsible for overseeing the management of conflicts of interest through the implementation of appropriate policies and procedures.

The organization is required under the Act to maintain a documented, effective system of internal controls for determining ratings. The Commission is charged with requiring that each NRSRO prepare an annual report regarding its controls. The report must include an attestation by the CEO that describes the responsibility of management for establishing and maintaining the system. Each NRSRO is also required to designate a compliance officer. That officer cannot perform credit ratings or participate in marketing or sales activities. Likewise, the compensation of the officer cannot be tied to the financial performance of the organization. Rather, it must be arranged to assure independence.

The compliance office is charged with preparing an annual report addressing changes in the internal compliance procedures and code of ethics of the organization. The report must also examine compliance with the securities laws and the organization’s policies and procedures. The SEC is required to review the code of ethics and conflict of interest policy of the organization annually, and whenever there are material changes.

The Act also addresses the “revolving door” issue between NRSROs and their clients. In this regard, Dodd-Frank requires that each NRSRO report to the SEC employment of certain senior officers associated with the rating agency in the prior five years where the agency has issued a rating for an instrument during the 12-month period prior to the employment of that person.

Several sections of the Act address the potential liability or litigation defenses of NRSROs. These include the application of expert liability. NRSROs will now be liable under section 11 of the Securities Act. Dodd-Frank overrides
Rule 436, which exempted these organizations from being considered part of a registration statement. Accordingly, to include a report in a registration statement, consent from the NRSRO will have to be obtained. The Commission is required to remove the exemption for public dissemination of information received by credit rating agencies in the ratings process currently granted under SEC Regulation FDc. The Act also requires all federal agencies to review and modify regulations to remove references or reliance on credit ratings, and to substitute an alternative standard of creditworthiness. The Act specifies that statements made by credit rating agencies are subject to liability in the same manner as those of accounting firms and securities analysts under the federal securities laws.

Finally, Dodd-Frank requires the preparation of studies and reports that may impact the future regulation of credit rating agencies. These include a report to Congress on the credit rating process for these products within 24 months of conclusion. It must include a study regarding the feasibility of establishing an independent organization to assign NRSROs to determine credit rating agencies, a report on the independence of NRSROs and how this impacts ratings, a study on the feasibility and desirability of standardizing credit rating terminology across credit rating agencies and asset classes, and a study of alternative means for compensating NRSROs to create incentives for more accurate ratings.

The SEC had already made some regulatory references to assigning ratings on a voluntary basis in 2009, but the Act now makes this obligatory. The SEC has indicated that it will resuscitate a plan it proposed in 2008, whereby rating references will be removed from the simplified registration form designed to expedite the process for a primary offering of public securities. Companies can qualify for this process if the debt is given an investment grade rating, so an alternative will need to be proposed—for example, a history of issue of more than $1 billion in nonconvertible debt securities over a three-year period. An alternative will also need to be provided for the qualification of securities held by money market mutual funds.
The difficulties surrounding the removal of ratings from formal regulations and the suspension of the liability exemption for NRSROs is visible in the fact that SEC regulations requiring credit ratings for public securitization issues remain to be eliminated at a future date, while the removal of the legal liability for ratings they issue went into effect upon passage of the Act. As a result, the rating agencies announced that they would no longer allow their ratings to appear in registration documents for new securitizations. Immediately after the passage of the Act, the SEC was forced to announce a six-month ratings exemption in registration statements for securitizations other than those issued as private placements under Rule 144a.

18 THE ROLE OF HEDGE FUNDS AND THE REFORMS

While hedge funds suffered substantial losses of both asset value and clients as a result of the crisis, it is generally believed that they played little role in the genesis of the crisis and those that were negatively impacted have been closed through normal processes of asset redemption—although with significant restrictions on the timing of payouts. Thus, the Dodd-Frank legislation does not create substantial new regulations for hedge funds. The two basic provisions are the possibility that the FSOC may classify a large fund as systemically important, and thus subject to additional regulations similar to those applied to other regulated institutions; or as a major swaps participant or swaps dealer, and thus subject to the swaps regulation discussed above.

The other basic change is the requirement on registration and record keeping. For funds in the managed-asset range of $25 million to $100 million, registration is required in the state of residence, unless the state does not have an exam requirement; if funds operate in more than 15 states that require registration, then SEC registration substitutes. For funds with managed assets exceeding $100 million, SEC registration is required unless the assets are under $150 million and deal only with private funds. As noted above, the Volcker rule prohibits banks from owning more than a certain share of hedge funds. This regulation is meant to
ensure that a bank might use a hedge fund in the same way it uses a securities affiliate.

As noted, there are exemptions that depend on the sophistication and net wealth of the investor in the case of private sales of assets by certain financial institutions. The value of the investor's house that has been included in the calculation of investor net wealth will now be excluded, although this may seem a case of acting after the horse has bolted.

On the other hand, given the restrictions placed on banks' proprietary and speculative activities, it is likely that hedge funds will continue to grow in size and number. Indeed, many banks that have shut down their proprietary trading desks have shifted personnel into client asset management units or seen their best traders leave to form stand-alone hedge funds—often with the backing of the bank they are leaving.

19 MULTIPLE AND OVERLAPPING REGULATORY AUTHORITIES

One of the criticisms that have traditionally been made of US financial regulation is the existence of multiple regulatory agencies, often with overlapping mandates. This is in part due to the federal structure of the United States, which leaves jurisdiction over certain activities to the individual states. For example, while the Constitution forbids the issue of currency by the states, it does not prevent them from chartering banks, with the result that there is an overlap between state and federal regulations. When the federal government attempted to regain its monopoly on the issue of bank notes in order to provide a uniform, national currency, it created the Office of the Comptroller of the Currency to oversee the national banks that issued the notes. Thrift institutions had their own state and federal regulatory structure, and when the Federal Reserve was created, it, too, took on regulatory powers, overseeing the issue of Federal Reserve notes. The introduction of deposit insurance under the New Deal led to the creation of the FDIC to operate that system, as well as the creation of the SEC. The CFTC was created to oversee agricultural futures. The current reform legislation does not
resolve this problem, and only eliminates one regulatory agency, the Office of Thrift Supervision (OTS). There are few thrifts still in existence, and the OTC had a reputation for lax oversight, which led to agency shopping; this was the regulatory agency that was responsible for AIG, and Countrywide made acquisitions designed to bring it under the authority of the OTC.

On the other hand, the Federal Reserve’s regulatory responsibilities were sharply increased, and it is now charged with overseeing all systemically important institutions as well as those classified as such by the FSOC. As a result, the potential conflict between the Fed’s role in designing and implementing price and output stabilization policy and undertaking the responsibility for financial stability assigned it by the Act have substantially increased. Minsky continually highlighted the fact that these two regulatory functions would be competing rather than complementary, and that this conflict would increase financial fragility in the system. This conflict can be seen in the current criticisms of the quantitative easing policy implemented by the Fed in order to restore financial stability, but which many see as inflationary. Minsky was more concerned with those periods in which the Fed would use tight monetary policy to dampen the level of activity and at the same time cause speculative funding units to become Ponzi units as the restrictive policy caused cash inflows to shrink. An example would be the increase in interest rates at the beginning of 1994, which produced a bond market crash and a reduction in global wealth that was much larger than the stock market break of 1987.

It was for this reason that Minsky argued in favor of a greater role for the central bank in promoting financial stability, given its position as unconstrained lender to the rest of the system; in exchange, it would leave economic policy to the fiscal decisions of the Treasury. Despite the fact that many its critics have suggested that the Fed has usurped the fiscal policy role of the Treasury, it has nonetheless seen its power over economic policy increased as its role in maintaining financial stability has grown. Indeed, many argue that the next financial crisis may be generated by the withdrawal of quantitative easing to counter inflation, with the rise in interest rates causing collapsing bond prices and losses.
for financial institutions and households on their holdings of what they considered to be safe assets.

Rather than using variations in the Fed funds rate and open market purchases and sales to attempt to influence the decision of financial institutions to fund the spending decisions of the private sector, Minsky favored more direct influence over bank lending by ensuring that financial institutions were always short reserves; that is, that the normal state of affairs would be for financial institutions to borrow from the Fed at the discount window. By providing most reserves through lending (rather than through open market purchases), the Fed could influence lending by choosing assets it would accept for discounting. In this manner, it would refuse to discount assets that resulted from what it perceived to be imprudent lending (e.g., subprime mortgages in a real estate bubble). It would also provide the Fed with more immediate information on the lending activities, and the associated innovations, of financial institutions. As a lender to financial institutions, the Fed would have access to their portfolios—and could issue warnings and “cease and desist” orders as necessary. This is a system that has been practiced with success in Germany, where financial institutions were normally “in the bank”—that is, using Bundesbank credit on a normal basis.

In addition, the belief that much of the damage from the sale and securitisation of sub-prime mortgage was due to predatory and/or fraudulent practices of financial institutions has led to the proposal for protection of the taxpayer from predatory business practices in the form of a Financial Products Safety Commission. The major questions at issue here is whether the Commission would be independent or an appendage of the Federal Reserve and which institutions would be exempt from its mandate. Proposals for exemptions have been made that would cover some 80% of the financial system.

Title X, Subtitle A, Section 1011 provides for the establishment in the Federal Reserve System of an independent bureau to be known as the “Bureau of Consumer Financial Protection”, which shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial
laws. It will be responsible for implementing the Federal consumer financial laws through rules, orders, guidance, interpretations, statements of policy, examinations, and enforcement actions; and performing such other functions as may be authorized or required by law.

There was a great deal of pressure from industry to suppress this agency, and many believed that it should be independent on a basis similar to the Food and Drug Agency. In the end it was housed in the Federal Reserve, but with a substantial number of guarantees to insure that it was not controlled or influenced by the Fed.

In the same way as the FSOC, it will have a research unit that will research, analyze, and report on developments in markets for consumer financial products or services, including market areas of alternative consumer financial products or services with high growth rates and areas of risk to consumers; access to fair and affordable credit for traditionally underserved communities; consumer awareness, understanding, and use of disclosures and communications regarding consumer financial products or services; consumer awareness and understanding of costs, risks, and benefits of consumer financial products or services; consumer behavior with respect to consumer financial products or services, including performance on mortgage loans; and experiences of traditionally underserved consumers, including un-banked and under-banked consumers.

It will also have a unit whose functions shall include providing information, guidance, and technical assistance regarding the offering and provision of consumer financial products or services to traditionally underserved consumers and communities, as well as an Office of Fair Lending and Equal Opportunity to provide oversight and enforcement of Federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for both individuals and communities that are enforced by the Bureau, including the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act. The hope is that it should prevent the deceptive practices of mortgage brokers seen in the recent crisis. It will also establish an Office of Financial Education to support financial education and
financial literacy, again with the intention to make consumers more aware of deceptive practices and fraud in the provision of financial services.

20 CAN DODD-FRANK PREVENT “IT” FROM HAPPENING AGAIN?

While Dodd-Frank contains many generic proposals for improvements to supervision, regulation, and resolution of financial institutions, its full implementation will require over 200 rule-making provisions by regulatory agencies, over 60 special reports, and an additional 22 reports. Thus, the final form will be largely determined by the interaction between the political incentive for reform and the ability of the various government agencies to fulfill the intentions of the legislation. However, as noted, it leaves in place the underlying business model for financial institutions and the contradictions inherent in the 1999 legislation that was at the core of the crisis. Indeed, the underlying logic of the Fed and Treasury rescue operations has been to restore this system. If the problem was the structure of the financial system, then Dodd-Frank will not prevent another crisis. It is likely that the next crisis will be handled in a better manner. However, since the reforms do not envision a policy to reduce concentration and size, resolution will involve institutions at least as big as those that faced problems in 2007.

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