Solution

Repealing and Replacing Dodd-Frank

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Executive Summary

- The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) doesn't need to be entirely repealed and replaced. Rather, parts of it should be repealed, parts should be replaced, parts should be kept intact, some new parts should be created, and a few parts need to be tweaked.
- Among those parts that should be repealed entirely are the Volcker Rule, Financial Stability Oversight Council (FSOC), and derivatives rules.
- New financial legislation should create reform of the housing Government Sponsored Enterprises (Fannie Mae and Freddie Mac), narrow banking, and tweak Dodd-Frank's current plans for the Consumer Financial Protection Bureau and Orderly Liquidation Authority.

Introduction

Any time Congress passes and the president signs a several hundred (or thousand) page piece of sweeping legislation, there will be calls to "repeal and replace" that law. Such has been the case with Dodd-Frank, which was the target of demands to repeal and replace even before many of its requirements took effect. The problem is that repealing and replacing a law so expansive can never be that cut and dried.

Sure, there are parts that should be repealed entirely, and, there are sections that need to be replaced. But there are also parts of Dodd-Frank that are effective and that should be kept, and there are things that Dodd-Frank left out that should be legislated. There are also parts of Dodd-Frank that, while not ideal, are now political necessities and must be preserved, but should be tweaked to be workable.

This paper is a platform for repealing, replacing, keeping, creating, and tweaking Dodd-

Frank. As Congress moves forward with reforms to financial regulation, and specifically those to Dodd-Frank, it should consider more than just repealing and replacing the law. Instead, it should use all the tools in its belt to craft the most effective and efficient new law.

Repeal

While not all of Dodd-Frank demands total repeal, several significant sections do. The following sections should be repealed in their entirety, not replaced, and not tweaked:

The Volcker Rule

In the world of really expensive solutions looking for problems, Volcker may very well lead the pack. Premised entirely on the false assumption that the crisis was caused by proprietary trading, Volcker is set to cost banks $4.3 billion according to the government's own estimates. Not only that, Volcker statutorily limits banks' ability to "make market" by buying, selling, and holding inventories in various securities. As a result, the Volcker rule contributes to liquidity decreases and the cost of capital increases – two outcomes that were not only unintended, but counter to the very purpose of financial reform. Repealing Volcker would lower banks' compliance costs, increase market liquidity, and reduce the overall cost of capital – all desirable results.

FSOC

Dodd-Frank created the FSOC, which, among other things, is tasked with designating companies as Systemically Important Financial Institutions (SIFIs). Unfortunately for those companies and their customers these designations can be slapped on companies that pose no discernible systemic risk to the U.S. economy, like insurance companies MetLife and Prudential. Nevertheless, they are being subjected to intrusive, unnecessary regulation that dries up capital for infrastructure projects and harms investors and policy holders. To make matters worse, FSOC's process for designating these companies completely lacks transparency and doesn't allow companies to work with FSOC to shed their designation. FSOC would be a more palatable Dodd-Frank creation if its designation processes were modified to increase transparency, but the optimal step to take is to wholly repeal FSOC – all of the entities its designating and overseeing are already under the watchful eye of multiple regulators anyway.

Disclosure Rules

In the years following the financial crisis the Securities and Exchange Commission (SEC) wrote 32 disclosure rules costing over $11.9 billion because Dodd-Frank mandated that they do so – most of which were either duplicative or completely arbitrary. Take, for example, the

Conflict Minerals provision which turned out to be the costliest of the bunch ($4.7 billion) but didn't even touch American companies, much less banks or anyone having anything to do with the credit bubble.

Instead, thousands of miles away in the Democratic Republic of the Congo, a mining industry is being crippled as a result of Dodd-Frank's requirement that companies disclose whether they are receiving any "conflict minerals" – a designation made on a case-by-case basis by the International Conference on the Great Lakes Region. In response, the Congolese government shut down the entire mining industry in 2010 before proposing a certification process to assure U.S. companies that the minerals aren't coming from conflict zones. As of 2011, only 11 of more than 900 mines in South Kivu, Congo, met Dodd-Frank's standards, and the more than 11 million people who were employed in the mines are forced to find work elsewhere – oftentimes with an armed militia.

Dodd-Frank's unnecessary disclosure requirements take time and money from American businesses (and international industries). While some disclosure is a good thing, most of the new, arbitrary disclosure rules in Dodd-Frank were duplicative and should be repealed.

Derivatives Rules

Non-credit derivatives did not substantially contribute to nor cause the financial crisis. Yet the regulation that followed cracked down on them as if they were the sole source the meltdown. Most often referred to as the "push out" rule, Dodd-Frank required banks to "push out" swaps and other derivatives to bank affiliates so as to not be traded directly by the bank. This not only complicates things for bank customers who seek a "one stop shop" for their financial needs, but it makes banks more complex – one of the concerns Dodd-Frank specifically sought to curtail.

Further, Dodd-Frank levied strict rules on swap dealers and those that it deemed "major swap participants." Among them were margin requirements and fiduciary duties. Sure, margin requirements and fiduciary duties have their time and place, but for a product and its dealers that did not have a hand in the crisis, this batch of rules was a mistake and should be repealed.

Replace

"Replace" is a tricky category because the things that should be repealed should be repealed entirely and never comeback, so everything else would seem to fall into the "keep" or "tweak" categories. Nevertheless, there is one section of Dodd-Frank that should be "replaced" and that is the Volcker Rule. As explained above, Mr. Volcker's original rule attacking proprietary trading should be repealed, and in its place should be another proposal from Mr. Volcker that never made it into Dodd-Frank: get rid of the Office of the Comptroller of the Currency (OCC), and merge the SEC and the U.S. Commodity Futures Trading Commission (CFTC) into one agency.

The functions of the OCC could be satisfactorily replaced by adding a board member to the FDIC or another bank supervisor that would represent its interests. Merging the SEC and the CFTC into one entity would enhance regulatory efficiency and eliminate duplicative rulemakings and supervision, thereby reducing the paperwork burden and compliance costs for the entities (and their customers and clients) that those agencies oversee.

Keep

Capital Standards

Perhaps the best thing to come out of all the post-crisis regulations, stress tests, and life lessons were greater capital reserves for financial companies. Throughout the crisis, many of the banks that eventually failed were leveraged at ratios of 35 to 1 or greater. While profitable when the economy was doing well, these companies were extremely exposed to any market fluctuation. With that leverage, just a three percent drop in the value of a company's assets would make it technically insolvent. Add that to portfolios that also were highly concentrated in correlated housing assets, and a big part of the propagation mechanism for the disaster was in place.

Dodd-Frank's capital mandates sought to prevent this by requiring banks to hold minimum capital buffers at rates determined by the Fed. Currently JP Morgan is required the hold the highest amount of capital, at 4.5 percent of total assets, with the next seven largest institutions holding between 1 and 3.5 percent. These surcharges come at a cost: reduced lending activity, increased client fees, etc., but most can agree that the benefits from at least some increase in banks' capital cushions outweigh those costs.

Office of Credit Ratings

One of the greatest lessons to come out of the financial crisis was the importance of the credit rating agencies. One might think that leading Wall Street firms, with large quantitative capabilities could and would do their own due diligence on the MBSs, CDOs, synthetic CDOs and other securities that became toxic. Not so. Instead, leading up to the crisis, credit rating agencies erroneously rated toxic mortgage-backed securities and their derivatives as safe investments, and markets priced them accordingly. Purchases of these products climbed steadily for several years through 2006, and, as a result, there was a steep decline in mortgage underwriting standards and a simultaneous spike in poorly-underwritten mortgages.

In response, Dodd-Frank created the Office of Credit Ratings within the SEC and required credit rating agencies to explain in their reports any representations made to investors and how those representations differ from any representations made in similar analytical issuances. It also subjects credit rating agencies to liability under the Securities Act of 1933 and requires disclosures to the SEC not unlike those required of financial institutions. These are prudent concerns that should have a place in the tapestry of financial regulation.

Create

On the flip side of all the unnecessary regulations created by Dodd-Frank, there were some issues that played important roles in causing the crisis that Dodd-Frank did absolutely nothing to address. Most glaring of those omissions was any reform to Fannie Mae (Fannie) and Freddie Mac (Freddie) (the GSEs), the two housing giants whose failures beckoned a $187 billion taxpayer bailout. If any financial legislation is truly aiming to achieve financial stability, it must do something about Fannie and Freddie.

<u>GSE Reform</u>

Not only does Dodd-Frank fail to reform the GSEs, it specifically exempts them from Orderly Liquidation Authority (OLA) to ensure, as Barney Frank said, that the costs are "borne by taxpayers" and not the banks. And the bailout of the GSE's, which was in fact "borne by taxpayers," was the biggest bailout in history – more than AIG and General Motors and all the big banks combined. Further, now over five years since Dodd-Frank, the GSEs are still under conservatorship on the government dole and are lapsing back into their past habits of underpricing risk and purchasing low-down payment mortgages that fueled the last financial crisis.

Any true financial reform must include real reform of the GSEs and their overseer, the FHFA. That does not mean to recapitalize and release the GSEs back to their pre-crisis state with the freedom to return to their old ways that helped cause the crisis. Rather, real reform should make significant changes to the affordable housing goals put in place by HUD. Although the goals did not singlehandedly cause the crisis, they certainly complicated HUD's mission by blurring public purpose and pursuit of private profits. Before the crisis, despite failing to meet their goals, HUD continued to add subgoals and consistently raised the purchase percentages of existing goals to ever-higher levels. That business model is not sustainable, and should not be allowed to continue to put the risk on the taxpayers.

The effects of housing affordability reform will ultimately depend on the system put in place. Whether the new system has many players, maintains the flow of mortgage credit and protects taxpayers from liabilities is more important than any single fund or program. The most important components of housing finance reform are the mechanics of a new system and how to transition to it – or how to wind down the GSEs entirely.

Narrow Banking

Several versions of narrow banking have been proposed even long before the financial crisis as a way to prevent systemic failure in the financial system. Ranging from limiting banks to investing only in safe assets like Treasury bills to allowing the bank to lend but only to small firms, the general consensus is that a narrow bank would undertake deposits and payment activity but would not lend any of its deposits and would carry an extremely low amount of risk. In short, a narrow bank is a traditional deposit-taking bank that, under a new regulatory framework, is restricted from holding certain assets.

Some sort of narrow banking proposal should be included in future financial reform. Instead of slapping arbitrary regulations on banks of all sizes, the creation of narrow banking would allow the government to focus its strictest activity restrictions on the narrow banks, while allowing other, more traditional banks to take on appropriate amounts of risk and retain their liquidity and market-making capabilities.

Tweak

Dodd-Frank had several big swings that were big misses, namely the creation of the Consumer Financial Protection Bureau (CFPB) and the creation of Orderly Liquidation Authority (OLA). While the ideas behind the two were good policy priorities, the execution of both was so poor that they have ended up being more harmful than helpful. Future financial reform should include some semblance of both the CFPB and OLA, but the structure of both must be substantially tweaked.

CFPB

The idea to create a government agency that would police the bad actors in the consumer financial product space is a fine goal. However, a government agency with a sole, unaccountable director that is not required to go through the Congressional appropriations process and need not answer to anyone, is a horrible idea. Unfortunately, the latter is exactly what was created when the CFPB was born in Dodd-Frank.

Two fairly simple fixes could make the CFPB more transparent and accountable. As it stands now, CFPB can hand out individual mandates in the form of fines or settlements to companies or industries with little to no input from involved stakeholders. At the very least, having some sort of comment or reaction period before issuing a new policy or guidance would allow for a better analysis of the issues and hopefully would result in more effective rules.

Second, the CFPB should be subject to more checks and balances. Unlike any other agency, the CFPB is led only by a sole director, has a very difficult veto process (needing 7 of 10 votes to overturn any decision, one of which is by the CFPB director himself), and is not dependent upon appropriations (rather relying on a set, guaranteed fund from the Federal Reserve). For CFPB to be an effective agency, it must be subject to oversight, whether that is commission-based leadership, a fairer veto process, reliance on appropriations, or all of the above.

OLA

Proponents of Dodd-Frank's overreaching regulatory authority argued that big banks were too big and caused the financial crisis. They suggested that banks should not be allowed to become Too Big To Fail (TBTF), but, instead, should be treated like "any other company" and be allowed to fail and go through bankruptcy proceedings. (Notice, however, that TBTF is not a failure of the private sector. It stems from risk-averse policymakers being unwilling to do the right thing.) However, once the rules were implemented, they did just the opposite. Banks now have their own way of shutting down through OLA and don't have to go through bankruptcy proceedings like "any other company." In fact, OLA allows for future AIG-style bailouts in which the creditors and counterparties of a failed SIFI are made whole if regulators determine that such assistance is necessary to contain financial contagion. This is bad policy on its face.

Big banks' importance and inherent complexities justify the creation of specialized bankruptcy proceedings, but laws that codify TBTF and specifically allow for taxpayer bailouts are not the answer. OLA (or whatever its future iteration may be called) should give failing banks the opportunity to work with their regulators and their shareholders to go through their shutdown plans as described in their living wills and ensure that their shutdown is in fact orderly and does not unnecessarily adversely affect any involved (or uninvolved, for that matter) parties.