Insight

A Decade of Dodd-Frank: A Dodd-Frank Primer

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Executive Summary

– The Dodd-Frank Act, a sweeping overhaul of the U.S. financial system, was signed into law in July 2010, a decade ago.

– This primer, the first in a series of pieces focused on the impact of this controversial and deeply complex rulemaking, sets out in brief the contents of each Title of the Act.

– Dodd-Frank moved regulators beyond oversight and supervision to dictating risk policies at financial services firms, a dramatic evolution in the purpose of regulators.

Context

The 2007-2008 credit bubble, subprime mortgage crisis, and subsequent run on banks demonstrated structural and systemic weaknesses in the housing and financial market sectors. In June 2009 President Obama proposed a "sweeping overhaul of the United States financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression." So keen was President Obama that the legislative process actually began prior to receiving the report of the Financial Crisis Inquiry Commission (FCIC), which Congress created to investigate the crisis (membership included American Action Forum (AAF) President Doug Holtz-Eakin). Legislation in response to the president's proposal was introduced in the House of Representatives by Congressman Barney Frank and the Senate by Senator Chris Dodd, and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was enacted on July 21, 2010.

The implications of Dodd-Frank were, and continue to be, enormous, as the law revamped financial regulation in the United States. Dodd-Frank created new government agencies and empowered existing ones, touching on all aspects of financial services regulation as well as several industries wildly unrelated.

This primer is the first of several research pieces reviewing the implications of Dodd-Frank a decade after it was passed into law by first setting out in brief what the law contained, by act title, with links to further AAF writings on each subject.

Title I – Financial Stability

(Systemically) Risky Business

Title I of Dodd-Frank created two new agencies tasked to monitor systemic risk: the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR), both within the Treasury Department (Treasury). Dodd-Frank empowered government to impose more stringent regulation on firms deemed of systemic importance, known as systemically important financial institutions (SIFIs), which share a loose overlap with the less technical category of firms identified as "too big to fail." These "enhanced supervisory measures" included additional capital requirements, the requirement that SIFIs write "living wills" or recovery and resolution plans, and undergo annual stress testing.

Under the provisions of Dodd-Frank, all banks holding over $50 billion in assets were automatically designated as SIFIs. In addition to this designation authority, Dodd-Frank granted FSOC sweeping discretionary powers to identify non-bank financial services companies as SIFIs, were FSOC to determine that "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States." Some 30 U.S. banks were captured under Dodd-Frank; FSOC exercised its authority to additionally designate insurers AIG, MetLife, and Prudential and General Electric's financing arm, GE Capital. The $50 billion threshold for banks was later lifted to $250 billion by the Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155).

FSOC drew enormous ire from its inception. The factors used to determine SIFI status are not weighted, and as a result the decision-making process is extremely opaque. On multiple occasions, FSOC was reproached by the Government Accountability Office (GAO) for a lack of transparency. Although bank SIFIs have adjusted to the new normal effectively, FSOC's decision to include insurers instigated a multi-year legal battle ending with the de-designation of all insurers and GE Electric, leaving only banks in the system. As complicated as whom FSOC chose to identify is whom FSOC neglected to – never once turning its attention to any other actors, most notably asset managers, or Fannie Mae and Freddie Mac, the government-sponsored entities (GSEs) at the heart of the subprime mortgage crisis. In late 2019 FSOC indicated that it would shift from its ultimately unsuccessful attempts to designate nonbanks as systemically important and instead hew closer to the original mandate by shifting to lateral "activities-based" supervision. More recently, FSOC has received criticism not simply for failing to anticipate the impact of the coronavirus pandemic (a clearly systemic risk) but for failing to provide a plan to address the ongoing crisis.

Further reading:

6/26/2020 – U.S. Banks Sufficiently Capitalized Even Against Worst-Case Coronavirus Scenarios

11/1/2018 – A Measure of Regulatory Relief for Mid-Size Banks

10/18/2018 – The Unraveling of FSOC

10/16/2018 – Bank Capital Requirements: A Primer

08/29/2014 – What the FSOC are you Thinking?

Title II – Orderly Liquidation Authority

Liquid lunch

Title II of Dodd-Frank refurbished the federal approach to bankruptcy and for the first-time included insurers in their procedures. The purpose of the Orderly Liquidation Authority (OLA) was to allow the regulator of a financial services firm entering dire straits to bypass bankruptcy proceedings and instead enter a resolution process run by the Federal Deposit Insurance Corporation (FDIC), which can draw on funds appropriated from Treasury to fund the resolution. OLA provides the FDIC with enormous power to manage the liquidation or sale of a failed financial company, a new skillset for the FDIC. Rather than amending bankruptcy rules themselves, OLA obfuscates responsibility for a firm's failure and undermines risk management at the firms themselves. Title II of Dodd-Frank has seen significant legislative challenge in the last decade, including proposals from Treasury.

Further reading:

2/4/2016 – FCIC Report: What have we learned since?

12/1/2014 – Bankruptcy and Too Big To Fail

Title III – Transfer of powers to the Comptroller of the Currency, the Corporation, and the Board of Governors

Thrift shop

Title III of Dodd-Frank eliminated the Office of Thrift Supervision, an agency so subject to regulatory capture that it actually marketed itself as a lax regulator. These powers were transferred to the Federal Reserve System (the Fed), FDIC, and the Office of the Comptroller of the Currency (OCC). Title III also increased the amount of deposits insured by FDIC from $100,000 to $250,000 despite evidence that government-backed deposit insurance undermines financial stability. Last, Title III required that the major regulatory agencies establish an Office of Minority and Women Inclusion, a laudable move even if one with no obvious relation to the then-current financial crisis or any future crises.

Title IV – Regulation of advisers to hedge funds and others

Cutting-hedge technology

Title IV of Dodd-Frank required many previously exempt investment advisors to register with the Securities and Exchange Commission (SEC), most obviously hedge fund and private equity fund managers. Title IV also significantly increased the reporting requirements of investment advisors. This title simultaneously drastically increased the oversight burden of the SEC and failed to address the problem it set out to solve, a tension seen in a decade of legal wrangling concerning the definition of a fiduciary duty.

Further reading:

30/10/2018 – Investment Funds: A Primer

8/8/2018 – Is the SEC Proposed Regulation in the Best Interest of Investors?

Title V – Insurance

Double indemnity

Title V of Dodd-Frank created the Federal Insurance Office (FIO) within Treasury, at best inadvertently opening the path for pre-emption of states' rights and the federalization of insurance regulation. While a systematic knowledge of insurance had historically been lacking in the federal government, and still remains under-appreciated, FIO additionally opened the door to a discussion of a federal charter for insurers. Perhaps most egregious to some is the power FIO annexed to enter into international insurance covenants on behalf of the United States.

Further reading:

9/6/2018 – Forthcoming Group Capital Requirements Inappropriate for U.S. Health Insurers

13/3/2015 – Developments in the Regulation of Global Insurance: A Primer

Title VI – Improvements to regulation of bank and savings association holding companies and depository institutions

Different strokes for different volckers

Title VI, or the "Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010," introduced the "Volcker Rule," named for former Fed chairman Paul Volcker, which restricted banks from performing certain kinds of speculative investing. The rule is also known as the ban of proprietary ("prop") trading, in that the rule prevented banks from trading activity with the goal of enriching the bank and bank shareholders rather than a directly identifiable customer.

AAF experts have long held that proprietary trading was not a cause of the 2007-2008 financial crisis. As then-Treasury Secretary Timothy Geithner remarked in 2010, the root cause was "classic extensions of credit." As such, the crisis was caused by banks acting in their primary capacity as lenders of credit (albeit on poor risk assumptions) and not as a result of securities trading. Virtually every financial crisis in history has been a lending-related crisis. In point of fact, banks performing securities trading helped avert the worst of the crisis, as well-diversified organizations were able to partially absorb their losses and stabilize failing organizations.

The Volcker Rule has been described as a solution in search of a problem, but that description understates the cost. As European and Asian banks are not prevented from proprietary trading, U.S. banks are at an international competitive disadvantage, both in terms of the suite of products they can offer and in the unnecessary compliance burden they must assume. The OCC itself estimated that the Volcker Rule would cost the industry $4.3 billion annually. By making it more difficult for U.S. banks to engage in securities trading, the Volcker Rule drives these activities from well supervised and regulated U.S. banks to the shadow banking industry, and at a time when the Federal Reserve must spread its resources to cover Volcker Rule compliance. Now that the Fed also regulates nonbanks, any mistake made by the Fed has the potential to infect the entirety of the financial services market.

Further reading:

09/04/2018 – Comments on proposed revisions to the Volcker Rule

12/10/2013 – Volcker Rule a Costly Way to Solve a Non-Problem

Title VII – Wall Street Transparency and Accountability and Title VIII – Payment, clearing, and settlement supervision

"Nick would hate that joke. Derivative! And then he'd add, 'although the word derivative as a criticism is itself derivative.'"

Titles VII and Titles VIII of Dodd-Frank both sought to provide guardrails to financial derivatives, and in particular the swaps market, a sub-market of derivatives (so called because they derive their value from something else, such as an interest rate or currency). Derivatives have long inspired fear and concern due to their complexity and supposed lack of regulation; for this reason Dodd-Frank provided a corral for the industry despite there being no evidence that derivatives contributed in any way to the crisis. As in all aspects of Dodd-Frank, Titles VII and VIII moved "clearing" (the procedures by which goods are exchanged between seller and buyer) from major financial institutions into clearinghouses by government mandate. Title VIII significantly increased the role of the Fed in the supervision and oversight of systemically important financial market utilities and over systemically important clearing activities.

Further reading:

29/6/2017 – No Financial Crisis = No Financial Regulation Reform?

23/10/2012 – Regulation Review: Dodd-Frank Security-Based Swaps Requirements

Title IX – Investor protections and improvements to the regulation of securities

It's all about SEC, baby

Title IX of Dodd-Frank contains an enormous number of provisions relating to the SEC, from changing its governing body and relationship with credit rating agencies to protecting and rewarding SEC whistleblowers. This title also includes new regulations regarding proxy disclosure, executive compensation ("say-on-pay"), and corporate governance.

Further reading:

7/4/2020 – Credit Scores: A Primer

Title X – Bureau of Consumer Financial Protection

Protection racket

Title X of Dodd-Frank created the Consumer Finance Protection Bureau (CFPB), the brainchild of Senator Elizabeth Warren. Tasked with regulating the consumer finance industry, the CFPB works to increase and improve transparency, accountability, and consumer protections, although, contrary to some claims, consumer protection pre-dated this agency at both the state and federal level. Structured so that the single director could only be fired for cause and insulated from the traditional appropriations process, the CFPB has seen significant constitutional challenge from inception. That legal challenge has reached an end point with the recent Supreme Court decision in *Seila Law vs. Consumer Financial Protection Bureau*, which held that the inability of the president to fire the CFPB director at will – and as a result the CFPB structure – is unconstitutional. Title X also contains the controversial “Durbin Amendment,” which requires the Fed to limit the fees charged to retailers for debit-card processing. A significant body of evidence has demonstrated that what is essentially government price fixing has transferred the cost of this process from retailers onto consumers.

Further reading:

6/29/2020 – Supreme Court Rules CFPB Structure Unconstitutional

8/5/2019 – The Fed and Real Time Payments

2/4/2019 – On the Constitutionality of the FHFA and the CFPB

5/10/2018 – Congressional Rebuke of CFPB Methods

Title XI – Federal Reserve System provisions

Can I speak to your supervisor?

Title XI of Dodd-Frank established a new vice chairman for supervision at the Fed, an executive responsible for the Fed’s execution of its enhanced supervisory powers. Title XI also amended the Fed’s emergency lending procedures under s.13(3) of the Federal Reserve Act by requiring that any such lending be broadly available and not targeted to any single company (for example, AIG). The Fed has subsequently used these amended 13(3) powers to introduce and reintroduce nine emergency lending facilities in response to the coronavirus pandemic.

Further reading:

6/29/2020 – Timeline: The Federal Reserve Responds to the Threat of Coronavirus

Title XII – Improving access to mainstream financial institutions

Access denied

Title XII of Dodd-Frank sought to improve the ability of low- and moderate-income (LMI) individuals to access mainstream financial institutions and products, but did so not by amending the copious regulatory barriers to entry for actors in this space or by encouraging innovation but instead by simply subsidizing private lending. This Title in many ways attempts to address the problems created by the CFPB itself, which only increased the legal risks of attempting to provide services to LMI individuals, a problem of Dodd-Frank’s own making.

Title XIII – Pay It Back Act

Baby got pay it back

Title XIII of Dodd-Frank amended the Emergency Economic Stabilization Act of 2008 to limit the Troubled Asset Relief Program (TARP) from $700 billion to $475 billion and prevented the use of unused funds in different programs. TARP was the immediate effort by the Bush Administration in 2008 to stabilize the housing market by purchasing vast amounts of toxic assets from private industry.

Further reading:

5/23/2012 – Revisionist History: Obama and Spending

4/16/2010 – Bailout Nation

Title XIV – Mortgage Reform and Anti-Predatory Lending Act

House of cards

Title XIV of Dodd-Frank made extensive changes to the rules concerning mortgage origination and the new rules relating to the qualified mortgage. Title XIV, however, is infamous less for its contents and more as a missed opportunity to address the role of government in housing, and in particular the conservatorship of the GSEs. Given the leading role of the GSEs in the subprime mortgage crisis, the startling omission of widescale housing reform from Dodd-Frank reflects Congress's inability to solve this problem, a problem only recently approached by the current administration.

Further reading:

11/5/2019 – Housing Finance Reform under FHFA Director Calabria

9/6/2019 – Treasury and HUD Release Sweeping Blueprint for Comprehensive Housing Finance Reform

7/31/2019 – Understanding the End of the QM Patch

Title XV – Miscellaneous Provisions and Title XVI – Section 1256 Contracts

Everything (including) the kitchen sink

Title XV of Dodd-Frank contains a grab-bag of miscellany on everything from studies on the effectiveness of Inspectors General to restrictions on U.S. approval of loans issued by the International Monetary Fund. Perhaps most startling was the inclusion of clauses relating to "conflict minerals," or the fear of Congress that mining in the Democratic Republic of the Congo was financing sexual and gender-based violence there.

Conclusions

Dodd-Frank had a simple theme: Give regulators enough power and information, and they can stop a financial crisis in its tracks. The natural result of this wishful thinking was a vast centralization of power and scope creep among regulators and other agencies of government, who were poorly equipped in resources and understanding to perform the new central planning role required of them. Further, the law removed responsibility from individuals and firms with the best information and most at stake. The economic devastation caused by the coronavirus a decade after Dodd-Frank demonstrates all too clearly that government is neither all-seeing nor all-knowing.