



# Five Years after Dodd-Frank: Unintended Consequences and Room for Improvement

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), signed into law on July 21, 2010, was a sprawling, imperfect, 2300-plus page response to the worst financial crisis in the U.S. since the Great Depression.

It likely will be the only major financial reform legislation for the next generation, so it warrants regular retrospectives. Marking the law's significant anniversaries gives policymakers an opportunity to evaluate areas for correction and amendment.

## **SURPRISES AND UNINTENDED CONSEQUENCES IN THE FIRST FIVE YEARS**

Five years after passage, many of Dodd-Frank's rules remain unwritten and some still await proposal, which is not surprising given the number of issues and agencies involved in writing and implementation. As of the fifth anniversary in July, only 63% of rules had been finalized, while about 20% had missed deadlines, the majority of which concern derivatives and mortgage reforms (Figure 1).<sup>1</sup> What is surprising, however, is that there is still so much regulatory pressure on systemically important financial institutions (SIFIs), particularly big banks. Many insiders expected from the outset that banks would be inducing regulatory rollbacks by now, but that has not happened.<sup>2</sup>

There are many reasons why regulators' policing efforts remain aggressive and why the U.S. is not moving

## **SUMMARY**

- This brief offers a 5-year retrospective on Dodd-Frank, pointing out aspects of the legislation that would benefit from correction or amendment.
- Dodd-Frank has yielded several key surprises—in particular, the extent to which the Federal Reserve has become the primary regulator of the financial industry. This reflects a problem, namely that the regulatory framework established by Dodd-Frank violates the requirements of the rule of law. It relies too heavily on regulatory discretion, is insulated from effective oversight, and eschews transparency.
- In light of Dodd-Frank's departures from rule of law, the legislation could be improved in several ways: by clarifying the rules by which regulators designate entities as strategically important financial institutions (SIFIs) and require their creation of living wills; providing better incentives for banks to downsize more efficiently; curbing incentives for banks to shift key operations to the shadow banking system; instituting bankruptcy reforms that would discourage government bailouts; and easing regulatory burdens on smaller banks that are disproportionately burdened by the SIFI designation process.



in a less regulatory direction after five years, but three causes stand out. The first is the London Whale incident of 2012, which single-handedly accounted for the severity of the Volcker Rule. The London Whale, a nickname given to JPMorgan trader Bruno Iksil, whose job entailed trading for his firm's own account (i.e., proprietary trading), developed an excessively large position in the credit default swap market that had to be written down as a loss. When the dust settled, the activities of this one trader caused a \$6.2 billion loss for his firm.<sup>3</sup> This type of high-capacity, high-risk trading within commercial banking and lending institutions like JPMorgan is what the Volcker Rule seeks to eliminate by limiting proprietary trading and separating it from a bank's normal, market-making and client-based activities. How the rule will work in practice is not so clear cut.<sup>4</sup>

An unintended consequence of Dodd-Frank is that the Volcker Rule already has pushed several critical banking functions into the shadow banking system and it likely will continue to do so.<sup>5</sup> Big banks appear to be retrenching on some of the operations the law permits them to engage in, such as market-making and trading for clients. This is especially true in

the case of bonds and is leading to liquidity issues in the bond market because banks have cut back on permissible and borderline bond trading as they have shed their proprietary trading businesses. As more and more activity moves into the shadow banking system, proprietary trading could become less regulated (and more elaborately disguised), defeating the initial intentions of the Volcker Rule.

The second spur for the surprisingly aggressive Dodd-Frank rule-making is the LIBOR scandal, a story that broke on the heels of the London Whale. Several British and international news agencies exposed widespread, fraudulent manipulation of LIBOR rates in trades between big banks, which colluded for over two decades to boost appearances of creditworthiness and to increase profits from this rate rigging. U.S. derivatives—a several hundred trillion dollar market—and other financial products benchmark their interest rates on LIBOR, so this manipulation affected markets and consumers around the world, but especially in the U.S. The British government gained oversight of LIBOR after much investigation, and new regulations soon passed the U.K. Parliament. In the U.S., this incident and the London Whale scandal

increased scrutiny into banks with global trading operations at a time when U.S. agencies were in the midst of Dodd-Frank rulemaking.

The third explanation for the current regulatory climate is Senator Elizabeth Warren (D-MA). The election of Warren to the Senate was an unintended consequence of critics' successful derailment of her nomination to head the new Consumer Financial Protection Bureau (CFPB), which was inspired by Warren's own research as a Harvard professor. If Warren had been approved as the first CFPB head, she wouldn't have run for the Senate. Since joining Congress in 2013, Warren has deftly utilized her new platform and committee positions, particularly her role in the Senate Committee on Banking, Housing, and Urban Affairs, to champion tough financial regulation and consumer protection among her colleagues and in the media. The CFPB, which she also helped to implement as an advisor to the President, has been a valuable and necessary innovation, but the Bureau does have a designated source of funding and a centralized structure, which makes overturning any of their decisions difficult. The CFPB will need to avoid mission creep in the long-run to avoid becoming another

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<sup>1</sup> <http://graphics.wsj.com/dodd-frank-anniversary/>.

<sup>2</sup> One major exception is the so-called "swaps pushout" rule. This would have required banks to move their derivatives trading out of their commercial bank subsidiaries, but was repealed as part of budget legislation.

<sup>3</sup> <http://www.bloomberg.com/news/articles/2015-05-21/jpmorgan-directors-don-t-have-to-face-london-whale-loss-claims>.

<sup>4</sup> The Volcker Rule did not take effect until July 2015.

<sup>5</sup> The shadow banking system refers to the entirety of non-

bank financial intermediaries that perform many of the same functions commercial banks do, but without oversight. Shadow banks raise funds to buy assets, but they have no deposit insurance and no recourse to the Federal Reserve in a crisis. Examples include hedge funds, money market mutual funds, structured investment vehicles, and many other types of entities. (For more, see: <http://www.imf.org/external/pubs/ft/fandd/2013/06/basics.htm>).

<sup>6</sup> This concern has merit, given recent loan regulations issued by the CFPB affecting auto dealers and for-profit colleges,

among other types of non-financial entities.

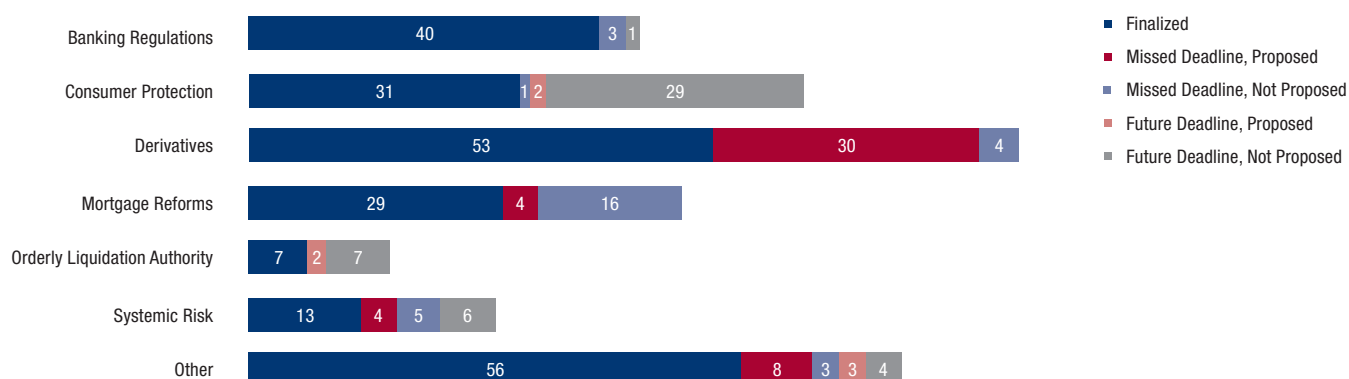
<sup>7</sup> For more information, see Susan Wachter, "Next Steps in the Housing Finance Reform Saga," Penn Wharton Public Policy Initiative Issue Brief, March 2015: <http://publicpolicy.wharton.upenn.edu/issue-brief/v3n2.php>.

<sup>8</sup> For more information on bank stress-tests, see Itay Goldstein, "Disclosure of Bank Stress-Test Results," Penn Wharton Public Policy Initiative Issue Brief, June 2013: <http://publicpolicy.wharton.upenn.edu/issue-brief/v1n6.php>.

<sup>9</sup> The Fed recently released its proposed rule implementing



**FIGURE 1: FIVE YEARS LATER: DODD-FRANK RULEMAKING PROGRESS (JULY 2015)**



Source: DavisPolk, "Dodd-Frank Progress Report," July 16, 2015.

negative, unintended consequence of Dodd-Frank.<sup>6</sup>

Another striking development (or lack thereof) in the last five years is lawmakers' failure to reform Fannie Mae and Freddie Mac since the federal government placed them in conservatorship in 2008. The U.S. Treasury has been collecting all profits from these entities since Fannie and Freddie began making them again in 2012, so in that sense the lack of reform and restructuring is not shocking. But because these institutions were key factors in the financial crisis, their exclusion from new legislation was odd five years ago and the continual absence of Fannie and Freddie reform is no less curious. Their limbo status in conservatorship effectively

halts any significant housing finance reform measures going forward.<sup>7</sup>

The final major surprise over the last five years is the extent to which the Federal Reserve has become the primary regulator of the financial industry via both Dodd-Frank and non-Dodd-Frank stress-tests, as well as living wills (see below).<sup>8</sup> Dodd-Frank did limit the emergency power of the Fed by prohibiting it from making emergency loans to individual institutions in an attempt to discourage future bailouts akin to those made in 2008.<sup>9</sup> But the Fed's enforcement of capital and liquidity standards now appears to be the most important regulatory development of Dodd-Frank, and this is one of several "rule of law" concerns to which we now turn.

## EVALUATING DODD-FRANK UNDER THE RULE OF LAW

The rule of law, according to the Resolution of the Council of the International Bar Association (2005), "establishes a transparent process accessible and equal to all. It ensures adherences to principles that both liberate and protect." In the context of financial regulation, the rule of law requires that any intervention by regulators be governed by legal rules and not merely by discretionary choice. In matters of discretion, policy must be decided by those who write the rules and not by those who enforce them. The rule of law, therefore, requires legal provisions to be specific. Furthermore, in the instance

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this restriction.

<sup>10</sup> David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* (Hoboken, NJ, 2011).

<sup>11</sup> In its short life, the FSOC already has considered designating as SIFs such entities as mutual funds and hedge funds, whose catastrophic impact upon theoretical failure is clearly debatable.

<sup>12</sup> [http://www.wsj.com/articles/fed-fdic-rebuke-bank-ruptcy-plans-of-11-of-nations-biggest-banks-](http://www.wsj.com/articles/fed-fdic-rebuke-bank-ruptcy-plans-of-11-of-nations-biggest-banks-1407270607?alg=y)

[1407270607?alg=y](http://www.wsj.com/articles/fed-fdic-rebuke-bank-ruptcy-plans-of-11-of-nations-biggest-banks-1407270607?alg=y).

<sup>13</sup> Single point of entry (SPOE), to oversimplify, entails taking over a holding company, establishing a bridge institution, and transferring all secured debt and short-term liabilities of the holding company to the bridge institution, as well as all licenses and other assets. Company stock and bond debt would remain with the holding company. The old stock would likely be canceled, and the bondholders would receive stock in the new bridge institution in place of their debt. The new bridge institution would thus be a recapitalized version

of the failed holding company. In recent months, the banks have suggested they would shed assets in connection with the recapitalization, which looks somewhat more like a liquidation than previous versions of the SPOE strategy.

<sup>14</sup> <http://www.bloomberg.com/news/articles/2014-03-20/volcker-rule-will-cost-banks-up-to-4-3-billion-occ-says>.

<sup>15</sup> The one day stay on derivatives does not apply to derivatives traded outside the U.S., and the largest banks have many subsidiaries overseas that engage in this activity. This appears to be part of the reason that the Fed failed the 11 liv-



of a violation or a regulatory intervention, the affected person or institution must have recourse to their right of due process. The regulatory framework established by Dodd-Frank violates all of these rule of law requirements. It relies heavily on regulatory discretion, is insulated from effective oversight, and eschews transparency.

Operating under the assumption that giant financial institutions are inevitable and that the federal government should simply make sure it has the tools to control them, Dodd-Frank foments a partnership between the government and the largest banks which began during the financial crisis when regulators rescued Bear Stearns—one of the nation's largest investment banks—rather than allowing Bear Stearns to file for bankruptcy in early 2008. This mistake shaped the subsequent actions of regulators, as well as the way that another investment bank, Lehman Brothers, chose to operate (and not seek to sell itself) before its own failure later that year. The partnership between the government and the biggest banks resembles the European style of regulation known as corporatism, which is far removed from the rule of law virtues traditionally associated with U.S. financial regulation.<sup>10</sup>

There are four important components of Dodd-Frank that violate the rule of law. The first is a feature of Title I, which gives regulators the authority to designate financial institutions as systemically important. Bank holding companies that have more than \$50 billion in assets are automatically deemed to be SIFIs and, as of late 2015, regulators from the new Financial Stability Oversight Council (FSOC) have designated as systemically important four other institutions: AIG, Prudential, GE Capital, and Metropolitan Life (although MetLife is contesting its SIFI status in court). Not only is this designation process overinclusive for bank holding companies, for already many regional banks that surpass the \$50 billion asset threshold are struggling with compliance requirements designed to apply equally to global behemoths, but it is highly arbitrary for other SIFIs, as well, since the FSOC faces few real constraints on which institutions to designate.<sup>11</sup> Title I reveals the problem with corporatism most starkly. SIFIs are subject to stricter regulations, including more stringent capital standards, but the largest SIFIs also have special relationships with their regulators who, through the law, protect them

from competition.

The second rule of law concern is another feature of Title I that requires institutions designated as SIFIs to prepare a rapid resolution plan each year, often referred to as a living will. Living wills are plans for how an institution would pursue an orderly bankruptcy in such a way as to minimize systemic damage. These plans are valuable and a welcome inclusion in Dodd-Frank because they can be used to simplify the structures of large financial institutions for regulators, but in practice their use has been far from transparent. The Fed and the FDIC have complete discretion to accept or reject a living will (with punishments attached), and in 2014 they chose to reject the living wills of 11 banks with assets greater than \$250 billion.<sup>12</sup> If this were an instance of clear cut non-compliance, the regulations would be working effectively. But the priorities and considerations of regulators in evaluating these living wills are opaque and not connected to any formal, public legal framework. Such cloudy regulatory intervention gives banks a strong incentive to be non-transparent themselves about their operations, contrary to the intended spirit of Dodd-Frank.

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ing wills in 2014. The Fed felt that single point of entry would not work without a stay on derivatives globally. The living will reprimands resulted in a new International Swaps and Derivatives Association (ISDA) protocol that mandates just that—a global one day stay. Every major bank has agreed to abide by the terms of the ISDA protocol.

<sup>16</sup> Dodd-Frank gives the Fed authority to rescue a failing clearinghouse.

<sup>17</sup> A similar policy was recommended in a bill sponsored by Senators Sherod Brown (D-OH) and David Vitter (R-LA) in

2013. For more on that bill, see: [http://dealbook.nytimes.com/2013/05/01/in-brown-vitter-bill-a-banking-overhaul-with-possible-teeth/?\\_r=0](http://dealbook.nytimes.com/2013/05/01/in-brown-vitter-bill-a-banking-overhaul-with-possible-teeth/?_r=0).



The third concern involves the Orderly Liquidation Authority under Title II, which was created to give regulators, in this case the Treasury, the Fed, and the FDIC, the authority to take over a financial institution facing an impending failure which could result in systemic harm. Regulators can trigger a takeover resolution by submitting a petition in federal court with extremely limited judicial review (24 hours). The speed and secrecy (the hearing itself is unannounced) of the decision essentially prevents companies from challenging a takeover. This process is likely unconstitutional, as it appears to violate the due process requirements of the U.S. Constitution, although it would be difficult in practice for a SIFI to challenge the violation before its takeover occurred.

For the moment, regulators thus have largely unchecked discretion over whether and when to take over a financial institution on the verge of default, as well as how to resolve the situation once the SIFI goes into receivership. As in the case of an ordinary bank resolution, Title II grants the FDIC blanket authority to pay claims to creditors in full if it wishes, and it also allows for established priority payment rules to be abandoned for the sake of systemic stability. Interestingly, despite the fact that Title II requires that its resolution provisions be used to liquidate troubled SIFIs and not to reorganize them, the FDIC has been exploring a strategy for resolving SIFI issues (i.e., reorganizing) over the last few years. Senator Barbara Boxer's (D-CA) "thou shalt liquidate" mandate may be the clearest directive of the entire Dodd-Frank Act, but the

FDIC's stated intention to utilize the so-called "single point of entry" strategy in the case of a future failure to recapitalize SIFIs seems to be in direct conflict with the language of Title II.<sup>13</sup> How this will play out in practice bears watching.

The final rule of law issue involves the Volcker Rule. As noted above, this rule attempts to achieve a 21st century version of the Glass-Steagall Act's separation of commercial and investment banking by prohibiting bank holding companies from engaging in proprietary trading and by limiting to 3% of total assets their investments in hedge funds and equity funds. This is a quixotic quest because it is nearly impossible to distinguish proprietary trading from normal market-making and client-based trading. Over time, even the line between investment and commercial banking within bank holding companies likely will blur, and the five different regulators charged with enforcing the Volcker Rule will not be able to sufficiently monitor trading in the world's largest financial institutions.

Beyond the clear and already present failures and inefficiencies of the Volcker Rule, the costs of compliance and implementation have skyrocketed to \$4.3 billion and \$413 million, respectively. The burden falls disproportionately on smaller community and regional banks that don't have legal resources comparable to the biggest banks.<sup>14</sup> This causes an economic drag when smaller banks are unable to make loans to small and mid-sized businesses at the level they might in the absence of these vast compliance challenges.

## OBSERVATIONS AND POLICY RECOMMENDATIONS FOR IMPROVING DODD-FRANK

One area of reform that Dodd-Frank largely got right concerns derivatives. The derivatives regulations in the law have been encouraging thus far, especially the creation of clearing-houses for over-the-counter trading, the increased disclosure requirements, and the establishment of a one day stay on derivatives.<sup>15</sup> The majority of interest rate swaps and credit default swaps now are being cleared over the exchanges, although foreign exchange and commodities derivatives did escape the new regulations. By requiring clearing, Dodd-Frank substitutes one type of too big to fail institution for another (yet another unintended consequence), but this is likely an improvement from the pre-crisis environment because regulators should be able to better manage a failing clearinghouse than they would a large bank with its complicated organizational structure.<sup>16</sup>

Given Dodd-Frank's unintended consequences and departures from the rule of law, how might the legislation be improved? Here are several recommendations.

**Recommendation 1:** Restore the rule of law by reducing regulator discretion. One obvious corrective might be to require greater transparency and clearer rules for Title I's designation and living will processes.

**Recommendation 2:** Relatedly, policymakers should give banks an incentive to downsize efficiently, as opposed to creating a blanket prohibition on proprietary trading. This would help to ensure that these



institutions do not also retreat from market-making and client services, which hurts system-wide liquidity, and that less activity gets pushed into the shadow banking system, which already is occurring because of the Volcker Rule. One solution might be onerous capital requirements on banks above a certain asset level (e.g., \$500 billion), which would let banks decide for themselves how to shed businesses.<sup>17</sup>

**Recommendation 3:** Policy-makers should be mindful of activity outside the traditional financial system and curb the incentives to shift key operations to the shadow banking system. This could include shadow banking regulations or new SIFI regulations focused on risk level rather than capital level, type of activity, or entity. Any regulations based on risk and not on entity type would require collapsing regulators (e.g., SEC and CFTC), and while there is little to no appetite for that in Washington, reforms that point in this direction are worth serious consideration.

**Recommendation 4:** To further reduce regulators' incentive to bail out large troubled financial institutions, lawmakers should adopt a

handful of bankruptcy reforms that would better facilitate a financial institution bankruptcy. The most important change involves imposing a stay, or a standstill, on derivatives counterparties when a SIFI declares bankruptcy. The derivatives industry managed to get an exemption from the normal bankruptcy rules, which mandate that collections be stopped immediately, contracts cannot be terminated, and collateral cannot be sold. In the last five years, there has been movement around this issue to help SIFIs on the verge of default by enacting bankruptcy reform similar to the single point of entry strategy. Legislation on this issue, which would include derivatives, is pending in Congress.

**Recommendation 5:** Off-ramps for small banks that are disproportionately burdened by the SIFI designation process's size limits and CFPB regulations would be beneficial. A bill sponsored by Senator Richard Shelby (R-AL), for instance, would authorize regulators to subject banks between \$50 billion and \$500 billion in assets to Title I oversight, but would make inclusion automatic only at the \$500 billion level. The Shelby bill would further

ease regulatory burdens on banks and credit unions with less than \$10 billion in assets, as these institutions would no longer need to abide by the Volcker Rule.

## CONCLUSION

The Dodd-Frank Act sought to limit risk in the financial system before a SIFI failure or crisis (and thus limit the amount of activity flowing into the shadow banking system) by regulating key instruments, like derivatives, and institutions, like banks and insurance companies. The law also sought to limit damage in the event of any systemically important financial institution's failure. Although the objectives and some of the new regulations are admirable, the legislation attempts to accomplish its dual mandate through corporatist regulations that stray from traditional U.S. rule of law virtues, and it has spawned a series of negative, unintended consequences. But the law can be corrected and improved. Dodd-Frank still has the potential to help safeguard the financial system if some of its obvious kinks are worked out.



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