VIEWPOINTS

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Dodd-Frank: Washington, We Have a Problem

Claude Lopez and Elham Saeidinezhad

The Dodd-Frank Act is the most far-reaching financial regulatory reform in the U.S. since the nation emerged from the Great Depression in the 1930s. The act aims to limit systemic risk, allow for the safe resolution of the largest intermediaries, submit risky nonbanks to greater scrutiny, and reform derivatives trading.

Nearly six years after the birth of the act, significant progress can be observed. However, the act itself remains highly controversial. With many of the bill's original supporters in Congress no longer in office and the urgency of the 2008 financial crisis fading from the public memory, the implementation of the remaining parts appears challenging, as shown by Congress' rollback of the "swaps push-out" rule and the recent federal court ruling against designating MetLife as a systemically important financial institution (SIFI). Furthermore, the weaker coordination among regulators combined with the forthcoming presidential election may trigger a change in regulatory regime, moving away from crisis-driven policy.

The public debate is often highly politicized and opinionated when it comes to Dodd-Frank. With that in mind, this paper seeks to assess Dodd-Frank implementation with respect to its initial goal of building "a safer, more stable financial system," in which proprietary trading and the business of banking are separated, and in which taxpayers and small businesses will not have to bail out failing large financial firms.[1] To make the assessment, this paper first establishes a timeline summarizing the Dodd-Frank final-rule milestones and then compares their implementation with the initial goals.

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[1] Based on https://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform

Milestone Timeline

The Dodd-Frank Act emphasizes macroprudential policy as an important component of financial regulation.[2] Monitoring systemically important institutions, markets, and activities is at its core. The act aims specifically at developing tools to (1) identify SIFIs, (2) monitor their resilience under stress and adjust the level of capital, liquidity, or leverage if deemed necessary, and (3) to facilitate their orderly liquidation in the case of failure while minimizing the impact to the overall economy. Figures 1 and 2 summarize the main final rules passed since 2010 for banks and nonbanks, respectively. Table 1 provides more detail regarding the goals and implementation of the rules.

2010–2011

The first step of Dodd-Frank implementation in 2010 was to reform the existing regulatory framework toward a more transparent and harmonized system by creating the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR). The aim of these is to enhance financial stability by mitigating "systemic risk." Their key objective has been to alleviate the so-called too-big-to-fail phenomenon by designating and monitoring SIFIs under the leadership of the Federal Reserve (Fed).

The SIFI framework first was applied to the banking sector. Since 2011, in an effort to move toward a better capitalized, more liquid, and more securely funded banking industry, SIFI-designated banks have been required to observe higher capital surcharges, lower leverage, and higher liquidity requirements. They also must pass a tougher yearly stress test by the Fed.[3] Rules related to prudential requirements were finalized between 2011 and 2015 and have been implemented. In contrast, the resolution plan requirements, finalized in 2011, are still a work in progress. As of June 2016, the "living will" of only one bank, Citigroup, has been deemed credible by the Fed and the Federal Deposit Insurance Corp. in allowing for an orderly liquidation in case of failure.[4]

2012–2013

In 2012 and 2013, the FSOC added major financial market utilities (FMU) and insurance companies to the SIFI list.[5] By creating this category, regulators emphasized the importance of market infrastructures that support multilateral payments as well as clearing and settlement activities. FMUs serve a critical role in supporting financial stability by reducing risk for their participants and counterparts. This role became increasingly important after the finalization of the Derivatives Clearing Organization (DCO) rule in 2011. By requiring standardized derivatives transactions to be centrally cleared, the rule has strengthened the role of central clearing counterparties, or clearinghouses (one type of FMU),

[2] See Lopez et al. (2015 a), and (2015 b) for more details on macroprudential policy.
[3] The Federal Reserve will stress test 33 large banks in 2016. These tests are binding for SIFIs denominated banks.
[4] Neither agency found that Citigroup's resolution plan was "not credible or would not facilitate an orderly resolution" under bankruptcy laws, but they did find shortcomings for the bank to fix.
[5] In developing these risk-management standards, U.S. supervisory agencies have been working with other global supervisors through the Basel Committee on Payments and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO), with a goal of global operating principles. These international efforts have resulted in two CPSS-IOSCO publications. The risk-management standards adopted by the Federal Reserve and the Securities and Exchange Commission and proposed by the Commodity Futures Trading Commission generally are based on the international standards of the Principles for Financial Market Infrastructures.

enhancing the amount of risk (credit, liquidity, and operational risk) held by each one. As a result, two clearinghouses have been designated systemically important derivatives clearing organizations (SIDCOs). Regulators further tightened the prudential standards by introducing "Enhanced Risk Management Standards" for SIDCOs in 2013.

In 2013, Dodd-Frank-driven regulations expanded to banks' activities in an effort to remove practices that played a major role in the global financial crisis, namely securitization activities and derivatives dealing. Before the crisis, most of these activities were off banks' balance sheets, and they remained mainly under the regulatory radar until the Fed had to backstop the system. Among the several changes made, two appear particularly important. The swaps push-out rule, introduced in 2013 and amended the following year, is the first main change pertaining to securitization. It prohibits banks from dealing with swaps on an asset-backed security (or a group or index consisting primarily of such securities). The Volcker rule, focused on derivatives dealing, separates proprietary trading from the actual market making, prohibiting banks from participating in proprietary trading.

2014–Present

Moving forward with their investigation of systemic markets, the SEC focused on the money market funds in light of their important role to "investors who use them as a cash management vehicle and to the corporations, financial institutions, municipalities, and others that use them as a source of short-term funding."[6] The new rules, finalized in 2014, require institutional prime and institutional municipal money market mutual funds to price and transact at a "floating" net asset value (NAV), permit certain money market mutual funds to charge liquidity fees, and allow the use of redemption gates to temporarily halt withdrawals during periods of stress.[7] The reform is an attempt to reduce investor runs and limit liquidity issues in time of stress.

Finally, a series of swap-related rules for nonbanks have been finalized since the swaps push-out rule. The goal is to increase the transparency of derivatives markets, enhance capital and margin requirements, and monitor cross-border activity.

Ambition vs. Achievements

As discussed above, the macroprudential policy driven by the Dodd-Frank Act focused primarily on monitoring systemically important institutions, markets, and activities. Conceptually, for this framework to be successful at mitigating systemic risk, the three required steps (identification, prudential enhancement, and resolution plans) would have to be respected and adapted to any financial intermediary, activity, or market that could pose a threat to U.S financial stability.

Table 1 contrasts Dodd-Frank goals with the rules finalized as of June 2016. A few facts stand out:

[6] https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542347679

[7] Berkowitz, Jeremy. (2015) "Money Market Mutual Funds: Stress Testing & New Regulatory Requirements." *The Harvard Law School Forum on Corporate Governance and Financial Regulation*.

- *SIFI framework:* Only the first phase, identification, has been applied to institutions other than banks in the U.S. However, one institution, insurance provider MetLife, successfully challenged its designation as systemically important earlier this year.[8] Only one of eight U.S. banks identified as SIFIs as of June 2016 had submitted a "living will" deemed acceptable by the Fed and the FDIC. In other words, only Citibank has completed the three steps necessary for the framework to work at the institutional level. Interestingly, other finalized rules, such as the one calling for the Derivatives Clearing Organization, led to the creation of more nonbank SIFIs, while the methodology on implementing steps 2 (prudential enhancement) and 3 (resolution plans) is still a work in progress.
- *Derivatives dealing and securities activities:* Regulations remain a work in progress, with a third of the rulings still to come. Meanwhile, the scope of the swaps push-out rule was significantly narrowed in its 2014 amended version, and full implementation of the Volcker rule has been delayed to 2017.
- *Financial stability and systemic risk monitoring:* Enhanced prudential rules were designed for SIFIs and have been finalized for both SIFI-designated banks and FMUs. As of June 2016, the Fed has invited comments regarding proposed rules for SIFI-designated insurance companies. The money market fund rule is the only major regulatory development concerning the asset-management industry.
- *Consumer and investor protection:* Most of the rules enhancing transparency developed by the SEC also enhance investor protection, which is part of the SEC mandate. The Consumer Financial Protection Bureau (CFPB) was created in 2011 to promote consumer protection, but questions regarding a lack of oversight and accountability have been raised. Among the concerns: The CFPB is not required to follow Office of Management and Budget guidelines, rules, and regulations and is exempt from congressional and executive oversight.[9]

Overall, while significant improvements have been achieved in terms of transparency, data sharing, and the resilience of the banking sector, Dodd-Frank implementation appears fragmented. It is a work in progress when compared with its initial goal of "building a safer, more stable financial system" while also ending taxpayers' bailout of the system. Furthermore, we consider that such goals cannot be reached unless issues related to regulatory consolidation, government-sponsored enterprises, regulation per function, and resolution process are addressed.

Regulatory consolidation: Little has been done to streamline the regulatory structure, which remains a mix of federal agencies with overlapping authority and mandates that do not automatically converge.[10] The FSOC was created to enhance coordination across these agencies, yet the most successful area of regulation, the banking system, is the industry that had a clear regulatory leader, the Fed, prior to the

[8] U.S. District Court for the District of Columbia decision, Case 1:15-cv-00045-RMC, Document 106, filed 03/30/16.
[9] Schultz (2014)
[10] See Volcker Alliance report (2015). "A multitude of federal agencies, self-regulatory organizations (SROs), and state authorities share oversight of the financial system under a framework riddled with regulatory gaps, loopholes, and inefficiencies. […] failure to reorganize the regulatory structure will contribute to the buildup of systemic risk."

FSOC's existence. The insurance industry is another illustration of a failed consolidation. The Federal Insurance Office (FIO) was created to monitor the industry, yet with the exception of the SIFI-designated insurers, insurance companies continue to be regulated, supervised, and guaranteed at the state level. Regulatory coordination should also go beyond the Dodd-Frank mandate and the FSOC's member agencies to properly assess the impact that the different layers of regulations, as well as their interaction, have on their targets. (For example, Dodd-Frank and Know Your Customer, or the fiduciary rule finalized by the Department of Labor, may not be coherent with the rule the SEC intends to propose next spring.)

Government-sponsored enterprises (GSEs): Fannie Mae and Freddie Mac accounted for the largest losses imposed on taxpayers during the financial crisis, estimated at $291 billion, or more than 5 percent of their mortgage portfolios at the end of 2009.[11] Yet no regulatory changes are observed. In recent years, nearly 80 percent of new mortgages have been backed by Fannie Mae, Freddie Mac, and other government agencies (such as the Federal Housing Administration).

Regulation by function: Nonbanks perform functions like banks while having other legal forms, yet the financial crisis of 2007–2009 showed that much of the wholesale banking system—investment banks through repos, money market funds, and asset-backed commercial paper conduits in particular—experienced runs and eventually were bailed out.[12] Difficulties encountered in fully implementing and adapting the current SIFI framework across the main actors of the financial system (asset managers, insurance companies, etc.) show that it will leave regulatory gaps that may create regulatory arbitrage at the cost of creating systemic risk. An alternative would be to impose similar regulations for institutions performing similar tasks (for example, depository institutions *and* money market funds) and to have requirements set consistently across markets and institutions. (If the risk of the underlying loans is the same, it should not matter how those loans are sliced and diced through securitization in terms of determining the required capital buffer of banking institutions.)

Resolution process for SIFIs: The motivation behind Dodd-Frank was to enhance financial stability and eliminate the need for a government agency to intervene using taxpayers' money to backstop the market. The resolution process, or Step 3 in the SIFI framework, is supposed to address this by ultimately requiring other SIFIs—and not the taxpayers—to bear the cost if one fails. In practice, however, this would work only if a single failure occurred at any given time. A problem, of course, arises during a systemic event when there might be multiple exposure failures by financial market utilities or insolvencies (by banks and insurance companies). An alternative framework would be to promote proper incentives and make restructuring workable in a crisis instead of focusing on the procedures for liquidation in the case of insolvency. Acharya et al. (2010) suggest the implementation of rule-driven recapitalization in bad times that does not depend on public assistance.[13] This would provide incentives

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[11] Congressional Budget Office testimony (2011)

[12] Acharya and Richardson (2012)

[13] Ceccheti and Schoenholtz (2014) provide the following illustration: "Let the capital structure of a bank's long-term liabilities be clearly stated and then honored if and when necessary. That is, think of the bank as having a hierarchy of long-term debt ranging from the most senior (call it tranche A) to the most subordinated (tranche Z for zombie!). Whenever a bank's capital position is deficient — say, because the market value of its equity sinks below a threshold ratio to its book assets — the resolution authority automatically makes some of the debt into new equity, starting with the Z tranche and then climbing up

for the private sector to adopt proper governance and monitoring. Dodd-Frank, by not providing for such a private mechanism, may ultimately reduce market monitoring. The focus should be on automatic recapitalization that does not depend on public assistance.[14]

Finally, although a plan to revamp Dodd-Frank—the Financial Choice Act—has been introduced in Congress, regulators must keep in mind that financial stability does not depend solely on financial and prudential regulations. Low real interest rates helped foster increased leverage across financial institutions, corporations, households, and markets. A high degree of leverage limits the ability of borrowers and the financial system to absorb shocks, leading to a quick erosion of capital buffers and a rapid decline in confidence. In other words, financial and prudential regulations should complement proper macroeconomic policies (monetary, fiscal, structural) and require international coordination.

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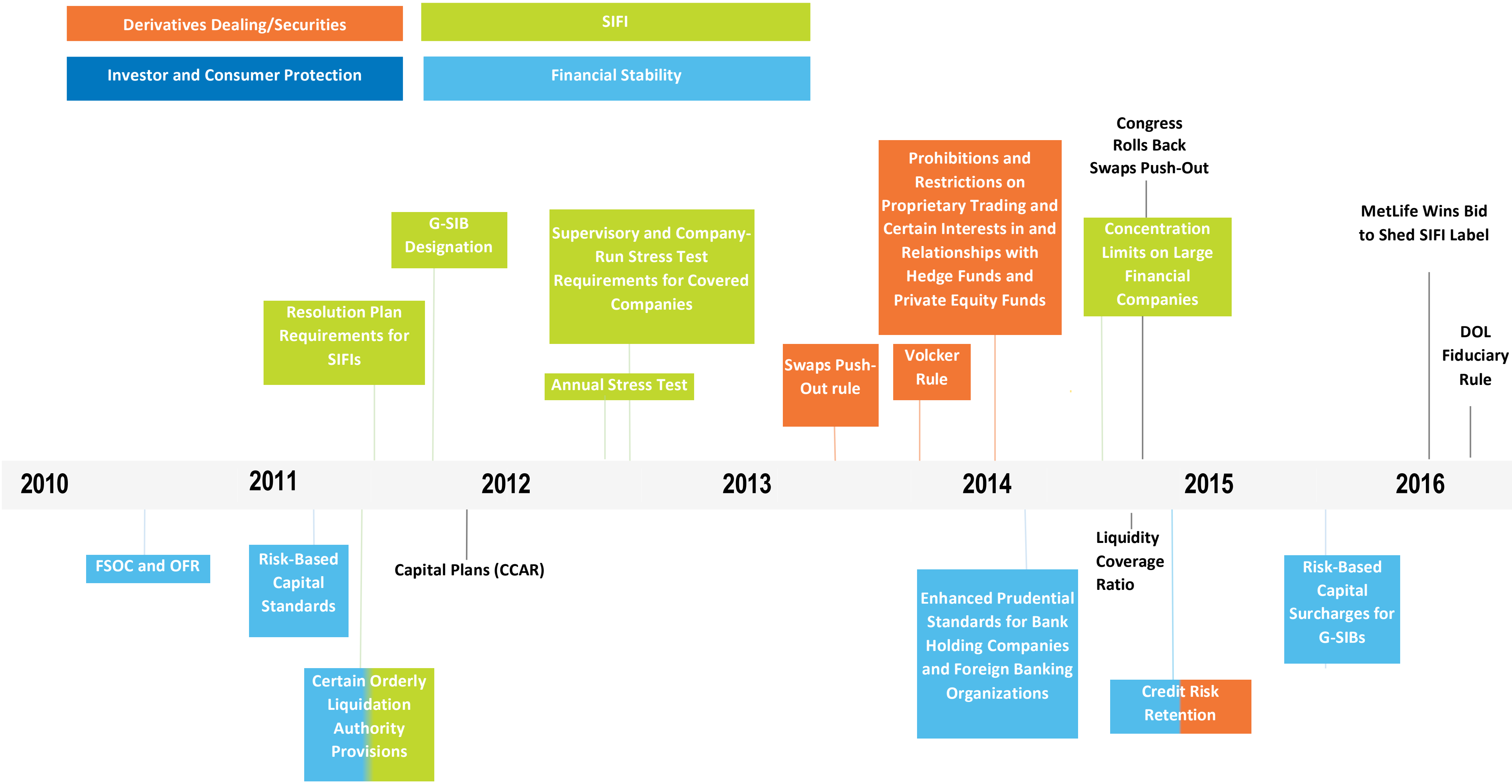
the alphabet until there is sufficient capital to return the bank above the regulatory minimum. Provided that there is sufficient long-term debt to absorb the losses, the concern remains a going one."

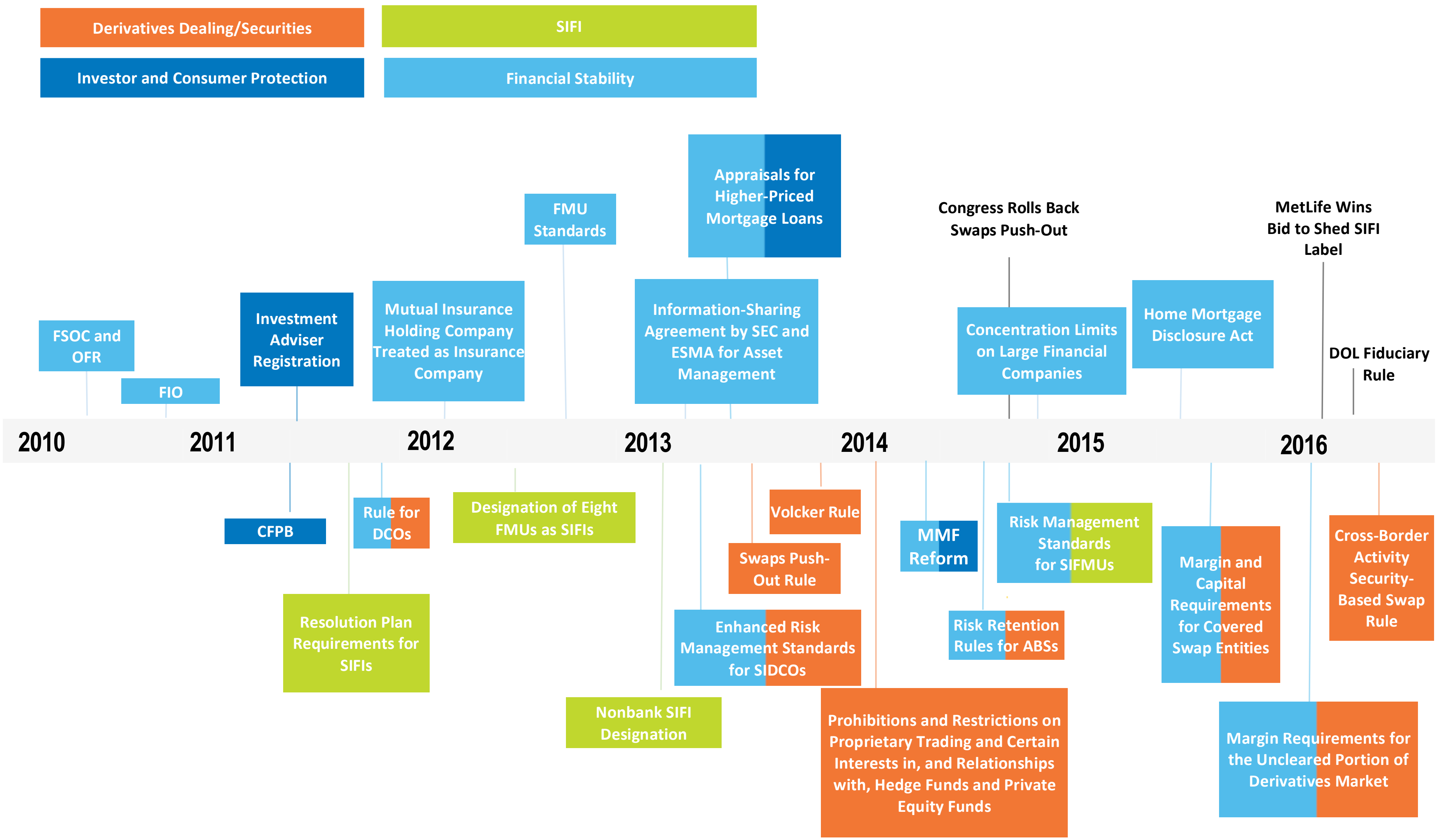
[14] See http://www.moneyandbanking.com/commentary/2014/10/13/living-wills-or-phoenix-plans-making-sure-banks-can-rise-from-their-ashes

FIGURE 1. Banks: Dodd-Frank Final Rules and Milestones



Source: Authors

FIGURE 2. Nonbanks: Dodd-Frank Final Rules and Milestones



Source: Authors

TABLE 1. Goals and Implementation

SIFIs

Goal	*Applies to institutions, activities, and markets deemed so important to the functioning of the economy that special rules and buffers were put in place to (1) reduce the probability of failure and (2) minimize spillovers in case of failure. Any firm designated a SIFI is subject to stricter oversight from the Federal Reserve, including taking stress tests, writing bankruptcy plans known as living wills, and meeting stricter capital requirements*		
Category	Rules	Targeted Outcome	Implementation (as of June 2016)
Milestones	Identification	Identify any financial intermediary that could pose a threat to U.S. financial stability, based on the size, interconnectedness, cross-jurisdictional activity, complexity and non-substitutability, or mix of these activities	Banks, insurance companies, and FMUs. MetLife successfully challenged its SIFI tag in 2014
	Stress tests	Assess an institution's capital plan and ability to continue providing financial services, without government assistance, following a specified shock	Only for banks
	Resolution plans or living wills	Establish a plan for how a SIFI would resolve itself if it failed. Based on that knowledge and in case of failure, the government would use Orderly Liquidation Authority to dismantle the firm so its losses would not affect others.	Only 1 bank
	Money market fund rules	Implement stress testing, disclosure, floating NAV, liquidity fee, and redemption gate	Conformance period ends Oct. 14, 2016

Derivatives Dealing/Securitization Activities

Goal	*Minimize systemic risk of derivatives trading, create transparency in derivatives markets, and prohibit entities holding customer deposits from engaging in speculative derivatives activity*		
Category	Rules	Targeted Outcome	Implementation (as of June 2016)
Milestones	Volcker Rule	Prohibit entities holding customer deposits from engaging in speculative derivatives activity	Conformance period extended to July 21, 2017
	Derivatives Clearing Organization Rule	Standardized derivatives transactions must be centrally cleared	Effective Jan. 9, 2012. On July 7, 2012, 2 DCOs are designated as systemically important FMUs

	Rules	Targeted Outcome	Implementation
	Swaps-related rules for banks and nonbanks	Enhanced regulations and increased transparency of derivatives markets regarding trade reporting, capital and margin requirements for non-centrally cleared derivatives, exchange of electronic platform, and cross-border activities	Work in progress, with 1/3 remaining

Financial Stability and Systemic Risk Monitoring

Goal *Enhance the stability, resilience, and transparency of the U.S. financial system*

Category	Rules	Targeted Outcome	Implementation (as of June 2016)
Milestones	Enhanced Prudential Rules (liquidity, capital, leverage, concentration limits, risk management, etc.)	Enhance the stability and resilience of SIFIs	Focus on banks, FMUs, and money market funds
	Transparency and harmonization	Simplify the financial regulatory system	FSOC, OFR

Consumer and Investor Protection

Goal *Strengthen protections for consumers and investors*

Category	Rules	Targeted Outcome	Implementation (as of June 2016)
Milestones	Investment Adviser Registration	Protect pensioners. Data must be made publicly available, even from exempt advisers, to increase transparency and access for prospective investors.	Pension consultants now must register with the SEC
	Consumer Financial Protection Bureau	Promote clear information for consumers and protect them from unfair practices; to promote fair, efficient, and innovative financial services for consumers; and to improve access to financial services	Home Mortgage Disclosure Act

Source: Authors

Glossary

ABS: An asset-backed security is a bond or note backed by financial assets.

CCAR: Comprehensive Capital Analysis and Review is an annual exercise by the Federal Reserve to assess the capital planning processes and capital adequacy of the largest U.S.-based bank holding companies.

CFPB: The Consumer Financial Protection Bureau is a government agency created after the 2008 financial crisis to protect consumers.

DCO: A Derivatives Clearing Organization is a clearinghouse for the settlement or netting of derivative obligations or that otherwise provides clearing services that mutualize or transfer credit risk among participants.

ESMA: The European Securities and Markets Authority's main mission is to contribute to safeguarding the stability of the European Union's financial system.

ETF: An exchange-traded fund is an investment fund traded on stock exchanges, much like stocks. It combines the valuation feature of a mutual fund or a unit investment trust with the tradability feature of a closed-end fund.

FIO: The mission of the Treasury Department's Federal Insurance Office is to provide necessary expertise and advice regarding insurance matters to the department and other federal agencies.

FMU: A financial market utility is a multilateral system that provides the infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions.

FSOC: The Financial Stability Oversight Council's mission is to provide comprehensive monitoring of the stability of the U.S. financial system.

GSE: A government-sponsored enterprise is a financial services corporation created by the United States Congress.

G-SIB: A global systemically important bank is defined as a financial institution whose distress or disorderly failure would cause significant disruption to the wider financial system and economic activity.

MMF: Money market mutual fund.

OFR: The Office of Financial Research's main mission is to deliver high-quality financial data, standards and analysis for the Financial Stability Oversight Council and the public.

SEC: The Securities and Exchange Commission holds primary responsibility for enforcing the federal securities laws, proposing securities rules, and regulating the securities industry.

SIDCO: Systemically important derivatives clearing organization.

SIFI: A systemically important financial institution is a financial company whose material financial distress—or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities—could pose a threat to U.S. financial stability.

SIFMU: Systemically important financial market utility.

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About the Authors

Dr. Claude Lopez is director of research at the Milken Institute, leading international finance and macroeconomic research. With her team, she investigates the linkages between the financial sector and the real economy, focusing on systemic risk, capital flows and investment. She brings expertise and experience on topics including exchange rates, capital flows, commodities, inflation, and time-series econometrics. Her research has been published in highly regarded academic journals and policy reports and is presented regularly at international conferences. Before joining the Institute, Lopez held management roles and was senior research economist at the Banque de France, the nation's central bank. She was professor of economics at the University of Cincinnati.

Dr. Elham Saeidinezhad is a research economist in international finance and macroeconomics at the Milken Institute, with an emphasis on systemic risk, macroprudential policy and financial stability. Saeidinezhad is an empirical macroeconomist by training, specializing in fiscal policy, monetary policy, and productivity growth. She also brings expertise in econometrics and time series approach. She has presented her research at several international conferences and has written for the Institute for New Economic Thinking's website. Prior to joining the Milken Institute, Saeidinezhad was a postdoctoral research fellow in the Financial Stability Research Group at the Institute for New Economic Thinking. She also held teaching positions at the University of Sheffield in the UK and Columbia University in New York.

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