



THE ROLLBACK OF THE DODD-FRANK ACT & FINANCIAL DEREGULATION

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March 25, 2015 |

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Rolling back reform of the financial system is at the top of the agenda for the new Congress. Opponents of a safe and honest financial system have waited until the abject horror of autumn 2008 faded from memory to deal the financial sector regulation a death of a thousand cuts. From time to time, the new Congress may attempt large rollbacks. But their likely strategy is that, after a couple of years of piecemeal repeal, financial regulation will be gutted and the good old days of financial markets that operated like casinos will return.

The effort started in the last session, as the House added a repeal of a provision of the Dodd-Frank Act—one that required insured banks to transact derivatives in separate subsidiaries—to the Continuing Resolution and Omnibus Spending Act (“CRomnibus”).

This provision would have inserted a firewall for taxpayers just in case something went wrong and a bank ended up on the losing side for big losses. Now taxpayers will bear the burden.

When the new Congress convened, more Dodd-Frank Amendments were stuck in a renewal of the Terrorism Insurance renewal. Both were passed and signed into law.

In the new financial deregulation strategy, one-by-one, it will be said that singled out provisions are not essential to avoid another crisis; after all, the particular prohibited behavior did not bring down the worldwide financial markets. This is like saying that a single brick in an entire wall can be taken away and the wall will still be a wall. But if you lose enough bricks, there goes the wall.

This explainer will outline some of the financial reform targets that are likely to be the subject of debate over the next two years. At the end, we have included an appendix that outline portions of the Dodd-Frank Act that include the targets for additional context.

The Volcker Rule

The Volcker Rule is extremely important to changing the financial sector and, as a result, is a major target. It is the primary part of Dodd-Frank that actually prohibits activities rather than simply creating rules that (hopefully) make engaging in activities safer for the public.

The Volcker Rule prohibits banks whose deposits are insured by the FDIC from trading securities and derivatives for their own account. This is called “proprietary trading” and is the type of trading that can damage the bank balance sheet if the trading risks are actually realized. Though there are too many exceptions in the law and the implementing rules could be stronger, the Volcker Rule will significantly reduce the risk of another crisis and bailout.

The bank lobby finds the Volcker Rule most abhorrent because it actually prohibits them from doing things. The extraordinarily slow implementation by the Administration and the regulators has made it vulnerable. For example, Volcker Rule implementation was delayed until 2016 by the Fed in November 2014—six years after it was originally supposed to be implemented. Also, the requirements that banks divest interests in certain hedge funds that constitute indirect proprietary trading were delayed until 2017 by an amendment stuck into the Terrorism Insurance Reauthorization Act, passed and signed into law as the new Congress convened.

There is little doubt that the Volcker Rule will be targeted for further roll back. Direct repeal of provisions is possible. Even more likely are legislated delays that provide a window to achieve outright repeal in a new presidential administration.

Consumer Financial Protection Bureau

This agency, created in Dodd-Frank to protect consumers from predatory financial entities, is particularly disliked by the majority in the new Congress. It is also beloved by much of the minority. It is unclear how it will be attacked, but it is very likely that some form of rollback will be undertaken.

One possibility is a change to the budgetary process to give Congress a more effective say over the bureau. The CFPB was created as a subsidiary agency of the Federal Reserve Board for budgeting purposes. As a result, the CFPB funding is independent of Congress. It is expected that attacks on independent funding will be forthcoming.

In addition, the agency is led by a director appointed by the president and subject to Senate confirmation. A number of proposals have included the conversion to a commission system, with two Republican and two Democratic commissioners and a chairman appointed by the president. This would allow the non-presidential party to introduce substantial influence on the process. In other commissioner systems, the minority commissioners have effectively slowed rulemaking and set rules up for court challenges.

The Financial Stability Oversight Council

One clear target is the Financial Stability Oversight Council (FSOC). For many reasons, the regulation of the financial sector was divided up over the decades before the crisis into many separate agencies. Each has a different responsibility, approach, and congressional oversight structures.

The FSOC was created as a forum in which the Treasury Department chairs discussions on major issues so that the agencies can be brought into harmony and perhaps achieve consensus. FSOC has a limited number of responsibilities for specific action. For example, it identifies which entities in the financial sector are so systemically important that special oversight and rules by the constituent agencies make sense.

There are proposals in Congress touted to increase the “transparency” of FSOC. The real outcome of these proposals would be a second level of process in order to bog down FSOC and generate findings and administrative procedures. There is no reason to force the body—which is really a forum for function administrative agencies—to establish a totally separate administrative bureaucracy just because it can make a handful of designations based on the findings of constituent agencies. Opponents of regulation have had some success with the DC Circuit Court in delaying regulations using procedural challenges. It is clearly true that the proposal imposes procedures on FSOC that can be challenged in court.

Regulatory Jurisdiction

The Commodity Futures Trading Commission (CFTC), which regulates the all-important derivatives markets, has promulgated a complete set of rules for implementation of Dodd-Frank’s Title VII. European and Asian authorities have been slower to complete the process. Derivatives markets are international, existing in cyberspace, and the issue of which rules apply to categories of activities is devilishly complex. To date, while the CFTC has issued guidelines on the issue, there is little consensus, especially between the US and the European Union.

Increasingly, the attack on financial reform is taking on an international flavor. The financial lobby has had great success in playing both sides of the Atlantic because the large European and American banks can move business rather freely between the two jurisdictions. The threat of losing business is an effective argument in both jurisdictions.

Jurisdiction is a major factor in the effectiveness of financial reform. If it is poorly constructed, traders can shop for the weakest regulatory regime and can continuously bargain for weak enforcement, threatening to move to another jurisdiction if the rules are too onerous. Because the derivatives regulations in the EU are not yet complete, jurisdiction will linger as an issue. Regulatory reform can be set back by Congress or the Administration, and there will be major efforts to do so.

Optimally, regulations in the two jurisdictions would be equivalent so that there could be no effective regulatory arbitrage. That will never be the case. The European rules are fundamentally weaker on data disclosure, consistent with historic practices. Moreover, many rules will be administered by member states that are easily influenced to protect home banks from foreign enforcement, especially US enforcement that involves harsher penalties. In recent

months, as the European economies have come under renewed pressure, tensions have grown for backing down from rules that could reduce bank profitability. This, in turn, puts the burden on US politicians and regulators to ease up on domestic regulation for fear of losing business to Europe.

The primary thrust of the effort is to force the US regulators into a loose interpretation of "equivalency." If that is done, the fine points of jurisdiction will be blurred. Some EU authorities have even suggested that derivatives traders could choose the regulatory regime they wish. While EU authorities have delivered much of the pushback, watchdog groups in Europe have found that the primary source of pressure on those authorities is, in fact, the US banking sector.

Repeal of the Swaps Push Out Requirement in the "CRomnibus"

Not all bank trading of derivatives was banned by the Volcker Rule. Several types of derivatives, mostly swaps, were excluded even though they were extremely risky. To protect against another bailout, insured banks were required to execute many (but not all) of these risky derivatives through subsidiary corporations. The swaps businesses were to be "pushed out" into a subsidiary. The idea was to insulate the key corporate entities from the risk so that the subsidiary could be shut down and the rest of the bank could survive if the business went bad.

The subsidiaries had to be separately capitalized, which would cost the banks more because the cost of that capital would be higher than for an insured bank, reflecting the firewall between the trading and bank credit. The swaps push out provision was successfully repealed because the incremental cost was viewed as unnecessary since the Volcker Rule provided some protection. And the Fed argued it was monitoring the banks to guard against unwarranted risk. Of course, the Fed was also monitoring the banks in 2008 and was unable to perceive the risks of derivatives.

End User Amendments

Dodd-Frank derivatives rules provide many exceptions for "end users," commercial entities that hedge the risks of their businesses using swaps. The end users that are heavy users of swaps have always been a potent lobby for rolling back rules in alliance with the banks. Typically, banks extend credit to end users and effectively forego the deposit of marginal collateral up to the credit extended. While this is clearly a form of borrowing, it is reported separately under accounting rules, making the credit a form of off-balance sheet financing. Dodd-Frank allows the regulators to require end users to post full collateral to cover the credit risks that their trading counterparts incur. However, the regulators have elected not to require end users to post collateral.

Now, opponents of financial reform have been proposing amendments to eliminate the power to require collateral of end users, even though the regulators have not yet required it. The FDIC required the banks to set limits on credit extended to end users and then to collect margin above the limits, a prudent banking practice. This is the real target of the amendments.

The motivation is not necessarily to get unlimited credit, because the banks actually do set limits. It concerns a practice of taking non-cash collateral. The FDIC requires cash collateral over the credit limit. This would effectively prohibit a form of energy asset transaction, most often involving liens on power plants, as credit backing for certain swaps. In these transactions, the corporate swap party puts up a lien on the energy asset in lieu of cash collateral. The FDIC requirement of cash collateral is clearly a safer practice.

A menu of end user rollbacks passed the House but not yet the Senate. These will be pursued and more are likely to come. President Obama has signaled that they would be vetoed.

Amendments Affecting the Regulatory Agencies

One way to roll back reform is to squeeze the budgets of regulatory agencies. The most vulnerable target is the CFTC, which was given the role of swaps market regulator in Dodd-Frank but has not been provided the budget increase to do the job, and instead has faced budget cuts.

There will also be a push to increase the requirement of elaborate cost-benefit analysis by regulators to justify regulation. This is a fertile area for lawsuits to delay or eliminate rules. As a complementary move, limitations on lawsuits to challenge rules are likely to be proposed.

Repeal by a Thousand Cuts

It is likely that Congress will continue to pass rollback provisions, often characterized as technical amendments and as relief from burdensome regulations, with the ultimate goal of functional repeal of Dodd-Frank. One argument will be that individual rules address problems that were not the proximate cause of the financial crisis. This misses the ultimate point that Dodd-Frank is a fabric of rules that work together to limit the risk and cost of the financial sector.

President Obama said in the State of the Union Address that he would veto legislation that "rolls back" financial regulation. Nonetheless, he signed the CRomnibus and the Terrorism Risk Insurance Acts doing just that prior to the Address. The question is whether the Administration will approve amendments that do not, in its view, roll back reform, especially if they are attached to important legislation.

APPENDIX

Outline Of Key Dodd-Frank Provisions Under Attack

There are several pillars of the regulatory structure of Dodd-Frank:

I.

The Consumer Financial Protection Bureau is established in order to oversee and regulate much of the financial sector in order to protect households from unfair and predatory practices in credit and other financial transactions.

II.

Financial Stability, or too-big-to-fail, is addressed in the Act. These are often referred to as prudential regulations.

A. The Financial Stability Oversight Council is established.

1. Membership is:

- Treasury Department (Chair)
- Chairman of the Board of Governors, Federal Reserve
- Comptroller of the Currency
- Director of the Consumer Financial Protection Bureau (within Treasury)
- Chairman of the SEC
- Chairman of the CFTC
- Chairman of the FDIC
- Director of the Federal Housing Finance Agency
- Chairman of the National Credit Union Administration
- Independent Insurance Expert appointed by the President and approved by the Senate

2. The FSOC is responsible for designating financial entities that are systemically important and require special regulation.

3. It also can become involved in high-level issues.

B. Bank capital requirements are the responsibility of the Fed, FDIC, the Comptroller of the Currency and other related regulators.

1. Analysis of risk and the reliability of funding are provided for to determine how much capital is needed.

2. The measurement of the amount of capital on hand is also provided for.

3. Stress tests to assess adequacy are provided for.

C. The Office of Financial Research within Treasury to provide analytics is established.

D. A process of resolution of failed banks is established to help address any crisis in the future.

1. Banks are required to produce and periodically update "living wills" that anticipate parameters of a potential resolution.

2. Resolution procedures are mandated to be established by the prudential regulators.

III.

The Volcker Rule establishes limitations on proprietary trading (or taking on trading risks that are backed by balance sheets) by federally insured banks.

- A.** This is one of the few absolute prohibitions of bank activities in Dodd-Frank.
- B.** Proprietary trading includes direct trading or trading through sponsored hedge funds, the type of proprietary trading that caused Bear Stearns to fail.

- C.** The key issues relate to exceptions.

1. Market making, a practice which is the subject of intense debate centering on its definition.
2. Hedging of risks.
3. Underwriting new issuance of securities.
4. Government securities.
5. Facilitating customer trades.

IV.

Derivatives regulations comprehensively govern the markets for derivative products, such as futures, swaps and options.

- A.** Jurisdiction is split between the CFTC and the SEC.

1. SEC jurisdiction is limited to derivatives on stocks and bonds, other than indexes of stock and bond prices.
2. The CFTC covers everything else.

- B.** Shared coverage between the US and other jurisdictions is addressed.

- C.** Registration of swap dealers, major swap market participants and swap market utilities (exchanges and clearinghouses) is required.

- D.** Transparency is addressed.

1. Pre-trade transparency deals with the market for swaps.
 - This centers on the requirement that swaps that are required to be cleared (see below) must be executed on swap execution facilities, platforms that provide for disclosure of proposed prices and competition.
 - Debate centers on the level of disclosure and competition required for types of swaps.
2. Post-trade transparency focuses on prices of swaps entered into, whether or not they are executed on exchanges or swap execution facilities.
 - Real-time reporting of data is required.
 - Swap data repositories to house the data are required.
 - Government agencies get all of the data and the public gets a narrower set based on confidentiality.

- E.** Market integrity is addressed.

1. The rules regarding manipulative practices are strengthened.
2. Standards for enforcement are adjusted to allow easier enforcement.

- F.** Rules to prohibit disruptive practices are enhanced.

1. Specific practices are identified.

2. Largely related to high-frequency trading.

G. Position limits are established to mitigate price effects based on large positions.

H. Rules governing the management of credit exposure in the swaps markets are established. This relates to margin, or the collateral that must be posted in order to secure credit exposures of participants in the swaps markets (like AIG in 2008).

1. Many swaps are subject to mandatory clearing, meaning that clearinghouses sit in the middle between the two sides of a swap trade and collect margin based on transparent rules that are monitored and approved by regulators.

- In essence, if a clearinghouse offers clearing for a type of swap, it must be cleared.
- The major exception is for non-financial companies that enter into swaps to offset legitimate business risks. This is referred to as the "end-user exception."

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