Banking, Dodd-Frank and Wall Street Reform

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What is the Dodd-Frank Wall Street Reform and Consumer Protection Act?

<u>What precipitated reform</u>?

Failure of Lehman Brothers and significant distress among other large financial institutions during the 2008 financial crisis exposed certain gaps in regulatory authority as the Federal Reserve, US Treasury and other government agencies worked to limit the fallout on the broader economy. After the financial crisis, many believed that reform was needed to provide additional tools to the regulators, so they could help prevent and better deal with future adverse events. Financial industry covers a great variety of areas fulfilling basic needs of many consumers (checking accounts, mortgages, credit cards, investments etc.) as well as very complex needs of institutions and corporations (currency exchange, global markets trading, hedging of risks, capital raising, etc.). Regulation of the financial sector is complicated and is continuously evolving. Dodd-Frank legislation stated aim is "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."

<u>How does the Dodd-Frank Legislation do this</u>?

Dodd-Frank created several new regulatory bodies to oversee the financial system: Financial Stability Oversight Council (FSOC), Office of Financial Research (OFR), Federal Insurance Office (FIO), and the Consumer Financial Protection Bureau (CFPB). It further defined and expanded the authority of the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve, enacted the "Volcker Rule", while also addressing investor protections, lending practices, regulations of hedge funds, and mine safety disclosures among others.

Financial Stability Oversight Council (FSOC)

FSOC role is to identify risks to US financial stability from ongoing activities of large interconnected financial companies, to promote market discipline, and to respond to emerging threats to financial stability. Chaired by the Secretary of the Treasury, it includes the Federal Reserve Board Chair, the Chair of the SEC, the head of the Consumer Financial Protection Bureau, the Head of the FDIC, the President of the National Credit Unions of America, the head of the Commodities Futures Trading Association, Office of the Comptroller of the Currency, Federal Housing and Finance Agency, and a Presidential appointee with expertise in the Insurance Industry. All these individuals are believed to have the expertise and judgment to evaluate potential financial issues arising in the complex US financial sector.

<u>Office of Financial Research (OFR)</u>

This office is a data analysis and support group that facilitates the work of the FSOC. The Office of Financial Research (OFR) does the research, modeling and support required by the FSOC to examine risks and problems within the various financial sectors they identify as requiring additional assessment.

Federal Insurance Office (FIO)

This office is to monitor all aspects of the insurance industry (except health insurance, some long-term care insurance, and crop insurance), including the identification of gaps in regulation of insurers that could contribute to a financial crisis.

Consumer Financial Protection Bureau (CFPB)

CFPB protects consumers from unfair, deceptive and abusive credit practices and takes legal action against companies that break the law. It also monitors financial markets for potential risks to consumers, investigates consumer complaints, and writes regulations to address potential problems or concerns related to consumer credit and financing.

What is the Volker Rule and why is it part of the Dodd-Frank Wall Street Reform Act?

When the Glass-Steagall Act was repealed in 1999, the separation of commercial banking from investment-related activities was eliminated. The Volker Rule re-imposes some of the limits on traditional commercial banking by limiting certain activities seen as "speculative", primarily trading on bank's own behalf, which is believed by many to have contributed to the development of the Financial Crisis. The intent is to reduce the level of risk taken by depositary institutions. Banks may still provide underwriting services, trading of government securities, insurance company activities, offer hedge funds and private equity funds, act as brokers, or provide custodial services. However, these activities and the its banking functions must remain separate.

Criticisms of Dodd-Frank

FSOC lacks transparency, as does the CFPB regarding their regulations and oversight. Authority, as defined, is too broad and limits are ambiguous. There is no assurance that the rules and regulations imposed will indeed be successful in preventing or resolving a future crisis. FSOC can define companies as Systemically Important Financial Institutions (SIFI) and expose them to intrusive, unnecessary regulations that potentially increase costs and capital requirements. The designation of SIFI may entrench "too big to fail" and spread the concept beyond banking. OFR and CFPB collect too much private, personally identifiable information and imposes significant unreasonable reporting burdens on financial institutions. The CFPB can impose rules without oversight that impact businesses and credit agencies, restricting the availability of credit. CFPB has vast power that is unchecked by the President or Congress. CFPB may regulate any area, however remotely tied to financial services.

Views from the Industry

New regulations have resulted in significantly more capital being required to operate in the banking business. They have also increased compliance costs to record levels. Regulations do not adjust for complexity, only for size. Our financial system is safer today because of increased capital and liquidity requirements. Compliance and control systems are far stronger than in the past. Too big to fail has been solved as bank debt and stock holders are at risk for all losses. Regulators have the tools to manage orderly liquidations of financial institutions. Rigidity of new rules may prevent banks from lending and providing liquidity during a crisis. Capital rules are too complicated. Stress testing is based on secret assumptions; results under the worst assumptions suggest banking industry is significantly overcapitalized. Regulations result in lower availability of credit to consumers with lower credit scores. Cost of servicing a mortgage in default are 13x that of a performing mortgage, incentivizing avoidance of any losses. There are overlapping regulators and too much complexity in the system. Smaller banks are struggling to meet the regulatory burdens.

Andy Barr on Financial Regulations and Responses to them

Andy Barr presents his desire to give consumers more choices and access to financial services. He wants to help community banks and decrease regulations that harm financial institutions ability to lend to small businesses.

Big banks have indeed gotten bigger and there are fewer small community banks today than 35 years ago. In the mid-1980's there were 14,500 banks, today there are 5.600 banks. In 1990 the 10 largest banks controlled 20% of assets, and by 2010 they controlled nearly 50% if assets. Bank consolidations do increase in volatile financial times like the market meltdown in 2008-2009 as failing institutions have been merged into healthy ones.

Andy claims there were 1,500 bank that have disappeared since 2010 and blames the Frank-Dodd Wall Street reform for their disappearance. There have been only 193 bank failures between 2011-2015 and only two bank failures in Kentucky. Although increased regulatory burdens may be part of the reason for consolidations, acquisitions tend to be driven primarily by opportunities to increase operating efficiency, not by Dodd-Frank legislation.

In a speech in Richmond, Kentucky to the Richmond Chamber of Commerce on March 9, 2016 Barr made several comments. He said, economic reform should focus on ending poverty by creating jobs, instead of trying to arbitrarily end income inequality. He then went on to blame income inequality being aggravated and the economy put at risk by the Dodd-Frank banking reform act. He went on to say lending is restrained so small banks are unable to provide the capital that small businesses need to grow and hire.

Any regulation has the potential to create winners and losers. Dodd-Frank was a reaction to the financial crisis when certain regulatory powers and processes were seen as inadequate. There are positive features to the law as there are likely undesirable ones. Carefully considered changes could be implemented to remove the undesirable effects, without replacing the entire law.

In an interview with Matt Young at the Kentucky Kernel in 2014, Barr blamed the financial crisis on government policy that induced over investment in subprime mortgages. He accused the Consumer Financial Protection Bureau of snooping on American's transaction history, harassing small financial institutions, preventing people from accessing credit and taking away choices from the American people. This has been what is limiting growth and economic recovery. He said because wealthy people don't face these same hurdles, it contributes to the income inequality gap and prevents poor people from achieving the same upward mobility. Barr also believes that government sponsored enterprises, Fannie Mae and Freddie Mac, should be wound down as they were responsible for the excess of subprime lending to take place causing the financial crisis.

It is difficult to pinpoint one actor or "the" cause for the financial crisis. However, 24 of the top 25 home loan originators were not regulated by any government agency. The fraudulent home loans resulted from a lack of regulation leading to trillions in subprime mortgages being given excellent credit ratings and sold to investors on the open market as high quality derivatives. A combination of private, public, and individual choices reacting to various incentives in the absence of any oversight, all likely contributed. The CFPB may have an important role to play as an advocate for consumers and needs information to ascertain when consumers are being disadvantaged. The CFPB does not collect identifiable individual transaction history, but rather the same anonymized financial information that is used by businesses to make decisions. This is used by the CFPB to identify trends or patterns in financial behaviors that may be relevant to its regulatory efforts. Regulations do limit growth, but when well designed, can help ensure better social outcomes than markets alone. Fannie Mae and Freddie Mac have played an important role in lowering the cost of mortgages by providing a government guarantee for the mortgage securities to investors. Winding down these institutions may have detrimental effects for home ownership rates.

Andy Barr recently wrote an article criticizing the structure of the CFPB and describing his efforts to reform the agency. (Richmond Register, April 5, 2017). Barr claims that the CFPB is not accountable for its spending and imposes regulations that have done little to help consumers. Barr proposes moving the funding source to the congressional appropriations process. The intent is for Congress to use the "power of the purse" to regulate the activities of the CFPB.

CFPB determines the funding it believes is necessary to meet its obligations within the limits set by the Dodd-Frank legislation, requests the funds from the Federal Reserve (these funds come for the Federal Reserve System earnings, most of which are normally transferred to the US Treasury), and informs the Committees on Appropriations and on Financial Service of the House of Representatives as well as the Committee on Banking, Housing, and Urban Affairs of the Senate. In its 2016 planning document, the CFPB reports having provided materials and decision tools to over 6.8 million consumers, handled over 265,000 consumer complaints, published several reports, and hosted public events on issues affecting credit cards, mortgages, auto finance, and payday lending. The agency's actions have also resulted in fines and payments to consumers from companies believed to have caused harm to them (for example, $100 million fine paid by Wells Fargo) totally over $11.8 billion during its first 4 years of operation.

The Financial CHOICE Act of 2017

Andy Barr is a co-sponsor of this legislation which was released from the House Financial committee in May 2017. It repeals much of the Dodd-Frank Wall Street reforms and replaces it with a very different type of financial regulation. The Financial Choices Act of 2017, will replace the head of the CFPB with a committee of 5 partisan board members (3 and 2, GOP and Democrat decided by Administration). It will eliminate most of the CFPB's ability to regulate credit rates and it eliminates restrictions on subprime mortgage loans, payday and title loans and the role of the CFPB in addressing unaffordable lending. It prevents consumers from engaging in class-action lawsuits to address widespread wrongdoing in lending practices and allows the return of forced arbitration contracts in which credit/financial companies caught breaking the law are permitted to use an arbitrator rather than facing court action to address their wrongdoing. It eliminates the Orderly Liquidation Authority (OLA) and the Office of Financial Research (OFR) and returns liquidation of companies to the bankruptcy process for failed financial institutions. It eliminates the Volker rule regarding the separation of bank speculation and other bank activities. It removes companies like AIG, Prudential Financial other non-bank financial institutions from FSOC oversight. It eliminates the ability of the government to oversee and provide accreditation for credit rating agencies. It requires that all major financial regulations receive Congressional approval prior to their implementation, giving financial institutions an additional avenue for veto power over future financial regulations. It repeals the mandate that publicly traded companies disclose the ratio of median vs CEO pay. Repeals SEC authority to restrict or eliminate securities arbitration. Repeals the SEC's authority to restrict short selling.

These changes are in part based on the view that Dodd-Frank is detrimental to consumer choice, harmful to small commercial banks and hurt financial speculation required to improve job and economic growth. However, there are two pieces of legislation already on the books to address Government Regulations and the burdens they impose on small business. They are ***The Regulatory Flexibility Act*** and the ***Small Business Regulatory Enforcement Act***. Together these acts state Government Regulations must be adjusted for the size and relevance of the small businesses they affect. They are designed to avoid the one size fits all approach to rules and regulations by Washington, so small businesses are not adversely affected by rules and regulations that pertain primarily to much larger businesses, but to which they must comply. Unregulated speculation was a primary source leading to the financial meltdown in 2008. Home loans were $1.8 trillion last year. Bank lending has grown at 6%/yr for the last 4 years, twice the rate of growth in GDP. Commercial lending to business of less than $1 million has nearly returned ($328 billion) to the level reached prior to the financial crisis ($336 billion).

What critics are saying about the Financial Choice Act of 2017

The bill places a far heavier burden on regulators generally. It repeals a number of regulations of Dodd-Frank, and imposes burdensome analyses of ALL available alternatives to the regulation. The regulatory agency is REQUIRED to select the rule that is least costly and burdensome. Every major financial rule would require Congressional approval or it would not take effect. The failure to embrace regulatory agency interpretation of the law when faced with ambiguity in a statute, means the Supreme Court Chevron doctrine will no longer apply to business disputes of agency regulations. Meanwhile, shareholders would have less power to make proposals regarding company policy, voting for company nominees

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