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Evaluating Key Aspects of Senator Dodd's Revised Financial Reform Bill

Senator Dodd, Chairman of the Senate Banking Committee, released today his much-anticipated revisions to his financial reform bill. The changes, by and large, are an attempt to gain a measure of Republican support without losing a larger number of his fellow Democrats. The revisions reflect in part the results of an extended attempt by Senator Dodd to reach a comprehensive compromise with Senator Corker, a Republican on the Banking Committee. (Those discussions followed earlier failed efforts to develop a compromise bill with the ranking minority member on the committee, Senator Shelby.)

Overall, I believe the bill would represent a major improvement to the status quo, but political compromises significantly diminish its effectiveness compared to an ideal set of reforms. This note will focus on a few key aspects of the 1000+ page bill, including:

- The approach to consumer protection
- The new mechanism for "resolving" troubled financial institutions
- The reshuffling of regulatory responsibilities

Likelihood of passage

Before discussing the policy issues, it is worth explaining my four reasons for continued optimism that comprehensive financial reform will be signed into law this year.

There is a reasonably wide consensus on the need for many of the reforms included in the bill. These less controversial points tend to receive little media attention because they are not the focus of ongoing fights.

Regulators have the authority to act on their own to put into place a number of the most important reforms, including some of the most expensive for the financial industry. For example, if there is no legislation this year, regulators will not wait for the next Congress to act (or choose not to act) before they raise capital and liquidity requirements. Further, they would likely impose a second tier of even higher requirements for the largest financial institutions, in line with the thinking of the Administration and of most legislative proposals.

The politics are very different than for healthcare reform. The public is demanding action, although the area is too technical for them to know exactly what they want. Further, they hate bankers with a passion at the moment and bankers are seen as the principal obstacle to passage of the bill. Thus, it is not clear that there are 41 senators who would be willing to stand up and filibuster a bill when that action would be portrayed as siding with the bankers.

Many leaders in the financial industry want to see a bill passed, in order to end the uncertainty and avoid some potentially very negative outcomes. In my view, the industry over-played its hand last year when it lobbied so hard, and effectively, on key points that it sometimes appeared that it could stop meaningful reform. Not only would this not be in the long-term interests of the industry, which needs a system less prone to failure, but it led to a backlash. Frustration reignited discussions of taxes on bonuses, spurred a proposed bank tax, and encouraged the Volcker Rule, a proposal to eliminate proprietary investment activities at the banks. This seems to have reminded the industry that there are many worse outcomes than the core proposals on the table. Equally importantly, the stock market is allergic to uncertainty and all of the leading financial firms are publicly traded. For that matter, it is frustrating and difficult for bank executives to plan when the basic rules are unclear.

Consumer protection

Virtually everyone agrees that regulators did a poor job of protecting consumers in the run-up to the financial crisis, particularly in the area of sub-prime mortgages and those that were issued with little or no documentation of income or assets. The controversial question is how best to ensure that regulators do better in the future.

The Administration has strongly pushed for a new, independent Consumer Financial Protection Agency (CFPA). This agency would take over the consumer protection functions of all of the existing federal financial regulators. The theory is that an independent agency with a sole focus on consumers would pay more attention to potential abuses, be more prone to act, and more effective when it did act. The existing regulators are viewed as being distracted by their "safety and soundness" responsibilities. Many argue that a regulator responsible for the safety and soundness of an industry will almost always place more weight on this responsibility than on consumer protection, especially if there is viewed to be a conflict. The potential for such a conflict is, in fact, high, because financial institutions generally only persist in actions that are strenuously opposed by consumer advocates if those activities are believed to be strongly profitable. Profitable operations are the bulwark of bank safety, since they provide income in the near-term to offset any losses and the accumulation of that income builds up as capital that provides long-term protection. Thus, safety and soundness regulators tend to listen carefully to industry arguments about the value of the products they offer. Some advocates of an independent agency go further and argue that safety and soundness regulators are also frequently "captured" by the industries they regulate, for a variety of political and bureaucratic reasons.

Opponents of an independent agency dispute the inevitability of a pro-industry bias at agencies whose principal responsibility is safety and soundness. Further, they argue that an independent agency would have its own pro-consumer bias which could transform into a bias against even reasonable transactions if they involve a measure of risk. In essence, they fear that such an agency might act like the caricature of the Food and Drug Administration, which is sometimes alleged to turn down valuable drugs that would save thousands of lives, if there is a chance of any deaths from side-effects. Translating this into the financial sphere, it is theoretically conceivable that such an agency might disallow mortgages with a down payment of less than 10%. This would reduce the number of families that got themselves in trouble by stretching too far to buy a house, but it would also eliminate the ability of many more families to buy a house, even when they would have been able to carry the mortgage.

In line with the Administration's proposal, Dodd's bill would require the agency to perform risk-reward analyses and provides guidelines for the agency to follow. However, opponents are unconvinced that this will make sufficient difference to the decision-making in practice.

A second fear is that a new consumer agency would provide an additional layer of bureaucracy that would be particularly hard on smaller banks who cannot afford large compliance departments to deal with numerous regulatory requests. Even the large banks worry that the bureaucracy could cause other problems by mandating or encouraging actions that conflicted with the guidance of the safety and soundness regulators.

This conflict about the independence and relative strength of a new consumer agency is very important politically, since Republicans are nearly or completely unanimous in opposing an independent agency. Dodd's bill attempts to thread the needle between those who support and those who fear a strong agency. He has chosen to propose an agency that would be housed within the Federal Reserve System, but which would have a Presidentially-appointed Director and very considerable autonomy. Balancing this relative independence would be an ability of a regulatory council to override the consumer agency's rules, if a two-thirds majority chooses to do so. Banks with less than $10 billion of assets would not deal directly with the consumer agency, but would face supervision and enforcement by their existing regulators. The agency would also have powers over many non-bank financial institutions.

The placement of the agency within the Fed, and the constraints on its actions, may not be enough to lure any Republican supporters for his bill, given the importance they have given to the consumer agency issue. However, it moves far enough to facilitate possible compromise either during the committee deliberations or prior to a final floor vote.

My own opinion is that an independent agency would be better, since I am not confident that an entity that is part of a larger organization with a safety and soundness mission would give a proper priority to consumer protection. Certainly the record to this point is highly discouraging. Concerns about regulatory overstretch by an independent agency are not unreasonable, but it appears that the legislative guidance emphasizing the balance of risks and rewards should help to discourage overkill. In any event, consumer regulation was so poor under the current system that an independent regulator appears the better choice, despite some level of risk.

If an independent agency is not politically feasible, which seems to be the case, then it will be important to allow it a high degree of operational independence. Senator Dodd appears to be trying to do this – hopefully that attempt will survive the inevitable compromises.

Ironically, banks themselves might be better off with a somewhat stronger consumer agency. Many of the worst practices leading up to the financial crisis came from non-banks that were significantly more weakly regulated than the banks were. An agency of adequate strength could create a more level playing field that should benefit the banks by shielding them from unfair competition coming from risky or shady operators.

Enhanced resolution authority

Federal regulators have extensive legal authority to intervene when a bank gets into trouble, but much less ability to intervene when other types of financial institutions hit problems. There is fairly broad agreement that regulators need enhanced "resolution" authority over non-bank financial institutions that are large enough or interconnected enough to be systemically important. This would give regulators access to a wider set of tools to deal with failures of such non-banks than they had with AIG, Lehman, and Bear Stearns. As with consumer protection, however, there is considerable disagreement about how best to accomplish this.

The Administration's proposal was to give regulators power over other systemically important financial institutions very similar to the power the FDIC has over troubled banks. However, there has been very considerable resistance in Congress, especially from the more or less unanimous opposition of Republicans. One source of concern is about moving from well-established bankruptcy procedures, which are fairly legalistic and give the parties involved a chance to make their case to a bankruptcy judge and to bargain with each other over an extended period, to a system where unelected officials make important choices very quickly with little recourse for the affected parties.

Perhaps even more important politically is the perception that a bankruptcy procedure would more or less preclude a government bailout. There is a fear that a resolution process run by bureaucrats, and guided to some extent by politicians, would tend to pull in taxpayer money in order to keep systemically important institutions running. The distinction is hardly clearcut, of course, since the government could provide Debtor in Possession financing or assist in other ways with a bankruptcy restructuring, as it did with GM and Chrysler. However, supporters of the bankruptcy approach do have a point that it might make it somewhat harder to provide restructuring aid than in a process directly controlled by the federal government.

Senator Dodd has proposed an approach that is apparently quite similar to the compromise he was working out with Senator Corker. The process is designed to ensure that bankruptcy is used in all but the most extreme cases, where systemic risk is clearly an issue. Bankruptcy would apply unless all of the relevant regulators, and the Secretary of Treasury certified that a systemic risk exception was warranted. This certification would be vetted by a special bankruptcy tribunal, composed of bankruptcy judges with expertise in financial institutions. If they agreed, then special resolution procedures would apply instead of bankruptcy law. If not, then bankruptcy law would continue to apply. The special resolution procedures would be set up to ensure that only the eventual liquidation of the financial institution was an option. There would be no equivalent of Chapter 11 of the bankruptcy law, which allows a restructured firm to emerge out of bankruptcy. The general idea is to make the special resolution process very onerous to all concerned, politicians, regulators, and the firms themselves, so that it would not be entered into lightly. The hope is to eliminate the "moral hazard" issue, where stakeholders in the firm, such as creditors, assume there will be a government rescue. The intent is for creditors, and everyone else, to truly be exposed to losses.

A related issue is the size and financing of a "resolution fund." Everyone accepts that there may have to be a rescue in the future, no matter how much we try to avoid it. If that happens, there is a strong consensus that the financial industry should pay any resulting costs. (In theory, there might not be any such costs, if creditors truly absorb any losses beyond the value held, and therefore lost, by shareholders. However, it is not yet clear that this will be completely feasible in a future crisis.) However, there is a fight about whether to charge premiums to build up a fund in advance. The industry is pushing fairly hard for any funding to be after the fact. The biggest advantage of prefunding is that it provides greater assurance that financial institutions will bear the cost, rather than taxpayers. In addition, premiums would likely be related in some way to the likelihood of being a recipient of a rescue, which would provide economic disincentives for firms to create that risk in the first place. The biggest disadvantages are that it would make lending and other financial activities more expensive, by virtue of the premiums, and that it might actually encourage a future "bailout" by creating a slush fund to work with.

Senator Dodd has proposed to effectively split the difference, setting up a fund that would collect premiums until it reached a $50 billion level. This is unlikely to be large enough to handle a severe financial crisis and therefore would probably need to be supplemented by ex post facto assessments. Earlier proposals for pre-funding suggested a $100 billion target or even higher.

I side strongly with the Administration on the resolution issue, for several reasons. First, the bankruptcy-based alternative would continue a distinction between banks and non-banks that is a disaster waiting to happen. The largest banking groups, which dominate our financial system, are each built around a major bank, but have many important non-bank affiliates. In particular, the bank holding company that owns the bank is not itself a bank. The problem, from a resolution point of view, is that the banking groups plan and operate in an integrated manner. This close integration makes it extremely difficult to deal with different pieces under separate insolvency regimes: bankruptcy law for everything except the core bank, which is controlled by the FDIC under its insolvency process. The potential for the two approaches to work at cross purposes is very high and would strongly discourage regulators from intervening as forcefully as they otherwise might. My earlier paper on pre-emptive bank nationalization demonstrated how this dichotomy would have made it very hard to take over Citibank, (see http://www.brookings.edu/papers/2009/0325_bank_nationalization_elliott.aspx.)

Second, I believe that an attempt to create an inflexible system to virtually ensure the absence of a taxpayer bailout is perversely more likely to set up such bailouts in a severe future crisis. (Such really severe crises should be the main focus of our thinking. We are in a much better position to handle isolated failures, even of very large institutions, than we are to deal with a situation in which confidence in the financial system is very low.) Systemically important institutions are critical principally because they have an established web of relationships with a wide range of other parties. Future politicians and bureaucrats are very unlikely to risk the liquidation of a series of such institutions in the midst of a severe financial crisis. To start with, there is the concern that the potential losses from such failures would carom through the financial system, endangering a wider and wider range of institutions as each suffers losses from the earlier failures. In addition, such liquidations would almost certainly induce a sharp credit crunch, since institutions that are going out of business, however slowly, are unlikely to make new loans, even to existing customers. (It might be argued that the banks themselves, where the loans are largely made, could be resolved by the FDIC under current rules, but this ignores the close integration described above. Liquidation of non-bank affiliates will strongly impact the banks themselves.) Taking this all together, I believe that structural inflexibility would likely force ad hoc solutions in the next severe financial crisis, creating the same type of stumbles and traumas as we just went through.

Third, the whole approach of bankruptcy law is not well suited to dealing with large financial institutions. These firms tend to have effects on the larger economy and society that are substantially bigger than for a similar sized manufacturing or service company. This is the fundamental reason that America, and most other large economies, went to such efforts to rescue their financial systems when threatened by the recent crisis. (Even Sweden, praised for its tough approach to bank rescues, guaranteed all bank liabilities.) Bankruptcy judges are good at divvying up the assets of a company among its creditors and other stakeholders. They have little experience with, and little legal basis for, taking account of larger societal impacts.

Fourth, I do not believe that there is sufficient specialized expertise in the bankruptcy courts to be sure of handling a complex financial institution effectively. Bankruptcies of large financial institutions remain fairly rare, partly because of the existence of regulation and partly because so much value is lost when such an institution goes into bankruptcy that a deal is usually worked out to avoid that necessity. (Proponents of the bankruptcy approach sometimes claim that the Lehman bankruptcy itself, as opposed to the effects on the financial markets of the surprise collapse, went quite smoothly. However, this ignores the manner in which we exported massive problems to Europe, where they are literally spending hundreds of millions of dollars to sort out Lehman's European operations and obligations and are far from the final answers.)

Pre-funding a resolution fund to a reasonable level appears to be the best approach, but the funding target can be set with some reliance on ex post facto replenishment. $50 billion seems too low, but there is no magic number.

Division of regulatory responsibilities

If one were to design the bank regulatory system from scratch, it would clearly not have as many regulators as the current system does. There are:

- The Office of the Comptroller of the Currency (OCC) for national banks.
- State regulators for banks with state charters.

- The Federal Reserve, regulating bank holding companies and acting as the federal regulator for some state-regulated banks
- The Federal Deposit Insurance Corporation (FDIC), acting as the federal regulator for the remaining state-regulated banks and, in a secondary manner, all banks with deposit insurance
- The Office of Thrift Supervision (OTS), for federal thrifts, which are now quite similar to banks.
- The National Credit Union Administration (NCUA), regulating credit unions, which are another form of bank-like entities

Unfortunately, it is very difficult politically to reduce the number of regulators since there are strong constituencies supporting the continued existence of each of them. Even the OTS, which is generally viewed as having done a particularly poor job (and which was the primary federal regulator tagged with the failures of AIG, Countrywide, and WAMU) has received strong backing from many of the thrifts which it regulates.

The Administration essentially chose to focus on what the regulations would be, rather than who the regulators would be, in order to sidestep another layer of political complication on top of an already difficult set of constraints. Senator Dodd, bravely, chose in his earlier proposal to try to integrate nearly all of the federal banking regulators into a single body. However, it never seemed likely that this would fly politically and his revised proposal recognizes this reality.

The new proposal merges the OTS into the OCC, as the Administration and the House have also proposed. Beyond that, it reshuffles responsibilities, but does not eliminate agencies. The Fed would pick up responsibility for systemically significant non-banks and solidify its control of banking groups with more than $50 billion of assets, but lose its large federal regulatory franchise with smaller state-regulated banks. The FDIC would pick up those banks, so that it now covered all state-regulated banks.

I would personally have preferred a more radical integration of federal banking regulation, similar to Senator Dodd's original proposal, although I was always skeptical that it could be done politically. My fear is that over the years one of the regulators will become lax. Lax regulators tend to pick up larger and larger shares of the industry to regulate, through a process known as "regulatory arbitrage". This would be particularly bad if there is a provision for an existing institution to change charters, as is true today. However, even without this, those organizations that are already covered by that regulator, plus newly chartered institutions, would have a competitive advantage that lets them grow at the expense of more tightly regulated firms. This problem becomes more serious with time, which is significant because it may be many years before we encounter the next truly severe financial crisis.

Conclusion

I would like to have seen legislation pass which avoided the compromises required on these three critical points. However, "politics is the art of the possible," and the revised bill would still improve the current system quite considerably. It would be better to move forward with something along the lines of Senator Dodd's bill than to fail to pass any legislation.