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# **Harmonising Basel III and the Dodd Frank Act**

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## ABSTRACT

This paper aims to highlight why the harmonization of two major legislative frameworks, namely, Basel III and the Dodd Frank Act, will contribute immensely to resolving future global as well as regional financial crises.

More specifically, the paper also aims to highlight the significance and importance of addressing the main transmission channels of financial instability and systemic risks at micro and macro prudential level as well as the need for consideration and redress of the obstacles confronted by Basel III – with particular regards to the impediment imposed by the Dodd Frank Wall Street Reform and Consumer Protection Act.

Key Words: Basel III; Dodd Frank; credit ratings; financial crises; regulation; financial stability; systemic risks

# HARMONISING BASEL III AND THE DODD FRANK ACT

*Marianne Ojo*

## **A. Introduction**

The structure of financial regulation has witnessed considerable reforms in various jurisdictions in the aftermath of the recent Financial Crisis. In several jurisdictions like the United States where, prior to the recent sub-prime Crisis, an overhaul of the structure of financial regulation was considered to have been a daunting task, changes to the structure of financial regulation have been implemented.

However, a major hurdle still persists in the successful implementation and harmonisation of two major financial regulatory reforms: The Basel III framework and the Dodd Frank Wall Street Reform and Consumer Protection Act.

The Dodd Frank Act prohibits US regulators from relying on external credit ratings in any regulation – thus „making the implementation of Basel reforms relating to securitization and resecuritizations impossible”.<sup>1</sup>

Furthermore, it:

Places US banks at a possible „competitive disadvantage under Basel III,”<sup>2</sup> as well as ;  
Imposes additional cost burdens and problematic implementation issues (in matters relating to consistency, comparability and reliability of risk weighting measurements) for foreign financial firms.

Whilst a focus on other urgent regulatory matters such as resolution regimes, the design of effective resolution frameworks and “living wills” for banks, is considered vital, future efforts and research aimed at developing means whereby some degree of harmonization between the Dodd Frank Act and Basel III could be achieved, may prove pivotal in the resolution or the prevention of potential and devastating financial crises.

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<sup>1</sup> See H Scott, „Reducing Systemic Risk Through the Reform of Capital Regulation“ Journal of International Economic Law 13(3) at pages 766-767.

<sup>2</sup> See Speech by Stefan Walter, Secretary General of the Basel Committee on Banking Supervision at the Risk Europe Pre Conference Summit, Brussels 4 April 2011.

## **B. The Increased Impact and Significance of Systemic Risks**

„The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on 21 July 2010. The Act requires all financial companies that have total consolidated assets over \$10 billion and that are regulated by specified federal financial regulators (namely the federal banking regulators, the Securities and Exchange Commission and the Commodity Futures Trading Commission) to conduct an annual stress test.

The federal financial regulators are required to issue rules implementing the annual stress-test requirement. Each agency’s rules must, for entities regulated by it, define the term “stress test”, establish methodologies for conducting the stress test that include at least three sets of conditions (baseline, adverse and severely adverse), and establish the form and content of a report regarding the stress test which must be submitted to the Federal Reserve Board and to the entity’s primary federal financial regulator.“<sup>3</sup>

Consequences emanating as a result of the introduction of the Dodd Frank Act are not only based on the findings of Congress, but also „because of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators.“<sup>4</sup>

The increased interconnectivity between banks, other financial intermediaries around the globe, as well as the resulting consequence of increased systemic risks, not only constitute reasons why harmonization has become so vital. The seriousness of the present crisis in the Eurozone and the devastating consequences of contagion to other crucial economies of the world, has re iterated the need for increased cooperation between financial regulators and supervisors around the globe.

The present state of financial stability within the Eurozone is indeed cause for concern. Harmonization of regulatory rules confers numerous benefits which include the mitigation of practices linked to regulatory arbitrage. However another consequence of increased integration and harmonization of rules between various jurisdictions is the increased awareness that the problem of a region is no longer solely and exclusively

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<sup>3</sup> European Central Bank, Financial Stability Review December 2010 at page 124  
<<http://www.ecb.int/pub/pdf/other/financialstabilityreview201012en.pdf>> (last visited 19 December 2011)

<sup>4</sup> See Section 931(1) of the Dodd Frank Wall Street Reform and Consumer Protection Act  
<<http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>>;  
„In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.“ See Section 931(5) of the Dodd Frank Wall Street Reform and Consumer Protection Act  
<<http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>>

restricted to that region or its neighboring regions. This is why huge efforts have been undertaken in recent months to revitalize and increase the stringency of rules relating to the European Stability and Growth Pact. Where initially established goals, initiatives or targets are not effectively complied with, and there is increased tendency of more than just one scenario involving future potential bailouts, then there is every possibility that incentives and efforts targeted at achieving such initially established goals will prove futile.

Integration is a vital tool in the harmonization of rules. More specifically, integration involving a firm commitment to compliance with rules, and the feasibility that jurisdictions involved in the integration process are: i) able to and ii) will comply with rules is of immense significance.

As highlighted by Steve Kamin, “The combination of high debt levels and low growth prospects in several European countries using the euro has raised concerns about their fiscal sustainability.”<sup>5</sup>

New steps<sup>6</sup> to address the crisis, including “proposals to strengthen fiscal rules and European fiscal coordination, as well as to enhance and provide additional clarity on the timing and design of a more credible euro-area financial backstop”, have recently been announced.

The systemic consequences of the financial stresses in Europe and the impact of these on the US economy are considered to include the following:<sup>7</sup>

- Restrain on exports,
- Lowering of business and consumer confidence, and
- Increased pressures on U.S. financial markets and institutions.

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<sup>5</sup> “Such concerns were initially focused on Greece but have since spread to other euro-area countries, leading to substantial increases in their sovereign borrowing costs. Pessimism about their fiscal situation, in turn, has helped to undermine confidence in the strength of European financial institutions, increasing their cost of raising funds and threatening to curtail their supply of credit. These developments have placed significant strains on global financial markets and have weighed on global economic activity.” See Testimony by Steven Kamin, Director of the Division of International Finance on the Economic Situation of Europe, before the Sub Committee on TARP and Financial Services, and Bailouts of Public and Private Programmes, Committee on Government and Oversight Reform, US House of Representatives Washington DC, December 16 2011. <http://www.federalreserve.gov/newsevents/testimony/kamin20111216a.htm>

<sup>6</sup> These steps are considered to be “a positive development and indicate the commitment of European leaders to alleviate the crisis. However, many key details of their proposed policies have yet to be worked out, and implementing them will be a challenge. Hence, it will be critical for European authorities to follow through on their commitments in the days and weeks ahead.” See *ibid*.

<sup>7</sup> It is also added that “foreign financial institutions, especially those in Europe, are finding it more difficult to fund themselves in dollars.” See *ibid*

## C. Conclusion

As rightly observed,<sup>8</sup> even though a lot of efforts and input have been invested into implementing Dodd-Frank, both at the Federal Reserve and at the other regulatory agencies, there is still considerable work to do.

Future efforts aimed at attaining increased harmonization of Basel III and the Dodd Frank Act, will, without doubt, require increased cooperation between global and leading financial regulators. As well as the need for increased unification of all embracing overarching goals which will complement, rather than conflict with each other, close collaboration between key macro prudential oversight frameworks, will also facilitate the process of ensuring that global financial stability objectives are achieved.

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<sup>8</sup> “Final regulations implementing some of the Act's most important provisions, such as the "living will" requirement and the Collins amendment, are now in place. Measures to implement other prominent provisions, such as the Volcker rule, have been proposed, but are not yet in final form. Still others, such as the section 165 requirements, have not yet been proposed.”

See Testimony by Daniel Tarullo on the Dodd Frank Act Implementation, December 6 2011

<http://www.federalreserve.gov/newsevents/testimony/77067FEB3388433982C1D5740D776DC5.htm>

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<<http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>>

## Comparison of UK, US and EU macro-prudential oversight frameworks

	UK	US	EU
<b>Overarching body</b>	<i>Financial Policy Committee (FPC)</i>	<i>Financial Stability Oversight Council (FSOC)</i>	<i>European Systemic Risk Board (ESRB)</i>
<b>Scope</b>	UK financial system	US financial system	EU-wide financial system
<b>Overall objective</b>	<p>Protect financial stability by</p> <ul style="list-style-type: none"> <li>▶ identifying and addressing aggregate risks and vulnerabilities across the financial system</li> <li>▶ enhancing macroeconomic stability by addressing imbalances, e.g. dampening the credit cycle</li> </ul>	<ul style="list-style-type: none"> <li>▶ Identify risks to financial stability</li> <li>▶ Promote market discipline</li> <li>▶ Respond to emerging threats to the stability of the financial markets</li> </ul>	<ul style="list-style-type: none"> <li>▶ Contribute to the prevention or mitigation of risks to financial stability in the EU that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress</li> <li>▶ Contribute to a smooth functioning of the internal market</li> </ul>
<b>Role of central banks</b>	<ul style="list-style-type: none"> <li>▶ The Bank of England has a key role as chairing and having majority on FPC</li> <li>▶ Can direct prudential interventions and supervision by PRA via FPC</li> <li>▶ PRA is a subsidiary of the Bank of England</li> <li>▶ The Bank of England oversees CCPs, settlement systems and payment systems</li> <li>▶ The Bank of England is lead resolution authority</li> </ul>	<ul style="list-style-type: none"> <li>▶ The Federal Reserve Board has significant role as macro- and micro-prudential regulator of systemic firms, including authority to require reports and conduct examinations of certain non-bank financial companies and bank holding companies</li> <li>▶ However, the Federal Reserve Board does not chair the FSOC. The Treasury has the coordinating role</li> </ul>	<p><b>Role of the ECB</b></p> <ul style="list-style-type: none"> <li>▶ The ECB President has a key role as chairing both the General Board and the Steering Committee (at least first five years)</li> <li>▶ The ECB shall ensure a Secretariat, and thereby provide analytical, statistical, logistical and administrative support to the ESRB</li> </ul> <p><b>Role of NCBs</b></p> <ul style="list-style-type: none"> <li>▶ All 27 NCB Governors are voting members on the General Board</li> <li>▶ Four NCB Governors are on the Steering Committee</li> <li>▶ NCBs provide staff to support the Secretariat of the ESRB</li> <li>▶ NCBs bring macro-prudential competence and provide understanding of effects of interventions in all EU countries</li> </ul>
<b>Crisis management</b>	<ul style="list-style-type: none"> <li>▶ The FPC will be involved in decisions to deploy regulatory tools for crisis management purposes</li> <li>▶ The Bank of England in its role as central bank, prudential regulator and resolution authority will be responsible for designing and executing the response to an emerging financial crisis</li> <li>▶ HM Treasury will control any decisions involving the use of public funds</li> </ul>	<ul style="list-style-type: none"> <li>▶ The FSOC will be involved in decisions to deploy regulatory tools for crisis management purposes</li> <li>▶ The Federal Reserve in its role as central bank, prudential regulator and resolution authority will be responsible for designing and executing the response to an emerging financial crisis</li> <li>▶ The Treasury will control any decisions involving the use of public funds</li> <li>▶ The FDIC will act as Orderly Liquidation Authority</li> </ul>	<ul style="list-style-type: none"> <li>▶ The ESRB does not have explicit tasks and powers on crisis management, apart from the power to advise the Council on the existence of an emergency situation</li> </ul>