



Munich Personal RePEc Archive

## **Dodd-Frank: Washington, We Have a Problem**

lopez, claude and Saeidinezhad, Elham

Milken Institute, Milken Institute

June 2016

Online at <https://mpra.ub.uni-muenchen.de/72267/>

MPRA Paper No. 72267, posted 28 Jun 2016 21:46 UTC

# Dodd-Frank: Washington, We Have a Problem

Draft, June 2016

JEL code: E6, G

Claude Lopez<sup>1</sup> and Elham Saeidinezhad

The Dodd-Frank Act was 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 derivative 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 crisis fading from the public memory, the implementation of the remaining parts appears challenging as shown by the Congress 'roll-back 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 to the forthcoming presidential election may trigger a change in regulatory regime, moving away from crises-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," where proprietary trading and the business of banking are separated, and where taxpayers and small business will not have to bail out failing large financial firms."<sup>2</sup> To make the assessment, the paper first establishes a timeline summarizing the Dodd-Frank final-rule milestones and then compares their implementation to the initial goals.

---

<sup>1</sup> Corresponding author: [clopez@milkeninstitute.org](mailto:clopez@milkeninstitute.org)

<sup>2</sup>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.<sup>3</sup> Monitoring systemically important institutions, markets or 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). These institutions' aim 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 SIFIs 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.<sup>4</sup> 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 FDIC in allowing for an orderly liquidation in case of failure.<sup>5</sup>

### *2012-2013*

---

<sup>3</sup> See Lopez et al. (2015 a), and (2015 b) for more details on macroprudential policy.

<sup>4</sup> The Federal Reserve will stress test 33 large banks in 2016. These test are binding for SIFIs denominated banks.

<sup>5</sup> Neither agency found Citigroup's resolution plan as "not credible or would not facilitate an orderly resolution" under bankruptcy laws, but they did find shortcomings for the bank to fix.

In 2012 and 2013, the FSOC added major financial market utilities (FMU) and insurance companies to the SIFI list.<sup>6</sup> 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 Derivative 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 clearing houses (one type of FMU), enhancing the amount of risk (credit, liquidity, and operational risk) held by each one. As a result, two clearing houses have been designated systemically important derivatives clearing houses (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 activities which played a major role in the global financial crisis, namely securitization activities and derivatives dealing. Prior to the crisis, most of these activities were off banks’ balance sheets, and they remained mainly outside of the regulatory radar until the Fed had to backstop the system. Among the several changes that have been made, two appear particularly important. The swaps push-out rule, introduced in 2013 and amended the following year, is the first main change regarding securitization. It prohibits banks from dealing with swaps on an asset-backed security (or a group or index primarily comprised of such securities). The Volcker rule, focused on derivative dealing, separates proprietary trading from the actual market making, prohibiting banks to participate in proprietary trading.

#### *2014-Present*

Moving forward with their investigation of systemic markets, regulators focused on the money market funds due to 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.” (Champ, 2013). 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

---

<sup>6</sup> In developing these risk management standards, the 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 SEC and proposed by the CFTC are generally based on the international standards of the Principles for Financial Market Infrastructures.

temporarily halt withdrawals during periods of stress.<sup>7</sup> The reform is an attempt to reduce investor runs and limit liquidity in time of stress.

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

## Comparison of Ambition and Achievements

As discussed above, the macroprudential policy driven by the Dodd-Frank Act focused primarily on monitoring systemically important institutions, markets or activities. Conceptually, for this framework to be successful at mitigating systemic risk, the three required steps (identification, prudential enhancement, and resolution plans) must be respected, and must be adapted and applied 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:

- *SIFIs 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.<sup>8</sup> Only one out 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 institution 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 how to implement steps 2 (prudential enhancement) and 3 (resolution plans) is still a work in progress.
- *Derivatives dealing and security 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 the full implementation of the Volcker rule has been delayed to 2017.
- *Financial stability and systemic risk monitoring*: Enhanced prudential rules are designed for SIFIs but so far have been finalized for both SIFI-designated banks and FMUs. As of June 2016, the

---

<sup>7</sup> Berkowitz (2015)

<sup>8</sup> U.S. District Court for the District of Columbia Decision, Case 1:15-cv-00045-RMC Document 106 Filed 03/30/16.

Fed has invited comments regarding proposed rules for SIFI-designated insurance companies. The money market fund rule is the only major regulatory development concerning 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 its lack of oversight and accountability have been raised. Among the concerns: CFPB is not required to follow Office of Management and Budget guidelines, rules and regulations and is exempt from congressional or executive oversight.<sup>9</sup>

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 to 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:* Very 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.<sup>10</sup> 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 FSOC existence. The insurance industry is another illustration of a failed consolidation. The Federal Insurance Office 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 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 one the SEC intends to propose next spring).

---

<sup>9</sup> Schultz(2014)

<sup>10</sup> 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.”

*Government-sponsored enterprises (GSE):* 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.<sup>11</sup> 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 2007–09 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.<sup>12</sup> Difficulties encountered in implementing fully and adapting the current SIFIs framework across the different 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 the similar tasks (for example, depository institutions *and* money-market funds) and to have requirements consistently set 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 SIFIs' framework, is supposed to address this point by ultimately requiring other SIFIs—and not the taxpayers—to bear the cost if one fails. In practice, however, this will work if only a single failure occurs at any given time. A problem, of course, arises during a systemic event when there might be multiple exposure failures (FMUs) or insolvencies (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. The focus should be on automatic recapitalization that does not depend on public assistance.<sup>13</sup>

---

<sup>11</sup> Congressional Budget Office Testimony (2011).

<sup>12</sup> Acharya and Richardson (2012).

<sup>13</sup> Cecchetti and Schoenholtz (2014) and (2015).

Finally, while 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.



Figure 1 Bank's Dodd-Frank Final Rules, Milestones

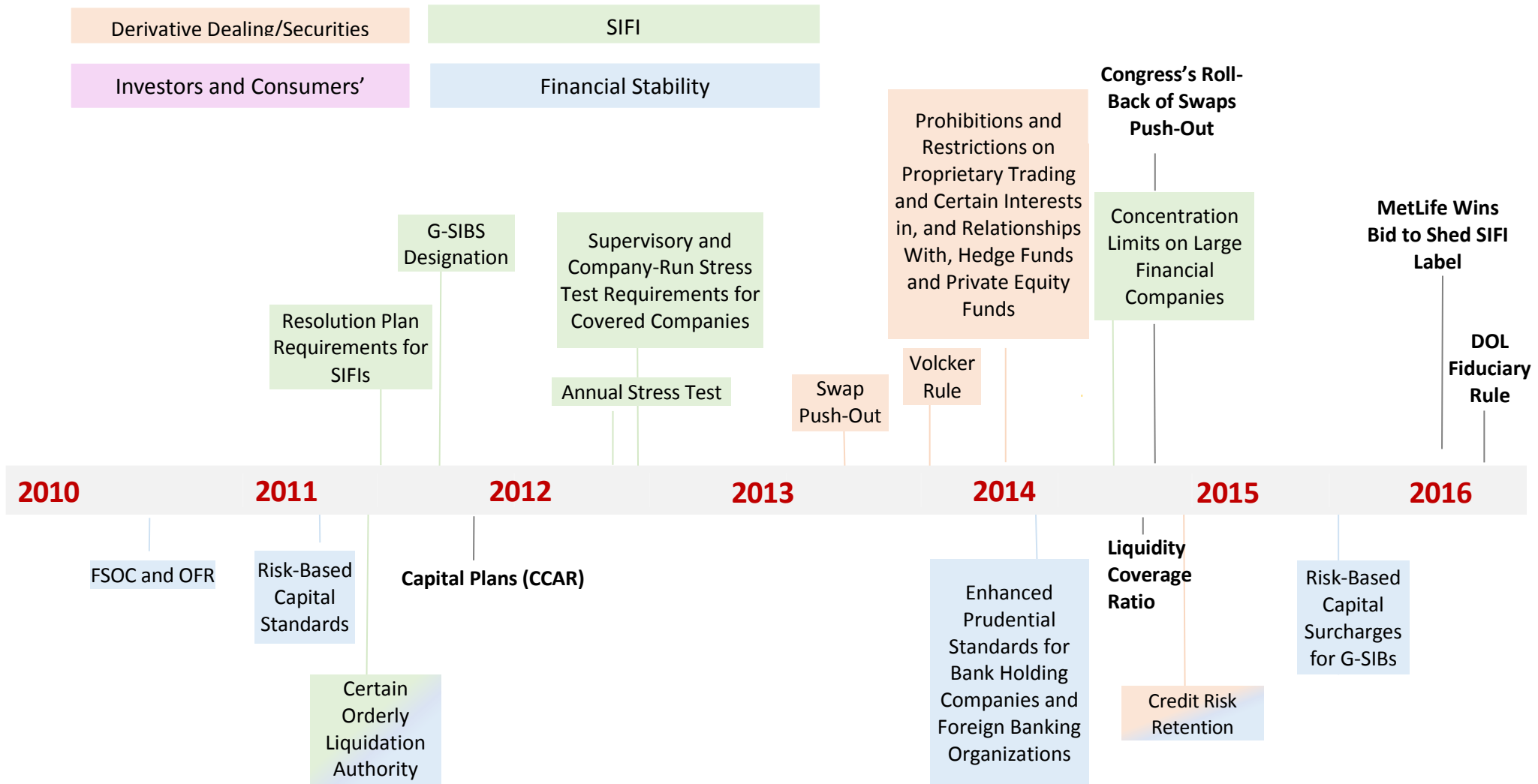
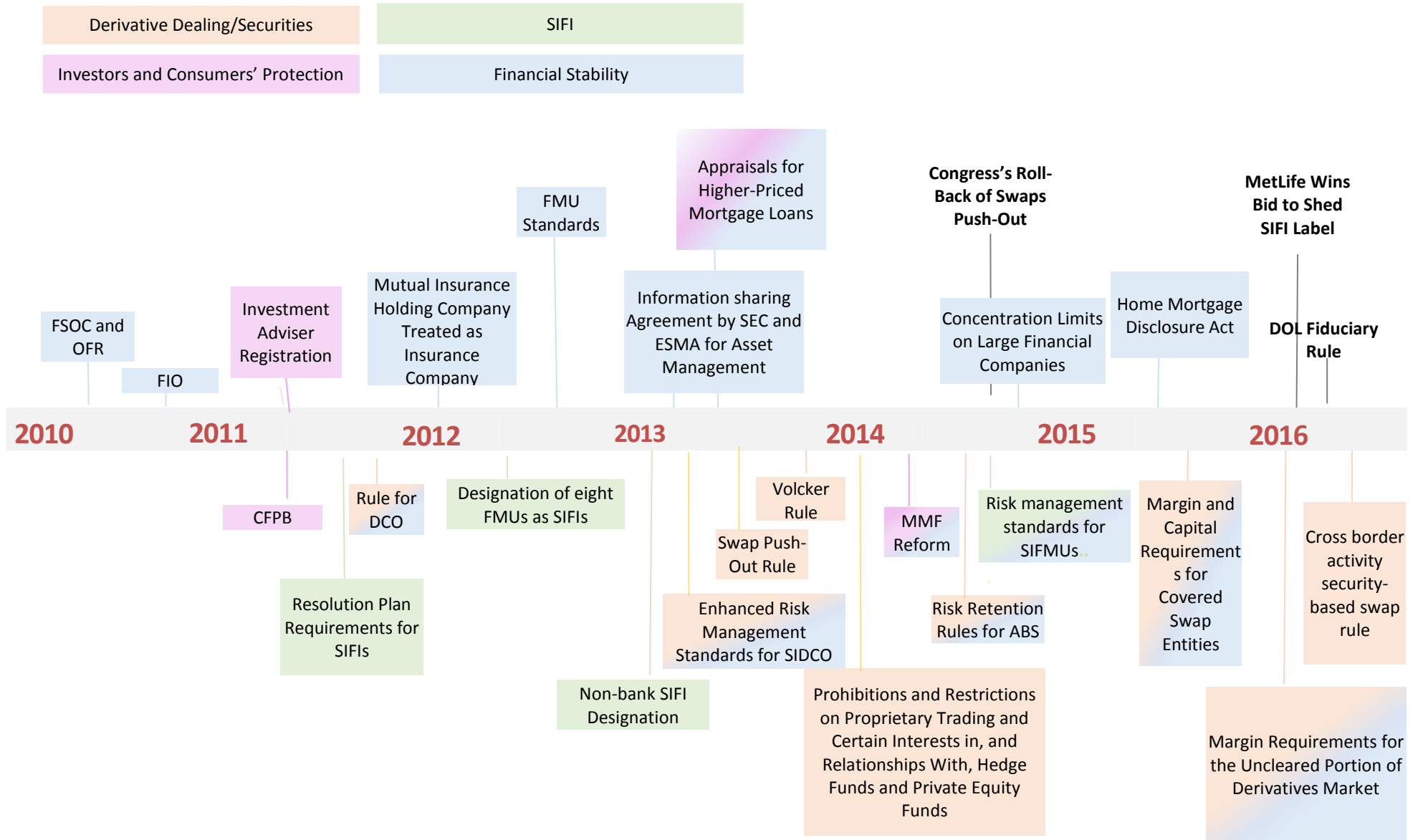


Figure 2 Non-Bank's Dodd-Frank Final Rules, Milestones



Source: Authors

**Table 1: Rules' goals and implementation**

<b>SIFIs</b>			
Category	Rules	Targeted Outcome	Implementation (as of June 2016)
Goal	Institutions, activities and markets that have been 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.		
Milestones	Identification	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 its activities	Banks, insurance companies and FMU. Successful Metlife's challenge in 2014
	Stress tests	Assess an institution capital plan and ability to continue providing financial services, without government assistance, following a specified shock	Only for banks
	Resolution plans or living wills	Plan on 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	Stress testing, disclosure, floating NAV, liquidity fee and redemption gate	Conformance period ends on Oct. 14, 2016
<b>Derivatives Dealing/ Securitization Activities</b>			
Goal	Minimize systemic risk of derivatives trading, create transparency in derivatives markets, prohibit entities holding customer deposits from engaging in speculative derivatives activity		
Category	Rules	Targeted Outcome	Implementation (as of June 2016)
Milestones	Volker 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 in January 9, 2012. In July 7 2012, 2 DCOs are designated Systemically Important FMU

Swaps related rules for bank 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, crossborder activities	Work in progress, with 1/3 remaining*
---	--	---------------------------------------

---

### Financial Stability and Systemic Risk monitoring

---

Goal Enhance the stability, resilience and transparency of the US financial system

---

Category	Rules	Targeted Outcome	Implementation (as of June 2016)
----------	-------	------------------	----------------------------------

---

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

---

### Consumer and Investor Protection

---

Goal Devoted to measures specifically intended to protect consumers and investors

---

Category	Rules	Targeted Outcome	Implementation (as of June 2016)
----------	-------	------------------	----------------------------------

---

Milestones	Investment Adviser Registration	To protect pensioners; requirement to publicly available the data, even for exempt advisers, in order to increase transparency and access for prospective investors	Pension consultants now need to register with SEC
	Consumer Financial Protection Bureau	created to promote clear information for consumers and protect them from unfair practices; promote fair, efficient and innovative financial services for consumers; improve access to financial services.	Home Mortgage Disclosure Act

---

Source: Authors

## References

- Acharya, Viral V., Matthew Richardson. (2012) "Implications of the Dodd-Frank Act." *Annual Review of Financial Economics*, 4: 1-38.
- Berkowitz, Jeremy. (2015) "Money Market Mutual Funds: Stress Testing & New Regulatory Requirements." *The Harvard Law School Forum on Corporate Governance and Financial Regulation Money Market Mutual Funds Stress Testing New Regulatory Requirements Comments*. NERA Publication.
- Cecchetti, Stephen G. and Kermit L. Schoenholtz. (2014) "Living Wills or Phoenix Plans: Making Sure Banks Can Rise from Their Ashes." *Money and Banking*, October.
- Cecchetti, Stephen G. and Kermit L. Schoenholtz. (2015) "Dodd-Frank: Five Years Later." *Money and Banking*, July.
- Champ, Norm. (2013) "Money Market Mutual Fund Reform: Opening Statement at the SEC Open Meeting." SEC, June.
- Congressional Budget Office Testimony. (2011) "The Budgetary Cost of Fannie Mae and Freddie Mac and Options for the Future Federal Role in the Secondary Mortgage Market." Congressional Budget Office Publication.
- Davis Polk Publication. (2015) "Dodd-Frank Progress Report: Fourth Quarter 2015."
- Lopez, Claude, Donald Markwardt and Keith Savard. (2015a), "Macroprudential Policy: A Silver Bullet or Refighting the Last War", MI report, July.
- Lopez, Claude, Donald Markwardt and Keith Savard (2015b), "Macroprudential Policy: What Does it Really Mean", *Banking and Financial Services*, 34 (10) 1-10, October.
- The Volcker Alliance. (2015) "Reshaping the Financial Regulatory System, Long Awaited, Now Crucial."
- White House website, "Wall Street Reform: The Dodd-Frank Act."  
<https://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform>

## Glossary

**ABS:** Asset-backed securities, called ABS, are bonds or notes backed by financial assets.

**CCAR:** Comprehensive Capital Analysis and Review is an annual exercise by the Federal Reserve to assess whether the largest bank holding companies operating in the United States.

**CFPB:** 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 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.

**ETFs:** An Exchange-Traded Fund is an investment fund traded on stock exchanges, much like stocks. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value.

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

**FMU:** Financial market utilities are multilateral systems that provide 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 US financial system.

**G-SIBs:** A Global Systemically Important Banks is defined as a financial institution whose distress or disorderly failure would cause significant disruption to the wider financial system and economic activity.

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

**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 Council and public.

**SEC:** The U.S. 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 Organizations.

**SIFIs:** 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 utilities.

## About the Authors

Dr. Claude Lopez is director of research at the Milken Institute, leading the International Finance and Macroeconomic Research. With her team, she investigates the linkages between the financial sector and the real economy, focusing on three core areas: systemic risk, capital flows and investment. She brings expertise and experience on several topics, including exchange rate, capital flows, commodities, inflation, and time-series econometrics. Her research has been published in highly ranked academic journals and policy reports, while presented regularly at international conferences. Before joining the Institute, Lopez held management roles while being senior research economist at the Central Bank of France, Paris (Banque de France), and 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 papers 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 in New York. She also held teaching positions at the University of Sheffield in the UK and Columbia University in New York.

## About the Milken Institute

The Milken Institute is a nonprofit, nonpartisan think tank determined to increase global prosperity by advancing collaborative solutions that widen access to capital, create jobs and improve health. We do this through independent, data-driven research, action-oriented meetings and meaningful policy initiatives.

©2016 Milken Institute

This work is made available under the terms of the Creative Commons Attribution-NonCommercial-



NoDerivs 3.0 Unported License, available at [creativecommons.org/licenses/by-nc-nd/3.0/](https://creativecommons.org/licenses/by-nc-nd/3.0/)