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The Future of U.S. Financial Regulation: Are Major Changes Coming?

By: James A. Haley

Changes are coming to U.S. financial sector regulations. The only question is whether these changes will "repeal and replace" the Dodd-Frank legislation passed in 2010 or will represent more modest "tweaks" to address regulatory overreach. Early statements from the Trump administration suggest the administration is aiming for the former.

Changes to U.S. financial sector regulation are likely in the coming months. But contrary to policy pronouncements from the White House and congressional Republicans, which presage a sweeping repeal and replacement of the 2010 Dodd-Frank legislation, actual legislative changes may be modest. There is scope, for example, for bipartisan action to relieve regulatory burdens on small community banks and to address inconsistencies in regulations limiting proprietary trading activities—the Volcker Rule—that reduce the liquidity of corporate securities.

More significant changes to the post-crisis regulatory framework could come from the regulatory agencies that enforce existing regulations. In this regard, a vigorous policy of non-enforcement and discretionary regulatory reversal is possible. However, without a major repeal of Dodd-Frank, regulatory laxity could be subject to judicial review and protracted legal disputes. This review process could limit regulatory discretion. At the same time, the assessment that only modest legislative and regulatory changes are likely is based on current Senate rules which require 60 or more votes to repeal or amend most parts of Dodd-Frank. If the Senate revises these rules, as the White House has recently proposed, more significant changes to the existing regulatory framework are possible.

Bold Ambitions, Political Realities

For its part, the White House has signaled that it is targeting a significant overhaul of Dodd-Frank. In February, the president said "we're going to be doing a big number on Dodd-Frank." He repeated the warning in April when he promised that the legislation would be subject to a "very major haircut." Meanwhile, in Congress, House Republicans have passed the draft Financial CHOICE Act. If enacted, this legislation would reverse key elements of the post-financial crisis regulatory framework.

First indications suggest therefore that major changes are in the works. But first appearances can deceive. While the intent of the administration and House Republicans may be "repeal and replace" Dodd-Frank, the actual outcome is likely to be more modest. Several factors account for this assessment.

To begin, start with the politics. Dodd-Frank represents a legislative response to the worst financial crisis since the Great Depression. Key elements of the legislation received broad bi-partisan support (at least in the Senate) and the simple fact is that under existing Senate rules repeal and replacement of Dodd-Frank requires bipartisan support. That support is likely lacking.

To see why this is the case, bear in mind that legislators must weigh whether the benefits of Dodd-Frank in reducing the likelihood and severity of potential financial crises exceed its costs. In a sense, their challenge is to ensure that the right balance is struck between stability and efficiency.

Balancing Efficiency and Stability

Before the global financial crisis, the financial system was incredibly efficient in the narrow sense that large banks leveraged a small capital base into a very large balance sheet of assets. Unfortunately, not all those assets were of high quality, and the financial system was highly unstable. The system was made more fragile by the use of new financial instruments. Large banks that were highly interconnected to the rest of the financial system used derivative instruments to greatly expand the size of their off-balance sheet activities through lightly, or unregulated, "shadow banks."

Rather than facilitate an efficient allocation of risk, however, these instruments concentrated risks in the balance sheets of very large institutions. The complexity and opacity of these instruments meant that they were difficult to value once problems in the subprime mortgage market emerged in 2006 and 2007. But if bankers couldn't value their own balance sheets, they certainly couldn't assess the financial viability of other banks—the resulting uncertainty and decline in trust was analogous to an infection spreading throughout the financial system, rendering the system susceptible to shocks. Following the collapse of Lehman Bros in the autumn of 2008, the loss in trust led to the breakdown of longstanding credit relationships.

Dodd-Frank was intended to rebalance the system towards "stability" away from "efficiency." Given the trauma inflicted on millions of Americans by the crisis and subsequent recession, the overarching objective of the legislation—to contain systemic risk-taking that can imperil the financial system and thus the economic security of all Americans—remains relevant. Indeed, the scars of the crisis and recession are still visible in many parts of the country nearly a full decade later.

So, while House Republicans assert that the costs of Dodd-Frank outweigh its benefits, moderate Republicans in the Senate may be more cautious. The House legislation is likely to be substantially pared back.

Problems with the Status Quo

This is not to say that Dodd-Frank cannot be improved. Even its most stalwart defenders acknowledge that some changes are required. The legislation is undoubtedly complex and has unquestionably raised banks' compliance costs. And since Dodd-Frank was passed almost seven years ago, concerns have grown that the regulatory burden it imposed has slowed growth and reduced competition as smaller community banks exit the market in the face of rising compliance costs. In addition, the Volcker Rule, which restricts proprietary trading of the kind of financial instruments that provided the tinder for the conflagration of the financial crisis, is widely viewed as reducing the liquidity of corporate securities.[1] Concerns have also emerged that the liquidity of high-quality government assets that satisfy liquidity requirements could be affected as institutions hoard these so-called safe assets.

The Financial CHOICE Act purports to address these concerns. If enacted as drafted, it would relax the enhanced prudential oversight of systemically-important financial institutions (SIFIs), and limit the ability of federal regulators comprising the Financial Stability Oversight Committee (FSOC) to designate bank and nonbank firms as systemically-important. The Act would also eliminate Title II of Dodd-Frank, which establishes an orderly liquidation authority (OLA) to ensure the winding down of large, complex financial institutions while mitigating the risk of contagion. It would also repeal the Volcker Rule. Moreover, the Financial CHOICE Act would reduce the independence of the Consumer Financial Protection Bureau (CFPB) by allowing the president to replace its director "at will," rather than "for cause," and make the organization dependent on discretionary sources of funding subject to congressional appropriations.

Sponsors of the draft legislation note that the Act would provide relief from the complex capital and liquidity reporting requirements imposed in the wake of the financial crisis by providing an "off ramp" for banks that choose to hold more capital. Banks that increase their capital-to-assets ratio would be excused from the enhanced capital requirements applied on SIFIs.

Lessons from the Crisis

While intuitively appealing, the "off ramp" provision of the Financial CHOICE Act is subject to several fundamental tensions associated with balancing efficiency and stability of the financial system. These tensions reflect several key lessons from the crisis.

1) Macroeconomic Perspective and the Too Big to Fail Problem

The most important lesson, arguably, is the need for a macro-prudential perspective on regulation that internalizes the externalities associated with financial markets.

Prior to the financial crisis, it was widely believed that if each individual institution was adequately capitalized, the system would be stable. The crisis demonstrated however that shocks to bank balance

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1 One problem is that an institution trading securities on behalf of its clients and not on their own account may be unable to perfectly synchronize its buying and selling, resulting in unintentional positions in securities which could be penalized under the Rules. Added to this is a multiplicity of regulatory requirements imposed by different agencies some of which may be inconsistent, raising compliance costs. Institutions seeking to avoid these potential costs may limit their trading operations, reducing the liquidity of these assets.

sheets can be amplified and transmitted through assets prices and other channels: a bank that experiences a negative shock and sells assets to meet liabilities coming due can drive down asset prices, adversely affecting other institutions. If these institutions are likewise forced to sell assets, the downward spiral of asset prices can be magnified such that banks that had appeared adequately capitalized beforehand are subsequently revealed to have far too small capital buffers to prevent failure.

Such effects are more likely to arise when systemically important institutions that are too big, too complex and too interconnected to fail encounter difficulties. This is the second key lesson from the financial crisis.

In 2008-09 regulators, central bankers and finance ministers feared that the failure of their institutions would lead to a collapse of the financial system and trigger a global economic depression. For this reason, authorities around the world engineered massive interventions to prevent the failure of such institutions. The problem is that such interventions can lead to a moral hazard problem in which the expectation of government bailouts incites risk-taking by bank managers which, in turn, increases the likelihood of future crises. It is a game of "heads I win, tails you lose."

Containing the moral hazard problem associated with institutions that are too big, too complex and too interconnected to fail requires that regulators have the ability to apply granular, bank-by-bank capital requirements, stress tests[2] and the capacity to designate an institution (bank or non-bank) as systemically important. This creates a challenge for regulators, however, in that such requirements have led to legal challenges based on the claim that regulatory discretion constitutes "arbitrary and capricious" treatment.

Moreover, while risk-based capital ratios are more complex and subject to being gamed, the simple leverage ratio proposed in the Financial CHOICE Act is subject to asset substitution: bank managers may have an incentive to increase the proportion of risky assets since the same amount of capital would be required to hold $1 of risky assets offering higher returns or $1 of less risky but low returning assets. Asset substitution wouldn't be a problem if the bank is fully financed by equity, but even a higher capital leverage ratio, such as the 10 percent level proposed in the draft legislation, would likely not be effective in containing macro-prudential and systemic concerns that motivated Dodd-Frank. The Federal Reserve Bank of Minneapolis has estimated, for example, that a simple leverage ratio of almost 40 percent would be needed to address the too big to fail problem. A prudent regulatory framework would include both a risk-weighted capital buffer and a simple leverage requirement. That is the current approach.

Another lesson of the crisis is the importance of liquidity.

2) Importance of liquidity

At the height of the crisis, banks lacking liquid assets were forced to sell illiquid assets at deep discounts ("fire sale" prices) in order to meet their obligations coming due. This contributed to the downward vortex of collapsing asset prices which amplified the price shock and spread the financial contagion to other institutions, other markets, and around the globe. Thankfully, the Federal Reserve expanded its emergency lending to halt the ensuing panic, while the U.S. Treasury mobilized $50 billion from the Exchange Stabilization Fund to guarantee certain money market deposits to limit the fallout to other sectors of the

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2 Such as the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR): https://www.federalreserve.gov/supervisionreg/ccar.htm

economy. However, these special authorities were scaled back as part of the political compromise that secured passage of Dodd-Frank, raising questions about the adequacy of the "safety net" when the next crisis hits. The Financial CHOICE Act would further restrict access to public funds to promote the orderly liquidation of large, complex institutions.

There may be sound reasons to limit the public sector's ability to provide liquidity; in particular, to avoid the moral hazard problem that induces imprudent risk-taking. Market discipline should in principle be the first line of defense against reckless risk-taking. But the tradeoff for smaller public safety nets should be enhanced liquidity buffers in the banks—in effect, private self-insurance.

This private self-insurance is the purpose of the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) regulators introduced post-crisis. And while there are legitimate concerns that the LCR and NSFR may introduce pro-cyclical behavior, as banks hoard high quality liquid assets in the event of a crisis, it would be imprudent to ignore the special nature of financial intermediation and financial markets that make banks and markets susceptible to bouts of panic and contagion.

3) Too big to fail and moral hazard

The final lesson in striking the right balance between efficiency and stability reflects the problem of inconsistent policy pronouncements that arises when institutions are too big to fail.

The problem emerges because such institutions enjoy an implicit guarantee by virtue of their size. If they are perceived to be too big to fail, the expectation is that they will likely be rescued by government bailouts. In such circumstances, depositors, investors and markets generally will view them as less risky. Deposit rates and the cost of capital will not necessarily reflect the underlying risk on their balance sheets, particularly when deposits are insured, breaking the nexus between risk and return. Moreover, government commitments to let market forces work and not support institutions that encounter difficulties are not credible because of the enormous costs.

As the crisis revealed, regulators could either allow SIFIs to fail, with possible catastrophic consequences, or allow them to privatize the returns from excessive risk-taking, profiting from risky bets that pay off, and socialize the risk of failed gambles as governments are forced to support insolvent institutions. The latter outcome is clearly incompatible with market efficiency and sound policy frameworks. In the wake of the crisis, the question legislators had to answer was how to resolve or minimize it.

There are two possible approaches to dealing with this problem.

The first approach is structural. In the debates preceding passage of Dodd-Frank, proposals were made to re-introduce the Glass-Steagall Act. This legislation enforced the separation of commercial banking—what is commonly associated with "banking"—and "investment" or corporate banking, largely consisting of assisting large firms raise new equity and issue bonds. Proponents of Glass-Steagall argued that it would separate insured deposits in commercial banks from the risky activities of investment banking. The idea remains popular with some legislators and draft bipartisan legislation for a "21st century Glass-Steagall law" has been introduced in the Senate.

Another proposal was to forcibly break up the largest banks to reduce them such that their failure would no longer pose a systemic threat to the financial system or the economy more broadly. In a sense, this would be akin to the dismemberment of the Rockefeller's Standard Oil Company in the progressive era a century ago, but for reasons of financial stability not anti-trust.

Neither of these structural options was supported by the financial industry citing the potential loss of economies of scale and scope as well as discouraging innovation. This left lawmakers with the only option available: an approach based on enhanced regulatory requirements that limits the systemic threat of very large institutions and creates a legal mechanism for the orderly winding down of operations without exposing taxpayers to potential financial risks. Experience teaches that merely asserting that market discipline will contain the too big to fail problem without introducing mechanisms that allow big institutions to fail while minimizing financial contagion would not be prudent.

Proponents of the Financial CHOICE Act argue that a new chapter in the U.S. bankruptcy code (Chapter 14) to deal with the failure of large financial institutions would address this problem. Experts warn, however, that while the proposed bankruptcy measures would complement Title II of Dodd-Frank, it is not a substitute. Relying solely on a revamped bankruptcy procedure, they argue, is unlikely to be effective in winding down the operations of a large, complex financial institutions without risking contagion to other institutions and financial markets.[3] As a result, Chapter 14 would not limit the too big to fail problem or the excessive risk taking it incites.

Prospects for a Bi-partisan Middle Ground

The stakes are high. No responsible legislator wishes to repeat the terrifying events of 2008-09 when financial markets crashed and output, employment and trade collapsed. And, while the actual outcome is uncertain, it seems likely that enough moderate Senate Republicans appreciate the tensions and tradeoffs between efficiency and stability to deny their more impulsive House colleagues a root and branch dismantling of Dodd-Frank. This result would be wholly consistent with the Senate's reputation as the "most deliberative body in the world."

That said, there are areas around which a bipartisan consensus on revisions to Dodd-Frank can form. There is broad agreement, for example, that regulations implementing the Volcker Rule limitations on proprietary trading are inconsistent and impose an unnecessary burden on banks, big and small, reducing the liquidity of corporate securities.

Moreover, all agree that the post-crisis regulatory framework has raised compliance costs. Small community banks have been disproportionately affected, reflecting the fact that larger institutions are better able to absorb the costs of complying with the myriad new regulations. Such banks are present in every congressional district in every state; needless to say, they form a large constituency that legislators are loath to ignore.

There is reason to believe that relief is on the way.

Small community banks were not responsible for the financial crisis and there is broad agreement that the enhanced capital and liquidity requirements designed to contain the risks of SIFIs need not apply to them. Moreover, responding to the legitimate concerns of these banks does not require a wholesale repeal and

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3 See, for example, Stephen Cecchetti and Kim Schoenholtz, "Bank resolution: The importance of a public backstop," *Voxeu* (29 May 2017) http://voxeu.org/article/bank-resolution-importance-public-backstop

replacement of Dodd-Frank. Higher capital and liquidity standards on small community banks reflect the discretionary powers of the regulators and these standards can be relaxed through regulatory rulemaking. In this respect, as outgoing Fed governor Daniel Tarullo noted in a valedictory speech reflecting on the financial stability, regulators recognize that, in the pursuit of financial stability, there may have been some degree of regulatory overreach that is not justified by the resulting loss of efficiency.[4]

Regulators can exercise discretion to reduce the regulatory burden on small banks that do not pose systemic threats. And where the law mandates enhanced requirements by virtue of size, a simple "tweak" to Dodd-Frank to raise the thresholds that trigger enhanced regulatory standards would exempt small community banks. But the scope for discretion also raises the question of whether, and to what extent, the Trump administration will use regulatory action or passive non-enforcement of existing rules to roll back the post-crisis regulatory framework.

A Regulatory Rollback?

In fact, the White House could fundamentally change financial sector regulation, not through legislation, but through the use of the presidential appointment process. By July 2018, the president will have had the opportunity to appoint nine of the 10 voting members of the FSOC. As Gary Cohn, the head of the National Economic Council, observed earlier in the year: "personnel is policy."[5] By adhering to a vigorous policy of non-enforcement, regulatory agencies could undermine the objectives of Dodd-Frank and the post-crisis effort to rebalance "efficiency" and "stability."

There are checks on discretionary regulatory actions, however.

The most important check is the possibility of judicial review. The Administrative Procedures Act, which was passed in the wake of a wave of New Deal regulatory agencies created by the Roosevelt administration, subjects all rule-making to judicial review to ensure consistency with the intent of Congress when delegating rule-making authorities. At the time it was passed, legislators worried that the creation of agencies independent of the legislative branch—to shield decision making from political pressures—could represent a de facto fourth branch of government not contemplated in the constitution.

Two principles in administrative law are relevant to such judicial reviews. First, regulations must generally meet a net benefits test—the benefits of a proposed regulation exceed its probable costs. Second, the intent of Congress in delegating rule-making authorities must be considered when determining benefits. In effect, this precludes regulators from identifying potential or hypothetical benefits not contemplated by Congress in order to justify their rule-making. In the case of Dodd-Frank, that intent was clearly to contain systemic problems created by SIFIs and to rebalance stability and efficiency.

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4 See Danial K. Tarullo, "Departing Thoughts" https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm

5 See Fred Barbash and Renae Marie ,"Trump to order regulatory rollback for finance industry starting with Dodd-Frank" *Washington Post* (Feb 3, 2017) https://www.washingtonpost.com/news/morning-mix/wp/2017/02/03/trump-to-order-rollback-friday-of-regulations-aimed-at-finance-industry-top-aide-says/?utm_term=.9553a349dcc6

In addition to these principles, a landmark Supreme Court decision enforces symmetry on rule-making: just as a net benefits test is enforced on the introduction of a new regulation, the same test is required on its removal. This implies that a party suffering damages could seek a judicial review to block or reverse a regulatory rollback.[6] And, while financial regulations are not necessarily subject to a strict net benefits test, courts are likely to examine the net benefits when determining whether a particular rule or systemic designation constitutes "arbitrary and capricious" actions against a particular institution. In the absence of a sweeping repeal and replacement of Dodd-Frank, the intent of Congress to limit systemic risks would be a relevant consideration for the courts when reviewing reduced compliance and enforcement decisions by regulatory bodies.

In this regard, it is tempting to speculate that, given the fragmented nature of U.S. financial sector regulation and the integration of financial markets, regulators from a few key states (New York and California, say) could petition the federal court to reverse regulatory actions (or inaction), arguing that they are harmed—exposed to greater systemic risks—contrary to the intent of Congress as expressed in Dodd-Frank. Such a petition would be heard in the D.C. federal court given the legal residency of federal regulatory agencies. In an interesting twist of fate, the chief justice of the D.C. court is Merrick Garland, President Obama's Supreme Court nominee, who was part of the legal team that successfully argued before the Supreme Court for symmetry in judicial reviews of regulatory actions.

All of this implies that attempts to mobilize regulatory discretion to achieve ends not attainable through legislation may end in litigation. This is consistent with de Tocqueville's observation: "Scarcely any political question arises in the United States that is not resolved, sooner or later, into a judicial question."[7] And, in this respect, administration ambitions for a fundamental rewrite of financial sector regulation may be subject to the checks and balances that reveal the genius of the Constitution.

This assessment is based on current Senate rules which require 60 or more votes to repeal or amend most parts of Dodd-Frank. But, if the Senate revises these rules as proposed by the White House, far more significant changes to the existing regulatory framework are likely.

Conclusion - Uncertain Change

To summarize, while presidential pronouncements and early legislative efforts presage a major overhaul of U.S. financial regulation, the actual changes to the existing regulatory framework may be more modest. There is considerable uncertainty involved in this assessment, however, and more expansive changes are possible. Such changes would come through the exercise of regulatory discretion in rule-making and enforcement, but even here the outcome is unclear.

6 Such an action would have to meet strict legal tests for standing, which requires that the party seeking the review has suffered an actual loss from the exercise of discretion rather than merely anticipates a loss, and ripeness—roughly speaking, that a court-imposed remedy is available and appropriate to resolve the issue.

7 Alexis de Tocqueville, *Democracy in America*, Book I, Chapter XVI.

Uncertainty with respect to the outcome of the regulatory review process has both national and international implications. At the national level, uncertainty creates an option value of waiting as decisions to restructure business models or establish new banks are postponed. Such deferred decisions could negatively affect the U.S. economy should they result in less competition, higher borrowing costs and lower lending volumes.

But there are also concerns regarding the effect of possible changes to U.S. regulations on the rest of the world. If actual changes are relatively minor, the impact on other countries would be limited. Given U.S. leadership of international efforts to strengthen the regulation of global banks through various international bodies, other jurisdictions would likely mirror modest changes to U.S. regulations.

If Senate rules are changed, however, it is possible to envision far more sweeping changes to financial regulation, including an "America First" regulatory framework that include punitive treatment for foreign institutions. Should the U.S. adopt such a stance, international regulatory harmonization would be set back as U.S. leadership is lost. This outcome could have grave consequences for global financial stability: In a world of highly-integrated financial markets, international harmonization of regulation is akin to building codes for high-density housing. Fragmentation and balkanization of the regulatory landscape could pose a threat to global prosperity and expose the international financial system to the threat of fire.

The author is a Canada Institute public policy fellow at the Woodrow Wilson International Center for Scholars, Washington, D.C. This article is based on a presentation to a Canada Institute Reception and Expert Panel, The Future of Cross Border Financial Services, Toronto, May 24, 2017 sponsored by Torys LLP, Promontory Financial Group and Investors Group. The views expressed are his own and should not be attributed to the Wilson Center or the event sponsors.

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