



The Case Against Dodd-Frank: How the “Consumer Protection” Law Endangers Americans

Edited by
Norbert J. Michel

The Case Against Dodd–Frank: How the “Consumer Protection” Law Endangers Americans

Edited by
Norbert J. Michel

© 2016 by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
202.546.4400 | heritage.org

All rights reserved.
Printed in the United States of America.

Cover photo © iStockphoto.com

TABLE OF CONTENTS

v	Contributors
1	Introduction
11	Chapter 1 • Why Large Portions of the Dodd–Frank Act Should Be Repealed or Replaced <i>Peter J. Wallison</i>
31	Chapter 2 • Repealing Dodd–Frank’s Qualified Mortgage and Qualified Residential Mortgage <i>Edward J. Pinto</i>
39	Chapter 3 • Title I and the Financial Stability Oversight Council <i>Peter J. Wallison</i>
55	Chapter 4 • Title II: Is Orderly Liquidation Authority Necessary to Fix “Too Big to Fail”? <i>Paul H. Kupiec</i>
87	Chapter 5 • Rethinking Title III: The Federal Deposit Insurance Corporation and Other Subtitles <i>Mark A. Calabria</i>
93	Chapter 6 • Revisiting Title IV: Why Mandatory SEC Registration for Hedge-Fund Advisers Is Not Necessary <i>J. W. Verret</i>
105	Chapter 7 • Title V and the Creeping Federalization of Insurance Regulation <i>Hester Peirce</i>
123	Chapter 8 • No Need for Title VI with Simpler, Higher Capital <i>Stephen Matteo Miller and J. W. Verret</i>
131	Chapter 9 • Fixing the Dodd–Frank Derivatives Mess: Repealing Titles VII and VIII <i>Norbert J. Michel</i>
149	Chapter 10 • Revisiting Title IX: Credit-Rating Agencies and Executive Compensation <i>Thaya Brook Knight and Mark A. Calabria</i>
157	Chapter 11 • Title X and the Consumer Financial Protection Bureau: Limiting Americans’ Credit Choices <i>Diane Katz</i>
169	Chapter 12 • Title XI Does Not End Federal Reserve Bailouts <i>Norbert J. Michel</i>
181	Chapter 13 • Title XII: Improving Access to Mainstream Financial Institutions <i>Mark A. Calabria</i>
185	Chapter 14 • Title IX Subtitle D and Title XIV: Likely to Increase Cost of Mortgage Credit and Increase Foreclosures <i>Mark A. Calabria</i>
193	Chapter 15 • How Title XV Mandated Disclosures Harm, Rather than Protect, Investors <i>David R. Burton</i>

CONTRIBUTORS

David R. Burton is Senior Fellow in Economic Policy in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.

Mark A. Calabria is Director of Financial Regulation Studies at the Cato Institute.

Diane Katz is Senior Research Fellow in Regulatory Policy in the Roe Institute.

Thaya Brook Knight is Associate Director of Financial Regulation Studies at the Cato Institute.

Paul H. Kupiec is Resident Scholar at the American Enterprise Institute.

Norbert J. Michel is Research Fellow in Financial Regulations in the Roe Institute.

Stephen Matteo Miller is Senior Research Fellow at the Mercatus Center at George Mason University.

Hester Peirce is Senior Research Fellow at the Mercatus Center and Director of the Financial Markets Working Group.

Edward J. Pinto is Resident Fellow and Co-Director of the American Enterprise Institute's International Center on Housing Risk.

J. W. Verret is Senior Scholar at the Mercatus Center, a member of the George Mason Financial Markets Working Group, and an Assistant Professor at George Mason University School of Law.

Peter J. Wallison is Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute and Co-Director of the American Enterprise Institute's Program on Financial Policy Studies.

INTRODUCTION

The *Case Against Dodd-Frank: How the “Consumer Protection” Law Endangers Americans* grew from a shared concern among the contributing authors about the direction that financial regulation in this country has taken since the 2007–2009 financial crisis, specifically due to the regulations of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act. Rather than dealing with the causes of the crisis, Dodd–Frank exacerbated and compounded the economy’s existing ills. The resulting financial regulatory framework has restrained the economy’s recovery, introduced even more moral hazard, and expanded the number of firms that are too big to fail. The contributors to this volume have used their knowledge of the financial sectors covered by Dodd–Frank to explain problems the act creates, and to propose solutions to them. The contributors have combined their work to paint a more comprehensive picture of this deeply flawed law, and—lest the reader despair—offer proposals for improving the way the financial markets are regulated.

Running through the 800-plus pages of Dodd–Frank is a regulatory approach that relies on the federal government to plan, protect, and prop up the financial system. This approach is based on a mistaken belief that the 2007–2009 crisis stemmed from unregulated financial markets. Quite to the contrary, the government’s extremely active role in directing the financial markets—and its promises to absorb the losses of private risk-takers—brought about the financial crisis.

Peter Wallison’s discussion of government housing policy illustrates how well-intentioned government interventions in financial markets can have devastating consequences. Wallison explains that the fundamental cause of the crisis was not an inherent flaw in the capitalist system, insufficient regulation of the private finance sector, or Wall Street greed. Instead, it was the misguided housing policies of the U.S. government itself, which encouraged a massive deterioration in residential mortgage underwriting standards and the creation of a vast number of subprime and other risky mortgages.

Ed Pinto follows and further illustrates that Dodd–Frank did not address the problem in any substantial way. Although Fannie Mae, Freddie Mac, and the Department of Housing and Urban Development were the central drivers of this credit deterioration, they were not addressed or reformed by Dodd–Frank. Achieving market stability requires policies that ensure that a substantial preponderance of mortgages are low-risk—meaning that they perform well under stress conditions. Pinto explains how the qualified mortgage (QM) and qualified residential mortgage (QRM) rules authorized by Dodd–Frank fail to restore sound underwriting policies that ensure good quality mortgages.

This volume makes the case that Dodd–Frank ignores the policy failures of the past and ensures their repetition in the future. A look through each title of Dodd–Frank provides ample reason to believe that its supposed solutions are seeds of future failure. There is little sense in continuing to embrace policies that do not address the causes of the last crisis, that lay the groundwork for the next crisis, and that impede economic growth in the interim. This volume suggests superior alternatives that allow market discipline to work on behalf of financial stability, shrink government safety nets, and recognize the limitations of regulators.

The paternalistic approach embodied in Dodd–Frank is not new. The notion that government must step in to protect people from freely operating markets has guided U.S. bank regulation for most of the country’s history, and, since the 1930s, has increasingly encroached on the regulation of U.S. capital markets. For decades, regulators—undaunted by their past failures—have grasped a more active role in managing financial firms’ risk-taking. The consequences—for the stability, competitiveness, and effectiveness of the financial system—have been grave. The financial crisis and the Dodd–Frank Act have now given financial regulators an unprecedented and dangerous opportunity to expand their already inappropriate jurisdiction and overarching power.

Proponents offer two main justifications for extensive federal regulation of banks: (1) the need to prevent problems at financial firms from turning into system-wide crises, and (2) the need to protect the Federal Deposit Insurance Fund (FDIC). Time and again, regulation—far from being a solution—has shown itself to be the source of additional

problems. The U.S. has had 14 major banking crises in the past 180 years—one of the worst track records of the developed world. The U.S. record is also among the worst even when focusing only on more recent time periods. One particularly notorious feature of bank regulation is the internationally agreed and designed Basel capital rules, which have informed bank capital since the 1980s. Not only did these rules fail to prevent banking crises, they made these crises more likely and more intense. Basel III, which is now being implemented, incorporates many of the errors of its two predecessor agreements.

Dodd–Frank introduces new safety nets and expands existing ones, mandates more regulatory control of bank risk taking, and expands this control to the rest of the financial system. The contributors to this book explain how those changes undermine financial stability, expose taxpayers to additional risk, give the government inappropriate authority over the financial system, and imperil economic growth.

The following chapters cover every important feature of the Dodd–Frank Act. Each expresses the views of its authors; they do not agree on all the recommendations, but they are all committed to the 10 core principles, listed at the end of the Introduction. Those principles, in turn, underlie each of the recommendations.

Peter Wallison's discussion of Title I demonstrates, among other dangers, the systemic instability inherent in authorizing the Financial Stability Oversight Council (FSOC) to designate firms and activities for special regulatory oversight. The FSOC's arbitrary and standard-less approach to carrying out this function makes matters even worse. The chapter recommends either eliminating the FSOC or refocusing it on bringing regulators together to discuss financial regulatory issues and share information.

As **Paul Kupiec**'s discussion of Title II details, Dodd–Frank created orderly liquidation authority (OLA) under the false presumption that a large, systemically important financial institution (SIFI) cannot be reorganized in bankruptcy without destabilizing financial markets. Current regulatory strategies for containing systemic risk using OLA can be replicated in bankruptcy if higher minimum capital requirements are required for operating subsidiaries instead of parent SIFI companies. Capital regulation for parent holding companies and the Federal Reserve "source of strength doctrine" should

be repealed and replaced with higher-equity capital requirements for operating subsidiaries. Such changes will ensure that these subsidiaries remain open and operating and have continued access to market funding and Federal Reserve liquidity, should the parent enter bankruptcy.

This solution to the too-big-to-fail (TBTF) problem does not require OLA, holding company capital regulation, the Federal Reserve "source of strength doctrine," the added complexity of new total loss absorbing capacity regulation, or mandatory convertible-contingent capital issuance. The solution retains the benefits of bank holding company consolidated-debt-interest tax shields, while fully protecting taxpayers from the cost of a future SIFI failure. Requiring higher-equity capital at operating subsidiaries is a transparent solution that removes the TBTF subsidy without the negative aspects of OLA, such as abridging investor's property rights, denying legal due process protections for parent SIFI creditors, and the potential for a disguised taxpayer subsidized bailout.

As **Mark Calabria** discusses in his chapter on Title III of Dodd–Frank, government-provided deposit insurance is widely acknowledged by economists as having destabilizing effects on financial systems. Dodd–Frank's permanent increase of deposit insurance to the current level of \$250,000 flies in the face of these economic findings. Calabria recommends lowering this amount, which is well above the average account size, to enhance financial stability, while continuing to protect most households.

In his assessment of Title IV, **J. W. Verret** discusses the unnecessary hedge-fund-adviser-registration mandate. A better approach would be to return to the pre-Dodd–Frank system in which advisers, informed by the demands of their investors, could decide whether to register with the Securities and Exchange Commission (SEC). The new "Form PF" on private funds also merits reconsideration in light of early indications that the cost of the disclosure outweighs the benefits. To counterbalance Dodd–Frank's narrowing of the accredited investor definition to exclude homes, a good option would be an expansion that ensures that sophisticated investors, and investors outside the highest-earning areas of the country, are allowed to invest.

Hester Peirce explains how Title V secured a foothold for the federal government in insurance regulation. Although seemingly innocuous, the new Federal Insurance Office established by Title V

works in concert with the Federal Reserve's expanded powers under Titles I and VI to undermine state-based insurance regulation. With the greater federal presence comes a greater likelihood of a federal taxpayer bailout for insurance companies. A better approach would be federal chartering, or a competitive state-based regulatory model.

Title VI, including the so-called Volcker rule in Section 619, attempts to improve the regulation of bank and saving association holding companies and depository institutions. **Stephen Miller** and **J. W. Verret** explain that it fails to deliver because it attempts to control the inner workings of banks. The statute presumes that regulators understand bank risks better than the banks themselves, that regulators should analyze and have a say in bank asset management, and that bank size, not the type of assets that banks hold, determines bank risk.

Norbert Michel highlights the intensely prescriptive nature of the new regime created by Title VII's overhaul of the derivatives regime. He points out the danger of government micromanagement of this part of the financial marketplace and the possibility that Title VII's clearing mandate will undermine—not enhance—financial stability. Allowing market participants to choose which instruments to clear would enhance financial stability and ensure that derivatives markets continue to serve customers' risk-management needs. The discussion of Title VIII—a companion provision to Title VII—highlights the dangers of the FSOC's power to designate systemically important “financial market utilities” and systemically important payment, clearing, and settlement activities. Michel explains that describing payment, clearing, and settlement companies as utilities confers on them an inappropriate quasi-monopoly status. He argues against designating these entities for special regulation and bank-like access to Federal Reserve accounts, services, and loans. He also shows how activity-based regulation could give regulators undue control over broad swaths of the financial system.

Title IX of Dodd–Frank is expansive, and **Thaya Brook Knight** and **Mark Calabria** argue that each of the subsections warrants reconsideration. Knight and Calabria discuss a number of changes that could improve the effectiveness of the SEC in satisfying its mission. These include repurposing the Ombudsman, revising the whistleblower provisions, making meaningful investor-centered reforms in the municipal securities space, ensuring SEC accountability in

enforcement actions, and removing the provisions in Dodd–Frank that suggest an SEC imprimatur on rating agencies.

In the chapter on Title X, which established the Consumer Financial Protection Bureau (CFPB), **Diane Katz** discusses the need to reformulate consumer protection in the financial products and services space. As currently structured, the CFPB restricts both consumer access to credit and innovation in financial products and services. Designed to be “independent,” the CFPB lacks political accountability and thus routinely exceeds its regulatory authority. Consumers would be more effectively protected by shifting the CFPB's responsibilities to the Federal Trade Commission or revamping the CFPB's structure.

Norbert Michel's chapter on Title XI explains the inadequacy of the title's changes to the Federal Reserve's emergency lending powers. Even with the changes, the Federal Reserve can still make many of the same types of emergency loans it made between 2007 and 2010, when it lent more than \$16 trillion to financial firms through its broad-based emergency programs. Here, Michel calls for a prohibition on emergency lending. Instead, he recommends eliminating the primary dealer system and allowing more financial firms to take part in open-market operations, thus enhancing the Fed's ability to provide system-wide liquidity.

Mark Calabria notes the incongruity of a section of Title XII devoted to encouraging financial institutions to make economically unsound loans—a practice that contributed to the financial crisis. He suggests that a better way to help underserved consumers would be to ensure that regulations do not impede financial institutions' ability to offer financial products and services on mutually beneficial terms to consumers. As he explains in this chapter, subsidies do not make products cheaper for society as a whole, and in many instances they ultimately are not even cheaper for the individual consumer. Nonetheless, Title XII is essentially designed to create a variety of taxpayer-subsidized alternatives to short-term consumer and payday loans.

Mark Calabria's chapter on Title XIV and Subtitle D of Title IX examines the QM rule, the QRM rule, and the risk-retention (skin in the game) rule required by Section 941 of Title IX. Rather than removing artificial incentives toward securitization, like those found in bank capital regulations, Subtitle D of Title IX mandates specific solutions

and attaches increased liability to any violation of those solutions. Calabria points out that risk retention was already common for subprime mortgage securities before Dodd–Frank, and argues that the new framework created by Section 941 is unlikely to improve the quality of mortgages originated since the financial crisis. Calabria also discusses major shortcomings in Title XIV, the Mortgage Reform and Anti-Predatory Lending Act. The act attributes the financial crisis to “predatory lending,” but it includes no *definition* of predatory lending. Instead, Title XIV is a collection of prohibitions and restrictions, with many of the details left to financial regulators, particularly the CFPB.

Title XV of Dodd–Frank misunderstands the purpose of the SEC, giving the commission three new disclosure mandates that are *not* intended to provide much-needed information to investors. Instead, these provisions represent the coopting of SEC disclosure for social and political purposes. **David Burton** argues that these particular disclosures should be eliminated, and that the SEC’s focus on providing investors with material disclosures should be highlighted.

Together, these chapters suggest that the approach adopted by Dodd–Frank—increasing government control of the financial regulatory system paired with generous government safety nets—is not the road to financial stability, economic growth, or consumer protection. Although paved with good intentions, it is the road to greater instability and the danger of further financial breakdowns. A better approach is guided by the following 10 core principles:

1. Private and competitive financial markets are essential for healthy economic growth.
2. The government should not interfere with the financial choices of market participants, including consumers, investors, and uninsured financial firms. Regulators should focus on protecting individuals and firms from fraud and violations of contractual rights.
3. Market discipline is a better regulator of financial risk than government regulation.
4. Financial firms should be permitted to fail, just as other firms are. Government should not “save” participants from failure because doing so impedes the ability of markets to direct resources to their highest and best use.

5. Speculation and risk-taking allow markets to operate. Interference by regulators attempting to mitigate risks hinders the effective operation of markets.
6. Government should not make credit and capital allocation decisions.
7. The cost of financial firm failures should be borne by managers, equity holders, and creditors, not by taxpayers.
8. Simple rules—such as straightforward equity capital requirements—are preferable to complex rules that permit regulators to micromanage markets.
9. Public-private partnerships in the financial realm often create financial *instability* because they create rent-seeking opportunities and misalign incentives.
10. Government backing for financial activities, such as classifying certain firms or activities as “systemically important,” inevitably leads to government bailouts.

Summary of Arguments

PRE-CRISIS HISTORY

- The claim that the crisis was the fault of excessive risk-taking by the financial sector is a false narrative that absolved the government of responsibility and provided a foundation for the comprehensive regulation embodied in the Dodd–Frank Act.
- The 2008 financial crisis was primarily caused by the U.S. government’s housing policies, not insufficient regulation of the financial system or greed on Wall Street.
- The crisis unfolded as follows:
 1. Congress set affordable housing goals for Fannie Mae and Freddie Mac that rose over time;
 2. Fannie Mae and Freddie Mac reduced underwriting standards—eventually including no-down-payment loans—to meet these goals;
 3. Fannie Mae’s and Freddie Mac’s loosened underwriting standards spread to the rest of the housing finance market;

4. A massive 10-year housing bubble between 1997 and 2007 resulted;
 5. As the housing bubble began to deflate in early 2007, an unprecedented number of homeowners defaulted on their mortgages;
 6. The financial institutions that held these mortgages—or the private mortgage-backed securities (PMBSs) based on them—had to write them down to market value and take losses;
 7. The government stepped in to rescue one of these financial institutions—Bear Stearns—which seemed to establish a policy that the government would rescue all large financial institutions;
 8. Assuming the government would act, managers of financial firms decided not to dilute their shareholders by raising substantial amounts of new equity; similarly, creditors decided to hold their undervalued debt securities instead of taking losses; and
 9. In September 2008 the government reversed its policy, allowing Lehman Brothers—an investment bank larger than Bear Stearns—to file for bankruptcy, thus upending the assumptions of all market participants, creating a market panic, and causing banks to hoard cash.
- The enactment of Dodd–Frank, rather than addressing the policies that created the financial crisis, absolved the government from responsibility for what happened in the financial crisis and allowed it to maintain the same policies, which continue to destabilize the housing market.
 - The United States will never have a stable housing finance market until the American public understands the government’s role in both the 2008 financial crisis and the continuing instability of the U.S. housing market.

DODD–FRANK AND THE SLOW RECOVERY

- The U.S. economy’s recovery from the financial crisis and the ensuing recession has been the slowest since the mid-1960s.
- This is principally attributable to the heavy load of new regulation imposed by the Dodd–Frank Act, which has affected—among other firms—small community banks that are important sources of credit for small businesses.

- Whereas larger businesses have been recovering from the crisis at about the same rate as in past recessions, small businesses have not been growing at all.
- This accounts for the weak overall U.S. recovery, something that will not change until Dodd–Frank is repealed or substantially reformed.

The following summary is listed in order of Dodd–Frank’s titles:

Title I

- The FSOC’s authority under Section 113 to designate nonbank financial firms as SIFIs should be repealed, including the language in Section 113 that permits the FSOC to designate SIFIs because of their “nature, scope, size, scale, concentration, interconnectedness, or mix of activities.”
- The FSOC’s authority under Section 120 to recommend “stringent” regulation of any “activity,” and its authority under Section 121 to terminate certain activities by any financial company, should be repealed.
- The statutory designation of bank holding companies as SIFIs under Section 165 should be repealed.
- The provisions of Section 165 that impose requirements for stringent regulation, stress tests, and living wills should apply only to the largest insured banks.
- If, contrary to the foregoing recommendations, the FSOC is to continue to have authority to designate nonbank financial firms as SIFIs, it should make public the basis on which its designations are or will be made, including the objective tests and metrics it uses. The standards for “de-designation” should also be clarified.
- If the FSOC is retained, and especially if it retains authority to designate SIFIs, the FSOC should be substantially restructured to eliminate its political direction.
- The FSOC could be retained solely as an information-sharing resource for financial regulators, like the President’s Working Group in prior Administrations.
- Whatever happens to the FSOC, the Office of Financial Research should be terminated and the FSOC should be funded by congressional appropriations.

Title II

- Dodd–Frank OLA is not necessary to prevent systemic risk.
- Financial stability goals can be better achieved by imposing higher equity-capital requirements on operating subsidiaries. This change would have the following advantages:
 - Implicit TBTF subsidies would be fully removed;
 - Taxpayers would be fully protected against bailout costs should a SIFI fail;
 - Large SIFI parent holding companies could fail without systemic ramifications;
 - Negative tax consequences would be neutralized by removing bank-holding-company minimum regulatory capital requirements and repealing the Federal Reserve “source of strength doctrine”;
 - Enhanced prudential standards for holding companies could be eliminated, including mandatory annual Fed stress tests, saving hundreds of millions of dollars wasted on unproductive regulation;
 - Legal due process for parent holding company shareholders and creditors would be protected;
 - The need for new complex total-loss-absorbing-capacity (TLAC) regulations or mandatory contingent convertibles (CoCos) would be eliminated; and
 - Parent SIFI shareholders and creditors, not the Federal Reserve, would be responsible for managing the parent SIFI’s risk profile.

Title III

The following measures would enhance financial stability:

- Repeal Title III Subtitle C of Dodd–Frank;
- Repeal the 2005 increase of deposit insurance cap for retirement accounts;
- Reduce the deposit insurance cap for all accounts to \$40,000;
- Limit the amount of the deposit insurance fund (DIF) available to any single bank to 5 percent of the DIF;
- Implement risk-based premiums according to state and charter type; and
- Restrict pricing competition for insured deposits.

Title IV

- Mandatory registration for investment advisers to hedge funds and other funds is unnecessary; it diverts the SEC’s resources from retail adviser examinations, fails to deter fraud, and misleadingly implies SEC approval.
- Returning to the pre-Dodd–Frank status, pursuant to which advisers to private funds may—but do not have to—register with the SEC, would allow investors to decide whether SEC registration is important and whether they are willing to pay for it.
- Policymakers could consider requiring registered advisers to pay for examinations by the SEC or by a third party.
- Extensive collection of data from private funds is unnecessary for financial stability.
- The accredited investor standard should be indexed for inflation and perhaps by the investor’s geographic area and also expanded to allow individuals who are sophisticated, but not wealthy, to invest in private funds.

Title V

- Title V, in conjunction with other parts of Dodd–Frank, establishes a back door for federal regulators to become a strong presence in insurance regulation and supervision.
- Title V of Dodd–Frank creates the Federal Insurance Office (FIO), enables it to collect (including by subpoena) information from across the financial industry, enables it to pre-empt state law, and creates an avenue for the FIO to assert increasing federal control over insurance regulation.
- The Federal Reserve is already a major insurance supervisor, and its role is likely to expand unless its holding company and SIFI supervisory authority is removed.
- Title V, in conjunction with other parts of Dodd–Frank, clears the path for international and banking regulators to increasingly dictate domestic insurance regulation. The likely result is further homogenization of the financial system and potential future taxpayer bailouts of insurance companies.
- Dodd–Frank’s back-door federalization of insurance should be replaced either with a federal insurance charter and a federal insurance commission, or with a competitive state-based chartering model, in which each insurer has a single state insurance regulator.

Title VI

- A key theme running through Title VI is that regulators should have more control over bank activities, including risk-taking and size.
- Title VI suggests that bank size and concentration help explain why the crisis occurred, but in fact, it was asset holdings that explained bank insolvency risk leading up to the crisis.
- As in the discussion of Title II, the problems addressed in Title VI, namely bank asset risk, can also be addressed through higher capital, which Title VI calls for in Section 606, without acknowledging that higher capital tends to reduce risk-taking.

Titles VII and VIII

- Titles VII and VIII of Dodd–Frank stem from a misunderstanding of the causes of the financial crisis.
- These titles are fundamentally altering the structure and operation of the over-the-counter derivatives (swaps) markets through clearing, trading, reporting, mandatory margining of uncleared swaps, and business-conduct requirements.
- The Title VII swaps-clearing mandate is particularly troubling as it threatens to undermine counterparty risk management, make hedging more costly for Main Street businesses, and give rise to large, unstable central clearinghouses.
- Title VIII worsens the problem by allowing these central clearinghouses access to Federal Reserve lending and essentially classifying them as public utilities—another set of TBTF entities, which will be subject to tight regulatory control and protected from competition.
- Title VIII also gives federal regulators broad discretionary authority to regulate much of U.S. financial activities on an ongoing basis. No independent federal regulator should have such power.
- Eliminating Title VII would enable the swaps markets to function effectively for the economy. A subset of swaps would naturally move toward clearing, but the choice to clear would not be dictated by regulators.
- If Title VII is reformed in this way, Title VIII can also be eliminated. Financial market infrastructures, such as clearinghouses, should be regulated pursuant to a broad set of principles, rather than a prescriptive set of regulations.

Title IX

Subtitle A (Investor Protection)

- To play a meaningful role, the Ombudsman should be moved from the Office of Investor Advocate and charged with serving as a voice within the SEC for regulated entities and public companies.
- The authority to mandate a fiduciary duty standard for brokers and dealers should be replaced by a mandate to develop, after investor testing, an effective method of communicating to retail investors to whom, for how much, and for which financial services they are paying. This would allow investors to choose the financial services relationship that best meets their needs.

Subtitle B (Enforcement)

- A statutory restriction of pre-dispute arbitration unnecessarily overrides the freedom of contract and may impose greater costs on investors.
- To properly incentivize whistleblowers, the whistleblower provisions could be rewritten to require whistleblowers (absent extenuating circumstances) to proceed internally first and to eliminate the minimum payout requirement.
- Dodd–Frank’s enforcement provisions should be revised to ensure that enforcement resources are properly allocated and to restrict the types of cases that can proceed administratively, as opposed to in court.

Subtitle C (Credit Rating Agencies)

- Removing statutory and regulatory requirements to use ratings is an important step toward eliminating the government seal of approval aura that credit-rating agencies enjoyed in the lead-up to the crisis. To fully eliminate the aura, regulators need to complete the removal process.
- The new regulatory infrastructure for credit-rating agencies that Dodd–Frank instituted runs directly counter to the removal provisions by making it look as if credit-rating agencies have the SEC’s seal of approval. Dismantling this infrastructure would allow the market to assess the value of rating services.
- Eliminating Dodd–Frank’s provisions with respect to credit-rating agency lawsuits would eliminate a barrier to the entry of new credit-rating firms.
- Involving the SEC or another government body in assigning particular securities to particular rating agencies—as set forth in Section 939F—would also give credit ratings a government seal of approval.

Subtitle D (Asset-Backed Securities)

- It is not true that there was no risk retention in this market before Dodd–Frank.
- The vast majority of issues had some form of risk retention, usually in the form of an equity tranche retained by the issuer.
- The overwhelming majority of private-label mortgage-backed securities (PLMBS) were held by sophisticated investors; outside of Fannie and Freddie, the largest single holders of PLMBS, most PLMBS were held by institutional investors.
- Leaving the disclosure and reporting section in place would allow market participants to make assessments about the underlying assets in asset-backed securities.

Subtitle E (Executive Compensation)

- Removing Dodd–Frank’s executive compensation provisions would enable companies to make disclosure decisions based on what is material to a reasonable investor.

Subtitle F (SEC Management)

- To improve the effectiveness and accountability of the compliance inspectors, Dodd–Frank’s plan to move them back into the rulemaking divisions should be implemented.

Subtitle G (Corporate Governance)

- Dodd–Frank continues the incremental federalization of corporate governance.
- A preferable approach would be to re-embrace state law federalism by allowing state and local government competition in corporate chartering.

Subtitle H (Municipal Securities)

- The structure and mission of the Municipal Securities Rulemaking Board (MSRB) should be revised to ensure that it is effective. In particular, Dodd–Frank’s addition of a mandate to protect municipal securities issuers should be revisited.
- The municipal advisor registration regime should be revisited to assess its effectiveness.
- Congress should consider the recommendations in the SEC’s 2012 report on municipal securities and should consider ways to intensify the SEC’s focus on the municipal markets.

Subtitle I (Miscellaneous)

- Congress should prohibit the Public Company Accounting Oversight Board (PCAOB) from publicizing instituted, but unresolved, enforcement actions.
- The SEC should conduct a review on the effectiveness of the PCAOB and report to Congress on whether it should continue in its current form.

Subtitle J (SEC Funding)

- The SEC should not be shifted to a self-funded model, since that shift could lead to accountability problems.

Title X

- The CFPB was designed to evade the checks and balances that apply to other regulatory agencies. Its structure and mandate invite expansive rulemaking, and it lacks accountability to Congress, the President, and the American people.
- The CFPB has abused its authority by regulating outside of its jurisdiction, and by employing supervisory and enforcement tactics that are not rooted in evidence-based analysis.
- One reform option would be to transfer the CFPB’s authorities to the Federal Trade Commission.
- Another option would be to impose greater accountability on the CFPB by, for example, funding the agency through congressional appropriations, subjecting the agency to rulemaking requirements, and limiting its supervisory and enforcement powers.

Title XI

- Title XI of Dodd–Frank fails to end the TBTF problem largely because it keeps in place the belief that the Fed should make emergency loans to firms during a financial crisis.
- Congress should prohibit the Federal Reserve from making emergency loans. If Congress deems emergency funds are necessary, it can directly appropriate the funds in a politically accountable manner.
- In place of emergency lending, the Federal Reserve should eliminate the current primary dealer system and allow all sound banks to directly take part in open-market operations.

-
- Congress should eliminate the FDIC’s systemic risk exception and prohibit the FDIC from providing any types of loan guarantees.
 - As long as emergency lending programs exist, Title XI transparency provisions should remain in place, and the Government Accountability Office should be authorized to audit—with appropriate delays regarding the release of sensitive information—all aspects of the Fed’s operations.

Title XII

- Title XII authorizes the government to encourage, including through subsidies, consumer lending that is not economically viable.
- Eliminating Title XII would further the effort to eliminate statutes and regulations that encourage financial institutions to lend irresponsibly.
- A better way to expand credit for the financial-ly underserved is to ensure that existing and future financial regulations are designed in a manner that achieves the regulatory objective without unduly impairing consumers’ access to credit.

Title XIII

- Title XIII can remain in place without impairing financial stability.

Title XIV

- Dodd–Frank attributes the increase in mortgage defaults associated with the financial crisis to “predatory lending,” and then fails to define the term.
- A recurring theme in Title XIV is the assumption that many borrowers defaulted because they were simply in the wrong loan. Based on this idea, mortgage originators are prohibited from steering borrowers toward loans under which the borrower lacks a reasonable ability to pay, or that have certain features.

- In general, mortgage originators who place borrowers into QMs will be protected from enforcement and liability for steering borrowers into problematic loans.
- Many of the details of required provisions in Title XIV have been left up to financial regulators, with the CFPB in the lead role. Although the QM and QRM rules will likely increase the cost of mortgage credit, their effects on reducing foreclosures during the next housing bust are likely to be modest and may even increase foreclosures.

Title XV

- The conflict-minerals provisions and resource-extraction provisions in Title XV impose undue costs on companies, without providing material information to investors.
- The mine-safety disclosure provisions duplicate other federal reporting requirements and are not based in materiality.
- To restore the SEC to its core statutory mission, Congress should replace these provisions with a requirement that the SEC use materiality to the reasonable investor as its standard for determining whether something must be disclosed.

Title XVI

- Title XVI can remain in place without impairing financial stability, even if Title VII, to which it is related, is repealed.

ENDNOTES:

1. Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Financial Crises and Scarce Credit* (Princeton, NJ: Princeton University Press, 2015), p. 5.
2. Titles XIII and XVI are not covered in this volume. These titles are narrow in application and can remain in place without undermining financial stability or running afoul of the core principles set forth below.

CHAPTER 1

Why Large Portions of the Dodd–Frank Act Should Be Repealed or Replaced

Peter J. Wallison

It sometimes seems puzzling to commentators in the media and elsewhere why, five years after its enactment, the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 remains so controversial.¹ The reasons are simple: The act was based on a false narrative about the causes of the financial crisis and thus inflicted needless harm on both the U.S. financial system and the economy it serves. Because of these questions about its legitimacy as well as its effects, the act is likely to remain under fire until it is appropriately reformed. In contrast, the reforms proposed in this book—which in some cases include repeal of specific titles—are intended to support financial stability and economic growth.

Dodd–Frank was signed into law by President Barack Obama on July 21, 2010, and thus began a prolonged and unnecessary period of anemic growth in the U.S. economy. The essays that follow—which cover each important title of the act—outline in detail the serious obstacles and risks that the act has placed before the normally vibrant and innovative U.S. financial system. Together, they show one of two things, and sometimes both: that the key provisions of the act (1) create costs and risks that far outweigh any benefits that their associated regulations might provide and (2) simply fail to achieve the goals they were designed to attain.

But before proceeding with our title-by-title analysis, it is important to note that the act has overriding deficiencies that are not made clear by a critique of its individual titles. In a sense, the whole is worse than the sum of its parts.

First, as shown in Section I below, Dodd–Frank was enacted by Congress without any significant effort to understand what actually caused the financial crisis. Instead, Congress and the Obama Administration—using the precept that one “should never waste a good crisis”²—followed an ideologically

motivated course to enact what Representative Barney Frank (D–MA) called “a new New Deal.”³ The result was a rush to the erroneous judgment—and the creation of a false narrative—that the crisis was caused by insufficient regulation of the private sector, particularly Wall Street.

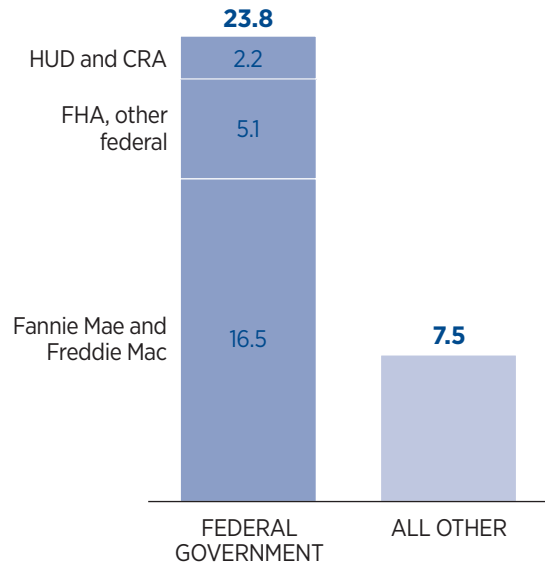
Later careful and less ideologically motivated reviews of the crisis showed that it was principally the result of the U.S. government’s housing policies, which Dodd–Frank did not address in any substantial way. Accordingly, because the act was carelessly and improvidently focused on the wrong target, it must be seen as illegitimate—a fit subject for repeal or substantial reform.

Second, the false narrative about the financial crisis has enabled the government to continue the policies that caused the 2008 crisis. Once again, by reducing underwriting standards, the government is setting off on a course that uses housing policy as social policy—a course that left millions of low-income Americans unable to meet their mortgage obligations and facing default and eviction. Millions are still in that position all across America. Although intended to help low-income Americans, these policies are the very opposite;

CHART 1

Federal Government Held Most High-Risk Mortgages Prior to Financial Crisis

Holders of Subprime and Other High-Risk Mortgages as of June 20, 2008, in Millions



NOTES: HUD—Housing and Urban Development, CRA—Community Reinvestment Act, FHA—Federal Housing Authority.

SOURCE: Edward J. Pinto, “Three Studies of Subprime and Alt-A Loans in the US Mortgage Market,” American Enterprise Institute, September 29, 2014, <http://www.aei.org/publication/three-studies-of-subprime-and-alt-a-loans-in-the-us-mortgage-market/> (accessed February 3, 2016).

heritage.org

they may temporarily garner votes, but they ultimately destroy the hopes that they create. For that reason alone, it is important for Americans to understand why there was a financial crisis in 2008; with that knowledge, they may be able to stop the government from making the same mistakes again.

Finally, any effort to repeal or replace major provisions of Dodd-Frank will be characterized by the act’s supporters as an attempt to roll back the “progress” they have made in preventing another financial crisis. Yet, if anything, by stifling economic growth, Dodd-Frank has made another financial crisis *more* likely, and has brought on the concerns about middle-income stagnation, income inequality, and a

future without economic progress that most Americans have never experienced before.

In a sense, the voters have already exacted their revenge for the enactment of Dodd-Frank; more than half of the Members of Congress who voted for Dodd-Frank have been voted out of office since 2010. It is now necessary to finish the job by reforming or repealing the portions of the destructive act they left behind.

WHAT REALLY CAUSED THE FINANCIAL CRISIS

The financial crisis was not the result of an inherent flaw in the capitalist system,⁴ insufficient regulation of the private finance sector, or even greed on Wall Street. Its fundamental cause was the housing policies of the U.S. government itself, which encouraged a massive deterioration in residential mortgage underwriting standards and the creation of a vast number of subprime and other risky mortgages. Because of these policies, by 2008, just before the crisis hit, 56 percent of all the mortgages in the U.S.—31 million mortgages—were subprime or otherwise risky,⁵ and of these, 76 percent were *on the books of government agencies*. This one fact demonstrates, without question, that the federal government—not the private sector—created the demand for the mortgages that caused the crisis.

Chart 1 shows where the subprime and other high-risk mortgages were held in 2008, just before the financial crisis. Table 1 provides the same data in greater detail.

The seeds of the crisis were planted with the enactment by Congress in 1992 of what were called “affordable housing goals” for the two gigantic government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac.⁶ Because they were chartered by Congress and provided with special privileges, it was widely expected in the financial markets that the GSEs would not be allowed to fail, enabling them to attract credit at a cost only slightly greater than the Treasury itself. Before 1992, these two firms were the dominant players in the housing finance market, especially after the savings and loan (S&L) industry—another government mistake—had collapsed. The GSEs were prohibited from making loans themselves, but were authorized to buy mortgages from banks and other lenders. Their purchases provided cash for lenders and thus encouraged home ownership by making more funds available for additional mortgages.

TABLE 1

Entities Holding Credit Risk of Subprime and Other High-Risk Mortgages

Entity	Subprime and Alt-A Loans (millions)	Unpaid Principal Amount (trillions)
Fannie Mae and Freddie Mac	16.5	\$2.5
FHA and Other Federal	5.1	\$0.6
CRA and HUD Programs	2.2	\$0.3
Total Federal Government	23.8	\$3.4
All Other (includes subprime loans, Alt-A whole loans, and private mortgage-backed securities issued or held by the private sector)	7.5	\$1.9
Total	31.0	\$5.3

NOTES: HUD—Housing and Urban Development, CRA—Community Reinvestment Act, FHA—Federal Housing Authority. **SOURCE:** Edward J. Pinto, “Three Studies of Subprime and Alt-A Loans in the US Mortgage Market,” American Enterprise Institute, September 29, 2014, <http://www.aei.org/publication/three-studies-of-subprime-and-alt-a-loans-in-the-us-mortgage-market/> (accessed February 3, 2016).

 heritage.org

Between 1991 and 2003, the GSEs’ share of the housing market increased from 28.5 percent to 46.3 percent.⁷ From this increasingly dominant position, they were able to set the underwriting standards for the market as a whole; few mortgage lenders would make middle-class mortgages—by far the predominant market—that could not be sold to Fannie or Freddie.

Other government agencies were involved in housing finance, notably the Federal Housing Administration (FHA), the Veterans Administration (VA), and the Department of Agriculture’s Rural Housing Service (RHS), but the GSEs were by far the most important. The GSEs’ and the government’s increasing dominance of the housing market is well-illustrated in Chart 2, in which the mortgage-backed securities (MBS) of the GSEs and government agencies, which were implicitly backed by the government, are included in “Agency and GSE mortgage pools.”

Before 1992, the GSEs had learned from experience which underwriting standards kept delinquencies and defaults low. These required down payments of 10 percent to 20 percent, good borrower credit histories, and a low debt-to-income ratio (usually no larger than 38 percent) after the mortgage was closed. These were the foundational elements of what was called a prime loan or a traditional mortgage. Mortgages that did not meet these standards were called “subprime” or “Alt-A.” A subprime loan is one in which the borrower has a FICO credit score of less than 660.⁸ An Alt-A loan is a loan with one of a number of deficiencies, such as a low down payment, a high debt-to-income ratio, or lack of amortization or documentation. In this chapter, subprime and Alt-A mortgages will, together, be called non-traditional mortgages (NTMs).

The Affordable Housing Goals. In a sense, the GSEs’ ability to dominate the housing finance market and set strict underwriting standards was their undoing. Community activists had had the two firms in their sights for many years, arguing that the GSEs’ underwriting standards were so tight that they were keeping many low- and moderate-income (LMI) families from buying homes. Finally, as housing legislation was moving through Congress in 1992, Congress directed the GSEs to meet a quota of loans to LMI borrowers when they acquired mortgages. These became known as the affordable housing (AH) goals. At first, the quota was 30 percent—in any year, at least 30 percent of the loans that Fannie and Freddie acquired from lenders must have been made to LMI borrowers who were at or below the median income in their communities.

But Congress gave the Department of Housing and Urban Development (HUD) the authority to increase the goals, and in succeeding years HUD raised the LMI goal to 42 percent in 1995, 50 percent in 2000, and 56 percent in 2008. Congress also required additional “base goals” that encompassed low-income and very-low-income borrowers (80 percent or 60 percent of median income, respectively) and residents of minority areas described as “underserved.” HUD increased these base goals between 1996 and 2008, and at a faster rate than the LMI goals.

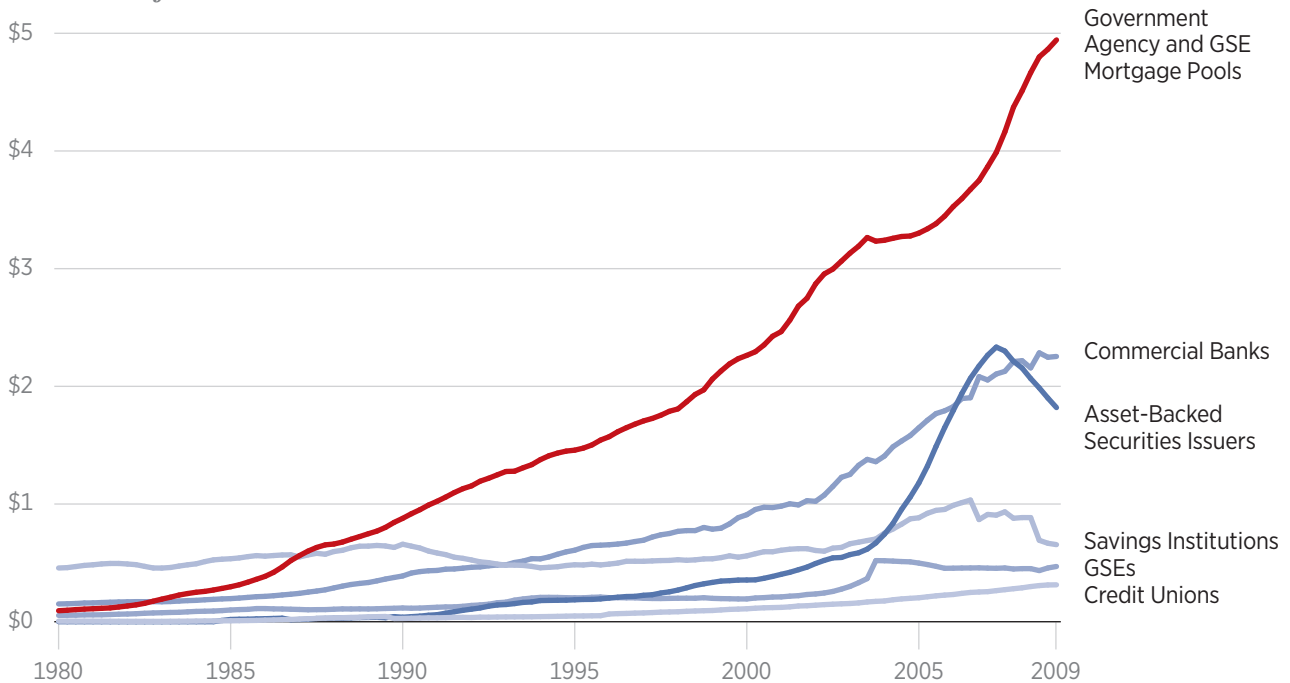
Chart 3 shows the increases in the affordable housing goals between 1996 and 2008, as well as the GSEs’ success in meeting them over time.

Although it was relatively easy for Fannie and Freddie to find prime borrowers when the LMI goal

CHART 2

Total Holdings of U.S. Home Mortgages by Type of Financial Institution

In Trillions of Dollars



SOURCE: Tobias Adrian and Hyun Song Shin, "The Changing Nature of Financial Intermediation and the Financial Crisis of 2008-09," Federal Reserve Bank of New York, *Staff Report* No.439, revised April 2010, p. 2.

 heritage.org

was 30 percent, it became far more difficult to find creditworthy borrowers as the quota increased, especially when it reached and then exceeded 50 percent. In order to meet these ever-increasing quotas, Fannie and Freddie had to reduce their underwriting standards. In fact, that was explicitly HUD's purpose:

Because the GSEs have a funding advantage over other market participants, they have the ability to underprice their competitors and increase their market share. This advantage, as has been the case in the prime market, could allow the GSEs to eventually play a significant role in the subprime market. As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market. *Since...one could define a prime*

*loan as one that the GSEs will purchase, the difference between the prime and subprime markets will become less clear.*⁹ (Emphasis added.)

As early as 1995, the GSEs were buying mortgages with 3 percent down payments, and by 2000, Fannie and Freddie were accepting loans with zero down payments. At the same time, they were compromising other underwriting standards, such as borrower credit standing and debt-to-income ratios, in order to find the NTMs they needed to meet the AH goals.

Reduced Underwriting Standards Build Historic Housing Bubble. The new easy credit terms brought many new buyers into the market, but the effect spread far beyond the LMI borrowers whom the reduced underwriting standards were intended to help. Mortgage lending is a competitive business; once Fannie and Freddie started to reduce their underwriting standards, many borrowers who could have afforded prime mortgages sought the easier terms now available so they could buy larger homes

with smaller down payments. As early as 1995, Fannie’s staff recognized that it was subsidizing homebuyers who were *above* the median income, noting that “average pricing of risk characteristics provides insufficient targeting of the subsidy. The majority of high LTV [loan-to-value] loans go to borrowers with incomes above 100% of the area median.”¹⁰

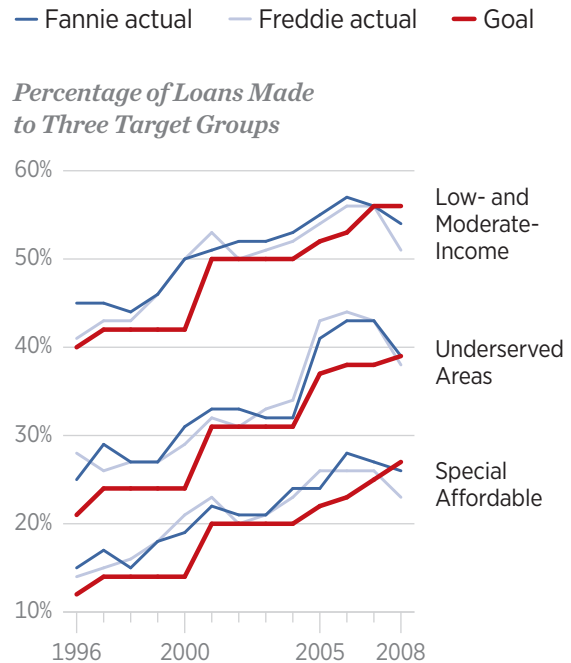
Thus, homebuyers above the median income were gaining leverage, and loans to them were decreasing in quality. In many cases, they were withdrawing cash from the equity in their homes through cash-out refinancing. Although the initial objective had been to reduce underwriting standards for low-income borrowers, the advantages of buying or refinancing a home with a low, or no, down payment were also flowing to high-income borrowers. Fannie never cured this problem. By 2007, 37 percent of loans with down payments of 3 percent went to borrowers with incomes above the median.¹¹

With many new buyers entering the market, and the lower underwriting standards and higher leverage induced by the affordable housing goals, housing prices began to rise. This process is easily understood by considering a change in down payment requirements. If a potential buyer has saved \$10,000 to buy a home, and the down payment requirement is 10 percent, he can buy a \$100,000 home. But if the down payment requirement is reduced to 5 percent, the same \$10,000 can be used to buy a \$200,000 home. Not only does this create upward pressure on home prices, but the buyer—who will now borrow \$190,000 instead of \$90,000—has become a greater credit risk. By 2000, the developing bubble was already larger than any bubble in U.S. history, and it kept rising until 2007, when—nine times larger than any previous bubble—it finally topped out and housing prices began to fall. Chart 4, based on Robert Shiller’s data, shows the relative size of the 1997–2007 bubble in relation to the two other bubbles of the post-war period.

Housing bubbles tend to suppress delinquencies and defaults while the bubble is growing. This is because, as prices rise, it becomes possible for borrowers who are having difficulty meeting their mortgage obligations to refinance or sell the home for more than the principal amount of the mortgage. Under these conditions, potential investors in mortgages or MBS receive a strong affirmative signal; they see high-cost mortgages—loans that reflect the risk of lending to a borrower with a weak credit history—but the expected number of delinquencies and

CHART 3

Fannie, Freddie Consistently Exceeded Affordable Housing Goals



SOURCE: Federal Housing Finance Agency, “The Housing Goals of Fannie Mae and Freddie Mac in the Context of the Mortgage Market: 1996–2009,” *Mortgage Market Note* 10–2, February 1, 2010, http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/20100201_MMNote_10-2_508.pdf (accessed March 2, 2016).

heritage.org

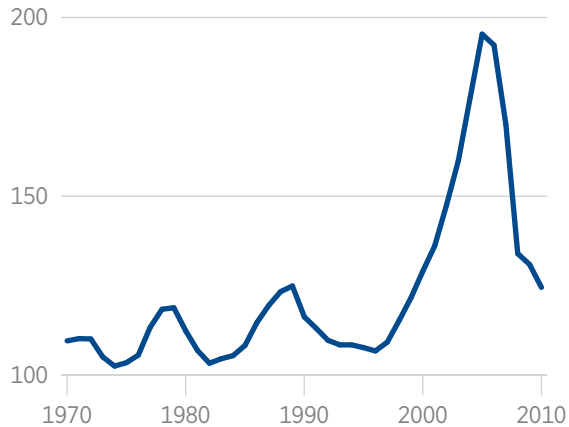
defaults have not occurred. So they come to think that “this time is different,” that the risks of investing in subprime or other weak mortgages are not as great as they had thought. This accounts for the enormous demand for private MBS backed by subprime mortgages: They looked like excellent risk-adjusted investments.

This investment interest brought many new buyers into the market looking to acquire securities backed by NTMs. Private mortgage-backed securities (PMBS), many of them backed by subprime and Alt-A mortgages, became a booming business, especially between 2004 and 2006, as private securitizers discovered ways to compete on price with securitizations by Fannie and Freddie. However, the GSEs

CHART 4

Home Prices Surged in 1997

Case-Shiller Home Price Index: 1970–2010



SOURCE: S&P Dow Jones Indices LLC, “S&P/Case-Shiller Home Price Indices,” <http://us.spindices.com/index-family/real-estate/sp-case-shiller> (accessed March 2, 2016).

heritage.org

themselves were by far the biggest customers for PMBS, because they received AH goals credit for the mortgages in the underlying pools that qualified for meeting the goals quota.

Still, privately acquired or securitized NTMs, including those securitized as PMBS, were only 24 percent of the NTMs outstanding in 2008, showing that PMBS and the financial institutions that held them were not the major source of the bubble or the crisis.

Housing bubbles are by definition pro-cyclical. When they are growing, they feed on themselves to encourage higher prices, through higher appraisals and other mechanisms, until prices get so high that buyers cannot afford them no matter how lenient the terms of the mortgage. But when bubbles begin to deflate, the process reverses. It then becomes impossible to refinance or sell a house that has no equity, financial losses cause creditors to pull back and tighten lending standards, recessions frequently occur, and low appraisals make it difficult for a purchaser to get financing. Many homeowners then suddenly find that their mortgage is larger than the value of the home, and are “underwater.” Sadly, many are likely to have lost their jobs, yet cannot move elsewhere for a job because they cannot sell their homes

without having to pay off the unpaid balance on their mortgages. In these circumstances, many homeowners simply walk away from the mortgage, knowing that in most states the lender has recourse only to the home itself. This, of course, weakens the banking system, with many banks left holding defaulted mortgages and unsalable properties.

This scenario raises an issue that is seldom mentioned but should be central to any discussion of the financial crisis. The policies that led to the crisis, specifically the affordable housing goals, were intended to help low-income and minority Americans buy homes, but as those policies worked themselves out—with a huge bubble and then a collapse—the greatest victims were the same low-income and minority Americans. A January 2015 article in *The Washington Post* summarizes one aspect of the problem:

The recession and tepid recovery have erased two decades of African American wealth gains. Nationally, the net worth of the typical African American family declined by one-third between 2010 and 2013, according to a *Washington Post* analysis of the Federal Reserve’s Survey of Consumer Finances, a drop far greater than that of whites or Hispanics.

The top half of African American families—the core of the middle class—is left with less than half of the typical wealth they possessed in 2007. The wealth of similarly situated whites declined by just 14 percent.¹²

Many observers of the housing market today believe that tight underwriting standards—occasionally called a “tight credit box”—adversely affect the homeownership rate in the U.S. Before the adoption of the AH goals, the homeownership rate was quite stable, hovering around 65 percent for about 30 years. Indeed, the inability of many other government policies to increase home ownership was one of the reasons for the enactment of the AH goals, as community activists argued that low-income families were prevented from becoming homeowners because the GSEs’ underwriting standards were too high. As underwriting standards—under the influence of the AH goals—deteriorated before the financial crisis, the homeownership rate did indeed begin to rise, reaching almost 70 percent by 2004. However, after the financial crisis, and all the mortgage defaults and foreclosures that occurred in the

years following, the homeownership rate in the United States has returned again to approximately 64 percent.

Most of the recriminations after the financial crisis focused on the taxpayer costs associated with preventing what some have claimed would have been a total collapse of the world's financial system. Although that is debatable, very little attention has been directed to the real losses of homeowners who continued to meet their mortgage obligations. These homeowners also suffered major losses, as home prices in their neighborhoods were driven down by the mortgage defaults among their neighbors. This is another cost of reduced underwriting standards, and American homeowners should understand that these costs will return if they again allow their government to set underwriting standards.

Accordingly, reduced underwriting standards provide little benefit over the long term either for homeowners or the nation as a whole. Eventually, they produce an unstable market; as rising defaults follow a downturn in the economy, the homeownership rate declines and people who are meeting their mortgage obligations suffer losses. Moreover, low-income homebuyers—often cited as the principal beneficiaries—turn out to be the principal victims.

Unfortunately, because Congress ignored the deterioration of underwriting standards as a cause of the financial crisis—falsely blaming the crisis on insufficient regulation of the private sector—the government has been left largely free to reduce underwriting standards again. In 2015, for example, under pressure from low-income housing advocates, the FHA—which insures risky mortgages for homebuyers who cannot meet conventional underwriting standards—reduced its insurance premium by 50 basis points. This makes mortgages more affordable, of course, but increases the likelihood of defaults in the future that the taxpayers and other homeowners will have to bear. Similarly, the Federal Housing Finance Agency (FHFA), the regulator of Fannie and Freddie (and their conservator since they became insolvent in 2008), told them in 2015 to reduce the down payments they would accept from 5 percent—already too low—to 3 percent. The fact that there was no outcry after these acts—which simply replicated the policies that were in place before the crisis—shows that the true lessons of the financial crisis have not been learned.

Defaults Begin. With the largest housing bubble in history deflating, and more than half of all

mortgages made to borrowers who had weak credit or little equity in their homes, or both, the number of delinquencies and defaults in 2007 and 2008 was unprecedented. One immediate effect was the collapse of the market for PMBS that were issued by banks, investment banks, or subprime lenders. Investors, shocked by the sheer number of defaults that seemed to be underway, fled the market. Mortgage values fell along with housing prices, with dramatic effect on the PMBS market.

Mark-to-Market Accounting Rules Cause Major Asset Writedowns. The fall in housing and mortgage values had an immediate and destructive effect on the apparent financial condition of many financial firms and banks. Since 1994, all financial institutions had been required to use market value in setting the balance sheet value of their securities assets and liabilities. In other words, the value of these assets on their balance sheets had to reflect the current market value of their PMBS.

These rules had a particularly troubling effect for banks and other financial institutions that followed the Basel risk-based capital rules. Since 2001, these rules had allowed banks to hold only 1.6 percent capital to back AAA-rated private MBS, even though 4 percent capital was necessary to back a whole mortgage. This rule, providing a strong incentive for banks to hold PMBS, essentially herded all banks into the very PMBS that were backed by NTMs. Moreover, many banks and other issuers of private MBS, unable to sell the lowest-quality tranches of the mortgage pools they were creating, used them to create collateralized debt obligations (CDOs) and sold the AAA-rated securities in these specialized pools. The revenues from these sales enabled them to compete on price with Fannie and Freddie, which were also selling MBS backed by NTMs. In many cases, the private issuers also held the “super-senior” portions of these CDOs—the ones deemed least likely to default. Unfortunately, when the mortgage defaults began, the super-seniors and all other CDO securities backed by the lowest-quality NTM tranches were hit hardest. One estimate is that the eventual losses on these CDOs will be \$420 billion (65 percent) of the \$600 billion in CDOs outstanding.¹³

The mark-to-market valuation system worked effectively as long as there was a market for the securities in question, but it was destructive in the market collapse precipitated by the vast number of delinquent and defaulting mortgages that began in 2007. With buyers pulling away, there was only a distress

market for private MBS, with exceedingly low prices. Although there were alternative ways for assets to be valued in the absence of market prices, auditors—worried about their potential liability if they permitted their clients to overstate asset values in the midst of the financial crisis—were reluctant to allow the use of these alternatives. Accordingly, financial firms were compelled to write down significant portions of their private MBS assets and take operating losses that substantially reduced their capital positions and created worrisome declines in earnings.

Moreover, because most private MBS held by financial institutions were rated AAA, they were used by many banks and other financial firms for short-term collateralized borrowing through repurchase agreements, popularly known as “repos.” Suddenly, when the PMBS market collapsed, no one wanted these securities as collateral, and many firms were left without sufficient liquidity to meet demands for cash by customers and creditors.

The asset writedowns and the liquidity constraints created great anxiety among market participants, who did not know whether the affected firms were solvent or insolvent. The Fed adopted a number of programs to provide liquidity to banks and some investment banks, but while that allowed them to meet withdrawals, it did nothing to improve their capital positions or compensate for their operating losses. Also, the natural effect of a fall in asset values is to reduce liquidity: With asset values lower, leverage rises, and intermediaries pull back on their willingness to lend.

Through the early part of 2007 and into early 2008, the news was uniformly frightening for investors and creditors. Formerly healthy firms that held large portfolios of private MBS were illiquid or insolvent and were declaring bankruptcy. On August 9, 2007, BNP Paribas, a major French bank, suspended redemptions from one of its managed funds because it could no longer be sure of the value of the private MBS assets that the funds were holding. This event shook the market and caused a sharp rise in indicators of market unease. Still, Ben Bernanke, the Fed chairman, and Hank Paulson, the U.S. Treasury Secretary, continued to assure the markets that the problem of subprime mortgages was manageable and the current troubles only temporary. In substantial part this was the result of the fact that neither they nor anyone else outside the GSEs knew that Fannie and Freddie had not disclosed the full extent of their NTM holdings; the mortgage market

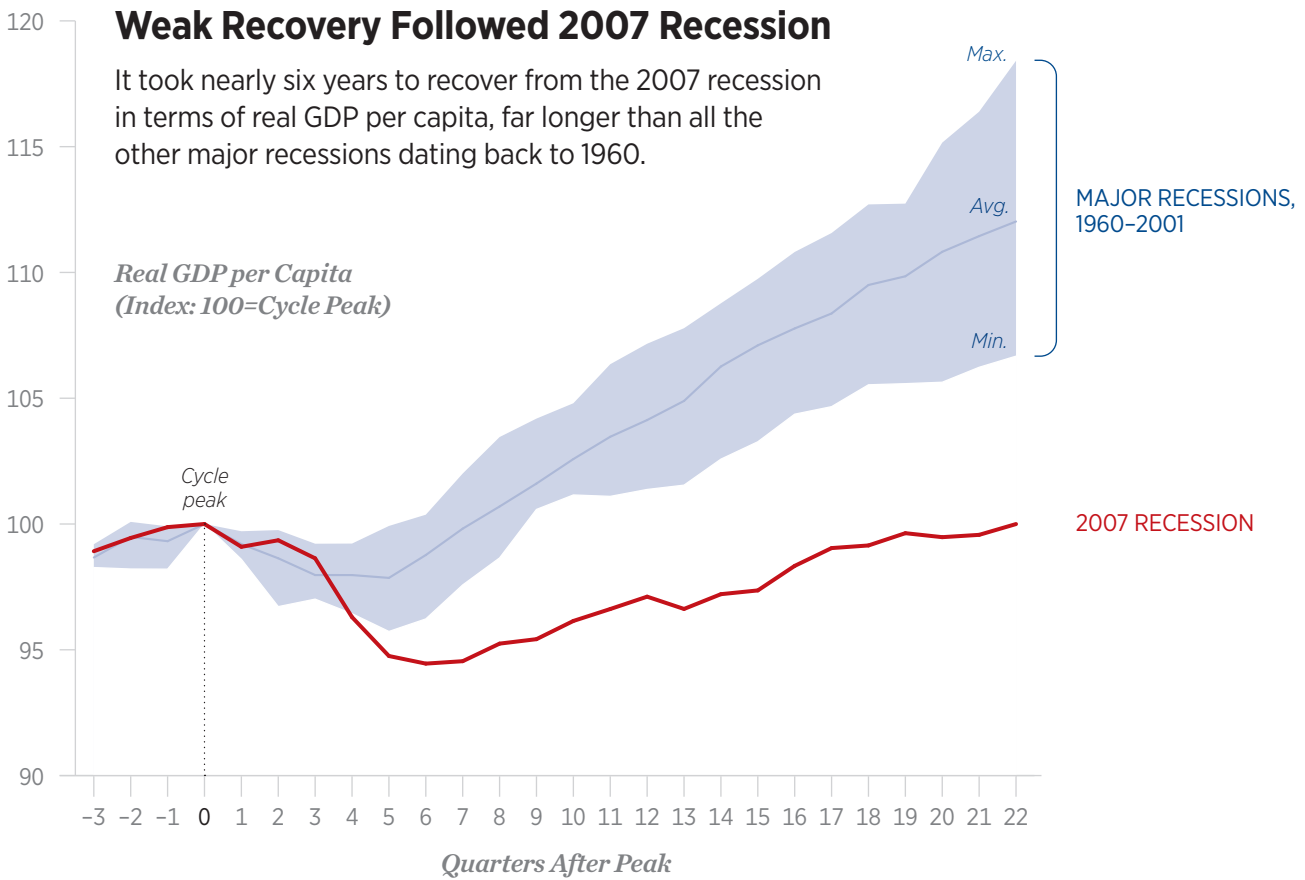
was substantially weaker than the publicly available data suggested.

In March 2008, however, Bear Stearns, the smallest of the five major Wall Street investment banks, was unable to fund its operations; it had lost the confidence of the market and was bleeding cash. Paulson and Bernanke were faced with the choice of either letting Bear Stearns fail or taking extraordinary steps to rescue it. They chose the latter. Bear Stearns was sold to the giant bank holding company JPMorgan Chase with the Fed providing \$29 billion in financial support as an inducement to the acquiring firm. This was a fateful move; in effect, the original sin.

The Rescue of Bear Stearns Creates Moral Hazard. Although the Bear Stearns rescue temporarily calmed the markets, it created substantial moral hazard. Market participants now believed that the government had established a policy of rescuing large failing financial institutions. This perception substantially affected subsequent decisions. Firms with weak cash or capital positions did not take the opportunity to raise as much new equity as their weakened conditions required; with the government likely to protect their creditors, there was little reason to further dilute their shareholders in order to foster creditor confidence; creditors could now believe they would be rescued and did not take losses on the securities they held in weak financial firms. Firms that might have been willing to accept acquisition offers now thought they could drive harder bargains, and erstwhile buyers backed away. Potential acquirers for Lehman, noting the \$29 billion support that JPMorgan Chase received from the Fed, were probably unwilling to buy a firm even larger than Bear with no financial support or risk-sharing from the U.S. government. Most specifically, the Reserve Primary Fund, a money market mutual fund, decided to retain the Lehman Brothers commercial paper in its portfolio, probably assuming that if Lehman went under, its creditors, like Bear’s, would be bailed out.¹⁴

The trigger for the ensuing crisis was probably—and fittingly—the government’s takeover of Fannie and Freddie on September 7, 2008. Because Fannie and Freddie had not disclosed the nature of their mortgage purchases after the enactment of the AH goals, most market participants continued to believe that the two GSEs had only bought prime mortgages. Thus, the government’s declaration that Fannie and Freddie were insolvent

CHART 5



NOTE: 1980 recession omitted from list of 1960–2001 major recessions due to its brevity.
SOURCE: Author’s calculations based on data from U.S. Bureau of Economic Analysis and U.S. Census Bureau.

heritage.org

came as a particular shock to market participants, who concluded that if prime mortgages were failing in such numbers that they drove the two GSEs into insolvency, the mortgage market was in much worse shape than they had imagined. That produced a new look at the large financial firms that were exposed to substantial mortgage risk, beginning with Lehman Brothers, a firm about 50 percent larger than Bear.

During the week after the government’s takeover of Fannie and Freddie, Lehman lost virtually all its liquidity, as investors came to believe that the firm could not survive its mortgage losses. Still, until the weekend, many investors assumed that Lehman, like Bear, would be rescued. Until it blew out on Friday, the credit default swap market on Lehman remained relatively steady, although slowly rising. Thus, when

Lehman filed for bankruptcy early on September 15, the market was shocked. Market participants, investors, and creditors who had assumed that the government would not allow any large financial institution to fail, now had to re-evaluate all their counterparties. The outcome was not conducive to calm reflection. Uncertainty about the financial condition of many firms caused investors and creditors to seek cash.

As a result, financial institutions—fearful of customer withdrawals—hoarded cash; in an unprecedented move, the largest banks were not willing to lend to one another, even overnight. All this caused a virtual collapse of liquidity and the market panic that we know as the financial crisis.

No Justification for Dodd–Frank. By 2010, many of the strongest supporters of affordable

housing as enforced by HUD had recognized their error. In an interview on Larry Kudlow's CNBC television program in late August, Barney Frank—the chair of the House Financial Services Committee and previously the loudest congressional advocate for affordable housing—conceded that he had erred: “I hope by next year we’ll have abolished Fannie and Freddie.... [I]t was a great mistake to push lower-income people into housing they couldn’t afford and couldn’t really handle once they had it.”¹⁵

Thus, the financial crisis was caused by the U.S. government's housing policies—primarily the AH goals—not by insufficient regulation of the financial sector. The collapse of the housing price bubble created by these policies, combined with mark-to-market accounting, weakened all large financial institutions. Then, the rescue of Bear Stearns introduced moral hazard, and the government's failure to rescue Lehman—possibly the greatest blunder in financial history—produced an investor panic.

Nothing, then, in this record justifies the enactment of the Dodd-Frank Act, a massive regulatory edifice that has imposed enormous and unwarranted costs on the U.S. economy and prevented the quick economic recovery that usually follows a sharp financial downturn. Instead of focusing on how to help the economy recover, President Obama and the Congress that took office after the 2008 election sought to punish the private financial sector through new and harsher regulation. The real causes of the crisis—the government's housing policies implemented largely through Fannie Mae and Freddie Mac—were left untouched; even today, the country is once again following the disastrous policies that led to the crisis.¹⁶

THE ECONOMIC CONSEQUENCES OF DODD-FRANK

Dodd-Frank became law on July 21, 2010. It is important to keep this date in mind, because it is the after-effects of the law that are of interest. Chart 5 was originally prepared by the Federal Reserve Bank of Dallas¹⁷ and shows the quarter-by-quarter growth of the U.S. economy from before the crisis to the second quarter of 2013. The gray area is the range, and the black line is the average, of prior cycles. The chart shows that the current recovery—the line below the shaded area—is far weaker than the range and average of prior periods.

Correlation, of course, is not causation, so the question is whether there is a plausible causal

connection between the Dodd-Frank Act and the slow recovery from the financial crisis.

Demonstrating such a connection is difficult; there is no data that does this effectively. What one can do, however, is to make clear how Dodd-Frank regulation could have caused or contributed to the slow growth in the economy. This chapter, accordingly, points to Dodd-Frank's extensive regulatory burdens on small banks—the 98.5 percent of all banks that have assets of \$10 billion or less—as the source of the slow recovery. The chapter posits that these costs and the strict one-size-fits-all lending standards that have been imposed by regulators under Dodd-Frank have reduced the productivity and raised the operating costs of small banks, limiting the amount of credit they could provide to small business borrowers—especially the small business start-ups that are largely responsible for increased jobs and economic growth.¹⁸

If this analysis is correct, one should see that firms with the ability to access the capital markets—firms that are not dependent on bank lending—have been growing at a pace that is consistent with most other recoveries. The data shows that this is true. One should also see that small businesses—those that rely on banks for their credit needs—are growing far more slowly than larger businesses that do not have to rely on bank credit. This is also supported by the data. Finally, there is the question whether the crisis of 2008—because it was a financial crisis—was destined to recover more slowly than any previous crisis or recession. Solid academic work has demonstrated that this is not true: Past financial crises have resulted in sharp recoveries—except where government has stepped in with new regulations. Together, these supporting elements add weight to the argument that the Dodd-Frank Act was a major cause of the U.S. economy's slow recovery from the 2008 crisis.

The Economic Growth Costs of Additional Regulations on Small Banks. As Chart 5 shows, through the first quarter of 2013 there had been some modest economic growth, but far less than in a normal recovery. Since then, as is known, the pattern has continued. A recent op-ed in *The Wall Street Journal* by Glenn Hubbard (former chair of the Council of Economic Advisers under George W. Bush) and Kevin Warsh (a former governor of the Federal Reserve) in effect updates the chart: “Economic growth in real terms is averaging a meager 2.2% annual rate in the 23 quarters since the recession's trough in June 2009. The consensus forecast

of about 1% growth for the first half of this year offers little solace.”¹⁹ In the last quarter of 2015, the economy stumbled again, with growth of less than 1 percent.

If there is a plausible connection between this slow growth and the Dodd–Frank Act, how is it occurring? In March 2014, JPMorgan Chase, the largest U.S. banking organization, cut back its projections for the coming year. It noted that it would add 3,000 new compliance employees, on top of the 7,000 it had added the year before; nevertheless, the banking organization said that during the coming year the total number of its employees was expected to fall by 5,000.²⁰ It seems clear that, no matter what the firm’s actual revenues and profits in 2013 or 2014, they would have been larger—other things being equal—had they not been required by new regulations to add 10,000 new compliance officers while reducing the overall size of their payroll by 5,000. Given the total workforce reduction, it is highly likely that the compliance officers hired in 2013 and 2014 would replace officers that otherwise would be calling on clients, evaluating loan applications, and making loans, or providing other revenue-producing services for the firm. Other costs of regulatory compliance will have the same effect, to a greater or lesser extent.

In developing and adopting the Dodd–Frank Act, Congress and the Administration did not appear to be concerned about placing additional regulatory costs on the financial system. For example, all bank holding companies with \$50 billion in assets or more were treated in the act as systemically important financial institutions (SIFIs) and subjected to “stringent” regulation by the Fed. Among many other requirements, these banking organizations must prepare “living wills”—detailing how they would be broken up if they fail—and participate in annual Fed-designed stress tests. These and other requirements add substantial additional costs to whatever “stringent” new regulation might entail. Even if only in the form of more compliance officers than loan officers, this will mean that these banks will supply less credit to the real economy. If these firms did not have to hire any additional compliance officers, all their new hires—if any—would likely be employees who produce revenue, and hence more revenue for the bank and more economic growth for the real economy.

In a study of the effect of the “systemic” regulations imposed on regional banks with assets of more than \$50 billion—not the largest banks that operate

nationally and internationally—Federal Financial Analytics concluded that “the direct costs of systemic standards for a sample of U.S. bank holding companies (BHCs) may be at least \$2 billion, resulting in a possible reduction of credit in the markets served by the largest of these BHCs of 5.7 to 8 percent. Over a five-year period, this reduction in lending by regional banks could total approximately \$14 to \$20 billion.”²¹

A similar analysis applies to small banks, which have also been required to conform to many new regulations coming out of Dodd–Frank, especially in mortgage and consumer lending. A study by the Government Accountability Office (GAO) identified seven Dodd–Frank titles that have the potential to increase the costs or the competitive burdens of “community banks,”²² which the GAO and many other government agencies define as banks with assets of \$10 billion or less. (Unless otherwise stated, this chapter will use that definition.) Similarly, studies by the Mercatus Center²³ and the American Enterprise Institute²⁴ have also shown that Dodd–Frank regulations have imposed substantial additional costs on community banks. As noted, banks of this size or less are 98.5 percent of all U.S. banks; there are only 98 banks in the U.S. with more than \$10 billion in assets,²⁵ and only 39 with assets of \$50 billion or more.

The additional costs are substantial. Mercatus, in particular, based its study on a survey of approximately 200 small banks, noting that “our survey reveals increased hiring of compliance personnel, more noncompliance employee time spent on compliance, and increased spending on compliance, trends noticed in other surveys.”²⁶ As the study further stated, “[A]pproximately ninety percent of respondents reported an increase in compliance costs, and most (82.9%) of participating banks reported that their compliance costs had increased by more than five percent.”²⁷ In effect, for these banks the median number of compliance personnel doubled—from one to two—after July 2010, and a quarter of respondents planned to hire additional compliance officers.²⁸ More compliance officers, or more noncompliance employees engaged in compliance activities, translates directly into higher employee costs and lower employee productivity—meaning, in the end, less credit or more costly credit for the small businesses that borrow from banks.

In 2013, three economists at the Federal Reserve Bank of Minneapolis actually looked at the effect

of new regulations on the profitability of very small institutions. They chose to model only the effects on bank hiring, although many other factors—risk-taking, legal liability, product costs—are affected by additional regulation. “[W]e find,” they write, “that the median reduction in profitability for banks with less than \$50 million is 14 basis points if they have to increase staff by one half of a person; the reduction is 45 basis points if they increase staffing by two employees. The former increase in staff leads an additional 6 percent of banks this size to become unprofitable, while the latter increase leads an additional 33 percent to become unprofitable.”²⁹

Although banks with less than \$50 million in assets are, of course, much smaller and simpler than banks with \$10 billion or \$50 billion in assets, the principle is the same when describing the effect of regulations on productivity and credit availability. If a banking organization larger than \$50 billion has to hire additional compliance officers in order to meet its new stringent regulations, and living-will and stress-test requirements, its profitability and productivity will also be reduced, and all of them will reduce the amount of credit they provide—or the credit they provide will be more expensive—because relatively more of their human capital is engaged in compliance rather than lending or other revenue-producing services.

Nevertheless, as a rule of thumb, whatever regulatory costs are imposed on banking organizations—whether they be \$2 trillion banks like JPMorgan Chase, \$50 billion banks, or \$50 million banks—the larger the bank, the more easily it will be able to adjust to these costs. As Federal Reserve Governor Daniel Tarullo has observed, “Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets.”³⁰ William Grant, then chair of Community Bankers Council of the American Bankers Association, noted in congressional testimony in 2012 that the “cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small banks than for large banks.”³¹ That is most likely why, since the enactment of Dodd-Frank, the smallest banks have suffered the greatest losses of market share and the largest banks have continued to grow.

Ironically, then, although there has been great concern in Congress about the financial advantages of too-big-to-fail (TBTF) banks—and the supporters

of Dodd-Frank claim that it has eliminated the TBTF problem—the heavy regulations in the act have given the largest TBTF banks even more significant competitive advantages over their smaller competitors. Indeed, Jamie Dimon, the chair of JPMorgan Chase, has referred to regulation as a “moat” that reduced competition from its smaller rivals.³²

Small banks have been losing market share to larger banks since the enactment of Dodd-Frank. In 2015, Marshall Lux and Robert Greene observed in a Harvard Kennedy School study:

Community banks withstood the financial crisis of 2008–09 with sizeable but not major losses in market share—shedding 6 percent of their share of U.S. banking assets between the second quarter of 2006 and mid-2010.... But since the second quarter of 2010, around the time of the Dodd-Frank Wall Street Reform and Consumer Protection Act’s passage, we found community banks’ share of assets has shrunk drastically—over 12 percent.... Since Q2 2010, the smallest community banks’ (\$1 billion or less in assets) share of U.S. banking assets has fallen 19 percent.³³

An important factor in this decline, according to Lux and Greene, is a 44 percent increase in commercial and industrial (C&I) loans outstanding since mid-2010:

Community banks’ share of this lending market is down 22.5 percent since Q2 2010 (from 20.6 percent to 16.0 percent). More striking, the smallest community banks’ market share is down 35.6 percent (from 9.6 percent to 6.2 percent) since Q2 2010, and despite overall growth in the sector, these banks realized a net decrease in volume of 7.5 percent.³⁴

Part of the reason that small banks have been losing market share is the decline in their numbers, due to acquisitions by larger banks and a complete collapse since the financial crisis in the chartering of new banks. Both can be attributed to Dodd-Frank. Many community banks are selling out to larger institutions, which can operate more cheaply in the costly regulatory environment since the enactment of Dodd-Frank. Kelly King, chairman of BB&T, a larger bank that is aggressively seeking to acquire community banks, recently observed:

I think a lot of banks with \$5 billion to \$10 billion in assets are going to recognize that it is an unsolvable problem when they look at the massive investment they have to make to comply.... The cost for them to expand is enormous, and they would go through a trough of several years where their stock price would be diluted. From an economic point of view selling is almost a no-brainer.³⁵

Indeed, the chartering of new banks, which at one time averaged 100 per year, has declined to an average of three per year since 2010.³⁶ This is almost certainly attributable to the squeeze on profits as a result of increased regulation, although low interest rates could also be a contributing factor. If existing community banks cannot make a go of it in the current environment, why would anyone invest in a new one?

Another factor causing difficulties for small banks and particularly the all-important start-ups is the narrative underlying the Dodd–Frank Act; in this narrative, the financial crisis was caused by insufficient regulation of banks and other financial firms allowing them to take risks that resulted in the financial crisis. As noted, this narrative is false, but blaming the failure of a large number of financial institutions on lax regulation has produced an examiner crackdown in the past, often accompanied by a downgrading of smaller banks. Larger banks are seldom downgraded. As one observer put it, referring to the 1989–1991 period when many banks had failed, the Comptroller of the Currency “had softened regulatory policies on banks early in his tenure, helping fuel excessive real estate lending by banks.” By mid-1990 and early 1991, however, regulatory attitudes had apparently changed: “Bank examiners became too restrictive, helping to create a near credit crunch.”³⁷ A recent paper by Paul Kupiec, Yan Lee, and Clair Rosenfeld has shown that when regulatory downgrades occur, loan growth is impaired. “[S]upervisory restrictions,” they report, “have a negative impact on bank loan growth after controlling for the impact of monetary policy, bank capital and liquidity conditions and any voluntary reduction in lending triggered by weak legacy loan portfolio performance or other bank losses.”³⁸

The idea that aggressive interventions of examiners with small banks can reduce lending activity received some confirmation from former Fed Governor Elizabeth Duke in testimony to Congress in February 2010: “Some banks may be overly conservative

in their small business lending because of concerns that they will be subject to criticism from their examiners.... [S]ome potentially profitable loans to creditworthy small businesses may have been lost because of these concerns, particularly on the part of small banks.”³⁹ Bank regulators, who have heard the politicians blame them for the lax regulation, have responded with tougher treatment of the smaller banks, even though they had no significant role in the financial crisis. Ironically, then, even though it is untrue, the claim that lax regulation caused the financial crisis has generated a bank examiner crackdown and tougher lending standards that in turn has reduced economic growth.

Because of their unique role in local economies, increases in the costs of community banks and tightening credit standards after Dodd–Frank are particularly bad news for small business start-ups. As Drew Breakspear, the commissioner of Florida’s Office of Financial Regulation, pointed out, “Community banks have traditionally supported local agricultural and small business needs by incorporating information about borrowers’ characters into lending decisions. But Dodd–Frank has standardized lending practices, which works to the advantage of large banks and punishes community banks.”⁴⁰

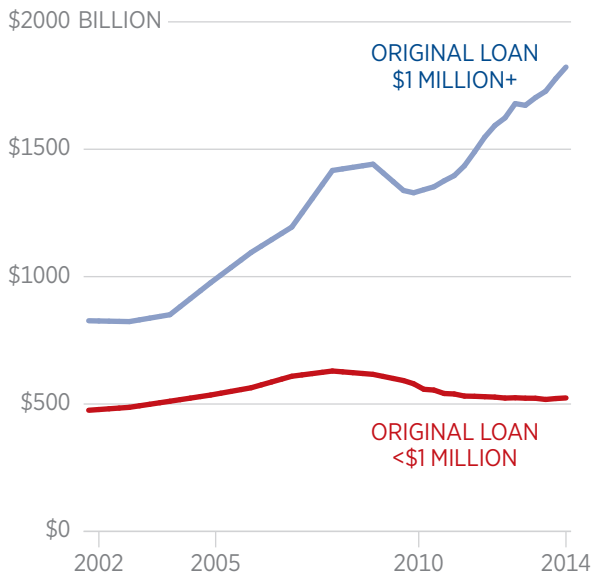
Indeed, anecdotal information from small business managers and small banks indicates that since the enactment of Dodd–Frank, examiners have been insisting that all borrowers with similar financial standing be treated the same way, so that credit is not necessarily available anymore to borrowers who do not meet certain revenue standards or do not have suitable collateral, guarantors, or vouching materials, such as audited financial statements. Character loans, as Breakspear described them, one of the strengths of community banks that know their customers, appear to be a thing of the past.

One-size-fits-all lending standards certainly reduce one of the key advantages of the small bank lending system, but it may be more important to understand that it also reduces the availability of credit for small business borrowers, especially start-ups, which, generally have none of the supporting elements for credit that regulators want to see. As one study noted, small banks can fill a niche “stemming from their ability either to successfully lend to what have been variously described as ‘informationally opaque’ borrowers—borrowers without long credit histories suitable for credit scoring or other model-based lending practiced by large banks—or to engage in relation- or reputation-based lending or lending

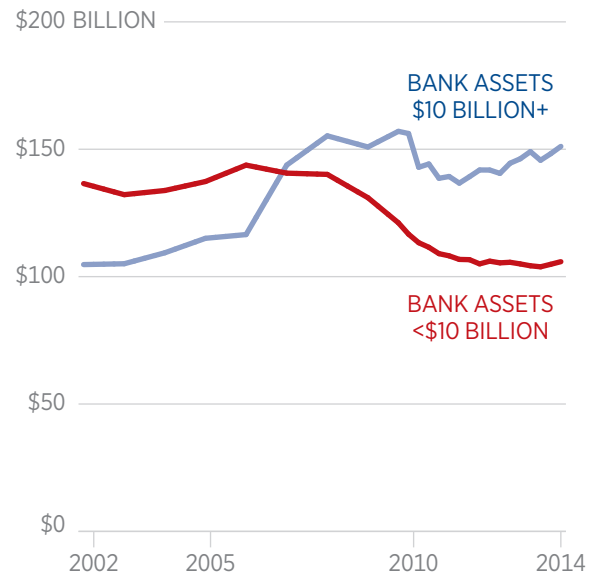
CHART 6

Small Business Loans Dwindled After Financial Crisis

Outstanding Loans to Businesses



*Outstanding Commercial and Industrial Loans**



* Loans with initial amounts of \$1 million or less.

SOURCE: Data provided by Board of Governors of the Federal Reserve System, extracted from Federal Financial Institutions Examination Council's Consolidated Report of Condition and Income data.

heritage.org

in low-volume markets.³⁴¹ In other words, small banks can be unique sources of credit both for start-ups and more mature small businesses that do not have credit histories, but because of tougher lending standards after Dodd-Frank, their role in lending—especially to new businesses—is quickly declining.

The Effect of Additional Regulatory Costs and Tighter Lending Standards on Small Businesses. At this point, it is necessary to make a key distinction about the contribution of small firms to economic growth and jobs. It is generally true that small firms are the principal drivers of new growth and jobs in the economy, but most of the discussion about small firms has focused on these firms as a single category. Within the small firm category, however, it turns out the major drivers of growth and jobs are start-ups—firms that are one to five years old. In an important paper on this subject, John Haltiwanger, Ron Jarmin, and Javier Miranda observed: “The share of jobs created and destroyed by different groups is roughly their share of total employment. An important exception in this context is the contribution of firm start-ups:

they account for only 3% of employment but almost 20% of gross job creation.”³⁴²

In other words, older and more established small firms are not major net contributors to economic growth. As Haltiwanger, Jarmin, and Miranda explain, using 2005 as an example: “About 2.5 million net new jobs were created in the U.S. private sector in 2005. Strikingly, firm start-ups (firms with age 0) created about 3.5 million net new jobs. In contrast, every other firm age class except for the oldest firms exhibited net declines in employment in 2005.”³⁴³

For this reason, data showing that small firms in general are not having difficulty finding credit, or do not need new credit,⁴⁴ should be understood as the result of sampling older established small firms, not the start-up category, which is where the economic and job growth in the U.S. economy is apparently concentrated. It is the start-up category that would be having the most difficulty obtaining bank credit as a result of the tightening lending standards and greater small bank regulatory costs induced by Dodd-Frank. Banks, especially small banks, are not venture capitalists; to the extent

that they are willing to take venture-type risks, it is with the “informationally opaque” firms that now draw criticism from examiners.

Lux and Greene report that:

[C]ommunity banks provide 51 percent of small business loans. In the decade before the crisis (Q2 1998 to Q2 2008), community banks’ lending to small business doubled in volume [citing FDIC data]. Small businesses create the majority of new jobs and account for the vast majority of employers.... Alarmingly, however, community banks’ overall volume of small business lending has declined significantly since Q2 2010—down 11 percent.⁴⁵

While this could also be the result of lower small business loan demand, Haltiwanger, Jarmin, and Miranda also point out that the volume of small business lending by the largest banks has declined only 3 percent.

Most significantly, in the same study, the results for community banks since the enactment of Dodd-Frank are even worse in the C&I loan market—loans made to businesses that are not agricultural loans or commercial and residential real estate loans. There, as noted earlier, community banks’ share of this lending market is down 22.5 percent since Q2 2010 and the smallest community banks’ market share is down 35.6 percent. Despite overall lending growth in the sector, these banks realized a net decrease in volume of 7.5 percent. These observations are supported by other data. In 2014, two researchers at the Federal Reserve, Dean Amel and Traci Mach, used data in bank call reports to assess whether there is a difference between large banks and community banks in business lending. “Following the financial crisis,” they wrote, “total outstanding loans to businesses by commercial banks dropped off substantially. Large loans outstanding began to rebound by the third quarter of 2010 and essentially returned to their previous growth trajectory while small loans outstanding continued to decline. Furthermore, much of the drop in small business loans outstanding was evident at community banks [Chart 6].”

Bank Call Reports do not provide information on the size of the business that received the loan, but as Amel and Mach note, loans up to \$1 million are frequently seen as a proxy for a small business loan. So what Chart 6 shows is that small business lending by small banks, and small business borrowing by

small firms, has not recovered from the post-crisis recession and has declined even more sharply after the enactment of the Dodd-Frank Act in 2010. Even banks over \$10 billion have not been expanding their lending to small business. The likely reasons, as outlined above, are that higher regulatory costs and one-size-fits-all lending standards imposed after Dodd-Frank have stymied lending, particularly to start-ups, which account for most of the economy’s new jobs and growth.

Finally, the new and more costly regulation imposed by Dodd-Frank appears to have stalled the formation of new banks, which, in turn, has also affected the availability of credit for the small and medium-sized businesses that are dependent on bank lending. As noted earlier, a Federal Reserve Bank of Richmond report in March 2015 observed that the rate of new-bank formation has fallen from an average of about 100 per year since 1990 to an average of about three per year since 2010. Trying to assess the reasons for this sharp decline, the report continued, “Banking scholars...have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as the Dodd-Frank Act. Such regulations may be particularly burdensome for small banks that are just getting started.”⁴⁶

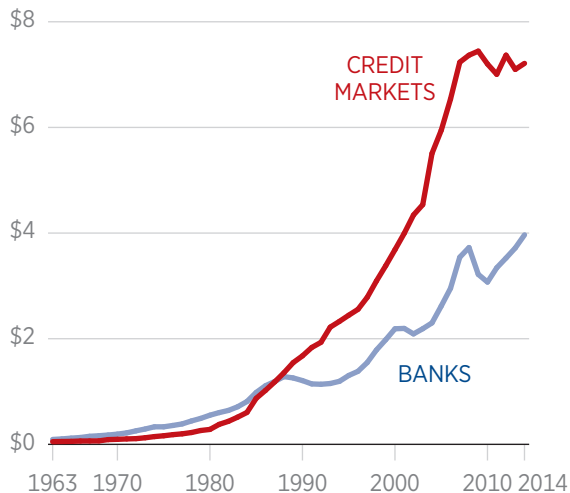
The authors of this report suggest other possible causes, but the fact that the decline became so severe in 2010, the year of the enactment of Dodd-Frank, is strong evidence that the new requirements in the act—which have been cited again and again by small banks since 2010—are responsible. In any event, the decline in the formation of new banks caused an overall decline of 800 in the total number of small independent banks between 2007 and 2013. All these factors—increased regulatory costs, tougher lending standards, and a decline in the absolute numbers of small banks because of regulatory costs—seem to have had an adverse effect on the small businesses, and particularly the small business start-ups, which depend on small banks for credit.

Small Business and the Bifurcated Credit Market. It is not generally understood that the U.S. has a sharply bifurcated credit market. According to the Small Business Administration, in 2010, there were 28 million small businesses in the U.S., defined as firms with fewer than 500 employees. Of these, about 5.5 million were employers; the rest were small proprietorships (“mom and pops”) with

CHART 7

Credit Markets Provide More Credit to Businesses than Banks

In Trillions of Dollars



SOURCE: Board of Governors of the Federal Reserve System, “Financial Accounts of the United States, Historical Data,” Table Z.1, <http://www.federalreserve.gov/releases/z1/current/data.htm> (accessed March 8, 2016).

heritage.org

no formal employees. At the same time, there were 18,500 larger businesses (less than 1 percent of all employers) with 500 employees or more.⁴⁷

These two classes of businesses have very different sources of credit. Most of the 18,500 larger businesses are in a position to borrow from banks or to finance in the credit markets. In 2014, there were approximately 10,000 firms registered with the Securities and Exchange Commission (SEC) and thus in a position to issue securities in the capital markets. However, the 28 million small businesses, including the 5.5 million that were employers, are likely to be completely dependent on banks for their credit needs. For these firms, increases in the cost, or reductions in the availability, of bank lending—particularly by small banks—would have a substantial impact on their prospects for growth.

Chart 7 shows that since the mid-1980s the capital markets have outcompeted the banking industry as a source of credit for business firms.⁴⁸

This alternative means of financing, however, is not available to small or medium-sized businesses, because they are not generally owned by public shareholders and do not report their financial results to the SEC. In addition, the considerable costs of maintaining a securities registration make registration unaffordable for smaller businesses. For these smaller firms, then, greater and more costly regulation of banks would inevitably cause either an increase in the cost of bank credit, a reduction in its availability, or both.

There is another explanation for the difficulty of small businesses, particularly start-ups, in obtaining credit for growth. The authors of a 2015 Goldman Sachs report, “The Two-Speed Economy,” posit that new banking regulations have made bank credit both more expensive and less available: “This affects small firms disproportionately because they largely lack alternative sources of finance, whereas large firms have been able to shift to less-expensive public market financing.”⁴⁹

Using IRS data, the Goldman study finds that large firms—those with \$50 million or more in revenue annually, have been growing revenue at a compounded annual rate of 8 percent, while firms with less than \$50 million in revenue have been growing revenue at an average of only 2 percent compounded annually. Even more significant, using Census data, the Goldman authors found that firms with more than 500 employees grew by roughly 42,000 per month between 2010 and 2012, exceeding the best historical performance over the prior four recoveries. In contrast, jobs at firms with fewer than 500 employees declined by nearly 700 per month over the same timeframe, although these small firms had grown by roughly 54,000 per month on average over the prior four recoveries.⁵⁰

This accounts for the dearth of new business formations. Small firms are simply unable to get the credit that used to be available to small business start-ups, and the credit that they can get is more expensive. This would also have a disproportionate effect on employment in the recovery, because small business start-ups are the principal source of new employment growth in the U.S. economy.

The Goldman report then turns to the lack of capital investment, and also finds the source of that in financial regulation:

Even as large firms experience a relatively robust recovery, they appear to be investing

less than we would expect given their historically high profit margins, and investing with a bias toward shorter term projects; this dynamic may be playing out because large firms are facing less competition from smaller firms. Investments in intellectual property, for example, are tracking nearly five percentage points below even the low end of the historical experience and more than 20 percentage points below the historical average.⁵¹

Since many start-ups are based on new ideas or new technology, their inability to get adequate credit has made them less competitive with existing larger firms, or more willing to sell out to larger firms, reducing the need for greater investments by larger firms in proprietary intellectual property.

Finally, the Goldman report notes concern that this is not necessarily a temporary phenomenon: “Taken together, the reduced competitiveness of small firms and the changing investment decisions of larger ones are reshaping the competitive structure of the US economy in ways that are likely to reverberate well into the future, and in ways that any future evaluation of the aggregate effects of post-crisis regulations should consider.”⁵²

It would be hard to find a better way to express the dangers of leaving the Dodd–Frank Act in place without serious reforms.

Are There Other Explanations for the Slow Recovery? Still, defenders of Dodd–Frank sometimes argue that a slow recovery is typical after financial crises and accounts for the slower economic growth since 2010, but recent scholarship casts doubt on this explanation. Michael Bordo and Joseph Haubrich studied 27 recession-recovery cycles since 1882 and concluded: “Our analysis of the data shows that steep expansions tend to follow deep contractions, though this depends heavily on when the recovery is measured. In contrast to much conventional wisdom, the stylized fact that deep contractions breed strong recoveries is *particularly true* when there is a financial crisis.”⁵³ (Emphasis added.)

Bordo and Haubrich find only three exceptions to this pattern, cycles in which the recoveries did not match the speed of the downturns. The three were the Depression of the 1930s, the 1990 recession that ended in March 1991, and the most recent recession, which ended in June 2009. It is useful to consider what these three exceptions have in common.

In each case, the government’s intervention in the financial system was unusual and extensive. During the Depression the Hoover and Roosevelt Administrations tried many ways to arrest the slide in the economy, all without success. Hoover was an inveterate activist in all things, and Franklin Roosevelt believed in constant experimentation until something worked. Neither of the two Presidents seemed to have a consistent theory about what brought on the economic downturn or how to address it. Under Herbert Hoover, Congress passed the Smoot–Hawley Tariff Act, and the Emergency Relief and Reconstruction Act, and established the Reconstruction Finance Corporation.

Under Roosevelt, the U.S. went off the gold standard and established a deposit insurance system and a federal regulatory system for state-chartered banks. Congress, meanwhile, adopted the National Recovery Act, the Emergency Banking Act, the Emergency Farm Mortgage Act, the Securities Act, the Securities & Exchange Act, the Glass–Steagall Act, and the Farm Credit Act. Other major laws with financial implications were the National Industrial Recovery Act and the Agriculture Adjustment Act (both of which were eventually declared unconstitutional by the Supreme Court). This enormous flurry of activity, however, while popular with the American people, did not produce a meaningful or prolonged recovery until the nation geared up for war at the end of the 1930s.

In addition, the Pecora hearings of the early Roosevelt Administration propagated the idea that banks’ securities activities had caused the crisis; this is uncannily similar to the narrative that produced the Dodd–Frank Act, which blamed the financial crisis on insufficient regulation of the financial system and greed and recklessness on Wall Street. The Pecora hearings resulted in the Glass–Steagall Act, which separated securities and banking activities. Whether that was harmful can be debated, but the wholesale revision of financial structures it entailed probably constricted credit and market confidence in the years that followed.

The recession in 1990 and early 1991 came after the collapse of the S&L industry in the late 1980s and the failure of almost 1,600 banks during the same period. Both were blamed on insufficient regulatory authority or lax enforcement—again like the narrative that supported passage of the Dodd–Frank Act—and produced the Financial Institutions Recovery, Reform and Enforcement Act (FIRREA) in 1989 and the FDIC Improvement Act (FDICIA) in 1991.

These laws increased the regulatory authority of federal bank regulators, and under pressure from Congress and the public they cracked down on depository institutions, causing a credit crunch and what was called a “jobless recovery” in 1991. In addition, the first set of Basel risk-based capital rules were adopted in 1988 and were gradually phased in at this time, requiring banks to re-compute their capital positions and, in many cases, to increase their capital by changing the nature of their investments and loans.

Thus, there is historical evidence that the slow recovery from the 2008 financial crisis is due in part—maybe primarily—to the fact that the Dodd-Frank Act was adopted shortly after the crisis. Instead of allowing the economy and the financial system to heal naturally, it introduced constraints, costs, and uncertainties that have interfered with the natural course of any recovery. Moreover, like the Pecora hearings, Dodd-Frank was based on the idea that the private sector was to blame for the crisis and thus sought to punish the very entities that were necessary to finance a recovery.

The idea that a post-recession series of actions can in fact slow an economic recovery receives added weight from a recent book by James Grant called *The Forgotten Depression*. Grant traces the sharp downturn and the following sharp recovery in 1920 and 1921. The downturn in 1920 was severe. “Just how severe,” writes Grant,

is a question yet to be settled.... Official data as well as contemporary comment paint a grim picture. Thus, the nation’s output in 1920-21 suffered a decline of 23.9 percent in nominal terms, 8.7 percent in inflation-(or deflation-) adjusted terms. From cyclical peak to trough, producer prices fell by 40.8 percent. Maximum unemployment ranged between two million and six million persons...out of a non-agricultural labor force of 31.5 million. At the high end of six million, this would imply a rate of joblessness of 19 percent.⁵⁴

But the government did nothing. President Woodrow Wilson had suffered a second severe stroke in October 1919, and was partially paralyzed, although this fact was withheld by the White House. What little energy Wilson had through the election year of 1920 was reserved for the fight over the League of Nations. The Harding Administration, which followed, did nothing either, says Grant:

The successive administrations of Woodrow Wilson and Warren G. Harding met the downturn by seeming to ignore it—or by implementing policies that an average 21st century economist would judge disastrous. Confronted with plunging prices, incomes and employment, the government balanced the budget and, through the newly instituted Federal Reserve, raised interest rates.... Yet by late 1921, a powerful, job-filled recovery was under way. This is the story of America’s last governmentally unmedicated depression.”⁵⁵

Needless to say, there was no new regulation, and the economy recovered quickly.

Adding new regulatory activity after a severe recession seems to slow a rapid return of economic growth, and that certainly seems to be borne out by the examples cited above.

It is, of course, possible that the 2008 financial crisis and the ensuing recession were such shocks to the economic system that they have caused a secular change in the performance of the U.S. economy—a “new normal” of slow growth and declining living standards for the middle class.

However, it is far more likely that government policies are responsible for these conditions, and when looking for the policies that could have had the greatest effect on the economy since the financial crisis, one finds only three—the Affordable Care Act (ACA), the Fed’s historically low interest rates, and the Dodd-Frank Act. Neither the ACA nor low interest rates should have had a repressive effect on new business formation; quite the contrary; it is more likely that they have both had temporarily stimulative effects by pumping more government money into the economy.

That leaves Dodd-Frank as the most likely cause of the slow-growth economy that Americans have been experiencing. The implication is strong that the heavy regulation imposed on the financial system—and particularly on community banks—has caused a slowdown in the growth of small businesses—especially small business start-ups—and hence the unusual and persistent slowdown in the growth of the U.S. economy after a severe recession.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. Victoria Finkle, "Why the Battle Over Dodd-Frank Will Never End," *American Banker*, July 1, 2015, <http://www.americanbanker.com/news/law-regulation/why-the-battle-over-dodd-frank-will-never-end-1075190-1.html> (accessed February 3, 2016).
2. Rahm Emanuel, "Don't Waste a Good Crisis," video, February 23, 2009, <https://www.youtube.com/watch?v=VjMTNPXYu-Y> (accessed February 3, 2016).
3. Robert G. Kaiser, "'Act of Congress': How Barney Frank Foiled the Banking Lobby to Form a New Financial Watchdog," *The Washington Post*, May 5, 2013, http://www.washingtonpost.com/business/economy/act-of-congress-how-barney-frank-foiled-the-banking-lobby-to-form-a-new-financial-watchdog/2013/05/05/94d93ed2-b0eb-11e2-9a98-4be1688d7d84_story.html (accessed February 2, 2016).
4. Jagdish Bhagwati, "The Critiques of Capitalism After the Crisis: Myths and Fallacies," *World Affairs Journal*, October 2009, http://www.columbia.edu/~jb38/papers/pdf/World_Affairs_Oct_2009.pdf (accessed February 3, 2016).
5. Beyond subprime loans, which had been made to borrowers with low credit standings, the "otherwise risky" loans were known as Alt-A, an abbreviation for "Alternative to Agencies." The term "Agencies" refers to the government-sponsored enterprises Fannie Mae and Freddie Mac. Until 1992 and the adoption of the affordable housing goals, Fannie and Freddie would not accept mortgages with deficiencies, such as low down payments, lack of documentation, or lack of amortization. These loans could not be sold to Fannie and Freddie (the Agencies), and thus were known as Alt-A.
6. Title XIII of the Housing and Community Development Act of 1992, Public Law 102-550, 106 Stat. 3672, H.R. 5334, enacted October 28, 1992.
7. Federal Housing Finance Agency, "Enterprise Share of Residential Mortgage Debt Outstanding, 1990-2010," <http://www.fhfa.gov/DataTools/Downloads/Pages/Current-Market-Data.aspx> (accessed February 10, 2016).
8. After a 1996 Federal Reserve study showed the extraordinary predictive power of FICO credit scores, the bank regulators ruled in 2001 that any loan made to a borrower with a FICO score lower than 660 was a subprime loan, irrespective of the loan's other terms. U.S. Department of the Treasury, Office of the Comptroller of the Currency, "Description: Expanded Guidance for Subprime Lending Programs," *OCC Bulletin* 2001-6, January 31, 2001, <http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-6.html> (accessed February 3, 2016).
9. Department of Housing and Urban Development, "HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)," *Federal Register*, Vol. 65, No. 211 (October 31, 2000), p. 65106, <http://www.gpo.gov/fdsys/pkg/FR-2000-10-31/pdf/00-27367.pdf> (accessed February 3, 2016).
10. Fannie Credit Policy memo, "Risk Pricing—Idea for August 3-4 Meeting and Addressing Short-Term Pricing Opportunities," July 21, 1995.
11. Department of Housing and Urban Development, Office of Policy Development and Research, "Profiles of GSE Mortgage Purchases in 2005-2007," Table 10a-2007. Loan-to-Value Characteristics of Fannie Mae's Purchases, 2007.
12. Michael Fletcher, "A Shattered Foundation," *The Washington Post*, January 24, 2015, <http://www.washingtonpost.com/sf/investigative/2015/01/24/the-american-dream-shatters-in-prince-georges-county/> (accessed February 3, 2016).
13. Larry Cordell, Yilin Huang, and Meredith Williams, "Collateral Damage: Sizing and Assessing the Subprime CDO Crisis," Federal Reserve Bank of Philadelphia *Working Paper* No. 11-30, May 2012, p. 14.
14. This is corroborated in a *Wall Street Journal* article in December 2008, in which Bruce Bent, the chairman of the Reserve Primary Fund said, before Lehman's bankruptcy, that the firm should be saved by the government because of its importance. Steve Stecklow and Diya Gullapalli, "A Money Manager's Fateful Shift," *The Wall Street Journal*, December 8, 2008.
15. Larry Kudlow, "In Praise (!) of Barney Frank," Kudlow's Corner, August 20, 2010, <http://www.cnbc.com/id/38791383> (accessed February 4, 2016).
16. Trey Garrison, "FHFA Director Announces Changes to Open Fannie, Freddie Credit Boxes," Housing Wire, October 20, 2014, <http://www.housingwire.com/articles/print/31778-fhfa-director-announces-changes-to-open-fannie-freddie-credit-boxes> (accessed February 3, 2016), and Trey Garrison, "It's Official: Obama to Direct FHA to Cut Mortgage Insurance Premiums," Housing Wire, January 7, 2015, <http://www.housingwire.com/articles/print/32533-its-official-obama-to-direct-fha-to-cut-mortgage-insurance-premiums> (accessed February 3, 2016).
17. Adapted from Tyler Atkinson, David Luttrell, and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis," Federal Reserve Bank of Dallas, *Staff Papers* No. 20, July 2013.
18. John Haltiwanger, Ron S. Jarmin, and Javier Miranda, "Who Creates Jobs? Small Versus Large Versus Young," *The Review of Economics and Statistics*, Vol. 95, No. 2 (May 2013), pp. 347-361.
19. Glenn Hubbard and Kevin Warsh, "How the U.S. Can Return to 4% Growth," *The Wall Street Journal*, June 23, 2015.
20. Dan Fitzpatrick, "J.P. Morgan Dims Its Light on 2014," *The Wall Street Journal*, February 26, 2014.
21. Federal Financial Analytics, Inc., "The Consequences of Systemic Regulation for U.S. Regional Banks," August 6, 2015, Executive Summary, <http://regionalbanks.org/wp-content/uploads/2015/08/FedFin-Study-The-Consequences-of-Systemic-Regulation-for-U.S.-Regional-Banks.pdf> (accessed February 4, 2016).
22. U.S. Government Accountability Office, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings*, GAO-12-881, 2012, Appendix II.

23. Hester Peirce, Ian Robinson, and Thomas Stratman, "How Are Small Banks Faring Under Dodd-Frank?" Mercatus Center *Working Paper*, February 2014, p. 15.
24. Tanya D. Marsh and Joseph W. Norman, "The Impact of Dodd-Frank on Community Banks," American Enterprise Institute May 7, 2013, <http://www.aei.org/papers/economics/financial-services/banking/the-impact-of-dodd-frank-on-community-banks/> (accessed February 24, 2016).
25. Peirce, Robinson, and Stratman, "How Are Small Banks Faring Under Dodd-Frank?" p. 11.
26. *Ibid.*, p. 16.
27. *Ibid.*, p. 34.
28. *Ibid.*, pp. 35–36.
29. Ron J. Feldman, Jason Schmidt, and Ken Heinecke, "Quantifying the Costs of Additional Regulation on Community Banks," Federal Reserve Bank of Minnesota, May 30, 2013, p. 2.
30. Daniel Tarullo, remarks at the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014.
31. William Grant, statement before the House Subcommittee on Financial Institutions and Consumer Credit, May 9, 2012.
32. John Carney, "Surprise! Dodd-Frank Helps JPMorgan Chase," CNBC, February 4, 2013, <http://www.cnbc.com/id/100431660> (accessed February 3, 2016).
33. Marshall Lux and Robert Greene, "The State and Fate of Community Banking," Harvard Kennedy School, Mossavar-Rahmani Center for Business and Government, *M-RCBG Associate Working Paper Series No. 37*, February 2015, p. 3.
34. *Ibid.*, pp. 17–18.
35. Kristin Broughton, "Too Costly to Grow: Why National Penn Decided to Sell," *American Banker*, August 18, 2015.
36. Roisin McCord, Edward Simpson Prescott, and Tim Sablik, "Explaining the Decline in the Number of Banks since the Great Recession," Federal Reserve Bank of Richmond *Economic Brief*, March 2015.
37. Alan Gart, *Regulation, Deregulation, Reregulation: The Future of the Banking, Insurance, and Securities Industries* (New York: John Wiley & Sons, 1994), p. 163.
38. Paul Kupiec, Yan Lee, and Claire Rosenfeld, "Does Bank Supervision Impact Bank Loan Growth?" draft, May 7, 2015, p. 1.
39. Quoted in *ibid.*, p. 4.
40. Drew Breakspear, "Too Small to Comply: Florida Regulator on Dodd-Frank's Defects," *Bank Think*, August 9, 2015.
41. Tim Critchfield et al., "The Future of Banking in America: Community Banks—Their Recent Past, Current Performance, and Future Prospects," *FDIC Banking Review* (2004), p. 4.
42. Haltiwanger, Jarmin, and Miranda, "Who Creates Jobs?" p. 360.
43. *Ibid.*, p. 350.
44. See, for instance, data of the National Federation of Independent Business (NFIB) for 2015 showing that members are having no difficulty obtaining credit. NFIB Research Foundation, "Opinions of Small Employers," October 2015, p. 8, <http://www.nfib.com/assets/small-employer-survey-nfib-201510.pdf> (accessed February 3, 2016).
45. Lux and Greene, "The State and Fate of Community Banking," p. 11.
46. McCord, Prescott, and Sablik, Note 41.
47. Small Business Administration, "Frequently Asked Questions About Small Business," September 2012, p. 1.
48. There are several likely reasons for this. Agency intermediation in the capital markets (through broker-dealers, mutual funds, and others) is more efficient than the principal intermediation of banks; banks are more heavily regulated agency intermediaries and thus have higher costs; and technological advances in information distribution have made it easy for firms to communicate their financial position directly to analysts and investors, so banks have lost their special position as the repositories of the best financial information about companies. The trend toward capital markets financing has caused a backlash from bank regulators, who now want to use the Dodd-Frank Act to regulate the capital markets—what they call the "shadow banking system."
49. Steve Strongin et al., "The Two-Speed Economy," Goldman Sachs, April 2015, p. 3, <http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf> (accessed February 24, 2016).
50. *Ibid.*, p. 8.
51. *Ibid.*, p. 3.
52. *Ibid.*
53. Michael D. Bordo and Joseph G. Haubrich, "Deep Recession, Fast Recoveries, and Financial Crises: Evidence From the American Record," National Bureau of Economic Research *Working Paper* No. 18194, June 2012, p. 2.
54. James Grant, *The Forgotten Depression—1921: The Crash that Cured Itself* (New York: Simon & Schuster, 2014), p. 4.
55. *Ibid.*, p. 1.

CHAPTER 2

Repealing Dodd–Frank’s Qualified Mortgage and Qualified Residential Mortgage

Edward J. Pinto

Real estate markets exhibit inherent volatility due to local, regional, and national market conditions, the use of leverage, and supply and demand imbalances. Volatility increases during stressful economic environments that combine high unemployment with sharp drops in house prices. Maintaining stability in the housing loan market requires policies that ensure that a substantial preponderance of mortgages perform well under highly volatile conditions. Low-risk loans are those that have performed well historically during stressful economic environments. Performing well means a low risk of default under such conditions. A housing finance market comprised predominantly of low-risk mortgages has the ability to withstand such a stress event without resulting in millions of foreclosures. However, policies that result in a housing finance market where a preponderance of loans are high-risk and medium-risk will fuel housing finance instability and can cause severe national economic stress.

For over 50 years, U.S. housing policy has focused on increasing leverage—and with it, increasing debt. This intervention has fueled rather than prevented instability. For example, the huge losses associated with the savings and loan (S&L) debacle of the 1980s, the Federal Housing Agency’s (FHA’s) 3.4 million foreclosures, and Fannie Mae and Freddie Mac’s recent collapse did not come about *in spite of* government support for housing finance but *because of* government backing. Any examination of housing finance policy must begin by acknowledging that government housing policies were at the root of the 2008 financial crisis. These policies include the FHA, Fannie Mae and Freddie Mac, and the Department of Housing and Urban Development (HUD), all of which, in a glaring but telling omission, were conspicuous in their absence from the Dodd–Frank Act.¹

During the long run-up to the financial crisis, government policies forced the deterioration in underwriting standards, making those policies the *sine qua non* of the crisis. Although the FHA, Fannie

Mae, Freddie Mac, and HUD were the central drivers of this credit deterioration, none of them were addressed or reformed in Title XIV—the qualified mortgage (QM)—which was the central mortgage related title. Moreover, this title as implemented by the Consumer Financial Protection Bureau (CFPB), failed to restore policies that ensure good-quality mortgages. The result is a housing finance system without the mortgage underwriting standards that are needed to create and maintain stability.

History has shown that the government cannot act responsibly when given authority to control the housing finance system. Necessary reform, therefore, would repeal both the QM provisions in Title XIV of Dodd–Frank and QRM provisions in Title IX and gradually move the government out of the housing finance system.

Housing Policies that Promote Market Stability. Real estate markets exhibit inherent price volatility due to local, regional, and national market and economic conditions, the use of leverage,

and the presence of supply and demand imbalances. Large home price declines are associated with periods of severe national or regional economic stress. A homeownership policy centered on excessive leverage and debt adds to inherent market instability by increasing home price volatility and results in a preponderance of high-risk mortgages prone to default and foreclosure.

A housing finance market comprised predominantly of low-risk mortgages has the ability to withstand the volatility associated with stressful economic environments without resulting in millions of foreclosures. On the other hand, millions of foreclosures are likely to characterize a housing market in which high-risk and medium-risk mortgages predominate. High levels of leverage, together with a high risk of foreclosures, can produce a threat to the financial system as a whole. Consider the analogy of the stock market, which has tremendous volatility but low leverage (debt) among shareholders. This lack of leverage tends to keep severe stock market declines from severely impacting the broader economy.

Maintaining stability in the mortgage market requires policies that ensure a substantial preponderance of low-risk loans, meaning a low risk of default. Yet for the month of January 2016, over 60 percent of home-purchase loans guaranteed by Fannie, Freddie, the Federal Housing Administration (FHA), the Veterans Administration (VA), and Rural Housing Service (RHS) were rated medium risk or high risk, with 86 percent of FHA loans being high risk.² For the same month, it is estimated that these five agencies accounted for 85 percent of all primary home-purchase loans. Thus, Dodd-Frank, as implemented, has failed to promote the necessary level of low-risk loans that are fundamental to promoting stability in the housing finance market.

Credit Risk and Propensity to Default. A loan's propensity to default under stressful economic environments may be ascertained at loan origination by applying historical loan performance data using such characteristics as loan-to-value (LTV) ratio, borrower credit history, debt-to-income (DTI) ratio, term length, occupancy, type, purpose, and documentation. A reasonable definition of a low-credit-risk loan is the test originally proposed by the six agencies: "low credit risk even in stressful economic environments that combine high unemployment with sharp drops in house prices."³ Low credit risk means a low incidence for default under

stress conditions.⁴ Conversely, high credit risk means a high incidence for default in stress conditions. In general, a low-credit-risk loan has a combination of risk factors resulting in low leverage, while the opposite is true for a high-credit-risk loan. For example, a 95 percent LTV, 20-year-term loan where the borrower has slightly better than average credit and a 43 percent debt-to-income ratio is low credit risk. Change the term to 30 years and it borders on high risk.

The concept of applying a stress test based on a severe economic event is not new. After the housing crash of the 1920s, the Alger Commission concluded in 1933 that "the mortgage business is intrinsically hazardous [and must be measured] against another major depression."⁵ In 1955, a stress test performed with respect to FHA lending was based on assuring "adequate provision for contingencies of a major depression magnitude."

The Data Demonstrates Credit Performance. The source of stability, sustainable lending, and wealth building through home ownership is the application of good underwriting standards. A loan's propensity to default under stressful economic environments may be ascertained at loan origination by applying historical loan-performance data using such characteristics as loan-to-value, borrower credit history, debt-to-income, term, occupancy, type, purpose, and documentation.

Loan performance data from the recent financial crisis can be used to rate how mortgages created under the qualified mortgage (QM) standards would perform under stressful economic environments. In March 2013, Freddie Mac released a loan-performance dataset containing 15 million fixed-rate, fully documented, 30-year mortgages that had been acquired by Freddie between 1999 and 2011 ("Freddie dataset"). This release included 15 million loans (53 percent of all loans made by Freddie during this period) and contains data such as LTVs, the size of down payments, FICO scores, DTI ratios, combined LTVs, occupancy, and loan purpose (purchase, rate and term refinancing, or cash-out refinancing). The remaining 13 million not released consisted primarily of higher-risk loans, the preponderance of which date to between 1999 and 2007. These include adjustable-rate mortgages, interest-only mortgages, and mortgages acquired under affordable housing programs. The exclusion of these riskier loans means that the dataset very likely consists of the best loans available in the market during this

TABLE 2

Default Rates for Different Risk Buckets

Risk Bucket	FICO Score	Combined Loan-to-Value (CLTV)	Total Debt-to-Income (DTI)	Default Rate
Very Low	≥ 770	61%–70%	≤ 33%	0.8%
Low	720–769	76%–80%	34%–38%	4.2%
Medium	690–719	81%–85%	39%–43%	9.3%
High	660–689	91%–95%	44%–50%	22.7%
Very High	620–639	> 95%	> 50%	45.8%

While better underwriting standards will improve mortgage credit performance and stabilize the market, they will also make it possible for American homeowners to reliably build wealth through homeownership. The table above does not reflect the effect of the amortization term of a mortgage on the loan's quality, but the effect is significant. With a 30-year fixed-rate term, the homeowner builds very little equity in the home for the first seven years—the average time, according to the data, that a home is kept. For the same reason, the mortgage itself is substantially riskier than shorter term loans.

Loans with a 15- or 20-year term experience much lower default rates than similar 30-year loans—only 30 percent and 45 percent respectively of the 30-year loans default rate. Shortening loan terms builds wealth more reliably for the homeowner and makes a loan a safer investment for the lender. For this reason, housing policy should focus on wealth-building loans for families, which would rely on shorter loan terms. The GSE affordable housing goals should be repealed and replaced with a targeted, one-time income tax credit for low-income, first-time home buyers.

NOTE: Default rates represent cumulative defaults through year-end 2012 for Freddie Mac's 2007 vintage of acquired loans. The loans included in the calculation are all primary owner-occupied, 30-year fixed-rate, fully amortizing, and fully documented home purchase loans.

SOURCE: Freddie Mac, Single Family Loan-Level Dataset, http://www.freddie.com/news/finance/sf_loanlevel_dataset.html (accessed March 10, 2016).

 heritage.org

period. However, as will be demonstrated, this does not mean all these loans are low credit risk.

Using this dataset one can determine, for example, how the purchase loans in the 2007 cohort performed in the stressful economic environment present between 2007 and 2012 (in general these loans suffered from five years of home price declines). As a result, one can predict with a high degree of confidence how various mortgages that would be permissible under QM—and now also the qualified residential mortgage (QRM)—will perform in the future if QM standards are the only underwriting standards in effect.

For example, a home-purchase loan that qualifies under QM could have a 580 FICO credit score, no down payment, and a 43 percent DTI. A loan with these characteristics acquired by Freddie in 2007 had a 42 percent failure rate under the adverse conditions that prevailed between 2007 and 2012.

Chart 1 demonstrates the wide spread of stressed default rates across risk buckets—all of which are QM eligible, including the “high” and “very high” risk buckets when underwritten by one of the five government guarantee agencies (Fannie, Freddie, the FHA, the VA, or the RHS).

QRM AND QM

With this background, one can affectively assess the likely effectiveness of the QRM in Title IX of the Dodd-Frank Act and the QM as outlined in Title XIV, as well as how these provisions were actually implemented by the regulatory agencies tasked with issuing the necessary rules.

The Dodd-Frank Act was intended to restore sound underwriting practices by introducing three new factors into housing finance: (1) a high-quality mortgage (the QRM) that would have a minimal incidence of default; (2) a set of minimum mortgage

standards (the QM); and (3) a requirement that the securitizer of any mortgage not meeting the QRM standards retain at least 5 percent of the risk of any mortgage pool it sponsors.

In framing the QRM-QM concepts, Congress sought to implement a simple idea: protect the financial system from another mortgage-induced collapse by controlling mortgage quality. The QM was intended to create a minimum credit standard—investors would be protected from borrowers' legal challenges only if the mortgage met certain minimum standards—while the QRM was intended to be a mortgage of unquestioned quality, the functional equivalent of a traditional prime mortgage. This idea was articulated by then-Federal Deposit Insurance Corporation Chairman Sheila Bair shortly before the Dodd-Frank Act was adopted:⁶

Traditional mortgage lending worked so well in the past because lenders required sizeable down payments, solid borrower credit histories, proper income documentation, and sufficient income to make regular payments at the fully indexed rate of the loan. Not only were these bedrock principles relaxed in the run-up to the crisis, they were frequently relaxed all at once in the same loans in a practice regulators refer to as “risk layering.”

The long-term credit performance of a portfolio of mortgage loans can only be as sound as the underwriting practices used to originate those loans.

However, as ultimately developed and issued by the regulatory agencies tasked with producing them, QM and QRM failed to address the inherent flaws in U.S. housing policy or to meet the basic standards that would result in a stable housing market or mortgages that are generally low risk. Indeed, after their development by the regulators, QM and QRM turn out to be fatally flawed, a failure compounded by permitting Fannie, Freddie, and the FHA to continue their risk-taking.⁷

As evidenced by its title—“Minimum Standards for Mortgages”—Title XIV claims to address the 2008 financial crisis by setting a minimum lending standard for single-family owner-occupied loans. This standard centers on a borrower's ability to repay (ATR) based on income, assets, and debts.

It provides:

- A maximum total DTI ratio of 43 percent of pre-tax income, subject to substantial exceptions;
- Points and origination fees generally limited to a total of three points;
- Negative amortizations, balloon payments, 40-year mortgages, or interest-only mortgages are not QM eligible; and
- “Safe-harbor” legal protections for QM loans, which are not available to non-QM loans.

Separately, the QRM provisions of section 941 claimed to address the 2008 financial crisis by imposing a 5 percent credit-risk-retention requirement on issuers of private mortgage backed securities (MBS) that were not backed fully by QRMs. QRMs were defined as mortgages with a lower risk of default, and issuers of MBS backed by non-QRM mortgages were required to retain at least 5 percent of the credit risk for a MBS.

MULTIPLE FLAWS IN QM PROVISIONS

Although the QM provisions were enacted to prevent a repeat of a housing-centric financial crisis and to “[protect] consumers from irresponsible mortgage lenders,” the QM rule finalized in January 2013 by the Consumer Financial Protection Bureau (CFPB) is yet another and more direct way for the government to keep mortgage underwriting standards low. One need look no further than the fact that the FHA, the VA, and the RHS are able to set their own QM standards. Fannie and Freddie have a seven-year exemption from core provisions, such as ATR's DTI limit of 43 percent. The Fannie and Freddie seven-year “patch” was promulgated by the CFPB and exempts loans approved under Fannie Mae or Freddie Mac's automated underwriting or other guidelines. This is a huge loophole, since 85 percent of single-family primary-owner-occupied purchase loans are agency guaranteed.

In January 2016, about 26 percent of agency single-family owner-occupied home-purchase loans had DTIs in excess of 43 percent, and 6 percent had DTIs in excess of 50 percent. The equivalent DTI percentages for the FHA are 44 percent and 17 percent. In a higher-interest-rate environment, it would be expected that perhaps 40 percent of agency purchase loans would exceed 43 percent. As a result, QM's 43 percent DTI limit is completely ineffectual, except in making it difficult for private lenders to compete.

In addition, QM fails to address two of the biggest loan risk factors: (1) equity or down payment levels and (2) credit score standards. For example, a mortgage with a 3 percent down payment, a 580 FICO score, and a 50 percent DTI ratio—a loan that would have been considered a subprime loan before the financial crisis—will now be marketed as prime if it is declared eligible for purchase by Fannie or Freddie, or eligible for insurance from the FHA. Indeed, the FHA approves such loans today. This is despite the fact that, under stressful economic environments similar to those experienced in 2007, this loan would have a greater than 40 percent chance of defaulting.

Third, QM does not provide for a rigorous analysis of ATR, as it does not require an evaluation of a borrower's non-debt obligations, as would be standard practice using a residual income analysis. This is not a new concept. While the FHA abandoned this approach sometime after the 1960s, the VA continues to use this approach. In response to the housing crisis of the late 1920s and 1930s, Congress passed Section 203 of the National Housing Act of 1934, which required the FHA administrator to set "periodic payments by the mortgagor not in excess of his reasonable ability to pay." This provision was implemented by the FHA by means of a housing DTI analysis; a payment shock analysis of the current rent payment versus housing expense-to-income; and a review of the borrower's household budget by means of a residual income analysis.⁸

Fourth, QM does not differentiate ATR based on loan-amortization terms, nor does it differentiate among purchase, cash-out refinances, and non-cash-out refinances—loans with vastly different risk ratings under stress.

Finally, QM's complexity severely disadvantages smaller financial institutions, which need sophisticated advice and expensive systems to avoid the severe penalties associated with violations.

MULTIPLE FLAWS IN QRM PROVISIONS

QRM was intended to set a standard for a low-risk mortgage, meaning one having a low risk of default under conditions of economic stress. A 5 percent retention requirement was imposed on issuers of securities backed by loans not meeting this low-risk standard. This approach had inherent flaws, such as ignoring key elements like the loan originator, a failure to define how the retention provision would be implemented, and the impact on smaller institutions, whose loans tended to perform much better

through the financial crisis. Crucially important was the fact that Ginnie Mae was exempt from the QRM provisions. Ginnie Mae securities are backed by high-risk loans insured by agencies such as the FHA and the RHS. The FHA and the RHS are also able to write their own QM rules, creating a regulatory void with respect to their high-risk loans. These two agencies are responsible for one-third of the home-purchase volume guaranteed by Fannie, Freddie, the FHA, the VA, and the RHS, yet 85 percent of FHA and RHS loans are high risk.

The QRM was supposed to be further developed by agreement among six regulatory agencies that are involved with mortgages, although the QRM, as already noted, was to have set a standard for a low-risk mortgage. In their initial proposed rulemaking, the six agencies sought a QRM that demonstrated "low credit risk even in stressful economic environments."⁹

The QRM rule as adopted requires a QRM to meet only the bare minimum standards of the QM. As noted, the QM is insufficient to support the credit quality on which a stable mortgage market depends, and will lead to precisely the result that the QRM standard was intended to prevent—a return to the policies that created the housing bubble, the mortgage meltdown and ultimately the financial crisis. The six agencies substantiated this conclusion by noting that they aligned QRM with QM in order to "preserve access to affordable credit."¹⁰

Thus, as implemented, the QRM provisions are fatally flawed. First, the six agencies defined a QRM to be the equivalent of a QM. The QM standard bears no relationship to the QRM intent of setting a standard for a low-risk mortgage. QM is simply another and more direct way for the government to keep mortgage underwriting standards low. Next, the 5 percent retention requirement may consist entirely of a vertical or "share and share alike" slice, which greatly diminishes risk-absorbing capacity, as compared to a horizontal or "first loss" slice. Also, risk-retention is imposed as an obligation of the issuer rather than the originator. Finally, this rule disadvantages smaller financial institutions by requiring that the risk be held for as long as 30 years, which only large balance sheets can do. At the same time, the federal guarantee agencies (including Fannie, Freddie, and Ginnie while in conservatorship) are exempt from QRM (and much of QM).

In short, neither QM nor QRM address the problems created by government support for housing

finance, the resulting levels of moral hazard and mispricing, and the deleterious impact on long-run market stability. These problems, along with the exemption of the agencies from much of QM and all of QRM, leaves well-capitalized private lenders reluctant to originate properly priced high-risk loans for their own portfolios that meet agency QM standards and non-QM loans due to unquantifiable legal liability. These unnecessary regulations are both costly and cumbersome, while leaving government agencies free to guarantee unlimited volumes of risky loans.

The QM and QRM provisions should be repealed. They are held up as a guardrail that will prevent a repetition of the mortgage meltdown of 2007 and 2008, but they fail to protect consumers and taxpayers. This gives a false sense of protection, as by their terms, QM and QRM fail to prevent destabilizing growth in leverage. They do not constrain collateral, income, and credit leverage (LTV/Combined LTV, FICO score, or total DTI). At the same time, QM and QRM dangerously tilt markets toward risky government guarantee agencies. Even today, leverage facilitated by QM and QRM, combined with an unprecedented period of low interest rates, are fueling an increase in real home prices, a process which history tells us will eventually correct itself—and such corrections are almost always painful.

CONCLUSION

The U.S. has a history of government involvement that creates upward pressure on home prices, promotes the spread of moral hazard, and mandates widespread mispricing of risk. The government's efforts to liberalize credit terms creates demand pressure that easily becomes capitalized into higher prices. This involvement also sets in motion political pressures for increasingly risky lending, such as “affordable loans” to constituent groups. Rather than creating affordability, the result is a further-removed goalpost for many aspiring low-income and middle-income homebuyers. The actual beneficiaries tend to be real estate brokers, builders, building laborers, the suppliers of building materials, and speculators.

Policies that promote moral hazard, loan mispricing, massive government intervention, and risk distortion must be eliminated or abandoned. Much of this federal support has been directed at promoting and subsidizing the 30-year fixed-rate mortgage, with subsidies provided by means of the FHA,

Fannie Mae and Freddie Mac, the affordable housing mandates, and the mortgage interest deduction.

U.S. housing finance policies must be completely redesigned:

- **The FHA and Fannie and Freddie (while they continue to exist) should be required to adopt sound underwriting, pricing, and capital standards in order to promote market stability.** Today, fewer than 40 percent of federal agency guaranteed or insured loans are rated low risk under stressful economic environments. With agency loans accounting for 85 percent of all primary-owner-occupied purchase loans, it is mathematically impossible for the substantial preponderance of mortgages to be low credit risk. Eventually, another financial crisis will result.
- **Fannie and Freddie, over time, should be required to include increasing percentages of private first loss coverage for mortgages they acquire.** That amount would increase over a period of five to 10 years so that by the end of the period, neither Fannie and Freddie, nor the taxpayers, would be taking any substantial mortgage risk; at that point their charters would sunset. This, plus other reforms, would reduce and eventually eliminate Fannie and Freddie's moral hazard threat and their government-mandated competitive advantages.
- **The FHA should be required to increase capital and end its abusive and unsustainable lending practices.** This, plus other reforms, would reduce and eventually eliminate the FHA's moral hazard threat and its government-mandated competitive advantages.
- **Policies that promote and support market stability should replace the current centralized command and control regulatory scheme.** These policies would include (1) an individual loan-default risk rating based on how a loan with similar risk characteristics would perform in stressful economic environments that combine high unemployment with sharp drops in housing prices; and (2) property valuation and lending standards that would take into consideration dangerous aberrations of market prices and require the use of the residual income methodology for assessing a borrower's ability to meet his or her obligations. With these policies in place, the free market

would determine the underwriting standards for mortgages. Finally, in order to achieve sustainable homeownership and promote reliable wealth accumulation for low-income families, Fannie's and Freddie's Low-income Housing Goals should be repealed and replaced with a policy that focuses on wealth building.¹¹

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. Edward J. Pinto, "Fifty Years of Housing Policy Failure: How Housing Policies Have Made Housing Unaffordable," American Enterprise Institute, International Center on Housing Risk, December 3, 2015, <http://www.housingrisk.org/fifty-years-of-housing-policy-failure-how-housing-policies-have-made-housing-unaffordable/> (accessed February 4, 2016).
2. Tobias Peter, "How to Avoid the Next Housing Debacle: Lessons from Europe and Where the U.S. Is Headed Today," American Enterprise Institute, International Center on Housing Risk, February 2, 2016, <http://HousingRisk.org> (accessed February 4, 2016).
3. U.S. Department of the Treasury et al., "Credit Risk Retention," Proposed Rule, *Federal Register*, Vol. 76, No. 83, April 29, 2011, p. 24118, <https://www.gpo.gov/fdsys/pkg/FR-2011-04-29/pdf/2011-8364.pdf> (accessed February 8, 2016).
4. The "low credit risk" test developed by the six agencies resulted in an average default rate on low-risk loans of about 3 percent, which results in a maximum default rate of less than 6 percent.
5. Report to the Governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. See Edward J. Pinto, "Alger Commission Report," American Enterprise Institute, March 20, 2011, <https://www.aei.org/publication/alger-commission-report/> (accessed February 4, 2016).
6. Federal Deposit Insurance Corporation, "Remarks by FDIC Chairman Sheila C. Bair to the Wharton School, University of Pennsylvania International Housing Finance Program; Philadelphia, Pa.," June 18, 2010, <https://www.fdic.gov/news/news/speeches/chairman/spjun1810.html> (accessed February 4, 2016).
7. Edward J. Pinto, "GAO Report on Mortgage Reforms Fails to Address Impact of QM and QRM," American Enterprise Institute, International Center on Housing Risk, September 15, 2015, <http://www.housingrisk.org/gao-report-on-mortgage-reforms-fails-to-address-impact-of-qm-and-qrm/> (accessed February 4, 2016).
8. A method of analyzing ATR used primarily by the VA that determines the sufficiency of consumers' residual income available to cover other recurring obligations and living expenses (such as food, clothing, and auto ownership) remaining after making a more comprehensive determination of a consumer's total monthly obligations relative to total monthly income. This method is broader than the total DTI method, which only considers monthly debt obligations, thereby excluding such expenses as taxes (other than property taxes), home utilities, property maintenance and repairs, and work-related commute expenses, and does not include a determination of the sufficiency of the remainder to cover remaining living expenses.
9. U.S. Department of the Treasury et al., "Credit Risk Retention," Proposed Rule, p. 101.
10. U.S. Department of the Treasury et al., "Credit Risk Retention, Final Rule," *Federal Register*, Vol. 79, No. 247, December 24, 2014, p. 77606, https://www.fdic.gov/news/board/2014/2014-10-21_notice_dis_a_fr.pdf (accessed February 8, 2016).
11. Edward J. Pinto, "A Housing Primer: Wealth Building for the 21st Century," American Enterprise Institute, International Center on Housing Risk, October 26, 2015, <http://www.housingrisk.org/wp-content/uploads/2015/12/A-Housing-Primer-Wealth-Building-for-the-21st-Century.pdf> (accessed February 4, 2016).

CHAPTER 3

Title I and the Financial Stability Oversight Council

Peter J. Wallison

The Dodd-Frank Act as a whole is founded on a false narrative—that the 2008 financial crisis was caused by insufficient regulation, or even deregulation, of the private financial sector. Titles I and II of the act are based on a narrower misconception: that the immediate cause of the crash in 2008 was the bankruptcy of Lehman Brothers, a large nonbank financial firm. As a result, Title I is focused on identifying and preventing the failure of large financial firms, while Title II attempts to provide an alternative to bankruptcy, which the act’s sponsors believed is an inherently disorderly process.

Reflecting the view that the failure or “material financial distress” of a nonbank financial firm could cause another financial crisis, Title I establishes a council of financial regulators—the Financial Stability Oversight Council (FSOC)—to identify these firms. When identified, a systemically important financial institution (SIFI) is then turned over to the Federal Reserve for special regulation that the act specifies must be both “prudential” and “more stringent” than the regulation to which similar firms are normally subject.

As shown earlier, however, the financial crisis was caused by the collapse of an entire asset class—home values and mortgages—brought about by the government’s own housing policies. Neither special stringent regulation of large firms nor a special non-bankruptcy resolution system will prevent another crisis in the future if the government continues the same policies that it pursued before 2008. Indeed, the policies introduced in Titles I and II will have harmful potential effects themselves. Among other things, they will create moral hazard and spread the too-big-to-fail (TBTF) problem—which has previously been limited to the banking industry—to other financial sectors. Since these policies

will do considerable harm to the U.S. economy, and do no discernible good, they should be eliminated through repeal of the FSOC’s authority to designate nonbank financial firms as SIFIs.

The following discussion is organized around the sections of Title I that establish the FSOC or provide it with authority to designate nonbank financial firms as SIFIs. The last section proposes the elimination of the Office of Financial Research.

THE STRUCTURE OF THE FSOC: SECTION 111

Section 111 of Dodd-Frank establishes the FSOC, and specifies that the voting members will be the Secretary of the Treasury, as the chair, and the chairs or heads of all the other federal financial regulators. In addition, the President is given the power to appoint an independent voting member with insurance expertise. This amounts to 10 voting members, all of whom are appointees of the President then in office, and three of whom are bank regulators.¹ Routine decisions are to be made by a majority, but decisions on SIFI designations must be made by a two-thirds vote and have the affirmative vote of the Secretary of the Treasury.

This structure—which constitutes the FSOC as a group appointed by the Administration then in office, and probably from the President’s party—makes the council a political body. This is a substantial break from the past, where important financial regulatory decisions were made by bipartisan commissions consisting of individuals who were deemed to be experts in a specific area of financial activity. Thus, the makeup of the FSOC raises questions that go beyond whether a bank regulator should be voting on a securities issue; it imports political and partisan considerations into what have traditionally been decisions that were made on the merits, in a bipartisan regulatory process. Although the heads of the financial regulatory agencies may be experts in regulation within their respective areas of specialty, their appointment by the President then in office—and the President’s ability to remove them as chairs or agency heads—makes them unusually responsive to the President’s political direction. This problem is made considerably worse by the appointment of the Secretary of the Treasury as the chair of the FSOC, which places one of the principal political officers of the Administration, usually a confidant of the President, at the head of the table in FSOC meetings. It would be natural, then, for the other appointees of the President’s political party to look for guidance on major decisions from the Secretary of the Treasury, instead of using their independent judgment. While political accountability is generally good, in financial regulation Congress has determined in the past that it is best achieved through the bipartisan balance that is inherent in the bipartisan commission structure—a structure that is upended in the FSOC.

In most cases other than SIFI designations, the FSOC’s role is to recommend action to constituent agencies that have the statutory power to carry them out, but in at least one case—the FSOC’s authority over risk management in Title VIII (dealing with payment, clearance, and settlement activities)—the FSOC is authorized to override the views of the primary regulator of a particular industry or firm. In other cases, the FSOC can exert public pressure on primary regulators, even though the FSOC’s members have none of the specialized knowledge about a particular regulatory field that the primary regulator ordinarily possesses.

All these elements argue for either the elimination of the FSOC or—if it is not eliminated—its transformation into a purely consultative body, similar to the President’s Working Group (PWG), which

was established by an executive order in the Reagan Administration and has continued to operate in subsequent Administrations.² In that case, the council could retain its current structure, with the Treasury Secretary as its chair.

However, if the council is to survive in any form that has actual authority over the functioning of the financial system, fundamental changes should be made in its composition and structure. The Secretary of the Treasury should be removed as a member and as chairman of the FSOC, and the chairmanship should rotate among the members. The Treasury Department could be an observer, a non-voting member, to provide financial and economic insight on the general economy. In addition, although the chair or head of each member agency could still be the voting member on the council, votes should reflect the views of all the members of the particular commission or board, and not just the views of the chair, and other members of commissions and agencies should be able to attend and speak at meetings, even though they would not necessarily be voting members.

POWERS AND DUTIES OF THE FSOC: SECTIONS 112 AND 113

Section 112 specifies that the FSOC has three distinct responsibilities: (1) “identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities,” of large bank or nonbank financial firms; (2) promote market discipline by assuring that counterparties of financial firms do not believe they will be shielded from losses; and (3) respond to emerging threats to the stability of the U.S. financial system.

To achieve these goals, the FSOC is directed to gather information, monitor the financial marketplace, recommend supervisory policies to members, identify gaps in regulation, require supervision of nonbank financial firms by the Fed when necessary, and provide a forum for information sharing among the members of the FSOC.

Section 113 authorizes the FSOC to designate particular nonbank financial firms for special “stringent” regulation by the Fed and subject them to prudential standards if the council “determines that material financial distress at the US nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities” of a firm “could pose a threat to the financial stability of the United States.”

This is the FSOC’s most distinctive power, and flows directly from the mistaken idea that the failure of a nonbank financial firm can cause another financial crisis. The sponsors of the act clearly believed that turning these firms over to the Fed for special stringent regulation would prevent their failure and thus—to that extent—prevent another financial crisis. This idea is wrong; as the first chapter of this book has shown, the failure of individual firms did not cause the 2008 financial crisis, and preventing such failures will not prevent another financial crisis. Moreover, there is no support in banking history for the proposition that Fed regulation can prevent bank failure—except, of course, through bailouts. Finally, there are reasons to believe that the FSOC is not pursuing a fair or objective investigative or decision-making process when it designates SIFIs. All of these are reasons for eliminating this authority.

FSOC IMPLEMENTATION OF SECTION 113 DESIGNATION AUTHORITY: THE METLIFE BRIEF

Based on the information it has released about its procedures, the FSOC has distilled all the factors that it believes are central to a designation decision into three “channels” through which to assess how a firm’s financial distress or failure might cause instability in the U.S. financial system. These are: (1) an exposure channel, through which other firms—because of exposures to the failing firm—might be severely damaged; (2) an asset liquidation channel, through which the failing firm might, in liquidating assets in a “fire sale,” weaken other firms by forcing down asset values in general; and (3) the critical function (or critical service) channel, in which a failing firm provides a service that is essential for maintaining market stability.

There has been widespread criticism of the “transparency” of the FSOC’s designation process, as well as the quality of its decisions. It is noteworthy that in the FSOC’s designations of two large insurers—Prudential Financial and MetLife—as SIFIs, the independent voting member of the FSOC with insurance expertise dissented, criticizing the council’s methodology and its understanding of the insurance business. Until recently, there had been no firsthand information about either the FSOC’s procedures or the standards and metrics it uses to make its decisions. However, both were severely criticized in a June 2015 brief for summary judgment that MetLife—in a legal challenge to its designation

as a SIFI in December 2014—submitted to the U.S. District Court for the District of Columbia.

In its brief, MetLife alleged:

During the [FSOC’s] process, companies under consideration are not given access to the record on which FSOC’s ten voting members rely when adopting the proposed and final designations, including the staff’s analyses of the company and its supposed risks, correspondence between the FSOC and the company’s regulators, and material furnished to FSOC by those regulators or other third parties.³

In addition, the brief reports, the FSOC persistently refused,

during the designation process to grant MetLife access to the administrative record—which has still not been produced in full to MetLife—and by the FSOC’s own unprecedented structure, which vests the same officials with legislative, investigative, and adjudicative responsibilities for the designation inquiry.⁴

With no access to the record, and without a disinterested adjudicator, MetLife claimed it was impossible to obtain a full and fair hearing on its own designation. These procedural faults, if true, raise serious questions about the sufficiency of Title I in requiring procedural fairness by the FSOC. The council certainly has the right and even the obligation to keep confidential the information that it has received from the company or its regulators, to the extent that the information would be damaging to the company if released to the public. But there is no reason for this information to be kept from the company itself, and of course no reason at all not to give the company full access to the administrative record on which it has been designated as a SIFI. Without that, there is no way to effectively challenge a company’s designation on the basis of the administrative record.

Reforms in the future—if the FSOC’s designation authority is retained—should specify which information should be provided to firms under consideration for designation, as well as an opportunity to appear before the council to challenge the administrative record before any decision is made. Companies being considered for designation should also

be given an opportunity to change their business models if that would eliminate activities or relationships considered major factors in the FSOC's designation decision. Consideration should also be given to separating the FSOC's investigative staff from its adjudicatory process; there is something Star Chamber-like when the FSOC is the investigator, the fact-finder, the adjudicator, and the appellate court. Although firms designated as SIFIs can appeal in the federal court system, they risk retaliation by their regulator if the appeal falls short, and the MetLife brief shows that appeals are handicapped by the refusal of the FSOC to furnish a designated company with the details that underlay its decision.

Perhaps more serious than the procedural faults of FSOC's process, were the substantive problems in the FSOC's argument. In its brief, the FSOC argued that, as an expert group, it could predict whether the financial distress of MetLife will be likely to cause financial instability in the U.S. financial system in the future, but it established no standards and referred to no historical precedents for doing so. Its essential position, then, was that, while it could or would not define what degree of interconnection in the exposure channel—or what degree of selling in the asset liquidation channel—would make a company a candidate for designation, MetLife's evidence was insufficient to show that its financial distress or failure would *not* cause instability in the U.S. financial system. Aply, MetLife's brief called this position *ipse dixit* (Latin for "because I said so"). On this basis, the council claimed that its position was entitled to deference from the courts against MetLife's argument that the council's conclusions were arbitrary and capricious.

These allegations are quite troubling. They raise questions on two key issues: (1) whether the FSOC is simply following the decisions of the Financial Stability Board (FSB), a mostly European group of central bankers and finance ministers of which the Treasury and the Fed are members; and (2) whether the FSOC actually has and employs data and metrics that allow it to make considered judgments—rather than arbitrary and capricious decisions—on whether the financial distress or failure of particular firms will cause instability in the U.S. financial system.

IS THE FSOC SIMPLY IMPLEMENTING DECISIONS OF THE FSB?

On the first issue, observers over the years have noted that the actions of the FSOC have mirrored

the decisions of the FSB. The concern is that the FSOC believes itself to be bound by FSB decisions made with the concurrence of the U.S. members. In July 2013, for example, more than a year before the FSOC designated MetLife, the FSB designated MetLife as a "global" SIFI, also without any disclosure of its evidence or its standards for doing so. The later FSOC decision, apparently without any significant standards, adds weight to the concern that the MetLife decision was actually made at the FSB.

If true, this would be a gross mishandling of the authority FSOC was given in the Dodd–Frank Act. When Congress authorized the FSOC to designate large nonbank financial firms as SIFIs, it almost certainly assumed that the FSOC would follow a fair, objective, and fact-based process in exercising that authority. Although FSOC officials have asserted that the FSOC's designation decisions have been the result of such a process, that assertion is not supported by the facts in the MetLife brief.

In 2009, the FSB was deputized by the G-20 leaders to reform the international financial system. After receiving this mandate, the FSB determined to proceed by designating certain firms as "global SIFIs," and on July 18, 2013, it designated nine large international insurers—including AIG, Prudential, and MetLife—as global systemically important insurers (G-SIIs).⁵ The FSOC had designated AIG as a SIFI before the FSB had made its designations, but Prudential was not designated as a SIFI until September 2013 and MetLife not until December 2014.⁶

The designation of SIFIs by the FSOC is what is sometimes called a quasi-judicial proceeding, where evidence is weighed against a statutory standard of some kind and an administrative agency applies the standard to a single party, the way a court—based on evidence—would apply the law to a single defendant. Quasi-judicial proceedings are usually expected to meet certain standards of fairness and objectivity. This fairness and objectivity was missing in the FSOC's treatment of at least two of the U.S. insurers—Prudential and MetLife—designated as G-SIIs by the FSB.

In March testimony before the House Financial Services Committee, Treasury Secretary Jack Lew stated that the FSB "acts by consensus."⁷ A consensus literally means an agreement; synonyms of consensus in most dictionaries are concurrence, harmony, accord, unity, and unanimity. So when these three firms were designated by the FSB as G-SIIs, the Treasury and the Fed necessarily concurred in the decision.

This means that months *before* the FSOC designated Prudential or MetLife as SIFIs, the Treasury and the Fed—the two most important members of the FSOC—had already determined, as members of the FSB, to designate Prudential and MetLife as G-SIIs. Obviously, if a firm is a G-SII on a global scale, it is a SIFI in its home country. Thus, whatever process the FSOC might have followed in the designation of Prudential and MetLife, it could not be considered fair, objective, and evidence-based if the chairman of the FSOC and the Fed—as members of the FSB—had already decided the issue months before.

Moreover, the FSB has not explained the basis for its designations of Prudential and MetLife, except to say that they were made in conformity with a methodology of the International Association of Insurance Supervisors. Although the methodology was made public, the FSB has never explained how the methodology applied to any of the insurers, including the three U.S. insurers. So the need for an objective, evidence-based, decision-making process could not be cured in any way by whatever process the FSB may have followed in making its designations.

Clearly, then, the FSOC's tainted designations of Prudential and MetLife cannot be considered the kind of deliberative process that was sanctioned by Congress when it authorized the FSOC to make SIFI designations. Instead, they suggest that these decisions were made to implement the FSB's decisions in the U.S., rather than on evidence that meets the requirement of Section 113 of the Dodd–Frank Act.

DID THE FSOC USE STANDARDS TO MAKE ITS METLIFE DECISION?

On the second issue, whether the FSOC has the evidentiary data and metrics to draw reasoned conclusions about whether a particular company should be designated as a SIFI, the MetLife brief raises serious questions about which, if any, standards the FSOC has been using to make its designations. MetLife is the first case in which the FSOC's standards have been publicly revealed. Apparently, the agency was prepared to designate MetLife as a SIFI without articulating any standards by which such a judgment would be made. Without standards, almost every prediction about whether the failure or material distress of a firm will cause financial instability in the future becomes arbitrary and capricious.

If the FSOC is to retain the authority to designate nonbank financial firms as SIFIs, Congress should insist on several baseline standards. First, the FSOC

should establish the metrics it will use to determine whether the failure of a large nonbank financial firm will expose others to losses substantial enough to cause instability in the financial system. That is, what percentage of exposure to a firm being considered for designation will be deemed unacceptable by the FSOC? And how many other firms, of what sizes, should have this level of exposure in order to trigger a finding that the interconnection is potentially dangerous? This metric should be made public, so that firms that are in jeopardy of SIFI designation can do something about it, as could firms that are seriously exposed to the firm under investigation.

The same should apply to the asset liquidation channel. The FSOC should establish a certain level of market impact as the effect that would trigger concern if a financial firm has to liquidate assets quickly in case of a liquidity problem. If a serious liquidity problem would not produce a “fire sale” that might seriously affect market values for certain assets, the firm being investigated should not be designated.

It is unfair and wrong that the FSOC may simply assert—as it has done in all previous designations—that other firms would be “significantly” exposed to the failure of the designated firm, or that the market would be “significantly” affected by the designated firm selling off assets to meet a cash crunch. The FSOC should be required to disclose the standards it is using, as well as its evidence for imposing these standards in particular cases. Moreover, the FSOC should make clear why these standards were chosen, and what kind of evidence indicated that these standards were appropriate for making a SIFI designation. With neither an understanding of why they were designated, nor the evidence underlying the designation, companies have no basis for seeking a “de-designation” by changing their business models, the composition of their assets, or their relationships with other firms.

SHOULD THE FSOC HAVE THE POWER TO DESIGNATE SIFIS?

As noted, the FSOC's designation authority is based on the notion, adopted by the sponsors of the Dodd–Frank Act, that because of “interconnections” among large financial firms, the failure of one large firm will drag down others, causing instability in the U.S. financial system. This led to the conclusion that additional regulation was necessary to assure that these large nonbank financial firms did not fail. Hence, the FSOC was given the extraordinary

authority to designate certain firms as SIFIs. When designated, they are turned over to the Fed for special “stringent” regulation—the statutory term—and other significant regulatory burdens described below that were intended to assure, insofar as possible, that these firms would not take the risks that might result in their failure.

There are substantial negative consequences of designating a firm as a SIFI. Principal among these is the danger that the firm will in effect have been labeled by the government as TBTF. After all, a SIFI designation is a statement by the government that allowing the firm to fail would be dangerous to the stability of the U.S. financial system. Under these circumstances, firms that are designated as SIFIs may have financial advantages over competitors because—other things being equal—it is less risky to lend to them than to lend to firms that have an equal risk of failure but, should they fail, will not be rescued by the government. In the discussion of Title II in Chapter 4 it becomes clear—especially in the “single point of entry” proposal—that the Federal Deposit Insurance Corporation (FDIC) sees Title II as a mechanism for preventing a large bank or nonbank financial firm from failing. This, of course, creates exactly the moral hazard problems that the Dodd–Frank Act was intended to prevent, and worsens the TBTF problem.

Some observers, such as former House Financial Services Committee chair Barney Frank (D–MA), argue that SIFI designation is not a financial advantage because the extra regulation to which designated firms will be subject as SIFIs will cancel out any financial benefit.

This could certainly be true, but it is fanciful to believe that the regulatory costs will *exactly* cancel out the credit benefits. One or the other will dominate over time. If the credit advantages dominate, the firm will be able to outcompete its rivals—just as Fannie Mae and Freddie Mac were able to dominate the housing finance industry because of the credit advantages that came from the market’s (ultimately correct) belief that they were backed by the government and would not be allowed to fail. On the other hand, if the extra regulation dominates, the designated firm will gradually weaken because its costs will exceed those of its non-SIFI competitors, and that in itself will cause deadweight losses to the economy, its investors, and customers—and possibly to the taxpayers if it has to be bailed out. In either event, however, there is still the moral hazard

problem: The designation leads creditors to believe that they will be bailed out if the firm were to fail.

Another important question is the effect of a SIFI designation on competition within a market. Insurance is a good example. It is not difficult to imagine that each of the three insurance firms that have been designated by the FSOC will be able to tell potential insurance customers that they are safer sources of insurance—whether life or property and casualty—than their competitors, because they have been designated as SIFIs and are likely to be protected or rescued by the government. As happened with Fannie Mae and Freddie Mac, these companies will be able to out-compete others in the same industry because their apparent government backing made their guarantees seem safer than those of their competitors.

Over time, SIFI designations could produce powerful and unassailable firms that can dominate markets, such as insurance, that never had a TBTF problem in the past. If designations continue, involving other kinds of firms—and the FSOC is arguing in the MetLife case that it has an unlimited license to designate *any* firm—this will produce unnecessary concentration in financial fields other than banking and insurance, as the firms designated as SIFIs come to dominate their markets. It may also lead to firms requesting designation so they can reap the crony capitalism advantages of their relationship with the Fed.

Barney Frank also noted, if the designation would provide such enormous advantages, why are so many companies trying to avoid it? Others, following the same line of reasoning, have asked why MetLife is challenging its designation in court.

The best answer is probably that GE Capital, having been designated as a SIFI in 2013, decided in 2015 to sell its assets in the hope of being “de-designated.” Given the stories about the Fed’s interference with the managements of firms that are under its oversight, the management of GE probably found that the Fed was becoming the real manager of the company—questioning decisions that are normally the prerogatives of management—and was inserting its tentacles into the management of GE itself. Not surprisingly, managements like to be fully in charge of the firms they manage, and they also want to produce profits by taking what they believe are prudent risks. It would not be surprising to find that a management’s idea of prudent risks differs substantially from the views of the bureaucrats and economists who are running the Fed. Even if a SIFI designation might provide funding advantages to a company,

most management would far prefer to run the company as profit-making enterprise than to have it turned into a utility run by its regulator.

IS SIFI DESIGNATION NECESSARY TO PROTECT THE FINANCIAL SYSTEM?

Against all these disadvantages and costs to the financial system, what evidence is there that designation is necessary for protecting the financial system? The short answer is: none. First, of course, when looking at what happened in the financial crisis, it does not appear that prudential bank-like regulation was superior to non-regulation or plain old market discipline in protecting financial firms from failure. Three large nonbank financial firms failed in the crisis—Bear Stearns, Lehman Brothers, and AIG; and three large heavily regulated banks—IndyMac, Washington Mutual, and Wachovia (in addition to hundreds of smaller banks)—also failed during the crisis period. One large heavily regulated banking organization, Citibank, might have been saved from failure by government assistance, but that is disputed by its management. Based on this evidence, there is nothing to make anyone confident that the regulation of banks produces firms that are safer for the system than firms regulated primarily by market discipline.

But it is the failure of the “interconnections” idea—the notion that if a large nonbank financial firm fails it will drag down others—that ultimately destroys the rationale underlying the Dodd–Frank Act. The idea grew out of the chaos that followed the bankruptcy of Lehman Brothers, but even a cursory look at that chaotic period reveals that the failure of Lehman—one of the largest financial firms in the U.S.—had no significant direct or indirect effect on other large financial firms. Despite the market’s anxious state before Lehman filed for bankruptcy, no other large firm failed due to being exposed to Lehman. This is true even though Lehman was a major player in the credit-default swaps (CDS) market, which has been wrongly charged with “bringing the financial system to its knees,” and there were many such swaps written on Lehman itself. For the same reason, AIG, rescued after Lehman failed, would not have had any significant effect on other firms either, had it been allowed to fail.

Seldom in social science studies can one demonstrate the fallacy of a major assumption on which legislation has been based, but this is one example. The Lehman case shows that—even under the

adverse conditions in which it occurred—the failure of a large nonbank financial firm will not drag down other large firms. The same would have been true if Bear Stearns and AIG had been allowed to fail.

This is understandable when it is given any thought; large firms are generally highly diversified, and the failure of one counterparty is unlikely to cause a diversified firm to fail. Indeed, this was confirmed by the MetLife brief. MetLife actually commissioned a study that showed that its complete collapse would not have a significant effect on the largest banks, which are likely to be highly diversified and hold the debt securities of many different issuers.

To be sure, a money market mutual fund—the Reserve Primary Fund—“broke the buck” because of its losses on Lehman, but that is far from an insolvency or failure of a company. It is roughly equivalent to a corporation suffering a loss in a year, with a resulting decline in the value of its shares. Ultimately, the shareholders of the fund received about 99 cents on the dollar,⁸ so their losses in any case were small and the fund could have continued in business. The Reserve Primary Fund was not covered by the insurance system that the Treasury put in place after it broke the buck, so the Treasury’s action does not account for the small losses that the fund ultimately suffered.

As discussed more fully in Chapter 1, it was the rescue of Bear Stearns in March 2008 that was the original sin. Once that occurred, market participants assumed that the government would rescue all other large financial firms. There was no logical reason, of course, that the government would rescue Bear’s creditors and not the creditors of others. This created a form of moral hazard; thereafter, the managers and creditors of large financial firms assumed that if a large nonbank firm failed, its creditors would be rescued just as Bear’s were rescued. Accordingly, managers of large firms did not believe that they had to raise as much additional equity as they normally would to reassure their creditors. Rather than further dilute their shareholders, it was sensible to wait out the weakness in the market. Creditors had the same reaction; instead of selling their holdings in a weak firm—and taking a loss—it made sense to stay where they were, since they would be made whole if the firm ultimately failed. That was probably the reasoning of the Reserve Fund’s management.⁹ Then, when the government failed to rescue Lehman—a firm that was 50 percent larger than Bear—all these assumptions were upended and a genuine financial panic ensued.

What actually happened in the financial crisis was not that Lehman dragged down other firms; it was the collapse of an entire asset class—mortgages and private mortgage-backed securities (MBS) backed by non-traditional mortgages (NTMs)—that were held by many financial institutions. Bear, Lehman, and AIG, for example, all suffered severe losses and liquidity problems because of private MBS; Bear and Lehman had heavily invested in them. AIG, on the other hand, had guaranteed CDS issued by a subsidiary that covered losses on private MBS by others; it then used cash collateral it had received through its securities lending operations to invest in additional MBS. Because these MBS became unmarketable when the private MBS market collapsed in 2007, AIG was then unable to meet its obligations to return the cash collateral when its counterparties demanded it.

In any event, for the same reason that Lehman's bankruptcy did not cause others to fail, it is doubtful that if AIG had been allowed to fail there would have been the catastrophic collapse of the market that government officials described in justifying their actions. Even if AIG had defaulted on its CDS coverage of private MBS, the counterparties affected could have purchased additional coverage in the CDS market, which continued to function all through the financial crisis. Indeed, Goldman Sachs, the largest counterparty of AIG's CDS protection, told the Financial Crisis Inquiry Commission that it was fully covered by others if AIG had failed.

It is important to keep in mind that the failures of both Lehman and AIG were the result of government policies: First, the government's housing policies, which reduced underwriting standards and built an unprecedented housing price bubble. Because defaults decline sharply in a bubble—rising prices allow homeowners who cannot meet their mortgage obligations to refinance—banks and other financial firms were lured into acquiring private MBS backed by NTMs, because the absence of widespread defaults caused these instruments to look like safer investments than in fact they were. Second, capital rules herded banks and other financial firms subject to the Basel rules into private MBS; under these rules, substantially less risk-based capital was required to hold MBS than to hold whole mortgages or corporate debt. Third, accounting rules required all financial firms to carry their securities assets at market value, requiring them to write down their assets when the market for MBS collapsed in 2007. Finally, the government's reversal of policy on

rescuing large financial firms threw the market into turmoil when Lehman failed.

None of this would have been prevented if, before the crisis, the Fed had had the authority to regulate a few large nonbank financial firms that had been designated as SIFIs. The crisis was not the result of a failure of individual institutions, but the failure of an enormous asset class—subprime and other risky mortgages—that government policies had promoted. Indeed, it might have been even worse had the Fed been regulating nonbank SIFIs, because the Fed might have encouraged the same investments in these mortgages that the government was supporting at the time.

The case against the FSOC's use of the asset liquidation channel is not as easy to demonstrate, simply because there is very little data to show the effect of a large company selling off large amounts of assets in order to meet its cash obligations. In the MetLife case, the FSOC found it necessary to posit a completely absurd hypothetical—that all MetLife's policy holders would cancel their policies and want a return of cash value—and even that did not show that MetLife's sale of assets to meet this cash outflow would cause a significant general decline in asset values. Given the enormous size of the assets held on corporate and financial balance sheets—many trillions of dollars—it seems highly unlikely that the sale by *any* firm would cause a major decline in asset values.

Again, the events in 2007 and 2008 should not be considered a valid precedent for how a financial crisis might recur. A free-market system is not inherently unstable. The financial system in 2008 was destabilized by government housing policies. The number of subprime mortgages on government and private balance sheets in June 2008—before the crisis—was over \$5 trillion, with almost \$2 trillion on private balance sheets. These values went into free fall when it became clear to investors that the number of mortgage defaults that were occurring was truly unprecedented. Investors fled the market, driving down MBS values to distress levels. But absent these unusual circumstances—where the value of a major asset class declines all at once—it is highly unlikely that a single firm liquidating its assets in the face of a creditor's demand for cash would have any significant effect on asset values. Although an Oliver Wyman study on the effects of MetLife selling substantial portions of its assets is still under seal in MetLife's suit against the FSOC, MetLife contended in its brief that the study showed no appreciable market disruption from a major MetLife asset liquidation. Under

these circumstances, it seems clear that there are few, if any, advantages to the financial system that arise from SIFI designations, but many significant disadvantages. It would make sense, then, to repeal the FSOC's authority to designate SIFIs. That would mean removing the term "nonbank financial companies supervised by the Board of Governors" from Title I and every other title of the act. A better system for protecting the largest banks from failure should be introduced. That is the subject of the Chapter 4, on Title II.

OTHER AUTHORITIES UNDER SECTION 113

In addition to the designation of SIFIs because of the supposed effects of their material distress, Section 113 also authorizes the FSOC to designate nonbank financial firms as SIFIs because their "*nature, scope, size, scale, concentration, interconnectedness, or mix of activities* of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States." (Emphasis added.) This is an extraordinary grant of power, even for the Dodd-Frank Act. And, it is a grant of power without any inherent standards or limitations. Did Congress really intend to give the FSOC the power to designate a nonbank firm as a SIFI—and thus subject it to stringent regulation by the Fed—because of its "nature"? At least in the case of large firms, it is possible to suppose that their failure could jeopardize others—so that is an inherent limitation—but in this list of unrelated items, Congress has granted what is essentially a license to designate *any* firm as a SIFI, and subject it to stringent new regulation by the Fed, for virtually any reason at all.

Although the legal principle of an unconstitutional delegation power has fallen into disuse in recent years, this is a case where it is applicable. Unless its supporters can place some kind of standards around its exercise—some kind of limiting principle that explains what Congress had in mind—this provision should be repealed.

Ironically, many financial firms—especially in the asset management business—believe that the FSOC's focus on "activities" would relieve them of the danger of designation as SIFIs. This might be true if the only standard for designation is size. Size is not relevant when the standard is activities. However, "activities" can capture many more firms, including the small as well as the large, because Section 113, as noted above, contains language that permits the

FSOC to designate firms as SIFIs because of many factors, and Section 120, as discussed below, authorizes the FSOC to recommend to the primary regulator more "stringent regulation" of an activity if it "could create or increase the risk of significant liquidity, credit, or other problems."

Thus, there is a plausible argument based on the language in Section 113 that the FSOC could designate as SIFIs all firms that engage in certain defined transactions—say, buying the commercial paper of asset-backed trusts—or participating in those transactions to an extent that exceeds some dollar amount. The danger of being designated for these suspect "activities" would be enough to give the Fed the ability to approve or disapprove transactions of that kind on a case-by-case basis—a plausible substitute for direct prudential regulation of firms such as asset managers, broker-dealers, investment funds, finance companies, and hedge funds, among others, which they characterize as "shadow banking." If so, regulation of these firms will stifle the competitive and innovative character of the securities and capital markets in the United States, with dire consequences for economic growth.

One does not know, of course, how the courts will respond to interpretations like these. Even when there is a distortion of the statutory language, courts often accord deference to agencies' interpretation of the scope of their statutory authority, especially if the court believes that the agency is attempting to address a serious problem that is within the "spirit" of the legislation. The FSOC and the Fed, in carrying out a mandate of the FSB, could claim that they have authority to take these steps because they are attempting to prevent another financial crisis, and no one might be willing—or have the standing—to challenge them. Cases like this suggest that the Supreme Court—as advocated recently by Chief Justice John Roberts¹⁰—should revisit such decisions as the 1984 decision *Chevron v. Natural Resources Defense Council*,¹¹ in which courts have granted substantial deference to administrative agencies' interpretations of their statutory authority.

Nevertheless, in this case, the likely decisions of the courts are not relevant. It is Congress that should prevent the excessive accretion of discretionary power by financial regulators. Power of this kind enables regulators to obtain compliance from individual firms by threatening to invoke this unbridled discretion. For the foregoing reasons, Section 113 should be repealed as an excessive grant of discretionary power.

SECTION 120

Similar questions arise under Section 120, which provides that the FSOC may recommend to the principal regulator of any financial activity that it should impose more stringent regulation of an “activity”—if the council determines that the “conduct, scope, nature, size, scale, concentration, or interconnectiveness” of the activity could “increase the risk of significant liquidity, credit, or other problems spreading” through other companies or markets.

This is not, strictly speaking, a power lodged in the FSOC, since the agency can only make recommendations to another agency. The FSOC’s recommendation still must be carried out by the primary regulator of the activity, which is under no legal compulsion to do so and may not even have the statutory power to carry out the recommendation. Still, given the fact that the FSOC is composed of appointees of the Administration in power, it is likely that the recommendation will be acted upon, at least in some way, because of political pressure brought on the chair of the agency that is the primary regulator of the industry involved.

Again, the question is whether any Administration should have authority to impose more stringent regulation on a financial activity based on nothing more than a belief—unfounded in actual experience—that the activity will produce unfavorable results in the future. The power to designate SIFIs at least implies that size is an important factor, and thus limits to some degree the scope of the FSOC’s authority, but the authority in the case of activities applies to *any* activity—no matter its size and no matter how many firms are engaged in the activity—even if it does nothing more than *create or increase the risk* that “significant liquidity, credit or other [undefined] problems” will spread in the markets. Apart from the actual use of the power granted by this language, it provides the FSOC and any Administration with the ability to extract compliance by the financial industry through its threatened use. The courts may or may not approve the use of this authority by the FSOC, but prudence counsels that Congress should not allow such a broad power over the markets to rest in the hands of any Administration.

SECTION 121

Section 121 authorizes the FSOC to “restrict the ability of [a] company to offer a financial product or service.” In other words, the council on its own motion, with no apparent standards of any kind, can

put a firm out of business. Again, even if unused, this authority would enable any Administration to control any financial company by threatening to invoke this power.

This section is another example of an extremely broad delegation of authority to the FSOC. Although it is not as far-reaching as the authority to regulate undefined “activities” under Section 120, and applies only to individual firms and not entire industries as is the case under Section 120, Section 121 still provides more discretionary and unrestricted power to an Administration than Congress should delegate. For this reason, the authority under Section 121 should be terminated.

FSOC’S AUTHORITY UNDER SECTION 165

Section 165 is as important in many respects as Section 113. It requires the Fed to create more stringent regulatory standards not only for nonbank firms that have been designated as SIFIs, but also for all bank holding companies (BHCs) with consolidated assets greater than \$50 billion. In effect, then, Section 165 designates as SIFIs all BHCs with consolidated assets of more than \$50 billion (BHC SIFIs). In addition to more stringent regulation, Section 165(d) also authorizes the Fed to require nonbank SIFIs and BHC SIFIs to prepare and submit to the Fed “living wills,” which outline in detail how they would be wound down in the event of their financial distress. Both requirements are based on the three fallacies discussed earlier: (1) that the failure of a large nonbank financial firm will drag down others through “interconnections”; (2) that the precipitating cause of the financial crisis was the disorderly bankruptcy of Lehman Brothers; and (3) that bankruptcy is inherently a disorderly and disruptive process.

Moreover, imposing the stress test and living will requirements on all BHCs with \$50 billion or more in consolidated assets is unreasonable. The total assets of the U.S. banking system, according to the Fed’s Flow of Funds accounts, is \$17 trillion. A bank with \$50 billion in assets has only 0.3 percent of the total assets of all banks, and an even smaller percentage of the \$85 trillion of all U.S. financial assets. The idea that the failure of a \$50 billion bank will cause instability in the U.S. financial system is fanciful at best. The same is true of BHCs with \$200 billion (1.2 percent of all bank assets) and even BHCs with \$500 billion (3 percent of total bank assets). As outlined in the earlier discussion of the costs imposed by Dodd-Frank, imposing costs for developing living wills or

complying with stress tests—and, as discussed below, supporting the Office of Financial Research and the FSOC itself—will only further reduce the amount of credit available to the small businesses in the U.S. or make that credit more expensive. Even regarding the largest BHCs, the living will requirement provides the Fed with extraordinary authority to force divestiture if the BHC does not organize itself as the Fed desires, which provides leverage for the Fed to bend regulated firms to its will.

As noted in the discussion about the effect of Lehman’s bankruptcy on other firms, there are good reasons to believe that the failure or financial distress of banks or nonbank firms up to \$500 billion in assets will not have any significant effect on other firms nor create instability in the U.S. financial system. Lehman itself was a firm larger than \$600 billion and declared bankruptcy in the midst of a market on the brink of wholesale panic. If Lehman did not cause other firms to fail, and it did not, Congress should revisit the whole question of whether smaller firms—like BHCs with assets up to \$500 billion and other nonbank firms—should be subjected to the extensive costs that living wills and stress test requirements impose.

These requirements should be repealed. As Federal Financial Analytics concluded in a 2015 report, “measuring systemic risk solely by size is no longer viewed as an effective method of determining systemic-risk potential.”¹² As discussed in Chapter 1, excessive systemic regulation where it is not necessary can have—and is likely to be having today—adverse effects on economic growth. The same Federal Financial Analytics report noted in connection with additional capital surcharges on regional banks with more than \$50 billion in assets: “Given that...smaller companies are most dependent on bank-credit channels and systemic-capital surcharges may adversely affect regional-bank balance-sheet capacity, higher capital intended for risks not generally presented by traditional, regional BHCs could have significantly adverse consequences in local markets.”¹³

INTERCONNECTIONS AND BHCS

The Lehman case also raises questions about whether the failure of any large nonbank financial firm will have a substantial effect on the financial condition of other large firms; the idea that there are dangerous “interconnections” between large financial firms is false. For that reason, and because there are moral hazard and other disadvantages of

designating nonbank financial firms as SIFIs, the FSOC’s authority to designate nonbank firms as SIFIs should be repealed. The same analysis applies to BHC SIFIs. BHCs are ordinary corporations that happen to control banks. They do not have any special advantages, such as access to the Fed’s discount window or to insured deposits, but their activities are severely restricted by law. In principle, there is no reason to believe that the failure of a BHC would be any more disruptive to the financial system than the failure of any other nonbank financial firm.

Indeed, in its December 2013 proposal to resolve SIFIs by taking over a parent holding company, the FDIC recognizes that BHCs themselves are not a systemic danger. This proposal, known as the single point of entry (SPOE), would permit the FDIC, under Title II of Dodd–Frank, to take control of a holding company and use its resources to prevent an operating subsidiary from failing. Thus, in its willingness to close a BHC in order to use its resources to save an operating subsidiary, the FDIC is signaling that the BHC is not a systemic entity, and clearly expendable.

Accordingly, all BHCs should also be exempted from the stringent regulation and living will requirements of Section 165, just as the FSOC’s authority to designate nonbank SIFIs should be terminated, and for the same reasons. Efforts to prevent market instability by preserving systemically important financial subsidiaries should be focused—as argued in the chapter on Title II—solely on the largest subsidiary banks of a BHC. If the failure of any financial institution is likely to have a systemic effect it is the bank, not its holding company.

Some will argue that eliminating the Fed’s regulation of BHCs will also eliminate the separation of banking and commerce and permit commercial firms to own banks. There is nothing inherently problematic about this. In fact, if firms that are not engaged solely in financial activities are allowed to control banks, that would add substantially to the likelihood that banks will have access to capital when they need it. Limiting BHCs to financial activities—as is true under current law—restricts their access to capital and makes them less likely to be able to supply capital to their subsidiary banks when necessary. This would be particularly helpful to small banks, which have difficulty raising capital and coping with new regulatory costs.

There may also be objections on the ground that BHCs engaged in commercial activities will be able to use the insured deposits of banks for their own

benefit. This is a canard. Since the 1980s, Sections 23A and 23B of the Federal Reserve Act have placed tight controls on transactions between banks and their holding companies or holding company affiliates, and they have been updated and tightened further in Section 608 of Dodd–Frank. These restrictions will continue to be enforced. In addition, under existing law, insurance companies, securities firms, and other financial firms are permitted to control banks, and there are no examples of these firms misusing bank subsidiaries for their own benefit.

SHOULD THE FSOC CONTINUE TO EXIST?

If the FSOC should no longer have the power to designate nonbank financial firms as SIFIs, or the other authorities in Sections 113, 120, and 121, is there any reason for its continued existence? There is a weak but plausible case for an FSOC that is merely a forum in which regulators can air their concerns. If one goes back to the causes of the financial crisis outlined in Chapter 1, one can see that the underlying reason was the collapse in value of a single asset class—subprime, and other low-quality, residential mortgages—NTMs. Fannie Mae and Freddie Mac were exposed to about \$2.5 trillion in NTMs, and the private sector about \$2 trillion. Much of this was not known at the time of the crisis, even by the Federal Reserve, with its legions of economists and huge data resources.

The Dodd–Frank solution, which focuses on a few large financial institutions, would do nothing to address the problem of many institutions holding the same weak assets. Because the narrative that formed the basis for Dodd–Frank focused solely on the failure of a few large financial firms, rather than the collapse of an entire asset class, it missed the essential fact about the cause of the crisis. Once the crisis is seen this way, it becomes clear that Dodd–Frank can never prevent a recurrence through stringent regulation of a few large firms. The regulators would be missing the forest for the trees.

One effective regulatory antidote to what actually caused the financial crisis would be awareness on the part of regulators that there was a danger of excessive exposure to any asset class, at the same time warning investors to be cautious about investing in entities that are taking major risks on a risky asset that is very widely held. This is not to say that regulators will be astute enough to do this—in fact, the record provides little support for the idea that regulators understand how markets are actually

operating—but at least it increases the likelihood of a better outcome if financial regulators have an opportunity to meet regularly and share this kind of information.

Accordingly, while the FSOC should be shorn of its ability to designate nonbank firms as SIFIs, it could serve some useful continuing function as a forum for regulators to exchange information about market conditions and possible risks to stability. Although, for the reasons discussed below, the likelihood that it will discover and prevent some future crisis is small, it would not be costly to provide an institutionalized platform for the exchange of information among regulators.

THE OFFICE OF FINANCIAL RESEARCH, SECTIONS 151–156

In addition to establishing the FSOC, Title I also created an Office of Financial Research (OFR) within the Treasury Department to support the work of the FSOC. The OFR is to be headed by a director, appointed by the President for a term of six years and confirmed by the Senate. There are no provisions for the director’s removal from office. The OFR is to be supported by assessments on all BHCs with assets of more than \$50 billion and all nonbank financial firms that have been designated as SIFIs and are supervised by the Federal Reserve. The funds it collects are to be used to support the work of the OFR as well as the FSOC (Section 118).

The principal function of the OFR is to serve as support for the FSOC by, among other things, collecting data on behalf of the FSOC and member agencies, performing research, and developing tools for risk measurement. In pursuit of these functions, the OFR was given limited rule-making authority, principally to standardize the data collection of the member agencies of the FSOC, and authority to issue subpoenas to obtain the data it wants.

The initial questions about the OFR are whether the government needs yet another data collection authority, whether it should be able to support itself through assessments on the largest firms in the financial industry, and whether there should be any check on size of those assessments.

The fact that the OFR uses its assessments to support the work of the FSOC is an immediate problem. The system of separation of powers created in the Constitution contemplated that one of the important checks and balances among the branches was to be the power of Congress to appropriate

funds for government operations. Although various assessment systems have already been established to support the Comptroller of the Currency and a few other agencies, that is not a reason to establish another such system, especially one that can support an agency with the extraordinary powers of the FSOC. For that reason alone, the OFR's assessment powers should be terminated and its work—if it survives—supported by appropriations to the Treasury Department. Through oversight and appropriation of funds, Congress should be able to control the degree to which the OFR imposes costs on the financial system through requests for information. For the same reasons, the FSOC, if it survives, should be supported by appropriations to its member agencies.

But there is a broader question about whether OFR should survive, especially if—as recommended—the FSOC's authority to designate SIFIs or regulate “activities” under Sections 113, 120, and 121 is terminated. Does it make sense to set up yet another government agency that will be imposing more costs on business and the taxpayers to gather information that will be only marginally useful? Data about the past, as F. A. Hayek advised, can never tell us what will happen in the future. There are simply too many factors at play, including information in the minds of millions of participants in any market. The financial crisis itself is an example of this problem. Although the OFR was established to solve the problem of a lack of information before the crisis, it seems unlikely—in light of what actually happened—that the OFR would have been able to change the course of history if it had existed at the time.

In the years leading up to the financial crisis, the most important people in the government thought that a financial crisis—if it occurred—would be the result of risk-taking by hedge funds. The OFR would have been kept busy collecting data from hedge funds—and the FSOC might have been designating them as SIFIs—while the real risks were building up in the mortgage market because of the growth of subprime and other NTMs.

Why were these mortgage risks not recognized? As noted in Chapter 1, when a bubble is growing, defaults decline; people who might otherwise default on their mortgages are able to sell or refinance. So even though the number of NTMs in the financial system was historically large, few of the experts watching the market saw this as a risk. In addition, Fannie and Freddie were not disclosing the number of NTMs to which they were exposed

both in the portfolios they held and in the MBS they were guaranteeing. No one thought to ask, because they were seen as government-backed, and no one holding their debt securities was concerned about a potential default.

The Federal Reserve, arguably the best-informed agency of the government on financial matters, with a staff of hundreds of economists, was worried about Fannie Mae and Freddie Mac taking interest-rate risk. The Fed, and its chairman—then Alan Greenspan—had no idea that Fannie and Freddie were taking on credit risk. The assumption was that they were continuing to purchase only prime loans. The rating agencies, also supposedly well-informed about the risks in the market, were unconcerned about major mortgage risks because, since World War II, there had never been a decline in housing values of more than between 3 percent and 4 percent, and these declines were regional, not national. The rating agencies probably felt justified in giving high ratings to geographically diversified pools since there had not been a nationwide collapse in housing values since the Depression.

All of this created a consensus among the cognoscenti—in government and out—that looking for a crisis in the mortgage market was a waste of time and resources. The likelihood is that when the crisis actually occurred, the staff of the OFR would have been as surprised as all the people in the banks, the financial regulatory agencies, the Fed, and the rating agencies.

However, what if—despite all this—some bright young economist at the OFR had concluded in 2005 or 2006 that there were enormous risks in the mortgage market? Suppose further that he had persuaded the OFR director to take the issue seriously, the OFR had then gone about collecting all the data on NTMs that was then available, and the director was alarmed by what he found. What could he have done with this information?

Had he gone to the FSOC, he would have been told that he was needlessly worried. After all, where were the defaults he feared and how did he know that there was actually a bubble? The economy was doing well, homeownership was growing, and people were buying second homes—it was all explainable. He would also have been cautioned that the Administration at that time was committed to and very proud of the growth in home ownership, and especially the fact that so many new home owners were low-income earners. Was he really going to blow the whistle on

a set of housing policies that had worked so well? If the director had then gone to Congress, the reaction there would have been even more skeptical and hostile, because many Members of Congress were deeply invested in the affordable housing policy and believed their policies to be hugely successful.

This recounting is a validation of Hayek's insight that the key information about whatever is going on in a market is dispersed in the minds of market participants and unavailable to those who might be able to use it for policy. Ironically, in questions of policy, it is often what is in the minds of policymakers that overrides or fails to make use of the data that is available. All this suggests that if OFR is intended to scope out the real risks in the financial system it will be a waste of resources, with a greater chance of leading policymakers in the wrong direction than preventing the next crisis.

For these reasons, the OFR should be terminated.

CONCLUSION

Title I of Dodd-Frank was based on the misconception that the 2008 market crash was caused by the bankruptcy of Lehman Brothers. In reality, Lehman stands for the opposite conclusion—that large nonbank financial institutions can fail *without* causing instability in the financial system. Accordingly, all of the powers accorded to the FSOC in Title I are unnecessary, and will not prevent another

financial crisis. Instead, if exercised as the FSOC has exercised them thus far, they will distort competitive conditions throughout the financial sector. For these reasons, the FSOC's power to designate SIFIs should be repealed.

The same is also true of the other authorities provided to the FSOC—Sections 120 and 121—which give the agency even more discretion than Section 113. Section 165, which imposes substantial costs on banks and other nonbank financial firms in the form of living wills and stress tests, is unnecessary for any but the largest banks, and should also be repealed for all institutions except for the largest insured banks (not including their holding companies).

If the FSOC's designation authority is repealed, it could be retained as a consultative body, like the President's Working Group in past Administrations. That would be marginally useful and would not involve material costs. If the FSOC's authority to designate SIFIs is repealed, there is no good reason for the OFR to exist. It is another costly body that will impose unlimited costs on the financial system and has little likelihood of doing any better at understanding what is happening in the economy than the Federal Reserve, which entirely failed to see the financial crisis coming.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. In addition to the Secretary of the Treasury, the voting members of the FSOC include the chairs of the Federal Reserve; the Securities and Exchange Commission; the Federal Deposit Insurance Corporation; the Commodity Futures Trading Commission; the National Credit Union Administration Board; the Comptroller of the Currency; the directors of the Consumer Financial Protection Bureau and the Federal Housing Finance Agency; and an independent member appointed by the President with the advice and consent of the Senate, having insurance expertise.
2. “Executive Order 12631—Working Group on Financial Markets,” March 18, 1988, appearing in *Federal Register*, Vol. 53, p. 9421, <http://www.archives.gov/federal-register/codification/executive-order/12631.html> (accessed February 5, 2016).
3. Met Life, “Plaintiff Metlife, Inc.’s Cross-Motion for Summary Judgment,” June 16, 2015, p. 9, https://www.metlife.com/assets/cao/sifiupdate/Motion_for_Summary_Judgment_As_Filed.pdf (accessed February 8, 2016).
4. *Ibid.*, p. 3.
5. Financial Stability Board, “Global Systemically Important Insurers (G-SIIs) and the Policy Measures that Will Apply to Them,” July 18, 2013, http://www.financialstabilityboard.org/wp-content/uploads/r_130718.pdf?page_moved=1 (accessed February 5, 2016).
6. U.S. Department of the Treasury, “Financial Stability Oversight: Designations,” July 27, 2015, <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> (accessed February 4, 2016).
7. American Enterprise Institute, “Exchange Between Rep. Jeb Hensarling and Treasury Secretary Jacob Lew,” May 6, 2015, http://www.aei.org/publication/exchange-between-rep-jeb-hensarling-and-treasury-secretary-jacob-lew/?utm_source=paramount&utm_medium=email&utm_campaign=wallison-kupiec-newsletter (accessed February 5, 2016).
8. News release, “Reserve Primary Fund to Distribute \$215 Million,” Resrv Partners, Inc., July 15, 2010, http://www.primary-yieldplus-inliquidation.com/pdf/PrimaryDistribution_71510.pdf (accessed February 5, 2016).
9. This assumption is corroborated by Bruce Bent, chairman of the Reserve Primary Fund saying, before Lehman’s bankruptcy, that the firm should be saved by the government because of its importance. See Steve Stecklow and Diya Gullapalli, “A Money Manager’s Fateful Shift,” *The Wall Street Journal*, December 8, 2008.
10. *City of Arlington, Texas v. FCC*, 133 S. Ct. 1863 (dissent by Roberts, Kennedy, and Alito) at 1877 (2013).
11. *Chevron v. Natural Resources Defense Council*, 104 S.Ct. 2778 (1984).
12. Federal Financial Analytics, Inc., “The Consequences of Systemic Regulation for U.S. Regional Banks,” August 6, 2015, Key Points, <http://regionalbanks.org/wp-content/uploads/2015/08/FedFin-Study-The-Consequences-of-Systemic-Regulation-for-U.S.-Regional-Banks.pdf> (accessed February 4, 2016.)
13. *Ibid.*, p. 6.

CHAPTER 4

Title II: Is Orderly Liquidation Authority Necessary to Fix “Too Big to Fail”?

Paul H. Kupiec

One of the primary goals of the Dodd–Frank Act was to solve the too-big-to-fail (TBTf) problem for the largest financial institutions. The act’s preamble states that it is intended to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.”

Title II—Orderly Liquidation Authority (OLA)—the act’s legislative solution to TBTf, is based on the premise that a large systemically important financial institution (SIFI) cannot fail in a judicial bankruptcy without *causing* a financial crisis. Because of the alleged ramifications of a SIFI failure, investors rationally surmise that governments will bail out SIFIs rather than let them fail. As a consequence, investors treat the liabilities of SIFI institutions as if they have an implicit government guarantee. This TBTf guarantee gives SIFI institutions access to subsidized funding and creates incentives for SIFI management to overleverage and expand SIFI investments into high-risk assets and activities.

Dodd–Frank starts with the premise that the TBTf hypothesis is true, and creates a four-layered approach to solving the problem. First, the act designates certain bank holding companies (BHCs) as *de facto* SIFIs. Second, it specifies general criteria that characterize SIFIs and empowers a group of government regulators—the financial stability oversight council (FSOC)—to examine all non-BHC financial institutions and identify those that satisfy SIFI criteria. Third, it requires the Federal Reserve Board (FRB) to impose new heightened prudential regulatory standards and undertake supervisory efforts

to ensure that the probability of an individual SIFI’s financial distress is especially remote. Lastly, should a SIFI become financially distressed, it creates a new resolution framework for SIFIs’ orderly liquidation. OLA empowers the Federal Deposit Insurance Corporation (FDIC) to act as receiver and “liquidate” the SIFI outside of judicial bankruptcy in an administrative resolution process. OLA is supposed to allow the FDIC to liquidate a failing SIFI without the need for taxpayer assistance and without creating a financial crisis.

Dodd–Frank was passed well before the true underlying causes of the financial crisis were identified, and it left many specific details to be worked out by financial regulators. OLA in particular does not explain how the FDIC can use its powers to resolve a SIFI without triggering a wider financial crisis.

Since the passage of Dodd–Frank in 2010, the FDIC has formulated a concrete strategy for using OLA should it be called upon to resolve a failing SIFI. A key presumption of the FDIC’s strategy for resolving a distressed SIFI, the so-called single-point-of-entry (SPOE) strategy, is that the parent holding company can be liquidated without systemic consequences, provided the SIFI’s operating subsidiaries remain open and operating. In fact, aside

from satisfying Dodd–Frank–mandated claims priorities and management changes, the primary goal of the FDIC’s OLA strategy is to keep critical operating subsidiaries functioning, and protect them from their own bankruptcy or resolution proceedings.

There is a simple alternative approach to regulation that can achieve all the FDIC’s OLA resolution goals without using OLA. The approach requires: (1) increasing minimum regulatory capital requirements for depository institutions¹ and critical functionally regulated subsidiaries;² (2) modifying prompt corrective-action intervention triggers; and (3) implementing mandatory contractual safeguards to ensure that banks and functionally regulated subsidiaries are not overly exposed to affiliates and not dependent on parent SIFIs for employees or critical services that could be suspended in bankruptcy. These straight-forward changes will allow a distressed SIFI’s parent to fail in bankruptcy without causing the failure of its critical operating subsidiaries. There is no need for OLA.

The most transparent way to ensure that critical operating subsidiaries remain open and operating is to substantially increase minimum capital requirements at subsidiaries. The additional capital at operating subsidiaries should be required by law and imposed by functional regulators. Higher capital requirements should be complemented by modifying prompt corrective-action intervention thresholds so that regulators intervene and impose remedial measures while subsidiaries still have adequate capital to support their continued operations. These changes will ensure that critical subsidiaries maintain uninterrupted operations should a distressed parent holding company reorganize under bankruptcy protection. Because the SIFI’s functional subsidiaries will remain solvent beyond question, nonbank subsidiaries will retain access to capital-market financing and insured depositories will be eligible for *normal* liquidity borrowings from the Federal Reserve.³

Under this alternative approach, capital requirements at the parent holding company need not be increased as mandated by Dodd–Frank. In fact, minimum capital requirements at parent BHCs could be reduced or even eliminated entirely if the SIFIs’ critical subsidiaries are required to be highly capitalized at all times on their own account.

Parent holding companies should be allowed to fund the new higher subsidiary equity capital requirements from the proceeds of debt issuance at

the parent holding company without the constraint of meeting strict minimum regulatory capital requirements at the consolidated BHC level. Parent holding companies can be as resilient or as fragile as their shareholders choose without any adverse systemic risk consequences, provided that their critical operating subsidiaries are required to maintain “fortress” balance sheets.

Should a parent holding company fail, it must be liquidated or reorganized in bankruptcy. There must be no “special” alternative resolution mechanism that allows the possibility that some creditors or counterparties may receive special protections, or TBTF will continue to be problematic.

This transparent alternative approach will accomplish the goals of Title II using *bankruptcy* without the need for OLA, but it will not remove TBTF investor expectations. Contrary to political folklore, TBTF expectations are not solely caused by the impossibility of safely reorganizing or liquidating a SIFI in bankruptcy.

TBTF expectations and implicit taxpayer subsidies arise when regulators expand explicit bank deposit insurance guarantees beyond legal limits, or take emergency actions that prevent some—but not all—financial institutions from failing. Such actions protect the uninsured creditors in some financial institutions, but not others, and without imposing a fair-market tariff for the additional government protection.

History shows that, should a *large* bank fail, the FDIC bank resolution process will inevitably protect all bank depositors. However, when a *small* bank fails, the same bank resolution process may impose losses on large uninsured deposit accounts. This facet of the bank resolution process effectively creates two different classes of deposit insurance protections: a small bank insurance system that protects all deposits under the legal limit, and a large bank insurance system that protects even the largest deposit accounts. Given this reality, it is not surprising that the largest banks have an advantage when attracting large deposits.

Moreover, the FDIC’s existing bank resolution process is virtually *designed* to create new TBTF institutions. The FDIC’s legal mandate to perform “least cost” resolutions ensures that, should there be a willing buyer, a large failing bank will be sold intact, usually with an agreement for the deposit insurance fund to absorb some portion of a failing bank’s losses. In such a transaction, insurance coverage is

extended to all depositors, not just to those insured under the legal limit, and the acquiring bank is virtually guaranteed to be a large bank or BHC.⁴

This flawed deposit insurance bank resolution process remains fully intact after Dodd–Frank.⁵ Moreover, if an OLA-SPOE liquidation is implemented instead of a deposit insurance bank resolution, *all* creditors of the failing SIFI’s bank subsidiary will be fully protected—not just the bank’s depositors. The SPOE strategy recapitalizes failing bank subsidiaries using holding company money in an OLA “liquidation” and thereby protects all bank creditors from loss. Thus, OLA-SPOE creates a new avenue through which the government protects the liabilities of a select group of the largest financial institutions. Because OLA permits the government to treat similarly situated creditors of different institutions that provide comparable financial services differently, the OLA-SPOE “solution” actually reinforces the TBTF problem.

In addition to investor perceptions that the largest banks enjoy virtually unlimited deposit insurance and potentially other creditor protections, investors also understand the inherent conflict created by a system that places supervisory authority over the largest financial institutions in a single consolidated regulator that is also the lender of last resort and the primary agency responsible for maintaining financial stability. This mix of regulatory responsibility encourages the belief that the entire capital and liquidity resources of a consolidated entity—including access to Federal Reserve System liquidity—will be available to protect SIFI creditors and counterparties from loss. Unfortunately, the Federal Reserve’s actions taken before and during the prior financial crisis fully justify such expectations.

Dodd–Frank redoubled the Federal Reserve’s supervisory powers and assigned it a new “heightened prudential” duty to ensure that the likelihood of failure is especially remote for the largest BHCs and designated nonbank SIFIs. Given the FRB’s expansive new regulatory powers and its operational history, it is difficult to imagine how investors would reach any conclusion other than that SIFI institutions are TBTF.

The importance of these issues should not be underestimated. The TBTF problem will not be solved by merely eliminating Title II and replacing it with heightened capital requirements on critical operating subsidiaries. To end TBTF, Congress must also (1) reform the FDIC’s bank resolution process to

require it to break up large failing banks in the resolution process,⁶ and (2) reorient financial regulation away from the FRB and remove or significantly curtail its current powers over consolidated capital regulation and supervision.

BHC ORGANIZATIONAL STRUCTURE AND SPECIAL SUBSIDIARY STATUS

This section provides an overview of the basic corporate structure used by all of the largest banking institutions in the U.S., and the normal protocols that apply when the parent corporation or one of their subsidiaries become financially distressed.

Most U.S. banks, including the largest financial institutions, are organized as BHCs.⁷ In addition, Dodd–Frank § 167(b)(1)(B) allows the FRB to require nonbank financial institutions designated by the FSOC to organize their systemically important financial activities under an intermediate financial holding company. An intermediate holding company has an organizational structure similar to that of a BHC, and it is subject to all the FRB’s BHC regulatory powers.

In a BHC corporate structure, a parent company holds the controlling interest in the equity shares of subsidiary corporations, which can include separately incorporated banks, functionally regulated companies (such as broker-dealers, futures commission merchants, and insurance companies), or other corporations involved in activities that are closely related to banking.⁸ Each of the parent’s subsidiaries is a standalone corporation that can issue their own equity and debt securities.

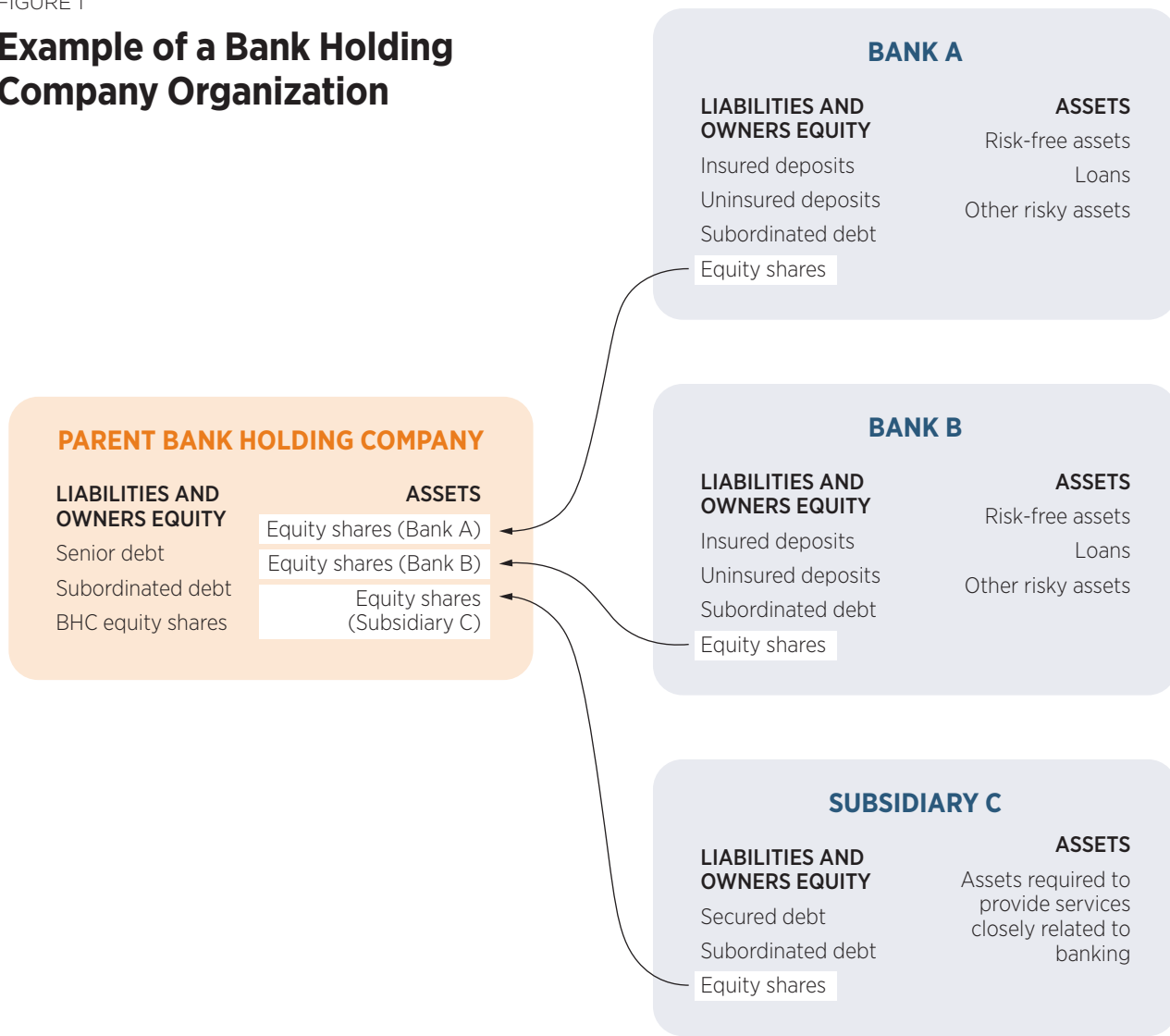
Chart 1 illustrates a simple stylized BHC structure. Subsidiaries are represented by Bank A, Bank B, and Subsidiary C. Subsidiary C could be a functionally regulated subsidiary, regulated by the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or a state insurance regulator.

The parent raises funds by issuing its own debt and equity securities. The parent uses the proceeds from issuing these securities to purchase the equity securities issued by its subsidiaries, to lend to its subsidiaries, or to invest in other affiliated firms. The parent also may guarantee the debt of its subsidiaries issued to outside investors or any derivative contracts into which the subsidiaries may enter.

Subsidiaries may also lend to the parent holding company, to other subsidiaries within the group, or even guarantee the debt issued by the parent or other subsidiaries.⁹ However, bank subsidiaries are

FIGURE 1

Example of a Bank Holding Company Organization



heritage.org

limited in their ability to lend or transact by Section 23A and Section 23B of the Federal Reserve Act. The restrictions are discussed in detail in a subsequent section, “TBTF Expectations and FRB Exemptions from Section 23A and 23B Rules.”

Within this organizational structure, subsidiaries of BHCs that are functionally regulated or deposit-taking institutions are special corporations in respect to their permitted activities, regulatory oversight, and their treatment in insolvency. Following is a brief overview of the special characteristics associated with banks, broker-dealers, and insurance companies.

Deposit-taking institutions—commercial banks, thrifts, and savings and loans institutions—are subject

to extensive regulation at both the state and federal level.¹⁰ Only banks can issue insured deposits and access Federal Reserve System discount window liquidity without penalty should they be well-capitalized and hold high supervisory ratings.¹¹ Should a bank become financially distressed and unable to meet current payment liabilities or become undercapitalized by regulatory minimum standards, or otherwise be shown to operate in an unsafe and unsound manner, it is required to comply with regulatory cease-and-desist orders that mandate remedial action. Should the bank fail to comply or remedy identified issues, it can be closed by its primary regulator and be liquidated using a special administrative process managed by the FDIC.¹²

If a subsidiary bank of a BHC should become undercapitalized or experience financial distress, the BHC powers of the FRB can also impact the bank recovery or resolution process. In particular, the FRB's source-of-strength doctrine can be used to encourage a BHC to interject capital into an undercapitalized depository subsidiary. The FRB's source-of-strength doctrine is important, controversial, and potentially a critical aspect of the SIFI resolution strategy articulated by the FDIC. For these reasons, I devote an entire section to its discussion ("The Federal Reserve Board Source-of-Strength Doctrine").

Registered broker-dealers are functionally regulated subsidiaries supervised by the SEC, registered exchanges, and the Financial Industry Regulatory Association (FINRA).¹³ Broker-dealers face minimum capital regulation and strict rules governing the management of their customer accounts. Should a broker-dealer fail to meet its minimum capital requirements, the SEC can require it to cease operations and force its liquidation. A broker-dealer will liquidate either in a distressed sale, under special rules that apply under Chapter 7 of the Bankruptcy Code, or under the provisions of the Securities Investor Protection Act (SIPA). Almost all broker-dealers are registered with the SEC and required to be members of Securities Investor Protection Corporation (SIPC), so most broker-dealer liquidations are conducted under SIPA rules and not under Chapter 7 of the Bankruptcy Code.

When a broker-dealer is liquidated, either in a Chapter 7 bankruptcy or in a SIPA liquidation, the goal is to protect and return its customers' securities and cash deposits. A court-appointed trustee will transfer customer accounts to a financially sound broker-dealer. Similar to insured depositories, broker-dealer insolvencies are settled using special legal rules that are designed to assign the highest priority to returning broker-dealer customer securities and cash deposits. A SIPA liquidation also includes limited insurance benefits.¹⁴ In a SIPA liquidation, securities in customer accounts are insured up to \$500,000, whereas cash deposits are insured up to \$250,000.¹⁵ Broker-dealer unsecured creditor claims have secondary priority, and there is no provision for using SIPA insurance (and no SEC emergency authority) that allows protection of broker-dealer creditors or shareholders from loss.¹⁶

Insurance companies are functionally regulated entities. Unlike banks and broker-dealers, insurance companies have no federal insurance charter

and no federal supervisory agency.¹⁷ Each insurance company's primary regulator is the insurance regulator in the state in which the company is chartered. Insurance can be sold across state lines but insurers must be licensed to do so. Depending on the state, regulators may not only regulate minimum solvency standards for insurers, they may regulate and approve policy terms, sales practices, and insurance products' premium rates.

An insurer's solvency is measured against a minimum regulatory solvency formula that provides a measure of an insurer's ability to pay policy claims. The solvency rules differ by the type of insurance underwritten, and solvency compliance is monitored by the insurer's home state regulator as well as by insurance rating agencies and the state insurance regulators in each state where the insurer is licensed to sell policies. Independent agency ratings for insurers are based on rating-agency assessments of the insurer's ability to pay policy claims, not on the insurer's ability to make timely payments on its unsecured debt obligations.

Regulators can impose corrective measures on insurers whom they deem to be in a hazardous financial condition even if the insurer exceeds required solvency standards. These corrective measures can, however, be challenged in court. Typically, regulators begin to impose corrective actions as an insurance company weakens but still meets regulatory solvency standards. If the regulatory actions do not return the insurer to financial health and its solvency condition continues to deteriorate, the regulator can negotiate a sale or merger of the troubled company or, failing this, can liquidate undercapitalized insurers.

In an insurance company liquidation, the home state regulator appoints a receiver to manage claims and sell the failed insurer's assets. The process is overseen by a state court. Licensed insurers are required to belong to separate state insurance guarantee associations for their property-casualty and life and health insurance businesses in every state in which they sell policies. In the case of liquidation, state guarantee associations insure policyholder claims up to a maximum claim value that varies by state.

Unless the OLA is invoked, a financially distressed SIFI parent holding company will be reorganized or liquidated in bankruptcy. As a consequence of the corporate separateness of the individual subsidiaries in the SIFI organization, and the limited liability of equity claims, subsidiaries can fail without causing a parent holding company failure, and the parent

holding company can also enter bankruptcy without causing the failure of a subsidiary.

Should a bank subsidiary fail and the parent BHC’s exposure be limited to its ownership of the failed bank’s equity shares, the holding company’s direct losses are limited to its equity investment. Under special circumstances, the parent holding company may be exposed to additional losses through enforcement of the FRB’s source-of-strength agreements. The circumstances under which these losses may occur are discussed in detail in the section, “The Federal Reserve Board Source-of-Strength Doctrine.” The parent holding company may also have indirect exposure if the failure of its bank subsidiary causes losses to the FDIC deposit insurance fund. Using its cross-guarantee power, the FDIC can assess the parent holding company’s surviving banks for the losses the bank insurance fund incurs in the bank resolution process. The Federal Deposit Insurance Company Improvement Act (FDICIA) does not allow the FDIC to assess the parent BHC directly for its insurance fund’s losses; the FDIC may only assess another bank that is under common control with the failed institution.

BHCs are special corporations in their own right, as they are subject to extensive Federal Reserve Board regulations under the 1956 Bank Holding Company Act (BHCA) and subsequent amendments. The BHCA was originally enacted to control geographic concentration of large bank groups, to prevent banking across state lines except in limited cases, to keep banking activities separate from commercial activities outside of limited exemptions provided in law, and to limit BHCs’ activities to businesses closely related to banking.¹⁸

BHCs are subject to comprehensive consolidated regulation and supervision by the FRB. The FRB has authority to determine BHCs’ permitted activities and investments, to approve applications for mergers and acquisitions, to set consolidated minimum-capital regulations, to impose inter-company credit exposure limits and to provide special exemptions from these limits, and more recently, the power to impose enhanced prudential standards of supervision and regulation on specially designated (large) BHCs and financial holding companies.

There are many historical instances in which the bank subsidiaries of a BHC were closed and liquidated in an FDIC resolution without a concurrent bankruptcy of the parent BHC. Similarly, there are many instances when BHCs entered bankruptcy

while their banks and other subsidiaries remained open and operating.¹⁹ The failure of a BHC subsidiary—whether a bank, a broker-dealer, or an insurance company—need not trigger a bankruptcy filing for the parent company, nor must the bankruptcy of a parent company trigger the liquidation of a subsidiary bank or functionally regulated corporation.

ORDERLY LIQUIDATION AUTHORITY

Section 203 of the Dodd–Frank Act authorizes the Secretary of the Treasury, with appropriate regulatory approval,²⁰ to begin the “orderly liquidation” of a covered financial company if, in the Secretary’s judgment, “the financial company is in default or in danger of default,”²¹ and the failure of the company and its resolution under any other federal or state law “would have serious adverse effects on the financial stability of the United States.” When prerequisite conditions are satisfied, the Secretary is authorized to take control of the financial company and appoint the FDIC as receiver with powers and duties enumerated under § 204 of the act.

The FDIC’s OLA powers are similar to the FDIC’s bank resolution powers under the Federal Deposit Insurance Act (FDIA) and its amendments. Among the powers granted to the FDIC is the power to charter a bridge financial institution to facilitate the SIFI liquidation. The bridge is exempt from regulatory capital requirements and all taxes (federal government, state, county, territory, municipality, or other local taxing authority). The bridge company charter expires after two years unless it is extended by the FDIC up to a maximum life of five years.

The FDIC may move any assets and liabilities from the receivership into the bridge financial company. The FDIC is prohibited from taking an equity interest or becoming a shareholder in the bridge holding company or any of its subsidiaries.

To provide temporary funding to the OLA receivership, Dodd–Frank establishes the Orderly Liquidation Fund (OLF). The OLF is a line of credit with the U.S. Treasury that allows the FDIC to pledge assets of the bridge to obtain funding.²² The Secretary of the Treasury must approve the FDIC’s strategy for liquidating receivership assets to repay OLF loan balances, including interest payments. The interest rate on an OLF loan will be set by the Secretary, but it must be at least as large as the prevailing interest rate on similar maturity corporate loans.²³

If the projected repayment schedule from the receivership liquidation plan fails to discharge the

OLF loan terms within 60 months of the loan initiation, the FDIC must impose a risk-based assessment on all BHCs with consolidated assets equal to or greater than \$50 billion and any nonbank financial company supervised by the Federal Reserve (that is, nonbank firms that have been designated as SIFIs).²⁴

Title II §§ 206–210 describe the FDIC’s OLA responsibilities.²⁵ When making recovery payments to the failed SIFI’s liability holders, the FDIC must abide by a specific claims priority. The highest claims priority is recovering any funds the FDIC borrowed from the OLF. The OLA also empowers the FDIC to treat similarly situated receivership creditors differently if doing so will prevent financial instability or maximize overall receivership recoveries, but disadvantaged claimants must receive a recovery at least as large as they would receive in Chapter 7 bankruptcy.²⁶

Dodd–Frank does not explain how these OLA powers will be used to resolve a failing SIFI without creating a financial crisis. The strategy for employing OLA powers is left to FDIC discretion, so it is important to understand how the FDIC will approach the resolution of a BHC SIFI should it be called on to use OLA.

FDIC SINGLE-POINT-OF-ENTRY APPROACH FOR RESOLVING A FAILING SIFI

In December 2013, the FDIC issued a *Federal Register* notice that outlined its SPOE strategy for conducting an orderly resolution.²⁷ The overriding goal of the SPOE is to keep the failing SIFI’s critical operating subsidiaries open and operating with adequate capital and liquidity to keep them out of their own bankruptcy or administrative resolution processes, and to avoid the need for asset fire sales.

In a joint paper on SIFI resolution policy,²⁸ the Bank of England and the FDIC have agreed that the key to achieving the orderly resolution of a SIFI without disrupting financial markets is to recapitalize SIFI operating subsidiaries to keep them open, liquid, operating, and out of competing insolvency proceedings.

The FDIC–Bank of England views regarding SIFI resolution are more widely shared among national financial regulators. In 2011, the Financial Stability Board (FSB)—an international organization of central banks and bank regulators empowered by the G-20 leaders to reform the international financial system—issued a report, “Key Attributes of Effective Resolution Regimes for Financial Institutions.” The report summarizes the G-20’s thinking on strategies

to resolve failing SIFIs and stresses the importance of “ensuring continuity of systemically important (or “critical”) functions.”²⁹

While specific details will vary across countries, the FSB argues that SIFI resolution is best accomplished using recapitalization strategies that: (1) impose first losses on SIFI shareholders; (2) convert unsecured and uninsured SIFI creditor claims into equity or receivership certificates; and (3) use the resources of the SIFI creditors left in receivership to absorb residual losses and recapitalize subsidiaries so they can continue to provide critical functions. The FDIC’s SPOE strategy is fully consistent with the FSB’s prescription for the orderly resolution of a distressed SIFI.

In a SPOE resolution, the FDIC will be appointed receiver of the top holding company in a BHC corporate group. The FDIC will then charter a bridge institution and transfer all holding company assets and secured liabilities to the bridge, including the company’s equity position in all subsidiaries.³⁰ The bridge will function as the new parent BHC, and the FDIC will appoint new management to operate the bridge and its subsidiaries.

The FDIC will leave the shareholders of the failed BHC parent, and most of the failed parent BHC’s unsecured liabilities, in the receivership. These claims will be converted into receivership certificates, so the bridge will have little debt when it is first formed. This transaction releases the value of shareholder and unsecured creditor positions in the parent BHC so it can be available to support the operations of the SIFI’s subsidiaries.

The SPOE approach for using OLA removes the parent BHC’s limited-liability protection, and holding company investors can be required to absorb losses that far exceed their equity investments in subsidiaries. In other words, when the secretary invokes OLA, it triggers a change in parent-company investor property rights under the unproven theory that expropriating the resources owned by the parent company’s investors and using them to protect creditors of the SIFI’s subsidiaries will protect the financial system from crisis.

The FDIC will then use the bridge institution to issue new debt, using the Dodd–Frank OLF if necessary.³¹ The proceeds will be used to recapitalize and liquefy distressed subsidiaries in order to keep them out of bankruptcy or receivership, and to allow them to meet investor-redemption demands without the need to engage in asset “fire sales.”

If the parent holding company has insufficient resources for the FDIC to expropriate, the FDIC will use taxpayer assistance in the form of an OLF loan to facilitate the SPOE resolution. To avoid using taxpayer funds, the FDIC and FRB have issued a proposal for new regulations that will mandate a minimum level of total loss absorbing capacity (TLAC) at parent holding companies. Because the design of TLAC requirements is an important issue for the SPOE approach, TLAC regulations are discussed in a subsequent section (“SPOE Requires New Minimum Total Loss Absorbing Capacity Regulations”).

CAN SPOE PREVENT SIFI DISTRESS FROM SPARKING A FINANCIAL CRISIS?

The theory behind the FDIC’s SPOE-OLA strategy is that the probability of triggering a financial crisis is minimized if the parent holding company resources can be used to keep the SIFI’s critical operating subsidiaries open and operating. To facilitate this plan, the FDIC must be able to assume ownership of a SIFI parent holding company’s assets, and there must be a legal avenue to raise new funds using these assets, and to downstream the proceeds to failing subsidiaries. There are a number of important issues that could prevent the FDIC from carrying out this plan.

First, consider a situation where a SIFI’s very large bank subsidiary is in danger of default. For the Secretary of the Treasury to invoke OLA and appoint the FDIC receiver of the parent SIFI, the parent also must be in danger of default. In 2015, Peter Wallison and I analyzed data on the largest banks and their parent SIFI BHCs and concluded that, should the largest banks in the U.S. suffer losses that wipe out their total equity positions, very few parent BHCs would suffer a loss that would trigger their insolvency.³² The analysis raises the seemingly unforeseen possibility that large and important operating subsidiaries could be in danger of default, and that OLA-SPOE strategy would not be an available option.

Critics of this analysis argue that the Federal Reserve Board would use its source-of-strength power to require the parent BHC not only to bear the loss of its equity investment in the bank subsidiary, but also to fully recapitalize the failing bank.³³ If the parent could not comply with the FRB source-of-strength recapitalization order, the Secretary could consider the parent to be in danger of default and invoke OLA. The Federal Reserve’s source-of-strength doctrine plays a key role in the arguments of those that claim

that OLA and SPOE will almost certainly be an option should a large depository institution fail.

The legislative and judicial history shows that the Federal Reserve’s source-of-strength powers have limits. The parent holding company need not agree to guarantee a prompt corrective-action recapitalization plan for its failing bank subsidiary, and even if it does, its loss exposure is limited to, at most, an additional 5 percent of the value of the subsidiary bank’s assets. While this could be a large loss, in most cases, the analysis in Kupiec and Wallison shows that the largest SIFI BHCs have sufficient capital to absorb this additional loss without becoming insolvent.

If the OLA cannot be invoked because the parent BHC is not in danger of default, the FDIC will be forced to resolve the failing bank subsidiary using its FDIA bank resolution powers. In the case of large banks, this nearly always entails a whole bank purchase and assumption sale, perhaps with an FDIC loss-share agreement. In other words, the FDIC will sell the large failing bank intact to a larger healthier BHC, fully protecting uninsured depositors and often agreeing to absorb a large share of the losses on the failing institution’s nonperforming assets. The discussion in a subsequent section, “Should Investors Think Large BHCs and Nonbank Designated Intuitions are TBTF?” highlights this type of transaction as a major factor that reinforces investor exceptions of TBTF because it protects all bank deposits, including those over the insurance limit.

Should a large, critically important nonbank subsidiary be in danger of default, the probability that the Secretary would authorize an OLA-SPOE resolution may also be remote. There is an inherent conflict of interest that may prevent the FRB from allowing the failure of an entity under its heightened prudential supervision. An important factor limiting the use of OLA-SPOE is the real possibility that the FRB will allow a SIFI’s bank subsidiary to provide emergency liquidity support to a distressed nonbank affiliate to keep the nonbank affiliate from failing. The FRB has allowed this type of support in the past, and there is nothing in the Dodd–Frank Act that prevents it from happening again.

In the last financial crisis, critical nonbank financial firms ultimately failed because of severe liquidity stress. Investors refused to roll over short-term loans to Bear Stearns and Lehman Brothers. The immediate cause of default or near default of these firms was not a regulatory capital deficiency, but a failure to attract sufficient short-term market funding.

As shown below (“TBTF Expectations and Federal Reserve Exemptions from Section 23A and 23B Rules”), in the last financial crisis, the FRB granted temporary exemptions from Section 23A and 23B rules to allow BHC bank subsidiaries to provide exceptionally large amounts of credit to their distressed nonbank affiliates. Neither Lehman nor Bear Stearns were given such exemptions.³⁴ The FRB’s ability to grant Section 23A and 23B waivers has not been eliminated in Dodd–Frank. It is not beyond imagination to think that the FRB would use a future waiver to allow a Federal Reserve-supervised SIFI to fund its nonbank subsidiaries using an exceptional amount of credit from a bank affiliate.

Should the Federal Reserve not intervene and allow a critical nonbank SIFI subsidiary to fail, unlike in the case of a failing bank subsidiary, bank-style prompt corrective rules may not apply. Functionally regulated nonbank subsidiaries are not yet subject to banks’ prompt corrective-action laws. Nor does Dodd–Frank explicitly include FRB source-of-strength power over nonbank functionally regulated subsidiaries. However, some have argued that Dodd–Frank does implicitly empower the FRB to require a SIFI to inject new capital to support a nonbank subsidiary.

The Dodd–Frank Act empowers the FRB to require a parent holding company to be a source of strength to the intermediate holding company, but there is no requirement that a BHC or an intermediate holding company be a source of strength to a failing nonbank subsidiary. However, the act does grant other regulatory powers that may allow the FRB to assert source-of-strength powers relative to nonbank subsidiaries, but these powers are not yet developed.³⁵ (This issue is discussed at length in the following section, “The Federal Reserve Board Source-of-Strength Doctrine.”)

Suppose the failure of one or more operating subsidiaries does put the parent holding company in danger of default, and the OLA can be invoked. Will the SPOE be able to inject capital into these subsidiaries to prevent their failure from causing a financial crisis? The answer depends on the type of SIFI operating subsidiaries that have become financially distressed.

In the case of a distressed subsidiary bank, there is an important legal issue that may be problematic. The language in Dodd–Frank clearly indicates that Congress never intended that OLA be used to recapitalize a failing bank. OLA is concerned solely with

the *liquidation* of failing nonbank financial institutions. The word “recapitalization” does not appear anywhere in Dodd–Frank; § 214(a) even explicitly says, “All financial companies put into receivership under this title shall be liquidated.”³⁶

Moreover, Title II explicitly states that its provisions do not apply to banks. Dodd–Frank § 201(a)(8)(B) states that the “term ‘covered financial company’...does not include an insured depository institution,” and § 201(a)(9)(A) says, “The term ‘covered subsidiary’ means a subsidiary of a covered financial company, other than...an insured depository institution.” Based on this explicit language, it is questionable whether FDIC actions taken to recapitalize a failing bank subsidiary using OLA authorities would prevail under a judicial challenge.

Other specific language in Title II also indicates that OLA was not intended to apply to banks. The OLA mandatory claims priority (§ 210(b)(1)), for example, does not mention bank deposits or insured deposits. Moreover, § 210(n)(8)(i) expressly prohibits the FDIC from using the OLF “to assist the Deposit Insurance Fund.” A SPOE-based bank recapitalization clearly “assists” the Deposit Insurance Fund (DIF) if it recapitalizes a failing bank subsidiary and consequently would appear to be prohibited in a Title II liquidation.³⁷ The explicit prohibition against using the OLF to favor the DIF could perhaps explain the priority that regulators have placed on imposing new minimum TLAC rules.

Notwithstanding the uncertain legal basis for using OLA to recapitalize failing bank subsidiaries, the FDIC’s public proposal to implement OLA using the SPOE strategy suggests that the FDIC will likely ignore the legal issues raised in this section. Should the SPOE be available to recapitalize a failing bank, the government will have a new option. On a case-by-case basis, the government can decide to impose bank-subsidary losses on either a bank’s creditors using an FDIA resolution, or on BHC creditors using the SPOE strategy. This option introduces an entirely new source of systemic risk.

The “resolution risk” created by the possibility of using SPOE to recapitalize a failing bank will create new liquidity stresses in the next financial crisis. Investors will be reluctant to fund either the parent BHC or their subsidiary banks if lenders are uncertain which lending channel could expose them to resolution loss. This source of systemic liquidity risk did not exist in the prior crisis; it has been newly created by the OLA-SPOE approach for SIFI resolution.

THE FEDERAL RESERVE BOARD SOURCE-OF-STRENGTH DOCTRINE

Writing in *Banking Perspectives*, Gregory Baer, former senior counsel at the Federal Reserve Board, and Assistant Secretary of the Treasury, characterizes the FDIC’s SPOE strategy as “the final step in implementing the source of strength doctrine that the Federal Reserve Board has enunciated for decades.”³⁸ While the source-of-strength doctrine may have motivated the SPOE approach for SIFI resolution, there are important unsettled questions about the limits of the FRB’s source-of-strength powers that are essential to understanding whether an OLA-SPOE strategy is likely to be available as a SIFI resolution option.

The source-of-strength doctrine is rooted in the Federal Reserve Board’s power to approve mergers and acquisitions under the 1956 Bank Holding Company Act.³⁹ In approving (or disapproving) a BHC application, § 3(c)(1)-(2) requires the FRB to consider (1) “the financial history and condition of the company or companies and banks considered; and (2), their prospects.” The FRB interpreted this requirement as congressional empowerment to determine, on a case-by-case basis, the minimum capitalization condition that is acceptable to approve a BHC application.

In 1976, the FRB rejected an application by First Lincolnwood Corporation to establish a BHC for the purpose of assuming control of the shares of a bank. The owners of the bank and the shareholders of the prospective BHC had borrowed to buy the controlling shares in the bank. In the process of reorganizing their controlling ownership through a BHC, the applicants wanted to replace the personal debt they had incurred to purchase the bank shares with BHC debt. The FRB rejected this application arguing that the holding company would have high indebtedness which could inhibit it from assisting the BHC’s bank subsidiary should the bank experience difficulties.

The FRB’s First Lincolnwood decision was appealed, and the court ruled against the FRB. The court argued that the transaction under consideration did not change the financial condition of the bank. This ruling in favor of Lincolnwood was subsequently overturned on appeal by the Supreme Court. The Supreme Court’s ruling established that the FRB had the undisputed legal power to require additional capital as a condition for approving a BHC application.⁴⁰

In 1984, the FRB revised its Regulation Y, adding a requirement that “a bank holding company should serve as a source of strength for its bank subsidiaries, and conduct its bank and nonbank operations in accordance with sound banking policy and practice.” The FRB justified this regulation by virtue of its power to set holding company capital from § 3(c)(2) of the BHCA, and its power granted by the Financial Institutions Supervisory Act (FISA) to issue cease and desist (C&D) orders to stop unsafe and unsound banking practices.

In 1987, the FRB issued a C&D order for unsafe practices to Hawkeye Bancorp because Hawkeye had failed to contribute capital to a failing bank subsidiary. Since the bank was taken into receivership before the FRB acted, the order was subsequently withdrawn, but the FRB publically reaffirmed its policy requiring BHCs to provide financial assistance to distressed bank subsidiaries.

In 1988, the Federal Reserve Board issued a C&D order for unsafe and unsound banking practices against MCorp because MCorp failed to inject additional capital into its failing bank subsidiaries. The FRB required MCorp to submit a capital plan in which “all of MCorp’s available assets are used to recapitalize the Subsidiary Banks that are suffering capital deficiencies.”⁴¹

Subsequently, a number of MCorp banks were put into receivership, and the FRB filed additional C&D orders alleging that MCorp had violated Section 23A of the Federal Reserve Act. MCorp petitioned a district court to enjoin the FRB’s C&D actions. The district court ruled in favor of MCorp, and the FRB appealed the decision.

The Fifth Circuit court was decisive in rendering an opinion on appeal. The court’s opinion first argued that the FRB’s power to require additional capital applies only in the holding company application approval process:

The BHCA does not grant the [Federal Reserve] Board authority to consider the financial and managerial soundness of the subsidiary banks after it approves the application, and First Lincolnwood finds this regulatory authority lacking in the day-to-day operations of a subsidiary bank. For these reasons, we conclude that the Board is without authority under the BHCA to require MCorp to transfer its funds to its troubled subsidiary bank.⁴²

The second notable aspect of the appellate court decision involves the FRB's claim that safe and sound banking practices require a BHC to inject additional capital into a failing bank subsidiary. In a clear rejection of the FRB's interpretation of "safe and sound banking practice," the court wrote:

Enforcement of the Board's source of strength regulation requiring MCorp to transfer MCorp's funds to the troubled subsidiary banks can hardly be considered a "generally accepted standard...of prudent operation." Such a transfer of funds could require MCorp to disregard its own corporation's separate status; it would amount to a wasting of the holding company's assets in violation of its duty to shareholders.⁴³

This strongly supports MCorp's argument that Congress never intended to grant authority to the Federal Reserve Board to require a holding company to inject capital into subsidiary banks as a safeguard against "unsafe and unsound" practices.⁴⁴

The FRB appealed the decision to the Supreme Court. The Supreme Court reviewed the case and ruled that the district and appeals courts did not have jurisdiction to enjoin the FRB's actions. The Supreme Court's technical dismissal of the lower courts' decisions nullified the clear legal ruling against the FRB's interpretation of its source-of-strength powers. Unfortunately, the Supreme Court ruling did not speak to the merits of the MCorp complaint. Consequently, the legal limits to the FRB's source-of-strength powers remained an unsettled legal issue.

Following the savings and loan crisis of the late 1980s, the FRB's strategy for imposing its source-of-strength doctrine changed as new legal tools became available. In 1991, Congress passed FDICIA, which included new prompt-corrective-action regulatory powers. Prompt-corrective-action legislation requires that undercapitalized depository institutions submit an acceptable capital restoration plan to their primarily federal regulator. For the plan to be acceptable, the law requires that

each company having control of the institution has—(I) guaranteed that the institution will comply with the plan until the institution has been adequately capitalized on average during each of the 4 consecutive calendar quarters; and (II) provided appropriate assurances of performance.⁴⁵

While regulators must require appropriate assurances from the holding company for the capital resolution plan to be acceptable, holding companies may choose to withhold filing a capital restoration plan or, should they file a plan, they may exclude an explicit holding company guarantee.

Should a holding company provide an explicit enforceable guarantee, FDICIA explicitly limits the holding company's exposure to the lesser of: (1) 5 percent of the distressed institution's assets measured at the time the guarantee is made; or (2) the amount needed to bring the institution into compliance with minimum capital standards.⁴⁶ Moreover, the regulator cannot require a company other than the company that controls the depository institution to guarantee the capital restoration plan, nor can the regulator require any nonbank subsidiaries or affiliates of the holding company to submit to a capital restoration plan.⁴⁷

Prompt corrective legislation places explicit limits on the support that a parent holding company must supply to its failing bank subsidiaries. The statute also explicitly rules out prompt-corrective-action capital-restoration-plan powers for nonbank holding company subsidiaries and affiliates.

In addition to prompt corrective action, Congress made changes to the bankruptcy code that gave priority to any holding company commitments made to a federal regulator for the purpose of maintaining the capital of its insured depository institutions. However, the ability to enforce BHC capital-restoration-plan commitments has been mixed in holding company bankruptcy cases. Courts sometimes uphold, and sometimes dismiss, regulatory claims against holding company bankruptcy estates based on implied holding company "commitments" made in capital restoration plans or in memorandum of understanding (MOU) agreements for settling FRB C&D orders mandating holding company source-of-strength support.

A recent bankruptcy case testing these authorities further demonstrates the limits of the FRB's power to enforce a source of strength capital maintenance agreement in a holding company bankruptcy. Unless these agreements are clear and explicit, and linked directly to a holding company application approval or to a prompt-corrective-action capital-restoration guarantee, they are unlikely to be binding in bankruptcy. In the Colonial BancGroup bankruptcy, the court held that each of the documents that claim to establish a claim against the bankruptcy estate:

requires the Debtor to assist the Bank in complying with the Bank MOU or the Bank C&D, whether by “taking steps designed to ensure that the Bank complies,” or by utilizing “its financial and managerial resources to assist” the Bank, or by taking “appropriate steps to ensure that the Bank complies.” The documents do not require the Debtor to comply on behalf of the Bank or impose liability on the Debtor in the event the Bank fails to reach the required capital ratios. In other words, the language in the documents does not make the Debtor either primarily or secondarily liable for the Bank’s obligations.⁴⁸

The language is broad and general and requires only that the debtor “assist” the bank. The language does not specify any particular method of assistance or prescribe specific steps that the debtor must take. The language does not dictate what financial and managerial resources the debtor must utilize. Nor does it require the debtor to serve as a guarantor of the capital ratios or to pledge any assets to secure any capital deficiency. Most important, the language does not require the debtor to make a capital infusion, in any amount, in the bank.

The court review did not find that the holding company had made a commitment within the meaning of 11 U.S. Code § 365(o). There are cases in which courts have found evidence of commitment, but the commitment language in those cases differs from the language in the Colonial BancGroup documents. In addition, the circumstances under which those commitments were made differ as well. In three cases, commitments were made as a condition of approval of an acquisition. A fourth case that finds commitment involves the prompt-corrective-action statute.

Legislation and case law suggest that, prior to the implementation of Dodd–Frank, there were limits on the FRB’s ability to require holding companies to inject capital into failing bank subsidiaries. The courts have established that the FRB has the legal power to set BHC-specific capital requirements in the BHCA application-approval process. If, in the context of an MOU addressing the prompt-corrective-action capital-restoration plan for a bank subsidiary, a holding company clearly and unambiguously agrees to guarantee a capital injection, then the holding company owners can be on the hook for injecting capital, even if the holding company subsequently declares bankruptcy.

But even when there is an enforceable prompt-corrective-action capital-restoration-plan guarantee, the law places clear limits on the parent holding company’s exposure. Moreover, there is no requirement that the holding company sign a guarantee agreement. It can submit a capital-restoration plan with an ambiguous unenforceable statement of support if the regulator finds it acceptable. There is no law or legal case that supports the claim that the FRB has the power to *require* a BHC to inject *unlimited* amounts of capital into a failing bank subsidiary. The limited nature of the source-of-strength doctrine is potentially an important issue that might make OLA unavailable in many cases.⁴⁹

Prior to the passage of Dodd–Frank, the FRB’s source-of-strength powers were not explicitly granted in law, but engineered by the FRB’s legal interpretation of its approval powers under the BHCA and its power to issue C&D orders under FISA. In 2010, Congress explicitly recognized the FRB’s source-of-strength power in Dodd–Frank Title VI § 616, where “source of financial strength” is defined as “the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution.”

Section 616 does not provide any clarity on the limits of the FRB’s source-of-strength power. The words “ability to provide financial assistance” do not imply *the obligation* to recapitalize a subsidiary depository regardless of the cost to the parent. Congress could have given the FRB authority to require a BHC to recapitalize a failing bank subsidiary, but it did not; § 616 simply endorses the source-of-strength doctrine without clarifying the limits of this power.

The language in § 616, moreover, explicitly restricts the use of the source-of-strength doctrine to the support of subsidiary depository institutions. Section 616(d) states:

The appropriate Federal banking agency for a bank holding company or savings and loan holding company shall require the bank holding company or savings and loan holding company to serve as a source of financial strength for any subsidiary of the bank holding company or savings and loan holding company that is a depository institution.

Contrary to what some scholars may have written, the Dodd–Frank language does not explicitly recognize source-of-strength powers for non-depository subsidiaries or affiliates of BHCs or thrift or savings and loan holding companies.⁵⁰ Dodd–Frank does not extend the FRB’s source-of-strength powers to non-bank subsidiaries or affiliates except in the specific case of an intermediate financial holding company.

Section 167 gives the FRB the authority to require nonbank SIFIs designated by the FSOC to place their financial activities in an intermediate holding company that will be supervised by the FRB. This intermediate holding company is subject to all FRB rules and regulations that apply to BHCs under the BHCA and its amendments. Section 167(b)(3) requires the parent nonbank SIFI to act as a “source of strength” to its intermediate holding company. Similarly, § 626(b)(1) gives the FRB the power to require a unitary thrift or savings and loan holding company to place its financial activities under an intermediate financial holding company, and § 626(b)(3) requires that a parent holding company act as a source of strength to its intermediate holding company.

Notwithstanding FRB powers granted by § 167 and § 626, there is no explicit requirement in Dodd–Frank that a BHC or an intermediate holding company act as a source of financial strength to a subsidiary unless the subsidiary is a depository institution.⁵¹ However, § 166 allows the FRB to issue prompt corrective rules that apply to nonbank affiliates of BHCs and nonbank designated SIFIs, and such rules could include capital restoration plans and language with source-of-strength provisions.

Section 166 requires the FRB, in consultation with other regulatory agencies, to prescribe prompt-corrective-rules action to provide, “early remediation of financial distress of a nonbank financial company supervised by the Board of Governors or a bank holding company described in section 165(a).”⁵² Such rules could include source-of-strength provisions as well as other intrusive remedial powers. However, to the best of my knowledge, the FRB has not promulgated any prompt-corrective-action rules for the nonbank SIFIs or large BHCs that are subject to its heightened supervision regime.

Thus, at present, there is no explicit Dodd–Frank language or FRB regulation that grants or asserts FRB power to require a BHC or intermediate financial holding company to be a source of strength to a non-depository subsidiary institution. However, history suggests that, should it find the need for such

a power in the future, the FRB would likely use its § 166 powers and issue prompt-corrective-action regulations that include source-of-strength powers over nonbank affiliates. But even then, as in the case of BHC bank subsidiaries, case law suggests that there will be limits on the FRB’s ability to require a parent to make capital injections into a failing nonbank subsidiary. If source-of-strength power is ever invoked for a nonbank subsidiary, the issue will almost certainly be litigated, and the courts will again be asked to interpret the limits that apply to the FRB’s source-of-strength power.

To date, the FRB has only limited ability to require a parent BHC to recapitalize its failing bank subsidiaries, and no explicit power to require recapitalization of nonbank subsidiaries. Granting the FRB discretionary powers to pierce parent company limited liability and corporate separateness by requiring parent companies to recapitalize any subsidiary regardless of loss would be a major change in U.S. corporate law. The courts have not yet accepted such an interpretation, and there is no language in Dodd–Frank that overturns the source-of-strength limits that have been set by the courts.

SPOE REQUIRES NEW MINIMUM TLAC REGULATIONS

For the OLA-SPOE strategy to work without OLF borrowing, the parent holding company must have sufficient resources available for the FDIC to expropriate and use to recapitalize critical operating subsidiaries in the resolution. To ensure that the parent has sufficient resources, the FDIC and FRB have proposed new regulations to require BHC SIFIs to meet minimum total loss absorbing capacity (TLAC) requirements.

While the U.S. regulators had not released a notice of proposed rulemaking for U.S. TLAC regulations at the time this was written, an FSB consultative document provided a rough outline for subsequent U.S. TLAC rules.⁵³ TLAC represents resources that are available at the parent holding company that can be used to provide capital and funding for subsidiaries should the parent holding company face severe financial distress.⁵⁴

The FSB proposal would require global systemically important banks (G-SIBs) to meet and maintain new minimum TLAC standards. Under this proposal, G-SIBs may be required to issue substantial amounts of unsecured debt that can be converted into equity to avoid bankruptcy in a bail-in strategy,⁵⁵ or converted into receivership certificates in a

regulator-administered resolution process. In certain specific instances, the TLAC proposal calls for parent companies to issue TLAC debt and re-lend the proceeds to critical subsidiaries so that this debt can be converted to equity, or be forgiven by the parent company should the subsidiary need to be recapitalized.⁵⁶

In the FSB proposal, G-SIB TLAC is comprised of equity and external debt issued by the parent holding company provided the debt is unsecured, subordinated to most other claims, and has a remaining maturity of at least one year. The FSB recommends a TLAC requirement in the range of 16 percent to 20 percent of risk-weighted assets, with an absolute TLAC floor of twice the Basel III leverage ratio.⁵⁷ The final calibration of minimum TLAC requirements is left to the discretion of national supervisory authorities.

According to the FSB, the objective of the TLAC requirement is:

[T]o ensure that the G-SIBs have the loss absorbing and recapitalization capacity necessary to help ensure that, in and immediately following a resolution, critical functions can be continued without taxpayers’ funds (public funds) or financial stability being put at risk.⁵⁸

Moreover, the FSB believes that:

TLAC, in conjunction with other measures should act to remove the implicit public subsidy from which G-SIBs currently benefit when they issue debt and incentivize creditors to better monitor G-SIBs’ risk taking.⁵⁹

There are many ways a G-SIB might alter its capital structure and investments to satisfy the FSB’s TLAC proposal. For example, the parent company of a TLAC resolution group might issue TLAC-compliant debt and invest the proceeds in low-risk assets. Alternatively, the parent might issue TLAC-compliant debt and lend the proceeds to a subsidiary bank, which in turn will determine how to use the proceeds.

In a related paper, I analyze the impact of alternative strategies that a BHC might employ in order to comply with the FSB-proposed TLAC rules.⁶⁰ Using an equilibrium-asset pricing model to analyze the economic consequences of alternative strategies, I show that the efficacy of a minimum TLAC regulation depends not only on the amount of TLAC debt securities the parent holding company is required to

issue, but also on how the proceeds from the issuance of new TLAC debt are employed within the BHC.

If the proceeds from new TLAC debt issuance are retained at the parent holding company and invested in activities independent of the holding company’s subsidiary activities (for example, if the parent invests in Treasury bills), the increase in TLAC need not reduce the BHC’s TBTF implicit interest rate subsidy. For example, the assets that the parent company buys using the proceeds of the required TLAC debt issue may strengthen the financial condition of the parent holding company and make it more difficult to invoke OLA should a subsidiary bank become financially distressed.⁶¹

In order for a TLAC rule to meet the goals of Dodd-Frank (ending TBTF) and the FDIC’s SPOE strategy (keeping critical operating subsidiaries open and operating), the rule must require TLAC debt at each critical subsidiary that authorities intend to keep open and operating; it cannot just require TLAC debt at the parent holding company. Moreover, the TLAC regulations must also include restrictions on how subsidiaries use the proceeds from their new TLAC debt. In order to reduce the TBTF subsidy and increase the probability that critical subsidiaries remain open and operating should the parent become financially distressed, the subsidiary’s TLAC debt proceeds must be invested in very-low-risk assets or be used to replace insured deposits in the subsidiary bank. If the TLAC proceeds are used to replace existing external uninsured bank liabilities, the TLAC regulation will not diminish the bank’s implicit funding subsidy.

The results show that an effective TLAC rule must require: (1) a sufficient volume of parent TLAC; (2) that the proceeds from the parent TLAC issues be used to fund an equivalent total amount of TLAC debt issued by critical operating subsidiaries, including all depository subsidiaries (back-to-back TLAC); and (3) that the proceeds from subsidiary TLAC debt either (a) replace insured deposit funding, or (b) be invested in risk-free assets. These requirements are needed to accomplish the stated twin goals of removing the TBTF subsidy and keeping subsidiaries open and operating. A TLAC rule that satisfies these conditions is economically equivalent to increasing the regulatory capital requirement (the required minimum equity-asset ratio) at the BHC’s critical operating subsidiaries and all depository subsidiaries.⁶²

The alternative solution of raising minimum equity capital requirements at subsidiary banks

and functionally regulated subsidiaries is far simpler and refreshingly transparent compared to the DFA-OLA-SPOE-TLAC solution. To accomplish the same job, Dodd–Frank requires: (1) enhanced consolidated capital requirements for large BHCs and designated SIFIs; (2) intrusive, imprecise, and expensive annual FRB stress tests; (3) new expansive FRB examination powers that duplicate examinations already conducted by functional regulators; (4) a new TLAC requirement for designated parent SIFIs that also must include subsidiary TLAC requirements and asset-investment restrictions; (5) a new administrative resolution scheme that the government can elect to use (but is not required to use); and (6) new powers that allow the government to select, on a case-by-case basis, which investors suffer a loss when a large financial institution fails.

The solution of heightened regulatory capital for subsidiary banks and critical functionally regulated affiliates will, of course, be unappealing to bankers, because it will reduce the implicit safety net subsidies they enjoy. The simplicity of this alternative capital approach is also likely to be unappealing to regulators, given their revealed preference for regulatory complexity and supervisory discretion.

To meet these new heightened subsidiary-capital requirements, parent holding companies should be allowed to borrow the funds just as they would if they were forced to issue TLAC-qualifying debt. But in the alternative approach of imposing higher regulatory capital requirements on the SIFI operating subsidiaries and not the parent, the capital (and loss-bearing) capacity of the critical banks and other subsidiaries are transparent in all states of the economy without any complications associated with debt conversion in a bail-in, or SPOE-TLAC in the OLA approach. Moreover, allowing BHCs to borrow the necessary funds to meet these new higher minimum regulatory requirements for subsidiaries preserves the BHCs' debt-finance tax benefit since tax liability is calculated on a BHC's consolidated income.

ORIGINS OF “TOO BIG TO FAIL”

The prior sections have discussed how a simple set of alternative capital regulations can replace the complex, messy, and expensive OLA mechanism imposed by Dodd–Frank. These changes alone are unlikely to eliminate TBTF subsidies. The TBTF problem is the consequence of a wider set of issues than those associated with Dodd–Frank's Title II.

The TBTF problem arises when investors believe that the government will take special measures to forestall the failure of some financial institutions, but not others, even though these institutions provide nearly identical financial services. The TBTF problem is also created when there is the possibility that, should financial institutions fail, the creditors and counterparties of some large financial institutions will be protected by special government measures that shield them from losses while the creditors and counterparties of smaller financial institutions offering similar financial services will not be protected by the government. When investors believe that the government will provide creditors of large institutions protections without imposing an explicit fair-market charge for the protection, the government creates a TBTF problem.

When investors treat the liabilities of SIFI institutions as if they have an implicit government guarantee, they behave as if the government—not the investor—will absorb the risk if a SIFI experiences a large loss. Consequently, investors do not charge the SIFI the full interest rate that is justified by the SIFI's risk profile. The SIFI enjoys an interest-rate subsidy because, correctly or incorrectly, investors believe that the government will protect them from loss should the SIFI experience losses that threaten its solvency.

The TBTF implicit subsidy creates a situation where SIFI shareholders' gain at taxpayer expense. When investors believe that the government will take measures to keep a SIFI open and operating even when it faces extreme losses, the belief indirectly encourages the SIFI's management to take on additional risk. Since the SIFI does not pay a fair price for this government protection, shareholders get to keep outsized positive returns while the government shifts outsized losses to the taxpayer and, all the while, the SIFI makes risky investments and funds them with artificially low borrowing costs.

The implicit government guarantee creates a misallocation of resources—SIFIs are implicitly subsidized to make risky investments that would not be selected except for the implicit government guarantee. Implicit government guarantees, even incomplete ones that protect only a limited class of investors, distort investments into activities that may not be appealing to investors without the potential for taxpayer bailouts.

Why do investors continue to believe that the government will bail out distressed SIFIs using

taxpayer money, even though some government officials emphatically deny that bailouts are still possible after the passage of Dodd–Frank? Investors, especially uninsured institutional investors who gain the most from implicit government subsidies, understand that history and existing law suggest that large financial institutions are likely to receive special government treatment should they face financial distress. And they expect that the special government treatment will shield them from the SIFI’s losses.

All else being equal, it is always better to lend money to the institutions that are likely to receive special treatment from the government—especially when there is no fair-market charge for the special treatment. The remainder of this section discusses some of the most important issues that lead investors to rationally conclude that SIFIs will receive special government support should they become financially distressed.

It is important to understand that the TBTF problem does not exist because SIFIs are too big to fail in bankruptcy. They are not. This folklore was politically useful to shift responsibility from the regulators and policies that failed in the last crisis, and to pass new legislation that increased discretionary government powers. Maybe in the past financial crisis it was too costly to allow many SIFIs to enter bankruptcy at the same time in part because their operating subsidiaries would have failed as well. However, with appropriate capital requirements for critical operating subsidiaries, operational and contracting safeguards, and prompt-corrective-action thresholds, some parent SIFIs, perhaps many of them, could have been allowed to fail in bankruptcy without magnifying financial instability.

The facts of the Lehman Brothers bankruptcy (reviewed in the following section, “Did a SIFI Bankruptcy Cause the Last Financial Crisis?”) show that a single large important financial institution can fail and be liquidated in judicial bankruptcy—even in the midst of an ongoing financial crisis—without causing a cascade of other financial firm failures. Even more amazing, the damage from the Lehman Brothers bankruptcy was minimal, even though the bankruptcy filing was completely disorganized and enjoyed no benefit from pre-planning.

Even without the regulatory capital reforms recommended in this chapter, many legal experts believe that bankruptcy, and not OLA, is the best way to facilitate a SIFI failure.⁶³ For example, H.R. 5421, “The

Financial Institution Bankruptcy Act of 2014,” commonly known as Chapter 14, amends the bankruptcy code so that it can more efficiently handle the failure and reorganization of a SIFI in a Chapter 11 bankruptcy.⁶⁴ Impartial courts, not government agencies, are best equipped to provide equal protections for investor property rights, and ensure that these protections are maintained over time.⁶⁵

Notwithstanding dubious claims about the impossibility of a SIFI bankruptcy, there are many features in the regulatory landscape that promote TBTF expectations. Unfortunately, many of these regulatory features were magnified—not removed—by the sweeping regulatory changes enacted in Dodd–Frank.

One regulatory feature that promotes TBTF expectations is the conflict created by assigning the Federal Reserve multiple roles as the supreme consolidated SIFI regulator-supervisor, the lender of last resort, and the agency primarily responsible for maintaining financial stability. The Federal Reserve is the only government agency that can take independent actions to help forestall SIFI failures by providing emergency liquidity assistance, yet the FRB is also the institution appointed by Dodd–Frank to ensure that the largest financial firms—large BHCs and FSOC-designated nonbank SIFIs—will not fail.

Through its powers to regulate BHCs, the FRB has long wielded consolidated supervision powers over BHCs. With the passage of Dodd–Frank, Congress singled out a new special group of financial institutions—BHCs with consolidated assets greater than \$50 billion and any financial companies designated by the FSOC—and gave the FRB new expanded powers and a responsibility to safeguard the solvency of this special group of institutions.

Dodd–Frank codifies a regulatory system in which the FRB has strong incentives to take extraordinary measures to save institutions that are subjected to the FRB’s heightened supervision and regulation should any of them become financially distressed. The reality of the post-Dodd–Frank regulatory structure is well described by David Skeel:

Dodd–Frank singles out a group of financial institutions for special treatment. The banks that meet the \$50 billion threshold, and the non-bank institutions designated by the new Financial Stability Oversight Council as systemically important, will be put in their own separate category. Unlike in the New Deal,

there is no serious effort to break the largest of these banks up or to meaningfully scale them down. Because they are special, and because no one really believes the largest will be allowed to fail, they will have a competitive advantage over other institutions. They will be able to borrow money more cheaply, for instance, than banks that are not in the club. Dodd–Frank also gives regulators a variety of mechanisms they can use to channel political policy through the dominant institutions. The partnership works in both directions: special treatment for Wall Street Giants, new political policy levers for government.⁶⁶

There are important regulatory features outside Dodd–Frank that promote the development of TBTF institutions. Foremost among these are the laws that govern the deposit insurance bank resolution process.

In the past, when a large bank fails, the FDIC has prevented a market disruption by selling the large failing bank to a single healthier (and typically larger) BHC. In most cases, large BHCs are the only institutions that are qualified to bid to acquire a failed bank from an FDIC receivership. To qualify as a bidder, an institution must be eligible to own a bank and have the capital, management systems, and managerial capacity to successfully manage the acquired institution. Moreover, academic evidence suggests that banks and BHCs are willing to bid a premium when an acquisition reinforces their TBTF status.⁶⁷

When no buyer could be found, the FDIC has used open bank assistance to keep large distressed banks open and operating.⁶⁸ When a buyer can be identified, a bank purchase and assumption transaction, often with an FDIC loss-sharing agreement, has almost always been the least-cost resolution for the bank insurance fund.

The FDICIA requires the FDIC to resolve a failing bank using the least-costly method that is available at the time of failure. Should a buyer be identified, whole-bank purchase and assumptions are not only the least-costly method, they have the additional benefit of avoiding the disruption in banking services that would be associated with a depositor payout and liquidation of a large failing bank’s assets.

The FDIC has never had the capacity to make timely deposit insurance coverage assessments when a large bank fails. In other words, the FDIC cannot close a large bank on Friday night and provide insured depositor funds the following Monday

morning, because the FDIC cannot determine which deposits are covered by deposit insurance and which are not.⁶⁹ If the FDIC manages the failed bank using a bridge bank receivership, it will have to open the bank on Monday morning. If by that time, the FDIC cannot separate insured from uninsured deposit accounts, the customer uncertainly will generate a depositor run as it did in the case of the IndyMac failure.⁷⁰ To avoid this problem, when a large bank fails, the FDIC favors solutions that transfer all of the failing bank’s deposit accounts to an acquiring bank in a purchase-and-assumption transaction. This approach justifies TBTF investor expectations because the transaction protects all depositors from loss, including large deposits that should have absorbed bank losses.⁷¹

The policy of selling large failing banks to larger more stable institutions is also the key mechanism that created several giant U.S. banks that many investors now consider TBTF. To end this problem, the FDIA bank resolution process should be amended by law to require the FDIC to break up banks over a certain asset-size threshold should they fail. Such a change will require that the FDIC’s mandate for “least cost resolution” be modified to require the least-costly resolution within the context of the mandatory break-up of large failing banks. This change in policy would have prohibited, for example, the acquisition of the failed Washington Mutual Bank and Washington Mutual FSB by JPMorgan Chase in the last financial crisis.⁷²

The FDIA bank resolution process should be amended to explicitly prevent the bank resolution process from creating TBTF institutions. It might also be sensible to concurrently amend Dodd–Frank’s Title I “living will” requirement (§ 165(d)(1)) so that it is refocused on ensuring that processes and procedures are in place to enable the FDIC to break up a large failing depository institution in an FDIA resolution at minimal cost.

DID A SIFI BANKRUPTCY CAUSE THE LAST FINANCIAL CRISIS?

There is no direct evidence that a SIFI bankruptcy will cause a wider financial crisis. The recent financial market experience has often been cited as *prima facie* evidence that supports the TBTF hypothesis.⁷³ On September 15, 2008, Lehman Brothers filed for bankruptcy, and its filing was followed by additional financial institution failures, mergers, and numerous government bailout programs.

Except in one special and relatively minor case, the Lehman failure did not generate losses that directly caused other large financial institutions to fail. A coincidence in the timing of events does not establish causality, and indeed, causality in the case of Lehman’s failure is probably reversed. It is likely that the Lehman Brothers bankruptcy was not the cause of the financial crisis; rather, the Lehman Brothers bankruptcy and other SIFI failures and near-failures were jointly caused by a deepening financial crisis that began more than a year earlier.⁷⁴ The latter interpretation is consistent with testimony of Chairman James Dimon of JPMorgan Chase:

I didn’t think it [the Lehman bankruptcy] was so bad. I hate to say that.... But I [thought] it was almost the same if on Monday morning the government had saved Lehman.... You still would have terrible things happen.... AIG was going to have their problems that had nothing to do with Lehman. You were still going to have the runs on the other banks and you were going to have absolute fear and panic in the global markets. Whether Lehman itself got saved or not... the crisis would have unfolded along a different path, but it probably would have unfolded.”⁷⁵

OLA is based on the presumption that a disorganized SIFI bankruptcy causes large losses that disrupt financial markets and endanger the solvency of other connected financial institutions. There is no question the Lehman bankruptcy was disorganized. Lehman management did not seriously consider bankruptcy or initiate any bankruptcy planning in large part because Lehman management believed the firm would be rescued by the government.⁷⁶ It did not hire bankruptcy council until September 10, 2008, or begin to prepare a bankruptcy petition until September 11.⁷⁷

Lehman’s failure to adequately plan for bankruptcy has been estimated to have cost its bankruptcy estate as much as \$75 billion.⁷⁸ But Lehman’s failure to plan for an orderly bankruptcy filing has not been identified as a causal factor in the failure of any Lehman counterparty.⁷⁹ To the contrary, Lehman’s managerial failure to plan for the most advantageous bankruptcy possible for its shareholders and creditors is estimated to have *saved* Lehman’s counterparties an estimated \$75 billion in immediate losses.⁸⁰

The only sizable institution to directly fail as a consequence of its exposure to Lehman Brothers

was an investment fund—an institution-only money market fund—the Reserve Primary Fund. This high-risk money market fund had a significant concentration in Lehman Brothers commercial paper.⁸¹ Lehman’s default triggered a run by the Reserve Primary’s institutional investors. The run caused the fund to “break the buck,” which forced the fund to liquidate under SEC regulations. While this failure is often discussed as if it was a singular traumatic event for the mutual fund industry, to keep this event in proper perspective, it is important to remember the Reserve Primary Funds remaining shareholders quickly recovered more than 98 percent of their investment.⁸²

The Lehman failure did trigger a number of legal complications associated with the closeout of derivative positions. Most of these complications can be traced to the lack of legal experience and undeveloped case law on issues related to the exercise of International Swaps and Derivatives Association (ISDA) master agreement closeout clauses. These issues would have arisen the first time any significant derivatives dealer failed. It just so happens that the first significant derivatives dealer-failure was Lehman Brothers.⁸³

Under ISDA master agreements that govern derivative transactions between counterparties, the default of a counterparty triggers a closeout netting process that unwinds the failing counterparty’s derivative positions. In theory, bankruptcy should trigger a process where all contracts to the failing counterparty under an ISDA master agreement are valued and netted. If the counterparty is owed money after netting, the claim is registered against the bankruptcy estate; if a counterparty owes money to the bankrupt estate, the liability must be promptly paid.

In reality, closeout netting is not so orderly. The Lehman estate had many ISDA master agreements. Derivative positions had to be netted under the correct master agreement, which, in many cases, may not have been immediately obvious.

A second issue was that, because there are multiple closeout options, it was a strategic decision to choose the contract termination process that was most beneficial for a counterparty. ISDA master agreements have two protocols: (1) automatic early termination—includes no optionality; all contracts with this clause terminate when one of the counterparties experiences an event of default; and (2) the non-defaulting counterparty has the option of early termination. If the derivative contract has a positive mark-to-market

value to the bankrupt estate, the non-defaulting counterparty may choose not to terminate the contract to avoid making a closeout payment.

There are other closeout choices that can be used by counterparties to impact the closeout payoff or liability to the bankruptcy estate. ISDA master agreements provide a number of alternative-valuation methods, including specific dealer quotes, a mid-market method, and a loss method that utilizes model-based valuation. In the Lehman closeout netting process, because of the ongoing financial crisis, derivative-market liquidity evaporated. The lack of transparent verifiable transactions prices made the choice of a closeout valuation method especially important.

In the absence of liquidity, derivative bid prices fell far more than asked prices, lowering mid-market valuations. Because of excessive dealer risk aversion, specific dealer bid quotes for an “in-the-money” derivative might also be abnormally low, a situation characterized as “fire sale conditions.” The final acceptable valuation approach is model-based valuation. In practice, model-based valuation is very flexible and can produce a wide range of “reasonable” closeout valuation estimates.

The multiplicity of derivative closeout valuation options added to the complexity of the Lehman closeout process. The Lehman bankruptcy trustee has argued that many Lehman counterparties “gamed” their valuation estimates to overstate the amount that Lehman owed them, or to reduce the amount the counterparties owed to the Lehman bankruptcy estate. For example, in one case, a counterparty that owed Lehman in the closeout used the dealer-quote method to value its positions, whereas Lehman argued that the positions should have been valued using the mid-market method, which produced a significantly larger payment to the bankruptcy estate.⁸⁴

The closeout of Lehman derivatives positions with structured finance vehicles—collateralized debt obligations (CDOs) and other securitizations—also created legal issues. Many structured finance products are backed by collateral pools, but they also include derivatives positions to hedge or enhance specific risk characteristics. The normal cash-flow waterfalls associated with structured finance vehicles account for normal expected derivatives contract payment liabilities in the highest-claim-priority tranche—payments that must be made before allocating cash flows to investors. However, when

cash flows are generated by the default of a derivative counterparty, the payment priority in many structured products was designed to change.

Many CDOs and securitizations included “flip clauses” that lowered the priority of cash payments to derivative counterparties if the payments were generated by the default of a derivative counterparty. Without flip clauses, should a derivative be “out of the money” when the derivative counterparty defaults, the structured vehicle could be required to make large unscheduled payments to the bankrupt counterparty’s estate. Without a flip clause, this unscheduled payment erodes the claims priority of the structured product’s senior investors.

Flip clauses became an important legal issue in the Lehman bankruptcy. Courts in the U.K. had recognized the validity of structured financial product flip clauses, but when the issue was litigated in the U.S., the court ruled that these clauses are not enforceable.⁸⁵ Subsequent to this ruling, the Lehman estate initiated a class-action lawsuit in the United States to recover as much as \$3 billion from structured-investment-vehicle counterparties that had exercised flip clauses to calculate close-out valuations.⁸⁶

There is little question that the Lehman Brothers bankruptcy was poorly planned and disorderly. However, poor planning on the part of Lehman Brothers management resulted in billions of dollars of losses to the Lehman estate, thereby *saving* Lehman’s counterparties an equal amount of losses. A more efficient bankruptcy filing would have imposed much larger and more immediate losses on Lehman’s financial counterparties, potentially weakening their post-bankruptcy financial condition.⁸⁷ It is difficult to see how a more efficient Lehman bankruptcy would have improved financial stability.

The Lehman Brothers derivatives closeout process generated substantial litigation, but the litigation would have been created by the failure of any sizable derivatives dealer, given the untested nature of the ISDA close-out process. For the most part, the litigation has been focused on the Lehman estate collecting additional funds from derivative counterparties. So again, for many counterparties, the extended derivatives litigation lessened the immediate loss and financial shock generated by the Lehman bankruptcy. On balance, there is little if any evidence that suggests that a more orderly Lehman Brothers bankruptcy would have lessened the severity of the prior financial crisis.

TBTF EXPECTATIONS AND FED EXEMPTIONS FROM SECTION 23A AND 23B RULES

The FRB source-of-strength doctrine is, in part, a tacit admission by the FRB that parent holding company shareholders accrue government safety net benefits from controlling the shares of a subsidiary-insured depository institution. In return for these benefits, the FRB expects BHC shareholders to inject new capital should a subsidiary depository institution become undercapitalized.

The source-of-strength contingent call on parent holding company capital is, in effect, the price that the parent BHC’s shareholders are expected to pay for access to subsidized funding through their subsidiary bank(s). Sections 23A and 23B, incorporated into the Federal Reserve Act by Congress in 1933, are rules intended to limit the ability of a parent BHC and its nonbank affiliates to extract safety net benefits from the BHC’s subsidiary-insured depository institutions.

Section 23A restricts a depository institution’s exposure in “covered transactions” with its BHC “affiliates.” “Covered transactions” and “affiliates” are carefully defined in the amended Federal Reserve Act or by subsequent Federal Reserve regulations. Nevertheless, the definitions of affiliates and covered transactions include many specific exemptions.

Section 23A limits covered transactions with a single affiliate to 10 percent of the depository institution’s capital stock and surplus. Total exposure to all affiliates is limited to 20 percent.⁸⁸ Section 23A prohibits the purchase of “low quality assets” from affiliates.⁸⁹ It requires that extensions of credit to affiliates be adequately collateralized at initiation, but it exempts loans and guarantees that are collateralized by U.S. government obligations from the definition of covered transactions. Section 23A includes a catch-all requirement that that all affiliate transactions be consistent with safe and sound banking practices.⁹⁰

Section 23B requires that any transactions with affiliates involving covered transactions be conducted on terms that are at least as favorable to the depository institution as the terms that would be available to the institution in an identical transaction with an unaffiliated counterparty.

Following the passage of the Gramm–Leach–Bliley Act, the Federal Reserve Board issued Regulation W to provide rules and procedures that clarify the FRB’s enforcement of Section 23A and 23B

restrictions.⁹¹ Prior to issuing Regulation W, the FRB had no formal public guidance on its interpretation and enforcement of Section 23A restrictions.

Regulation W defines “capital stock and surplus,” which, up to that point, had not had a clear legal definition. In addition, Regulation W clarifies which institutions are included as affiliates. When it issued regulation W, the FRB did not include Special Purpose Entities (SPEs) in the definition of affiliates:

Due to complexities of this issue and the pending proposal by the Financial Accounting Standards Board (“FASB”) on the consolidation of SPEs, the [Federal Reserve] Board is deferring at this time any rulemaking with respect to the relationships between member banks and SPEs.⁹²

This omission, which remained in place throughout the crisis,⁹³ allowed banks to create large uncontrolled exposures by extending liquidity and credit guarantees to affiliate SPEs that issued subprime mortgage-backed securities and CDOs to outside investors.⁹⁴

Regulation W excluded derivatives, other than credit default swaps, from the definition of covered transactions, but requires that all derivative transactions comply with Section 23B rules:

Banks are expected to: “have policies and procedures to monitor and control the bank’s credit exposure to affiliates in derivative transactions...and insure that its derivative transactions with affiliates comply with Section 23B.”⁹⁵

The reasoning behind excluding derivatives, other than credit derivatives, was to allow the BHC to use derivatives to hedge its exposure on a consolidated basis.

The derivative exemption allowed substantial uncollateralized exposures between banks and affiliated companies. By excluding derivatives from Section 23A limits, the failure of a nonbank affiliate could endanger the solvency of the BHC bank subsidiary if the bank had taken a large position on behalf of the affiliate.⁹⁶ In this case, the FRB was effectively relying on its consolidated supervision and source-of-strength powers—not Section 23A limits—to ensure that an insolvency at a BHC nonbank affiliate did not endanger the group’s consolidated performance on positions with external counterparties.⁹⁷

Regulation W also allows the FRB to grant discretionary exemptions from Rule 23A and 23B.⁹⁸ To request a Section 23A exemption, an institution must explain (1) the details of the transactions and its relationship with affiliates; (2) the rationale for requesting the exemption; and (3) why the exemption is in the public interest and consistent with the purposes of the law. Regulation W does not explain the requirements for requesting a Section 23B exemption.

Furthermore, there is no publicly available comprehensive record of FRB decisions regarding bank-specific requests for Section 23A exemptions.⁹⁹ Decisions are made informally through pre-emptive orders, interpretive issuances,¹⁰⁰ and through private communications with the banks. Bank requests for specific exemptions that are unlikely to be approved are discouraged informally. As a consequence, there is little if any public information on specific exemption requests that the FRB declined to approve.

Table 1 provides a summary of the publicly available information on Section 23A exemptions granted by the FRB between 2000 and 2009. Exemptions may be required when a bank extends credit to an affiliate that exceeds Section 23A limits, or when it purchases the securities issued by an affiliate, or purchases assets from an affiliate other than assets or affiliates that are explicitly exempt from Section 23A.¹⁰¹ Merging an affiliate into a member bank is considered a “purchase of assets” and can trigger Section 23A limits.¹⁰² Section 23A expressly prohibits a bank from purchasing low-quality assets from an affiliate.

Between 2003 and 2006, as the entries in Table 1 show, the FRB approved a number of Section 23A exemptions that allowed banks to move potentially risky assets from affiliates into BHCs’ large insured depository institutions. The data show that Citibank was the beneficiary of a number of these exemptions. HSBC and GMAC also received exemptions to consolidate potentially risky assets into their insured depositories.

In the case of Citibank, the multiple 23A exemptions granted by the FRB allowed high-risk assets, including nearly \$20 billion in subprime mortgages assets, to be transferred from nonbank affiliates to Citibank, the largest insured bank subsidiary in Citigroup.¹⁰³ All of the exemption requests in Table 1 were reviewed by the Office of the Comptroller of the Currency (OCC) and the FDIC, including the Citibank exemptions, and neither the OCC nor the FDIC raised objections to any of these transactions.

Another notable pattern in the exemptions data reported in Table 1 is the number of exemptions granted for securities-lending operations. Two distinct kinds of exemptions were granted, and the dual character of these exemptions is informative.

Exemptions granted in 2005, prior to the financial crisis, facilitated securities transfers within the BHC group. For instance, one exemption allowed a trust bank to lend securities to affiliates who would in turn lend these securities to customers or use them in broker-dealer proprietary transactions.¹⁰⁴ In a second exemption granted in 2005, the bank was allowed to borrow securities from its affiliate broker-dealer so the bank could engage in proprietary trading and hedging activities.

The nature of Section 23A exemptions changed following the meltdown in the asset-backed commercial paper market. From August 2007 onward, the exemptions for securities-financing transactions allowed affiliated broker-dealers to provide customers with loans collateralized by securities. The affiliated broker-dealers, in turn, would use securities to collateralize borrowing from an affiliated bank. These Section 23A exemptions coincided with the FRB’s emergency 50-basis-point reduction in the discount rate, and the extension of discount-window loan maturity from overnight to 30 days.¹⁰⁵ The link between Section 23A exemptions and emergency Federal Reserve liquidity became even more pronounced when the FRB created the Term Auction Facility in December 2007. This allowed banks to use pledged securities to access emergency funds without the “stigma” of discount-window borrowing.

Thus, using its Section 23A exemption powers, the FRB provided emergency liquidity support to broker-dealers owned by large BHCs when the subsidiary bank had an approved exemption. At the same time, the FRB was *not* providing exceptional liquidity support to broker-dealers who were not affiliates of a FRB-regulated BHC or did not ask for the exemption.¹⁰⁶ Eventually, the FRB created the Primary Dealer Credit Facility, a facility that would allow primary broker-dealers direct access to emergency Federal Reserve liquidity, but not until March 17, 2008, after the distress-sale of Bear Stearns took place. Goldman Sachs, Morgan Stanley, Merrill Lynch, Bear Stearns, and Lehman Brothers all owned depository institutions and presumably could have asked for Section 23A exemptions for securities-financing transactions to support their broker-dealer subsidiaries.¹⁰⁷

TABLE 3

Publicly Available Information on Section 23A Exemptions, 2003–2009 (Page 1 of 2)

Date	Bank Receiving Exemption	Reason for Section 23A Exemption
February 27, 2003	Citibank	To acquire Citimortgage, Inc., St Louis
August 14, 2003	Valley Independent Bank	To purchase loans from a Dutch affiliate bank
November 19, 2003	Bank of Wausau	To purchase premises from an affiliate
December 22, 2003	First Alliance Bank	To acquire AMC Acquisition, Inc.
December 29, 2003	HSBC Bank USA	To purchase mortgages from affiliates
February 10, 2004	Merrill Lynch Bank	To acquire Merrill Lynch Private Finance, Inc.
May 14, 2004	Citicorp Trust Bank	To acquire Citi Financial Mortgage Co. Inc., St Louis
July 7, 2004	GMAC Bank	To acquire mortgages from GMAC Commercial Holding Corp.
December 22, 2004	HSBC Bank USA	To acquire assets from Household International, Inc.
April 1, 2005	Preferred Bank	To acquire assets from Klein Financial
April 8, 2005	Omni National Bank	To purchase aircraft from affiliate
May 5, 2005	Bank of New York	To extend credit to securities affiliate to support securities lending
June 7, 2005	Bank of America, NA	To extend credit to securities affiliate to support securities lending
October 3, 2005	Banco Popular de Puerto Rico	Credit to customers secured by shares in an affiliate
October 25, 2005	Citibank	To enter into tax-sharing agreement with Australian affiliate
November 22, 2005	Charter One Bank	To acquire RBS Asset Finance, Inc.
November 22, 2005	FirsTier Bank	To purchase premises from affiliate
May 1, 2006	Legg Mason Trust Co.	To acquire Legg Mason Investment Counsel, Inc.
June 30, 2006	Citibank	To acquire Citi Financial Mortgage Co., Inc., Irving, Texas
September 29, 2006	Wachovia Bank	To extend credit to securities affiliate to support securities lending
October 24, 2006	E-Trade Bank	To acquire all the shares in E-Trade Clearing Corp.
January 23, 2007	Bank of America, NA	To extend credit to securities affiliate to support securities lending
June 12, 2007	Wachovia Bank	To extend credit to securities affiliate to support securities lending
September 20, 2007	Citibank	To extend credit to securities affiliate to support securities lending
September 20, 2007	Bank of America, NA	To extend credit to securities affiliate to support securities lending
September 20, 2007	JPMorgan Chase, NA	To extend credit to securities affiliate to support securities lending
October 12, 2007	Deutsche Bank	To extend credit to securities affiliate to support securities lending
November 11, 2007	Barclays Bank, PLC	To extend credit to securities affiliate to support securities lending
November 12, 2007	Royal Bank of Scotland	To extend credit to securities affiliate to support securities lending
November 23, 2007	Citibank	To extend credit to securities affiliate to support securities lending
December 21, 2007	Capital One, NA	To acquire all the shares of Capital One Autofinance, Plano, Texas
March 25, 2008	Minnwest Bank Metro	To acquire all shares in two non-bank affiliates
April 1, 2008	JPMorgan Chase	To extend credit to Bear Sterns affiliates
May 19, 2008	Merrill Lynch Bank	To extend credit to Merrill Lynch mortgage affiliate
June 26, 2008	JPMorgan Chase	To exempt covered transactions with Maiden Lane LLC
July 23, 2008	Generic	Letter clarifying Board's position on affiliate status
October 6, 2008	Redacted	To exempt purchases of assets from an affiliate MMMF
October 29, 2008	Wells Fargo Bank	To purchase assets and loan commitments from non-bank affiliates
November 20, 2008	Wells Fargo Bank	To exempt extension of credit to Wachovia Bank National Assoc.

NOTE: MMMF—money market mutual funds.

TABLE 3

Publicly Available Information on Section 23A Exemptions, 2003–2009 (Page 2 of 2)

Date	Bank Receiving Exemption	Reason for Section 23A Exemption
November 24, 2008	Union Bank and Trust	To exempt purchase of student loans from affiliates
December 1, 2008	Redacted	To exempt purchases of assets from an affiliate MMMF
December 24, 2008	GMAC Bank	To exempt credit extended to affiliate auto dealers
December 29, 2008	Wachovia Bank	To exempt purchase of auction rate securities from affiliates
January 9, 2009	BB&T	To exempt purchase of auction rate securities from affiliates
January 9, 2009	Northern Trust Bank	To exempt purchase of auction rate securities from affiliates
January 12, 2009	GE Money Bank	To allow asset purchase from an affiliate
January 14, 2009	HSBC Bank USA	To allow asset purchase from an affiliate
January 30, 2009	Fifth Third Bank	To exempt purchase of auction rate securities from affiliates
March 31, 2009	ING Bank	To exempt credit extended to transfer ownership of MBS to an affiliate
April 13, 2009	CIT Bank	To acquire all assets of three affiliates
April 22, 2009	Morgan Stanley	To transfer assets to a subsidiary bank
April 22, 2009	Goldman Sachs	To transfer assets to a subsidiary bank
May 21, 2009	Ally Bank	To exempt credit extended to affiliate auto dealers
June 23, 2009	First Farmers and Merchants State Bank	To acquire premises from an affiliate

NOTES: MMMF—money market mutual funds, MBS—mortgage-backed securities.

SOURCE: Board of Governors of the Federal Reserve System, Legal Interpretations of the Federal Reserve Act, <http://www.federalreserve.gov/bankinfo/LegalInterpretations/legalinterpretations.htm> (accessed March 14, 2016).

 heritage.org

As the financial crisis progressed, the FRB used Section 23A exemptions repeatedly to allow banks to access Federal Reserve emergency liquidity and pass this liquidity on to support nonbank affiliates. This emergency provision of credit exposed banks beyond the limits that Congress established in Section 23A legislation. These programs funneled emergency Federal Reserve liquidity support into bank-affiliated money market mutual funds, asset-backed commercial paper conduits, and other affiliated SPEs, as well as to broker-dealer affiliates that sponsored auction-rate securities. This exceptional special liquidity support was not widely available and, according to the publically available record, was only made available to nonbank affiliates of a FRB-regulated BHC when the subsidiary bank asked for, and received, a Section 23A exemption.

The FRB granted several other Section 23A exemptions to facilitate (*ex post*) the distressed sale “bailouts” of Bear Stearns, Wachovia, Merrill Lynch,

and GMAC/Ally Bank. In three of these cases, the FRB determined that it was in the public interest to waive section 23A limits to allow these distressed sales to create the largest TBTF institutions that exist to this day. The GMAC exemption was required to facilitate the bailouts of the General Motors and Chrysler Corporations.

In many cases, the FRB exemptions granted in Section 23A included conditions that closely mimicked the FRB’s source-of-strength doctrine. The parent BHC was required to guarantee the financial health and capital adequacy of the bank as a condition for granting the Section 23A waiver. While the conditions for granting a waiver varied according to the type of transaction generating the request, conditions often included: requirements that bank exposure be secured by high-quality collateral; that the exempted transaction satisfy Section 23B; that “low-quality assets” be offset with a transfer of cash or government securities; that a parent BHC pledge

to repurchase any transferred assets that subsequently become “low-quality” for a period up to two years, and in some cases five years; and that the bank and the parent BHC remain well-capitalized after the transaction.

Dodd–Frank included a number of amendments related to Section 23A. First, § 608 and § 611 require all derivatives to be included as Section 23A covered transactions. Other clauses in § 608 require that Section 23A transactions be fully collateralized at all times, not just when the transaction is initiated. Section 608 also transfers exemption powers to the FDIC and the OCC when they are the primary federal regulator of the bank. Section § 608 also gives the FDIC the power to stop any exemption that would create undue risk for the deposit insurance fund. Section 609 eliminates the exemption of covered transactions between a bank and its subsidiary. The Volcker Rule, § 619, prohibits (or severely limits) banks’ and their affiliates’ ability to conduct proprietary trading or have ownership interests in a hedge fund.

Some of these amendments place important limitations on the ability to transfer implicit insurance subsidies from banks to nonbank affiliates using Section 23A exemptions. Should the FDIC actually exercise its power to veto Section 23A exemptions, it could be an important constraint.

Among the Dodd–Frank changes to Section 23A, the Volcker Rule almost certainly places new limits on a BHC’s ability to exploit the implicit government guarantee. However, the new requirement to include all derivatives as covered transactions may have less of an impact than first appearances might suggest. Regulatory authorities have indicated that they intend to protect all legitimate derivative transactions in an OLA resolution, and large bank FDIC resolutions virtually always protect derivative transactions. Consequently, SIFI derivative counterparties are likely to be protected in SIFI transactions regardless of whether the counterparty is the bank or a nonbank affiliate.

ARE INVESTORS TO THINK LARGE BHCs AND NONBANK INSTITUTIONS ARE TBTF?

In the earlier section “Did a SIFI Bankruptcy Cause the Last Financial Crisis?” I argued that large nonbank financial institutions can fail in bankruptcy, even in a disorganized bankruptcy, in the midst of a financial crisis, and that the bankruptcy need not

cause a cascade of other financial institution failures. The claim that large financial institutions are TBTF because they cannot be reorganized or liquidated in a judicial bankruptcy process without causing a financial crisis is not supported by the historical facts.

The primary source of investor TBTF expectations is the design of the system of financial-sector supervision and regulation. Overreliance on consolidated supervision and regulation encourages creditors and counterparties to view transactions with SIFIs as though they are backed by the entire resources of a holding company instead of the resources of the single legal entity counterparty in the transaction. This belief is reinforced by the FRB’s long-standing insistence that a parent BHC’s entire resources will be made available, if necessary, to support the liabilities and creditors of a failing bank subsidiary.

Dodd–Frank reinforces this source of TBTF expectations by “codifying” the FRB’s source-of-strength doctrine in multiple sections of the act, and seemingly expanding this doctrine (if only imperfectly in the legislation) to cover nonbank affiliates of the largest BHCs and designated nonbank SIFIs subject to heightened supervision by the FRB. Moreover, the OLA-SPOE approach to resolution expands on the source-of-strength idea and promises to protect all creditors and counterparties of a failing SIFI’s “critical operating subsidiaries.” The Dodd–Frank requirements that the FRB impose heightened prudential capital standards, conduct annual SIFI stress tests, and be the guardian of financial-sector stability only reinforce the perception that the largest financial firms will receive special assistance to prevent their failure.¹⁰⁸

Expectations that SIFI investors will benefit from special government protections in the future are fully rational. In the past, regulators have taken extraordinary measures to keep SIFI subsidiaries, especially large bank subsidiaries, open and operating when they otherwise might have failed. Dodd–Frank does not remove the FRB’s discretionary power or its incentives to provide emergency assistance to keep one of its distressed SIFI clients from failing.¹⁰⁹ The FDIC’s bank resolution process is still in place—a process that protects all deposits in large failing banks, but not in small failing banks. Should the Secretary of the Treasury use OLA to “liquidate a distressed SIFI,” the FDIC is likely to fully protect the creditors of large bank and other critical operating subsidiaries.

Through its actions during the recent financial crisis, the FRB was, of course, trying to limit financial-sector distress. However, it is also undeniable that the preferential regulatory actions undertaken by the board—which were only available to a select group of financial institutions regulated by the FRB—provided credit to nonbank affiliates at discount rates (not true market rates). This emergency support undoubtedly aided the nonbank affiliates that received it. Indeed, some might have failed without this support. The TBTF problem arises when one group of distressed financial institutions receives special government support without charge, and this support is unavailable to other institutions. So, regardless of whether the FRB’s support was “in the public interest” at that time, without doubt, it helped to create the TBTF problem.

On balance, there is little wonder that investors treat SIFIs as TBTF. In its roles as lender of last resort, supreme macro prudential regulator, and the consolidated regulator of the largest financial institutions, the FRB has been given enormous power and conflicted mandates. How can the FRB let a SIFI fail when it is charged with ensuring that its client SIFIs are ultra-safe? In the past, the FRB has taken extraordinary measures to keep the affiliates of the SIFIs it regulated open and operating. The FRB and companion bank regulators still have the power to grant Section 23A exemptions. Would anyone stop the FRB, the OCC, or the FDIC from granting temporary Section 23A exemptions to save SIFI affiliates in the next financial crisis?

CONCLUSION

Dodd–Frank’s OLA has not ended TBTF. OLA has serious legal issues that may prevent it from being used, especially in the case of a large failing bank. So, even with Dodd–Frank, the FDIC may again be forced to sell a large failing bank to a large healthy BHC, protecting all depositors and creating a new TBTF institution.

Ending TBTF requires regulatory reform. The necessary reforms include: (1) increasing minimum regulatory capital requirements for depository institutions and critical functionally regulated subsidiaries; (2) modifying prompt-corrective-action-intervention triggers; (3) requiring mandatory contractual safeguards to ensure that banks and functionally regulated subsidiaries are not overly exposed to affiliates and do not depend on parent SIFIs for employees or critical services that could be suspended in bankruptcy; (4) modifying the FDIC “least cost” resolution mandate to require the breakup of large failing banks; (5) removing the FRB-centric approach to consolidated supervision and capital regulation; and (6) relaxing Dodd–Frank’s heightened prudential capital requirements to allow parent holding companies to meet higher prudential subsidiary capital requirements by issuing debt at the parent holding company.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. Henceforth, to simplify the text, I will use the term “bank” and “depository institution” interchangeably. Should the discussion focus on a specific class of depository institutions, such as a thrift or savings bank, I will make the distinction clear in the text.
2. The Gramm–Leach–Bliley Act defines functionally regulated subsidiaries as registered broker-dealers, registered investment advisors, registered investment companies, insurance companies subject to state supervision, and entities subject to regulation by the Commodities Futures Trading Commission. See 12 U.S. Code § 1844(c)(5).
3. Banks and other subsidiaries can continue to operate normally when their holding companies are in bankruptcy proceeding. Recent examples include BHCs that are in bankruptcy because of failure to make payment on Trust Preferred Security obligations. Most of the banks owned by these BHCs remain open, operating normally.
4. A large institution bias enters because the FDIC will only sell a failing bank to a “qualified” bank or BHC, meaning that the bidding institution must have the capital and management capacity to successfully manage the acquired institution. There is also evidence that banks offer higher prices to acquire institutions that will put them over the perceived TBTF size threshold. See Elijah Brewer and Julapa Jagtiani, “How Much Did Banks Pay to Become Too-Big-to-Fail and to Become Systemically Important?” Federal Reserve Bank of Philadelphia *Working Paper* No. 11-37, 2011.
5. Dodd–Frank § 623(a) prohibits the Federal Reserve from approving a bank acquisition if the combined deposits of all banks in the resulting BHC would exceed 10 percent of total deposits in insured banks. However, § 623(b) provides an exemption from this deposit limit if the bank is being acquired from an FDIC-failed-bank receivership.
6. Significantly higher capital requirements and modified prompt corrective action intervention thresholds will limit the extension of deposit insurance coverage to large shareholders because large depositories will face intervention and be broken up by the FDIC before losses exhaust the failing bank’s capital.
7. Nearly 85 percent of all depository institutions are owned by a BHC. See Partnership for Progress, “Bank Holding Companies and Financial Holding Companies,” <https://www.fedpartnership.gov/bank-life-cycle/grow-shareholder-value/bank-holding-companies> (accessed February 8, 2016).
8. A BHC application is required when the Fed determines that a covered company has a “controlling interest” in a bank. The Federal Reserve Board regulates the permissible activities of BHCs. The Bank Holding Company Act of 1956 limits BHC activities to those deemed to be “closely related to banking.” Over time, the list of permissible BHC activities has expanded to include mortgage banking, loan servicing, commercial and consumer financing, leasing, collection agency services, asset management, trust companies, real estate appraisal services, management consulting, employee benefits consulting, career counseling services, and certain insurance-related activities.
9. In the simple stylized example in Chart 1, I assume that the parent owns only the equity of its subsidiary companies.
10. Credit unions also provide insured deposit accounts. They can be federally chartered, in which case they are regulated by the National Credit Union Administration, or chartered and regulated by a state government authority. For example, credit unions chartered in the state of Virginia are regulated by the Virginia Bureau of Financial Institutions. The discussion excludes credit unions since they are excluded from BHC regulations by the Competitive Equality Banking Act of 1987 and unlikely to be considered candidates for an OLA liquidation.
11. For details on bank access to the discount window, see Federal Reserve Bank of New York, “The Discount Window,” July 2015, <http://www.ny.frb.org/aboutthefed/fedpoint/fed18.html> (accessed February 8, 2016).
12. The FDIC has the power to close an insured depository institution without the consent of the bank’s primary federal regulator, but typically the primary federal regulator is the agency that revokes the bank’s charter. A bank could liquidate voluntarily without any regulatory or FDIC intervention. See FDIC, “Resolutions Handbook,” 2015, <https://www.fdic.gov/bank/historical/reshandbook/> (accessed February 8, 2016).
13. Routine surveillance of registered broker-dealers conducted by exchanges and FINRA, the industry’s nonprofit self-regulatory agency as authorized by 15 U.S. Code § 78iii(c).
14. The legal claims priority in a SIPA liquidation are defined in 15 U.S. Code § 78fff-2(c)-(f).
15. For legal processes and procedures for a SIPA liquidation, see SIPC, “Securities Investor Protection Act of 1970,” <http://www.sipc.org/about-sipc/statute-and-rules/statute> (accessed February 8, 2016). SIPA insurance seeks to guarantee the return of customers’ property such as securities holdings and cash at the liquidating broker-dealers, and if that is not possible guarantees their mark-to-market value at the time of failure. Customer securities are insured up to \$500,000 (15 U.S. Code § 78fff-3(a)) if for some reason fraud or mismanagement is involved and the broker-dealer has not properly segregated customer security holding. 15 U.S. Code § 78fff-3(d) insures cash deposits at registered broker-dealers up to \$250,000.
16. 15 U.S. Code § 78ddd(g) empowers the SEC to make loans to the SIPC up to a total amount of \$2.5 billion, if the SIPC’s insurance fund lacks the resources necessary to deliver on its customer account insurance obligations and the SEC determines that additional SIPC funding is needed to maintain investor confidence in the system. SIPC has never used its SEC backup line of credit.

17. The Federal Insurance Office, created by the Dodd–Frank Act, does not supervise or monitor any individual insurance firms. Following the passage of the act, the Federal Reserve Board has used its new powers over thrift holding companies, including its new power to examine nonbank thrift holding company subsidiaries and affiliates even if they are functionally regulated, to initiate an on-site examination program for insurance company subsidiaries. This newly expanded effort has made the Federal Reserve a de facto national insurance regulator against the express intent of the Congress. Further details are provided in my testimony before the Senate Committee on Banking, Housing, and Urban Development, “Federal Reserve Accountability and Reform,” March 4, 2015.
18. Saule Omarova and Margaret Tahyar, “That Which We Call A Bank: Revisiting the History of Bank Holding Company Regulation in the United States,” *Review of Banking and Financial Law*, Vol. 31 (2011), pp. 114–198, review the congressional intent behind the enactment of the Bank Holding Company Act of 1956 and its subsequent amendments.
19. For example, following the financial crisis, there have been many bankruptcy filings for holding companies driven by extended payment delinquencies on parent holding company Trust Preferred Securities. Many bank subsidiaries owned by these holding companies have remained well-capitalized, open, and operating.
20. § 201 specifies that BHCs are eligible for OLA, but the insured bank subsidiaries of a BHC are not eligible (§ 201(a)(8)(B)). Nor are insured bank subsidiaries included as covered subsidiaries under Title II (§ 201(a)(9)(A)).
21. For the purposes of Title II, a financial company shall be considered to be in default or in danger of default if: (1) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code; (2) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; (3) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or (4) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.
22. Within the first 30 days of the appointment of the FDIC as receiver, the amount of OLF funding is limited to 10 percent of the consolidated assets of the distressed holding company as reported on its last available financial statement. After 30 days, the FDIC can borrow up to “90 percent of the fair value of the total consolidated assets of each covered financial company that are available for repayment.” § 210 (n)(6)(A).
23. Dodd–Frank requires an interest rate at least as large as the prevailing rate on U.S. government obligations of a similar maturity plus a risk premium at least as large as the difference between the prevailing rate in a corporate bond index of similar maturity and the prevailing rate on U.S. government securities of a similar maturity. Dodd–Frank does not specify any specific credit quality for the corporate bond index.
24. There is an extensive list of criteria that the FDIC must consider in setting the assessment rates. § 210(o)(4).
25. These include: managing the receivership to promote financial stability, not to preserve the failed institution; ensuring that the receivership recoveries respect Title II claims priority; ensuring that the failed institution’s management and board of directors are removed; managing the receivership assets to maximize the value of the receivership consistent with promoting financial stability; and ensuring that the maximum liability imposed on any receivership claimant is consistent with the amount the claimant would receive in a Chapter 7 Bankruptcy.
26. The FDIC board has adopted a policy to limit use of its discretionary power over similarly situated claimants to holding company liabilities with maturity under one year. “Federal Deposit Insurance Corporation SPOE Notice of Proposed Rulemaking,” *Federal Register*, Vol. 78, No. 243, December 18, 2013, p. 76618. This interpretation of § 210(10)(B)(5)(I) is based on the FDIC’s authority to repudiate parent BHC contracts and the legal limits on recovery should the FDIC’s action be successfully challenged in court.
27. “Federal Deposit Insurance Corporation SPOE Notice of Proposed Rulemaking,” *Federal Register*.
28. Federal Deposit Insurance Corporation and Bank of England, “Resolving Globally Active, Systemically Important, Financial Institutions,” December 10, 2012.
29. Financial Stability Board, “Charter of the Financial Stability Board,” June 2012, p. 5, <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf> (accessed February 9, 2016).
30. “Federal Deposit Insurance Corporation SPOE Notice of Proposed Rulemaking,” *Federal Register*, p. 76617.
31. The bridge could borrow from Treasury using the OLF, or it could use the OLF to guarantee bridge liabilities that will be sold to market investors.
32. Paul Kupiec and Peter Wallison, “Can the ‘Single Point of Entry’ Strategy Be Used to Recapitalize a Systemically Important Failing Bank?” *Journal of Financial Stability*, Vol. 20 (2015), pp. 184–197.
33. In a public event at the American Enterprise Institute, Randy Guynn and Gregory Baer both argued that the board’s source-of-strength doctrine would allow the Secretary of the Treasury to invoke OLA, invalidating the issue raised by Kupiec and Wallison. See American Enterprise Institute, “Does the FDIC’s Single Point of Entry Strategy Eliminate Too Big to Fail?” December 8, 2014, <https://www.aei.org/events/fdics-single-point-entry-strategy-eliminate-big-fail/> (accessed February 8, 2016).
34. There is no public record (of which I am aware) that indicates that any of the non-BHC financial holding companies that owned depository institutions ever asked the Federal Reserve for a Section 23A exemption to channel bank funding to nonbank affiliates. Such a request would not be made public if it was not approved. Lehman Brothers owned an Industrial Loan Corporation (ILC—a special type of depository charter) that was supervised by the FDIC. Lehman’s ILC did not fail when Lehman Brothers filed for bankruptcy. Merrill Lynch and Goldman Sachs also owned ILCs and neither of them received a Section 23A waiver until after the parent companies were converted into BHCs.

35. Many would argue that, because the Federal Reserve regulates the parent holding company, ignoring that the board's order to inject capital into a nonbank subsidiary would create “long-run regulatory costs” that make it in the shareholders' interest to comply with the Federal Reserve's initial capital injection order. While the Federal Reserve is certainly not beyond coercion, the OLA cannot be said to “work” if regulators must rely on extra-legal means to recapitalize a distressed critical nonbank subsidiary. This coercive mechanism, moreover, reinforces an implicit government guarantee that creates the TBTF problem.
36. The tension between a SPOE recapitalization and the OLA requirement for a liquidation has been recognized by several scholars. See, for example, David A. Skeel Jr., testimony before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives, May 15, 2013; David A. Skeel Jr., “Single Point of Entry and the Bankruptcy Alternative,” University of Pennsylvania Law School, Pennsylvania Law School, Legal Scholarship Repository 2-26-2014, 2014; John B. Taylor, “Too Big to Fail, Title II of the Dodd-Frank Act and Bankruptcy Reform,” testimony before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives, May 15, 2013; Joshua Rosner, “Who Is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer Funded Bailouts?” testimony before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives, May 14, 2013; Richard Fisher, “Correcting ‘Dodd-Frank’ to Actually End ‘Too Big to Fail,’” testimony before the Committee on Financial Services, U.S. House of Representatives, June 26, 2013; and Stephen Lubben, “OLA After Single Point of Entry: Has Anything Changed?” Seton Hall *Public Law Research Paper* No. 2353035, November 11, 2013.
37. An OLA-SPOE resolution that recapitalizes a failing bank subsidiary will protect the bank's creditors, not just its depositors. This “solution” extends the deposit insurance guarantee beyond large uninsured depositors and creates a new source for TBTF subsidies, as some large banks would be “eligible” for OLA protection while other banks would not. See Kupiec and Wallison, “Can the ‘Single Point of Entry’ Strategy Be Used to Recapitalize a Systemically Important Failing Bank?” for further discussion of this issue.
38. Gregory Baer, “Regulation and Resolution: Toward a Unified Theory,” *Banking Perspectives*, Quarter 1 (2014), p. 2.
39. Public Law 84-511, 84th Congress. H.R. 6227.
40. *Board of Governors of FRS v. First Lincolnwood* (1978).
41. *MCorp Financial v. Board of Governors of the Federal Reserve System*, United States Court of Appeals, Fifth Circuit, 900 F.2d 852 para. 2.
42. *Ibid.*, para. 65.
43. *Ibid.*, para. 75.
44. *Ibid.*, para. 76.
45. Public Law 102-242, § 38(e)(2)(C)(ii).
46. *Ibid.*, § 38(e)(2)(E)(i).
47. *Ibid.*, § 38(e)(2)(E)(ii).
48. 436 B.R. 713 (Bankr. M.D. Ala. 2010).
49. The implications of the limits on source-of-strength powers for OLA and SPOE is discussed in the section, “Can SPOE Prevent SIFI Distress from Sparking a Financial Crisis?”
50. For example, Paul Lee, “The Source of Strength Doctrine: Revered and Revisited—Part II,” *The Banking Law Journal*, Vol. 129, No. 10 (2012), pp. 867-906 presumes that Congress intended to extend this power to nonbank subsidiaries. Robert E. Litan, “Sources of Weakness: Worrisome Trends in Solvency Regulation of Insurance Groups in a Post-Crisis World,” Brookings Institution, August 6, 2014, argues that Dodd-Frank extended the board's source of powers to nonbank subsidiaries, citing Paul Lee, Gregory Baer, “Regulation and Resolution: Toward a Unified Theory,” *Banking Perspectives*, Quarter 1 (2014), pp. 12-21, also makes this claim, without reference to Lee.
51. Intermediate holding companies are subject to BHC rules, so they must act as a source of financial strength to subsidiary depository institutions.
52. § 165 (a) applies to BHCs with consolidated assets of at least \$50 billion.
53. Financial Stability Board, “Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution,” November 10, 2014, <http://www.fsb.org/2014/11/adequacy-of-loss-absorbing-capacity-of-global-systemically-important-banks-in-resolution/> (accessed February 9, 2016).
54. In Europe, TLAC may take the form of contingent convertible debt (so-called co-cos) issued by the parent holding company that can be converted into equity “automatically” by a capital-adequacy or regulatory-triggering mechanism. In the U.S., TLAC is likely to take the form of subordinated debt issued by the parent holding company that can be converted in equity in an FDIC SPOE resolution.
55. So-called bail-in strategies rely on parent company issuance of co-cos. See, for example, discussions in Charles W. Calomiris and Richard Herring, “Why and How to Design a Contingent Convertible Debt Requirement,” in Yasuyuki Fuchita, Richard J. Herring, and Robert E. Litan, eds., *Rocky Times: New Perspectives on Financial Stability*, Chapter 5 (Washington, DC: Brookings Institution, 2012); Charles W. Calomiris and Richard Herring, “How to Design a Contingent Convertible Debt Requirement that Helps Solve Our Too-Big-to-Fail Problem,” *Journal of Applied Corporate Finance*, Vol. 25, No. 2 (2013), pp. 21-44; Christopher L. Culp, “Contingent Capital vs. Contingent Reverse Convertibles for Banks and Insurance Companies,” *Journal of Applied Corporate Finance*, Vol. 21, No. 4 (Fall 2009), pp. 17-27, <http://rmcsinc.com/articles/CRCs.pdf> (accessed February 9, 2016); Mark J. Flannery, “Stabilizing Large Financial Institutions with Contingent Capital Certificates,” University of Florida *Working Paper*, October 5, 2009, <http://saturn.iww.uni-bonn.de/seminare/2011/regulierung/unterlagen/Thema%203.4%20Flannery%202009.pdf> (accessed February 9, 2016); and Stefan Avdjiev, Anastasia Kartasheva, and Bilvana Bogdanova, “Co Cos: A Primer,” *BIS Quarterly Review* (September 2013), pp. 43-55.

56. The TLAC proposal does not specify a mechanism for conversion of the subsidiary debt into equity.
57. The Basel III leverage ratio is Tier 1 capital divided by total consolidated exposure which include all on- and off-balance-sheet positions calculated using specific regulatory guidelines. The minimum Basel III leverage ratio is 3 percent; the U.S. minimum Basel III leverage ratio is 5 percent for all advanced approach BHCs and 6 percent for all advanced approach banks.
58. Financial Stability Board, "Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution," p. 13.
59. *Ibid.*, p. 6.
60. Paul H. Kupiec, "Will TLAC Regulations Fix the G-SIB Too-Big-To-Fail Problem?" American Enterprise Institute Economic Policy *Working Paper*, No. 2015-08, November 25, 2015, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2631617 (accessed February 9, 2016), and forthcoming in *The Journal of Financial Stability*.
61. For example, depending on how the parent invests the TLAC proceeds, it may have no trouble servicing its TLAC debt, making it much harder for the Secretary to make the claim that the parent is in danger of default.
62. This claim is formally proven in Kupiec, "Will TLAC Regulations Fix the G-SIB Too-Big-To-Fail Problem?"
63. See, for example, Kenneth E. Scott and John B. Taylor, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, CA: Hoover Institution, 2012), and John B. Taylor, "How Bankruptcy Reform Can Address 'Too Big to Fail,'" testimony before the Subcommittee on Financial Institutions and Consumer Protection, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 29, 2015.
64. H.R. 5421 in the U.S. House of Representatives, S. 1861 in the U.S. Senate.
65. Given the latitude for government action granted by OLA, the government is very likely to alter investor protections across SIFI resolutions as the current political fashion changes, and as unique background factors make a particular loss assignment the most expedient one for government regulators at that date and time.
66. David Skeel, "The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences," University of Pennsylvania Law School Institute for Law and Economics *Research Paper* No. 10-21, 2010.
67. Brewer and Jagtiani, "How Much Did Banks Pay to Become Too-Big-to-Fail and to Become Systemically Important?"
68. In 1984, when the FDIC could not find a buyer for the Continental Illinois Bank, it recapitalized the institution by extending unlimited deposit guarantees, purchasing billions of dollars of the bank's bad loans, and injecting new preferred equity and subordinated debt. FDICIA limited the FDIC's ability to provide "open bank assistance" and instead required the FDIC to choose a resolution method that imposed the least cost on the deposit insurance fund. FDICIA allows the FDIC to bypass the least cost method if it "would have serious adverse effects on economic conditions or financial stability" and if bypassing the least-cost method would "avoid or mitigate such adverse effects." A FDICIA systemic-risk exception required a special approval process including consultation with the President. The FDIC used the systemic-risk exception to provide open bank assistance to many institutions in the financial crisis. Section 1105 of Dodd-Frank amended the FDICIA systemic-risk exception to require congressional approval and limit the methods the FDIC can use to provide open bank assistance in exceptional circumstances.
69. There are many complicated but legal ways to structure deposit accounts so that an individual can obtain insurance coverage that is greater than the nominal deposit insurance limit. See FDIC, "What's Covered," <https://www.fdic.gov/deposit/covered/> (accessed February 9, 2016).
70. The FDIC's inability to determine which depositors were covered by deposit insurance and inform depositors in a timely manner fueled a bank run when the FDIC closed IndyMac in July 2008. For a concurrent local news report, see "Huge IndyMac Bank Run in Southern California," KTLA 5, video, broadcast July 14, 2008, <https://www.youtube.com/watch?v=IVRgZ9LizZQ> (accessed February 9, 2016).
71. These losses are instead transferred to the deposit insurance fund.
72. While Wachovia was on the verge of failure, it was acquired without being placed under FDIC receivership.
73. The only direct failure tied to the Lehman bankruptcy was the failure of an institution-only money market fund, the Reserve Primary Fund. Fund shareholders eventually recovered more than 98 percent of their investments. There are many examples that claim that the Lehman bankruptcy was an important contributing cause of the financial crisis. See, for example, Federal Deposit Insurance Corporation, "The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act," *FDIC Quarterly*, Vol. 5, No. 2 (2011), pp. 3-4, and Federal Reserve Chairman Ben Bernanke, "Hearing on Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis, Session 1: The Federal Reserve," testimony before the FCIC, September 2, 2010, p. 78.
74. When Lehman Brothers failed without a government rescue in September 2008—the failure did not directly drag down any other significant financial firm, even though Lehman was one of the largest nonbank financial institutions in the U.S. The chaos following Lehman's bankruptcy reflected the government reversal on its policy of rescuing large financial firms (the Bear Stearns rescue in March 2008 and the Fannie Mae and Freddie Mac rescue earlier in September). This reversal shattered investors' expectations, who responded by hoarding cash, shunning financial institution exposure, and draining liquidity from the financial system.
75. James Dimon interview by Financial Crisis Inquiry Commission, October 20, 2010.
76. Anton Valukas, "Examiner's Report: Bankruptcy of Lehman Brothers Holdings, Inc.," *United States Bankruptcy Court Southern District of New York*, Chapter 11, Case No. 08-13555 (JMP), Vol. 2, No. 43 (2010), p. 718.
77. *Ibid.*, p. 719.
78. *Ibid.*, p. 725.

79. Reportedly, \$468 million in customer assets were temporarily seized in the wind-down of Lehman broker-dealer operations. These assets were returned in February 2009. This “disorderly” aspect of the Lehman failure has not been identified as a cause of any specific knock-on failures. See Federal Deposit Insurance Corporation, “The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd–Frank Act,” p. 4. The bankruptcy filing by Lehman Brothers’ parent company subsequently triggered a SIPA liquidation of Lehman Brothers’ U.S. broker-dealer subsidiary. The SIPA liquidation process returned 100 percent of the broker-dealer’s customer collateral without any loss to the SIPC insurance fund. See news release, “SIPC Applauds Lehman Trustee on Milestone 100 Percent Return of Securities Customers’ Property,” SIPC, June 7, 2013, <http://www.sipc.org/news-and-media/news-releases/20130607> (accessed February 9, 2016).
80. These bankruptcy losses from lack of proper planning should have been collected and made available to Lehman creditors. But these losses to Lehman creditors are gains to the Lehman counterparties, who would have had to make payments or returned collateral in a well-organized bankruptcy.
81. Akay Ozgur, Mark D. Griffiths, and Drew B. Winters, “Reserve Primary: Fools Rush in Where Wise Men Fear to Tread!” *Journal of Investment Management* (March 2015).
82. The run on mutual funds in the wake of Lehman Brothers’ default did not occur in a vacuum. The commercial paper market had already experienced a severe crisis the prior summer when default rates in the subprime-mortgage-backed securities caused investors to withdraw from investing in asset-backed commercial paper issues. See Daniel Covitz, Nellie Liang, and Gustavo Suarez, “The Evolution of a Financial Crisis: Collapse of the Asset-Backed Commercial Paper Market,” *The Journal of Finance*, Vol. 68, No. 3 (2013), pp. 815–848.
83. Bear Stearns derivative positions were not subject to ISDA closeout procedures, as Bear did not fail before it was absorbed by JP Morgan Chase.
84. *Michigan State Housing Development Authority v. Lehman Brothers Derivatives Products Inc. and Lehman Brothers Holdings Inc.* (In re *Lehman Brothers Holdings Inc.*), WL 6671630 (Bankr. S.D.N.Y. Dec. 19, 2013).
85. The U.K. supreme court upheld the validity of flip clauses in *Belmont Part Investments PTY Limited (respondent) v. BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc.* (appellant) UKSC 38 (2011). *Lehman Brothers Special Financing Inc. v. BNY Corp. Services Ltd.*, Case No. 08-13555, Adv. No. 09-01242 (Bankr. S. D.N. Y. Jan. 25, 2010).
86. “Lehman Seeks to Force Defendant Class in \$3B Derivative Suit,” *Law360*, October 28, 2014.
87. The losses to the Lehman estate caused a single failure. It is possible that should the bankruptcy have been better planned, the estate could have recovered additional value from counterparties and turned these over to creditors, including the Reserve Primary Fund. The financial stability impact of a more efficient bankruptcy filing would depend on whether the additional recovery by the Lehman estate would have prevented the Reserve Primary Fund from defaulting, and simultaneously would not have caused any other Lehman counterparties paying these claims to default.
88. “Covered transactions” include extensions of credit and guarantees, the purchase of an affiliate’s securities, and the purchase of affiliate assets, unless there is an active market for these assets and they are purchased at the market price. Section 23A explicitly excludes from covered assets the purchase of nonrecourse loans from affiliates.
89. Low-quality assets are defined as assets classified as substandard, doubtful, loss, or special mention, assets that are in nonaccrual status, assets that are more than 30 days past due, or assets with terms that have been renegotiated due to a deterioration in the financial condition of the obligor. Federal Reserve Board, “Transactions Between Member Banks and Their Affiliates,” Regulation W; Docket No. R-1130, p. 27, <http://www.federalreserve.gov/boarddocs/press/bcreg/2002/20021127/attachment1.pdf> (accessed February 9, 2016).
90. Section 23A restriction are given in 12 U.S. Code § 371c.
91. Regulation W (12 CFR Part 223) became effective April 1, 2003.
92. Federal Reserve Board, Regulation, “Transactions Between Member Banks and Their Affiliates,” p. 20.
93. The first amendment to Regulation W listed on the FRB’s website was a temporary exemption that allowed banks to extend credit for securities-financing transactions with affiliates, effective September 14, 2008.
94. BHCs also developed guarantee contracts that minimized or even avoided any regulatory capital requirement for SPE guarantees. See, for example, Viral V. Acharya, Philipp Schnabl, and Gustavo Suarez, “Securitization Without Risk Transfer,” *Journal of Financial Economics*, Vol. 107, No. 3 (2013), pp. 515–536.
95. Federal Reserve Board, Regulation, “Transactions Between Member Banks and Their Affiliates,” p. 70.
96. For example, the bank might enter into an energy-derivative contract with an energy trading affiliate, and then conduct a back-to-back transaction with an outside dealer, which except for credit risk, hedges the bank’s energy exposure from the affiliate trade. The energy affiliate might prefer this indirect method of trading if the bank obtains more favorable derivative terms (on price or collateral) due to its more favorable external credit rating.
97. Market participants did not rely solely on Fed source-of-strength assurances. Instead, it is common to require cross-guarantee provisions in the ISDA agreements between the parent BHC and affiliates to ensure group performance on consolidated derivative positions.
98. The authorizing law allows the FRB to make such exemptions. 12 U.S. Code § 371c(f)(2) and § 371c-1(e)(1).
99. This section borrows from Saule Omarova, “From Gramm–Leach–Bliley to Dodd–Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act,” *North Carolina Law Review*, Vol. 89 (2011), pp. 1683–1776, and her extensive research on Fed Section 23A exemptions.
100. For example, some of the specific requests for interpretations of Section 23A and 23B rules are posted in Board of Governors of the Federal Reserve System, “Legal Interpretations,” <http://www.federalreserve.gov/boarddocs/legalint/> (accessed February 9, 2016).

-
101. For example, a bank purchase of assets from a wholly owned subsidiary of the bank is not subject to Section 23A restrictions because the bank's consolidated position already includes exposure to its subsidiaries' assets.
 102. Federal Reserve Board, Regulation, "Transactions Between Member Banks and Their Affiliates," p. 30.
 103. John C. Dugan, Comptroller of the Currency, Statement before the Financial Crisis Inquiry Commission, April 8, 2010.
 104. For example, to short sell securities or to facilitate structured arbitrage trading strategies.
 105. News release, "Federal Reserve Board Discount Rate Action," Federal Reserve Board, August 17, 2007, <http://www.federalreserve.gov/newsevents/press/monetary/20070817a.htm> (accessed February 10, 2016).
 106. Since the Fed does not publicly report on Section 23A exemption requests that it has denied, there is no record of a bank asking for Section 23A exemptions to support nonbank affiliates and having their request denied by the FRB.
 107. In many cases, these institutions owned Industrial Loan Corporations supervised by the FDIC. Presumably these depository institutions could have asked for a Section 23A exemption. Because the FRB does not publish notices of exemption request denials, it is unknown whether these depositories requested exemptions and were discouraged from formally asking for an exemption, or whether perhaps they did not need an exemption because their customer loan demand was not sufficient to test Section 23A limits. Discussions with knowledgeable industry professionals who worked for non-BHC institutions during the financial crisis suggest that the former explanation is probably closer to describing the events that actually transpired, but there is no public record on these events.
 108. Since, post-Dodd-Frank, virtually all large important financial firms are either large BHCs or designated SIFIs under heightened prudential supervision by the FRB, and virtually all of these institutions have a depository subsidiary, it is unclear why the Fed would still need Section 13(3) emergency lending powers. Should there be a next financial crisis, the FRB could instead do what it did in the last crisis—provide emergency liquidity to bank subsidiaries and waive Section 23A affiliate lending limits.
 109. Merriam-Webster defines client as "one that is under the protection of another."

CHAPTER 5

Rethinking Title III: The Federal Deposit Insurance Corporation and Other Subtitles

Mark A. Calabria

While the transfer of Office of Thrift Supervision (OTS) powers and personnel to the Office of the Comptroller of the Currency (OCC) garners the most attention in Dodd-Frank's Title III, the changes in deposit insurance contained in Subtitle C are likely to have greater long-term impact. As these modifications expand the bank safety net, further eroding market discipline, they will contribute to both the frequency and severity of future financial crises. Accordingly, they should be repealed.

Discussions of moral hazard during the financial crisis generally focused on the incentives of management and equity holders, yet far greater moral hazard—a reduction in monitoring by creditors—is likely to be of far greater consequence. The most important creditor class for a commercial bank is depositors, who provide about 75 percent of funding for the total banking sector (the rest coming from equity and borrowed funds). There is substantial academic literature demonstrating that depositors are capable of monitoring banks and that government-provided deposit insurance reduces that monitoring and results in greater risk-taking by banks.¹

The public interest would be further served if Congress were to reduce federal deposit insurance coverage to the pre-1980 limit of \$40,000. To further the goal of reducing systemic risk, Congress should also limit the total deposit insurance coverage of any one bank to 5 percent of total insured deposits. Given the current size of the fund, approximately \$6.3 trillion, such would imply that no one bank would hold more than \$320 billion in insured deposits. There are currently four banks above that level. A transition plan would have to be developed to

allow these banks to either shed their excess insured deposits or shift to other funding sources.

The Federal Deposit Insurance Corporation (FDIC), as of the first quarter in 2015, backs \$6.3 trillion in deposits. This represents about 60 percent of outstanding U.S. domestic deposits. It also represents a 50 percent increase—more than \$2 trillion—in insured deposits since the end of 2007. Perhaps more shocking is that this change also represents an almost doubling of insured deposits since 2003. Part of this increase was due to the Federal Deposit Insurance Reform Act of 2005, which raised the limit for deposit insurance for retirement accounts to \$250,000. Congress should also repeal those provisions of the 2005 act. Congress had also, within the Troubled Asset Relief Program (TARP), raised the deposit insurance cap to \$250,000 until January 1, 2010. Dodd-Frank essentially made permanent the coverage expansion contained in TARP.

Dodd-Frank's Section 335 extends the 2005 retirement coverage limit of \$250,000 to all accounts. According to the Federal Reserve's Survey of Consumer Finance, the median U.S. household held \$4,100 in a checking account. For the less than 10 percent that held certificates of deposit, the

median holding was \$16,000. A cap of \$40,000 (pre-savings-and-loan crisis) would more than adequately cover the vast majority of U.S. households while also greatly improving market discipline in U.S. banks. Even the typical (median) retirement accounts, not all of which are held at banks, are under \$60,000.

The holdings of deposits are also highly concentrated. For instance, a fourth of all deposits are held by the wealthiest 1 percent of households. The top 10 percent of households hold 67 percent of all deposits.² These wealthiest households also, on average, have considerable non-deposit sources of wealth, such as stocks and bonds. Middle-income and low-income families could still be completely protected even with significant reductions made to deposit insurance coverage.

The argument behind expanding deposit insurance is that it reduces the risk of panic and bank runs. Such may well be true in the short run, but it also comes at the cost of a tremendous reduction in market discipline. A World Bank study of more than 150 countries found that, all else equal, those countries with more generous deposit insurance schemes also suffered more frequent banking crises.³ Similar results hold for the U.S., as various academic studies have found that U.S. uninsured deposits provide substantial monitoring of bank health. The related decline in market discipline that results from deposit insurance has been documented across time and differing regulatory structures.⁴ Few relationships in economics have been found in so many different settings as the link between expanded deposit insurance and bank instability.

President Franklin Roosevelt and the New Deal have been invoked regularly as a model for solving our current financial crisis. But FDR vocally opposed the creation of deposit insurance and threatened to veto the Glass–Steagall banking bill over its inclusion, stating it “would lead to laxity in bank management and carelessness on the part of both banker and depositor.” Ultimately, he signed Glass–Steagall into law, believing its other provisions outweighed the potential harm that might follow from the creation of the FDIC. History continues to confirm FDR’s initial fears toward deposit insurance.

The performance of the Canadian banking system compared to that of the United States during the Great Depression illustrates the problems of deposit insurance. The Canadian banking system, which lacked any deposit insurance during the 1920s and 1930s, suffered only one bank failure in the 1920s

and none in the 1930s. The U.S., with its state-based deposit insurance system, suffered over 6,000 bank suspensions and almost 4,000 mergers and acquisitions in the 1920s alone. The worst of those failures were found in states with the most generous deposit insurance systems.

THE FDIC ASSESSMENT BASE

Dodd–Frank’s Section 331 changes the assessment base for bank-paid premiums into the deposit insurance fund. Prior to Dodd–Frank, premiums were based on coverage. Section 331 changed this assessment system to total assets minus tangible equity. So even if a bank were to fund its operations with either debt or uninsured deposits, it would pay a premium to FDIC for the assets funded. This creates the troubling incentive for banks to substitute debt and uninsured deposits with insured deposits, increasing moral hazard and placing the deposit insurance fund at ever greater risk. Even if one were to subscribe to the concern about runs, the solution lies in forms of debt that are less subject to potential runs, not more insured deposits, as will be the result under Section 331. Perhaps more troubling is that Section 331 may well create the expectation that these “uninsured” liabilities are actually insured, as an insurance premium will now be paid against them. While bank-funding sources should ultimately be driven by market considerations, one can only get closer to a market-driven funding structure by reducing incentives for banks to shift into government-guaranteed liabilities.

One problem with the current system of deposit insurance is the lack of any real risk-based pricing. One might defend Section 331 on such basis, yet there has been no evidence to that effect. The sometimes large losses to the FDIC from bank failures with considerable uninsured liabilities are not due to the nature of those liabilities, but because the FDIC has chosen to cover said liabilities (think *Continental Illinois*⁵). If the FDIC was to faithfully follow its least-cost-resolution requirements, this issue falls away. If policymakers are concerned about the “runability” of uninsured depositors, such depositors can be made explicitly senior to other general creditors.

Despite having some flexibility to base insurance premiums on risk, the FDIC has been reluctant to do so to a significant degree. Congress should mandate differential pricing across states. Of the 516 depositories that failed from 2006 to 2015, approximately

half were located in just four states. One out of six failures was located in the state of Georgia.⁶ A handful of states actually witnessed zero bank failures over the past decade. Clearly the quality of bank supervision differs dramatically across states. Congress should end the ability of some states to transfer their bank losses to others via the deposit insurance fund.

While the majority of bank failures over the past decade have been commercial banks, both the rate and severity of failure continues to be higher for thrifts (savings banks and associations). Congress, in small part, recognized this problem by folding the OTS into the OCC. Congress would do better by directing the FDIC to charge premiums based on differences in bank charters.

With the inflationary environment of the late 1970s, Regulation Q had to be repealed, else the entire banking and thrift systems would have been destroyed. Yet deposit insurance, especially non-risk-based, encourages banks to compete for deposits on the basis of interest paid. In order to reduce this competition, Congress should mandate a floating cap (indexed to inflation) on interest paid on insured deposits. Said cap should not apply to uninsured deposits or debt.

Section 331, in part, shifted the assessment base to assets, instead of insured deposits, out of concerns over the risk of large institutions to the insurance fund. The cleanest and most direct avenue for minimizing such risk is to limit the total amount of insured deposits that can be held by any one institution. A hard cap of 5 percent of insured deposits should allow any bank to fail without posing a significant risk to the fund.

CONCLUSIONS

Rather than take the opportunity to reduce moral hazard by reforming deposit insurance, Dodd–Frank worsened its structure. This guarantees that future crises will be more frequent and more costly. Congress should repeal these, and other, provisions with an eye toward reducing moral hazard and increasing market discipline. Such can be accomplished in a manner that continues to protect retail depositors.

Title III Subtitles A and B—Office of Thrift Supervision. Subtitles A and B of Title III transfer the authorities and responsibilities of the OTS to the OCC. Supervision for thrift holding companies is transferred to the Federal Reserve. These changes appear to have far more impact than they actually do

in substance. In truth, these titles did not eliminate the OTS, but changed the OTS into an office of the OCC. OTS staff were retained in their current roles, with extensive employment protections. Subtitles A and B of Title III are essentially exercises in moving boxes around on an organization chart. Repealing these subtitles would make little difference in terms of the quality of bank supervision.

One narrative behind Dodd–Frank is that competition among financial regulators allowed financial institutions to choose the weakest regulator, and also encouraged regulators to weaken their supervision and enforcement in order to attract more entities toward their charter. The supposed evidence is the failures of AIG and Countrywide, both supervised by the OTS. This theory is false.

Regardless of their charters, all insured depositories, even those chartered at the state level, are subject to supervision by the FDIC. At one extreme, the FDIC could end a bank's ability to offer federally insured deposits, and could do so without the approval of the bank's primary regulator. Under the Bank Holding Company Act, the Federal Reserve maintains considerable supervisory powers over the activities of any company maintaining a bank subsidiary. The narrative of extensive competition and charter-shopping is largely a myth. Of course, in the aftermath of a housing bust, one would expect entities engaged primarily in mortgage finance (thrifts) to perform poorly compared to other entities. The worst performing institutions, Fannie Mae and Freddie Mac, had no choice as to their regulator. Given the near-failure of Citibank, a responsibility of the OCC, the argument that the OCC performed better than the OTS, accounting for the importance of housing to thrifts is little more than an unproven assertion.

Setting aside the validity of the “race to the bottom” theory, it should be noted that Dodd–Frank does not “end” either the OTS or the thrift charter, but simply moves both to the OCC.⁷ If OTS employees had failed, one would have expected them to be punished or fired. They were not. Dodd–Frank transfers all OTS employees to the OCC. The thrift charter is maintained.

While there is some merit in regulatory consolidation, such would not have avoided the crisis. If Congress were to pursue regulatory consolidation for reasons unrelated to the crisis, the best path would be to consolidate such regulation into the FDIC, which ultimately stands behind the deposit

insurance fund and has a far greater incentive to protect the health of depositories than either the OCC or the OTS.

Subtitles D and E. The remainder of Title III contains miscellaneous issues (subtitle D), as well as technical and conforming amendments (subtitle E). A repeal of subtitles A, B, or C would make subtitle E unnecessary; in fact, it would necessitate a repeal of E. Any changes to subtitles A, B, or C would need to be reflected in changes to subtitle E. Section 343, dealing with insurance of transaction actions, is no longer relevant, as it has sunset. Section 342 on the

Office of Minority and Women Inclusion is a labor issue, not a banking issue, and is best addressed outside the banking context; hence, it should be repealed. There is some merit to retaining Section 341, addressing branches of thrifts that convert to a bank charter, although the issue is not of such importance that its retention merits retaining other sections of Title III.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES

1. See, for example, Reint Gropp and Jukka Vesala, "Deposit Insurance, Moral Hazard and Market Monitoring," *European Finance Review*, Vol. 8, No. 4 (2004), pp. 571–602; Erlend Nier and Ursel Baumann, "Market Discipline, Disclosure and Moral Hazard in Banking," *Journal of Financial Intermediation*, Vol. 15, No. 3 (2006), pp. 332–361; David C. Wheelock and Paul W. Wilson, "Explaining Bank Failures: Deposit Insurance, Regulation, and Efficiency," *The Review of Economics and Statistics* (1995), pp. 689–700; Linda M. Hooks and Kenneth J. Robinson, "Deposit Insurance and Moral Hazard: Evidence from Texas Banking in the 1920s," *The Journal of Economic History*, Vol. 62, No. 3 (2002), pp. 833–853; and Clifford F. Thies and Daniel A. Gerlowski, "Deposit Insurance: A History of Failure," *Cato Journal*, Vol. 8 (1988), p. 677.
2. Edward N. Wolff, "Household Wealth Trends in the United States, 1962–2013: What Happened over the Great Recession?" NBER Working Paper No. 20733, December 2014, <http://www.nber.org/papers/w20733> (accessed February 10, 2016).
3. Asli Demirgüç-Kunt and Enrica Detragiache, "Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation," *Journal of Monetary Economics*, Vol. 49, No. 7 (October 2002), pp. 1373–1406.
4. Asli Demirgüç-Kunt and Harry Huizinga, "Market Discipline and Deposit Insurance," *Journal of Monetary Economics*, Vol. 51, No. 2 (2004), pp. 375–399.
5. See Irvine Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues* (Washington, DC: Beard Books, 1986).
6. Christian Rauch, "Bank Fragility and the Financial Crisis—Evidence from the U.S. Dual Banking System," *International Finance Review*, Vol. 11 (201), pp. 33–86.
7. Whether the "race-to-the-bottom" theory is correct, see Mark Calabria, "Would Consolidating Regulators Avoid the Next Crisis?" Wharton School *Lombard Street*, Vol. 1, No. 16 (November 16, 2009), http://fic.wharton.upenn.edu/fic/Policy%20page/Lombard-Street-Issue-16.2_1.pdf (accessed February 10, 2016).

CHAPTER 6

Revisiting Title IV: Why Mandatory SEC Registration for Hedge-Fund Advisers Is Not Necessary

J. W. Verret

Dodd-Frank’s Title IV, “The Private Fund Investment Advisers Registration Act,” achieved what the Securities and Exchange Commission (SEC) had tried in vain to do on its own—mandatory SEC registration of advisers to hedge funds.¹ Congress, motivated by systemic risk and investor-protection concerns,² directed the SEC to reinstitute mandatory registration for most advisers to hedge funds and other private funds. In addition, Title IV further limited the pool of potential investors in hedge funds and other private offerings and imposed substantial reporting requirements on private-fund advisers. Title IV will not achieve its objectives of enhancing financial stability and protecting investors—it will impede economic growth instead.

WHAT TITLE IV DOES

Title IV of Dodd-Frank accomplishes several things. First, Title IV eliminates private-fund advisers’ ability to opt out of SEC registration by eliminating the registration exemption for advisers with fewer than 15 clients.³ Advisers to hedge funds and private equity funds must register with the SEC and are subject to recordkeeping rules and other requirements applicable to registered advisers. Dodd-Frank requires the SEC to “conduct periodic inspections of the records of private funds.”⁴ Venture capital funds and private-fund advisers with less than \$150 million under management need not register, but are subject to reporting requirements and arguably examinations.⁵ Certain foreign advisers are also excluded,⁶ as are certain small business investment company advisers⁷ and certain advisers registered with the Commodity Futures Trading Commission (CFTC).⁸ Family offices, which manage wealthy families’ money, are also exempt from registration.⁹ Title IV imposes recordkeeping and reporting requirements on registered private-fund advisers. It requires the SEC to conduct “periodic

inspections” of private-fund records and authorizes the SEC to conduct examinations.¹⁰

Second, Title IV allows collection of private-fund data by authorizing the SEC to require registered advisers to maintain records and file with the SEC “reports regarding private funds that registered advisers advise, as necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk by the Financial Stability Oversight Council.”¹¹ Dodd-Frank specifically requires the collection of information regarding the amount and type of assets under management, leverage, counterparty credit risk, trading and investment positions, valuation, side arrangements with investors, trading practices, and other information that is “necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.”¹²

Third, Title IV adjusted the minimum for permissible SEC registration from \$25 million to \$100 million for the purpose of shifting more advisers into states’ regulatory jurisdiction.¹³ This change helped to offset the influx of newly registered private-fund

advisers, but increased the burden faced by small advisers operating in multiple states.¹⁴ With fewer smaller registrants, the SEC could shift resources from the oversight of smaller advisers with retail clients to newly registered private-fund advisers.

Fourth, Title IV directed the SEC to modify the net-worth standard for accredited investors, which determines who is entitled to invest in certain nonpublic securities offerings.¹⁵ In response to the dramatic rise and fall in home prices, Dodd–Frank directed the SEC to remove the value of investors’ homes from their net-worth calculation.¹⁶ The statute authorized the SEC to adjust the \$1,000,000 net-worth threshold¹⁷ and to periodically assess the continuing relevance of the other criteria that can make a natural person an “accredited investor” in light of investor protection, the public interest, and the economy.¹⁸ In addition, Dodd–Frank required the SEC to periodically adjust for inflation dollar amounts in its standard for qualified clients—a set of investors who may pay performance-based fees to private funds.¹⁹

Title IV opens the door to future, more interventionist, regulation. Professor Lyman Johnson has described the requirements of Title IV as “really in the nature of an extended study” of hedge funds, which could eventually form the basis for “an even more potentially disquieting debate about the social responsibilities and legal rights of those who facilitate rapid, large capital movements in a way that may destabilize modern markets.”²⁰ Regulators could use the information collected through Form PF, the centerpiece of Title IV’s financial stability efforts, to push an interventionist regulatory agenda with respect to the asset management industry.²¹

LIMITS OF TITLE IV IN ACHIEVING INTENDED OBJECTIVES

Title IV protects neither financial stability nor investors. Instead, it replaces an effective private, contractually based regulatory scheme with a costly, new government regulatory scheme that has potentially adverse effects on economic growth.

Title IV Does Not Bolster Financial Stability. Title IV is one component of Dodd–Frank’s plan for enhancing systemic stability. By empowering regulators to collect information about private funds and their advisers, Title IV is intended to provide regulators a better sense of what is happening in the hedge fund industry and to stop emerging problems before they endanger the financial system. By displacing market

monitoring with regulatory monitoring and imposing barriers on funds’ ability to perform stability-enhancing functions, Title IV undermines market discipline.

If market participants believe that the government is monitoring the markets, private monitoring likely will decrease. Registered advisers will be presumed to be subject to close SEC oversight. Advisers themselves may rely on the government to warn them of imprudent investment strategies.²² The perception of regulatory monitoring will dissuade market participants from undertaking due diligence of their own and responding rationally and promptly to emerging problems by raising them with investment advisers and—in the face of the adviser’s unresponsiveness—switching to a new adviser.²³ Detailed, timely knowledge of what is going on in the markets will be lost if private fund investors outsource their due diligence to the SEC. A multitude of spontaneous decisions by individual investors, their representatives, and others who do business with investment advisers is more effective at uncovering and disciplining underperforming or inept advisers than a system that relies on coordinated actions by regulators to spot and correct problems. Policymakers would do well to heed the warnings of Friedrich Hayek, who has demonstrated the futility and danger of relying on government oversight and management of markets.²⁴

Regulators simply are not equipped to collect and process information and use it in a timely manner to stop problems, especially financial stability problems. According to SEC Chair Mary Jo White, the information collected on Form PF will facilitate regulators’ oversight of financial stability:

Form PF provides information on the types of assets [hedge funds] are holding to help to inform government regulators tasked with monitoring systemic risk. Using this information, regulators can then assess trends over time and identify risks as they are emerging, rather than reacting to them after they unfold.²⁵

While regulators need insight into financial market activity, expectations about what they will be able to do with the information they collect must be moderated. As Michael King and Phillip Maier explain, “It is not clear that more transparency—in the extreme, hedge funds reporting on their positions in a timely fashion—would substantially limit systemic risks, since processing this information is difficult and time consuming.”²⁶

Proponents of Title IV might respond that the government is uniquely interested in systemic risk and therefore has a role to play in monitoring private funds. Government regulators, even when interested in systemic risk, are plagued by the knowledge problem. Aggregating, understanding, and responding to position-specific information in a timely manner is a difficult, and perhaps impossible, task for regulators.²⁷ Michael Cappucci has pointed out that collecting the right information and collecting it in a timely manner is extremely difficult:

[T]he knowledge problem is endemic to any human activity that involves planning or prediction. Additional observation and data cannot solve the core problem, which stems from the inherent inability of finite beings to fully understand complex situations on the basis of insufficient knowledge. The prevalence of the problem is why genuine, true knowledge is scarce, expensive, and hard to come by, and why presumed knowledge so often wilts under close scrutiny.²⁸

Cappucci argues that “the task of containing systemic risk given to the [Financial Stability Oversight Council] is not just difficult, but impossible.”²⁹ Collecting the right information about the financial markets in a timely manner and then acting properly in response are impossible objectives.

Regulators must have access to sufficient information about private funds to develop a broad understanding of the markets. Policymakers, however, should moderate their expectations about how much regulators can do with the information and, accordingly, should limit the amount of information they collect.

Form PF is not a modest information collection effort; it is an ambitious undertaking that illustrates the difficulties in systemic risk regulation. The form consists of four parts³⁰ (some of which apply only to certain categories of private fund advisers) and allows periodic reporting by advisers to private funds.³¹ Large advisers report quarterly and small advisers annually. The SEC and Commodity Futures Trading Commission (CFTC) jointly designed Form PF, although neither is intended to be the primary consumer of the information it collects.

Form PF is designed to collect information for the Financial Stability Oversight Council (FSOC). The chairmen of the SEC and CFTC are members of FSOC, but it is a distinct regulatory body with distinct powers. Consequently, Form PF reflects the best guesses

of the SEC and CFTC—formed after consultation with the FSOC—as to what information the FSOC might want.³² Figuring out what information will be useful in identifying and measuring risks is difficult.

The natural tendency of regulators is to expand the amount of information collected, as regulators hopefully anticipate that real discernment will come with the collection of additional information.³³ Requesting more data is a defensive measure by regulators who do not want to be faulted for failing to ask the right questions or collect the right information. For example, the Office of Financial Research (OFR)³⁴ recently released a paper concluding that Form PF does not do a good job of differentiating among funds posing different levels of risk.³⁵ The paper’s authors recommend “captur[ing] additional characteristics on the form to constrain the range of possible risk profiles more tightly.”³⁶ Yet, as the authors also note, Form PF is already “a complicated report, and its intricacies are a source of possible measurement errors and ambiguities.”³⁷

Most private-fund failures do not have financial stability implications. The failures of Long Term Capital Management and Amaranth, however, are stark reminders that private-fund failures can destabilize markets. Financial stability might be better achieved by relying on “indirect regulation” through hedge funds’ prime brokers and counterparties.³⁸ As discussed below, there are also other, more effective, means for achieving investor protection—the other main objective of Title IV.

Title IV Does Not Support Investor Protection.

In addition to its systemic risk objective, Title IV has an investor-protection objective. Registration of private-fund advisers is perceived to be an investor-protection measure. The experience with Bernard Madoff—who was a registered investment adviser during the final years of his fraud, and arguably should have been registered earlier—illustrates that a registration requirement does not necessarily protect investors.³⁹ Advisers determined to steal client money are also likely to be willing to ignore the registration requirement. Title IV undermines investor protection by serving as a tax on private-fund investors who must indirectly bear the cost of registration, and by diverting scarce SEC resources from retail-investor protection.⁴⁰ It also undermines investor protection by further narrowing the group of investors eligible to invest in private funds.

The time the SEC spends on matters related to private funds is not available for matters related to

retail investors. Under existing accredited investor standards, few retail investors can directly invest in private funds, so they cannot benefit from the SEC's allocation of resources to oversight of private funds. As former SEC Commissioners Paul Atkins and Cynthia Glassman wrote in their dissent from the SEC's earlier unsuccessful attempt to register hedge fund advisers:

In contrast to mutual fund investors, hedge fund investors have not been conditioned to rely on Commission oversight. They can perform due diligence (or hire someone else to do so for them), review audit reports or third-party internal control reports, and enlist help if they suspect fraud or malfeasance. By adopting the registration requirement, the Commission has upset the private-public balance and taken on a task that it might not have adequate resources to perform.⁴¹

Private-fund investors must satisfy wealth or sophistication criteria. Commission resources devoted to private funds protect these sophisticated institutional investors and wealthy individual investors. Some contend that SEC oversight is needed because private-fund investors include pension funds, operated for the benefit of individuals of modest income.⁴² These funds, however, employ highly knowledgeable employees who are able to assess the quality of private-fund advisers.

The SEC has established a Private Funds Unit, has conducted examinations of a quarter of the newly registered advisers,⁴³ and is bringing enforcement actions against private-fund advisers.⁴⁴ Yet, the SEC examined only 10 percent of all registered advisers in 2014.⁴⁵ The SEC, therefore, is devoting a lot of resources to the private-fund space that would otherwise be directed at firms serving retail investors of more modest means. In addition, the SEC's enforcement agenda has shifted as it has consciously chosen to devote resources to bringing a number of enforcement actions against private-fund advisers for alleged abuses.⁴⁶ As one commentator noted, the costs that the SEC incurs in overseeing private-fund advisers to protect investors amounts to a "public subsidy of wealthy investors" that runs counter to the decision to allow these investors to essentially opt out of certain investor protections.⁴⁷ Investors in private funds could instead be protected through antifraud rules, investor demands for transparency,

and their own wealth and sophistication.⁴⁸ Given the SEC's frequent requests for additional resources, directing many of them to the investors that are best situated to monitor their advisers may be unwise.⁴⁹

Particularly given the SEC's expenditure of resources to protect private-fund investors, Title IV's simultaneous move to reduce the number of investors eligible to invest in private funds is puzzling. By removing the value of an investor's home from the accreditation calculation, Dodd-Frank reduced the ranks of investors able to invest in private funds. Private funds can serve a valuable role in investors' portfolios and, as Professor Houman Shadab has explained, "the true impact of wealth-based qualifications is to prevent retail investors who have a sufficient understanding of hedge funds from reducing risk and maximizing their investment returns."⁵⁰

The SEC Is Indirectly Instituting a Broad Regulatory Regime for Private Funds. Title IV of Dodd-Frank was not designed to provide the SEC with powers to regulate the disclosure that hedge funds, private funds, and venture capital funds provide to their wealthy and sophisticated investors. The SEC, however, appears to be indirectly using its authority under Title IV to change the way fund advisers communicate and interact with their investors.

As former SEC Chairman Harvey Pitt has explained, the SEC sometimes uses enforcement to accomplish regulatory ends:

It is, understandably, far easier for SEC officials to defend and pursue individual enforcement actions, particularly if they are highly visible enforcement actions, than to attempt to develop and maintain comprehensive regulatory responses to difficult and technical industry and professional issues.... Among other things...the agency is not required to chart out, explicate, maintain or perfect a comprehensive solution to identified issues, taking into account those circumstances where deviation from normative standards might be appropriate.... [C]ritics and overseers of the agency's activities are less likely to be able to detect inconsistent approaches by the agency to comparable problems, or even to ascertain guiding principles or policies employed by the agency to respond to certain types of situations.⁵¹

In the private-fund context, the SEC is using a regulation-by-enforcement approach to achieve a regulatory framework that is more appropriate for retail funds. In a recent speech, SEC Chair Mary Jo White outlined obligations for the private-fund industry and signaled the prospect of an aggressive SEC examination and enforcement response for funds that do not adhere to these recommendations.⁵² She cited advisers' fiduciary duty as the basis for a long list of concerns that could serve as the groundwork for a mandatory disclosure regime for private funds. White directed private-fund advisers to turn their attention to "some firm-specific risks you should be actively considering in your own business." She identified a long, detailed list of purported problems identified by SEC examiners in their Dodd–Frank reviews or that had been the subject of SEC enforcement actions against private funds. Highlighted problematic practices included misleading marketing materials, inadequate conflict disclosure, unfair trade and expense allocations, inadequate disclosure regarding hiring conflicted parties and borrowing from clients, misallocating expenses to funds, unauthorized and undisclosed payment of operating expenses, and failure to disclose service-provider fees and discounts. Chair White concluded that the SEC's "oversight and exam program...identifies practices that would have been difficult for investors to discover by themselves" and directed "investment advisers to funds—including private funds catering to sophisticated investors—[to] disclose material facts to clients." Thus, the SEC seems to be using its enforcement program to establish a de facto set of mandated disclosures. White has also contemplated mandating standardized performance disclosures for hedge funds.⁵³

The SEC's antifraud authority allows it to pursue fraud by private-fund advisers, but the disclosures that Chairman White is calling for were not authorized by Dodd–Frank, were not adopted pursuant to a notice and comment rulemaking, and were not subjected to an economic analysis as is required of SEC rulemakings. These requirements pre-empt and impede the development of fund-specific governance arrangements that were previously developed pursuant to state contract law and state business entity law, as the following section will describe.

Title IV Pre-Empts and Inhibits the State Law Contractual Rights by Which Investors in Private Funds Can Regulate Private Funds. Investors in private funds typically become limited

partners in limited liability partnerships (LLPs) formed under state business-law codes governing those business-entity forms.⁵⁴ The most popular domicile for creation of limited partnerships for hedge funds is the state of Delaware, which provides strong default contractual obligations for general partnerships to limited partnerships with respect to managerial decisions like those described by Chair White in the previous section. Those default obligations include a requirement that the general partner meet an obligation of a duty of the utmost loyalty and care in management of the partnership.

Delaware and many other states also provide substantial contractual flexibility to limited partnerships to create stricter obligations, or more narrowly tailored obligations, as investors in the partnership prefer to define those obligations. Carefully tailored provisions in limited partnership contracts have typically created effective corporate governance arrangements to monitor and address possible conflicts of interest. These arrangements include the creation of advisory boards of directors that can police conflicts of interest by the general partner managing the fund. For specific transactions, those boards also are often empowered to hire outside advisers to opine on the usefulness and propriety of transactions subject to conflicted motives, such as fee arrangements.

Delaware limited partnership law also provides limited partners with default tools in addition to any tools they may bargain for through the initial contract. Default tools are common in the limited partnership laws of other states as well. For example, investors in LLPs have a default right to inspect partnership books and records. Limited partners can expect to be granted wide latitude from Delaware courts to inspect documents if alleging particularized facts showing mismanagement or wrongdoing by the general partner.⁵⁵ Investors in LLPs also typically have a right to a judicial appraisal of the value of their interest in the partnership upon certain triggering events.⁵⁶

Furthermore, Delaware contract law includes an implied duty of "good faith and fair dealing." This obligation provides limited partners with judicial redress in the event of theft or fraudulent disclosure by the general partner, and actions by the managing general partner not otherwise authorized by the LLP's charter, undertaken in bad faith, that deprive LLP limited partners of the fruits of the LLP bargain.⁵⁷

As the SEC undertakes action that pre-empts state contract law, the incentives of these sophisticated and wealthy investors in hedge funds to formulate and enforce their rights is reduced. A false signal of bonding from the SEC will reduce incentives to monitor and to enforce rights through litigation. It will also reduce incentives of private investors to bargain for specialized provisions in their LLP agreements with hedge funds and private equity funds, since they know the agreements they enter into can always be made redundant by SEC action.

Title IV Imposes Costs on Investors, Competition, and Economic Growth. Hedge funds, private equity funds, and venture-capital funds play an important role in investor portfolios, the financial system, and the economy. They not only strengthen and diversify investors' portfolios,⁵⁸ but foster financial system health and economic growth.⁵⁹ The burdens flowing from Title IV make it more difficult for private funds to perform these important roles.

Private-fund investors arguably benefit from SEC oversight, but they have to bear the costs associated with registration. Registration comes with record-keeping, reporting, and other requirements. In addition, SEC examinations are costly for examined firms, which must expend considerable high-level time to meet examiner demands. Investors are likely to bear some or all of the costs of these regulatory requirements through increased fees. Prior to the adoption of Dodd–Frank, investors could choose to invest in a fund the adviser of which was registered or—if they believed the costs of registration outweighed the benefits—could invest with an unregistered adviser. Title IV eliminated this choice.

As noted, private-fund advisers must complete Form PF. Investors bear at least a portion of the cost of completing this form, but it is designed to meet the needs of systemic regulators, not fund investors.⁶⁰ As one would expect, burdens differ markedly depending on whether a firm is large or small.⁶¹ Although costs will fall over time, the form's length, complexity, and potential for future expansion means that investors may continue to bear substantial costs for the preparation of Form PF without direct benefit.⁶²

Dodd–Frank's enhanced regulatory framework makes it more difficult for new private funds to enter the industry to serve investors, allocate capital, act in the marketplace, add balance to the financial system, and foster economic growth. Mandatory registration has garnered support from existing fund advisers, who might view it as a welcome barrier to the entry

of new competitors.⁶³ Start-up advisers will have to spend time and money wading through regulatory requirements, whereas their established competitors will have ready access to legal and compliance help.

Even firms that are not required to register may face burdens that affect their ability to serve a vital role in the economy. Title IV, as implemented by the SEC, substantially burdens venture capital firms and small private-fund advisers. As former SEC Commissioner Kathleen Casey noted when the SEC adopted its final rules:

Venture capital fund advisers, along with mid-sized private fund advisers, although explicitly exempt from registration under the Dodd–Frank Act, have been designated under the rules' framework to be "exempt reporting advisers," and are therefore subject to many of the same requirements as registered advisers, including public reporting requirements, and eventually recordkeeping obligations, just as if they were registered.⁶⁴

These burdens could increase. Commissioner Troy Paredes observed that "VC fund managers will likely be obligated to disclose more and more information over time, steadily thwarting the purpose behind the venture-capital (VC) registration exemption that Congress enacted."⁶⁵ Investors in these funds will bear additional costs as a result of these requirements.

Aside from the costs associated with being registered, maintaining required records, and hosting SEC examinations, private-fund advisers now face the potential cost of losing control of proprietary information. Commissioner Paredes made the additional point that the public disclosure required of VC funds could end up causing the release of "competitively sensitive" information, the mandatory disclosure of which "could harm VC funds and the very investors that the rule purports to protect."⁶⁶ For information provided only to the government, Title IV contains confidentiality protections,⁶⁷ but government data breaches happen.⁶⁸ Moreover, regulators with access to the information may use their knowledge of proprietary practices at private funds when they leave government. Title IV permits the SEC to share information it collects with other regulators.⁶⁹ Although there are good reasons for such interagency information sharing, doing so increases the likelihood that confidential information will be compromised either through a data breach or

through a government regulator who departs for the private sector. The specificity of the information collected on Form PF raises particular concerns.

Private funds play an important role in monitoring the financial system and identifying potential dangers. During the crisis, for example, certain hedge fund advisers spotted the growing housing finance problems.⁷⁰ During a crisis, private funds can bolster stability. As Jón Daniélsson, Ashley Taylor, and Jean-Pierre Zigrand point out, “the trading behavior of hedge funds can improve market efficiency, price discovery and consumer choice” and can offset trading by banks directed by regulators during a crisis.⁷¹ They also point out the theoretical, albeit “not settled” possibility “that regulating hedge funds could actually increase market volatility and decrease liquidity and stability of financial markets.”⁷² By placing a regulatory tax on hedge funds performing beneficial roles in the market, Title IV ironically could make the financial system more—not less—unstable.

A BETTER WAY TO ACHIEVE TITLE IV OBJECTIVES

The objectives of Title IV—promoting financial stability and protecting investors—are valid. A more effective way to achieve these objectives would be to return to a voluntary registration model. Investment advisers could choose to register with the SEC, if they believe their investors would value it. To address concerns that such an approach would unduly burden the SEC, Congress could require that advisers to private funds pay for SEC examinations or periodic third-party examinations. This requirement might dissuade some advisers from choosing SEC registration and encourage them to explore other alternatives, such as hiring third-party examiners to conduct periodic compliance reviews.⁷³ Such a result would help to preserve SEC resources for purposes more directly related to retail-investor protection and would enable fund investors to tailor outside monitoring arrangements to their needs.

The information-collection requirements under Title IV are intended to form the basis for systemic intervention by the FSOC. Not only is it difficult to collect the appropriate information, but properly calibrating the regulatory reaction to such information is difficult. Accordingly, Form PF should be discontinued or pared back so that it only serves a basic census function to provide the SEC with information about the number and type of private funds. The elimination of the general solicitation

ban pursuant to the Jumpstart Our Business Startups (JOBS) Act removes one barrier to private-fund transparency, which means that—even absent a census framework—investors and regulators likely will find it easier to obtain information about private funds.⁷⁴

If the accredited investor definition is not fundamentally reconsidered, it should be reworked to allow broader participation in private offerings by individuals who do not meet current wealth and income thresholds. Geographic adjustments to the numerical values should be considered a way to ensure that wealthy investors in the heartland—not just investors who live on the comparatively wealthier East and West Coasts—can participate in private offerings. Policymakers should avoid one-off exclusions of assets from the wealth calculation, such as Dodd-Frank’s primary residence exclusion. Exclusions of these types lead to arbitrary distortions in investor behavior. The required inflation adjustments of the qualified client standard should also be eliminated. A more meaningful change would be the elimination of the standard so that performance-based fees are no longer limited to a small subset of wealthy investors.

CONCLUSION

Title IV of Dodd-Frank embraced the theme that pervades the rest of the statute—regulators, armed with enough information, can stop financial crises. As with the other key pieces of Dodd-Frank, the prescription in Title IV places unrealistic hope in regulators to collect the right data and use it properly to avert systemic problems. A better way to achieve financial stability is to minimize regulatory burdens on private funds so that they can continue to play their important role in disciplining market participants, fostering economic growth, and contributing to market liquidity. Antifraud provisions of the federal securities laws and private contracting under state law effectively protect private-fund investors. Reducing regulatory burdens also will make it easier for new entrants to join the industry. Opportunities to invest in private funds should be opened to a broader circle of investors than is currently allowed under the restrictive accredited-investor standard. Finally, private-fund investors should be permitted to choose SEC-registered advisers, but should bear the cost so that they choose wisely.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. The SEC adopted a registration requirement only to have it overturned in court. *Goldstein v. SEC* (D.C. Cir., 2006) vacated and remanded the SEC's hedge fund registration rule, which was grounded in the SEC's "manipulation of [the] meaning" of the term "client."
2. See, for instance, U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act," p. 9, (undated), https://web.archive.org/web/20100707081557/http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (accessed February 12, 2016). The summary explains that the legislation "(e)nds the 'shadow' financial system by requiring hedge funds and private equity advisors to register with the SEC as investment advisers and provide information about their trades and portfolios necessary to assess systemic risk."
3. Dodd-Frank § 403 (amending 15 U.S. Code § 80b-3(b)).
4. Dodd-Frank § 404 (adding 15 U.S. Code § 80b-4(b)(6)).
5. Dodd-Frank §§ 407-408 (adding 15 U.S. Code § 80b-3(l)-(m)). Commissioner Troy Paredes pointed out that "because Congress put the new VC registration exemption in Section 203(l) of the Advisers Act instead of Section 203(b), where the former private adviser exemption was found, the SEC would appear to have the authority to examine VC fund managers that are exempt from registration, meaning that exempt VC fund managers may be subject to still more regulatory burdens than the new public reporting obligations." Securities and Exchange Commission, "Speech by SEC Commissioner Troy A. Paredes: Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets Under Management, and Foreign Private Advisers and Final Rules Implementing Amendments to the Investment Advisers Act of 1940," June 22, 2011, http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm#_ftnref1 (accessed February 10, 2016).
6. This exemption "has only very limited application." Kaitlin Curry Albiez, "Hedge Fund Oversight and Title IV: Less than Meets the Eye," *Seton Hall Legislative Journal*, Vol. 37, No.1 (2013), pp. 145 and 157, <http://scholarship.shu.edu/cgi/viewcontent.cgi?article=1046&context=shlj> (accessed February 10, 2016).
7. Dodd-Frank § 403 (amending 15 U.S. Code § 80b-3(b)).
8. Dodd-Frank § 403 (amending 15 U.S. Code § 80b-3(b)).
9. Dodd-Frank § 409 (amending 15 U.S. Code § 80b-2). The SEC's implementation of this section warrants retrospective review. Dodd-Frank and the implementing regulations caused many family offices to register, or to change their structure to avoid registration.
10. Dodd-Frank § 404 (adding 15 U.S. Code § 80b-4(b)(6)).
11. Dodd-Frank § 404 (adding 15 U.S. Code § 80b-4(b)(1)). The SEC has made the data available to the Office of Financial Research rather than directly to the Financial Stability Oversight Council. Securities and Exchange Commission, "Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports," August 13, 2015, p. 4. The SEC also makes certain data available in aggregate form to the Financial Stability Board and the International Organization of Securities Commissions: SEC, "Annual Staff Report," p. 6.
12. Dodd-Frank § 404 (adding 15 U.S. Code § 80b-4(b)(3)).
13. Dodd-Frank § 410 (adding 15 U.S. Code § 80b-3a(a)).
14. See, for instance, Seth Chertok, "A Detailed Analysis of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act," *University of Virginia Law and Business Review*, Vol. 6, No. 1 (Spring 2011), p. 22. Chertok points out that "given a choice between federal and state registration, many investment advisers will choose to register with the SEC, rather than register with the applicable state authorities because state registration can be more onerous by requiring registration and filing fees in multiple states, various testing requirements for investment adviser representatives and compliance with certain state rules."
15. Dodd-Frank § 413 (15 U.S. Code § 77b note).
16. Dodd-Frank § 413(a).
17. Dodd-Frank § 413(a).
18. Dodd-Frank § 413(b).
19. Dodd-Frank § 418 (amending 15 U.S. Code § 80b-5(e)).
20. Lyman Johnson, "Why Register Hedge Fund Advisers—a Comment," *Washington and Lee Law Review*, Vol. 70, No. 1 (2013), pp. 723-724.
21. See, for instance, Board of Governors of the Federal Reserve System, "Speech: Daniel K. Tarullo, Advancing Macroprudential Regulatory Objectives," January 30, 2015, <http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm> (accessed February 11, 2016). Governor Tarullo noted that "[a]sset management activities have commanded considerable attention lately, both internationally at the [Financial Stability Board (FSB)] and domestically at the Financial Stability Oversight Council (FSOC)." The FSB is looking at "financial stability risks from asset management activities." News release, "Next Steps on the NBNI G-SIFI Assessment Methodologies," Financial Stability Board, July 30, 2015, <http://www.financialstabilityboard.org/2015/07/next-steps-on-the-nbni-g-sifi-assessment-methodologies/> (accessed February 11, 2016).
22. Michael R. King and Phillip Maier, "Hedge Funds and Financial Stability: The State of the Debate," Bank of Canada *Discussion Paper* No. 2007-9, September 2007, p. 16. King and Maier observe that "[h]edge funds might take on positions in the false belief that supervisors will alert them if different strategies become crowded or hazardous."

23. See, for instance, Franklin R. Edwards, “Hedge Funds and Investor Protection Regulation,” as presented at Federal Reserve Bank of Atlanta Financial Markets Conference, May 15–18, 2006, footnote 15, https://www.frbatlanta.org/news/conferen/06fmc/06fmc_edwards.pdf (accessed February 11, 2016). Edwards notes that “[t]here also is a possibility that SEC registration will result in a higher incidence of fraud because hedge fund investors may become more reckless in their choice of advisers because of a belief that SEC oversight now protects them against such fraud.”
24. Nobelprize.org, Prize Lecture by Friedrich von Hayek, “The Pretence of Knowledge,” December 11, 1974, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html (accessed February 11, 2016). Hayek remarked: “The recognition of the insuperable limits to his knowledge ought indeed to teach the student of society a lesson of humility which should guard him against becoming an accomplice in men’s fatal striving to control society—a striving which makes him not only a tyrant over his fellows, but which may well make him the destroyer of a civilization which no brain has designed but which has grown from the free efforts of millions of individuals.”
25. Mary Jo White, “Hedge Funds—A New Era of Transparency and Openness,” Securities and Exchange Commission, speech, October 18, 2013, <http://www.sec.gov/News/Speech/Detail/Speech/1370539892574> (accessed February 11, 2016).
26. King and Maier, “Hedge Funds and Financial Stability.”
27. See, for instance, Jón Daniélsson, Ashley Taylor, and Jean-Pierre Zigrand, “Highwaymen or Heroes: Should Hedge Funds Be Regulated?” *Journal of Financial Stability*, Vol. 1, No. 4 (2005), pp. 36–37. The authors observe, in connection with position-level reporting to regulators, that “[e]ffectively, the supervisor would have to run a risk engine that simultaneously encompasses the positions of all hedge funds. Such a task is beyond the limits of existing technology.”
28. Michael Cappucci, “Prudential Regulation and the Knowledge Problem: Towards a New Paradigm of Systemic Risk Regulation,” *Virginia Law and Business Review*, Vol. 9 (Fall 2014), p. 25.
29. *Ibid.*, p. 5.
30. Specifically, Form PF is broken into one section each for: all private fund advisers, large hedge funds, large liquidity fund advisers, and large private equity fund advisers.
31. Securities and Exchange Commission, “Form PF: Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors,” OMB No. 3235–0679, <https://www.sec.gov/about/forms/formpf.pdf> (accessed February 11, 2016).
32. “Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF,” *Federal Register*, Vol. 76, November 16, 2011, p. 71129. The notice explains: “The SEC is adopting Advisers Act rule 204(b)-1 and Form PF to enable FSOC to obtain data that will facilitate monitoring of systemic risk in U.S. financial markets. Our understanding of the utility to FSOC of the data to be collected is based on our staffs’ consultations with staff representing the members of FSOC.... The policy judgments implicit in the information required to be reported on Form PF reflect FSOC’s role as the primary user of the reported information for the purpose of monitoring systemic risk. The SEC would not necessarily have required the same scope of reporting if the information reported on Form PF were intended solely for the SEC’s use.”
33. Admittedly, there is a countervailing incentive for regulators *not* to collect information for fear of later being faulted for not stopping a crisis despite being in possession of information. See, for instance, Daniélsson, Taylor, and Zigrand, “Highwaymen or Heroes: Should Hedge Funds Be Regulated?” p. 537: “In the event of future problems relating to hedge fund activity, regulators are exposed to an ex post criticism that they had the information and should have prevented the problem.” Because Title IV authorizes the collection of extensive information, however, if regulators choose not to collect it, they are likely to be blamed for not exercising their authority.
34. The OFR is associated with, but distinct from the FSOC, and receives Form PF information from the SEC.
35. Mark D. Flood, Phillip Monin, and Lina Bandyopadhyay, “Gauging Form PF: Data Tolerances in Regulatory Reporting on Hedge Fund Risk Exposures,” OFR *Working Paper* July 30, 2015, p. 22. The authors “show that equivalent filings of Form PF can represent a wide range of actual risk as measured by a broad array of measures.”
36. *Ibid.*, p. 26.
37. *Ibid.*, p. 10.
38. See King and Maier, “Hedge Funds and Financial Stability.” See also Daniélsson, Taylor, and Zigrand, “Highwaymen or Heroes: Should Hedge Funds Be Regulated?” p. 537. Daniélsson and his co-authors argue that prime brokers “play a role as risk managers and can use their power to recall short-term credit lent to the hedge funds in order to impose acceptable levels of risk taking.” Daniélsson and his co-authors also argue for a resolution mechanism, in which “[p]rime brokers may also need to make funds available during such a resolution procedure, which provides incentives for their closer prudential monitoring of hedge funds” (pp. 540–541).
39. SEC Office of Investigation, “Investigation of the Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme (Public Version),” Office of Inspector General Report No. OIG–509, August 31, 2009, p. 348. “The Enforcement staff decided that Madoff was not eligible for the broker-dealer exemption of the Investment Advisers Act of 1940, because he managed more than fifteen discretionary accounts.” (Footnote omitted.)
40. See, for instance, Cynthia A. Glassman, “Policy Session II: Hedge Funds and Investor Protection Regulation,” remarks at Federal Reserve Bank of Atlanta Financial Markets Conference May 2006, https://www.frbatlanta.org/news/conferen/06fmc/06fmc_glassman_comments.pdf (accessed February 11, 2016). Glassman notes that hedge-fund-adviser registration would result in “the diversion of resources that would otherwise be available to inspect the much larger universe of advisers to mutual funds, 529 plans, and annuities—whose investors number more than 90 million, relative to the fewer than 1 million individual and institutional hedge fund investors.”

41. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, *Federal Register*, Vol. 69, December 10, 2004, p. 72094. (Footnotes omitted.)
42. See, for instance, Securities and Exchange Commission, Registration Under the Advisers Act of Certain Hedge Fund Advisers, *Federal Register*, Vol. 69, December 10, 2004, p. 72057. The SEC noted that with the increased investment by “public and private pension funds, as well as universities, endowments, foundations, and other charitable organizations” to hedge funds, unsophisticated and non-accredited investors are indirectly exposed to hedge funds.
43. SEC Office of Compliance Inspections and Examinations, “Private Equity: A Look Back and a Glimpse Ahead,” speech by Mark Wyatt, acting director, May 13, 2015. Wyatt stated: “OCIE has now completed our Presence Exams, which examined 25 percent of the newly registered private fund advisers (including both private equity and hedge funds).”
44. For example, SEC enforcement director Andrew Ceresny was quoted recently, in connection with a case about allegedly improper fees: “Our clear message to the entire private-equity industry is that this is an area of great risk, and that whatever the success of the fund over time, hidden or inadequately disclosed fees will not be tolerated regardless of the size of the adviser.” Lisa Beilfuss and Aruna Viswanatha, “Blackstone in \$39 Million SEC Settlement,” *The Wall Street Journal*, October 7, 2015.
45. See, for instance, Mary Jo White, “Testimony on the Fiscal Year 2016 Budget Request of the U.S. Securities and Exchange Commission,” Securities and Exchange Commission, May 5, 2015, <http://www.sec.gov/news/testimony/testimony-fy-2016-sec-budget-request.html> (accessed February 11, 2016). White explains that “the SEC was only able to examine 10 percent of registered investment advisers in FY 2014,” and observes that a “rate of adviser examination coverage at that level presents a high risk to the investing public.”
46. See, for instance, the enforcement cases cited in footnotes 21–24 of Mary Jo White, “Five Years On: Regulation of Private Fund Advisers after Dodd–Frank,” keynote address at the Managed Fund Association, MFA Outlook 2015 Conference, New York, October 16, 2015, <http://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html> (accessed February 11, 2016).
47. Vijay Sekhon, “Can the Rich Fend for Themselves? Inconsistent Treatment of Wealthy Investors Under the Private Fund Investment Advisers Registration Act of 2010,” *Hastings Business Law Journal*, Vol. 7 (2011), p. 8.
48. Luther R. Ashworth II, “Is Hedge Fund Adviser Registration Necessary to Accomplish the Goals of the Dodd–Frank Act’s Title IV?” *Washington and Lee Law Review*, Vol. 70, No. 1 (2013), p. 654.
49. As noted earlier, dissenting Commissioners Paul Atkins and Cynthia Glassman made a similar argument when the SEC adopted its subsequently invalidated hedge fund registration mandate.
50. See, for instance, Houman B. Shadab, “Hedging One’s Bets—Increasing Access to Hedge Funds,” *Mercatus on Policy* No. 15, February 2008, p. 4, <http://mercatus.org/publication/hedging-ones-bets-increasing-access-hedge-funds> (accessed February 11, 2016).
51. J. W. Verret, “Economic Analysis in Securities Enforcement: The Next Frontier at the SEC,” *University of Cincinnati Law Review*, Vol. 82 (2013), p. 494 (quoting Harvey L. Pitt and Karen L. Shapiro, “Securities Regulation By Enforcement: A Look Ahead at the Next Decade,” *Yale Journal on Regulation*, Vol. 7 (1990), pp. 156–157).
52. White, “Five Years On: Regulation of Private Fund Advisers after Dodd–Frank.”
53. White, “Hedge Funds—A New Era of Transparency and Openness.” White asks whether “the SEC or some other organization attempt to mandate standardized performance disclosure for hedge funds [is] consistent with a recommendation from our Investor Advisory Committee.”
54. Grant Thornton LLP and Stonegate Capital Partners, “How Do You Start a Hedge Fund? The New Era of Hedge Fund Creation and Operational Management,” December 2011, <https://www.managedfunds.org/wp-content/uploads/2012/03/Starting-a-hedge-fund-GrantThornton-Stonegate-Capital-Dec-2011.pdf> (accessed February 11, 2016).
55. Delaware Code, Title 6, Section 17–305.
56. Delaware Code, Title 6, Section 17–212.
57. *Nemec v. Schrader*, 991 A.2d 1120 (Del. 2010).
58. See, for instance, Shadab, “Hedging One’s Bets—Increasing Access to Hedge Funds,” pp. 2–3. Shadab notes that “while hedge fund returns do not always beat market returns, they almost always produce annual gains regardless of the direction of the general market.”
59. See, for instance, J. W. Verret, “Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal,” *Delaware Journal of Corporate Law*, Vol. 32, No. 3 (2007), pp. 804 and 815. Verret discusses some of the positive functions played by hedge funds.
60. For survey-generated cost estimates associated with Form PF, see Wulf A. Kaal, “Private Fund Disclosures Under the Dodd–Frank Act,” *Brooklyn Journal of Corporate, Financial, and Commercial Law*, Vol. 9 (2015), pp. 439–453.
61. Kaal found that small firms spent an average of just under \$10,000 on the initial filing, and that large firms spent an average of \$155,000. *Ibid.*, p. 447.
62. Approximately one-quarter of advisers was asked by investors for the Form PF, and some advisers accommodate these requests. *Ibid.*, pp. 467–468.
63. See, for instance, J. W. Verret, “Review: Is Hedge Fund Registration Necessary?” *Washington and Lee Law Review*, Vol. 70 (2013), p. 710. Verret notes that “the fact that the hedge fund industry itself embraced the mandatory registration regime, or at least did not fight against it, presents a puzzle for which public choice theory may provide an answer.”

-
64. Kathleen L. Casey, “Statement at SEC Open Meeting—Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets Under Management, and Foreign Private Advisers,” speech by SEC Commissioner, June 22, 2011, <https://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm> (accessed February 11, 2016).
 65. Troy A. Paredes, “Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets Under Management, and Foreign Private Advisers and Final Rules Implementing Amendments to the Investment Advisers Act of 1940,” speech by SEC Commissioner, June 22, 2011, http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm#_ftnref1 (accessed February 11, 2016).
 66. *Ibid.*
 67. Dodd–Frank § 404 (adding 15 U.S. Code § 80b-4(b)(8)).
 68. See, for instance, Marcia Breen, “OPM Finishes Mailing Letters to Most Data Breach Victims,” *NBCNews.com*, December 11, 2015, <http://www.nbcnews.com/tech/tech-news/opm-finishes-mailing-notification-letters-data-breach-victims-n478721> (accessed February 11, 2016). Breen reports that “21.5 million Americans...had their personal information stolen” due to “a data breach at the U.S. Office of Personnel Management.”
 69. Dodd–Frank § 404 (adding 15 U.S. Code § 80b-4(b)(7)).
 70. See, for instance, Gregory Zuckerman, “Trader Made Billions on Subprime,” *The Wall Street Journal*, January 15, 2008. Zuckerman explains how hedge fund manager John Paulson identified and profited from the housing bubble.
 71. Danielsson, Taylor, and Zigrand, “Highwaymen or Heroes,” p. 523.
 72. *Ibid.*, p. 535.
 73. See, for instance, Verret, “Dr. Jones and the Raiders of Lost Capital,” pp. 833–835. Verret recommends that the SEC “take steps to encourage creation of a private market intermediary” (citing Harvey Westbrook Jr., “Hedge Fund Industry Structure and Regulatory Alternatives,” SEC Office of Economic Analysis, September 8, 2003, <http://www.q-group.org/conf/Westbrook.pdf> (accessed February 11, 2016)).
 74. See, for instance, White, “Hedge Funds—A New Era of Transparency and Openness.” White observed that because of the lifting of the general solicitation ban, “hedge fund managers feel they have a new freedom to communicate with the public, to advertise, to talk to reporters, to speak at conferences and, most importantly, communicate with investors openly and frankly...without the fear of securities regulators knocking on your door, or your outside counsel screaming at you.”

CHAPTER 7

Title V and the Creeping Federalization of Insurance Regulation

Hester Peirce

A quick reading of Dodd–Frank—if such a thing is possible—would lead one to conclude that the insurance industry got a pass. Dodd–Frank introduced a new consumer financial products regulator, created a council of regulators to monitor the financial system, devised a comprehensive regulatory structure for derivatives, and generally expanded regulators’ discretionary authority over the financial sector. Dodd–Frank did not explicitly remake the insurance regulatory framework. The McCarran–Ferguson Act’s assurance that insurance is primarily the province of state regulation remains the law.¹

Nevertheless, Dodd–Frank, perhaps inadvertently, paves the way for federalization of insurance regulation. In doing so, it conflicts with the spirit of McCarran–Ferguson by allowing non-insurance laws to override state insurance regimes. The expanding federal role in insurance regulation is likely to gradually undermine state regulation and fuel an expectation of a federal backstop, which will only serve to heighten calls for increased federal oversight of the industry. This chapter examines each Dodd–Frank contributor to the federalization of insurance, with particular emphasis on Title V, Dodd–Frank’s often-ignored insurance title. The chapter concludes with a brief sketch of possible alternatives to Dodd–Frank’s haphazard federalization approach.

DODD–FRANK’S FEDERALIZATION OF INSURANCE REGULATION

The federal government was not entirely absent from insurance regulation before Dodd–Frank,² but the act markedly increased the federal presence and opened the door to an even greater presence in the future. The dramatic downfall and federal bailout of the insurance giant American International Group (AIG) serves for some as a justification for a more

active federal role in overseeing insurance companies.³ Proponents of state regulation contend that AIG’s failure was not related to insurance, a claim that glosses over AIG’s life insurance subsidiaries’ troubles.⁴ Yet, even if one concedes that the insurance sector was caught up in the crisis, Dodd–Frank could make matters worse by layering an awkward, arbitrary, and costly federal framework on top of the existing state framework.

While this chapter’s main emphasis is on the federalization of insurance regulation that has and likely will continue to occur under Title V of Dodd–Frank, federalization is occurring through four Dodd–Frank routes:

Title I. First, Title I of Dodd–Frank created the Financial Stability Oversight Council (FSOC) to monitor and manage risk across the financial system, including in the insurance sector. Title I views certain financial companies and activities as potential threats to financial stability and creates the FSOC to monitor and keep in check those firms and activities. The FSOC’s members include the heads of the federal financial regulators and other relevant experts, including the director of the new Federal Insurance Office, a state insurance commissioner, and an

“independent member appointed by the President with the advice and consent of the Senate, having insurance expertise.”⁵ Of these three insurance representatives, only the independent insurance expert has voting power. The presence of three insurance members underscores that Dodd–Frank’s drafters saw insurance firms and activities as well within the FSOC’s purview.

Among the FSOC’s tools for managing systemic risk—which is difficult to define and harder to measure—is the power to designate systemically important companies—including insurers. The Board of Governors of the Federal Reserve System, in consultation with the FSOC, has broad authority to develop tailored prudential standards for designated companies, including liquidity, risk management, and disclosure requirements.⁶ These prudential standards must be “more stringent than the standards and requirements applicable to” their purportedly less risky competitors.⁷

The systemic risk associated with insurers—especially life insurers—has been a matter of lively academic debate, particularly in the wake of the problems suffered by AIG and several other large insurance companies during the financial crisis.⁸ The FSOC has weighed in on this debate by designating three large insurers—AIG, Prudential, and MetLife—as systemically important and in need of special regulation by the Federal Reserve.⁹ The statute directs the FSOC to designate a nonbank financial company systemically important if the FSOC “determines that material financial distress at the... company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the [company’s activities] *could* pose a threat to the financial stability of the United States.”¹⁰ (Emphasis added.) The statute further directs the FSOC to look at a broad range of issues through a multi-step process in deciding whether to designate a company as needing special regulation by the Federal Reserve. By using “could” and providing the FSOC with an open-ended list of factors to consider, Dodd–Frank affords the FSOC broad designation power.¹¹ To justify the insurer designations, the FSOC patched together complex failure scenarios from an unrealistic bundle of assumptions about the insurance industry, state insurance regulators, and the designated companies.¹² Prudential and MetLife publicly challenged the FSOC’s systemic determination, and MetLife is engaged in an ongoing lawsuit to overturn its designation.¹³

Regardless of how that lawsuit turns out, the initial insurer designations have begun to take effect. Insurance companies, counterparties, and consumers now operate with added uncertainty because of the FSOC’s power to designate companies and activities. The Federal Reserve already has a powerful place in the insurance regulatory landscape. The extra regulatory costs associated with designation are driving strategic decision making.¹⁴ These costs could increase as the Federal Reserve further determines how it will exercise its regulatory authority over designated insurance companies. FSOC designations also affect non-designated companies, which now face rivals that are earmarked as being too important to fail. For insurance companies that market their longevity and reliability, such a designation could be a real competitive advantage.¹⁵ Thus, Title I embodies a substantial step toward the federalization of insurance regulation, without a clear benefit.¹⁶

Title II. The second Dodd–Frank path toward federalization of insurance regulation is Title II, which establishes a non-bankruptcy mechanism for resolving financial companies identified as systemically risky by the Treasury Secretary and the Federal Reserve in consultation with the President and relevant federal regulators.¹⁷ Insurance companies and insurance holding companies are among the financial institutions that can be identified for resolution under Title II.¹⁸ The Federal Deposit Insurance Corporation (FDIC) serves as receiver for companies selected for resolution under Title II. For insurance companies, however, once a systemic-risk determination is made, Dodd–Frank allows the state law resolution mechanisms to operate (except for the company’s non-insurance subsidiaries and affiliates).¹⁹ If state regulators fail to act within 60 days of the systemic-risk determination, Title II allows the FDIC to step in to resolve the affected insurance company under state law.²⁰

The federal government has not yet invoked Title II, but Dodd–Frank raises the possibility of federal involvement in traditional state functions of identifying and resolving failing insurance companies. States manage insurer failures through state receivership proceedings in which the state insurance commissioner typically serves as receiver, and nonprofit guaranty associations established under state law ensure a statutorily established minimum recovery for policyholders.²¹ When multistate insurers fail, state guaranty associations coordinate their actions through a national association of guaranty

associations. The government’s potential to intervene in this process adds a measure of uncertainty to the regulatory landscape for large insurance companies, their customers, and counterparties.

Titles III and VI. The third route toward greater federal control over insurance comes through Titles III and VI of Dodd–Frank. Title III transferred to the Federal Reserve the now-defunct Office of Thrift Supervision’s (OTS’s) authority over savings-and-loan holding companies (SLHCs).²² Because many insurance companies—particularly large ones—owned thrifts at the time Dodd–Frank took effect,²³ the law made the Federal Reserve an important insurance supervisor. The Federal Reserve, through its authority over FSOC-designated insurers and insurer SLHCs, oversees approximately one-third of the insurance industry.²⁴

Title VI of Dodd–Frank gives the Federal Reserve broad supervisory authority over SLHCs and their subsidiaries. The Federal Reserve may obtain reports from SLHCs and their subsidiaries and examine them to gain information about “the nature of the operations and financial conditions”; “financial, operational, and other risks” that might threaten an insured depository within the holding company or “the stability of the financial system of the United States”; and “systems...for monitoring and controlling [these] risks.”²⁵ Although Dodd–Frank directs the Federal Reserve to rely on the reports of, and coordinate with, other regulators, the degree to which it does so is up to its own discretion.²⁶ Dodd–Frank requires the Federal Reserve to examine SLHC non-thrift subsidiaries’ activities “in the same manner, subject to the same standards, and with the same frequency as would be required” for the thrift’s activities.²⁷ Activities conducted by insurance subsidiaries are excluded, but certain non-insurance activities conducted by insurers may still be covered by this requirement.²⁸

The Federal Reserve exercises its holding company authority with the objectives of “protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions while mitigating any risks to financial stability.”²⁹ In practice, those objectives translate into substantial control over insurers, and the Federal Reserve plans to use its holding company authority more aggressively than its predecessor, the OTS.³⁰ The Federal Reserve plans “to establish an SLHC supervisory program similar in nature to its long-established supervisory program for bank holding companies.”³¹ In its new

supervisory capacity, the Federal Reserve is working on matters, such as developing capital requirements, subjecting regulated companies to stress tests, and setting risk-management and corporate-governance standards.³² The Federal Reserve does not have extensive insurance expertise.³³ As a consequence, its tendency is likely to be to approach matters from its traditional bank regulatory perspective.

As a major insurance supervisor, the Federal Reserve participates in the global standard-setting deliberations of the International Association of Insurance Supervisors (IAIS) and the Financial Stability Board (FSB).³⁴ The Federal Reserve may not be of one mind with state regulators in international regulatory dialogues. The Federal Reserve insists that its regulatory interests are “complementary to, and coordinated with, state insurance regulation,”³⁵ but Paul Kupiec has identified potential “serious conflicts” between state insurance regulations and “new Federal Reserve examination and capital policies for insurers affiliated with a depository institution.”³⁶

Title V. The final insurance-related piece of Dodd–Frank—Title V, although innocuous at first glance—makes it unlikely that any aspect of insurance regulation is beyond the reach of federal regulators. Title V creates a new Federal Insurance Office (FIO). The FIO is not a front-line regulator, but it may become a backdoor regulator. On the one hand, the FIO brings insurance expertise to the federal government, something that has been lacking at the federal level.³⁷ On the other hand, although limited in apparent reach, Title V lays the groundwork for a larger future role for the federal government in insurance regulation. The potential role of the FIO in expanding federal insurance regulation is the subject of the next section.

THE ROLE OF THE FIO IN EXPANDING FEDERAL REGULATION

Title V of Dodd–Frank—the “Federal Insurance Office Act of 2010”—creates the Federal Insurance Office, an office within Treasury. The FIO’s mandate includes all insurance except medical, long-term care, and federal crop insurance.³⁸ The office acts “pursuant to the direction of the Secretary.”³⁹ The Treasury Secretary appoints the FIO director, but has limited ability to remove him from the position.⁴⁰ Dodd–Frank authorizes the FIO director—in carrying out its functions—to consult with state regulators, but the extent of that consultation is left to the director’s discretion.⁴¹ Dodd–Frank disclaims

any intention of making the FIO an insurance regulator or supervisor,⁴² and the FIO, too, disclaims such a role.⁴³ Nevertheless, the FIO establishes a federal presence in the insurance industry. As Patricia McCoy points out, by bringing insurance experts into the federal government, the FIO makes a more active federal role in insurance likely.⁴⁴

Functions of the FIO. The FIO plays an important role in influencing domestic and international insurance policy. The FIO director advises the Treasury secretary “on major domestic and prudential international insurance policy issues.”⁴⁵ The FIO is charged with seven broad responsibilities: (1) monitoring the insurance industry,⁴⁶ including identifying systemically consequential regulatory gaps; (2) monitoring “access to affordable insurance products” for “traditionally underserved communities and consumers, minorities...and low- and moderate-income persons”; (3) recommending insurers for FSOC designation; (4) helping to administer the Terrorism Insurance Program; (4) playing a lead role in international insurance discussions and negotiations; (5) determining whether state regulations are pre-empted by international prudential regulatory agreements; (6) consulting with states on national and international issues; and (7) carrying out “other related duties and authorities as may be assigned” by the Treasury Secretary.⁴⁷

The FIO has a number of powers, which offer it substantial ability to affect the financial landscape. The FIO may collect information from insurers⁴⁸ and their affiliates,⁴⁹ “enter into information-sharing agreements”; “analyze and disseminate” the information it collects; and issue reports.⁵⁰ Dodd-Frank does not meaningfully limit the data that the FIO can collect. “Small” insurers are exempt from data collection, but the FIO determines what “small” means.⁵¹ Although Dodd-Frank requires the FIO to see if it can obtain the information in a timely manner from federal and state insurance regulators before collecting the information itself, the statute empowers the director to collect the information directly if he determines that the other regulator cannot provide the information on time.⁵²

Dodd-Frank provides the director with subpoena power to get the information—a power limited only by the requirement that he make a written finding that the FIO needs the information and has worked with other regulators to get it.⁵³ Because affiliates of insurance companies are covered, the range of companies subject to this subpoena power

is quite broad. Depending on the breadth and timing of the demands, such data requests could be extremely burdensome. The power to disseminate the information it collects may give the FIO leverage with other regulatory bodies, including state regulators, which may want access to the information.⁵⁴ The dissemination power also might give the FIO power to exert a substantive influence over insurers’ activities; an insurer might cease engaging in certain activities—such as risk-based pricing—if the company knows that the FIO plans to disclose the information. Nonpublic information is protected under the statute.⁵⁵

The FIO plays a role in extending systemic regulation to insurance companies. The FIO’s director serves as a nonvoting “advisory” member of the FSOC.⁵⁶ In that capacity, the FIO director has acceded to the insurance company designations under Title I of Dodd-Frank. Dodd-Frank also gives the FIO a coordinating role in the Federal Reserve’s stress testing of designated insurers.⁵⁷ Under Title II of Dodd-Frank, the director, along with two-thirds of the Federal Reserve’s Board of Governors, can recommend that the Treasury Secretary make a systemic-risk determination with respect to an insurance company, or a company the largest subsidiary of which is an insurer.⁵⁸ The Treasury Secretary can initiate the process by which the FIO and the board consider whether to make a recommendation, but absent a recommendation, the Secretary cannot make the designation.⁵⁹ The right to assent to or block a determination is a significant power for the FIO director.

As developer of “Federal policy on prudential aspects of international insurance matters,”⁶⁰ the FIO’s role in international discussions is also important. Under Dodd-Frank, the FIO represents the United States at the IAIS, an organization of 200 insurance regulators focused on fostering consistent regulation and financial stability.⁶¹ At the IAIS, the FIO serves on the Executive and Financial Stability Committees and chairs the Technical Committee.⁶² In these capacities, the FIO is involved in discussions of great importance to the insurance industry, including methods for identifying global systemically important insurers, the initiative to establish common standards for the supervision of internationally active insurance groups (Com-Frame), equivalency determinations under Europe’s Solvency II, and capital requirements for large insurers.⁶³ The FIO could use international negotiations to advocate regulatory approaches that are

dependent on consolidated supervision and uniform national standards, which may be easiest to achieve through federal regulation. Thus, the FIO's international work could help to shift the balance of regulatory power in the U.S.

The FIO is able to influence state insurance regulation by using its platform as in-house insurance expert for the federal government, representing the U.S. in international insurance discussions, exercising its information-collection and dissemination powers, and engaging in systemic regulation discussions pertaining to insurance companies. Of particular importance, however, is the FIO's pre-emption power.

FIO Pre-emption Power. Dodd–Frank allows the FIO director to pre-empt certain state insurance laws and regulations. Specifically, the FIO may pre-empt prudential state insurance laws and regulations that are inconsistent with an internationally negotiated covered agreement,⁶⁴ and disadvantage insurance companies domiciled in foreign countries that are part of the agreement.⁶⁵ Covered agreements relate to equivalency determinations about prudential regulation of insurance or reinsurance.⁶⁶ The FIO is not authorized to pre-empt state measures governing “rates, premiums, underwriting, or sales practices”; “coverage requirements”; or state antitrust law and may not disturb Title X of Dodd–Frank, which created the Bureau of Consumer Financial Protection.⁶⁷ Thus, pre-emption is excluded in areas in which some have argued the federal government could play a positive role in paring back excessive regulation.⁶⁸

In November 2015, the Treasury Secretary and the U.S. Trade Representative informed Congress of their intent to open covered agreement negotiations with the European Union.⁶⁹ The stated objectives of the negotiations are (1) an equivalency determination by the EU for the U.S.; (2) EU recognition of the mixed state-federal insurance regulatory system; (3) facilitation of regulators' cross-border information exchange; (4) “nationally uniform treatment of EU-based reinsurers operating in the United States, including with respect to collateral requirements”; and (5) EU recognition of the equivalency of U.S. insurance and reinsurance solvency regimes.⁷⁰ The Administration promised to allow state insurance regulators to play “a meaningful role during the covered agreement negotiating process.”⁷¹ State insurance regulators, however, do not have a legislatively guaranteed seat at the table in this or any other covered agreement negotiation. The FIO is likely to use

its pre-emption powers in connection with the fifth objective to override state reinsurance collateral regulations, which has already engendered concerns among state regulators.⁷²

The pre-emption process is unlikely to be used frequently because it is cumbersome. Once a covered agreement is in place, to effect a pre-emption, the FIO must notify the affected state and the U.S. Trade Representative and publish a notice and request for comment in the *Federal Register*.⁷³ If the director decides to proceed with the pre-emption, he must notify the state and Congress, and allow at least 30 days for the pre-emption to take effect so that the state can take action to eliminate the need for pre-emption.⁷⁴ After pre-emption, consumers must be protected in a “substantially equivalent” manner to that afforded by the pre-empted state measure.⁷⁵ The FIO pre-emption determinations are subject to the Administrative Procedure Act and *de novo* judicial review.⁷⁶ Despite these procedural protections, the pre-emption power is nevertheless a substantial power for a federal government official to wield unilaterally. Moreover, although the pre-emption power is now limited to matters implicating covered agreements, it could expand over time.⁷⁷

The FIO and Future Federalization. On balance, the FIO seems to envision further federalization in the future. One of the FIO's major initial projects was a report to Congress “on how to modernize and improve the system of insurance regulation in the United States.”⁷⁸ Among the topics for consideration were the merits and drawbacks of federal insurance regulation.⁷⁹ While the modernization report handles the federalization issue delicately, read as a whole, the report raises the possibility that federalization and the FIO role will grow over time.

Generally, although the modernization report highlights potential benefits from federalization, it does not answer the federalization question definitively.⁸⁰ The FIO points out that federal insurance regulation could lower costs for insurance companies and their consumers and provide uniformity, which, in turn, would facilitate oversight and international negotiations and reduce opportunities for regulatory arbitrage.⁸¹ The report balances these points with the lukewarm concession that the “limitations inherent in a state-based system of insurance regulation, however, do not necessarily imply that the ideal solution would be for the federal government to displace state regulation *completely*.”⁸² (Emphasis added.) After all, the report continues,

insurance products have a local character, and creating a federal insurance regulator would be “a significant undertaking.”⁸³

The FIO modernization report identifies a role for the federal government in some areas. The report calls for immediate federal involvement in several areas, including federal standards for mortgage insurers,⁸⁴ and FIO participation in supervisory colleges for national and international insurers.⁸⁵ The FIO contends that its participation in supervisory colleges would “not only strengthen the U.S. system of insurance regulation but also support the global credibility of the U.S. insurance industry.”⁸⁶ The FIO’s direct, insurer-specific engagement with insurance supervisors also would give the FIO a quasi-regulatory role, which is a substantial step toward federalized insurance supervision.⁸⁷ The FIO also has suggested a possible federal role in the consolidated supervision of global insurers.⁸⁸

The FIO attempts—in the modernization report and otherwise—to nudge state insurance policy toward greater national uniformity and toward achieving policy objectives favored by the FIO. The FIO can offer a valuable outside perspective on state insurance policy,⁸⁹ but its recommendations could subtly displace state regulators’ independent decision making. The FIO’s recommendations may not be superior to state regulators’ decisions, particularly because the FIO is not accountable to policyholders.⁹⁰ The FIO modernization report recommends that states take particular actions, including imposing character and fitness requirements on insurers’ officers and directors and adopting the NAIC’s model suitability regulation for annuity transactions.⁹¹ The FIO’s 2015 annual report notes the slow adoption of the model standard since the modernization report’s publication and suggests “[i]n the absence of more uniform adoption and implementation of the Model Suitability Regulation, federal authorities should consider appropriate action.”⁹² In the annual report, FIO “encourages state insurance regulators to assess the current [risk-based capital] approach and explore appropriate ways to increase incentives for infrastructure investments by insurers, an objective consistent with the Administration’s broader support for infrastructure investment.”⁹³ It also urges state regulators to “assess whether marital status is an appropriate underwriting or rating consideration” or whether it unfairly penalizes “consumers [who] opt not to marry, or are divorced or widowed.”⁹⁴

The annual report similarly asks state regulators to reconsider allowing automobile insurers to use gender as an underwriting criterion, particularly given complexities associated with gender identity.⁹⁵ In the area of cybersecurity, the FIO recommends that state regulators “develop, adopt and uniformly implement examination standards for insurer cyber security that are consistent across all states and which comply with best practices for oversight of financial institutions.”⁹⁶

Although not mandates, these recommendations relate to areas previously secured in the province of states. Moreover, the FIO suggests future federal involvement if the states do not conform to the recommendations.⁹⁷ The FIO can also influence state regulation through its collaboration with state regulators on pilot programs related to reforms of rate regulation.⁹⁸

Once a bureaucracy is established, its tendency is to expand,⁹⁹ and the FIO has identified a number of areas in which it might expand. As it identifies areas in which states are falling short, the FIO is likely to seek a more active role for itself in shaping insurance policy.

OTHER COMPONENTS OF TITLE V

In addition to creating the FIO, Title V addresses surplus lines (also known as non-admitted insurance) and reinsurance. Surplus lines enable customers to obtain coverage “for risks that are not adequately insured by insurers licensed to do business” in their state, and may cover property in more than one state.¹⁰⁰ Dodd–Frank sought to streamline and bring uniformity to the taxation, regulation, purchase, and broker licensing in connection with surplus line insurance.¹⁰¹ As of December 2013, according to the FIO, “states have not fulfilled this vision.”¹⁰² Title V likewise tried to rationalize the regulation of reinsurance by placing (1) regulatory responsibility over reinsurance contracts and the decision of whether to credit reinsurance with the home state of the insurer purchasing the reinsurance and (2) sole regulatory responsibility for a reinsurer’s financial stability with the home state of the reinsurer.¹⁰³ These provisions apply only to NAIC-accredited states or those with “substantially similar” requirements.¹⁰⁴

The purpose of these sections of Dodd–Frank is to provide certainty and consistency in areas where there has been confusion. Although these provisions leave some implementation questions unanswered, they have begun the process of resolving long-standing jurisdictional conflicts. Repealing them would

reintroduce uncertainty. In fact, these provisions could be supplemented by additional efforts to bring certainty to insurance regulation, a subject that the next sections will discuss.

CURRENT SYSTEM OF STATE-BASED REGULATION

Insurance regulation has historically relied on separate regulatory infrastructures in each state, but coordination among states has increased over time. State insurance regulation may include requirements such as licensing, adherence to solvency standards, pre-approval of form and rate changes, and compliance with underwriting and rate-setting limitations and market conduct standards.¹⁰⁵ State regulators monitor solvency through a system of risk-based capital.¹⁰⁶ One state typically takes the lead in monitoring an insurer's financial status. If there is an insolvency, policyholders are protected through state guaranty funds administered by nonprofit, state-level, insurance-line-specific entities that are typically funded by ex-post assessments on other insurance companies licensed in the state.¹⁰⁷ State insurance regulators have developed a deep expertise in insurance regulation and have increasingly worked with one another through the NAIC and supervisory colleges to improve insurance regulation nationwide.

The state-based insurance regulatory system poses a number of difficulties. Insurance companies, unlike other financial services companies operating across state lines, must be licensed in each state in which they operate.¹⁰⁸ The duplication of regulatory effort and prescriptive nature of regulation translates into higher prices and fewer product offerings for, and less responsiveness to, consumers.¹⁰⁹ It is not clear that consumers benefit.¹¹⁰ Does a consumer really need her insurance company and its products to be approved by a regulator in her own state? Would she be better off if she also had access to insurers and products regulated elsewhere? State regulation serves as a barrier to competition.¹¹¹ Moreover, the lack of a single voice in insurance has made U.S. participation in international insurance discussions difficult.¹¹² State regulators—along with their federal counterparts—do not have an impeccable track record.¹¹³

Efforts at increasing national uniformity, making international negotiations easier, and lowering barriers to entry and duplication of effort have had mixed success in the context of the state-based system. The NAIC, which has existed for nearly a

century and a half, brings state insurance regulators together to address issues of common concern, facilitate information sharing, promulgate best-practice standards and model laws, provide training, and coordinate supervisory efforts.¹¹⁴ Often prompted by the threat of federal action, the NAIC has increased uniformity across and cooperation among states.¹¹⁵ States, however, retain their independent legislative and regulatory authority and are free to ignore NAIC recommendations and standards.¹¹⁶

As the next section will show, Dodd–Frank does not offer an effective answer to the problems associated with state-based insurance regulation.

ALTERNATIVES TO DODD-FRANK'S BACKDOOR FEDERALIZATION

For years there has been a vibrant debate about what role federal regulators should play in insurance regulation. Participants in the debate have highlighted the costs and benefits associated with a greater federal role.¹¹⁷ Calls for more federalization have been driven by concerns about the expense and inefficiency of state regulation, a belief that a national insurance market needs a national regulator, the failures of state regulators, the need for a consistent international voice in insurance regulation, and—most recently—financial stability concerns.¹¹⁸ Others have argued that the state regulatory system works well and should remain intact.¹¹⁹ Dodd–Frank complicates the debate by increasing federalization without definitively embracing it.

Dodd–Frank retains the state-by-state system, but adds a layer of federal regulation. This system preserves problematic aspects of state regulation; adds uncertainty through the FSOC's designation powers; gives substantial supervisory power over insurance to the inexperienced and overextended Federal Reserve; and, in the FIO, creates a foothold and an advocate for an increasing federal role in insurance regulation. As one industry observer said of pre-Dodd–Frank efforts to federalize undesirable parts of state regulation, “[t]hat insidious approach to a patchwork system of shared regulation, unfettered by serious regulatory policy discussion, is probably the worst of all possible alternatives.”¹²⁰ Dodd–Frank has added new complexities, uncertainties, and redundancies by charging federal regulators with operating alongside—and sometimes in competition with—the existing state regulatory system.

Rather than continue with the post-Dodd–Frank hybrid, policymakers may want to take a more

comprehensive look at insurance regulation. Two alternatives are described briefly below, but these and other options warrant more careful consideration as part of an effort to improve the effectiveness and efficiency of insurance regulation.

Federal Charter Alternative to Backdoor Federalization. One alternative to Dodd–Frank’s backdoor federalization is an explicit embrace of federal regulation through the adoption of a federal chartering regime for insurance companies. Insurance companies chartered at the federal level would be able to offer insurance products in any state. A conscious decision for a federalized insurance regulatory regime—as opposed to Dodd–Frank’s indirect embrace of a federalized scheme—would require policymakers to engage in careful deliberation about the many difficult issues associated with transitioning to and operating a federal system.

Federal chartering could be optional for all insurance companies or mandatory for a subset. Federal chartering has long been a topic of discussion in policy circles.¹²¹ Many view it as an opportunity to modernize insurance regulation and improve its efficiency and efficacy.¹²² Advocates contend that a federal charter would be more appropriate than a state charter for nationally and internationally active insurance companies.¹²³ They maintain that insurance companies are at a competitive disadvantage because other financial services companies, such as banks, can avail themselves of a federal charter and federal pre-emption.¹²⁴ Optional federal chartering, based on the bank regulatory model, would give insurers the choice of a state or federal license.¹²⁵ A *mandatory* federal charter for insurance companies operating in multiple states is an alternative approach that would ensure that the federal government exercised regulatory authority over multistate insurers—a more predictable alternative to the unevenly applied FSOC designations.

A federal insurance regulator could bring uniformity, consolidated supervision, and cost reductions for insurers and their customers. A dedicated federal regulator could also facilitate U.S. insurers’ functioning in the international marketplace. The federal charter therefore would effectively address financial stability concerns and provide a single national voice in international insurance discussions. Policymakers would have to rethink the role that state guaranty funds would play in a federal system. One cost to be weighed in connection with

federal regulation is the inevitable pressure for an accompanying federal guaranty.¹²⁶

If the federal charter route were chosen, the FIO could be converted into a politically balanced independent insurance commission outside the Treasury.¹²⁷ Its members would be presidentially nominated and Senate-confirmed. It could charter, regulate, and supervise insurers. Removing the Federal Reserve’s powers over insurance SLHCs and FSOC-designated insurers would be a necessary complement to a federal charter approach in order to avoid duplicative federal effort.¹²⁸ The federal approach would leave the state system intact, as many insurance companies would not be covered by the federal regime.

State-Based Competitive Approach to Insurance Regulation. A different alternative to Dodd–Frank’s uncomfortable mix of state and federal regulation would be a state-centric approach that allows an insurer chartered, regulated, and supervised by one state to provide insurance in any other state. There is no reason to assume that federal regulators will be better at insurance regulation than their more experienced state counterparts.¹²⁹ A state-centric approach also would erode the expectations of federal bailouts of insurance companies, which accompany federal regulatory regimes.¹³⁰ Moreover, as Professors Martin Grace and Robert Klein point out, “the scope and design of insurance regulatory policies is probably more important than whether authority resides with the federal government or with the various states.”¹³¹ Accordingly, instead of building a new federal regulator, this approach would rely on existing regulators.

A state regulatory approach could be based on a proposal made by Professors Henry Butler and Larry Ribstein.¹³² Specifically, Butler and Ribstein would allow insurance companies to choose a state regulator and the law that would govern their insurance policies: “Insurers would get a single state charter under which they could do business everywhere. That state would both regulate solvency and provide the relevant guaranty fund.”¹³³ Professor Scott Harrington similarly has suggested “allow[ing] insurers to choose a ‘primary state’ for the purpose of rate, form, and possibly a number of other types of regulation and allow them to operate in all other states where they are licensed (‘secondary states’) without having to meet the corresponding requirements in those states.”¹³⁴

The state-based competition approach has precedent. States compete based on the quality of their laws for corporate charters.¹³⁵ A single state-based

licensing model also has precedent in the European passport approach, which allows companies licensed in one European country to operate in others.¹³⁶

A state-based system would enable states to try different regulatory methods. The regulatory diversity associated with a state-based model would facilitate comparisons of different approaches, but could also be better from a financial stability perspective. As former insurance regulator Therese Vaughan cautions, “uniformity is efficient, but it can be efficiently and catastrophically wrong.”¹³⁷ Under the current system, states guard their profitable insurance regulatory franchises.¹³⁸ The new approach would reward states that develop efficient regulatory systems with insurance revenue. The European experience suggests that a state competition model might generate pressure for minimum nationwide standards to ensure that no state was able to woo insurers with a less rigorous regulatory model.¹³⁹

Rather than relying on uniform minimum standards, however, a state-based approach could rely on insurance companies to monitor state regulators. Insurance companies likely would avoid states with costly regulatory regimes, but they would also shy away from cheap, yet ineffective, regimes. Insurers are currently exposed to one another through guaranty funds,¹⁴⁰ and this exposure could be heightened under a state-based model by requiring the guaranty fund of the chartering state to cover all policyholders regardless of where they live,¹⁴¹ and eliminating the ability that many states afford for insurers to offset guaranty fund contributions against their premium tax bills.¹⁴² Moreover, insurance companies in need of a regulator that will pass muster with foreign countries would press states to develop effective, but reasonable regulatory regimes. As suggested by Ribstein and Butler, a more creative element of the approach could be a requirement that insurance companies “issue solvency bonds that default if the state guaranty fund fails.”¹⁴³ Not only would these bonds—the prices of which would reflect market participants’ assessment of the efficacy of the relevant state’s regulatory system—help to push states toward the right level of regulation, they would provide valuable information to the broader market.¹⁴⁴

Under this state-based approach, the federal presence in insurance regulation could be limited. The FIO could be eliminated, or its powers pared back substantially. The Federal Reserve would shed its insurance supervisory responsibilities. The FSOC’s power to designate insurance companies for Federal

Reserve supervision would be eliminated as coordination issues across multiple state insurance regulators would be minimized. To address the systemic concerns that motivated Dodd–Frank’s designation framework, states could condition a state charter on the ability to monitor and exert some degree of regulatory authority over the actions of an insurer’s affiliates.¹⁴⁵

CONCLUSION

Dodd–Frank adds to the complexity of the insurance regulatory framework without enhancing stability or augmenting consumer protection. The statute layers a new federal insurance bureaucracy—comprising the FSOC, the Federal Reserve, and the FIO—on top of the existing state regulatory framework. The FSOC and the Federal Reserve now are important factors in shaping the insurance regulatory landscape. Although the FIO’s powers seem limited at first glance, they offer the federal government a base from which to exert expanding control over insurance regulation. The result is a combination of undesirable features from the pre-existing state insurance regulatory system and the new Dodd–Frank regime. Insurers continue to have to deal with multiple states, and consumers bear the cost of state and federal regulation. The FSOC takes an expansive approach in designating insurers. The Federal Reserve brings little insurance expertise and a bank-centric approach to its increasing role as an insurance regulator. The FIO has authority to pre-empt state law, impose uniform standards of its choosing on states, and subject insurers and their affiliates to additional reporting burdens. The intensified federal presence in insurance regulation is likely to reinforce the expectation in the minds of insurers’ customers and counterparties, which was created by the AIG rescue, that the federal government will step in to rescue an insurer that fails on its watch. Such assumptions are bolstered by Title II of Dodd–Frank.

A better approach would replace Title V’s backdoor federalization either with an open, considered embrace of federal insurance regulation through federal chartering and the creation of a dedicated federal insurance regulator, or with a competitive state-based regulatory model. As the flaws of Dodd–Frank’s mixed approach become more evident, each of these possible alternative approaches merits more extensive analysis by academics and policymakers.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. See 15 U.S. Code § 1011, which declares “that the continued regulation and taxation by the several States of the business of insurance is in the public interest,” and 15 U.S. Code § 1012(a), which states that the “business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.” The McCarran–Ferguson Act only allows federal law “to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business [if the law] specifically relates to the business of insurance.” 15 U.S. Code § 1012(b).
2. Viral V. Acharya and Mathew Richardson, “Is the Insurance Industry Systemically Risky?” in John H. Biggs and Matthew P. Richardson, eds., *Modernizing Insurance Regulation* (New York: Wiley, 2014), pp. 151–152. As examples of the federal government’s “interven[tion] in states’ insurance regulation,” Acharya and Richardson point to the Employment Retirement Income Security Act’s pre-emption of state regulation, the Securities and Exchange Commission’s regulation of variable annuities and insurers’ financial reporting, the Terrorism Risk Insurance Act, and the federal law that allows risk-retention groups to operate under a single charter.
3. See, for instance, “Brief of Better Markets as Amicus Curiae Supporting Defendant,” *MetLife v. Financial Stability Oversight Council*, No. 15-cv-45, 6, May 22, 2015. Better Markets explains: “AIG’s role in the crisis prompted Congress to give FSOC broad-ranging authority to designate nonbanks—including insurance companies—for enhanced supervision, and to take international activities into account in the process. Notwithstanding the fact that AIG was an insurance conglomerate, with significant overseas operations, it nevertheless played a central role in precipitating a financial crisis of epic magnitude here in the United States.”
4. Arguments that state-regulated insurance companies were not implicated in or affected by AIG’s downfall found a receptive audience among policymakers, but a key aspect of AIG’s downfall was the life insurance subsidiaries’ securities lending activities. See, for instance, Hester Peirce, “Securities Lending and the Untold Story in the Collapse of AIG,” Mercatus Center *Working Paper* No. 14-12, May 2014, http://mercatus.org/sites/default/files/Peirce_SecuritiesLendingAIG_v2.pdf (accessed February 12, 2016).
5. Dodd–Frank § 111 (12 U.S. Code § 5321).
6. Dodd–Frank § 165 (12 U.S. Code § 5365).
7. Dodd–Frank § 165(a) (12 U.S. Code § 5365(a)).
8. See, for instance, Acharya and Richardson, “Is the Insurance Industry Systemically Risky?” Based on their empirical analysis, Acharya and Richardson conclude that today’s “insurance sector may be a source for systemic risk,” because it is engaged in nontraditional activities and “(1) offers products with nondiversifiable risk, (2) is more prone to a run, (3) insures against macro-wide events, and (4) has expanded its role in financial markets.” For another view, see J. David Cummins and Mary A. Weiss, “Systemic Risk Regulation of the U.S. Insurance Industry,” in Biggs and Richardson, eds., *Modernizing Insurance Regulation*, pp. 85–135. Cummins and Weiss conclude that insurance companies’ noncore activities and some life-insurance core activities are associated with systemic risk, but that insurers tend to be “victims rather than propagators of systemic risk events.” See also Scott E. Harrington, “Designation and Supervision of Insurance SIFIs,” in Biggs and Richardson, *Modernizing Insurance Regulation*, pp. 139–141. Harrington summarizes the findings of qualitative studies that core insurance activities are not systemic, and raises questions about the accuracy of quantitative measures that implicate insurance companies as systemic risks. See also Anna Paulson et al., *Assessing the Vulnerability of the U.S. Life Insurance Industry* in Biggs and Richardson, eds., *Modernizing Insurance Regulation*. Based on an analysis of the liquidity of life insurance companies’ assets and liabilities, Paulson et al. assess the vulnerability of life insurance companies under different stress scenarios. Finally, see Daniel Schwarcz and Steven L. Schwarcz, “Regulating Systemic Risk in Insurance,” *University of Chicago Law Review*, Vol. 81 (2014), p. 1639. Schwarcz and Schwarcz argue “that insurance-focused financial firms can be systemically risky not only due to their size—which is currently the primary focus of federal regulation in insurance, spurred by AIG’s near failure—but also due to commonalities and correlations in insurance products, investment strategies, risk exposures, risk management, and interconnections to the larger financial system.”
9. All of these insurers have global designations as well. The Federal Reserve has an outsized voice in global insurer designations through its active role on the international Financial Stability Board (FSB), which designates global systemically important financial institutions (G-SIFIs). A follow-on FSOC designation of a G-SIFI is extremely likely. See, for instance, Roy Woodall, “Independent Member Having Insurance Expertise,” FSOC, “Dissenting Views on the FSOC’s Designation of MetLife, Inc.,” December 18, 2014, p. 4. Woodall wrote: “It is clear to me that the consent and agreement by some of the Council’s members at the FSB to identify MetLife a G-SIFI, along with their commitment to use their best efforts to regulate said companies accordingly, sent a strong signal early-on of a predisposition as to the status of MetLife in the U.S.—ahead of the Council’s own decision by all of its members.”
10. Dodd–Frank § 113(a)(1) (12 U.S. Code § 5323(a)(1)).
11. The statute lists 11 considerations, including leverage, regulatory status, and the all-encompassing “any other risk-related factors that the Council deems appropriate.” Dodd–Frank § 113(a)(2) (12 U.S. Code § 5323(a)(2)).

12. For the bases for the determinations, see U.S. Department of the Treasury, “Financial Stability Oversight Council: Designations,” <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx#nonbank> (accessed January 20, 2016). The FSOC’s independent insurance expert Roy Woodall objected that his colleagues had based MetLife’s designation on an improbable hypothetical, grounded in “stem[ming] from a sudden and unforeseen insolvency of unprecedented scale, of unexplained causation, and without effective regulatory responses or safeguards.” See U.S. Department of the Treasury, “Views of the Council’s Independent Member Having Insurance Expertise,” p. 3, <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf> (accessed February 16, 2016). Similarly, John Huff, then the FSOC’s insurance commissioner representative, objected to the FSOC’s designation of Prudential based on “merely speculative outcomes related to the liquidation of assets that are not supported by a sufficient understanding of the heterogeneity of insurance products or insurer asset disposition.” See U.S. Department of the Treasury, “Resolution Approving Final Determination Regarding Prudential Financial, Inc.,” p. 1, <https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf> (accessed February 16, 2016).
13. MetLife, “Information Regarding MetLife’s SIFI Designation: About the SIFI Designation and Judicial Review,” <https://www.metlife.com/sifiupdate/index.html> (accessed January 18, 2016).
14. Illustrating the Federal Reserve’s influence, MetLife recently announced its intention to spin off a large part of its retail operations. MetLife CEO Steven A. Kandarian explained the move:

Currently, U.S. Retail is part of a Systemically Important Financial Institution (SIFI) and risks higher capital requirements that could put it at a significant competitive disadvantage. Even though we are appealing our SIFI designation in court and do not believe any part of MetLife is systemic, this risk of increased capital requirements contributed to our decision to pursue the separation of the business. An independent company would benefit from greater focus, more flexibility in products and operations, and a reduced capital and compliance burden.

News release, “MetLife Announces Plan to Pursue Separation of U.S. Retail Business,” MetLife, January 12, 2016, <https://www.metlife.com/about/press-room/index.html?compID=192215> (accessed February 16, 2016).
15. See, for instance, Scott E. Harrington, “Designation and Supervision of Insurance SIFIs,” in Biggs and Richardson, eds., *Modernizing Insurance Regulation*, p. 146. Harrington explains that “other things being equal, a SIFI designation could allow a designee to obtain funding at a lower cost and have a competitive advantage in attracting risk-sensitive policyholders.”
16. See chapter 3 in this book (Peter Wallison on Title I) for a more comprehensive critique of systemic-risk designations. Scott Harrington has argued against systemic-risk designations in the insurance context. See, for instance, Scott E. Harrington, “The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation,” *Journal of Risk and Insurance*, Vol. 76 (2009), p. 808. Harrington asks: “What would the Federal Reserve have done differently if it had systemic risk authority [over AIG] before the crisis?” See also Harrington, “Designation and Supervision of Insurance SIFIs,” pp. 143–147. Harrington outlines the potential adverse consequences of designating insurers as systemically important.
17. For the systemic-risk determination process, see Dodd–Frank § 203 (12 U.S. Code § 5383). The statute prescribes a special process, which requires the assent of the Director of the Federal Insurance Office for “cases involving insurance companies.” Dodd–Frank § 203(a)(1)(C) (12 U.S. Code § 5383(a)(1)(C)).
18. Dodd–Frank § 203(a)(1)(C) (12 U.S. Code § 5383(a)(1)(C)) sets forth procedures for selecting insurance companies for orderly liquidation.
19. Dodd–Frank § 203(e)(3) (12 U.S. Code § 5383(e)(3)).
20. Dodd–Frank § 203(e) (12 U.S. Code § 5383(e)).
21. For a discussion on insurance receiverships at the state level and state guaranty associations, see Peter G. Gallanis, “Policyholder Protection in the Wake of the Financial Crisis,” in Biggs and Richardson, eds., *Modernizing Insurance Regulation*, pp. 207–240.
22. Dodd–Frank § 312(b) (12 U.S. Code § 5412(b)).
23. Some insurers sold or converted their thrifts to avoid falling under Federal Reserve supervision. See, for instance, Elizabeth D. Festa and Arthur D. Postal, “Insurers Face New Regulation from Federal Reserve,” LifeHealthPro.com, May 2, 2012. Festa and Postal report: “Some of the companies on the Fed’s list are already either shedding their operations, or are planning to do so out of a concern of facing an additional layer of regulation through the Fed.” See also Young Ha, “W.R. Berkley Corp. Divests, Connecticut Bank Acquires InsurBanc,” *Insurance Journal*, April 22, 2013, <http://www.insurancejournal.com/magazines/features/2013/04/22/288675.htm> (accessed February 17, 2016). Ha reports: “W.R. Berkley said in its SEC filing that to avoid adverse consequences of enhanced restrictions, the board decided to divest its banking operations so that it could deregister as a savings and loan holding company.”
24. Mark E. Van Der Weide, Deputy Director, Division of Banking Supervision and Regulation, Federal Reserve Board of Governors, statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 28, 2015. Van Der Weide stated: “The insurance holding companies for which the Federal Reserve is the consolidated supervisor hold approximately one-third of U.S. insurance industry assets and vary greatly in size and in the types of products they offer.” In his oral testimony, Van Der Weide indicated that the Federal Reserve supervises 17 insurers. U.S. Senate, Committee on Banking, Housing, and Urban Affairs, “Hearings: The State of the Insurance Industry and Insurance Regulation,” April 28, 2015, video, (at approximately 1:25), <http://www.banking.senate.gov/public/index.cfm/hearings?ID=29608126-AE85-4568-87B2-14E1A61D9774> (accessed February 24, 2016). See also Bipartisan Policy Center, “How the Federal Reserve Became the De Facto Federal Insurance Regulator,” July 30, 2014, <http://bipartisanpolicy.org/blog/how-federal-reserve-became-de-facto-federal-insurance-regulator> (accessed February 17, 2016).
25. Dodd–Frank § 604(g) and (h) (amending 12 U.S. Code § 1467a(b)).
26. Dodd–Frank § 604(h) (amending 12 U.S. Code § 1467a(b)(4)).

27. Dodd–Frank § 605(a) (amending 12 U.S. Code § 1811 et seq.).
28. State-regulated insurance companies are functionally regulated subsidiaries (and thus not subject to this provision), but only “with respect to insurance activities of the insurance company and activities incidental to such insurance activities.” 12 U.S. Code § 1844(c)(5)(iv)(2014).
29. Van Der Weide, statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate.
30. See, for instance, “Board of Governors of the Federal Reserve System, Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies,” *Federal Register*, Vol. 76, April 22, 2011, p. 2263. The notice explains that “the Board’s consolidated supervision program may entail more intensive supervisory activities than under current OTS practice, at least for some SLHCs.” The notice further explains that this approach “may entail more rigorous review of internal control functions and consolidated liquidity, as well as the conduct of discovery reviews of specific activities” and “may entail heightened review of the activities of nonbank subsidiaries.” *Ibid*.
31. Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, “Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program,” *Supervision and Regulation Letter* SR 14-9, November 7, 2014.
32. *Ibid*. See attachment Listing of Federal Reserve Guidance Applicable to Savings and Loan Holding Companies Issued Prior to Transfer Date of July 21, 2011 (as of November 7, 2014).
33. See, for instance, Bibeka Shreshtha, “Think Tank Unveils Road Map for US Financial Oversight,” Law360.com, April 10, 2014, <http://www.law360.com/articles/527088/think-tank-unveils-road-map-for-us-financial-oversight> (accessed February 17, 2016). Shreshtha quotes Aaron Klein, director of the Bipartisan Policy Center’s Financial Regulatory Reform Initiative: “We’re four years into Dodd–Frank, the Federal Reserve is still trying to hire people with insurance expertise. That’s kind of stunning to me.” But, see also Van Der Weide, statement before the Senate Committee on Banking, Housing, and Urban Affairs, U.S. Senate: “The Federal Reserve is investing significant time and effort into enhancing our understanding of the insurance industry and firms we supervise, and we are committed to tailoring our supervisory framework to specific business lines, risk profiles, and systemic footprints of the insurance holding companies we oversee.”
34. For a discussion of the Federal Reserve’s international role and how it might conflict with state-based insurance regulation, see Paul H. Kupiec, “Federal Reserve Accountability and Reform,” statement for the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 4, 2015, <http://www.aei.org/publication/federal-reserve-accountability-reform-2/> (accessed February 17, 2016).
35. Van Der Weide, statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate.
36. Kupiec, “Federal Reserve Accountability and Reform.”
37. See, for instance, Robert C. Eager and Cantwell F. Muckenfuss III, “Creating Federal Insurance Regulation: A Zero-Based Approach,” in Peter J. Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies* (Washington, DC: AEI Press, 2000), pp. 153 and 163. Muckenfuss contends that one of the benefits of an optional federal charter would be “the presence of an agency with in-depth industry knowledge within the federal government.”
38. 31 U.S. Code § 313(d). Long-term care insurance is within the FIO’s jurisdiction if it “is included with life or annuity insurance components.” 31 U.S. Code § 313(d)(2).
39. 31 U.S. Code § 313(c).
40. 31 U.S. Code § 313(b). The FIO director has a “career reserved position in the Senior Executive Service,” which means that he is a career appointee for whom “[d]isciplinary removal procedures and rights are similar to those for competitive service employees, except that the standard for action is ‘misconduct, neglect of duty, malfeasance, or failure to accept a directed reassignment or to accompany a position in a transfer of function.’” Office of Personnel Management, “Senior Executive Service,” <https://www.opm.gov/policy-data-oversight/senior-executive-service/performance/#url=Suspension+%26+Removal> (accessed September 2, 2015). Arguably, however, the Treasury Secretary could control the FIO director by threatening to deny the FIO staff and other resources. Dodd–Frank § 502 (adding 31 U.S. Code § 313(q)).
41. Dodd–Frank § 502 (adding 31 U.S. Code § 313(h)).
42. Dodd–Frank § 502 (adding 31 U.S. Code § 313(k)).
43. News release, “Remarks by Federal Insurance Office Director Michael McRaith at Property/Casualty Insurance Joint Industry Forum,” U.S. Department of the Treasury, January 10, 2012, <http://www.treasury.gov/press-center/press-releases/Pages/tg1393.aspx> (accessed February 17, 2016). McRaith stated: “To be clear, FIO is not a regulator—that remains the province of the states.” In the same speech, however, McRaith promised that the FIO would not “sit idly by while the world spins” and would be “engaged and assertive, when necessary, to offer views, leadership, and guidance on insurance in the United States.”
44. Patricia A. McCoy, “Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance,” Boston College Law School *Legal Studies Research Paper* No. 349, January 1, 2015, p. 36.
45. Dodd–Frank § 502 (adding 31 U.S. Code § 313(c)(2)).
46. One commentator points out: “Whereas states are limited to the McCarran–Ferguson Act’s definition of the ‘business of insurance,’ the Dodd–Frank Act expands the federal government’s reach to ‘all aspects of the insurance industry.’” Kelly Kirby, “Supervisory Colleges: Improving International Supervisory Coordination,” *Connecticut Insurance Law Journal*, Vol. 19 (2012), p. 184.
47. Dodd–Frank § 502 (adding 31 U.S. Code § 313(c)(1)).

48. An “insurer” is defined as “any entity that writes insurance or reinsures risks and issues contracts or policies in 1 or more States.” Dodd–Frank § 502 (adding 31 U.S. Code § 313(e)(2)(B)).
49. An “affiliate” is “any person who controls, is controlled by, or is under common control with the insurer.” Dodd–Frank § 502 (adding 31 U.S.C. § 313(r)(1)).
50. Dodd–Frank § 502 (adding 31 U.S. Code § 313(e)(1)).
51. Dodd–Frank § 502 (adding 31 U.S. Code § 313(e)(3)).
52. Dodd–Frank § 502 (adding 31 U.S. Code § 313(e)(4)).
53. Dodd–Frank § 502 (adding 31 U.S. Code § 313(e)(6)).
54. Dodd–Frank § 502 (adding 31 U.S. Code § 313(e)(5)).
55. Dodd–Frank § 502 (adding 31 U.S. Code § 313(e)(5)).
56. 31 U.S. Code § 313(c)(3), and Dodd–Frank § 111(b)(2)(B) (12 U.S. Code § 5321(b)(2)(B)).
57. Dodd–Frank § 165(i) (12 U.S. Code § 5365(i)).
58. Dodd–Frank § 203(a)(1)(C) (12 U.S. Code § 5383(a)(1)(C)).
59. Dodd–Frank §§ 203(a)(1)(C) and (b) (12 U.S. Code § 5383(a)(1)(C) and (b)).
60. Dodd–Frank § 502 (adding 31 U.S. Code § 313(c)(1)(E)).
61. *Ibid.* The Federal Reserve, the National Association of Insurance Commissioners (NAIC), and the states are also members. See International Association of Insurance Supervisors, “About the IAIS: IAIS Members,” <http://iaisweb.org/index.cfm?event=getPage&nodeId=25189> (accessed February 17, 2016). Aaron Klein points out that the multiple representation may “sen[d] an unclear signal to the international community as to who speaks for the United States between the chair of the Federal Reserve Board, the director of FIO, or the NAIC.” Hearing, *Finding the Right Capital Regulations for Insurers*, Subcommittee on Financial Institutions and Consumer Protection, Committee on Banking, Housing & Urban Affairs, U.S. Senate, 113th Cong., 2nd Sess., March 11, 2014, statement by Aaron Klein, Director, Financial Regulatory Reform Initiative, Bipartisan Policy Center.
62. Federal Insurance Office, “How to Modernize and Improve the System of Insurance Regulation in the United States,” December 2013, p. 64.
63. For a discussion of international insurance regulatory issues and structures, see Therese M. Vaughan and Mark A. Calabria, “International Developments in the Insurance Sector: The Road to Financial Instability?” Cato Institute *Working Paper* No. 30, May 27, 2015.
64. Dodd–Frank sets forth the procedures pursuant to which the Treasury Secretary and U.S. Trade Representative negotiate covered agreements and Congress has an opportunity to weigh in. Dodd–Frank § 502 (adding 31 U.S. Code § 314). One of the FIO’s functions is “assisting the Secretary in negotiating covered agreements.” Dodd–Frank § 502 (adding 31 U.S. Code § 313(c)(1)(E)). The FIO, however, claims a more direct role. “Under Title V of the Dodd–Frank Act, FIO and the United States Trade Representative (USTR) are authorized, jointly, to negotiate and enter into ‘covered agreements.’” FIO, “How to Modernize and Improve the System of Insurance Regulation in the United States,” p. 38.
65. Dodd–Frank § 502 (adding 31 U.S. Code § 313(f)(1)). The state measures that may be pre-empted include “any State law, regulation, administrative ruling, bulletin, guideline, or practice relating to or affecting prudential measures applicable to insurance or reinsurance.” Dodd–Frank § 502 (adding 31 U.S. Code § 313(r)(7)).
66. Dodd–Frank § 502 (adding 31 U.S. Code § 313(r)(2)).
67. Dodd–Frank § 502 (adding 31 U.S. Code § 313(j)).
68. See, for instance, Scott Harrington, “Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation,” Networks Financial Institute *Policy Brief* No. 2006-PB-02, February 2006, p. 3, http://www.scottharringtonphd.com/2006-pb-02_Harrington.pdf (accessed February 17, 2016). Harrington explains: “Despite a number of positive and incremental reforms throughout the past decade, several key aspects of state insurance regulation, including regulation of rates, rate classification, and policy forms, remain substantially dysfunctional in many states—with no end in sight and with significant burdens on interstate commerce. A transformation of insurance regulation to reduce those burdens by promoting healthy price and product competition and eliminating regulatory micromanagement of price and product decisions will not be achieved without federal intervention.”
69. See, for instance, Letter from Anne Wall, Assistant Secretary for Legislative Affairs, Department of the Treasury and Mike Henry, Assistant U.S. Trade Representative for Congressional Affairs, Office of the U.S. Trade Representative, to Richard Shelby, Chairman, Senate Committee on Banking, Housing, and Urban Affairs, November 20, 2015, <https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/Covered%20Agreement%20Letters%20to%20Congress.pdf> (accessed February 17, 2016).
70. *Ibid.*, p. 2.
71. *Ibid.*

72. Bipartisan Policy Center, "Global Insurance Regulatory Issues: Implications for U.S. Policy and Regulation," November 2015, <http://bipartisanpolicy.org/library/global-insurance-regulatory-issues/> (accessed February 17, 2016). This piece describes the disagreements between the National Association of Insurance Commissioners and the FIO on this issue and concludes that "[t]his makes reinsurance collateral a potential target for a covered agreement and federal preemption of state measures that address the subject." See also National Association of Insurance Commissioners, "Covered Agreement," August 24, 2015, http://www.naic.org/cipr_topics/topic_covered_agreement.htm (accessed February 17, 2016). The NAIC writes: "In light of the progress made by the NAIC and the states to modernize credit for reinsurance rules, the NAIC is neither convinced nor persuaded that a covered agreement for reinsurance collateral is necessary."
73. Dodd-Frank § 502 (adding 31 U.S. Code § 313(f)(2)(A)).
74. Dodd-Frank § 502 (adding 31 U.S. Code § 313(f)(2)(C) and (3)).
75. Dodd-Frank § 502 (adding 31 U.S. Code § 313(f)(2)(B)).
76. Dodd-Frank § 502 (adding 31 U.S. Code § 313(g)).
77. Schwarcz and Schwarcz, "Regulating Systemic Risk in Insurance," pp. 1635-1636. The authors call for the FIO to have authority, subject to the FSOC's sign-off, to pre-empt state law for systemic-risk reasons.
78. Dodd-Frank § 502 (adding 31 U.S. Code § 313(p)).
79. Dodd-Frank § 502 (adding 31 U.S. Code § 313(p)(3)).
80. FIO, "How to Modernize and Improve the System of Insurance Regulation in the United States," p. 5. The report concludes that "the proper formulation of the debate at present is not whether insurance regulation should be state or federal, but whether there are areas in which federal involvement in regulation under the state-based system is warranted." See also Elizabeth D. Festa, "FIO Modernization Report: It's Out, But Where Is It Going?" LifeHealthPro, December 13, 2013, <http://www.lifehealthpro.com/2013/12/13/fio-modernization-report-its-out-but-where-is-it-going?life-products> (accessed February 17, 2016). Festa notes that the FIO's "long-simmering report on modernization was greeted like a wonk's Rorschach ink blot" because it "either affirms state regulation or allows for the hand of the federal government to guide insurance regulation down a smoother path, both for interested parties and for itself in certain areas."
81. FIO, "How to Modernize and Improve the System of Insurance Regulation in the United States," p. 5.
82. *Ibid.*
83. *Ibid.*
84. *Ibid.*, pp. 31-32.
85. *Ibid.*, pp. 41-42.
86. FIO, *Annual Report on the Insurance Industry*, September 2015, App. p. vi, https://www.treasury.gov/initiatives/fio/reports-and-notice/Documents/2015%20FIO%20Annual%20Report_Final.pdf (accessed February 17, 2016).
87. Michael Nelson and Nicholas Bacon, "The Long Arm of the FIO," *Insider Quarterly* (Spring 2014), <http://www.insiderquarterly.com/the-long-arm-of-the-fio> (accessed February 17, 2016). Nelson and Bacon write: "If the FIO joins the supervisory colleges, it may provide a platform for the FIO to become involved in regulatory decisions despite being denied regulatory authority under Dodd-Frank."
88. FIO, "How to Modernize and Improve the System of Insurance Regulation in the United States," p. 42. The report concludes: "Given concerns about the adequacy of solo entity supervision for larger groups, particularly for U.S.-based firms operating globally, consolidated supervision for large, internationally-active U.S.-based insurance firms will require continued focus and *national* attention." (Emphasis added).
89. FIO, *Annual Report on the Insurance Industry*, pp. 58-59. The annual report notes the move away from risk-based capital to principles-based reserving (PBR), which "relies heavily on each insurer's application of internal models to complex data sets, which are unique to each insurer, and necessarily demanding of expertise and resources," and observes that "[t]his approach makes sense from the industry perspective, but raises questions about the limitation of state regulatory capacity." And, on App. p. x, the report notes that the NAIC's "Commercial Lines Working Group recommends against the development of an interstate compact for commercial lines, thereby potentially preserving an unnecessary inefficiency that neither bolsters consumer protection nor promotes efficiency of insurance regulatory oversight."
90. Martin F. Grace and Robert W. Klein, "Efficiency Implications of Alternative Regulatory Structures for Insurance," in Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies*, p. 84. Grace and Klein observe that a federal regulator might be more susceptible than a state regulator to "interest-group pressures" pushing for "regulations motivated by social and political preferences" in lieu of competitive outcomes. See also Scott E. Harrington, "The History of Federal Involvement in Insurance Regulation," in Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies*, p. 39. Harrington notes that the existence of state competition may be salutary in ensuring that regulation does not become a way "to promote inefficient wealth transfers."
91. FIO, "How to Modernize and Improve the System of Insurance Regulation in the United States," pp. 6-7. The report recommends a list of action items for states, including converging "[s]tate-based solvency oversight and capital adequacy regimes...toward best practices and uniform standards," "adopt[ing] and enforce[ing] the National Association of Insurance Commissioners Suitability in Annuities Transactions Model Regulation," and "extend[ing] regulatory oversight to vendors that provide insurance score products to insurers."
92. FIO, *Annual Report on the Insurance Industry*, p. 54.
93. *Ibid.*, pp. 45-46.

-
94. *Ibid.*, p. 48.
 95. *Ibid.*, pp. 47–48.
 96. *Ibid.*, p. 66.
 97. FIO, “How to Modernize and Improve the System of Insurance Regulation in the United States,” p. 8. The report recommends that “should the states fail to accomplish necessary modernization reforms in the near term, Congress should strongly consider direct federal involvement.” The report goes on to consider ways in which the federal government could get involved, including direct federal regulation. *Ibid.*, pp. 8–10.
 98. FIO, “How to Modernize and Improve the System of Insurance Regulation in the United States,” pp. 54–56, and FIO, *Annual Report on the Insurance Industry*, App. p. xii. In light of NAIC inaction, the FIO announces its intention to “move forward to identify those states and markets where a reduction in rate oversight could be tested.”
 99. James Buchanan, “Politics Without Romance: A Sketch of Public Choice Theory and Its Normative Implications,” *The Logical Foundations of Constitutional Liberty*, Vol. 1 (1999), pp. 45 and 57. Buchanan notes the ability of bureaucracies to “manipulate the agenda for legislative action for the purpose of securing outcomes favorable to its own interests” and to “play off one set of constituents against others, insuring that budgets rise much beyond plausible efficiency limits.”
 100. FIO, “How to Modernize and Improve the System of Insurance Regulation in the United States,” p. 58.
 101. Dodd–Frank §§ 521–525 (15 U.S. Code §§ 8201–8205).
 102. FIO, “How to Modernize and Improve the System of Insurance Regulation in the United States,” p. 59.
 103. Dodd–Frank §§ 531–532 (15 U.S. Code §§ 8221–8222).
 104. *Ibid.*
 105. This list is drawn from a more comprehensive list in Harrington, “Federal Chartering: Options and Alternatives for Transforming Insurance Regulation.” For a helpful history of the development of state insurance regulation, see Harrington, “The History of Federal Involvement in Insurance Regulation.” Harrington observes that the “history of insurance regulation is characterized by a series of perceived market or regulatory failures, followed by threats of federal regulation and subsequent changes by the states that have helped forestall federal action.” Harrington, “History of Federal Involvement,” p. 21.
 106. For a discussion of risk-based capital, see NAIC, “Risk-Based Capital,” http://www.naic.org/cipr_topics/topic_risk_based_capital.htm (accessed September 10, 2015).
 107. For a discussion of state guaranty funds, see Peter G. Gallanis, “Policyholder Protection in the Wake of the Financial Crisis,” in Biggs and Richardson, eds., *Modernizing Insurance Regulation*, pp. 207–240.
 108. Peter J. Wallison, “Competitive Equity: An Optional Federal Charter for Insurance Companies,” AEI Financial Services Outlook, March 2006, pp. 1–2. Wallison points out the competitive disadvantage that insurers face in comparison to banks and securities firms.
 109. See generally, Harrington, “Federal Chartering: Options and Alternatives for Transforming Insurance Regulation.”
 110. Sheila Bair, “Consumer Ramifications of an Optional Federal Charter for Life Insurers,” University of Massachusetts Isenberg School of Management, 2004, p. 2, http://www.socmavotes.com/afc/UMass_Report.pdf (accessed February 17, 2016). Bair’s report explains: “Difficulties and time delays in securing form filing approvals inhibits the ability of life insurers to modify products in response to consumer demand and impairs competition with banks and securities firms which do not have to undergo advance merit review of permitted product offerings.”
 111. See, for instance, Elizabeth Brown, “Implementing the Dodd–Frank Wall Street Reform and Consumer Protection Act: Will the FIO Improve Insurance Regulation?” *University of Cincinnati Law Review*, Vol. 81 (2012), p. 566. Brown explains: “The significant costs involved, both in terms of time and money, for a company to get licensed as an insurance provider and to get its products licensed have created substantial barriers to entry in the insurance industry.”
 112. For a discussion of the international concerns raised by the existing state-based system, see Brown, “Implementing the Dodd–Frank Wall Street Reform and Consumer Protection Act,” p. 566.
 113. Martin Grace and Richard Phillips, “The Allocation of Governmental Regulatory Authority: Federalism and the Case of Insurance Regulation,” *Journal of Risk and Insurance*, Vol. 74 (2007), p. 208. Grace and Phillips explain that insurer insolvencies in the late 1980s and early 1990s raised congressional concern about state insurance regulation. State and federal regulators missed the problems at AIG. See, for instance, Roddy Boyd, *Fatal Risk: A Cautionary Tale of AIG’s Corporate Suicide* (New York: Wiley, 2011), and David J. Merkel, “To What Degree Were AIG’s Operating Insurance Subsidiaries Sound?” *Finacorp Securities*, April 28, 2009, <http://alephblog.com/wp-content/uploads/2009/04/To%20What%20Degree%20Were%20AIG%E2%80%99s%20Operating%20Subsidiaries%20Sound.pdf> (accessed February 17, 2016).
 114. NAIC, “About the NAIC,” http://www.naic.org/index_about.htm (accessed September 10, 2015). The NAIC explains: “Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight.” See also Grace and Klein, “Efficiency Implications of Alternative Regulatory Structures for Insurance,” pp. 94–95. Grace and Klein list services provided by the NAIC.
 115. Michael Kerley, “Insurance Agents and Advisors,” in *Optional Federal Chartering and Regulation of Insurance Companies*, p. 176. Kerley observes: “Every time there is movement in the federal government to step in and do something, it seems to spur the NAIC, and state insurance commissioners in general, to go forward.”
-

116. As Roger Ferguson explains, “legislators in some large and important states, perhaps wary of additional oversight and loss of authority within their borders, have refused to join [multi-state compacts created by the NAIC], limiting their effectiveness.” Roger W. Ferguson Jr., “Why Insurance Needs a Federal Regulator Option,” in Biggs and Richardson, eds., *Modernizing Insurance Regulation*, p. 27.
117. For arguments on both sides and the complexities associated with transitioning to federal insurance regulation, see Biggs and Richardson, eds., *Modernizing Insurance Regulation*, and Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies*.
118. For a discussion of the historical arguments for federal involvement in insurance regulation and the states’ responses, see Brown, “Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act,” pp. 560–579, and McCoy, “Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance,” pp. 11–16.
119. Eric Dinallo, “Lessons Learned from AIG for Modernizing Insurance Regulation,” Biggs and Richardson, eds., *Modernizing Insurance Regulation*, pp. 243–260.
120. Jack R. Wahlquist, “Why the Dogs Are Not Barking,” in Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies*, p. 68.
121. See, for instance, Bair, “Consumer Ramifications of an Optional Federal Charter for Life Insurers,” pp. 2–3. Bair summarizes prior policy discussions of the optional federal insurance charter. See also Bill McCartney and Bob Litan, “Revisiting Insurance Regulatory Reform in a Post-Crisis World,” *The Hill*, March 10, 2015. McCartney and Litan call for consideration of “whether an optional federal insurance charter makes sense in a post-Dodd Frank world.” For different views about the need for and implications of an optional federal charter, see Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies*. Recommendations for federal charters also have taken shape in the form of legislative proposals. See, for instance, H.R. 1880, 111th Cong., 1st Sess. (2009), which proposed to create an Office of National Insurance to oversee national insurers; S. 40, 110th Cong., 1st Sess., 2007, which proposed to create an Office of National Insurance to oversee national insurers; and H.R. 4900, 102nd Cong., 2nd Sess., 1992, which proposed to create a Federal Insurance Solvency Commission with the power to “issue a certificate of solvency to engage in the business of insurance.”
122. See, for instance, Eager and Muckenfuss III, “Creating Federal Insurance Regulation: A Zero-Based Approach,” pp. 153–154. Eager observed: “To replicate the existing state system at the federal level makes no sense. We can and should develop a federal charter that embodies contemporary insights about regulation, market dynamics, and best practices in general.”
123. See, for instance, Joel Wood, “Broker Organizations,” in Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies*, p. 173. Wood argues: “Especially in the commercial context, the insurance business is...national and international in scope and character as are the businesses of those who seek insurance protection.”
124. See, for instance, Ferguson Jr., “Why Insurance Needs a Federal Regulator Option,” p. 26. Ferguson contends: “The convergence of [financial services] industries, without any accompanying change in the insurance regulatory system, has left insurers—at least those with a national footprint—at a competitive disadvantage.” See also Wallison, ed., *Optional Federal Chartering for Life Insurance Companies*, pp. 51–52. Wallison points out the competitive disadvantage faced by life insurance companies as compared to banks and securities firms, which “appear to have competitive advantages arising out of their more flexible regulatory regimes.”
125. For a concise discussion of the benefits of an optional federal charter, see Wallison, “Competitive Equity: An Optional Federal Charter for Insurance Companies.” See also Hal Scott, “Optional Federal Chartering of Insurance: Design of a Regulatory Scheme,” Networks Financial Institute *Policy Brief* No. 2007-PB-04, March 2007.
126. See, for instance, Bert Ely, “The Fate of the State Guaranty Funds After the Advent of Federal Insurance Chartering,” in Wallison, ed., *Optional Federal Chartering and Regulation of Insurance Companies*, p. 137. Ely compares insurance to a product warranty and explains that “if government wants to be in the business, for whatever reason, of regulating financial institutions, then it has no choice but to provide a warranty for the service that business supposedly provides to the general public.” See also Harrington, “The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation,” p. 810. Harrington predicts: “The history of federal deposit insurance and TBTF policy suggests that, either initially or later on, [an optional federal charter] could expand government guarantees of insurers’ obligations, thereby undermining market discipline and incentives for safety and soundness.” Some are already calling for a federal safety net as an alternative to the existing state guaranty system. See, for instance, John H. Biggs, “Modernizing the Safety Net for Insurance Companies,” in Biggs and Richardson, eds., *Modernizing Insurance Regulation*, pp. 181–205. Biggs identifies flaws—including lack of uniformity, lack of prefunding, inadequacy to deal with large failures, and absence of risk-based pricing—in the state guaranty association structure and calls for a federal system based on the FDIC.
127. Others have suggested an independent bureau within Treasury modeled on the Office of the Comptroller of the Currency. See, for instance, Eager and Muckenfuss III, “Creating Federal Insurance Regulation: A Zero-Based Approach,” p. 159. Given that the federal regulator would have policymaking responsibilities, however, a politically balanced commission is a better model.
128. The Federal Reserve would not be a good candidate for serving as the federal insurance regulator. See, for instance, *ibid.* Eager points out that “[b]ank regulation today is a secondary function at the Fed, and it is not clear how the addition of an insurance regulatory mission would fit into that agency’s structure,” and notes that the “secondary importance of the regulatory function today tends to magnify the clout of Fed staff, which has even less public accountability than have the Fed governors.”
129. In the area of consumer protection, some states have shown a lack of appreciation for the importance of access and competition to consumers, but it is not clear that a federal regulator would be any better. In the area of consumer finance regulation, for example, the newly created Bureau of Consumer Financial Protection has been criticized for failing to properly assess the value of consumer choice and access. See, for instance, Todd Zywicki, “The Dodd-Frank Act Five Years Later: Are We More Stable?” statement before the Committee on Financial Services, U.S. House of Representatives, 114th Cong., 2015.

-
130. Scott Harrington has warned that federal regulation carries with it a greater likelihood of bailouts. See, for instance, Harrington, "Insurance Regulation and the Dodd-Frank Act," Networks Financial Institute *Policy Brief* No. 2009-PB-01, March 2011, p. 13.
 131. Grace and Klein, "Efficiency Implications of Alternative Regulatory Structures for Insurance," p. 125. According to Grace and Klein's careful, empirical analysis, an optional federal charter likely would generate small savings in solvency and financial regulation, larger savings in market regulation, but nevertheless small savings in the aggregate when compared with total industry premiums. But, see also, Bair, "Consumer Ramifications of an Optional Federal Charter for Life Insurers," Executive Summary. Bair concludes "that the current multi-state system is structurally resistant to needed reforms, even in the face of broad consensus that greater uniformity and centralization is needed in the oversight of life insurance products."
 132. Henry N. Butler and Larry E. Ribstein, "A Single-License Approach to Regulating Insurance," *Northwestern Law and Economics Research Paper* No. 08-10, 2008.
 133. *Ibid.*, p. 15.
 134. Harrington, "Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation," p. 28.
 135. Roberta Romano, *The Genius of American Corporate Law* (Washington, DC: AEI Press, 1993).
 136. Vaughan and Calabria, "International Developments in the Insurance Sector: The Road to Financial Instability?" p. 10. See also HM Revenue & Customs, *General Insurance Manual*, § 3030: "Regulatory Framework: the European 'Single Passport,'" <http://www.hmrc.gov.uk/manuals/gimmanual/gim3030.htm> (accessed February 17, 2016). The manual explains that under "the 'single passport' framework, "[c]ompanies whose head office is elsewhere in the European Economic Area (currently the EU countries together with Norway, Iceland and Liechtenstein) are permitted to conduct insurance business in the UK on the strength of an authorisation in their Home State."
 137. Therese M. Vaughan, "Observations on Insurance Regulation—Uniformity, Efficiency, and Financial Stability," in Biggs and Richardson, eds., *Modernizing Insurance Regulation*, pp. 31 and 39.
 138. See, for instance, Grace and Phillips, "The Allocation of Governmental Regulatory Authority: Federalism and the Case of Insurance Regulation," p. 211. Grace and Phillips find that in 2000, "the average state used only 8.78 percent of the revenues collected from the insurance industry to finance the operations of the regulator in the state."
 139. Such concerns were the impetus for Europe's Solvency II initiative. See Vaughan and Calabria, "International Developments in the Insurance Sector: The Road to Financial Instability?" and European Commission, "Internal Market and Services DG," pp. 10–12. See also "Solvency II: Frequently Asked Questions (FAQs)," http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/faq_en.pdf (accessed February 7, 2016). The FAQs explain: "The third-generation Insurance Directives established an 'EU passport' (single licence) for insurers based on the concept of minimum harmonisation and mutual recognition. Many Member States have concluded that the current EU minimum requirements are not sufficient and have implemented their own reforms, thus leading to a situation where there is a patchwork of regulatory requirements across the EU. This hampers the functioning of the Single Market."
 140. As Scott Harrington has pointed out, state guaranty funds' purported inadequacy may actually be useful in prompting effective market discipline. Harrington, "Insurance Regulation and the Dodd-Frank Act," p. 13.
 141. Currently, a state's guaranty fund is responsible only for the policyholders residing in their state. Gallanis, "Policyholder Protection in the Wake of the Financial Crisis," p. 220. Gallanis explains: "A covered person is protected by the guaranty association of the jurisdiction where the person resides at the time the insurer fails, even though the insurer whose liquidation triggers the association's coverage responsibility may be domiciled in a different jurisdiction."
 142. As Bert Ely has explained, "Premium tax offsets permit surviving insurance companies to pass the cost of insurance company failures through to general taxpayers." Ely, "The Fate of the State Guaranty Funds After the Advent of Federal Insurance Chartering," p. 142.
 143. Butler and Ribstein, "A Single-License Approach to Regulating Insurance," p. 18.
 144. *Ibid.*
 145. Cummins and Weiss, "Systemic Risk Regulation of the U.S. Insurance Industry," pp. 110 and 125. Cummins and Weiss argue that "the key to effective insurance regulation is to design a regulatory system that effectively encompasses both core and noncore enterprises of the insurance sector and coordinates regulation across national boundaries," but they also note that "it is not clear that federal regulators would be more effective than state regulators." States recently have been focusing more attention on group supervision. See National Association of Insurance Commissioners, "Group Supervision," December 14, 2015, http://www.naic.org/cipr_topics/topic_group_supervision.htm (accessed February 18, 2016).

CHAPTER 8

No Need for Title VI with Simpler, Higher Capital

Stephen Matteo Miller and J. W. Verret

Title VI—Improvements to Regulations of Bank and Savings Association Holding Companies and Depository Institutions—has as a stated objective to improve the regulation of depository institutions. Sections 606 and 607 of Title VI call for bank holding companies (BHCs) to be “well capitalized,” rather than “adequately capitalized.” If Dodd–Frank stopped here, perhaps we would have had the foundation for what might have served as a sound framework for the regulation of depository institutions.

However, like much of Dodd–Frank, Title VI reflects a reversal of what Fischer Black, Merton Miller, and Richard Posner described when they noted that a “striking and heartening development in banking regulation in the last decade has been a movement away from exclusive preoccupation with bank-asset safety and toward greater awareness of the benefits of competition.”¹ They were speaking of the increase in national bank charters, the increasing number of activities banks were allowed to engage in by comptrollers of the currency, and tolerance for BHCs as a way of circumventing onerous state branch-banking laws. Title VI attempts to fix perceived, perhaps even misdiagnosed, problems during the most recent crisis, rather than addressing the source of the historically fragile design of U.S. banks, which explains the large number of banking crises throughout U.S. history.

WHY THERE ARE CRISES

Charles Calomiris and Stephen Haber,² as well as Michael Bordo and two co-authors,³ document how, in the U.S., populist politicians and small bank interests have historically colluded from the outset to pass laws preventing not only branch banking but

also interstate banking. These restrictions made U.S. banks fragile. Until the recent crisis, banking crises, including the Great Depression, fit this pattern, whereby a large number of small banks would fail because they were largely prohibited from diversifying regional shocks through branching and interstate banking.

Calomiris and Haber, as well as Bordo and co-authors, point out that frequent banking crises are not inevitable. They point to the Canadian banking system, which, since confederation in 1867, has relied on a system of large national banks that operate from coast to coast, and has never experienced a system-wide crisis. That is despite the fact that Canada only founded the Bank of Canada in 1935, and only created the Canadian Deposit Insurance Corporation in 1967. For comparison, Calomiris and Haber list a total of 10 crises from 1867 to the present in the U.S., which averages almost one every 15 years.⁴

The most recent crisis appears to break that pattern. At first glance, the crisis seemed concentrated among large banks rather than small banks. However, rather than bank size, the most recent crisis reflects the spectacular crash of the market for tranches (that is, bonds) of structured-finance

collateralized debt obligations (CDOs), which are structured products backed by tranches of residential mortgage-backed securities (MBS) and home-equity-loan-backed securities.

To examine why structured-finance CDOs are at the heart of the recent crisis, Larry Cordell, Yilin Huang, and Meredith Williams reconstruct 727 deals between 1999 and 2007, valued at roughly \$641 billion.⁵ They find that the expected losses on the original structured-finance CDO issuance equaled \$420 billion, roughly 65 percent of the original value. Expected losses were even higher for CDOs issued in 2006 and 2007. Isil Erel, Taylor Nadauld, and René Stulz show that while bank holdings of CDOs were largely unknown, they can reconstruct a measure of highly rated, private-label MBS tranches from BHC data that behaves much like alternative measures they construct, which include estimates of bank CDO tranche holdings.⁶ Erel, Nadauld, and Stulz estimate that average on-balance-sheet holdings of private-label asset-backed securities, MBS and CDO tranches, across all bank holding companies in their sample equaled 5 percent in 2006 (6.6 percent if including off-balance-sheet items). However, some banks had higher exposures, such as Citigroup, where holdings on- and off-balance sheet reached 10.7 percent. Erel, Nadauld, and Stulz illustrate how this situation could be problematic for Citigroup, which had an equity capital-to-total asset ratio equal to 6.3 percent. A hypothetical loss of 60 percent on the highly rated tranches (roughly equal to Cordell, Huang, and Williams's historical average) would effectively wipe out the equity capital.

Erel, Nadauld, and Stulz examine a number of competing hypotheses to explain why banks held so many highly rated private-label MBS and structured-finance CDO tranches. They find evidence that banks that securitized loans held more highly rated tranches, to signal to buyers that they stood by their products, but find no evidence that other factors, such as option-like features of executive pay, or poor risk-management practices, explained those holdings.

Erel, Nadauld, and Stulz also examine whether the Recourse rule⁷ explained bank holdings of those highly rated, private-label tranches. To understand the rule change, while perhaps not the primary concern, the Recourse rule, finalized in late 2001, lowered risk weights for bank holdings of private-label MBS and structured-finance CDOs from 100 percent to 20 percent for AAA-rated and AA-rated

tranches. Translating the change in risk weights into a change in capital requirements, bank capital requirements on these holdings would have fallen from 8 percent to 1.6 percent. For A-rated tranches, the risk weights fell from 100 percent to 50 percent, which means that bank capital requirements on these holdings would have fallen from 8 percent to 4 percent. Erel, Nadauld, and Stulz test whether banks that increased their leverage following the Recourse rule increased their holdings of the highly rated, private-label tranches, but find no evidence that leverage-seeking explained the holdings.

Stephen Matteo Miller⁸ uses Erel, Nadauld, and Stulz's measure of highly rated private-label MBS tranches and finds that in the run-up to the crisis, some banks tilted their portfolios toward the highly rated tranches after the Recourse rule. Banks with greater holdings of the highly rated tranches, *ceteris paribus*, were much closer to default by the time of the crisis in 2008, while official measures of bank complexity and thresholds for bank size (for example, \$50/\$250 billion in total assets) were unrelated to default. In short, while commercial banks experienced the same distress as some investment banks and insurance companies during the recent crisis, the distress in commercial banks presented an additional challenge arising from insured deposits, and the potential for taxpayers to be on the hook if many banks failed.

HOW CAPITAL REQUIREMENTS CAN LESSEN CRISES

To see how higher capital helps address the banking crisis, Michel Crouhy and Dan Galai⁹ examine how banks have to make decisions concerning: (1) capital structure, which consists of how banks choose deposits and equity (assuming no additional debt for simplicity) to fund their loan origination and investments; and (2) capital requirements. While much has been written about capital requirements since their study, a key feature of their framework is their comparison of an unregulated banking system versus a banking system with regulatory capital requirements and government-insured deposits.

Crouhy and Galai show that in their hypothetical unregulated market, there is no optimal capital structure. In their approach, while equity starts out as a source of funding, once issued, it measures the difference between the bank's assets and liabilities. Both the numerator and denominator of the equity-to-asset ratio fluctuate such that when asset values change, the equity measure changes along with it. That means

the equity-to-asset ratio provides no information about solvency, at least not until it hits zero.

Under these conditions, as the capital structure varies, so does the interest rate paid to depositors. For instance, for a given amount of asset risk, the higher the equity capital, the lower the likelihood of the bank's default, so the bank can offer lower rates to depositors, since they are now exposed to less default risk. Alternatively, for a given equity-capital-to-asset ratio, the lower the asset risk, the lower the interest rate the bank should offer. This outcome changes with the addition of government-deposit insurance, which through the guarantee means that depositors should earn a lower (risk-free) interest rate, and now the government insurer, and possibly the taxpayer, assumes bank-default risk.

Under these conditions, which better characterize the current regulatory environment, the capital structure should vary with the insurance premium paid to the deposit insurer, as is currently practiced. For instance, for a given amount of asset risk, the higher the equity capital, the lower the likelihood of the bank's default, so the bank pays a lower premium to the deposit insurer, reflecting the lower default risk. Alternatively, for a given equity-capital-to-asset ratio, the lower the asset risk, the lower the premium that the bank pays to the deposit insurer. The unregulated and regulated banking scenarios provide useful intuition, but additional issues arise with the implementation of regulatory capital requirements.

TOWARD BANK CAPITAL ADEQUACY STANDARDS

Current capital adequacy standards focus attention on the holding company. Yet, Black, Miller, and Posner,¹⁰ like Paul Kupiec in Chapter 4 of this book, suggest that within the context of the regulation of bank holding companies, higher capital requirements at the level of a banking subsidiary rather than the holding company provide a sound, less-onerous framework for regulating banking. Alternatively, Black suggests that bank regulation might simply entail a "dollar-for-dollar" rule, whereby for every dollar of deposits that a bank creates, it must have at least an additional dollar of capital, comprised of long-term bonds and/or stock measured at market value.¹¹

The benefits of this latter proposal lies in the fact that measuring capital at market value would help foster market discipline. For instance, Mark

Flannery and Emanuela Giacomini argue¹² that book measures of equity, which have long been embedded in holding company bank regulatory capital requirements, (1) do not reflect loss-absorbing capacity at banks; (2) lag behind market values; and (3) can be manipulated by accountants. On the latter point, Harry Huizinga and Luc Laeven show¹³ how bank accounting discretion during the recent crisis helped banks appear less distressed than they actually were.

A potential problem with the proposal to measure capital-at-market value could be that bank holding company shares are traded, while bank shares often are not.¹⁴ Making this work might entail moving away from using the holding company as a reference point for regulation and instead focusing on banks themselves.

Shifting the focus of bank regulation from holding companies and toward banks may make sense now. As Randall Kroszner and Philip Strahan¹⁵ and Calomiris and Haber,¹⁶ point out, the holding company was initially created as a way to facilitate branching in states where regulations prevented branching, although it did not cover interstate banking. Calomiris and Haber also observe that the Garn–St. Germain Depository Institutions Act of 1982¹⁷ allowed banks, not just holding companies, to acquire failed banks in any state. With that, states began entering into regional and national reciprocal arrangements, which effectively allowed interstate banking. The subsequent Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994¹⁸ facilitated interstate banking through the holding company.

The BHC, therefore, may once have served a purpose to lower transaction costs for banks that were prohibited from taking advantage of the benefits of branching. The growing regulatory burden arising from Dodd–Frank means that, ultimately, there may be a point where the business and regulation of banking can be done more effectively through banks rather than holding companies, and where regulation entails simpler, higher capital requirements.

DEFINING SIMPLER, HIGHER CAPITAL REQUIREMENTS

Simpler capital requirements imply eliminating the so-called risk weighting inherent in Basel capital adequacy standards, and reverting to simpler measures, such as the leverage ratio. Higher capital requirements address the problem of bank insolvency risk and potentially bank runs.¹⁹

We offer no single suggestion for how high capital requirements should be, but Will Gornall and Ilya Strebulaev have shown²⁰ that merely doubling capital requirements from 8 percent to 16 percent might eliminate roughly 90 percent of bank default risk, while Anat Admati and Martin Hellwig have suggested²¹ a 20 percent to 30 percent capital buffer, comprised of long-term debt and equity, but offer no guidance on that level except that much higher capital might be preferred. Alternatively, Black suggests a simple “dollar-for-dollar” rule.²² This proposal would likewise imply eliminating the Basel-type risk weights, and would mean that in addition to standard deposits, banks would have to seek funding from bond and equity markets, where capital (comprised of long-term bonds and stock) would be measured at market value. Black’s “dollar-for-dollar” proposal therefore shifts the discussion from one where the bank has to raise capital to back assets to one where a bank has to raise capital to back deposits. In any case, the composition of capital also matters.

Black, Miller, and Posner²³ argue that the appropriate composition of capital might depend on the aims of the regulation. If the aim is to protect depositors (their preferred aim), the composition of capital matters little—except to the extent that more equity, rather than various forms of debt and their associated bankruptcy costs, would mean that there is more left for depositors in the event of a bank failure. However, if the aim is to prevent bank failures, a tilting of the composition of capital toward debt would not be desirable, since that would increase leverage. In contrast, Kupiec suggests raising capital in the form of bonds at the banking subsidiary level as part of a broader solution to end the “too-big-to-fail” problem, since shares for banks within holding companies may not trade. With these alternatives in mind, we now turn to how simpler, higher capital requirements obviate the need for much of Title VI.

SIMPLER, HIGHER BANK-CAPITAL REQUIREMENTS OBVIATE NEED FOR TITLE VI

As observed, Black, Miller, and Posner argue that capital requirements offer a lower-cost alternative to overseeing holding company activities. Yet, Title VI fails to acknowledge that simpler, higher capital requirements can foster the stability within the financial system, at least for depository institutions, that many sections of Dodd–Frank seek to address

by controlling banking activities through more onerous bank regulation.

For instance, Section 604, subsection (d) seeks to prevent mergers if regulators deem the merger to increase system-wide risk; financial holdings companies must also gain permission if they seek to acquire a firm with more than \$10 billion in assets. However, simpler, higher bank, rather than holding company, capital requirements, whether to protect depositors or prevent bank failures, would mean that the banking subsidiary can function even in the event of a failed holding company.

Section 605 calls for regulatory oversight of non-banking subsidiaries by bank regulators. As Hester Peirce points out in Chapter 7 of this book, the Federal Reserve has dramatically increased its regulatory scope, even as Black, Miller, and Posner have observed that supervising non-banking subsidiaries would be unappealing. Raising capital requirements for the banking subsidiary offers a lower-cost alternative to lessen the likelihood of either depositor losses or bank failures.

Sections 610 and 611 attempt to restrict derivatives activities, while Sections 614 and 615 attempt to limit transactions with insiders. Here again, since simpler, higher bank, rather than holding company, capital requirements lessen the likelihood of either depositor losses or bank failures, these sections of Title VI seem to be more costly to implement.

The proposal to establish capital requirements for the banking subsidiary rather than for the holding company stands in sharp contrast to the “source-of-strength” doctrine endorsed by Section 616. Section 616 may help preserve the holding company, but that does not mean the benefits of a financially sound holding company will extend to the banking subsidiary.

Section 620 calls for the scrutiny of bank investments. Miller (2015) shows that the de facto lowering of regulatory capital requirements for highly rated, private-label tranches following the Recourse rule may help explain why banks increased their holdings of the very assets that experienced catastrophic losses during the crisis. This explanation should speak for simpler and higher capital requirements, rather than greater scrutiny of bank investments.

Section 622 calls for limiting any financial institution from having liabilities that exceed 10 percent of the entire financial system’s liabilities. This section suggests a size threshold exists, beyond which banks suddenly become riskier.

However, Miller shows²⁴ that while bank holdings of private-label structured-product tranches might explain which banks were closer to default, official measures of bank complexity and thresholds for bank size did not.

In the context of interstate mergers, Section 623 places a limit on banks such that they may not exceed 10 percent of the entire banking system's deposits. Since bank size alone does not explain the crisis, the focus on placing limits on bank size is at best arbitrary.

THE VOLCKER RULE VS. SIMPLER, HIGHER CAPITAL REQUIREMENTS

Section 619 of the Dodd–Frank Act, termed the “Volcker Rule,” as it was adopted at the suggestion of former Federal Reserve Chairman Paul Volcker, restricts banks or their affiliates from sponsoring or investing in hedge funds or private-equity funds, and prohibits banks from engaging in so-called proprietary trades (for instance, short-term trades intended to profit from the difference in the purchase and the sale price). There are a number of exemptions adopted by the statute and defined by way of an extensive rulemaking, including exemptions for market making and for hedging activities.

Market making helps to alleviate market panics and provides liquidity to markets that are otherwise infrequently traded. A market maker can also assist with execution of large block trades off exchange and thereby minimize the price impact of the large trade. Market makers are responsible for most trading in government and corporate bonds.

An Oliver Wyman study found²⁵ that there were 37,000 unique corporate bonds outstanding in the U.S. market with a value of \$7 trillion. The extent to which corporate bonds are issued in individual tranches with a wide diversity of terms and maturity dates results in a market that is quite fragmented, and thus means it is far less regularly traded than the typical company's equity securities. Due to the low average trading volume for corporate bonds, market makers who stand ready to facilitate trades play a vitally important role. Market makers provide liquidity, which effectively means that they stand willing to buy or sell securities even during crisis conditions. The presence of market makers in the corporate bond market helps to reduce the cost of issuing securities and provides benefits to both issuers of, and investors in, corporate bonds.

Yet Darrell Duffie suggests that, as unintended consequences of the Volcker rule:

investors would experience higher market execution costs and delays. Prices would be more volatile in the face of supply and demand shocks. This loss of market liquidity would also entail a loss of price discovery and higher costs of financing for homeowners, municipalities, and businesses....

The financial industry would eventually adjust through a significant migration of market making to the outside of the regulated bank sector. This would have unpredictable and potentially important adverse consequences for financial stability.²⁶

The findings of Tobias Adrian and his co-authors suggest²⁷ that Duffie's first unintended consequence has not happened; they do, however, conclude that there may have been a shift into the non-banking sector. All told, the final impact of the Volcker Rule on the corporate debt market will take time to manifest and to be measured, particularly given that the final rule was only recently adopted and that the rule has a multi-year implementation schedule going forward. However, the fact that much activity has migrated elsewhere in the financial system suggests that the Volcker Rule has imposed costs in a way that has significantly altered this segment of the financial system.

As is true for many other sections of Title VI, an alternative to the onerous Volcker Rule would be simpler and higher capital requirements applied to banking subsidiaries, rather than at the holding company, to lessen the likelihood of either depositor losses or bank failures. A first best solution might even entail a repeal of the Volcker Rule.

Alternatively, the Volcker Rule might also be amended to more closely adhere to congressional intent in originally requiring exemptions for market making and hedging. The draconian holding-period presumptions and the byzantine hedging metrics might be reconsidered in favor of a clearer approach to defining the reach of the exemption. One potential formulation could be a limitation on the percentage of an entity's revenue that trading under the exemption can represent. That was the same approach that banking regulators adopted in allowing bank affiliates to increasingly trade in certain securities in the lead-up to the Financial Services Modernization Act of 1999.²⁸

Other exemptions contained in the Volcker Rule that permit banks to obtain some limited streams of healthy, diversified non-loan revenue, such as an exemption for securitization vehicles and for joint ventures, might also be expanded. Claire Hill and Richard Painter argue²⁹ that when investment banks were still organized as partnerships, the general liability of the individual partners served to reduce agency costs at the firms and discourage excessive risk taking. An additional exemption may therefore be considered for hedge funds or private-equity funds, to allow them to be owned and sponsored by bank affiliates, for funds in which the executive members of the Board of Directors of the bank affiliate or the financial holding company also serve as general partners of the fund.

CONCLUSION

U.S. banking historians have identified laws and regulations as the key culprit behind the excessive number of banking crises observed throughout U.S. history. While the laws and regulations that explain crises prior to 2007 may have been eroded through the changing political landscape and subsequent legislation, legislators and regulators have tended to take a “let’s fix the last crisis” approach to financial regulation. Instead of enacting new laws and finalizing new regulations to handle the last crisis, which may have the potential to create unpredictable instability elsewhere in the financial system, a better approach may involve using market discipline to regulate banks. In a banking system with deposit insurance, simpler and higher capital requirements at the level of a bank, rather than at the holding company level, can serve as a cost-effective foundation for a sound financial system.

Any views expressed here are those of the authors, not necessarily of The Heritage Foundation.

ENDNOTES:

1. Fischer Black, Merton Miller, and Richard Posner, "An Approach to the Regulation of Bank Holding Companies," *Journal of Business*, Vol. 51 (1978), pp. 379–412.
2. Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton, NJ: Princeton University Press, 2014), Chapter 6.
3. Michael Bordo, Angela Redish, and Hugh Rockoff, "Why Didn't Canada Have a Banking Crisis in 2008 (or in 1930, or 1907, or...?)" *Economic History Review*, Vol. 68, (2015), pp. 218–243.
4. Calomiris and Haber, *Fragile by Design*, p. 5. The years for which they list a crisis occurring from 1867 onward are: 1873, 1884, 1890, 1893, 1896, 1907, the 1920s, 1930–1933, the 1980s, and 2007–2009.
5. Larry Cordell, Yilin Huang, and Meredith Williams, "Collateral Damage: Sizing and Assessing the Subprime CDO Crisis," Philadelphia Federal Reserve Bank *Working Paper* No. 11-30, 2012.
6. Isil Erel, Taylor Nadauld, and René Stulz, "Why Did Holdings of Highly Rated Securitization Tranches Differ So Much Across Banks?" *Review of Financial Studies*, Vol. 27 (2014), pp. 404–453.
7. U.S. Department of the Treasury, "Risk-Based Capital Guideline; Capital Adequacy Guideline; Capital Maintenance; Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations," *Federal Register*, Vol. 66, No. 230, November 20, 2001, pp. 59614–59667, <https://www.gpo.gov/fdsys/pkg/FR-2001-11-29/pdf/01-29179.pdf> (accessed February 22, 2016).
8. Stephen Matteo Miller, "The Recourse Rule, Highly Rated Tranche Holdings, and the Crisis," unpublished *Working Paper*, 2015.
9. Michel Crouhy and Dan Galai, "An Economic Assessment of Capital Requirements in the Banking Industry," *Journal of Banking and Finance*, Vol. 10 (1986), pp. 231–241.
10. Black, Miller, and Posner, "An Approach to the Regulation of Bank Holding Companies."
11. Fischer Black, "Bank Funds Management in an Efficient Market," *Journal of Financial Economics*, Vol. 2, No. 4 (1975), pp. 323–339.
12. Mark Flannery and Emanuela Giacomini, "Maintaining Adequate Bank Capital: An Empirical Analysis of the Supervision of European Banks," *Journal of Banking and Finance*, Vol. 59 (2015), pp. 236–249.
13. Harry Huizinga and Luc Laeven, "Bank Valuation and Accounting Discretion During a Financial Crisis," *Journal of Financial Economics*, Vol. 106 (2012), pp. 614–634.
14. See, for instance, Paul Kupiec, Chapter 4 of this book.
15. Randall S. Kroszner and Philip E. Strahan, "What Drives Regulation? Economics and Politics of the Relaxation of Bank Branching Restriction," *Quarterly Journal of Economics*, Vol. 114 (1999), pp. 1437–1467.
16. Calomiris and Haber, *Fragile by Design*, Chapter 6.
17. Public Law 97–320; 96 Stat. 1469.
18. Public Law 103–328; 108 Stat. 2338.
19. John Cochrane argues that the "first-come, first-served" nature of fixed-value deposits (deposits whose value remains fixed, irrespective of the financial condition of the bank's assets) makes banks prone to runs. John Cochrane, "Toward a Run-free Financial System," in Martin Neil Bailey and John B. Taylor, eds., *Across the Great Divide: New Perspectives on the Financial Crisis* (Stanford University, CA: Hoover Press, 2014), pp. 197–249, <http://www.hoover.org/sites/default/files/across-the-great-divide-ch10.pdf> (accessed February 18, 2016).
20. Will Gornall and Ilya Strebulaev, "Financing as a Supply Chain: The Capital Structure of Banks and Borrowers," unpublished manuscript, 2014.
21. Anat Admati and Martin Hellwig, *The Bankers' New Clothes* (Princeton, NJ: Princeton University Press, 2013).
22. Black, "Bank Funds Management in an Efficient Market."
23. Black, Miller, and Posner, "An Approach to the Regulation of Bank Holding Companies."
24. Miller, "The Recourse Rule, Highly Rated Tranche Holdings, and the Crisis."
25. "The Volcker Rule: Considerations for Implementation of Proprietary Trading Regulations," Oliver Wyman, January 2011, <http://www.oliverwyman.com/insights/publications/2011/jan/the-volcker-rule--considerations-for-implementation-of-proprieta.html#VsZcgE3lvGg> (accessed February 18, 2016).
26. Darrell Duffie, "Market Making Under the Proposed Volcker Rule," Stanford University, January 16, 2012, p. 2, <http://www.darrellduffie.com/uploads/policy/duffievolckerrule.pdf> (accessed February 16, 2016).
27. Tobias Adrian, Michael Fleming, Or Shachar, and Erik Vogt, "Has U.S. Corporate Bond Market Liquidity Deteriorated?" *Liberty Street Economics*, October 5, 2015, <http://libertystreeteconomics.newyorkfed.org/2015/10/has-us-corporate-bond-market-liquidity-deteriorated.html> (accessed February 18, 2016).
28. Also known as the Gramm–Leach–Bliley Act. Public Law 106–102; 113 Stat. 1338.
29. Claire Hill and Richard Painter, "Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability," *University of Seattle Law Review*, Vol. 33, No. 4 (2010), <http://ssrn.com/abstract=1510443> (accessed February 18, 2016).

CHAPTER 9

Fixing the Dodd–Frank Derivatives Mess: Repealing Titles VII and VIII

Norbert J. Michel

“[I]n the popular press and to the average citizen, ‘derivatives,’ much like speculation, has become a dirty word, hindering informed discussion.”

—*Roberta Romano,*
Maryland Law Review, 1996

The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act was Congress’s response to the 2008 financial crisis.¹ Titles VII and VIII of the act dramatically altered the way certain derivatives markets are regulated. These titles are largely based on the faulty premise that the swaps market contributed to the 2008 crisis because it was unregulated. This notion is demonstrably false, because federal banking regulators have publicly acknowledged that they regulated the bulk of the swaps market before the crisis. Nonetheless, Title VII sets up a new framework whereby federal regulators micro-manage the swaps industry—as if regulators can better manage risks than market participants can.

Title VII imposes new clearing, trading, reporting, margining, and business conduct requirements on swap market participants. All of these requirements impose additional costs on swaps users, but the Title VII clearing mandate is particularly troubling. This directive, the central component of the new regime, threatens nonfinancial businesses’ safety by making it more costly to hedge commercial business risks. Worse, the clearing mandate is likely

to undermine financial stability because it gives rise to larger, less stable central clearinghouses. In particular, the clearing requirement concentrates formerly decentralized financial risks in a small number of large clearing firms.

Title VIII of Dodd–Frank magnifies this financial stability problem by conferring a special status on these clearing companies. These firms, identified as financial market utilities (FMUs), are the Title VIII counterpart to the so-called systemically important financial institutions (SIFIs), which Title I of Dodd–Frank addresses. Title VIII provides these companies with direct access to Federal Reserve lending, creating more moral hazard and further undermining financial stability. Title VIII also gives federal regulators a little-discussed discretionary authority, with practically no standards, that could be used to regulate virtually any sector of U.S. financial markets. Titles VII and VIII are two good examples of why the Dodd–Frank Act should be repealed.

OVERVIEW OF DERIVATIVES MARKETS AND SWAPS

Derivatives securities are essentially contracts between buyers and sellers (commonly referred to as counterparties), but there are many different types of derivatives. Broadly speaking, these (typically) long-lived contracts bind the counterparties to buy or sell some asset at a future date at a certain price. The value of the contract—the derivative itself—is therefore tied to some underlying asset, such as a

corporate bond. In general, the counterparties buy and sell these contracts so that they can lower their exposure to uncertain future price movements.² Speculation aside, that is, the primary use of derivatives is to reduce financial risk.

Three of the more common types of derivatives are futures, forwards, and swaps. Futures are derivatives contracts used so commonly that they are standardized financial instruments, a feature that allows them to trade on exchanges, much like stocks.³ The Chicago Mercantile Exchange, for instance, provides a market where counterparties can buy and sell standardized futures contracts on commodities, such as butter, lumber, cattle, foreign currencies, and even stock market indexes. Forwards, on the other hand, are most often specialized contracts between two financial firms or between a financial firm and its customer. Internationally active corporations regularly enter into forward contracts to hedge against losing money on future changes in exchange rates.⁴

Whereas futures contracts typically do not require the physical delivery of an asset at maturity, forward contracts normally do require delivery. Swaps are similar to forward contracts, but they require counterparties to make a *series* of future payments, whereas forward contracts require only one future payment. Swap contracts can, therefore, be viewed as a series of forward contracts. The most commonly used swaps are those that hedge against interest rate risk, but market participants use many different types of swap contracts.⁵ Historically, most swaps have been negotiated directly (bilaterally) between large banks and other institutional investors—such as insurance companies, pension funds, and mutual funds—on the over-the-counter (OTC) market rather than purchased on exchanges.⁶

Exchanges Versus OTC Markets. Standardized financial instruments typically trade on exchanges, whereas nonstandard financial products, such as highly customized credit default swaps (CDSs), tend to trade in OTC markets. In general, the idiosyncratic nature of customized financial products reduces the number of interested buyers and sellers, thus making the instruments poor candidates for trading on an exchange. Many OTC derivatives are tailored for specific firms' hedging strategies, so relatively few parties are interested in buying such instruments. Buyers and sellers of standardized exchange-traded derivatives, on the other hand, generally have no trouble finding many others

with whom they can execute trades. Furthermore, all market participants can easily identify the prices at which exchange-traded securities are being sold, and use that information to determine whether they feel the price is too high or, alternatively, represents a bargain.⁷

This price transparency exists before and after all trades, and prices can reflect all sorts of information available to market participants—even information that turns out to be incorrect. On the other hand, many highly customized OTC derivatives will always be unlikely to trade in great volumes and, therefore, will not be priced as transparently as many exchange-traded products. The trading venue would not, however, preclude regulators from requiring any needed information about the underlying contracts. Historically, as particular financial products become more widespread, they become more standardized and their trading migrates to exchanges.⁸ This natural process may or may not develop for certain products, but whether a derivative trades on an exchange or in the OTC market by itself says very little about the risks the contract poses to counterparties.

Risk and the OTC Derivatives Market. Many commentators have pointed to the enormous *notional* size of the OTC derivatives markets—approximately \$700 trillion—as an ominous indicator of the systemic risk that derivatives create.⁹ This statistic is misleading for several reasons. To begin, the notional size of the market obscures the fact that derivatives, such as CDSs, improve firms' ability to diversify and reduce their risks.¹⁰ In fact, derivatives securities, such as OTC market CDSs, do not create any new risk. Instead, a CDS merely provides protection to end users by shifting *existing* risks to other firms that are more willing and able to risk their capital. The notional amount of a derivatives contract does not accurately reflect even the amount of capital at risk.

The notional size of an OTC contract merely represents the maximum amount to which a counterparty could be exposed.¹¹ For example, JP Morgan could sell a CDS contract, based on a notional value of \$10 million, to a jet fuel supplier that wants to protect itself should United Airlines be unable to pay its monthly fuel bills.¹² The fuel company would then pay a periodic fee—a percentage of the notional amount—to JP Morgan for the length of the CDS contract. The contract would spell out various default scenarios and obligations, and JP Morgan

DERIVATIVES: REGULATED BEFORE DODD-FRANK

Media accounts have repeatedly claimed—inaccurately—that the derivative known as a *swap* was an unregulated financial product prior to Dodd-Frank.¹ While it is true that OTC swaps were not regulated by either the CFTC or the SEC, the overwhelming majority of these swaps were regulated by state and federal banking regulators. Historically, large banks have always been the heaviest users of interest rate swaps, the type of swap that accounts for more than 80 percent of the OTC derivatives market.²

Federal banking regulators, including the Federal Reserve and the Office of the Comptroller of the Currency (OCC), constantly monitor banks' financial condition, especially the banks' swaps exposure.³ Even the very first iteration of the Basel capital requirements, implemented in the late 1980s, required banks to account for their swaps when calculating regulatory capital ratios. In particular, capital had to be held against the *credit-risk equivalent* to the swaps, essentially treating them as other loans in their risk-adjusted assets.⁴

Simply put, none of these transactions took place outside of bank regulators' purview, and there is no shortage of public acknowledgements attesting to this fact. For instance, a 1993 Boston Federal Reserve paper notes that “[b]ank regulators have recognized the credit risk of swaps and instituted capital requirements for them and for other off-balance-sheet activities, as part of the new risk-based capital requirements for banks.”⁵ Similarly, a 1996 OCC guidance bulletin notes that:

Bank management must ensure that credit derivatives are incorporated into their risk-based capital (RBC) computation. Over the near-term, the RBC treatment of a credit derivative will be determined on a case-by-case basis through a review of the specific characteristics of the transaction. For example, banks should note that some forms of credit derivatives are functionally equivalent to standby letters of credit or similar types of financial enhancements. However, other forms might be treated like interest rate, equity, or other commodity derivatives, which have a different RBC requirement.⁶

Just before the recent crisis, a 2006 OCC report stated:

As a result, derivatives activity is appropriately concentrated in those few institutions that have made the resource commitment to operate the business in a safe and sound manner. Further, the OCC has examiners on site in these large banks to evaluate the credit, market, operational, reputation and compliance risks in the derivatives portfolio on an ongoing basis.⁷

Even the controversial credit default swap used by the failed company AIG took place under the watchful eye of the Office of Thrift Supervision (OTS), a federal banking regulator. The notion that these swaps transactions took place in some shadowy, hidden room of finance, where regulators had no clue what was going on, is absolutely false. Under the new Basel III requirements, banking regulators remain responsible for certifying that banks are meeting their regulatory capital ratios, even when they use swaps. Nonetheless, Title VII of Dodd-Frank gives the CFTC and the SEC explicit authority to regulate the OTC swaps markets and market participants.⁸

-
1. Matthew Philips, “Traders Take Their Swaps Deals to Futures Exchanges,” *Bloomberg Business*, January 24, 2013, <http://www.bloomber.com/bw/articles/2013-01-24/traders-take-their-swaps-deals-to-futures-exchanges> (accessed October 13, 2015).
 2. International Swaps and Derivatives Association, “The Value of Derivatives,” 2014, <http://www2.isda.org/about-isda> (accessed June 23, 2015).
 3. Futures, another type of derivative, were also regulated prior to Dodd-Frank; they were, and still are, regulated differently than swaps. Until 1974, the U.S. Department of Agriculture regulated the futures market, and the first federal statute regulating futures, the Grain Futures Act of 1922, was enacted in the wake of declining crop prices after European agricultural production recommenced post-World War I. The Commodity Futures Trading Commission was created in 1974 soon after newspaper reporters blamed a steep increase in food prices on speculative trading. See Roberta Romano, “A Thumbnail Sketch of Derivative Securities and Their Regulation,” *Maryland Law Review*, Vol. 55, No. 1 (1996), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2985&context=fss_papers (accessed June 22, 2015).
 4. Katerina Simons, “Interest Rate Structure and the Credit Risk of Swaps,” Federal Reserve Bank of Boston, *New England Economic Review* (July/August 1993), <https://www.bostonfed.org/economic/neer/neer1993/neer493b.pdf> (accessed June 22, 2015). Simons also points out that “to the extent that swaps replace on-balance-sheet obligations of counterparties, they reduce rather than increase the credit risk in the financial system.”
 5. *Ibid.*
 6. Office of the Comptroller of the Currency, “Credit Derivatives,” *OCC Bulletin* 1996-43, August 12, 1996, <http://www.occ.gov/news-issuances/bulletins/1996/bulletin-1996-43.html> (accessed October 13, 2015).
 7. Comptroller of the Currency Administrator of National Banks, “OCC’s Quarterly Report on Bank Derivatives Activities, First Quarter 2006,” <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq106.pdf> (accessed October 13, 2015).
 8. Section 701, Subtitle A (Regulation of the Over the Counter Swaps Markets), U.S. Code Title 15, Chapter 109, Subchapter I.

would be obligated to pay some amount to the fuel supplier if United could not pay its bills. Depending on the nature of the default conditions in the contract, JP Morgan would most likely have to pay less than the \$10 million notional amount on which the CDS is based.

Moreover, firms that sell CDS contracts typically protect their own financial exposure by purchasing separate CDS contracts. JP Morgan, for instance, can buy a CDS contract to protect itself against having to pay the jet fuel supplier, as can the firm that sells this new CDS to JP Morgan, and so on. But the real risk remains whether United can pay its bills. The CDS merely transfers the risk from the jet-fuel supplier to firms willing to risk their capital. In this sense, CDS could not have caused the 2008 financial crisis—only the underlying risk to which the CDS was tied could have caused the crisis. While instructive at some level, the notional amount does not accurately reflect this underlying risk nor the amount of that risk to which the counterparties are exposed.

A better measure of the risk that OTC-derivative counterparties take on is the amount of *credit risk* they face. Credit risk, in turn, is the risk that a counterparty may be unable to make the payments it agreed to in the original contract. The Bank for International Settlements (BIS) estimates total credit risk in the OTC derivatives market with a measure called *gross market value*. In 2011 the BIS reported a gross market value of \$19 trillion based on a notional amount of more than \$700 trillion.¹³ Even this measure, however, fails to account for *netting* among counterparties as well as *collateral*, both of which further reduce counterparties' exposure on derivatives contracts.

The process of netting essentially offsets a counterparty's gains and losses so that OTC counterparties cannot simultaneously default on one contract while accepting payment on another—the *net* difference has to be paid (or received).¹⁴ This practice is standard in the International Swaps and Derivatives Association (ISDA) Master Agreement, and it binds a defaulting counterparty to offset defaulting (negatively valued) contracts with non-defaulting (positively valued) contracts.¹⁵ Many of the large institutional investors in the OTC derivatives market have multiple contracts with each other, so applying netting to the gross market value in the OTC market reduces aggregate credit exposure even further.

In 2013, the ISDA estimated that netting reduced credit exposure in OTC derivatives to less than \$4

trillion, a large amount, but far less than \$700 trillion.¹⁶ Similarly, the Office of the Comptroller of the Currency estimates that U.S. commercial banks and savings associations netted more than 90 percent of their derivatives exposure between 2009 and 2012.¹⁷ Credit risk on OTC derivatives is even further reduced by the collateral (margin) requirements commonly negotiated between the counterparties.

As of June 2013, the ISDA estimated that accounting for both netting and collateral reduced the credit exposure in OTC derivatives to \$1 trillion.¹⁸ This lower amount represents less than 0.5 percent of the notional amount outstanding, and the exposure is roughly consistent with data from both 2011 and 2012 as well. It is also true that some of these individual measures, even after accounting for netting and collateral, can fail to provide a complete picture of system-wide risk because some OTC derivatives participants rely on a process called clearing.

Clearing and Central Counter Parties in the OTC Market. Prior to the 2010 Dodd-Frank Act, a relatively small portion of OTC derivatives market participants relied on central counterparties (CCPs) to reduce their credit risk through a process called central clearing.¹⁹ Compared to separately (bilaterally) negotiated contracts, the CCP clearing process tends to provide more uniform collateral and netting rules, as well as additional protections for the original counterparties. Through this clearing process, CCPs assume the risks of counterparties to derivatives contracts. As a result, the original buyer of a derivatives contract can ignore whether the original seller will uphold its end of the contract.

In return, the CCP requires both parties to post collateral (margin) when they submit a contract for clearing, as well as to provide additional collateral (variation margin) as market conditions change. Typically, a CCP also requires its members to contribute to a guarantee fund to cover losses that exceed the collateral (and other assets), thus mutualizing CCP members' default losses.²⁰ Because all original counterparties to derivatives contracts end up with the same counterparty—the CCP that clears their original contract—the underlying risks of cleared derivatives end up with the CCP.

Some derivatives, such as futures contracts, are more readily amenable to clearing because their standardization enhances transparency and liquidity. These factors contribute to a robust secondary market on *futures* exchanges where market participants regularly offset their risks through various

hedging strategies with widely available standardized contracts. More complex, customized swaps, however, typically have not been centrally cleared because they do not offer the same advantages. Many of the derivatives used by the failed American International Group (AIG), for example, were too specialized for clearing.²¹

Still, even without central clearing, bilateral agreements offer counterparties their own advantages, such as the ability to better tailor contracts to specific risks. Furthermore, these counterparties have regularly managed their risk exposure by bilaterally negotiating their own netting, collateral, and other credit enhancement agreements.²² Even though central clearing is not appropriate for all derivatives, a clearing mandate for swaps is a central component of the new regulatory framework in Dodd–Frank Title VII.

DODD–FRANK TITLE VII

Title VII of Dodd–Frank creates a far-reaching new regulatory framework for the OTC swaps market, principally through amending the Commodity Exchange Act and the Securities Exchange Act of 1934.²³ The stated main goals of Title VII are to “reduce risk, increase transparency, and promote market integrity within the financial system.”²⁴ It fails to achieve these goals largely because it is based on the demonstrably false notion that the swaps market contributed to the 2008 crisis because it was unregulated. (See Appendix A.) Furthermore, Title VII incorrectly assumes that regulators can better manage risks in derivatives markets, and more accurately price risks, than market participants themselves.

Title VII splits oversight in the OTC swaps markets between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), such that the CFTC regulates *swaps*, while the SEC regulates *securities-based swaps*.²⁵ Although there are many distinct details across the two regulatory agencies’ implementation of Title VII, the general principles are the same, and the bulk of swap market regulations fall under the CFTC’s jurisdiction. Title VII left many key issues to be settled during the regulatory rule-making process, so it has given regulatory agencies considerable new discretionary authority. Thus far, the CFTC and the SEC have issued thousands of pages of rules and regulations, with many more regulations to come.²⁶

The Title VII framework is centered on a counterproductive clearing mandate. This directive

requires swaps to be cleared through a registered derivatives-clearing organization (DCO) *if* the CFTC determines the swap has to be cleared. The new regulatory regime also requires cleared swaps to be executed on a designated contract market (DCM) or a newly created entity known as a swap execution facility (SEF), unless no DCM or SEF has made the particular swap in question available for trade. Additionally, swap agreements must now be reported to either a swap data repository (SDR) or the CFTC, a feature that requires a great deal of additional record keeping and compliance. The Title VII framework also includes extensive new margin and position limit (the maximum number of contracts allowed on one underlying security) requirements.

Collectively, these changes have ensnared commercial end users in a mass of regulatory compliance even though their use of swaps had nothing to do with the 2008 financial crisis. End users include farmers and agricultural businesses, as well as other participants in physical commodities markets. The main characteristic of an end user is someone who produces, processes, and sells physical products and also uses swaps to hedge commercial risk. Aside from any specific requirements in Title VII that raise end users’ cost of doing business, it is likely that regulators’ newfound discretion will restrict end users’ ability to hedge commercial risk in the future.²⁷ Title VII wrongly assumes that regulators can design the perfect OTC market and then micro-manage it to eliminate systemic risk.

Swap Dealers, Major Swap Participants, and Eligible Contract Participants. Title VII tries to specify exactly to whom the new regulatory framework will apply. The general idea is to require firms with relatively large swaps positions—other than end users—to adhere to the new regulations. The main entities directly subject to Title VII’s new regulatory framework are known as *swap dealers*, *major swap participants*, and *eligible contract participants*.²⁸ Title VII also stipulates that depository institutions are *not* to be considered swap dealers simply for engaging in the practice of offering swaps to their customers in connection with a loan they have made.²⁹ Title VII defines a swap dealer as any entity that:

- (i) holds itself out as a dealer in swaps;
- (ii) makes a market in swaps;
- (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

The swap dealer definition also excludes entities that enter into a swap agreement on their own account but not as part of their regular business, as well as dealers that engage in a de minimis (minimal) amount of swap dealing. The de minimis is currently capped at \$8 billion of swaps activity over the previous 12 months. However, at the end of a (yet to be determined) phase-in period, the cap is set to decrease to \$3 billion, and the CFTC can change this amount.³⁰ Commodities end users have testified to Congress that these arbitrary amounts will eventually result in end users being defined and regulated as swap dealers.³¹

Dodd-Frank introduced the term *major swap participant* as a way to regulate non-dealers who use large amounts of swap contracts. The definition is designed to include anyone whose outstanding swaps could have “serious adverse effects” on U.S. financial stability.³² Title VII defines a major swap participant as any entity that is not a swap dealer but “maintains a *substantial position* in swaps for any of the *major swap categories* as determined by the Commission.” Regulators issued a joint rule which states that an entity is deemed to have a *substantial position* in a major swap category if it has a daily average current uncollateralized exposure in a calendar quarter of at least \$1 billion (\$3 billion in the case of rate swaps).³³

Title VII amends the definition of *eligible contract participant* (ECP) to include the terms swap dealers and major swap participants, as well as their securities-based counterparts, because these entities “are likely to be among the most active and largest users of swaps and security-based swaps.”³⁴ While there are many details unique to each category, swap dealers, major swap participants, and eligible contract participants are all now subject to the same new regulatory framework. Under the new regime, swap dealers have the highest level of obligation, followed by major swap participants and ECPs, respectively.

Implementation of these rules has caused a great deal of confusion, particularly for end users who fear costly new regulations. Rather than use swaps to hedge their risks and deal with increased regulatory costs, end users will ultimately have to choose between using futures markets and forgoing the underlying economic activity they normally undertake. That is, rather than engaging in a customized contract to hedge their risk, end users could simply

decide to forgo the underlying activity that generates their business risk.

Trading Venue Requirement. Certain swap market participants are now subject to, among other things, trading venue requirements. For instance, Title VII generally requires *cleared* swaps to be executed on an exchange or an SEF, an exchange-like facility created by Dodd-Frank.³⁵ Title VII also makes it illegal for any person other than an ECP to enter into a swap unless that swap is “on, or subject to the rules of, a board of trade designated as a contract market” under section 5 of the Commodity Exchange Act (CEA), the law that codifies the CFTC’s jurisdiction.³⁶ A *board of trade designated as a contract market*, also known as a designated contract market, is an exchange that the CFTC has designated for trading futures or options under the CEA.³⁷

Thus, Title VII tries to speed up the natural migration of customized financial products onto exchanges. This requirement is based on the premise that exchanges provide more liquid and transparent markets, but that premise is a post hoc fallacy: Exchange trades are more liquid and transparent than OTC trades, but not because they are taking place on exchanges. Many OTC swaps are thinly traded precisely because they are uniquely tailored to specific users’ needs. Forcing these swaps to trade on an exchange is unlikely to produce the “better” pricing that regulators (and apparently some institutional investors) seek.

Any thinly traded financial instrument is susceptible to greater price volatility from any given trade. The pre-trade transparency that exchange trades require makes it easy for other traders to “see” how the market is unfolding and make their own trades in ways that greatly impact the price of thinly traded instruments. Knowing this problem exists, anyone contemplating offering a swap for sale would either avoid the contract altogether or raise the price to compensate for the additional price risk. In any case, forcing the trade onto an exchange by itself does nothing to lower systemic risk, or to increase the kind of transparency that regulators could use to understand the details of OTC swaps contracts.

Title VII Clearing Mandate. The clearing mandate is the main element of the Title VII regulatory framework. In general, swaps must now be cleared through a registered clearinghouse that serves as a central counterparty (CCP). Central clearing is a major change in the swaps market because prior to the 2010 Dodd-Frank Act, only a small portion of

swaps were centrally cleared.³⁸ Title VII provides several exceptions to the clearing mandate, and also gives regulators a great deal of discretion to decide (on an ongoing basis) which swaps will be cleared.³⁹

In one sense this type of rule is worse than a blanket mandate because the process is more susceptible to regulatory capture and failure, and also creates additional uncertainty among market participants. Regardless, the clearing mandate is misguided and likely to undermine financial stability. The Title VII clearing requirement states that:

It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization that is registered under this Act or a derivatives clearing organization that is exempt from registration under this Act *if the swap is required to be cleared*.⁴⁰ (Emphasis added.)

Title VII allows the CFTC to initiate a review of whether a swap should be cleared, and it allows the CFTC to rely on industry practice to determine whether a swap should be cleared.⁴¹ Title VII states that:

A derivatives clearing organization shall submit to the Commission each swap, or any group, category, type, or class of swaps *that it plans to accept for clearing*.⁴² (Emphasis added.)

Title VII also provides several exceptions to the clearing requirement, including what is commonly referred to as the *end-user exception*.⁴³

The end-user exception applies if one of the swap counterparties (1) is not a financial entity; (2) uses swaps to hedge commercial risk; and (3) notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps.⁴⁴ The CFTC (using its Title VII authority) also promulgated rules that exempted certain small banks, saving associations, farm credit system institutions, and credit unions from the definition of *financial entity*, and that provided a clearing exemption for swaps between certain affiliated entities.⁴⁵ On an ongoing basis, Title VII adds regulatory uncertainty to a highly dynamic market because it provides regulators with so much discretion for determining which swaps must be cleared.

Title VII requires the CFTC to consider five subjective factors when determining whether

previously uncleared swaps will have to be cleared. These factors include the impact that clearing will have on systemic risk, as well as “the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.”⁴⁶ As previously discussed, notional exposures do not provide a complete picture of swaps’ risk, and trading illiquidity and lack of robust pricing data are inherent features of customized OTC financial products. These factors should make highly specialized swaps likely to remain uncleared, but there is no reason to have these rules unless the intent is for regulators to force more swaps into CCPs.⁴⁷

In much the same way that the trading requirement is misguided, the drafters of Dodd-Frank assumed that the effective central clearing that already existed in derivatives markets could be extended via legislation. As discussed previously, while it is true that central clearing has previously been beneficial for some derivatives users, it does not follow that all swaps should be centrally cleared. In fact, forcing too many customized swaps into CCPs—the most likely result of the clearing mandate—unambiguously concentrates financial risk in a small number of large clearing firms.⁴⁸

This increased concentration compounds the fact that central clearing can increase systemic risk in a number of ways. For example, concerns over a CCP’s solvency could lead market participants to “run” from their CCP in an attempt to save their collateral.⁴⁹ The resulting run on the CCP could cause a liquidity shock in much the same way a bank run could prevent a bank from meeting its obligations to depositors.⁵⁰ The following list summarizes some of the ways that clearing at CCPs can increase systemic risk.⁵¹

- **Increased moral hazard.** CCPs mutualize losses, thus providing an incentive for individual members to take greater risks. In other words, all else being equal, CCP members would be more likely to clear riskier derivatives with a CCP than to retain the original counterparty to such a contract.
- **Increased interconnections.** CCPs are large, interconnected firms that are integral to the operation of financial markets. One expert referred to clearing as the “mother of all interconnections” because virtually all large financial institutions funnel the bulk of their derivatives trading through the same few CCPs, and

virtually all CCPs have many of the same members. Thus CCPs provide one of the few examples of how large financial firms are directly interconnected, and how the failure of one clearing member can transmit financial stress to other clearing members.

- Exacerbate liquidity problems. Most large financial institutions funnel their derivatives trading through the same few CCPs, and virtually all CCPs have many of the same members. Because CCPs are so interconnected, liquidity problems at any one CCP are likely to transmit to other CCPs. Additionally, any system-wide crisis that impacts a large group of firms is likely to spread to multiple CCPs. Regardless of the source of the financial stress, if a CCP faces liquidity strains, its members can face liquidity shortfalls that trigger a cascade of failures beyond the CCP, transmitting liquidity risk more broadly to a wider set of (interconnected) market participants.
- Deny resources to other creditors. CCPs require margin and collateral which, by definition, represent financial resources that can no longer be used by other financial firms. Furthermore, CCPs might protect their own solvency and liquidity with margin calls, thus requiring members to provide additional cash or securities to the CCP. These CCP margin calls could worsen—or even trigger—a liquidity crisis by draining liquid assets from other sectors of the financial industry.

At the very least, the clearing mandate will heighten the financial system's exposure to more adverse liquidity shocks as more liquid assets are obligated to CCPs for margin requirements. Title VII further compounds this problem because it also requires regulators to set capital and margin requirements in connection with *uncleared* swaps.⁵² Rather than trust counterparties to carefully negotiate OTC swaps with each other (bilaterally), thus keeping risks decentralized throughout financial markets, the Title VII clearing mandate will concentrate these risks in a small number of CCPs.

Registration and Other Requirements. One major consequence of being labeled a swap dealer or a major swap participant is the possibility of higher capital and margin requirements. Commercial end users, for example, fear both having higher regulatory costs passed on to them by existing dealers, as

well as being labeled a swap dealer or a major swap participant. Some swaps users have simply left the market and, instead, began using futures to avoid these problems. For instance, end users in the energy industry stopped using nearly 1,000 swaps contracts and instead began using futures contracts on the electronic platform run by IntercontinentalExchange (ICE).⁵³ Given the relative complexity of the new framework compared to the regulations for futures markets, it seems likely that other swap users will also choose alternative derivatives as a way to hedge their risk.⁵⁴

Title VII also requires swap dealers, major swap participants, and eligible contract participants to register with the CFTC, a requirement that includes many detailed obligations.⁵⁵ Using the authority granted in Title VII, the CFTC paired this registration requirement with the duty to become a member of a registered futures association (RFA). The CFTC also delegated the registration process to the National Futures Association (NFA), currently the only RFA in the U.S.⁵⁶ The NFA's existing member registration process will now be forced—at a substantial cost—on all those who apply.⁵⁷

Separately, Title VII requires the commission to regulate swap dealers and major swap participants with regard to items such as reporting and record-keeping, documentation requirements, and general business conduct standards.⁵⁸ The CFTC has decided to issue separate rules for each of these Title VII items, and as of this writing they have not been finalized.⁵⁹ However, these types of rules do tend to protect existing firms from potential competitors, so it is likely that they will eventually serve as barriers to competition. Regardless, the clearest danger is that Title VII will undermine financial stability as the clearing mandate causes more derivatives to be cleared with CCPs. Title VIII of Dodd-Frank addresses this problem with a new regulatory framework for (among others) firms that clear derivatives.

TITLE VIII: PAYMENT, CLEARING, AND SETTLEMENT

Title I of Dodd-Frank created the Financial Stability Oversight Council (FSOC) and gave it the power to designate certain financial companies and activities for special regulatory oversight.⁶⁰ These firms are commonly referred to as systemically important financial institutions. Title VIII of Dodd-Frank, also known as the Payment, Clearing, and Settlement Supervision Act of 2010, is similar

to Title I in that it authorizes the FSOC to single out certain financial companies and activities for special regulatory oversight. Nominally, a key difference is that Title VIII focuses on PCS firms and activities that could threaten the stability of the financial system.⁶¹ The PCS sector includes the CCPs that clear derivatives centrally.

Title VIII formally charges the FSOC with determining “whether a financial market utility or payment, clearing, or settlement activity is, or is likely to become, systemically important.”⁶² Title VIII is essentially the Federal Reserve’s response to the Title VII clearing mandate. Since the 1990s, the Fed has expressed concern that financial difficulties at CCPs could cause (or worsen) a broader financial crisis, and the Title VII clearing mandate only magnified the risk of such a CCP-induced crisis.⁶³ Title VIII gives designated CCPs explicit access to the Fed’s deposit and payment services, as well as to the Fed’s so-called emergency lending.⁶⁴

Financial Market Utilities (FMUs). Title VIII authorizes the FSOC to identify a new class of financial companies that regulators view as too big to fail.⁶⁵ Specifically, Title VIII authorizes the FSOC to “designate those financial market utilities...that the Council determines are, or are likely to become, systemically important.”⁶⁶ Ostensibly, the term financial market utility refers to the largest clearinghouses and other PCS firms, such as those that serve as CCPs.⁶⁷ Thus, the term “systemically important FMU” refers to a specially designated firm under Title VIII.

The Federal Reserve will now be the primary regulator of any designated FMU that was not previously regulated by either the SEC or the CFTC. Additionally, all designated FMUs will have deposit and payment services with a district Federal Reserve bank—privileges previously reserved for depository institutions.⁶⁸ This change alters the structure of the PCS sector because it allows designated FMUs to transfer large dollar payments *directly* instead of relying on private commercial banks.⁶⁹

Title VIII also grants these systemically important FMUs direct access to the Federal Reserve’s discount window. In particular, the Fed can now provide discount window loans—direct (typically short-term) loans from the central bank—to designated FMUs in “unusual or exigent circumstances.”⁷⁰ This access increases moral hazard because it lowers CCPs’ incentive to accept only the safest clearing members. Furthermore, the recognition that CCPs are federally backed lowers the incentive

for clearing members to choose a CCP based on financial strength. In other words, CCPs have a reduced incentive to compete based on their own financial strength because they are now federally backed. The fact that designated CCPs are now backed by the Federal Reserve magnifies the threats to financial stability caused by Title VII.

At a minimum, these changes provide a competitive advantage to specially designated firms; at worst they invite future taxpayer bailouts. Sheila Bair, former chairman of the Federal Deposit Insurance Corporation, testified to Congress that granting FMUs access to the discount window “not only gives these firms a real advantage over other ‘non’ systemic competitors, it opens up taxpayers to potential losses and creates moral hazard.” Bair also testified that “Title VIII FMUs will very likely become the new GSEs [government-sponsored enterprises] and a new source of system instability,” and recommended that this “unwarranted expansion of the government safety net” be repealed.⁷¹

Title VIII all but ensures that the Federal Reserve—and therefore the federal government—will be viewed as part of even the *nonbank* financial sector’s PCS system. Indeed, the term FMU, a variation of *public utility*, is anticompetitive and shows that federal regulators believe that the financial industry cannot function unless it is highly regulated and largely devoid of competition. The public utility arrangement has effectively created the only lasting class of monopolies that exists in the U.S., and there is a real danger that Title VIII will broadly extend this anticompetitive arrangement to financial firms. (See Appendix B.) Several other Title VIII details pose a direct threat to the ability of competitive financial markets to function properly.

TITLE VIII: OVERLY BROAD REGULATORY AUTHORITY

On the surface, Title VIII deals only with regulators’ ability to regulate the largest clearinghouses, such as the specially designated FMUs. However, Title VIII actually gives regulators an overly broad authority that could allow them to impose rules and regulations on financial firms beyond the PCS sector.⁷² One potential source of this broad authority lies in the formal definition of FMU. Section 803(6) defines the term FMU as “any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial

PCS FIRMS AND UTILITIES: A POOR ANALOGY

Private clearinghouses in the banking industry have existed in the U.S. since at least the 1830s, and there are virtually no historical references to these firms as utilities.¹ More specialized payment, clearing, and settlement (PCS) firms, such as those that clear derivatives contracts, have also operated in the U.S. since the 1800s, but few—if any—modern derivatives textbooks refer to these firms as public utilities.² One of the earliest examples of policymakers comparing PCS firms' operations to those of a public utility dates to the 1970s and serves as a prime case *against* applying the concept to these companies.³

A large spike in trading volume in the 1960s spurred Congress, the SEC, as well as the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX), to push for a national clearing system. There was clearly no monopoly in the industry, but the dominant firms—the NYSE and AMEX—worked with Congress to help design this national system.⁴ Ultimately, Congress passed the Securities Act Amendments of 1975, legislation that marked a major shift in the way the SEC regulated the securities industry.

These amendments required, among other things, clearing firms to register with the SEC, thus subjecting them to extensive regulation. Smaller regional exchanges opposed this effort on the grounds that it would remove competition from the clearing market, but Congress chose to establish a national market despite any anticompetitive effects.⁵ One former SEC commissioner involved in the process noted that the “law was an attempted political compromise of deep economic divisions within the financial community, about the extent to which brokers, dealers, banks, and other financial institutions should be permitted to freely compete with one another.”⁶

Regardless of which groups benefited the most, there is no doubt that the 1975 amendments greatly influenced the structure of the financial industry. After the amendments passed, the NYSE, AMEX, and the National Association of Securities Dealers merged their respective clearing firms into a single entity named the National Securities Clearing Corporation (NSCC). When the new firm registered with the SEC, the Bradford National Clearing Corporation filed suit claiming (among other things) that the “anticompetitive impact of NSCC’s operation outweighs the beneficial effects thereof.”⁷ Eventually, a U.S. appeals court sided with the NSCC, and its decision refers to one aspect of clearing as a public utility. The appeals court noted that

for purposes of comparing NYSE and AMEX transactions, NSCC is essentially a public utility that is afforded a monopoly but must offer its services to all qualified customers (its own participants or other clearing agencies) at cost.⁸ (Emphasis added.)

Aside from whether it did so correctly, the court applied the public utility concept to one narrow aspect of the NSCC’s operations based on the finding that certain customers would have no choice but to use some NSCC services. In hindsight, the decision was premature because future technological changes soon radically altered even this narrow aspect of the NSCC’s operations. The court did not envision, for instance, millions of consumers with instant access to stock transactions via the Internet and their home computers. Regardless, the court did not refer to the NSCC’s overall operation as a public utility, even though it acknowledged that the company effectively had a clearing monopoly in New York. This monopoly, of course, was a direct result of the 1975 amendments.

-
1. The regulated firms that provided electricity and water were undoubtedly referred to as public utilities long before the Fed was created in 1913, but official documents during this era did not refer to clearinghouses as utilities. See, for instance, J. G. Cannon, “Clearing-House Methods and Practices,” in *Publications of National Monetary Commission*, Vol. 6 (1911), https://fraser.stlouisfed.org/docs/historical/nmc/nmc_491_1910.pdf (accessed February 9, 2015).
 2. See, for instance, John C. Hull, *Options, Futures, and Other Derivatives* (Upper Saddle River, NJ: Pearson Education, 1997).
 3. Neal Wolkoff and Jason Werner, “The History of Regulation of Clearing in the Securities and Futures Markets, and Its Impact on Competition,” *Review of Banking & Financial Law*, Vol. 30 (2010), pp. 313–381.
 4. As of 1975, the NYSE and AMEX (combined) cleared more than 70 percent of all shares traded in the U.S. See *ibid.*, p. 314.
 5. The SEC also sought to increase competitive forces by abolishing rules that tied regional clearinghouses to their respective exchanges. See *ibid.*, p. 336.
 6. Roberta Karmel, *Regulation by Prosecution: The Securities & Exchange Commission Vs. Corporate America* (New York: Simon and Schuster, 1982), p. 114.
 7. Open Jurist, *Bradford National Clearing Corporation v. Securities and Exchange*, 590 F. 2d 1085, <http://openjurist.org/590/f2d/1085/bradford-national-clearing-corporation-v-securities-and-exchange-commission-> (accessed January 26, 2015).
 8. *Ibid.*

institutions or between financial institutions and the person.”

Title VIII excludes “national securities exchanges, national securities associations, alternative trading systems,” and various other institutions from the FMU definition.⁷³ The exclusion is ambiguous, though, because it also says that these institutions are not FMUs

*solely by reason of their providing facilities for comparison of data respecting the terms of settlement of securities or futures transactions effected on such exchange or by means of any electronic system operated or controlled by such entities, provided that the exclusions in this clause apply only with respect to the activities that require the entity to be so registered.*⁷⁴ (Emphasis added).

Presumably, these firms could still be identified as an FMU for another reason.

Similarly, the Title VIII definition of an FMU excludes brokers, dealers, transfer agents, and investment companies “solely by reason of functions performed by such institution[s] as part of brokerage, dealing, transfer agency, or investment company activities.”⁷⁵ The exclusion also states that these firms will not be deemed FMUs “solely by reason of acting on behalf of a financial market utility...provided that services performed by such institution do not constitute critical risk management or processing functions of the financial market utility.”⁷⁶ The efficacy of the exclusion thus depends partly on how narrowly the FSOC interprets, for example, *critical risk-management functions*, a term that Dodd–Frank does not define. Indeed, much of Dodd–Frank is written to give regulators flexibility under a mandate of maintaining financial stability.

Other Title VIII definitions provide a similar cause for concern. For instance, Title VIII is ostensibly only concerned with payment, clearing, and settlement activities. However, Section 803(7) defines a “payment, clearing, or settlement activity” to mean “an activity carried out by 1 or more financial institutions to facilitate the completion of financial transactions, but shall not include any offer or sale of a security under the Securities Act of 1933 (15 U.S.C. 77a et seq.), or any quotation, order entry, negotiation, or other pre-trade activity or execution activity.”⁷⁷ Title VIII does not define the term *to facilitate*, but does define *financial transactions* very broadly,

so that it includes funds transfers, repurchase agreements, financial derivatives contracts, and “any similar transaction that the Council determines to be a financial transaction for purposes of this title.”⁷⁸

It is also noteworthy that the Title VIII definition of FMU does not explicitly use the words “payment, clearing, or settlement activity.” Instead, the FMU definition identifies firms that operate a multilateral system “for the purpose of transferring, clearing, or settling payments, securities or other financial transactions.” That is, Title VIII does not simply define an FMU as a company that operates a multilateral system “for the purpose of undertaking payment, clearing, or settlement activities,” even though it does define that term. Worse, the term is defined broadly enough that regulators could possibly reach beyond the traditional PCS sector.

Systemically Important FMUs and Activities. Title VIII states that “the Board of Governors, by rule or order, and in consultation with the Council and the Supervisory Agencies, shall prescribe risk management standards...governing (A) the operations related to the payment, clearing, and settlement activities of designated financial market utilities; and (B) the conduct of designated activities by financial institutions.”⁷⁹ As noted, several terms in the Title VIII definition suggest that regulators could broaden the FMU concept beyond what is traditionally viewed as the PCS sector. The *activities* designation, however, appears to leave regulators with even more leeway.

Title VIII defines *designated activities* to include those “payment, clearing, or settlement” activities that the FSOC designates as systemically important,⁸⁰ and it defines *payment, clearing, or settlement activities* as an “activity carried out by 1 or more financial institutions to facilitate the completion of financial transactions.”⁸¹ Title VIII also defines *financial institutions* very broadly, including depository institutions, broker dealers, investment companies and advisers, as well as “any company engaged in activities that are financial in nature or incidental to a financial activity.”⁸² These terms are defined so broadly that Title VIII gives federal regulators discretionary authority, with essentially no standards, to potentially regulate practically any financial firm in the securities or capital markets segments.⁸³

After the FSOC makes a systemic designation of an FMU or a financial institution’s activities, Title VIII even gives the Federal Reserve the authority to overrule a firm’s primary regulator. While the

SEC and the CFTC—primary regulators of some PCS firms prior to Dodd–Frank—are still allowed to prescribe risk-management standards for the designated firms they supervise, they now must do so in consultation with the Fed Board of Governors and the FSOC.⁸⁴ Ultimately, the Fed can decide whether these regulations “are insufficient to prevent or mitigate significant liquidity, credit, operational, or other risks to the financial markets or to the financial stability of the United States.”⁸⁵ Should the SEC or the CFTC object to the Fed’s proposed standards, a two-thirds vote by the FSOC resolves the dispute.⁸⁶

It would be a mistake to view the Title VIII designation narrowly because it specifically gives the Fed the authority to “prescribe risk management standards.” Title VIII unquestionably allows the Fed to regulate a key aspect of financial firms’ activities in the name of maintaining financial stability. Furthermore, the broad definitions of key Title VIII terms—such as financial transactions and financial institutions—suggest that regulators can use Title VIII to reach well beyond the PCS sector.⁸⁷ Combined, Titles I and VIII of Dodd–Frank give the FSOC—and the Fed—the authority to regulate virtually any aspect of U.S. financial markets on an ongoing basis with an enormous amount of discretion. It is difficult to justify giving such broad power to any federal regulator.

CONCLUSION

The 2010 Dodd–Frank Act was Congress’s response to the 2008 financial crisis, and two of its titles—VII and VIII—have dramatically altered the way certain derivatives markets are regulated. These titles are largely based on the faulty premise that the swaps market contributed to the 2008 crisis because it was unregulated—a demonstrably false notion. Title VII created a new framework whereby

federal regulators micromanage the swaps industry as if regulators can better manage (and accurately price) risks than market participants themselves.

Title VII imposes new clearing, trading, reporting, margining, and business conduct requirements on swap market participants. While all these requirements impose additional costs on swaps users, the Title VII clearing mandate is particularly dangerous. This mandate, the main component of the new regulatory framework, makes it more costly to hedge commercial business risks and also undermines financial stability. The clearing requirement undermines financial stability because it creates moral hazard and concentrates formerly decentralized financial risks in a small number of large clearing firms. Title VIII magnifies these problems by conferring a special status on so-called systemically important central clearing companies.

These firms, identified as designated financial market utilities (FMUs), are the Title VIII counterpart to the so-called SIFIs that Title I of Dodd–Frank addresses. Title VIII provides these companies with direct access to Federal Reserve lending, creating more moral hazard and further undermining financial stability. Title VIII also gives federal regulators a very broad discretionary authority that could ultimately be used to regulate firms in nearly any sector of U.S. financial markets. Together, Titles VII and VIII ensure further consolidation in financial markets, create moral hazard, undermine financial stability, and add to the number of too-big-to-fail institutions. These two titles provide excellent examples of why the Dodd–Frank Act should be repealed.

This chapter was originally published as a Heritage Foundation Backgrounder—“Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII”—on November 16, 2015.

ENDNOTES:

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, 2010, <https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf> (accessed March 6, 2015).
2. John Hull, *Options, Futures, and Other Derivatives*, 3rd ed. (Upper Saddle River, NJ: Prentice-Hall, 1997).
3. *Ibid.* Historically, the exchanges have set the rules and procedures for standardization of futures contracts.
4. *Ibid.*, and Roberta Romano, "A Thumbnail Sketch of Derivative Securities and Their Regulation," *Maryland Law Review*, Vol. 55, No. 1 (1996), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2985&context=fss_papers (accessed June 22, 2015).
5. As of June 2013, the International Swaps and Derivatives Association (ISDA) reported that interest rate swaps accounted for more than 80 percent of the over-the-counter (OTC) derivatives market. See ISDA, "The Value of Derivatives ISDA's-2014 Brochure," <http://www2.isda.org/about-isda> (accessed June 22, 2015).
6. In the U.S., swaps markets are heavily concentrated among commercial banks, perhaps the largest institutional users. For instance, the largest five banks account for roughly 95 percent of all swaps among the largest 25 commercial banks. Comptroller of the Currency, "OCC's Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2012," Table 1, Quarter 3, 2012, <http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq312.pdf> (accessed October 7, 2015). Similar concentration appears globally; see Darrell Duffie, "Futurization of Swaps," Bloomberg Government, January 28, 2013, p. 2, http://www.darrellduffie.com/uploads/policy/DuffieBGOV_FuturizationOfSwaps.pdf (accessed July 28, 2015).
7. Randall Dodd, "Markets: Exchange or Over-the-Counter," International Monetary Fund, March 28, 2012, <http://www.imf.org/external/pubs/ft/fandd/basics/markets.htm> (accessed July 28, 2015).
8. Duffie, "Futurization of Swaps." For more on the OTC markets, see Darrell Duffie, *Dark Markets: Asset Pricing and Information in Over-the-Counter Markets* (Princeton, NJ: Princeton University Press, 2012), pp. 1-9.
9. ISDA, "The Value of Derivatives-ISDA's 2014 Brochure."
10. Contrary to popular belief, not only did derivatives fail to play the principal role in Lehman's bankruptcy, but Lehman's main U.S. derivatives trading entity, Lehman Brothers Special Financing, added more value to the bankruptcy than other Lehman subsidiaries. See Kimberly Summe, "Misconceptions About Lehman Brothers' Bankruptcy and the Role Derivatives Played," *Stanford Law Review Online*, Vol. 64, No. 16 (November 28, 2011), pp. 16-21, <http://www.stanfordlawreview.org/online/misconceptions-about-lehman-brothers-bankruptcy> (accessed September 6, 2015).
11. Nicholas Vause, "Counterparty Risk and Contract Volumes in the Credit Default Swap Market," *BIS Quarterly Review*, December 2010, p. 61, http://www.bis.org/publ/qtrpdf/r_qt1012g.pdf (accessed September 7, 2015).
12. Most such CDS contracts are written on a firm's obligations, such as a notional amount of its corporate bonds. See Andrew Chisholm, *Derivatives Demystified: A Step-by-Step Guide to Forwards, Futures, Swaps, and Options*, 2nd ed. (United Kingdom: John Wiley & Sons, 2010), pp. 69-82.
13. Bank for International Settlements, "OTC Derivatives Market Activity in the First Half of 2011," Monetary and Economic Department, November 2011, p. 12, http://www.bis.org/publ/otc_hy1111.pdf (accessed June 22, 2015). Accurate aggregate data for the CDS market, a subset of OTC derivatives, is difficult to obtain. Experts have pointed out, for instance, that the gross notional CDS outstanding reported by the ISDA (\$55 trillion in 2008) appears to include a high degree of double counting. See Richard Flavell, *Swaps and Other Derivatives*, 2nd ed. (United Kingdom: John Wiley and Sons, 2010), p. 84.
14. Darryll Hendricks, "Netting Agreements and the Credit Exposure of OTC Derivatives Portfolios," Federal Reserve Bank of New York *Quarterly Review*, Spring 1994, http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n1article2.pdf (accessed June 22, 2015).
15. Participants in the OTC derivatives markets have long relied on their private trade association known as the International Swaps and Derivatives Association (ISDA). The ISDA Master Agreement is the contract under which virtually all OTC derivative transactions take place. See Geoff Chaplin, *Credit Derivatives: Trading, Investing, and Risk Management*, 2nd ed. (United Kingdom: John Wiley and Sons, 2010), pp. 60-61.
16. ISDA, "The Value of Derivatives-ISDA's 2014 Brochure." See also David Mengle, "The Importance of Close-Out Netting," *ISDA Research Notes* No. 1, 2010, <http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf> (accessed June 22, 2015).
17. See *Ibid.*, and Comptroller of the Currency, "OCC's Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2012," Graph 5B.
18. ISDA, "The Value of Derivatives-ISDA's 2014 Brochure."
19. Chaplin, *Credit Derivatives: Trading, Investing, and Risk Management*, pp. 350-352. Credit risk is commonly referred to as *counterparty performance risk*; see Craig Pirrong, "The Economics of Central Clearing: Theory and Practice," *ISDA Discussion Papers Series* No. 1, May 2011, <http://www2.isda.org/news/isda-publishes-the-economics-of-central-clearing-theory-and-practice-a-discussion-paper-on-clearing-issues> (accessed June 22, 2015).
20. John W. McPartland, "Clearing and Settlement of Exchange Traded Derivatives," Federal Reserve Bank of Chicago, *Chicago Fed Letter* No. 267, October 2009, <https://www.chicagofed.org/publications/chicago-fed-letter/2009/october-267> (accessed February 3, 2015), and Pirrong, "The Economics of Central Clearing: Theory and Practice."

21. Robert McDonald and Anna Paulson, "AIG in Hindsight," *The Journal of Economic Perspectives*, Vol. 29, No. 2 (Spring 2015), pp. 81-105, http://www.jstor.org/stable/24292124?seq=1#page_scan_tab_contents (accessed September 29, 2015). Also see Darrel Duffie, "Replumbing Our Financial System: Uneven Progress," *International Journal of Central Banking* (January 2013), <http://www.ijcb.org/journal/ijcb13q0a12.pdf> (accessed June 22, 2015).
22. Christopher L. Culp, "OTC-Cleared Derivatives: Benefits, Costs, and Implications of the 'Dodd-Frank Wall Street Reform and Consumer Protection Act,'" *Journal of Applied Finance*, No. 2 (2010), pp. 1-27, <http://www.rmcsinc.com/articles/OTCCleared.pdf> (accessed September 20, 2015).
23. 7 U.S. Code § 1 and 15 U.S. Code 78a, respectively. Separately, Title XVI of Dodd-Frank addresses the tax treatment of certain derivatives. These issues are beyond the scope of this *Backgrounder*, but Title XVI could remain in place without threatening financial stability.
24. "Commodity Futures Trading Commission, Registration of Swap Dealers and Major Swap Participants," *Federal Register*, Vol. 77, No. 12, January 19, 2012, p. 2613, <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-792a.pdf> (accessed June 22, 2015).
25. In general, the key difference is on which item the derivative instrument is based. For instance, a swap based on a particular interest rate would be classified as a swap, whereas a swap based on the value of a securities index would be a securities-based swap. Often, regulators synonymously refer to these financial products as Title VII instruments.
26. Title VII requires the CFTC and the SEC to consult with each other, as well as any prudential regulators affected, before issuing new rules for their respective segments of the market. Section 712, 15 U.S. Code § 8302. The prudential regulator could be any of the following: the Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, or the Federal Housing Finance Agency. See Section 721(a)(39), 7 U.S. Code § 1a (39). The agencies are also required to issue joint rules, in consultation with the Fed, for *mixed swaps*, those that combine certain characteristics of swaps, and securities-based swaps. See 7 U.S. Code 1a(47)(D). Title VII empowers the Financial Stability Oversight Council (FSOC) to resolve any rulemaking disputes. See Section 712(d)(3), 15 U.S. Code § 8302(d)(3).
27. See, for instance, Gregg Doud, "Position Limits for Derivatives, RIN 3038-AD99," Commodity Markets Council, February 10, 2014, <http://www.commoditymkt.org/wp-content/uploads/2014/05/CMC-Position-Limits-Comment-Letter-2-10-2014.pdf> (accessed July 29, 2015).
28. Regarding securities-based swaps, Title VII defines the terms *security-based swap dealer* and *major security-based swap participant*. Eligible contract participant was a pre-Dodd-Frank term but Title VII altered the definition.
29. Section 721(a)(49)(A), 7 U.S. Code 1a(49)(A). Section 716 instituted a provision known as the "swaps push out rule," whereby banks were forced to choose between eliminating their swaps business or losing access to FDIC-insured deposits and the Fed discount window. However, in December 2014, Congress largely revoked this provision. See Norbert Michel, "CRomnibus Swaps Rhetoric for Reality," *Forbes*, December 22, 2014, <http://www.forbes.com/sites/norbertmichel/2014/12/22/cromnibus-swaps-rhetoric-for-reality/> (accessed October 9, 2015).
30. "CFTC and SEC: Final Rule," *Federal Register*, Vol. 77, No. 156, August 13, 2012, and "CFTC and SEC: Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant,' and 'Eligible Contract Participant,' Joint Final Rule; Joint Interim Final Rule; Interpretations," *Federal Register*, Vol. 77, No. 100, May 23, 2012, <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-10562a.pdf> (accessed October 9, 2015).
31. Testimony of Lance Kotschwar, on behalf of the Commodity Markets Council, General Farm Commodities and Risk Management Subcommittee, Committee on Agriculture, July 24, 2013, <http://docs.house.gov/meetings/AG/AG16/20130724/101181/HMTG-113-AG16-20130724-SD003.pdf> (accessed September 26, 2015).
32. Section 721(a)(33), 7 U.S. Code 1a(33). The definition does include certain exclusions, such as for hedging commercial risks.
33. The rule does allow an entity to calculate its current uncollateralized exposure by accounting for netting agreements on a counterparty-by-counterparty basis. See "CFTC and SEC Joint Final Rule; Joint Interim Final Rule; Interpretations," *Federal Register*, Vol. 77, No. 100, May 23, 2012, p. 30664. The rule also provides further detail on many related issues. For instance, an entity can be deemed to have a *substantial position* if its current uncollateralized exposure plus *potential future exposure* is \$2 billion (\$6 billion in the case of rate swaps). (See p. 30671.) The rules do not, however, specify precise guidelines for measuring the value of collateral or potential future exposure. (See pp. 30661-30697.) The four major swap categories are *rate swaps* (including both interest rate and foreign exchange swaps), *credit swaps*, *equity swaps*, and *other commodity swaps*, and the two major categories for securities-based swaps are debt-security-based swaps and other security-based swaps. (See pp. 30662-30663.)
34. "CFTC and SEC Joint Final Rule; Joint Interim Final Rule; Interpretations," *Federal Register*, p. 30655. There are many other details surrounding the ECP definition, including explicit prohibitions of certain foreign-exchange-related swaps activity from the ECP classification. (See pp. 30646-30661.)
35. 723(a)(8), 7 U.S. Code 2(h)(8).
36. 723(a)(2), 7 U.S. Code 2(e).
37. See U.S. Commodity Futures Trading Commission, "A Guide to the Language of the Futures Industry," http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_co#contractmarket (accessed July 29, 2015).
38. The Chicago Mercantile Exchange (CME), for example, cleared bilateral transactions through an entity called ClearPort. See, for instance, Hal Weitzman, "ClearPort Is a Central Part of CME's Strategy," *Financial Times*, October 20, 2009.

39. Title VII also mandates that all cleared swaps have to be traded on an exchange, either a DCM or a swap execution facility (SEF) under section 5 of the CEA, but exchange trading and clearing are separate functions. See Section 723(a)(3), 7 U.S. Code 2(h)(8).
40. Section 723(a)(3), 7 U.S. Code 2(h). Also, 7 U.S. Code § 1a(15) defines a derivatives clearing organization (DCO) as “a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that” meets several conditions, all of which relate to enabling counterparties to execute (for instance, settle, net, clear) their agreements.
41. Section 723(a)(3), 7 U.S. Code 2(h)(2).
42. Section 723(a)(3), 7 U.S. Code 2(h)(2)(B)(i). Also see “Commodity Futures Trading Commission, Process for Review of Swaps for Mandatory Clearing: Final Rule,” *Federal Register*, Vol. 76, No. 143, July 26, 2011, p. 44473, <http://www.gpo.gov/fdsys/pkg/FR-2011-07-26/pdf/2011-18663.pdf> (accessed June 25, 2015).
43. “Commodity Futures Trading Commission, End-User Exception to the Clearing Requirement for Swaps: Final Rule,” *Federal Register*, Vol. 77, No. 139, 17 CFR Part 39, July 19, 2012, <http://www.gpo.gov/fdsys/pkg/FR-2012-07-19/pdf/2012-17291.pdf> (accessed July 28, 2015).
44. Section 723(a)(3), 7 U.S. Code § 2(h)(7).
45. See CFTC, “Clearing Requirement Determination Under Section 2(h) of the CEA: Final Rule,” *Federal Register*, 17 CFR Parts 39 and 50, <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister112812.pdf> (accessed June 30, 2015).
46. Section 723(a)(3)(2)(D)(ii), 7 U.S. Code 2(h)(2)(D)(ii).
47. In December 2012, the CFTC determined that swaps in two classes of CDS and four classes of interest rate swaps would have to be cleared to meet the Title VII requirements. The type of controversial CDS that AIG used prior to the crisis was not among those listed for clearing. “Commodity Futures Trading Commission, Clearing Requirement Determination Under Section 2(h) of the CEA: Final Rule,” *Federal Register*, Vol. 77, No. 240, December 2012, p. 74287.
48. Robert McDonald and Anna Paulson, “AIG in Hindsight,” *The Journal of Economic Perspectives* (2015).
49. Regulatory concerns over lowering systemic risk through clearing date, at least, to the early 1990s when the Bank for International Settlements published a report analyzing what it termed “centralized” clearing systems. Sheila Bair, “Regulatory Issues Presented by the Growth of OTC Derivatives: Why Off-Exchange Is No Longer Off-Limits,” in *The Handbook of Derivatives and Synthetics*, ed. by Robert Klein and Jess Lederman (Chicago, IL: Probus Publishing, 1994), p. 709.
50. On the other hand, under a mandatory clearing regime, running could be difficult unless there are competing CCPs clearing the relevant type of derivative.
51. For a full list and explanation of these factors, see Hester Peirce, “Derivatives Clearinghouses: Regulatory Designs and Private Solutions,” Mercatus Center at George Mason University, forthcoming.
52. Dodd–Frank § 731 (adding 7 U.S. Code § 6s(e)) (providing for capital and margin requirements for swaps), and § 764 (adding 15 U.S. Code § 78o–8(e) (providing for capital and margin requirements for security-based swaps). The regulatory agencies have not yet finalized the rules for uncleared swap margins, but this provision surely creates an added incentive against using bilateral swap agreements that avoid central clearing. Former Treasury Secretary Timothy Geithner, a policymaker instrumental in shaping Dodd–Frank, openly explained the rationale behind the provision in this manner. News release, “Remarks by Treasury Secretary Timothy F. Geithner to the International Monetary Conference,” U.S. Department of the Treasury, June 6, 2011, <http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx> (accessed October 9, 2015).
53. Matthew Philips, “Traders Take Their Swaps Deals to Futures Exchanges,” Bloomberg Business, January 24, 2013, <http://www.bloomberg.com/bw/articles/2013-01-24/traders-take-their-swaps-deals-to-futures-exchanges> (accessed June 22, 2015). In 2012, after the promulgation of many of the rules to which swap dealers would be subject, the CFTC and SEC issued a 169-page joint-rule to clarify ambiguities in a previously issued final rule. See *ibid.*, and “CFTC and SEC Joint Final Rule; Joint Interim Final Rule; Interpretations,” *Federal Register*.
54. Department of the Treasury, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and Federal Housing Finance Agency, “Margin and Capital Requirements for Covered Swap Entities: Proposed Rules,” *Federal Register*, Vol. 79, No. 185, September 24, 2014, Part III: Federal Housing Finance Agency, <http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf> (accessed July 30, 2015).
55. Section 731, 7 U.S. Code § 6s. Additionally, Section 725 (7 U.S. Code § 7a–1) requires derivatives clearing organizations (DCOs) to register with the CFTC, and the details of that process are similar to those for swap dealers, major swap participants, and eligible contract participants.
56. “Commodity Futures Trading Commission, Registration of Swap Dealers and Major Swap Participants: Final Rule,” *Federal Register*, Vol. 77, No. 12, January 19, 2012, p. 2624, <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-792a.pdf> (accessed June 25, 2015).
57. The non-refundable application fee to register is \$15,000, and the membership dues to the NFA range from \$150,000 (for the smallest major swap participants) to \$1,000,000 (for the largest swap dealers). National Futures Association, “Registration Information for Swap Dealers and Major Swap Participants,” <http://www.nfa.futures.org/NFA-registration/sd-and-msp/index.HTML> (accessed October 9, 2015).
58. In the case of uncleared swaps, swaps dealers and major swap participants are required to notify counterparties of the right to require the firm to segregate funds used as (among other things) margin and collateral. Section 724(c), 7 U.S. Code § 6s(l).
59. See, for example, CFTC, “Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants,” *Federal Register*, Notice of Proposed Rulemaking, Vol. 75, No. 236, December 9, 2010.

60. Norbert J. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, <http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail>.
61. The expression payment, clearing, and settlement (PCS) firms is not statutory and is used only for descriptive purposes because there is wide variation within this financial sector. For instance, both the Clearing House Payments Company and the Chicago Mercantile Exchange are in the PCS sector, yet their operations are very different.
62. Section 804, 12 U.S. Code § 5463.
63. According to former FDIC chairman Sheila Bair, then-New York Fed President Gerald Corrigan was "among the first to articulate this concern publicly." Bair, "Regulatory Issues Presented by the Growth of OTC Derivatives," p. 709.
64. Many aspects of the Title VIII framework are part of a larger international regulatory effort to harmonize financial markets. See CFTC, "Derivatives Clearing Organizations and International Standards: Final Rule," *Federal Register*, Vol. 78, No. 231, December 2013, <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister111513.pdf> (accessed October 9, 2015); CFTC, "Enhanced Risk Management Standards for Systemically Important Derivatives Clearing Organizations: Final Rule," *Federal Register*, Vol. 78, No. 158, August 2013, <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-19791a.pdf> (accessed October 9, 2015); and Board of Governors of the Federal Reserve System, "Financial Market Utilities: Final Rule," *Federal Register*, Vol. 79, No. 214, November 2014, <http://www.gpo.gov/fdsys/pkg/FR-2014-11-05/pdf/2014-26090.pdf> (accessed July 2, 2015).
65. Many of the same criticisms that apply to the FSOC regarding SIFIs under Title I apply to Title VIII. See Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail.'"
66. 12 U.S. Code 5463, Section 804.
67. Title VIII, Section 803(6) defines the term FMU as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person." As of this writing, the FSOC has designated eight systemically important FMUs. See "Designated Financial Market Utilities," Federal Reserve Board of Governors, January 29, 2015, http://www.federalreserve.gov/paymentsystems/designated_fm_u_about.htm (accessed February 9, 2015). Internationally, the term "financial market infrastructures" is more common.
68. "Federal Reserve Board of Governors, Financial Market Utilities: Final Rule," *Federal Register*, Vol. 78, No. 245, 12 CFR Part 234, December 2013, <http://www.gpo.gov/fdsys/pkg/FR-2013-12-20/pdf/2013-29711.pdf> (accessed June 30, 2015).
69. Anna Paulson and Kristin Wells, "Enhancing Financial Stability: The Case of Financial Market Utilities," Federal Reserve Bank of Chicago, *Chicago Fed Letter* No. 279, October 2010, <https://www.chicagofed.org/publications/chicago-fed-letter/2010/october-279> (accessed February 3, 2015).
70. 12 U.S. Code 5465(b), Section 806(b). This extension of credit is separate from the Fed's emergency program provisions in Section 13(3) of the Federal Reserve Act, and it does require a majority vote of the Fed Board of Governors.
71. "Failing to End 'Too Big to Fail': An Assessment of the Dodd-Frank Act Four Years Later," report prepared by the Republican staff of the Committee on Financial Services, U.S. House of Representatives, 113th Congress, July 2014, p. 81, http://faculty.haas.berkeley.edu/ross_levine/Other/House_Republications_071814_tbt_f_report_final.pdf (accessed February 20, 2015).
72. Similar arguments can be made against Title I of Dodd-Frank, though Title VIII appears more open-ended.
73. 12 U.S. Code § 5462 (6)(B)(i), Section 803(6)(B)(i).
74. *Ibid.*
75. 12 U.S. Code § 5462 (6)(B)(ii), Section 803(6)(B)(ii).
76. *Ibid.*
77. 12 U.S. Code § 5462 (7)(A), Section 803(7)(A).
78. 12 U.S. Code § 5462(7)(B), Section 803(7)(B).
79. 12 U.S. Code § 5464, Section 805(a)(1).
80. 12 U.S. Code § 5462(2), Section 803(2).
81. 12 U.S. Code § 5462(7)(A), Section 803(7)(A).
82. 12 U.S. Code § 5462(5), Section 803(5). The complete citation is "any company engaged in activities that are financial in nature or incidental to a financial activity, as described in section 4 of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k))." Section 1843(k), in turn, broadly describes nonbank financial firms' activities that can be considered *financial in nature*, including (among others) "Lending, exchanging, transferring, investing for others, or safeguarding money or securities." See 12 U.S. Code 1843(k)(4).
83. See also Peter Wallison, "The Regulators' War on Shadow Banking," American Enterprise Institute, January 2015, pp. 15-17, <https://www.aei.org/wp-content/uploads/2015/01/Regulators-war-on-shadow-banking.pdf> (accessed October 14, 2015). Other financial regulations already apply a very broad definition of financial institutions. For instance, anti-money-laundering regulations apply to financial institutions as defined by Title 31 U.S. Code § 5312. Other than banks (broadly defined), Title 31 defines firms such as insurance companies, jewelry dealers, pawn shops, automobile dealers, and travel agencies as financial institutions.
84. 12 U.S. Code 5464(a)(2)(A), Section 805(a)(2)(A). These risk-management regulations apply both to systemically designated firms and to the financial institutions conducting designated activities for which the CFTC or the SEC is the appropriate regulator.

85. 12 U.S. Code 5464(a)(2)(B), Section 805(a)(2)(B).
86. 12 U.S. Code 5464(a)(2)(E), Section 805(a)(2)(E). Title I of Dodd–Frank does not empower the Fed or the FSOC in exactly the same manner with respect to SIFIs (banks and nonbanks).
87. Even the designation process in Title VIII is a broad, ill-defined authority. For instance, Title VIII provides a broad set of guidelines for FSOC to follow when making a systemic designation, but it includes the catchall: “Any other factors that the Council deems appropriate.” 12 U.S. Code § 5463(a)(2)(E), Section 804(a)(2)(E).

CHAPTER 10

Revisiting Title IX: Credit-Rating Agencies and Executive Compensation

Thaya Brook Knight and Mark A. Calabria

SUBTITLE C: REGULATION OF CREDIT-RATING AGENCIES

While each financial crisis seems to have a cycle of complaints about failures among the rating agencies, previous legislative responses, such as the Sarbanes-Oxley Act, have relied mostly on further study rather than wholesale reform of the ratings process. The Dodd-Frank Act attempts to address the quality of ratings via a variety of mechanisms, the most extensive of which are found in Section 932.

The primary focus of the Dodd-Frank changes to the regulation of rating agencies is an attempt to “insulate” the agencies from various perceived conflicts of interest. For instance, Dodd-Frank requires improved “internal controls” for the ratings process; separating the sales and marketing functions of the agencies from the ratings process; increasing the number of independent directors on the agencies’ boards; as well as increasing the responsibilities of the ratings agencies’ boards of directors. Many of these features mirror the expanded corporate governance requirements for auditors imposed by the Sarbanes-Oxley Act. There is little expectation that such provisions will work any better in improving credit ratings than they did—or failed to do—in improving the quality of financial audits.¹

The quest for board independence is a repeated theme in corporate governance reforms. As mentioned, increasing the number of independent board members was included for auditors under Sarbanes-Oxley, with similar provisions covering rating agencies in Dodd-Frank. These repeated attempts at independence, however, find little support in the academic literature. Some researchers, in the case of banks during the financial crisis, find that greater

board independence is associated with *worse* outcomes. Dodd-Frank further muddies the waters by allowing some of the “independent” board members to be users of ratings. This ignores the fact that investors in rated securities have their own incentives to avoid downgrades. Instead of reducing conflicts of interests, Dodd-Frank may very well simply be substituting one conflict of interest for another.

One of the Dodd-Frank rating-agency reforms has already had tremendous negative impact on U.S. capital markets, so much so that the Securities and Exchange Commission (SEC) has effectively voided the provision. This Section, 939G, repeals SEC rule 436(g), which had exempted nationally recognized statistical rating organizations (NRSROs) from being deemed part of a security’s registration statement. Rule 436(g) had protected NRSROs from liability under Section 11 of the 1933 Securities Act. This protection actually increased the flow and quality of information received by investors by encouraging the use of ratings in offering statements. Dodd-Frank’s repeal of rule 436(g) effectively shut down the new offerings market for asset-backed securities and corporate debt. It was only the issuance of a “no-action” letter from the SEC to Ford Motor

Credit Company that allowed this market to function. However this no-action letter is only in effect temporarily, leaving considerable uncertainty about how the debt markets will function in the absence of rule 436(g), at least until such time that the markets evolve beyond the regular use of credit ratings.

The Dodd–Frank Act, like the Sarbanes–Oxley Act before it, attempts to remedy regulatory failures with the increased use of private litigation. Section 933 expands the potential legal liability of rating agencies in three ways.² First, an established private right of action under Section 18 of the 1934 Securities Act for any material misstatements contained in reports to the SEC. Second, an established liability for errors in factual assumptions used in a ratings methodology. An example of such would be the range of forecasted house prices over the life of a mortgage-backed security. Third, an established legal liability under Section 21(e) of the 1934 Securities Act for misstatements in any forward-looking statements made by the rating agencies.

Of course, one defense to these charges would be to adopt a “reasonable standard” approach to ratings methodology and predictions. Basing ratings on consensus or even government forecasts of key economic variables would likely provide some shield to liability. Providing a consensus viewpoint could, however, greatly reduce the informational value provided by ratings. Increased liability could easily make rating agencies risk-averse and less likely to offer unconventional points of view. Agencies could also be subject to suit by investors “harmed” by the downgrade of assets which they hold. Until these provisions are tested in the courts, their ultimate impact on ratings’ quality will remain unknown. It is likely, however, that the increased incentives for risk averseness will greatly reduce the value of ratings to the capital markets with potential harm to both price discovery and liquidity. The liability provisions of Section 933 apply to all rating agencies, not just those recognized by the SEC as NRSROs.

Other provisions of Dodd–Frank are also likely to reduce the utility of rating agencies, with detrimental impacts on capital markets. For instance, Section 939(b) eliminates the rating agencies exemption from Regulation FD, covering the “fair disclosure” of information. Regulation FD prohibits senior executives of public companies, who regularly communicate with the public, from making selective disclosure of nonpublic informational material to select persons. Prior to Dodd–Frank, the rating agencies

were exempted, with the understanding that the ratings process would be better informed if the rating agencies had occasional access to nonpublic information. Section 939(b) has the potential to reduce the flow of information between public companies and the rating agencies, with the result that ratings become less “informed.”

Not all of the credit-rating provisions of Dodd–Frank are harmful or misguided. In fact, the law takes a serious step toward reducing the regulatory reliance on the rating agencies. Section 939(a) of Dodd–Frank requires all federal agencies to review their existing regulations and to provide alternative standards of credit risk. Although the federal bank regulators have requested public comments as to possible alternatives, these same regulators have moved slowly on Section 939(a), and have shown a general resistance to abandoning their reliance on the rating agencies. While Section 939(a) has the potential to address some of the central flaws discussed in this chapter, it also leaves considerable discretion to the very same regulators who instituted those flaws. The history of regulatory reliance on rating agencies is one more of the failings and short-sightedness on the part of regulators than on the usual failings of Congress. For Section 939(a) to have real impact, however, it may well take the continued involvement of Congress. There is, of course, some risk that, were regulators to reduce their reliance on rating agencies, a system of government-created ratings would be used as a substitute. Given the history of favorable treatment by regulators of the debt of entities such as Fannie Mae and countries such as Greece, replacing the use of private ratings in regulation with government-created ratings could be worse than the current situation. One need only examine the history of risk weights under the Basel Capital Accords to see such in practice.

Overall, the Dodd–Frank Act is at best a mixed bag when it comes to the credit-rating agencies.³ Some provisions have a real potential for reform, but also have their success contingent on the same regulatory process that created the problems. Unfortunately, other, more concrete provisions of Dodd–Frank have already had a significant negative impact on U.S. capital markets. A repeal of these later provisions, particularly Sections 932, 933, 939(b), and 939(g), would protect the positive capital-market functions of the rating agencies. Section 939(a), which attempts to reduce regulatory reliance on the rating agencies, may be retained, but may be in

need of strengthening.⁴ Perhaps most troubling is that by creating a new regulatory framework for NRSROs, Dodd–Frank doubles down on the notion that NRSROs enjoy a government seal of approval. Thus, there is a very real possibility of reducing the due diligence of market participants and, accordingly, reducing the overall level of monitoring in U.S. financial markets. The objective of reform should be to increase market discipline, which requires increased due diligence by market participants. Dodd–Frank in its regulation of NRSROs, as in many other areas, goes in the wrong direction, further insulating firms from market discipline.

While theory can be a useful guide, empirical research can help distinguish between competing hypotheses. Dodd–Frank’s rating reforms are based on the premise that fraud and conflicts of interest among rating agencies contributed to the crisis. If such were the primary driver, then Dodd–Frank’s reforms might prove useful. If, however, a lack of competition was the primary flaw in rating-agency behavior, Dodd–Frank could make it worse with its additional barriers to entry. At least one study has attempted to empirically measure the impact of Dodd–Frank’s rating reforms. Its results find “following Dodd–Frank, CRAs [credit-rating agencies] issue lower ratings, give more false warnings, and issue downgrades that are less informative” than before Dodd–Frank, and concludes that “increasing the legal and regulatory costs to CRAs might have an adverse effect on the quality of credit ratings.”⁵

Proposal for Reform. The ultimate goal should be a market for credit ratings that is competitive, where users can choose to rely on ratings or not, and one where ratings are treated as one among many inputs into the credit decision.⁶ This would calibrate incentives in such a way that issuers, investors, and credit-rating agencies have an incentive to promote the public good while seeking their own self-interest. The benefits likely achieved in a competitive, open-market regime include higher-quality investment instruments, higher-quality ratings, increased methodological innovation, and investor focus on informational value rather than regulatory privilege.

To achieve such requires ending regulatory reliance on credit-rating agencies and repealing NRSRO designation, and allowing competition in the marketplace of credit-rating firms. Market participants may still use credit ratings to evaluate credit risk, but are also free to incorporate new innovations into their credit-risk evaluations. Ultimately, these

reforms will help reduce government-created entry barriers and reduce artificial demand for credit ratings.

SUBTITLE E: ACCOUNTABILITY AND EXECUTIVE COMPENSATION

It has been an ongoing feature of the financial crisis narrative that the crisis was caused by “greed” and “excessive risk-taking.” It is therefore not surprising that Dodd–Frank includes a number of provisions aimed at reining in “out of control” corporate boards and their “greedy” executives. Philosophical questions about the value of greed aside, it is to everyone’s benefit if executives are appropriately compensated for their work. In many cases this means ensuring that their compensation includes incentives to develop and expand the business and, where regulation exists, to protect the company from unnecessary entanglements with regulators or the courts. This is not, of course, the same as saying that any amount of compensation, no matter how generous, is appropriate. There are undoubtedly overcompensated executives in the workforce—there are overcompensated and undercompensated workers at every level because it is hard to judge exactly the right level of compensation. But the evidence does not suggest that overcompensation caused the crisis.

Additionally, to the extent that overcompensation is a problem (and it is not clear that it is), it is unlikely that regulation will produce more appropriate compensation than existing practices. Indeed, given the need for *appropriate* compensation—compensation carefully calibrated to provide the right incentives to the right executives in light of each company’s and industry’s particular needs and challenges—a regulatory one-size-fits-all approach is almost sure to backfire.

The new requirements under Title IX, subtitle E, of Dodd–Frank follow two troubling trends in corporate regulation: (1) a trend toward increased regulatory incursion into matters of corporate governance and (2) a trend toward using the SEC’s regulatory disclosure regime for purposes unrelated to securities regulation. Both trends are troubling, for reasons discussed in greater detail below. Given the widespread animosity toward both highly compensated executives and the securities industry in the wake of the financial crisis, it is especially troubling (although not at all surprising) that these trends have surfaced in the section of Dodd–Frank related to executive compensation. The ideal solution

would be to repeal the entire subtitle, as its existence risks legitimizing the substitution of government oversight for governance by corporate boards. The second-best solution would be to retain Sections 951, 952, and 955; revise Section 953 to render the pay-ratio number more accurate; revise Section 954 to ensure it is not applied unjustly and to improve efficiency; and repeal Section 956.

Section 951 includes the “say on pay” provision, which requires public companies to hold a non-binding shareholder vote at least once every three years to approve executive compensation.⁷ This provision is puzzling at best. Under existing regulations,⁸ public companies must disclose the compensation of the executives whose compensation will form the subject of the vote. Presumably, any shareholder dissatisfied with the compensation package can either communicate that dissatisfaction directly to the board of directors, or can take action by simply selling the company’s stock. It is not clear how a non-binding vote is likely to have more effect than a very binding sale of stock. And, in practice, it seems that the new rule has had very little effect. Since it became effective in 2011, only about 2 percent of executive-compensation votes have failed, and most receive 90 percent shareholder support.⁹

It is, of course, possible that the low failure rate simply reflects changes in pay structure aimed at securing a favorable vote; that boards have identified the “lightning rods”¹⁰ likely to ignite shareholder ire and are therefore avoiding them. If that is true, is “say on pay” working and improving corporate compensation practices? Not necessarily. Avoiding lightning rods is not the same as making sound business decisions. Ultimately, while this provision adds unnecessary complexity to a company’s compliance process and may nudge the company toward popular (but not necessarily ideal) compensation structures, its harm is minimal compared with other sections in this subtitle.

Section 952 attempts to address the heart of the perceived problem by increasing independence of boards’ compensation committee members. There is something inherently appealing about this approach. It seems that if a board is too close to management, especially to the CEO, its members may be less willing to push back on out-sized pay packages and may even proactively dole out benefits to their friends. But the research does not support this theory. In fact, board independence has been found to have no statistically significant effect on executive

compensation or on firm performance.¹¹ Indeed, corporations may benefit from having a number of insiders on the board to ensure that directors remain sufficiently plugged in and responsive to day-to-day life at the company. The evidence does not suggest that mandating independence for compensation committee members is likely to improve the committee’s ability to calibrate executive compensation and may impair its ability to staff the committee with the most competent members. However, once again, while there is little to suggest that this provision will provide much benefit, ultimately it will be more of an inconvenience than a serious hindrance.

Section 953 requires companies to disclose the ratio of CEO pay to the average company employee’s pay. This provision is a naked attempt to address perceived wealth disparities and is unrelated to securities regulation. To the extent that public companies are subject to mandated disclosures to the SEC, these disclosures should be limited to information that is material to the average investor.¹² There is no reason to think that this pay ratio would be material, especially since reporting companies must already disclose top management’s compensation, including CEO compensation.

Although proponents of the rule may argue that it provides insight into how a company treats its workers, this argument misunderstands how companies determine pay. Consider, for example, a company that needs to hire a new receptionist. It will go into the market and hire someone, paying a salary in a range set by the market. It might pay a higher salary to obtain a better-quality receptionist, or might pay a lower salary if it offers other enticements (such as a pleasant work environment and favorable hours) but it will likely pay something similar to what similar employers pay. When the company needs other things—office space, paper, Internet service—it similarly goes into the market and obtains the things it needs at the prices set by the market. If it lowered its CEO pay, there is no reason to think that the funds that had previously been spent on the CEO would go into the pockets of the company’s other employees. If a company is not willing to pay extra rent to the owner of its office space, or to pay more to its paper supplier, why would it pay more to its receptionist? Compensation is not a pot of money to be distributed among the company’s employees; it is a price paid to obtain a service. If anything, the need to disclose this ratio may drive employers to hire *fewer* low-wage workers, use more contractors, replace workers

with automation, or take other measures to improve the ratio in ways that are unfavorable to workers.

In addition to being useless to investors, the pay-ratio disclosure is also likely to be misleading. The calculation does not take into account the company's industry, business model, location (including differentials in cost of living between areas within the U.S. and between U.S. and foreign operations), or use of part-time or contract employees. To the extent that Dodd-Frank addresses the behaviors of companies closely involved in the crisis, this rule will, ironically, favor those companies. A financial institution whose employees are overwhelmingly highly paid professionals will have a much smaller gap between CEO and average employee pay than, for example, a large national retailer. Aside from the fact that the disclosure is likely to be both useless and misleading, the rule continues a distressing trend of, as former SEC Commissioner Daniel Gallagher put it, "hijacking" the SEC's disclosure regime for political purposes. The SEC's mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. This disclosure fits nowhere in that list.

Even if the pay-ratio disclosure is an inappropriate use of the SEC's disclosure regime, it could at least be made somewhat more accurate. Currently, part-time employees and employees based overseas are included in the ratio. At the very least, these employees should be excluded from the calculation. There are other tweaks that could improve the number's ability to reflect, for example, the difference between a company that employs mainly low-skilled or mid-skilled workers, and one that employs almost exclusively highly skilled professional staff (for example, a large manufacturing company versus a smaller professional services firm), but the risk in making these distinctions is complicating the calculation to the point that the burden on reporting companies is even greater. The pay-ratio disclosure, whatever adjustments may be made to it, will be a useless figure. The best option is to minimize the burden required to produce it.

Section 954 creates a claw-back requirement, whereby exchanges must require listed companies to undergo a mandatory restatement recovery from executives' incentive-based pay from the previous three years that was paid in excess of what the executive would have received had the financial information been correctly reported. The provision applies explicitly to current as well as to former executives.

Additionally, its implementing regulation requires no culpability or knowledge on the part of the executive, nor does it include any *de minimis* exemption. In general, there is a certain logic to having an executive pay back what was essentially unearned compensation. If the compensation is intended to function as an incentive to improve company performance, the executive should not receive pay based on erroneous financial results. However, aside from the basic flaw that plagues the entire subtitle (that is, the incursion into the board's prerogative to establish corporate policy, including compensation), this provision will also result in injustice and inefficiency.

Of all the company's employees, the most senior executives are typically the best-placed to ensure that financial information is properly reported and hence there is merit in the notion of holding them accountable if a restatement is necessary. However, to the extent that an executive has no control over the company's financial reporting—because she is the head of a business line whose financials were properly reported, or she oversees a support department such as human resources¹³—holding her "accountable" will not result in any improvement in reporting. Additionally, recovering compensation from executives that was paid three years ago could be difficult since most executives will have already used the money for living expenses, or will have invested it in illiquid assets, such as retirement accounts. To avoid the risk of having to repay funds long since spent, including funds received from a previous employer (since the provision includes former executives), most executives will negotiate for guaranteed pay instead of incentive pay, or will purchase insurance that will pay any recovered amounts in the event of a restatement.¹⁴ Either option will nullify the initial purpose of the rule while injecting unnecessary cost. Additionally, to the extent that incentive-based pay is a useful tool in securing high performance from executives, that tool's utility will be reduced.

The provision will also result in inefficiency for the company. Although the rules permit a company to determine that it is not worthwhile to pursue recovery of funds, there is no *de minimis* exemption. This means that a board must go through the entire process of evaluating whether recovery is worthwhile even if the amount of money at issue is vanishingly small. In many cases, simply calculating the amount of compensation to recover will be a complicated undertaking. While there may be instances in which it is fairly straightforward to determine what

the executive's compensation would have been under the restated financials, in many instances, including any involving stock options, it will require conjecture to estimate what the price of the stock would have been at the time the compensation was awarded and, in subsequent years, if the information had been accurately reported. In some cases, this calculation may be no better than guesswork.

This provision should be revised to ensure that it is not applied unjustly, and to prevent wasteful inefficiency. There should be no requirement that the claw-back apply to executives who had no control over the reporting of the relevant financials. Additionally, there should be a *de minimis* exemption that would require no board action regarding recovery of compensation in the event of a restatement. This exemption should apply both to the overall decision whether to recover compensation from any executives at all, and to the decision whether to recover compensation from specific executives. Finally, there should be a non-exclusive safe harbor that would enable a company to quickly and efficiently calculate the amount to be recovered based on certain approved assumptions.

Section 955 requires issuers to disclose whether employees or directors are permitted to purchase securities designed to hedge a decrease in the value of equity securities either issued as part of compensation or held by the employee or director. On the one hand, it is easy to see how it might be appealing to know whether those in charge of running and supporting the company are able to nullify the impact of stock price fluctuations on any incentive-based compensation.¹⁵ On the other hand, disclosing whether such a policy exists tells investors very little. Without information about the compensation received by each director and every employee, including how much compensation is in the form of equity, and about the equity holdings of all directors and employees, the fact that the directors and employees are permitted to buy hedging instruments provides little insight. Issuers may, however, fear that lack of a non-hedging policy would signal to investors that employees and directors are completely hedged, and that issuers, fearing a negative response, would implement a policy whether it was in the company's best interest or not. It is likely, however, that companies that might otherwise not implement an anti-hedging policy, but which are able to retain reasonably skilled counsel, will be able to craft policies that prohibit hedging without imposing undue burdens on either employees or directors.

Section 956 is one of the more troubling sections of this subtitle. Covered financial institutions—including investment advisers, broker-dealers, depository institutions, credit unions, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation—with assets of more than \$1 billion must disclose to their relevant regulator¹⁶ the structure of all incentive-based compensation sufficient for the regulator to determine whether the compensation structure “provides an executive officer, employee, director, or principal shareholder...with excessive compensation, fees, or benefits...” Further, the relevant regulators must jointly implement regulation to:

prohibit any types of incentive-based payment arrangement...that the regulators determine encourages inappropriate risks by covered financial institutions by providing an executive officer, employee, director, or principal shareholder...with excessive compensation...or that could lead to material financial loss to the covered financial institution.

This provision is drawn almost verbatim from section 39(c) of the Federal Deposit Insurance Act (FDIA), which provides that federal banking agencies must prescribe:

standards prohibiting as unsafe or unsound practice any employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement that would provide any executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits; or could lead to material financial loss to the institution.

Whether or not this requirement is appropriate for depository institutions, it can at least be argued that they have the backing of the Federal Deposit Insurance Corporation (FDIC), and that therefore the FDIC has an interest in preserving their safety and soundness. Preserving the stability of broker-dealers or of investment advisers, however, has never been the duty of the SEC. Placing the named regulators in the role of determining what constitutes “excessive” compensation or risk-taking puts them in an entirely inappropriate position vis-à-vis

the regulated entities. It is not for the regulators to substitute their judgment for that of the boards of the companies they regulate. More than any other section in this subtitle, Section 955 usurps the duty and prerogative of the corporate board and places the federal government in its stead. Not only is this improper, the evidence does not suggest that any regulator will be a better judge of what type of compensation structure is in the interest of any covered institution than that entity's own board.

Additionally, by placing these regulators in a role similar to that of the FDIC, which explicitly insures the depository institutions it regulates, this section creates the implication that the regulators (or, at least, the federal government) may similarly backstop the covered institutions under their purview, entrenching the concept of "too big to fail."

Even if there were any basis for implementing this kind of oversight, the example of the FDIC suggests it will be ineffective. Almost identical language existed in the FDIA pre-crisis, yet banks failed and the 2008 crisis happened.

It is difficult to imagine an appropriate revision to this provision. It strikes at the heart of corporate governance, erodes companies' ability to self-govern, and strengthens the notion that certain large financial institutions are backstopped by the federal government. As demonstrated by the FDIA example, it provides no meaningful bulwark against failure. The only appropriate solution is repeal.

Proposal for Reform. Assuming that any section under this subtitle will reduce the risk of

another financial crisis is to assume the truth of two fallacies: first, that the recent crisis can be attributed to executive compensation practices; second, that federal regulators have better insight into what appropriate compensation is than the companies' own boards. The best way to ensure good corporate practices in general, including compensation practices, is to ensure that companies bear the consequences of their own actions. Companies that pay too much for any good or service—be it lavish office suites or lavish CEO pay—will be weaker than their more disciplined peers. Federal regulation risks leveling the field and fostering the same practices across the board, masking poor corporate judgment and propping up weak companies while simultaneously acting as dead weight on more adroit competitors. This subtitle perpetuates a harmful mythology while usurping the rights of corporate boards, and offers nothing of benefit in return.

Nonetheless, the changes to several provisions, described above, could at least blunt some of the harmful (and unintended) effects of this subtitle. Ultimately, attempts to control executive compensation have rarely fared well.¹⁷ While the current attempt is unlikely to prove the exception, it, like its predecessors, runs the risk of exacerbating the harms it attempts to prevent.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. See generally, Roberta Romero, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," *Yale Law Journal*, Vol. 114 (2005), and Stephen Bainbridge, "Dodd-Frank: Quack Corporate Governance Round II," *Minnesota Law Review*, Vol. 95 (2011).
2. Carrie Guo, "Credit Rating Agency Reform: An Empirical Review of Dodd-Frank Section 933(b)'s Effect Since Enactment," *Columbia Business Law Review*, forthcoming.
3. On the conflicting goals of Dodd-Frank rating-agency reform, see Jeffrey Manns, "Downgrading Rating Agency Reform," *George Washington Law Review* (2013).
4. Christian Opp, Marcus Opp, and Milton Harris, "Rating Agencies in the Face of Regulation," *Journal of Financial Economics*, Vol. 108 (2013), pp. 64-81.
5. Valentin Dimitrov, Darius Palia, and Leo Tang, *Impact of the Dodd-Frank Act on Credit Ratings*, Rutgers University Working Paper, undated, <http://andromeda.rutgers.edu/~dpalia/papers/DoddFrankCreditRatings.pdf> (accessed February 19, 2016).
6. Claire Hill, "Limits of Dodd-Frank's Rating Agency Reform," *Chapman Law Review*, Vol. 15, No. 1 (2011).
7. Under the implementing regulations, companies must first have a non-binding shareholder vote on how often the shareholders want to have a non-binding vote on executive compensation, with the options being every year, every other year, or every three years. This process must be repeated at least once every six years. 17 C.F.R. § 240.14a-21.
8. 17 C.F.R. § 229.402.
9. "U.S. Executive Pay Advisory Votes: 2014 Results for the Russell 3000," Towers Watson, January 30, 2015, <https://www.towerswatson.com/DownloadMedia.aspx?media=%7B22F30746-3665-4F63-845C-C045244497A4%7D> (accessed February 19, 2016).
10. Emily Chasen, "Say-on-Pay Vote Failures Remain Rare," *The Wall Street Journal*, May 19, 2015.
11. See, for instance, Katherine Guthrie, Jan Sokolowsky, and Kam-Ming Wan, "CEO Compensation and Board Structure Revisited," *The Journal of Finance*, May 21, 2012.
12. Materiality is determined using the test set out in *Basic v. Levinson*, which holds that a fact is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Basic v. Levinson*, 485 U.S. 224, 231-232 (1988).
13. The provision's proposed implementing regulation would include in the definition of "executive officers" not only the CEO, CFO, and principal accounting officer, but also any vice president in charge of a principal business unit, division or function, and any other person who performs policymaking functions for the company. Securities and Exchange Commission, "Listing Standards for Recovery of Erroneously Awarded Compensation," *Federal Register*, Vol. 80, No. 134, July 14, 2015, pp. 41152-4153, <https://www.gpo.gov/fdsys/pkg/FR-2015-07-14/pdf/2015-16613.pdf> (accessed February 22, 2016).
14. Executives would have to pay the premium on this insurance themselves, as the rules prohibit the company from indemnifying executives for amounts paid under this provision and from paying premiums on any related insurance.
15. The inclusion of stock held not as part of a compensation package suggests that this provision intends also to prevent "betting against" the company. Of course, hedging is not actually betting against anything and is in truth not betting at all. This is not how the optics may play out, however.
16. The SEC, the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Housing Finance Agency, or the National Credit Union Administration.
17. For example, there is evidence that the limit on deductibility of executive compensation imposed by Section 162(m) of the federal tax code *increased* base pay for some executives and led to an explosion in the use of stock options, which increased compensation through the bull market of the 1990s. Kevin Murphy, "Executive Compensation: Where We Are, and How We Got There," in George Constantinides, Milton Harris, and René Stulz, eds., *Handbook of the Economics of Finance* (North Holland, MI: Elsevier Science, 2013), pp. 211-356.

CHAPTER 11

Title X and the Consumer Financial Protection Bureau: Limiting Americans' Credit Choices

Diane Katz

The Consumer Financial Protection Bureau (CFPB) was established under Title X of Dodd–Frank to “regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws.”¹ Prior to its creation, authority for some 50 rules and orders stemming from 18 consumer-protection statutes² was divided among seven agencies.³ But more than simply consolidating regulatory authority, Congress granted the new agency unparalleled rulemaking, supervisory, and enforcement powers over virtually every consumer financial product and service. As currently structured, the CFPB unduly restricts access to credit without oversight from Congress or the executive branch.

This result is not the unintended consequence of a misguided bureaucracy. It is the calculated result of a departure from the principles that governed consumer protection law for decades.⁴ By design, the CFPB is limiting the availability of credit,⁵ and curtailing Americans' choices for investment and wealth creation.

Until passage of the Dodd–Frank Act in 2010, most consumer protection law was designed to equip consumers with the information necessary to act on their preferences, given market conditions, and to punish fraud and other wrongdoing. The role of government, at least theoretically, was to facilitate choice and competition—an approach reflecting the belief that free enterprise, albeit imperfect, yields greater benefit than autocratic alternatives.

That deference to consumer autonomy has now been supplanted by a regulatory framework that treats consumers as fundamentally irrational and prone to act against their self-interest. In the words of Oren Bar-Gil and Elizabeth Warren, the academic architects of the bureau, consumers suffer “cognitive limitations” and their “learning is imperfect.”⁶ Indeed, the bureau takes the position that “too much

information” can “detract from consumers' decision-making processes.”⁷ Under this paternalist paradigm,⁸ regulatory intervention is necessary to protect consumers from themselves by limiting complex credit options and standardizing “qualified” loans.

This approach is, of course, inherently contradictory. If consumers suffer cognitive limitations with respect to financial matters, would the politicians and bureaucrats who dictate the terms and conditions of credit not be afflicted by biases of their own, most notably political and institutional incentives? As noted by economist Edward Glaeser, “Human beings surely make mistakes about their own welfare, but the welfare losses created by these errors are surely second order relative to the welfare losses created by governments which not only make errors, but also pursue objectives far from welfare maximization.”⁹ Indeed, the bureau's very existence is rooted in the lapses of seven other regulatory behemoths that were supposed to protect the nation from financial calamity.

In just four years, the bureau has restructured the mortgage market by broadening lenders' fiduciary responsibilities and standardizing home loans.

(CFPB officials also claim to have “streamlined” the mortgage process, although the new rules encompass a whopping 1,888 pages.) There are new restrictions on credit cards, ATM services, auto lending and leasing, electronic funds transfers, and student loans. More rules are in the pipeline for credit reporting, overdraft coverage, arbitration, debt collection, and general-purpose reloadable cards.

The CFPB is also amassing the largest government database of consumer data ever compiled to monitor virtually every credit card transaction.¹⁰ And, it is aggressively soliciting unverified complaints from consumers with which to impugn the reputations of lenders and creditors.¹¹

Prior to the 2008 financial crisis, there certainly was a need to modernize the federal consumer protection regime. But a lack of consumer protection was not a major factor in the 2008 financial crisis.¹² Now, however, the structural flaws of the CFPB are contributing to a different crisis: an ever-expanding administrative state that is suffocating free enterprise and individual liberty.

THE BEGINNINGS

As with much of Dodd–Frank, Congress created the CFPB without a thorough understanding of the housing market collapse, the subsequent failure of major financial firms, or the resulting shock to the economy. However, the crisis provided an opportunity for the Obama Administration and Congress to fulfill a regulatory wish list consistent with the Progressive agenda.

The bureau was designed to evade the checks and balances that apply to most other regulatory agencies. Although established within the Federal Reserve System, the bureau operates independently, with virtually no oversight. CFPB funding is set by law at a fixed percentage of the Federal Reserve’s operating budget.¹³ This budget independence limits congressional oversight of the agency, and its status within the Fed also precludes presidential oversight. Even the Federal Reserve is statutorily prohibited from “intervening” in bureau affairs.

Bureau proponents deny any lack of accountability, claiming that the CFPB can be overruled by the Financial Stability Oversight Council (FSOC), which is composed of representatives from eight other financial regulatory agencies.¹⁴ However, the council’s oversight authority is narrow, confined by statute to cases in which CFPB actions would endanger the “safety and soundness of the United States

banking system or the stability of the financial system of the United States.” Any veto of bureau action requires the approval of two-thirds of the FSOC’s 10-member board.

The CFPB became operational on July 21, 2011, but was limited by statute to enforcing existing rules for banks and credit unions (with more than \$10 billion in assets) until a director was confirmed by the Senate. To launch the bureau, President Obama appointed Elizabeth Warren as a “special advisor.”¹⁵

The President subsequently dispensed with the confirmation process required by statute and appointed former Ohio attorney general Richard Cordray as CFPB director, claiming the action was a “recess appointment”—though the Senate was not in recess.¹⁶

Ultimately, the U.S. Supreme Court invalidated three other appointments of the same type,¹⁷ which cast doubt on the validity of bureau actions under Cordray’s (unconfirmed) tenure. Upon his subsequent confirmation, however, Cordray reaffirmed his earlier actions to thwart a legal challenge.

Once Cordray was confirmed, the bureau commenced its supervision of so-called nonbank firms as called for under Title X, including mortgage originators, brokers, and servicers, as well as payday lenders and private education loans. The bureau also has authority to designate additional “larger participants” in nonbank services, which currently include debt collection, credit reporting, auto lending, international money transfer, and student loan servicing.¹⁸

Reflecting the overly broad nature of its powers, the agency may also supervise *any* nonbank firm that it deems as posing a “risk” to consumers or engaging in “unfair, deceptive, or abusive” practices.¹⁹ While the terms “unfair” and “deceptive” have been defined in other regulatory contexts,²⁰ the term “abusive,” has not been defined in law and thus grants the CFPB inordinate discretion.

The bureau’s estimation of risk largely determines whether a financial firm is subjected to ongoing “supervision.” Supervision is no small matter.²¹ The bureau may require a firm to divulge reams of documents and records, and submit to ongoing scrutiny of its entire framework of policies and practices. Bureau procedures also call for background checks of company officers, directors, and other key personnel. Bonding requirements may be imposed.

Prior to Dodd–Frank, nonbank financial services did not exist in a regulatory vacuum. For example,

consumers had recourse under the Federal Truth in Lending Act and the Real Estate Settlement Procedures Act, while many states and municipalities regulated (or prohibited) a variety of nonbank financial services. Federalizing nonbank regulation eliminates regulatory competition which, in turn, undermines market competition.

THE PRECAUTIONARY PRINCIPLE

Despite the magnitude of powers granted to the bureau to deter risk, there is no description in Title X of what constitutes risk.

According to the bureau's 924-page Supervision and Examination Manual, "Risk to consumers is the potential for consumers to suffer economic loss or other legally cognizable injury (e.g., invasion of privacy) from a violation of Federal consumer financial law."²² Bureau staff is directed to gauge this risk potential based on "the nature and structure of the products offered, the consumer segments to which such products are offered, the methods of selling the products, and methods of managing the delivery of the products or services and the ongoing relationship with the consumer." In other words, the bureau acts upon a *supposition* of future harm rather than actual violation of law.

Examiners are also expected to determine the likelihood that a supervised entity will not comply with federal consumer financial law in the future, and forecast whether risk will decrease, increase, or remain unchanged—a magical ability that every investor would undoubtedly covet. This subjective calculation of risk means that firms are being regulated based on ever-shifting criteria. Companies may be penalized for conduct that they had no reason to believe was improper. Such a system does not comport with constitutional tenets of due process.

All financial products and services involve risk—to consumers and creditors alike. Prior to Dodd-Frank, consumers could comparison shop, seek recommendations from friends and family, or employ experts on their behalf to weigh drawbacks and benefits. For their part, firms traditionally account for risk with pricing. Under Dodd-Frank, the CFPB determines what degree of risk is lawful—at the same time that the bureau's actions distort market signals that would otherwise signal risk.

REGULATORY "ABUSE"

The bureau's authority to protect consumers from "abusive" practices is likewise vaguely defined.

Title X of Dodd-Frank characterizes as abusive any action that:

1. Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
2. Takes unreasonable advantage of
 - a) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
 - b) the inability of the consumer to protect his interests in selecting or using a consumer financial product or service; or
 - c) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

How can the CFPB determine consumer "ability" or the requisite degree of consumer "understanding" for an exceedingly diverse population? In effect, the bureau is regulating the finance sector based on a notional assessment of consumers' aptitude and their presumed inability to make rational decisions about their personal finances.

The agency has issued neither guidance nor rules to define abusive practices, nor have officials shown much willingness to provide clarity—even when asked explicitly to do so by Congress.²³ During a 2012 hearing of the House Financial Services Committee, for example, when asked by lawmakers to define "abusive," Cordray said, "We've been trying to puzzle through...exactly how that...term...should be applied in the facts and circumstances of individual situations."

In other words, bureau regulators do not quite know what it means, but they will know it when they see it. Covered institutions evidently are supposed to glean from enforcement actions what the bureau considers to be abusive at any point in time.

INVESTIGATIONS

The bureau has launched dozens of investigations and issued multiple subpoenas demanding customer data, testimony from executives, and piles of internal policy documents. The CFPB is not required to possess evidence of wrongdoing before initiating a probe. Bureau officials launch an investigation by issuing a Civil Investigative Demand (CID), which is a form of subpoena.²⁴

The target of a CID has only 10 days to confer with bureau staff if he intends to seek modification

of a subpoena. As noted by the law firm of Venable LLP, that is hardly sufficient time to assemble a legal team, evaluate the CID, consult with relevant IT and business personnel, and craft a response.²⁵

CID targets may have counsel present for on-the-record testimony before the bureau, but the opportunity for counsel to make objections is limited.²⁶ A petition to modify or set aside any of the investigative demands must be submitted within 20 days of receiving the CID. CFPB officials are allowed to confer in secret. The decision on a petition to modify a CID rests solely with the director, and the rules contain no provision for judicial appeal of this decision.²⁷ A firm's only alternative is to refuse to abide by the CID and raise objections before a judge—after the bureau seeks a court order to enforce its demands.

ENFORCEMENT

The CFPB is authorized to obtain “any appropriate legal or equitable relief” for violations of federal consumer financial laws. The bureau has been particularly aggressive in obtaining financial “relief” for consumers, with \$5.8 billion in orders announced to date.

As called for by statute, the bureau has established a Civil Penalty Fund into which enforcement penalties are deposited and payments to victims are made. Of the \$342 million in civil penalties collected between 2012 and 2015, just \$190 million (55 percent) has been used to compensate victims.²⁸ Another \$13 million has been used for “consumer education and financial literacy” when victims could not be located or payments were “otherwise not practicable.”²⁹

THE DRIVE FOR DATA

CFPB officials tout the bureau as a “data-driven agency.”³⁰ They emphasize that bureau policies and priorities are based on research and analyses of financial products and services, with particular emphasis on discerning “risk to consumers.”

Measuring various aspects of a market may be beneficial, of course. But not all data collection leads to credible conclusions. Nor does data, in and of itself, determine sound policy. Consider the bureau's use of complaint data, which officials identify as the “start and end” of the bureau's rulemaking and enforcement, and which Cordray has called the CFPB's “lifeline.”³¹ For all the consequential uses to which the data are put, however, none of it is verified.³²

According to the CFPB, it solicits consumer complaints to gain a better understanding of what is occurring in the financial marketplace, and to “help”

the market work more efficiently. Staff has been instructed to regard complaint data as “indications of potential regulatory violations, including unfair, deceptive, or abusive acts or practices.”³³ The complaint database is also intended to inform consumers about financial products and services.

The CFPB initiated its complaint portal for credit cards in July 2011,³⁴ and launched the public Consumer Complaint Database in June 2012.³⁵ Mortgage complaints were subsequently added, followed by complaints about checking accounts, savings accounts, CDs, and student loans. Most recently, the database was expanded to include payday loans and prepaid cards, other consumer loans, and other financial services. The CFPB issued a final policy statement in March 2015 to expand the Consumer Complaint Database to include consumer narratives.

The bureau does not verify the complaint allegations; it only takes steps to confirm whether there exists a commercial relationship between the consumer and the company in question.³⁶ Each complaint is catalogued on the agency's website, including the name of the accused, the nature of the alleged offense, the date of the complaint, and the zip code of the complainant (whose identity is not revealed). In addition to providing public access to this raw data, the bureau reports the complaints to various federal and state regulatory agencies, and also issues periodic reports about “trends.”

There is also no way to determine whether a complaint relates to dissatisfaction with or misunderstanding of legitimate terms of service—as opposed to actual wrongdoing. The system relies on individuals to categorize their complaints, but the limited number of broad categories invites mischaracterization. Nor is there any way to distinguish whether a complaint is made because a company failed to offer an adequate remedy to the customer, or if the customer simply rejected a reasonable response.

The CFPB's Legal Division concluded that federal Information Quality Guidelines do not apply to the Consumer Complaint Database because the published complaint data do not meet the definition of disseminated “information.” The Legal Division also has noted that the CFPB's disclaimer about the lack of verification sufficiently counters any appearance that the Consumer Complaint Database represents the agency's views.³⁷ CFPB officials have stated that the unverified complaints have value to the public and that “the marketplace of ideas will determine what the data show.”³⁸

The database also lacks statistical validity. Self-reporting does not ensure that the complaints represent the experiences of the population as a whole. Consequently, any of the policies derived from the data are not applicable to the general population. The complaint data also lacks context. The bureau reports the total number of complaints by type, but gives no indication of the size of the market. For example, a total of 14,000 credit card complaints were submitted to the bureau in 2014, but there were 550 million credit cards in circulation that year—among just Visa, MasterCard, and American Express.³⁹ Thus, the complaints represent only 0.0025 percent of credit card holders.

Such a system exposes financial firms to unwarranted reputational harm and lawsuits. The aggregation of unverified complaints by zip code also may expose firms to claims of lending discrimination or “disparate impact”—which CFPB officials have aggressively pursued. Congress authorized creation of a complaint database, but set no data quality standards. Lawmakers may have mistakenly assumed that the CFPB would manage the data in a more responsible manner.

HOME MORTGAGE DISCLOSURE ACT

Although already in possession of a massive amount of consumer financial data, the CFPB recently increased data collection requirements for lenders under the Home Mortgage Disclosure Act (HMDA). Dodd–Frank mandated some new data collection, but the bureau has vastly exceeded those provisions with its new 797-page rule.⁴⁰ Instead of just nine data fields, lenders will have to report 45 separate data points about mortgage applicants, borrowers, and the underwriting process; the property that is securing the loan; features of the loan; and other unique identifiers.⁴¹

The HMDA was originally approved by Congress in 1975 for monitoring geographic lending patterns. The HMDA was followed by passage of the Community Reinvestment Act (CRA), which was intended to track mortgage lending to reduce discriminatory credit practices in low-income neighborhoods.⁴² Compliance with the CRA was necessary for banks to be approved for new branches, mergers and acquisitions, and other bank actions.⁴³

The CFPB already has acquired consumer financial information on 173 million mortgages from an outside data aggregator.⁴⁴ The new HMDA requirements provide the bureau with far more information

than is necessary to monitor mortgage trends. For example, the agency is requiring that lenders report on the age of applicants and borrowers, their debt-to-income ratios, credit scores, and a host of other financial information unrelated to home loans.

Dodd–Frank explicitly prohibits the bureau from collecting personally identifiable information. But so vast is the HMDA data set that homeowners’ privacy is at considerable risk. Nor is the data secure. A 2014 study by the Government Accountability Office found that “additional efforts are needed in several areas to reduce the risk of improper collection, use, or release of consumer financial data.”⁴⁵

DISPARATE IMPACT

The bureau places considerable emphasis on enforcement actions against discriminatory lending. The bureau’s determination of discriminatory lending involves analysis of “disparate impact,” a widely disputed doctrine by which a creditor’s practice may be considered unlawful if it results in a discriminatory effect—even if the creditor has no intention to discriminate and the practice appears neutral on its face.⁴⁶ The supposed discriminatory effect applies to race, color, national origin, religion, sex, or familial status.

A finding of discriminatory effect requires documentation of a disparate outcome. Demographic data is available for some financial products and services, such as mortgages under the HMDA. However, there is a dearth of such data for a variety of other financing, so the bureau has resorted to proxies instead.

The bureau’s method has involved constructing a probability of consumers’ race and ethnicity based on their surname and their place of residence. However, this “methodology”⁴⁷ amounts to little more than guessing, which has been admitted by agency officials.⁴⁸ Nonetheless, they cited their deeply flawed findings as justification for enforcement actions against car dealers for (supposedly) racist auto-loan practices. Although Title X specifically prohibits the CFPB from regulating auto dealers, the bureau is effectively doing so by constraining the ability of dealerships to set the terms of auto loans.⁴⁹ And, the elimination of flexible discounts to buyers will hurt the consumers that the CFPB was tasked to protect.

The ultimate irony is that the bureau itself is guilty of the very actions it is empowered to punish. Employee performance reviews have shown a

pattern of white employees ranking distinctly better than minorities. Overall, whites were twice as likely to receive the agency's top grade as African American or Hispanic employees.

Rob Cauldwell, president of National Treasury Employees Union Chapter 335, which represents CFPB workers, told Congress in 2015 that the agency is "a cesspool of poor behavior, discrimination and retaliation."⁵⁰ The bureau had the most Equal Employment Opportunity complaints of any federal regulator in the year, he said. Bureau officials have announced that a new performance review system will focus "primarily on employee growth and development, with less emphasis on numerical ratings."⁵¹

RULEMAKING

The bureau's authority to prescribe regulation is vast. Title X even instructs the judiciary to grant ultimate deference to the CFPB in the event of territorial squabbles over financial regulations among various regulatory agencies.⁵² At the time of publication of this book, the CFPB has issued 117 final rules. Following are descriptions of some of the bureau's most significant regulations.

Mortgage Restructuring. Mortgage "simplification" is one of the 400-plus regulatory requirements called for in the 2,300-page Dodd-Frank Act. The regulatory approach taken by the bureau illustrates both the theoretical shift of consumer protection as well as the unparalleled powers granted the CFPB.

The Dodd-Frank Act requires the bureau to devise an "integrated" form to disclose the terms of a mortgage application (the Loan Estimate) and mortgage closing (the Closing Disclosure).⁵³ To that end, the CFPB has devised a more "consumer friendly" mortgage process.⁵⁴ The previous loan form had been five pages long; the new one is three pages. The closing form remains at five pages. But the agency's requirements to implement the new forms and related rules run 1,888 pages.⁵⁵

The new forms entail major changes to lenders' operations, including revising forms, IT systems, and policies. The CFPB estimates the costs of new software and employee training to be \$100 million.⁵⁶ The pending reform ranks as lenders' greatest compliance concern, with 48 percent citing it as a "high" concern and an additional 33 percent citing it as a "medium" concern, according to the annual survey by QuestSoft, a regulatory consultancy.⁵⁷

Redesigning the mortgage documents apparently required the assistance of Kleimann Communication Group, Inc., a self-described "small, agile, woman-owned" business, at a cost to taxpayers of nearly \$900,000. The Kleimann Group performed "qualitative testing" of various loan formats with 92 consumers and 22 lenders in Baltimore; Los Angeles; Chicago; Albuquerque; Des Moines; Philadelphia; Austin, Texas; Springfield, Massachusetts; and Birmingham, Alabama.⁵⁸

According to the bureau, both forms have been designed to "reduce cognitive burden." The 533-page chronicle of the bureau's feat—"Know Before You Owe: Evolution of the Integrated TILA-RESPA Disclosures"—includes insights such as, "We found the most effective way to reduce confusion surrounding the APR [annual percentage rate] was to clarify that it was not the interest rate by adding the simple statement: 'This is not your interest rate.'"⁵⁹

The new regulations also prohibit balloon payments, that is, smaller mortgage payments every month, followed by a single, one-time payoff at the end of the loan. Late fees also are capped, which will likely prompt lenders to vigorously enforce payment deadlines and use of collection agencies. The bureau is also restricting loan-modification fees, which will likely limit lenders' options for customizing loans. In sum, the bureau's notion of "improving outcomes" will likely result in fewer mortgage options for consumers and higher borrowing costs.

Mortgage Servicing. The bureau has issued more than 500 pages of rules for mortgage servicing, which encompass the collection of mortgage payments, maintenance of escrow accounts, loan modifications, and foreclosures, among other functions.⁶⁰ Many provisions dictate the timing, content, and format of disclosures. The rules coincide with provisions of a settlement between states and the five largest mortgage-servicing banks that had been accused of mistreating borrowers. Bureau officials are hyping the proposed regulations as the solution to the wave of foreclosures in recent years.⁶¹

Lenders will face more requirements in processing a foreclosure, but that will not save borrowers who, for a multitude of reasons, cannot afford their payments. It does make mortgage servicing more time-consuming and costly. The burden of such rules falls disproportionately upon community banks, which have far fewer resources to reconfigure services. To the extent that the CFPB's regulatory onslaught overwhelms small banks, their larger

brethren benefit—becoming all the more powerful as community banks close. That is the very outcome that Dodd–Frank supposedly was enacted to prevent.

Of particular concern are the proposed obligations on servicers’ dealings with a delinquent borrower. The bureau seems to think it is the responsibility of servicers to rescue such borrowers from their predicament. For example, servicers are now required to inform borrowers about financial “counseling,” while also being prohibited from initiating a foreclosure sale until the delinquent borrower has exhausted his or her options and appeals.

Another provision prohibits servicers from obtaining “forced place” insurance following a finding that the borrower has failed to maintain property insurance as required. Instead, servicers are required to give borrowers two opportunities to produce proof of insurance over 45 days before charging for insurance, as well as provide advance notice and pricing information to the borrowers and allow them to obtain their own replacement insurance. In other words, borrowers who have violated the conditions of their mortgage by failing to maintain home insurance must be given a second chance (or third or fourth) to honor the terms of their mortgage agreement.

Such requirements significantly reduce lenders’ control over the loans they make.

Qualified Mortgages. Of enormous consequence to the fate of the housing market is how the bureau defines a “qualified mortgage.” The definition is central to a provision of Dodd–Frank that requires lenders to determine a borrower’s “ability to repay” any loan “secured by a dwelling.”⁶² The qualified mortgage requirements act as the standard for loan terms that lenders can reasonably expect a borrower to repay. Under this “ability to repay” regime, the lender—not the borrower—can be blamed for a loan default. Dodd–Frank allows homeowners to sue lenders if they cannot make their payments and face foreclosure.⁶³ Such standards effectively require banks to act as personal advisers or intermediaries despite long-held legal precedent that they are not fiduciaries in retail banking.

But how does a lender guarantee that a customer understands the terms of a loan? And, in the event that a bank deems customers’ understanding as deficient, is that bank at risk of violating fair lending laws? CFPB officials have emphasized that they will aggressively monitor firms to ensure that financial products and services are available to various

racial, ethnic, and gender groups in direct proportion to their share of the population.⁶⁴ Thus, lenders are trapped in a Catch-22: To abide by the “ability to repay” rule could mean not meeting race and gender quotas, or vice versa.

“Payday” Lending. A total of 48 states already regulate payday lending, and yet the CFPB is proposing to dramatically limit the availability of small-dollar, short-term loans.⁶⁵ The proposed payday rules would limit the interest rates that payday lenders can charge, prohibit borrowers from taking out more than one loan at a time, and require lenders to assess the borrower’s ability to repay. In effect, the regulations would make it difficult, if not impossible to offer this type of loan, which would have a disparate impact on the low-income households and immigrants who rely on them.

According to Heritage Foundation Research Fellow Norbert J. Michel, the CFPB’s own complaint database does not support the claim that there is a systemic problem in this industry.⁶⁶ From July 2011 to August 2015, Michel noted, consumers lodged approximately 10,000 complaints against payday lenders. Ignoring the fact that these are unverified complaints, the figure pales in comparison to the more than 12 million people per year using payday loan services.

There is a great deal of misinformation spread by critics about small-dollar loans. One of the most common claims is that payday lenders gouge customers by charging a high annual percentage rate. Such criticism is misplaced, in part because it misuses the APR concept.⁶⁷ Properly used, the APR represents the actual rate of interest someone pays over the course of a year due to compounding, the process whereby interest is added to unpaid principal. However, in a typical case, payday loan customers do not borrow for a full year, and the interest charges do not compound. Thus, there usually is no APR on a payday loan.

The bureau’s regulatory framework is based on the false claim that short-term lenders systematically prey on customers who cannot repay their debts. The evidence does not support such a claim.

Prepaid Cards. General purpose reloadable cards (GPRs) have exploded in popularity. According to one recent study, the share of spending with prepaid cards increased 200 percent between 2009 and 2014.⁶⁸

Consumers obviously find the cards useful. One would not know it from the stance of CFPB officials, who are eager to impose the same degree of regulation that has made checking accounts and credit

cards more costly—and induced consumers to turn to prepaid cards. In its notice of proposed rulemaking, the CFPB claims to be “particularly interested in learning more about this product.” Yet even before “learning more,” the bureau has already decided to propose new regulations,⁶⁹ which would impose many of the same requirements on prepaid cards that currently apply to credit cards—which would raise costs.

Prepaid cards are available with a variety of terms and fees that vary by issuer. Those options are beneficial to consumers—particularly so to the “unbanked” and “underbanked” users who heavily rely on the cards. To the extent that regulators impose service conditions and requirements, fewer firms will offer the cards, while the cost of those that remain will rise. Innovation of this nascent product will be inhibited as well. Indeed, the bureau also intends to regulate mobile devices that access consumer accounts—a grossly overbroad use of its powers.⁷⁰

Reform Alternatives. The best option going forward is outright elimination of the CFPB through repeal of Title X of the Dodd–Frank Act. Authority for the 18 pre-existing consumer protection laws assumed by the CFPB should be returned to the seven agencies that originally administered them. However, it is not enough to simply return to the old regulatory model. There is considerable regulatory overlap that Congress must eliminate—along with numerous obsolete rules. The goal should be to devolve authority for consumer protection to the states except when interstate regulation is unavoidable.

More immediate relief requires Congress to enact the following reforms:

- **Abolish the CFPB’s current funding mechanism and subject it instead to congressional control.** Although some financial regulatory agencies (such as the Federal Deposit Insurance Corporation and the Fed itself) also fall outside the congressional appropriations process, they are the exceptions rather than the rule among government agencies. Given the CFPB’s broad policymaking role, there is no justification for allowing the bureau to escape congressional oversight.
- **Strike the undefined term “abusive” from the list of practices under CFPB purview.** There is no regulatory precedent or

jurisprudence that interprets the term in the context of consumer financial services, and the bureau should not have discretion to define its own powers.

- **Require the CFPB specifically to apply definitions of “unfair” and “deceptive” practices in a manner consistent with case law.** Otherwise, regulatory uncertainty will inhibit the availability of financial products and services.
- **Prohibit public release of unconfirmed complaint data.** The publication of mere accusations can subject businesses to undeserved reputational harm and unnecessary litigation.
- **Abolish the inordinate deference in judicial review granted to the CFPB.** The Dodd–Frank statute instructs judges to defer to the bureau’s regulatory decisions as if it “were the only agency authorized to apply, enforce, interpret, or administer the provisions of such Federal consumer financial law.” However, judicial scrutiny is a necessary check on the CFPB’s otherwise unconstrained powers.
- **Require the CFPB to obtain approval for all major rulemakings from the Office of Information and Regulatory Affairs.** Such oversight would increase agency transparency and accountability.

CONCLUSION

The current structure of the CFPB, with its lack of accountability and absence of oversight, invites regulatory excess. Along with its unparalleled powers and approach to regulation and enforcement, the bureau’s actions can be expected to chill the availability of financial products and services. The CFPB’s paternalistic view of consumers also means fewer choices and higher costs for credit. This will undoubtedly leave families and entrepreneurs without customized options with which to invest and build wealth. Consumer protection against fraud and other misdeeds is certainly necessary, but the bureau is on a regulatory tear that extends well beyond what is reasonable. The obvious two questions to consider are: (1) Can consumers expect the federal government—with a national debt of \$18.9 trillion—to do a better job of managing individuals’ finances than the individuals who know their own circumstances and preferences? They cannot. (2) Are regulators any less “biased” than consumers in their financial preferences? They are not.

This chapter will be published as a Heritage Foundation Backgrounder—“Consumer Financial Protection Bureau: Limiting Americans’ Credit Choices”—in April 2016.

ENDNOTES:

1. Dodd–Frank Wall Street Reform and Consumer Protection Act, Title X, Sec. 1011(a).
2. Including the Truth in Lending Act; the Fair Credit Reporting Act; the Fair Debt Collection Practices Act; the Equal Credit Opportunity Act; and the Electronic Funds Transfer Act. Section X of Title X includes a complete list.
3. Those seven agencies were: (1) the Board of Governors of the Federal Reserve; (2) the Federal Deposit Insurance Corporation; (3) the Office of the Comptroller of the Currency; (4) the Office of Thrift Supervision; (5) the National Credit Union Administration; (6) the Federal Trade Commission; and (7) the Department of Housing and Urban Development.
4. For a fuller examination of this change, see Joshua D. Wright, “The Antitrust/Consumer Protection Paradox: Two Policies at War with Each Other, George Mason University *Law and Economics Research Paper* No. 12-45, May 31, 2012, http://www.law.gmu.edu/assets/files/publications/working_papers/1245AntitrustConsumerProtectionParadox.pdf (accessed February 22, 2016).
5. Section 1402 of the Dodd–Frank Act states that stricter mortgage requirements are necessary because “economic stabilization would be enhanced by the protection, *limitation* and regulation of the terms of residential mortgage credit.” (Emphasis added.)
6. Oren Bar-Gil and Elizabeth Warren, “Making Credit Safer,” *University of Pennsylvania Law Review*, Vol. 157, No. 1 (November 2008), <https://www.law.upenn.edu/live/files/112-bargillwarren157upalrev12008pdf> (accessed February 22, 2016).
7. Consumer Financial Protection Bureau, “Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z),” *Federal Register*, Vol. 77, No. 164, August 23, 2012, p. 51126.
8. The President extended this regulatory framework to all agencies in “Executive Order 13707: Using Behavioral Science Insights to Better Serve the American People,” September 15, 2015, <https://www.gpo.gov/fdsys/pkg/FR-2015-09-18/pdf/2015-23630.pdf> (accessed February 29, 2016).
9. Edward L. Glaeser, “Psychology and the Market,” National Bureau of Economic Research, *Working Paper* No. 10203, January 2004, <http://www.nber.org/papers/w10203> (accessed February 22, 2016).
10. News release, “CFPB’s Mass Data Collection Threatens Consumers’ Financial Safety,” House Financial Services Committee, December 16, 2015, <http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=400102> (accessed February 22, 2016).
11. Jonathan Thessin, “Request for Information Regarding Consumer Complaint Database,” American Bankers Association, August 31, 2015, http://www.aba.com/Advocacy/commentletters/Documents/cl-ConsumerComplaintDB-Aug2015.pdf#_ga=1.88021978.353812757.1444751158 (accessed February 22, 2016).
12. Norbert Michel, “The Myth of Financial Market Deregulation,” Heritage Foundation *Backgrounder*, forthcoming.
13. This was 12 percent in FY 2015, for a total cap of \$618.7 million. The bureau requested transfers of \$485 million. See CFPB, “Financial Report of the Consumer Financial Protection Bureau,” November 16, 2015, http://files.consumerfinance.gov/f/201511_cfpb_report_fiscal-year-2015.pdf (accessed February 22, 2016).
14. These include the Board of Governors of the Federal Reserve, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Treasury Department.
15. Warren reportedly pitched the idea of a consumer protection agency to then-Senator Barack Obama’s office in early 2007. She outlined her regulatory goals in: Elizabeth Warren, “Unsafe at Any Rate,” *Democracy*, No. 5 (Summer 2007), <http://www.democracyjournal.org/5/6528.php?page=all> (accessed February 22, 2016).
16. Proponents claimed that the President was forced to act after some Republicans threatened to block any nomination unless changes were made to the agency’s structure.
17. *National Labor Relations Board v. Noel Canning*, 2014.
18. Dodd–Frank Wall Street Reform and Consumer Protection Act, Title X, Sec. 1024.
19. Dodd–Frank Wall Street Reform and Consumer Protection Act, Title X, Secs. 1024 and 1031.
20. For example, the Federal Trade Commission Act was amended in 1938 to prohibit “unfair or deceptive acts or practices.”
21. The CFPB describes supervision as “a comprehensive, ongoing process of pre-examination scoping and review of information, data analysis, on-site examinations, and regular communication with supervised entities and prudential regulators, as well as follow-up monitoring. For most depository institutions supervised by the CFPB, periodic examinations will be conducted. For the largest and most complex banks in the country, the agency has implemented a year-round supervision program that will be customized to reflect the consumer protection risk profile of the organization. The agency has implemented a risk-based nonbank supervision program that will include conducting individual examinations and may also include requiring reports from businesses to determine what businesses need greater focus.” See CFPB, “Supervision,” <http://www.consumerfinance.gov/jobs/supervision/> (accessed February 22, 2016).
22. Consumer Financial Protection Bureau, “CFPB Supervision and Examination Manual,” Version 2, October 2012, http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf (accessed February 22, 2016).
23. Hearing, *The Semi-Annual Report of the Consumer Financial Protection Bureau*, Financial Services Committee, U.S. House of Representatives, March 29, 2012, <http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=286519> (accessed February 22, 2016).

-
24. While the investigation itself is not public, a petition to modify or set aside the CID will be made public by the bureau. See Jonathan L. Pompan and Alexandra Megaris, "What to Expect When You're Under a CFPB Investigation—Negotiating the Scope of the CID," Venable LLP, October 1, 2012, <http://www.mondaq.com/unitedstates/x/199248/Consumer+Trading+Unfair+Trading/What+To+Expect+When+Youre+Under+A+CFPB+Investigation+Negotiating+The+Scope+Of+The+CID> (accessed February 22, 2016).
 25. *Ibid.*
 26. *Ibid.*
 27. Loeb & Loeb, "CFPB Announces Rules Governing Investigations," CFPB Alert, August 2012, <http://www.loeb.com/articles-clientalertsreports-20120816-cfpbannouncesrulesgoverninginvestigations> (accessed February 22, 2016).
 28. Consumer Financial Protection Bureau, "Report of the Consumer Financial Protection Bureau Pursuant to Section 1017(e)(4) of the Dodd-Frank Act," December 31, 2015, http://files.consumerfinance.gov/f/201512_cfpb_report_section-1017e4-appropriations.pdf (accessed February 22, 2016).
 29. *Ibid.*
 30. Consumer Financial Protection Bureau, "Consumer Financial Protection Bureau Strategic Plan FY 2013–FY 2017," <http://www.consumerfinance.gov/strategic-plan/> (accessed February 22, 2016).
 31. Kate Davidson, "Trying to Stay Above Politics: A Conversation with Richard Cordray," *American Banker*, March 23, 2012, http://www.americanbanker.com/issues/177_58/cordray-cfpb-supervision-enforcement-consumers-UDAAP-UDAP-1047798-1.html (accessed February 22, 2016).
 32. The CFPB Consumer Complaint Database states: "We do not verify the accuracy of all facts alleged in these complaints, but we do take steps to confirm a commercial relationship between the consumer and the identified company." See CFPB, "Consumer Complaint Database," <http://www.consumerfinance.gov/complaintdatabase/> (accessed February 22, 2016).
 33. Consumer Financial Protection Bureau, "Supervision and Examination Manual, Version 2."
 34. Consumer Financial Protection Bureau, "CFPB Ready to Help Consumers on Day One," July 21, 2011, <http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-ready-to-help-consumers-on-day-one/> (accessed February 22, 2016).
 35. Consumer Financial Protection Bureau, "CFPB Launches Consumer Complaint Database," June 19, 2012, <http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-launches-consumer-complaint-database/> (accessed February 22, 2016).
 36. Office of Inspector General, "Opportunities Exist to Enhance Management Controls Over the CFPB's Consumer Complaint Database," *Audit Report*, September 10, 2015, <http://oig.federalreserve.gov/reports/cfpb-management-controls-consumer-complaint-database-sep2015.pdf> (accessed February 22, 2016).
 37. Office of Inspector General, "Opportunities Exist to Enhance Management Controls Over the CFPB's Consumer Complaint Database."
 38. CFPB, "Disclosure of Consumer Complaint Data: Notice of Final Policy Statement," Docket No. CFPB-2012-023, http://files.consumerfinance.gov/f/201303_cfpb_Final-Policy-Statement-Disclosure-of-Consumer-Complaint-Data.pdf (accessed February 22, 2016).
 39. Daniel P. Ray and Yasmin Ghahremani, "Credit Card Statistics, Industry Facts, Debt Statistics," <http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php> (accessed February 22, 2016).
 40. Consumer Financial Protection Bureau, "Home Mortgage Disclosure (Regulation C)," Docket No. CFPB-2014-0019, http://files.consumerfinance.gov/f/201510_cfpb_final-rule_home-mortgage-disclosure_regulation-c.pdf (accessed February 22, 2016).
 41. *Ibid.*
 42. The CRA was among a variety of low-income housing programs that contributed to the 2008 financial crisis by promoting mortgages for families who could not afford them. See Norbert J. Michel, "Government Policies Caused the Financial Crisis and Made the Recession Worse," Heritage Foundation *Commentary*, January 28, 2015, <http://www.heritage.org/research/commentary/2015/1/government-policies-caused-the-financial-crisis-and-made-the-recession-worse>.
 43. Dodd–Frank, Section 1022.
 44. Government Accountability Office, "Consumer Financial Protection Bureau: Some Privacy and Security Procedures for Data Collections Should Continue Being Enhanced," GAI-14-758, September 2014, <http://www.gao.gov/assets/670/666000.pdf> (accessed February 22, 2016).
 45. *Ibid.*
 46. Consumer Financial Protection Bureau, "CFPB Bulletin 2012-04 (Fair Lending)," April 18, 2012, http://files.consumerfinance.gov/f/201404_cfpb_bulletin_lending_discrimination.pdf (accessed February 22, 2016). Disparate impact can only be justified if the creditor practice meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact.
 47. Rachel Witkowski, "CFPB Overestimates Potential Discrimination, Documents Show," *American Banker*, September 17, 2015, <http://www.americanbanker.com/news/law-regulation/cfpb-overestimates-potential-discrimination-documents-show-1076742-1.html> (accessed February 22, 2016).
 48. In a variety of documents, agency personnel repeatedly acknowledged the weaknesses of their proxies. See *ibid.*
-

49. By a vote of 332 to 96, the House passed H.R. 1737, which would nullify the CFPB's indirect auto finance guidance and a notice and comment period issuing a new one. The bill also would require the CFPB when proposing and issuing such guidance to make publicly available "all studies, data, methodologies, analyses, and other information" it relied on.
50. Sean Higgins, "Consumer Bureau a 'Cesspool' of Discrimination and Retaliation, Union Head Says," *Washington Examiner*, June 25, 2015, <http://www.washingtonexaminer.com/consumer-bureau-a-cesspool-of-discrimination-and-retaliation-union-head-says/article/2567054> (accessed February 22, 2016).
51. Eric Katz, "Widespread Discrimination Forces Agency to Create New Pass-Fail Performance Rating System," *Government Executive*, May 27, 2014, <http://www.govexec.com/management/2014/05/widespread-discrimination-forces-agency-create-new-pass-fail-performance-rating-system/85246/> (accessed February 22, 2016).
52. Title X—Bureau of Consumer Financial Protections, Sec. 1022 Rulemaking Authority.
53. Dodd–Frank, Title X, Sec. 1032.
54. Consumer Financial Protection Bureau, "CFPB Proposes Allowing Companies to Run Trial Disclosure Programs," December 13, 2012, <http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-proposes-allowing-companies-to-run-trial-disclosure-programs/> (accessed February 22, 2016).
55. Consumer Financial Protection Bureau, "Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z)," Docket No. CFPB-2012-0028, http://files.consumerfinance.gov/f/201311_cfpb_final-rule_integrated-mortgage-disclosures.pdf (accessed February 22, 2016).
56. *Ibid.*
57. News release, "TILA/GFE Reform, Fair Lending and RESPA Tolerances Rank as Mortgage Lenders' Greatest Compliance Concerns," QuestSoft, April 17, 2012, http://www.questsoft.com/downloads/QuestSoft_PR_Compliance_Concerns_12-0417.pdf (accessed February 22, 2016).
58. Kleimann Communication Group, Inc., "Know Before You Owe: Evolution of the Integrated TILA-RESPA Disclosures," July 9, 2012, http://files.consumerfinance.gov/f/201207_cfpb_report_tila-respa-testing.pdf (accessed February 22, 2016).
59. *Ibid.*
60. Consumer Financial Protection Bureau, "2013 Real Estate Settlement Procedures Act (Regulation X) and Truth in Lending Act (Regulation Z) Mortgage Servicing Final Rules," <http://www.consumerfinance.gov/regulations/2013-real-estate-settlement-procedures-act-regulation-x-and-truth-in-lending-act-regulation-z-mortgage-servicing-final-rules/> (accessed February 22, 2016).
61. In a press release announcing the proposed regulations, for example, Cordray claimed the new rules would prevent foreclosures. "Millions of homeowners are struggling to pay their mortgages, often through no fault of their own," he said. "These proposed rules would offer consumers basic protections and put the 'service' back into mortgage servicing. The goal is to prevent mortgage servicers from giving their customers unwelcome surprises and runarounds." News release, "CFPB Proposes Rules to Protect Mortgage Borrowers," Consumer Financial Protection Bureau, August 10, 2012, <http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-proposes-rules-to-protect-mortgage-borrowers/> (accessed February 22, 2016).
62. Dodd–Frank, Title XIV, Sec. 1411.
63. Jonathan Green, "Preparing for Litigation Under the Ability to Repay Rule," *National Mortgage News*, February 24, 2014, <http://www.nationalmortgagenews.com/blogs/lens/preparing-for-litigation-under-the-ability-to-repay-rule-1041172-1.html> (accessed February 22, 2016).
64. Consumer Financial Protection Bureau, "CFPB to Pursue Discriminatory Lenders," April 18, 2012, <http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-to-pursue-discriminatory-lenders/> (accessed February 22, 2016).
65. Barbara Mishkin, "New Report Shows Negative Effect of CFPB's Contemplated Payday Loan Proposals on Credit Availability," *CFPB Monitor*, June 18, 2015, <https://www.cfpbmonitor.com/2015/06/18/new-report-shows-negative-effect-of-cfpbs-contemplated-payday-loan-proposals-on-credit-availability/> (accessed February 22, 2016).
66. Norbert J. Michel "Dodd–Frank and the Consumer Financial Protection Bureau Put Squeeze on Private Payday Lenders," *Heritage Foundation Issue Brief* No. 4479, November 4, 2015, <http://thf-reports.s3.amazonaws.com/2015/IB4479.pdf>.
67. *Ibid.*
68. Business Wire, "The Nilson Report: U.S. Card Spending at Merchants 2014," May 26, 2015, <http://www.businesswire.com/news/home/20150526006149/en/Credit-Cards-Continued-Rebound-Debit-Prepaid-Cards#.VWTzp1lVhBc> (accessed February 22, 2016).
69. "Electronic Fund Transfers (Regulation E)," *Federal Register*, Vol. 77, No. 101, May 24, 2012, p. 30923, <http://www.regulations.gov/#!documentDetail;D=CFPB-2012-0019-001> (accessed February 22, 2016).
70. Consumer Financial Protection Bureau, "CFPB Launches Inquiry into Mobile Financial Services," June 11, 2014, <http://www.consumerfinance.gov/newsroom/cfpb-launches-inquiry-into-mobile-financial-services/> (accessed February 22, 2016).

CHAPTER 12

Title XI Does Not End Federal Reserve Bailouts

Norbert J. Michel

A stated purpose of the Dodd–Frank Wall Street Reform and Consumer Protection Act was to end the too-big-to-fail problem. In other words, the Dodd–Frank Act was supposed to protect taxpayers from saving insolvent financial firms in the future as they did during the 2008 financial crisis. Title XI of Dodd–Frank amended the Federal Reserve’s emergency lending authority to curb its ability to save insolvent financial institutions. However, Dodd–Frank still allows many of the emergency lending programs that were conducted during the 2008 crisis. Perhaps the biggest mistake of Dodd–Frank is that it leaves intact the notion that the Fed should make emergency loans to firms during a financial crisis, even though there is no clear economic rationale for providing these loans. Congress should restrict the Fed to providing system-wide liquidity on an ongoing basis. The Fed does not need emergency lending authority to conduct monetary policy.

THE FEDERAL RESERVE: LENDER OF LAST RESORT

A stated purpose of Title XI of Dodd–Frank was to protect taxpayers by restricting the Federal Reserve’s ability to provide emergency loans. Many of the changes instituted by Title XI essentially force the Fed to adhere to the classic prescription for a lender of last resort (LLR). The classic LLR prescription was mainly developed in the 19th century by Walter Bagehot, longtime editor of *The Economist*.¹

Throughout its history, the Fed has been criticized for helping failing firms to stay afloat largely because it has failed to follow this prescription. Two norms summarize the essence of this classic LLR policy:

1. The central bank should prevent panic-induced contractions of the economy’s stock of money.
2. During a crisis, the central bank should provide short-term loans to all solvent institutions, on good collateral at a high rate of interest.

The main focus is to prevent a short-term shrinkage of the money supply from becoming a full-blown economic contraction. A central bank accomplishes this by managing the monetary base, a measure that consists of all currency in circulation plus commercial banks’ reserves. Economists refer to the base as high-powered money because the central bank controls how much of this money exists and because the base ultimately determines the maximum quantity of money that can be created in the banking system.²

Put differently, the central bank ensures that the entire banking system has enough liquidity (base money) to prevent a panic from spreading to the broader economy. However, the classic prescription made clear that a central bank had no duty to save specific firms. To avoid sustaining insolvent private banks, the central bank was to provide temporary, high-interest-rate loans only to borrowers who could post sound collateral.

However, policymakers should recognize that even the classic LLR prescription is a second-best

solution to private banks (under the threat of failure) providing all of the lending that markets need. Thus, the classic LLR prescription is a flawed concept upon which to base emergency loan restrictions.

PROBLEMS WITH THE CLASSIC PRESCRIPTION

One concern with central banks providing direct loans is a basic moral hazard problem. Namely, if central banks provide liberal credit to private banks (or other private firms) on a regular basis, the knowledge of having easy access to these loans would likely encourage private companies to take on additional risk.³ However, the moral hazard problem is only one issue that casts doubt on the wisdom of allowing central banks to make loans directly to firms.

In fact, Bagehot offered his ideas as a second-best solution to private markets fulfilling this lending role. He even viewed central banking as an undesirable, destabilizing⁴ force:

I know it will be said that in this work I have pointed out a deep malady, and only suggested a superficial remedy. I have tediously insisted that the natural system of banking is that of many banks keeping their own cash [i.e., specie] reserve, with the penalty of failure before them if they neglect it. I have shown that our system is that of a single bank keeping the whole reserve under no effectual penalty of failure. And yet I propose to retain that system, and only attempt to mend and palliate it.

I can only reply that I propose to retain this system because I am quite sure that it is of no manner of use proposing to alter it.... You might as well, or better, try to alter the English monarchy and substitute a republic.⁵

Aside from Bagehot's own views, upon close inspection the classic LLR prescription is clearly a flawed standard with respect to preventing bailouts. With everything else constant, any modern financial institution would normally make short-term loans to solvent firms—even at market rates of interest—on good collateral.⁶ Thus, the widespread refusal by private lenders to make such loans would likely indicate the existence of a solvency crisis, not a liquidity crisis. Put differently, the only loans that would not be made during a crisis are the loans that should not be made under any circumstances.⁷ Interestingly,

the Fed has successfully provided system-wide liquidity and avoided bailouts several times without using its emergency lending authority.

LIQUIDITY AND OPEN MARKET OPERATIONS

Throughout its history, the Federal Reserve has used several different methods to fulfill its LLR function. The principal method has been open market operations that the Fed uses to manage the monetary base. Through these operations, the Fed has regularly maintained liquidity in the entire market by purchasing Treasury securities, and these operations can be temporarily expanded in the event of a crisis. At all times, these purchases add reserves to the banking system, thus flooding the federal funds market—a private market where banks lend reserves to each other—with additional funds.

An injection of reserves tends to lower the federal funds rate (the rate that banks charge each other for overnight loans in this market), thus providing banks with easier access to a highly liquid source of borrowing. Therefore, the federal funds market provides a way for the Fed to add to the monetary base—even if only temporarily—and to allow banks to allocate credit to specific institutions as they see fit. In several earlier crises the Fed successfully provided system-wide liquidity by temporarily expanding its open market purchases. Yet these successful examples are outnumbered by many instances of the Fed providing direct loans to firms with poor financial health.⁸

THE DISCOUNT WINDOW AND EMERGENCY LENDING

The Fed principally lends directly to banks through its discount window, a method of lending that was originally envisioned as the main tool of monetary policy.⁹ Initially, each District Reserve Bank had a physical discount window in its lobby to make these loans to member banks, and the provision of such credit has always been controversial.¹⁰ The term now refers more generally to the regular provision of credit, as opposed to emergency credit, by the central bank to individual depository institutions on predefined terms.¹¹

In 1932, the Glass–Steagall Act significantly expanded the Fed's ability to provide direct loans by adding Section 13(3) to the Federal Reserve Act.¹² This change opened the Fed's discount window to nonbanks—individuals, partnerships, and corporations—in “unusual and exigent circumstances.”¹³

In 1934, the Industrial Advances Act created Section 13(b) of the Federal Reserve Act, authorizing the District Banks to provide working capital loans directly to industrial and commercial businesses for up to five years without any collateral restrictions.¹⁴ By 1939, the District Banks had provided nearly \$200 million in working capital loans to nearly 3,000 applicants.¹⁵

The Small Business Investment Act of 1958 repealed Section 13(b). During the congressional debate on the 1958 bill, Fed Chairman William McChesney Martin testified to Congress that the Fed should not provide capital to institutions and that its primary objective should be “guiding monetary and credit policy.”¹⁶ Roughly 20 years later, the Fed appropriately refused to open the discount window when the Nixon Administration asked the New York Fed to provide loans to the financially troubled Penn Central Railroad.

That success was short-lived, and the Fed immediately followed its refusal with what monetary scholar Anna Schwartz called “the ‘too-big-to-fail’ doctrine in embryo.”¹⁷ Ostensibly worried about fallout from Penn Central’s bankruptcy—particularly its default on \$82 million in commercial paper—the Fed announced that it would provide discount window lending to banks to assist in meeting the needs of all businesses that could not issue new commercial paper. Thus, the Fed showed that it would go to great lengths to stem a financial crisis in the event a large firm, not even a financial firm, might fail. This action implied that the bankruptcy of a large firm would cause a financial crisis, although only conjecture—no analysis—supports such a position.

Another major break with traditional LLR lending occurred in 1974 when the Fed provided discount window loans to Franklin National Bank until the Federal Deposit Insurance Corporation (FDIC) found a buyer for the *failed* bank. For five months, the New York Fed lent continuously to Franklin for a total of \$1.75 billion, approximately 50 percent of Franklin’s assets. The Fed took a similar approach with Continental Illinois, lending as much as \$8 billion over the course of one year until the FDIC resolved the *failed* bank in 1985. Evidence also suggests that the Fed continuously provided capital loans to many troubled banks during the late 1980s and early 1990s.

The House Banking Committee reported that, of the 530 depository institutions that failed from January 1985 to May 1991, 437 had been formally rated

with the poorest CAMEL rating¹⁸ of “five” (most problem-ridden), and 51 had the next poorest rating of “four.” The whole class of “five”-rated banks had been allowed to operate for a mean period of one year. At the time of actual failure, 60 percent of the banks had outstanding discount window loans for an aggregate of roughly \$8 billion.¹⁹ Given these banks’ poor CAMEL ratings, it is difficult to argue that the Fed believed it was making loans only to solvent banks.

Fed Lending Programs During the 2008 Financial Crisis. During the 2008 crisis the Fed allocated credit directly to firms and provided loans through several broad lending programs. For instance, on March 14, 2008, the Fed provided a \$13 billion loan to Bear Stearns, one of the Fed’s largest primary dealers. Bear Stearns repaid the loan in days, but then the Fed provided a \$30 billion loan to facilitate J. P. Morgan Chase’s acquisition of Bear Stearns via a special purpose vehicle named Maiden Lane LLC. Shortly after this deal was completed, former Fed chairman Paul Volcker remarked that this loan was “at the very edge” of the Fed’s legal authority.²⁰ In September 2008, the Fed loaned American International Group (AIG) \$85 billion and, as a condition of the loan, took 79.9 percent equity ownership in AIG.²¹ In June 2015, a U.S. District Court ruled that “Section 13(3) did not authorize the Federal Reserve Bank to acquire a borrower’s equity as consideration for the loan.”²²

Separately, the U.S. Government Accountability Office (GAO) estimated that the Federal Reserve lent financial firms more than \$16 trillion through its Broad-Based Emergency Programs from December 1, 2007, through July 21, 2010.²³ In comparison, U.S. annual gross domestic product (GDP) reached \$16.8 trillion in 2013—an all-time high for U.S. non-inflation-adjusted GDP. During the crisis, the Fed created more than a dozen special lending programs by invoking its emergency authority under Section 13(3).

The Fed shut down most of these special programs by 2010, although approximately \$2 billion from some of the lending facilities remains on the Fed’s balance sheet.²⁴ The following list²⁵ provides just a few examples of the Fed’s emergency lending in the wake of the 2008 crisis:

- **Term Securities Lending Facility (TSLF).** The TSLF was created on March 11, 2008, to provide short-term loans to the Fed’s primary dealers. It was the first time during the crisis that the Fed provided funds to nondepository

institutions. According to the GAO, many market participants believed that the TSLF was designed primarily to help Bear Stearns.²⁶

- **Term Auction Facility (TAF).** The TAF was created on December 12, 2007, to auction one-month and three-month loans to depository institutions so that they could avoid the stigma of borrowing at the discount window. Almost \$4 trillion was provided through the TAF between 2007 and 2010.²⁷
- **Primary Dealer Credit Facility (PDCF).** Created on March 17, 2008, the PDCF provided overnight cash loans to primary dealers against “eligible collateral,” as defined by the Fed. Nearly \$9 trillion was loaned through the PDCF by 2010.

Bear Stearns used the PDCF before the Fed facilitated the Bear Stearns–J.P. Morgan merger, but three other primary dealers—Citigroup Global Markets, Merrill Lynch Government Securities, and Morgan Stanley & Company—relied on the PDCF for more than double the amount that Bear Stearns borrowed.²⁸ Of more than 20 primary dealers, almost 80 percent of the PDCF lending went to these four firms.²⁹ Furthermore, the Fed made special concessions on the type of collateral accepted for these loans, and it provided PDCF loans at below market rates.³⁰

Typically, high-grade bonds and securities for government-sponsored enterprises have accounted for nearly all of the collateral used in these types of borrowings. However, after the 2008 Lehman Brothers failure, the Fed accepted equities and speculative grade debt as collateral for PDCF loans.³¹ The Fed clearly relaxed credit standards relative to what was normally accepted in this short-term lending market. Although difficult to gauge exactly, evidence also suggests that the Fed provided favorable rates on most of its emergency lending programs.

For example, Bloomberg Markets estimates that the Fed charged \$13 billion below market rates for its emergency loans from 2007 to 2010.³² Charging below market rates on suspect collateral is the antithesis of the classic LLR prescription. The goal should be to lend as safely as possible at high rates so that firms have every incentive to stop relying on the Fed for funds. Instead, the Fed effectively provided financial institutions with a source of subsidized capital for up to several years. Proponents argue that these crisis loans were necessary because market participants had difficulty determining the

value of various securities. The truth is that the Fed did not want many banks to sell securities at the low prices that the market was offering at that time.

This fact also highlights a major problem with attempts to ensure that the Fed can provide emergency loans only to *solvent* companies. For example, if bank assets are marked to market during a crisis, insolvency would likely be widespread. On the other hand, if bank assets are not marked to market during a crisis, nearly all financial institutions will appear sound on paper, leading to widespread emergency loans. Ironically, one of the Fed’s special lending programs could be modified to improve the Fed’s current open market operations process, making liquidity crises less likely in the first place.

IMPROVING SYSTEM-WIDE LIQUIDITY

Since the 1930s the Fed’s main monetary policy tool has been open market operations, the process of buying and selling (mainly) U.S. Treasuries on the open market.³³ Traditionally, the Fed has conducted these operations via a limited number of financial firms known as primary dealers.³⁴ In practice, when the Fed wants to expand the monetary base so that banks can lend more, it directs its traders to buy Treasuries from the primary dealers. The Fed then electronically credits the reserve accounts of the dealers’ banks, thus leaving it to the primary dealers to distribute credit through the federal funds market.

The federal funds market is essentially a private market where banks regularly lend and borrow excess reserves on an overnight basis. Thus, a main goal of open market operations is to maintain a liquid market for reserves so that private financial firms can provide financing to other private companies as needed. In this sense, the Fed regularly tries to maintain system-wide liquidity to prevent economic slowdowns. During the 2008 crisis, the primary dealer system’s reliance on a small number of firms actually hampered the Fed’s ability to maintain system-wide liquidity.³⁵ According to Donald Kohn, former Vice Chairman of the Federal Reserve Board of Governors:

The fact that primary dealers rather than commercial banks were the regular counterparties of the Federal Reserve in its open market operations, together with the fact that the Federal Reserve ordinarily extended only modest amounts of funding through repo agreements, meant that open market operations were not

particularly useful during the crisis for directing funding to where it was most critically needed in the financial system.³⁶

One obvious solution to this problem is to discontinue the primary dealer system so that most financial firms can directly participate in open market operations. The European Central Bank (ECB), for instance, conducts its open market operations with more than 500 bank counterparties in the eurozone.³⁷ Moving to such a system would at least “reduce dependence upon a geographically concentrated set of counter parties, and enhance the monetary policy transmission process.”³⁸

Historically, open market operations have proved superior to the discount window in maintaining system-wide liquidity. In general, market participants have traditionally attached a stigma to discount window loans, and banks rarely use the discount window. Thus, it is not surprising that the Fed’s discount window lending proved inadequate during the 2008 crisis.³⁹ In fact, several monetary scholars had previously recommended that the Fed rely solely on open market operations to provide liquidity rather than on direct credit allocation through emergency and discount window lending.⁴⁰ Moreover, in response to rapid declines in the amount of outstanding Treasury debt in the late 1990s, the Fed studied alternative methods to both open market operations and discount window lending to ensure that it could maintain system-wide liquidity.

In 2002, the Fed published a report that discussed an auction-based lending facility as one method for providing liquidity to the banking system.⁴¹ Nonetheless, the Fed maintained its traditional blend of policy tools leading up to the crisis and then, in December 2007, introduced the Term Auction Facility (TAF) to enhance system-wide liquidity. The TAF was a lending program that combined aspects of open market operations and discount window lending. According to Kohn,

The legal form of the TAF is the same as that of regular discount window loans. But by providing funds through an auction mechanism rather than through a standing facility, the TAF resembles open market operations rather than the standard discount window and, partly as a result, it appears to have largely avoided the stigma problem that limited the effectiveness of the discount window.⁴²

Experience from the 2008 crisis therefore suggests a modified TAF program could enhance the

Fed’s ability to maintain system-wide liquidity and ultimately replace both the discount window and the primary dealer system. Rather than rely on a small number of primary dealers, the Fed could open auctions of regular short-term advances to all banks that have the safest two CAMELS ratings.⁴³

Such auctions could become the primary method for the Fed to provide liquidity and could include collateral and lending limit restrictions to mitigate moral hazard problems. Banks could also be allowed to lend these short-term loans in the interbank lending market. While no system is foolproof, such a change would drastically reduce the need to expand the Fed’s lending authority on an ad hoc basis, and fear of losing eligibility to participate in these auctions would likely provide further incentive for banks to improve their financial conditions. Dodd–Frank stopped well short of this type of reform and, instead, attempted to increase restrictions on the Fed’s emergency lending.

TITLE XI AMENDMENTS TO EMERGENCY LENDING

Prior to passage of the Dodd–Frank Act, Section 13(3) of the Federal Reserve Act authorized the Federal Reserve to make loans commonly referred to as emergency lending. In particular, Section 13(3) allowed the Federal Reserve Board of Governors to authorize any of the Federal Reserve District Banks to extend credit to “any individual, partnership, or corporation” in “unusual and exigent circumstances.”⁴⁴ Overall, these loans were subject to four conditions:

1. The Fed extends such loans in only “unusual and exigent circumstances”;
2. At least five members of the Board of Governors vote to allow the loans;
3. The loans be indorsed or otherwise secured to the satisfaction of the District Bank; and
4. The lending District Bank obtains evidence that the borrower is unable to secure adequate financing from private banking institutions.

Title XI of Dodd–Frank amended the Federal Reserve Act to limit the Fed to providing only emergency lending programs that have “broad-based eligibility.” In other words, the Fed can no longer provide loans to individual firms. It can make loans available to only *groups* of companies. However, even if these changes had been in place prior to the 2008

crisis, the Fed still could have conducted roughly half of its special lending programs.⁴⁵

Title XI also requires the Federal Reserve Board to consult with the Treasury Secretary to develop its emergency lending policies and procedures, and it further stipulates that the Board cannot establish any such program without the Treasury Secretary's prior approval.⁴⁶ Section 1101(a)(6) of Dodd-Frank requires:

Such policies and procedures shall be designed to ensure that any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, and that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion.⁴⁷

Additionally, Title XI requires the Board to develop rules that prohibit emergency lending to insolvent borrowers and that ban lending programs designed to remove assets from a specific firm's balance sheet to enable that company to avoid insolvency.⁴⁸ Aside from the fact that this type of collaboration is wholly contrary to the notion of central bank independence from the executive branch, the new requirements ignore that the central bank's function is already to provide system-wide liquidity. If the central bank provides such liquidity, there is no reason to require an additional set of rules for providing such liquidity in special circumstances. During a crisis, if Congress desires to provide additional taxpayer funds to firms, it can do so directly in a politically accountable manner.

These Dodd-Frank changes were meant to provide stricter rules *before* another financial crisis occurs, but Title XI also included several provisions to increase Congress's post-crisis oversight over the Fed. For instance, no later than seven days after the Fed authorizes an emergency program, it must provide Congress with a detailed report.⁴⁹ Additionally, Section 1102 authorizes the U.S. Government Accountability Office (GAO) to audit any of the Fed's emergency lending programs. These GAO audits can investigate nearly all aspects of the programs, including whether they were designed to benefit specific firms and even whether the collateral requirements were effective.⁵⁰ Because firms could be hesitant to avail themselves of emergency lending for

fear of signaling financial weakness, Title XI also provides for a delayed release of GAO reports on emergency lending.⁵¹

ADDITIONAL FEDERAL RESERVE CHANGES

Dodd-Frank made several basic improvements to Fed transparency. For instance, Section 1103 requires the Fed to post GAO audit reports of emergency lending on its website. This section also requires the Fed to post its audited financial statements, as well as other information concerning "the borrowers and counterparties participating in...discount window lending programs, and open market operations."⁵² Congress should maintain these types of changes in the spirit of providing full Federal Reserve transparency.

Prior to Dodd-Frank, all members of each District Bank's Board of Directors voted to select their new bank president. Section 1107 amends the Federal Reserve Act so that Class A directors—those selected by member banks to represent the stockholding banks—can no longer vote in the election of a new District Bank president.⁵³ Now, only Class B directors, who are elected by member banks to represent the public rather than the stockholding banks, and Class C directors, who are selected by the Board of Governors to represent the public, can vote in the election.⁵⁴ This provision does not appear to solve any existing problem or serve any material purpose other than to increase the Board's influence on the District Banks.

Dodd-Frank also increased the Fed's emphasis on financial regulations by creating the position of Vice Chair for Supervision on the Board of Governors. This position is appointed by the U.S. President with the advice and consent of the Senate. Dodd-Frank requires the Vice Chair to "develop policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board" and to "oversee the supervision and regulation of such firms."⁵⁵ Relative to the overall regulatory authority vested in the Federal Reserve, this change appears rather small. However, Fed Governor Daniel Tarullo has served as the *de facto* Vice Chair for Supervision since Dodd-Frank was enacted without formally answering to Congress.⁵⁶

Aside from this new position, Dodd-Frank has expanded the Fed's regulatory authority, and many

scholars have pointed out that a central bank does not need to be a financial regulator to conduct monetary policy.⁵⁷ Allowing the Fed to serve as a financial regulator increases the likelihood that policy decisions will be compromised as the Fed's employees become embedded in the financial firms that they are supposed to oversee. It is also unnecessary in a practical sense because removing the Fed from its regulatory role would leave at least five other federal regulators overseeing U.S. financial markets.

FDIC GUARANTEES

The government's response to the financial crisis also included various measures by the Federal Deposit Insurance Corporation (FDIC). Separate from an expansion of its normal deposit insurance program, the FDIC implemented a Temporary Liquidity Guarantee Program (TLGP). The TLGP consisted of two components: the Transaction Account Guarantee Program (TAGP) and the Debt Guarantee Program (DGP).

The TAGP guaranteed all domestic non-interest-bearing transaction deposits, low-interest negotiable order of withdrawal (NOW) accounts, and Interest on Lawyers Trust Accounts (IOLTAs). Originally, the guarantee applied to all of these accounts held at participating banks and thrifts through December 31, 2009. The deadline was later extended and ultimately expired on December 31, 2010. In combination with the FDIC's main deposit insurance program, the TAGP allowed the federal government to temporarily guarantee nearly all bank deposits.⁵⁸

The DGP provided a federal guarantee for certain types of new debt issued by private firms. Specifically, these guarantees applied to senior unsecured debt issued between October 14, 2008, and October 31, 2009. The FDIC guarantee for this debt extended through maturity or December 31, 2012, whichever came first.⁵⁹ Many large financial firms—such as Citigroup, Bank of America, and Goldman Sachs—used the DGP to issue government-guaranteed debt. Over its entire existence, firms issued \$345.8 billion of federally guaranteed debt. The FDIC has collected \$10.4 billion in fees under the DGP.⁶⁰

Dodd-Frank includes several provisions that appear to restrict the FDIC's ability to conduct these types of programs in the future. These restrictions are similar to the new restrictions that Dodd-Frank placed on the Fed's emergency lending authority. For instance, Title XI stipulates that the FDIC can only

“create a widely available program to guarantee obligations of solvent insured depository institutions or solvent depository institution holding companies (including any affiliates thereof) during times of severe economic distress.”⁶¹

Title XI further stipulates that the FDIC cannot create any such guarantee program without first securing an official determination that a *liquidity event* (i.e., a systemic crisis) exists.⁶² This determination is a process that requires an affirmative two-thirds vote of both the FDIC board and the Federal Reserve Board of Governors. Dodd-Frank further stipulates, among other requirements, that this determination include a written evaluation of the evidence that a liquidity event exists.

Title XI also requires the Treasury Secretary and the GAO to provide respective reports to Congress explaining the determination and, in the case of the GAO, its effects.⁶³ Furthermore, the FDIC cannot actually issue guarantees until Congress formally approves the guarantee program.⁶⁴ While the type of collaboration that Title XI now requires between the Fed, the FDIC, and the Treasury Department is similar to the type of collaboration that took place during the 2008 crisis, these particular changes at least provide a process for political accountability. Still, short of explicitly prohibiting these types of FDIC guarantees—the preferred solution—it is doubtful that any formal restrictions will prevent their use in future crises.

WHAT CONGRESS SHOULD DO

The Federal Reserve serves as the U.S. economy's lender of last resort (LLR), a function that it carries out through emergency lending, discount window loans, and open market operations. Throughout its history, the Fed's emergency lending and discount window loan policies have jeopardized its operational independence and put taxpayers at risk. During the 2008 crisis, the Fed lent financial companies more than \$16 trillion through broad-based emergency lending programs, at approximately \$13 billion below market rates. This type of lending perpetuates the too-big-to-fail problem, yet Dodd-Frank allows the Fed to conduct emergency loans via broad-based programs.

Congress should restrict the Fed to providing system-wide liquidity on an ongoing basis. Emergency lending authority is unnecessary for conducting monetary policy. To this end, Congress should:

- **Revoke Section 13(3) of the Federal Reserve Act.** This section allows the Federal Reserve Board of Governors to authorize Fed District Bank lending to “any participant in any program or facility with broad-based eligibility” in “unusual and exigent circumstances.” Dodd–Frank amended this authority after the 2008 crisis, but even if these restrictions had been in place, the Fed still would have been able to conduct many of the lending programs that allowed it to prop up failing institutions.
- **Close the Federal Reserve’s discount window.** The discount window is a relic of the Fed’s founding and is no longer necessary. As it stands, a stigma is attached to lending through the discount window, and it is simply another way for the Fed to allocate credit directly to firms. The Fed can fulfill its lender-of-last-resort function by focusing on system-wide liquidity.
- **Improve system-wide liquidity by replacing the primary dealer system.** The Fed conducts its open market operations—buying and selling Treasury securities to implement monetary policy—with a limited number of financial firms known as primary dealers. The current primary dealer framework was created in the 1960s when a centralized open market system in New York offered clearer advantages. Now, however, there is good reason to believe that allowing all member banks to participate in open market operations would provide a more liquid interbank lending market. The Fed successfully used the Term Auction Facility to inject liquidity into the market during the 2008 crisis, and this program could be modified to replace the current primary dealer system. The current system requires the Fed to depend on a small number of large financial institutions, thus making system-wide liquidity provision needlessly cumbersome and reinforcing the notion of systemically important firms. The current system perpetuates the too-big-to-fail problem. Congress should formally examine all possible improvements to the framework.
- **End the FDIC’s authority to provide guarantees.** The FDIC provided hundreds of billions in loan guarantees in the wake of the 2008 crisis, mainly by invoking its systemic risk exception in Section 13(G) of the Federal Deposit Insurance Act. Congress should eliminate the FDIC’s

systemic risk exception and prohibit the FDIC from providing any types of loan guarantees.

- **Retain and expand key Dodd–Frank transparency improvements.** Section 1102 of Dodd–Frank authorizes the GAO to audit any of the Fed’s emergency lending programs, and Section 1103 requires the Fed to post key GAO audit results on its website. Congress should retain these provisions as long as emergency lending programs exist, and the GAO should be authorized to audit—with appropriate delays regarding the release of sensitive information—all aspects of the Fed’s operations.

CONCLUSION

Overall, the Fed has done a poor job of adhering to the classic lender-of-last-resort (LLR) prescription. Throughout its history, the Fed’s LLR policies have jeopardized its operational independence and put taxpayers at risk. These problems are easily avoidable because no clear economic rationale calls for the Fed to provide emergency loans to private firms. Implementing monetary policy involves ensuring that the entire banking system has enough liquidity to prevent panic from spreading to the broader economy. Monetary policy does not require the Fed to make emergency loans.

Little evidence suggests that Federal Reserve emergency lending to individual institutions is either necessary or proper, but such lending clearly politicizes the Fed’s monetary policy. Merely restricting the Fed’s emergency lending leaves intact the notion that the Fed should bail out firms—a dangerous view, to say the least. Title XI of Dodd–Frank failed to end the too-big-to-fail problem largely because it retained this belief.

Congress can easily fix this problem by prohibiting the Fed from making emergency loans in the first place. Using public funds to bail out private firms in any way for any reason is and should remain a part of the government’s fiscal operations. If Members of Congress want to use taxpayer dollars to save troubled firms, they should do so directly so that voters can hold them accountable.

This chapter was originally published as a Heritage Foundation Backgrounder—“Dodd–Frank’s Title XI Does Not End Federal Reserve Bailouts”—on September 29, 2015.

ENDNOTES:

1. See Thomas M. Humphrey, "Lender of Last Resort: What It Is, Whence It Came, and Why the Fed Isn't It," *The Cato Journal*, Vol. 30, No. 2 (Spring/Summer 2010), pp. 333–364, <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2010/5/cj30n2-7.pdf> (accessed July 2, 2014).
2. Commercial banks are required to hold reserves in an account at their district Federal Reserve bank, and these reserves ultimately determine how much money banks can lend (that is, how much new money that banks can create) to their customers. See Norbert J. Michel, "The Fed at 100: A Primer on Monetary Policy," Heritage Foundation *Backgrounders* No. 2876, January 29, 2014, <http://www.heritage.org/research/reports/2014/01/the-fed-at-100-a-primer-on-monetary-policy>.
3. At least one of Bagehot's contemporaries recognized this basic moral hazard problem. See Humphrey, "Lender of Last Resort," p. 340.
4. See George Selgin, "Central Banks as Sources of Financial Instability," *The Independent Review*, Vol. 14, No. 4 (Spring 2010), pp. 485–496, http://object.cato.org/sites/cato.org/files/articles/tir_14_04_01_selgin.pdf (accessed June 2, 2015).
5. Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873; New York: John Wiley & Sons, 1999), p. 329.
6. Alternatively, strict reserve or regulatory requirements could prevent private firms from making loans, in which case removing these restrictions would allow private lenders to provide loans. This sort of problem has several historical precedents. For instance, regulations prohibited even the temporary relief from strict reserve requirements during the panic of 1907. One prominent banker involved in the 1907 crisis noted, "While one thousand millions of dollars were lying idle in our banks and trust companies as so-called reserves, this money, by virtue of the law, could scarcely be touched!" See Richard Timberlake, "Clearing House Currency," *The Cato Journal*, Vol. 34, No. 2 (Spring/Summer 2014), p. 309, <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2014/5/cato-journal-v34n2-6.pdf> (accessed July 24, 2014).
7. Even protecting central bank emergency loans with strict collateral requirements—assuming it can be valued properly—could add to moral hazard by allowing creditors of a failing bank to escape any losses. See Marvin Goodfriend and Jeffrey M. Lacker, "Limited Commitment and Central Bank Lending," Federal Reserve Bank of Richmond *Economic Quarterly*, Vol. 85, No. 4 (Fall 1999), pp. 1–27, https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_quarterly/1999/fall/pdf/goodfriend.pdf (accessed August 2, 2015).
8. For a complete overview, see Norbert J. Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation *Backgrounders* No. 2943, August 20, 2014, <http://www.heritage.org/research/reports/2014/08/the-feds-failure-as-a-lender-of-last-resort-what-to-do-about-it>.
9. The term "discount" refers to the practice of discounting and rediscounting (that is, lending). At the time of the Fed's founding, bills of exchange and banker's acceptances (forms of short-term credit) were frequently used as collateral in lending. This practice formed the idea behind the Fed's discount window: Banks could borrow (discount and rediscount) from the Fed to obtain currency against the private loans (bills of exchange) that they were holding.
10. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review*, Vol. 74, No. 5 (September/October 1992), pp. 58–69, <http://research.stlouisfed.org/publications/review/article/2582> (accessed July 3, 2014).
11. The authority for discount window lending is mostly in Section 10B of the Federal Reserve Act. 12 U.S. Code §§ 341–364. See Federal Reserve Board, "Discount Window Lending," http://www.federalreserve.gov/newsevents/reform_discount_window.htm (accessed July 9, 2014).
12. It is convenient to make a distinction between discount window loans and emergency loans, but technically even discount window loans are made under primary, secondary, and seasonal lending programs. Furthermore, under the current U.S. Code, Section 13(3) of the Federal Reserve Act authorizes the Fed to provide "discounts." 12 U.S. Code § 343.
13. David Fetting, ed., "Lender of More Than Last Resort," Federal Reserve Bank of Minneapolis *The Region*, December 2002, <https://www.minneapolisfed.org/publications/the-region/lender-of-more-than-last-resort> (accessed August 21, 2015).
14. *Ibid.*, p. 19.
15. Schwartz, "The Misuse of the Fed's Discount Window," p. 61.
16. *Ibid.*, p. 62.
17. *Ibid.*
18. In 1996, the Federal Reserve formally updated the CAMEL rating system to the CAMELS system. Banking regulators now use CAMELS ratings to rate the strength of banks based on six (rather than five) factors: (C) capital adequacy, (A) asset quality, (M) management quality, (E) earnings, (L) liquidity, and (S) sensitivity to market risk. See press release, Federal Reserve Board of Governors, December 24, 1996, <http://www.federalreserve.gov/BoardDocs/press/general/1996/19961224/default.htm> (accessed July 12, 2014).
19. Schwartz, "The Misuse of the Fed's Discount Window," pp. 58–59.

20. John Brinsley and Anthony Massucci, "Volcker Says Fed's Bear Loan Stretches Legal Power," Bloomberg News, April 8, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPDZWKWhz21c> (accessed July 8, 2014). Similarly, former New York Fed lawyer Walker Todd argued, "Much less of [the Federal Reserve's emergency] lending is based on clear statutory authority than one might prefer if one cared about the rule of law and the potential for tyrannical government. The Fed interprets 13(3) as essentially giving it carte blanche. One has to read between the lines and off the edge of the page, however, to find authority for the Fed to purchase assets that are not 'notes, drafts, and bills of exchange,' or authority to create special subsidiaries to do so." Lawrence H. White, "The Rule of Law or the Rule of Central Banks?" *The Cato Journal*, Vol. 30, No. 3 (Fall 2010), pp. 451-456, <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2010/11/cj30n3-3.pdf> (accessed August 2, 2015).
21. The Fed created two additional Maiden Lane entities to complete the AIG bailout. The combined net holdings of the three Maiden Lane LLCs are currently more than \$1.7 billion, and the original Maiden Lane LLC accounts for nearly all of this total.
22. *Starr International Company v. U.S.*, No. 11-779C, at 2 (Fed. Cl., June 15, 2015), https://ecf.cofc.uscourts.gov/cgi-bin/show_public_doc?2011cv0779-443-0 (accessed June 22, 2015).
23. U.S. Government Accountability Office, "Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance," GAO-11-696, July 2011, p. 131, <http://www.gao.gov/new.items/d11696.pdf> (accessed July 3, 2014).
24. See Federal Reserve Board of Governors, "Factors Affecting Reserve Balances," May 28, 2015, <http://www.federalreserve.gov/releases/h41/current/h41.htm> (accessed June 4, 2015).
25. For a complete list, see U.S. Government Accountability Office, "Federal Reserve Bank Governance: Opportunities Exist to Broaden Director Recruitment Efforts and Increase Transparency," GAO-12-18, October 2011, p. 76, <http://www.gao.gov/new.items/d1218.pdf> (accessed July 3, 2014). See also Lawrence H. White, testimony before the Subcommittee on Monetary Policy and Trade, Committee on Financial Services, U.S. House of Representatives, March 12, 2014, <http://mercatus.org/publication/ending-federal-reserve-system-s-overreach-credit-allocation> (accessed July 1, 2014).
26. U.S. Government Accountability Office, "Federal Reserve Bank Governance," p. 84.
27. Because the TAF allowed the Fed to auction a pre-announced amount of credit to firms, it was a way to directly inject liquidity into the market where it was most needed (at market rates). The TAF could even be superior to open market operations for the purpose of providing regular liquidity to the market. See Olivier Armantier, Sandra Krieger, and James McAndrews, "The Federal Reserve's Term Auction Facility," Federal Reserve Bank of New York *Current Issues in Economics and Finance*, Vol. 14, No. 5 (July 2008), http://newyorkfed.org/research/current_issues/ci14-5.html (accessed June 4, 2015).
28. Brian Sheridan, "Lender of Last Resort: An Examination of the Federal Reserve's Primary Dealer Credit Facility," University of Notre Dame *Working Paper*, April 2011, p. 29, https://economics.nd.edu/assets/41471/brian_sheridan_lender_of_last_resort.pdf (accessed July 3, 2014).
29. *Ibid.*
30. Technically, the PDCF borrowing occurred in the short-term repurchase (repo) market.
31. After the Lehman failure, 26.4 percent of the collateral consisted of equity securities and 16 percent consisted of speculative-grade bonds. See Sheridan, "Lender of Last Resort," p. 16.
32. Bloomberg derived these estimates based on data from a Freedom of Information lawsuit. See Bob Ivry, Bradley Keoun, and Phil Kuntz, "Secret Fed Loans Gave Banks \$13 Billion Undisclosed to Congress," *Bloomberg Markets Magazine*, November 27, 2011, <http://www.bloomberg.com/news/print/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html> (accessed July 3, 2014).
33. See David Marshall, "Origins of the Use of Treasury Debt in Open Market Operations: Lessons for the Present," Federal Reserve Bank of Chicago *Economic Perspectives* (1st Quarter, 2002), pp. 45-54, <https://ideas.repec.org/a/fip/fedhep/y2002iqip45-54nv.26no.1.html> (accessed June 15, 2015).
34. Currently, 22 primary dealers serve as counterparties to the Fed's trades. See Federal Reserve Bank of New York, "Primary Dealers List," http://www.newyorkfed.org/markets/pridealers_current.html (accessed June 15, 2015).
35. Several Federal Reserve officials acknowledged the primary dealer system, with its reliance on a small number of firms, hampered the Fed's ability to provide liquidity. See George Selgin, "L Street: Bagehotian Prescriptions for a 21st Century Money Market," *The Cato Journal*, Vol. 32, No. 2 (Spring/Summer 2012), <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2012/7/v32n2-8.pdf> (accessed June 15, 2015).
36. Donald L. Kohn, "Policy Challenges for the Federal Reserve," speech at the Kellogg School of Management, Northwestern University, Evanston, IL, November 16, 2009, <http://www.federalreserve.gov/newsevents/speech/kohn20091116a.htm> (accessed June 15, 2015).
37. Shadow Financial Regulatory Committee, "Reforming the Primary Dealer Structure," American Enterprise Institute *Shadow Committee Statement* No. 280, December 14, 2009, <https://www.aei.org/publication/reforming-the-primary-dealer-structure/> (June 15, 2015).
38. *Ibid.* To force such a change in Fed procedure, Congress would likely need to amend the Federal Reserve Act. Section 14 of the Federal Reserve Act authorizes open market purchases under the "rules and regulations prescribed by the Board of Governors." 12 U.S. Code § 353.
39. Kohn, "Policy Challenges for the Federal Reserve."
40. For example, see Goodfriend and King, "Financial Deregulation, Monetary Policy, and Central Banking."

-
41. Federal Reserve System Study Group on Alternative Instruments for System Operations, "Alternative Instruments for Open Market and Discount Window Operations," Board of Governors of the Federal Reserve System, December 2002, http://www.federalreserve.gov/boarddocs/surveys/soma/alt_instrmnts.pdf (accessed June 15, 2015).
 42. Kohn, "Policy Challenges for the Federal Reserve."
 43. For a more detailed plan to end the need for emergency lending and transition to a market-wide auction process, see Selgin, "L Street." American Enterprise Institute scholar Paul Kupiec has suggested (in public forums) a similar idea whereby the Fed would sell options on a regular cycle. Under this sort of plan, any bank that owns an option and the underlying security that it references can "repo" the security back to the Fed at a given repo rate (agreed upon in advance) provided there was no downgrade on the collateral.
 44. 12 U.S. Code § 343.
 45. White, testimony before the Subcommittee on Monetary Policy and Trade.
 46. Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, §1101(a)(6)(B)(iv); 12 U.S. Code § 343(3)(B)(iv). The Federal Reserve issued proposed rules for its new emergency lending policies in January 2014 and is receiving public comments. See Federal Reserve System, "Extensions of Credit by Federal Reserve Banks," *Federal Register*, Vol. 79, No. 3 (January 6, 2014), pp. 615–620, <https://www.federalregister.gov/articles/2014/01/06/2013-31025/extensions-of-credit-by-federal-reserve-banks> (accessed June 2, 2015). In August, a bipartisan group of lawmakers criticized the proposal for not doing enough to guard against future bailouts. See Jonathan Ernst, "Lawmakers Slam Fed's Crisis Lending Proposal," Reuters, August 18, 2014, <http://www.reuters.com/article/2014/08/18/us-financial-regulations-fed-idUSKBN0G11Z020140818> (accessed June 2, 2015).
 47. 12 U.S. Code § 343(3)(B)(i).
 48. Dodd–Frank Act, §1101(a)(6)(B)(ii–iii); 12 U.S. Code § 343(3)(B)(ii–iii).
 49. Dodd–Frank Act, §1101(a)(6)(C); 12 U.S. Code § 343(3)(C). The Fed also must update Congress on outstanding programs once every 30 days.
 50. Dodd–Frank Act, § 1102; 31 U.S. Code § 714(f).
 51. The delay is for one year after the program terminates, but the Fed Chair has the discretion to release this information sooner. See 12 U.S. Code § 248(s)(3).
 52. See 12 U.S. Code § 248(s).
 53. 12 U.S. Code § 341.
 54. See 12 U.S. Code § 302.
 55. Dodd–Frank Act, § 1108(a)(1); 12 U.S. Code § 242.
 56. See Joseph Lawler, "Regulatory Power Has Shifted to Fed's Tarullo," *Washington Examiner*, March 10, 2015, <http://www.washingtonexaminer.com/regulatory-power-has-shifted-to-feds-tarullo/article/2561280> (accessed July 31, 2015).
 57. See Goodfriend and King, "Financial Deregulation, Monetary Policy, and Central Banking," and Norbert J. Michel, "A Roadmap to Monetary Policy Reforms," *The Cato Journal*, Vol. 35, No. 2 (Spring/Summer 2015), <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2015/5/cj-v35n2-9.pdf> (accessed July 31, 2015).
 58. From December 31, 2010, through December 31, 2012, Dodd–Frank provided temporary *unlimited* deposit insurance coverage for non-interest-bearing transaction accounts and IOLTAs, but not low-interest NOW accounts, regardless of the balance in the account and the ownership capacity of the funds. This coverage essentially replaced the TAGP, which expired on December 31, 2010, and was available to all depositors. The coverage was separate from and in addition to the standard insurance coverage provided for a depositor's other accounts held at an FDIC-insured bank.
 59. These periods were extended. The original DGP guarantees applied to debt issued between October 14, 2008, and June 30, 2009, and extended no later than June 30, 2012.
 60. See Federal Deposit Insurance Corporation, "TLGP Debt Guarantee Program: Issuer Reported Debt Details," https://www.fdic.gov/regulations/resources/tlgp/total_debt.html (accessed June 3, 2015), and "Temporary Liquidity Guarantee Program," <https://www.fdic.gov/regulations/resources/tlgp/> (accessed June 3, 2015).
 61. Dodd–Frank Act, § 1105; 12 U.S. Code § 5612. This section also prohibits the FDIC from using any such program to inject any form of equity into a firm.
 62. Dodd–Frank Act, § 1104; 12 U.S. Code § 5611. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) largely prohibited the FDIC from protecting uninsured depositors or other uninsured creditors, but it included a *systemic risk* exception that still exists. See 12 U.S. Code § 1823(c)(4)(G). See also Sharon Foster, "Dodd–Frank Wall Street Reform and Consumer Protection Act," *Arkansas Law Review*, September 28, 2010, <http://lawreview.law.uark.edu/dodd-frank-wall-street-reform-and-consumer-protection-act.html> (accessed August 2, 2015).
 63. Dodd–Frank Act, § 1104; 12 U.S. Code § 5611.
 64. Formally, a request by the President under this section is considered granted by a joint resolution of Congress. Dodd–Frank Act, § 1105(c–d); 12 U.S. Code § 5612(c–d).
-

CHAPTER 13

Title XII: Improving Access to Mainstream Financial Institutions

Mark A. Calabria

Title XII of Dodd-Frank is essentially designed to create a variety of taxpayer-subsidized alternatives to short-term payday loans. It does so via three separate authorities. Section 2014 authorizes the Secretary of the Treasury to establish a variety of subsidies to encourage depositories to offer low-cost accounts. Section 1205 authorizes the Secretary of the Treasury to establish subsidies for the provision of alternatives to traditional payday loans. Section 1206 established at Treasury a grant program for Community Development Financial Institutions (CDFIs) to provide small-dollar loans.

A primary difference across the three sets of programs potentially created by Title XII is which entities are eligible. Section 1204 is targeted at insured depositories, Section 1205 is open to a broad category of entities, including 501(c)(3) nonprofits, and Section 1206 is limited to CDFIs. The programs also differ in the types of products offered. Section 1204 addressed primarily checking and savings accounts, Section 1205 addresses the duration of the loan (short term), and Section 1206 addresses the size of the loan (limited to under \$2,500).

All of the products targeted by Title XII are already offered widely in U.S. financial markets. In many instances, these products are offered in relatively open and competitive markets. Where these products are not available, such as for payday loans, this is the result of legislative or regulatory barriers, not a lack of willingness by businesses to provide such products.

All of the products mentioned are also expensive to offer.¹ The typical checking account can cost between \$200 and \$300 to maintain annually. Underwriting and providing small-dollar costs can be time-intensive and easily outweigh any actual financing costs. The same holds for short-term loans.

Lending, like many industries, displays economics of scale, both in relation to duration and size of the loan or account: There are fixed costs, and those fixed costs constitute a larger percentage of the loan, the smaller or shorter duration of the loan or account. While improvements in information technology, such as the expansion of credit scoring, has reduced these costs, substantial differences in costs along these margins remain.

Some have interpreted these cost differences as “unfair” or “predatory.” Setting aside the subjective nature of these arguments, there is little evidence that consumers are entering these contracts in ignorance of the costs and nature of the products. These products are “expensive” because the fixed cost of providing them is spread over a smaller amount.² For instance, a number of nonprofit credit unions have attempted to offer alternatives to traditional payday loans. Despite the best of intentions, these credit union alternatives have not been cheaper for consumers.³

Title XII does not change the economics of these products; it simply seeks to make such products cheaper by having the taxpayer cover part of the expense. Of course one should be wary of such

an approach, as subsidies in areas like education, health care, and housing have made such products more expensive, not less. Policymakers should be equally concerned with the total costs to society. Redistribution should be done directly via the welfare system, not the financial system. As the financial crisis so painfully demonstrated, using finance to redistribute income or solve unrelated social issues ends poorly.

It is important to remember that none of the products targeted in Title XII contributed to the financial crisis. Title XII was another example of using the cover of financial reform to address unrelated issues that would have not become law on their own merits.

The authorities created in Sections 1204, 1205, and 1206 depend on the authorization of appropriations in Section 1208. Until Title XII is repealed, the public interest would be best served were Congress

simply to not provide appropriations for these programs. The remaining sections of Title XII provide definitions and additional regulatory authorities related to the three programs under Sections 1204, 1205, and 1206. Modification or elimination of these programs would necessitate modification or elimination of the remainder of this title.

Ultimately, the best way to provide low-cost, fair products to consumers is to encourage and allow competition. Where the high cost of a product is in part the result of regulations, those regulations should be evaluated and, when appropriate, eliminated. Subsidies do not make products cheaper to society as a whole, and in many instances they ultimately are not even cheaper for the consumer.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. Victor Stango and Jonathan Zinman, "What Do Consumers Really Pay on Their Checking and Credit Card Accounts? Explicit, Implicit, and Avoidable Costs," *American Economic Review Papers and Proceedings*, Vol. 99, No. 2 (2009).
2. Mark Flannery and Katherine Samolyk, "Payday Lending: Do the Costs Justify the Price?" FDIC Center for Financial Research *Working Paper* No. 2005-09, June 2005, https://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf (accessed February 23, 2016).
3. Victor Stango, "Are Payday Lending Markets Competitive?" *Regulation* (Fall 2012), <http://object.cato.org/sites/cato.org/files/serials/files/regulation/2012/11/v35n3-5.pdf> (accessed February 23, 2016).

CHAPTER 14

Title IX Subtitle D and Title XIV: Likely to Increase Cost of Mortgage Credit and Increase Foreclosures

Mark A. Calabria

The residential mortgage market plays a central role in most accounts of the financial crisis. This is true whether one believes government mandates were the driver, or if one assigns that role to Wall Street “greed.” It should therefore come as little surprise that Dodd–Frank devotes considerable attention to the mortgage market. Although the appropriate target is identified, Dodd–Frank’s reform in the area of mortgage finance falls far short of the mark.

TITLE IX SUBTITLE D: REGULATION OF CREDIT RISK RETENTION

One narrative behind Dodd–Frank is that the originators of mortgages lacked appropriate incentives because they could simply transfer the risk to other parties (ultimately, investors) via securitization. This narrative rests on the assumption that investors or others, such as issuers of securities, cannot monitor or discipline originators. Part of this narrative is that investors in mortgage-backed securities were “taken advantage of” by issuers or originators. A solution was found in requiring issuers to maintain “some skin in the game” so as to align incentives for proper underwriting along the entire mortgage production channel.

The required “skin in the game” is found in Section 941’s “Regulation of Credit Risk Retention,” which prohibits the issuance of any asset-backed security (ABS) under the Securities Exchange Act of 1934 unless the issuer retains “not less than 5 percent of the credit risk for any asset that is not a qualified residential mortgage,” or meets the definition of a qualified residential mortgage (QRM) that is determined by regulations issued jointly by the federal financial regulators, the Department of Housing

and Urban Development (HUD), and the Securities and Exchange Commission (SEC). Although Section 941’s risk-retention requirement applies to any ABS issued under the 1934 act, Dodd–Frank gives broad discretion to the SEC to make determinations for ABS that do not contain residential mortgages.

Unlike other classes of ABS, Section 941 establishes a number of statutory criteria to guide the regulatory QRM definition. These statutory requirements include documentation of the borrower’s financial resources, debt-to-income standards, mitigation of payment shock for adjustable-rate products, consideration of other credit enhancements, and the restriction of loan terms that have been demonstrated to exhibit a higher risk of borrower default. As Section 941 creates a new section—15G—to the 1934 act, it incorporates all of the anti-fraud provisions of Section 15, including the use of private rights of action.

Dodd–Frank exempts Federal Housing Administration (FHA), Veterans Administration, Rural Housing Service, and Farm Credit loans from the risk-retention requirements. Regulators have discretion to extend that exemption to loans that are securitized by the Federal National Mortgage

Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac). By definition, mortgages held in portfolio would be exempt from the QRM requirements.

The QRM possesses the potential to dramatically shape the characteristics of which loans may or may not be sold into the public secondary markets. Because the QRM is also an amendment to the 1934 act, mortgage-backed security (MBS) issues that are later determined to be non-QRM would subject the issuer to liability under SEC rule 10b-5. Given the subjectivity in some of the documentation requirements under QRM and potential rule 10b-5 liability, documentation and verification costs will increase, ultimately being passed along to investors and borrowers.

Subtitle D is premised upon the assumption that conflicts of interest dominate securitization. Rather than removing artificial incentives toward securitization, such as those found in bank capital regulations, Subtitle D mandates specific “solutions,” while also attaching increased liability to any violation of those solutions.

The False Premise of Risk Retention. On its face, required risk retention can sound attractive and almost common sense. That is, of course, if one ignores (or is ignorant of) how the MBS market functioned prior to Dodd–Frank.

Perhaps the biggest misperception is that there was no risk retention before. Why mandate that which is already being done, especially if it did not prevent a crisis? The vast majority of issues, however, did have some form of risk retention, usually in the form of an equity tranche retained by the issuer. Nor was this a secret. Investors had access to the size of the risk retention and priced accordingly. Researchers have found that, all else equal, higher risk retention (larger equity tranche) yielded a better price for the non-equity tranches.¹ The lower the rating of the security, the larger the effect.

Nor was the level of risk retention trivial. For subprime MBS, the average equity tranche in 2006 was 1.9 percent.² A number of pools had tranches over 7 percent. As a reminder: Equity tranches were in a first-loss position (called “horizontal” retention by regulators). If Section 941 required issuers to maintain a 5 percent first loss, that would be a significant increase for most issues. A vertical retention, where issuers retain 5 percent of each tranche, results in significantly less than a 5 percent first loss. In fact, it ends up being not far from 1.9 percent—the average prior to Dodd–Frank.

Issuers also retain considerable risk when they retain the servicing.³ Prior to Dodd–Frank, nearly 80 percent of servicing rights and responsibilities were maintained by the originator.⁴ Unfortunately, Dodd–Frank has actually undermined this relationship, resulting in a growing separation of origination and servicing.

Servicing was not the only other manner in which risk was retained. Issuers maintained a significant volume of MBS on their own balance sheets. A large number of mortgage-market participants failed because they retained “too much” risk, rather than “not enough.” The largest examples of such are Fannie Mae and Freddie Mac. Had Fannie and Freddie transferred all credit risk in their issues to investors, they would likely not have failed.

Sponsors of MBS could also protect investors and retain some residual risk by way of over-collateralizing the pools; that is, the balance of underlying mortgages would be greater than the face value of the issued security. Researchers have found that unsurprising sponsors traded off among these various methods of investor protection.⁵ Where deals displayed greater over-collateralization, the equity tranche was smaller. A likely consequence of Section 941’s risk-retention requirement is that sponsors will simply offset any increased risk retention with a reduction in other pool protections, such as over-collateralization.

Perhaps most damning to the narrative behind risk retention is that the overwhelming majority of private-label MBS (PLMBS) were held by “sophisticated” investors. Outside Fannie and Freddie (the largest single holders of PLMBS),⁶ most issues were held by institutional investors. Even the significant holdings of U.S. PLMBS held by European investors were held by financial entities.⁷ PLMBS were largely purchased by “qualified institutional investors” generally assumed under U.S. securities laws to be able to fend for themselves.⁸ There was very little, if any, defrauding of small-retail investors (like that in the Madoff scheme) in the PLMBS market. The “victims” were generally experts in the mortgage market with their own extensive research support. The most high-profile PLMBS case brought by the SEC involved the German bank IKB, which advertised itself as an expert in the ABS market.⁹ The problem, of course, is that these investors all seemed to believe that house prices could only go up.

While Section 941 applies to all ABS, not only MBS, Dodd–Frank does not raise or address the

question of why only the MBS market witnessed large declines in underwriting during the boom. Other property classes, such as office, apartment, and retail, witnessed similar price booms. Some of these booms peaked before that of the single-family-housing market. These other asset classes are also heavily securitized, as are auto and credit card loans. Yet there is little evidence that securitization in these markets behaved as poorly as those for residential mortgages. This suggests that the problem is not driven by securitization, per se, but by features particular to the residential mortgage market.

Risk retention was already common for subprime mortgage securities prior to Dodd–Frank. It was so widespread, in fact, that it impacted the pricing of securities. The QRM framework of Section 941 is unlikely to improve the quality of mortgages originated. Nor will it help avoid future financial rescues. If the goal is to reduce the likelihood of bailouts, policymakers should encourage a less concentrated financial sector. Risk retention will instead push toward a more concentrated sector. The only winners from the QRM will be the securities lawyers who sue the next time the housing market goes south. Ultimately, those increased litigation costs will be passed along to borrowers and investors.

Short of Repeal. If Congress decides to maintain some form of risk retention, significant changes to Subtitle D of Title IX will be needed. Since the primary goal of Subtitle D is investor protection, all its authorities should be vested solely with the SEC. Choosing to single out residential mortgages continues the special treatment of this asset class that has repeatedly contributed to financial crises. One can only imagine that the inclusion of HUD in the rulemaking was not to protect investors but to protect housing subsidies. Perhaps worse is the inclusion of the Federal Housing Finance Agency in the QRM rulemaking. Its incentive is to protect Fannie and Freddie—which is at odds with a competitive market for MBS.

In order to provide greater legal and investor certainty, as well as address the primary driver of mortgage default, risk retention should be limited to pools of mortgages where the borrowers are of subprime credit quality. While enshrining FICOs in statute would be misguided, aiming for a cutoff equivalent to a 660 FICO would be prudent. Currently, Section 941 offers regulators too much discretion to ignore the loan features that primarily drive default in favor of politically convenient targets.¹⁰ Scholars have found

that existing risk retention primarily appeared to impact pricing and deal structures for no-documentation or low-documentation mortgage pools.¹¹ If Section 941 is retained, considerable compliance and litigation cost can be saved, without much loss in impact, by limiting the definition of QRM to only those mortgages with full documentation.

Much of decline of underwriting standards in the PLMBS market were driven by the fact that the majority of ultimate investors were protected from market discipline. While Congress cannot prohibit foreign entities from investing in PLMBS, Congress can prohibit U.S. federally backed entities from doing so. Foremost among these would be Fannie Mae and Freddie Mac, although such a prohibition should also be extended to the Federal Home Loan Banks. Concentration limits for federally insured depositors would also be prudent. Instead of trying to protect these investors from themselves, a fool's errand when there are such strong incentives to take risk, reform should focus on subjecting these investors to greater market discipline. Doing so would cause their cost of funds to be related to their investment activities, better aligning those activities with overall financial stability.

It should also be recognized that bank capital standards incentivized the holding of PLMBS.¹² While Basel III does attempt to address this distortion, it does not go far enough in reducing the regulatory incentives for holding MBS. Ultimately replacing Basel's risk-weighted approach with a simple leverage ratio may be the best approach. Additionally, Fannie Mae and Freddie Mac received housing goal credit for their purchase of PLMBS. Short of eliminating the overall housing goals, a needed reform, Fannie Mae and Freddie Mac should not be allowed to satisfy those goals via the purchase of PLMBS.

Mandated Disclosure of Representations and Warranties. Subtitle D contains two new disclosure provisions: (1) Section 942 requires the SEC to develop disclosure standards for asset-backed securities, while also allowing the SEC to develop broad exemptions for these standards; and (2) Section 943 relates to the requirements in the offering details. Both place the SEC in the position of micro-managing which details investors find useful, and, of course, subjecting issuers to significant liability for any errors. To the degree that information is material to the performance of an ABS issue, such is already required for inclusion in any prospectus. Subtitle D takes the SEC further along the path of

deciding which specific information is material or not, something best left to the issuer.

Section 943 also imposes new requirements for credit-rating agencies in their rating reports on ABS.¹³ This new requirement would mandate that rating agencies include a description of the representations and warranties for the underlying mortgages, as well as a comparison of those with similar issuances. While such may well be important to the performance of the pool, what is relevant to the rating should ultimately be determined by the rating agency. Ratings are, after all, opinions, and should be treated as such. Section 943(2) misunderstands the failings of the current regulatory regime for ratings, and risks the further politicization of the ratings process. If Congress and the SEC can determine what information must be included in a rating, they could just as easily decide that certain factors, such as borrower credit quality, not be included. This is not only an issue of forced commercial speech, but risks undermining the integrity of the ratings process.

Both sections 942 and 943 should be repealed. They will add little useful information to what investors currently demand and receive, while greatly increasing the litigation risk associated with ABS. If the architects of Dodd–Frank believed these additional disclosures would be useful, one is left wondering why the largest issuers of ABS—Fannie Mae and Freddie Mac—remain exempt from their requirements.

The standardization requirements of Section 942 risk furthering the overreliance on mathematical modeling by financial regulators as well as by the credit-rating agencies. Mathematical models can, of course, be useful and informative in evaluating risk. It would be foolish to abandon them. It would be equally foolish to place the weight of one’s financial system on them.¹⁴ Section 942 continues along the path of homogeneity in disclosure and risk analysis. A more robust financial system would be one with greater diversity of both business models and portfolio holdings.¹⁵ Subtitle D runs the very real risk of reducing that diversity.

Conclusion. Dodd–Frank’s Subtitle D displays a profound misunderstanding, even an ignorance, of how modern ABS markets function, both before and during the crisis. While recognizing the potential for conflicts of interest and asymmetric information, Subtitle D takes no account of how market participants structured transactions to overcome such concerns. The evidence is fairly consistent that

such structures worked as intended. Of course, disruptions in the ABS market were an important characteristic of the crisis. Such, however, was primarily the result of the extreme leverage in the securitized mortgage market, which was largely the result of bank capital standards. Coupled with the insulation from market discipline of the largest investors in PLMBS, a crisis was certainly inevitable.¹⁶ Unfortunately Subtitle D does little to address the actual drivers of the crisis, while adding significantly to the cost of securitization activities.

TITLE XIV: MORTGAGE REFORM AND THE ANTI-PREDATORY LENDING ACT

Dodd–Frank attributes the increase in mortgage defaults associated with the financial crisis to “predatory lending,” as reflected in Title XIV, the Mortgage Reform and Anti-Predatory Lending Act. Despite the title, no definition of predatory lending is contained in Title XIV, which is a collection of prohibitions and restrictions. The major substantive provisions of Title XIV are structured as amendments to the Truth in Lending Act of 1968. Title XIV somewhat mirrors the anti-predatory lending statutes passed in North Carolina beginning in 1999.

Subtitle A. A theme of mortgage reform before Dodd–Frank was the focus on mortgage brokers versus lenders. Because of their rise from the ashes of the savings and loan crisis of the 1980s, mortgage brokers grew to be a significant share of mortgage originations. For a variety of reasons, including their lack of established reputation and focus on performance-based compensation, brokers were often assigned responsibility for poor underwriting decisions made in the years leading up to the crisis. Congress reacted to such concerns in 2008 by including the Secure and Fair Enforcement for Mortgage Licensing (SAFE) Act as Title V of the Housing and Economic Recovery Act of 2008.

Section 1401 expands the definition of mortgage originator and adds new requirements for persons falling under such definition. A mortgage originator under Section 1401 is a person

who, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain—(i) takes a residential mortgage loan application; (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or (iii) offers or negotiates terms of a residential mortgage loan.

Although the act contains exceptions to this definition, all mortgage brokers and many bank

employees (other than administrative and clerical) will be considered mortgage originators, and hence subject to both enforcement and litigation risk.

After a person is considered to be a mortgage originator, a variety of duties and restrictions apply, including the requirement to be qualified and licensed under the SAFE Act. Section 1403 prohibits the compensation of originators from varying based on the terms of the loans, rather than based on the principal amount. Originators may receive compensation from a party other than the borrower only in instances where the borrower pays nothing to the originator and pays no upfront fees or points. Originators can, however, continue to be compensated on the volume of loans closed. The intent of these restrictions is to limit the incentive of originators to place borrowers in higher-cost loans.

A recurring theme in title XIV is the assumption that many borrowers were simply in the wrong loan. Along this line of thinking, mortgage originators are prohibited from steering borrowers toward loans under which the borrower lacks a reasonable ability to pay or that have certain features (Section 1403). Originators are also prohibited from mischaracterizing either the credit history of the borrower or their loan options. The intent here reflects a belief that many prime borrowers were steered into subprime products. In general, originators placing borrowers into qualified mortgages (QM) will be protected from enforcement and liability.

Subtitles B and C. The heart of the QM standards are found in Section 1411's "ability to repay" requirements. Section 1411 prohibits lenders from making a residential mortgage unless the lender makes a good-faith determination that the borrower has a reasonable ability to repay the loan. Although Section 1411 does provide some guidance on what constitutes a good-faith determination and what is reasonable, most details are left to regulators. Due to concerns over the lack of clarity in the ability-to-repay standard, Section 1412 allows the creation of a safe harbor from liability if lenders meet the definition of a QM. It is in minimizing liability risk that lenders will attempt to meet the standards for a qualified mortgage.

Section 1412 also limits points and fees to no more than 3 percent of the loan amount. For adjustable-rate mortgages, Section 1412 requires loans to be underwritten at the maximum possible rate during the first five years of the loan. Loan terms may not exceed 30 years. Income and financial

resources must be fully documented. Title XIV also directs regulators to establish maximum debt-to-income ratios for QMs.

Because Title XIV amends the Truth in Lending Act, violations that fall outside its safe harbor subject lenders to significant liability. Delinquent borrowers can also use violations of the QM rule as a defense to foreclosure proceedings (Section 1413).

Section 1414 severely limits the use of prepayment penalties, prohibiting them for non-QM loans, and capping their amount and duration for QM loans. Despite the increased liability from Title XIV, or perhaps because of it, lenders are prohibited from requiring mandatory arbitration for all residential mortgages. Even if such did not increase liability costs, it is likely to increase the variance of liability costs. Section 1414 also requires lenders to make borrowers aware of their ability to "walk away" in anti-deficiency states. Section 1417 increases civil-money penalties under the Truth in Lending Act, of which QMs as well as the Home Ownership and Equity Protection Act are a part.

Subtitle D—Housing Counseling. Subtitle D of Title XIV creates a new Office of Housing Counseling at HUD. The office would provide grants, via appropriated funds, to HUD-certified counselors (Section 1444). Subtitle D also directs HUD to establish standards for material used by homeownership counseling providers. The Office of Housing Counseling will not be only focused on pre-purchase counseling, but also on foreclosure prevention and education.

Housing counseling, on its face, may seem at worst harmless, and at best, helpful in educating borrowers. Yes, as HUD itself has documented, housing counseling is often served as a vehicle to direct potential borrowers to industry representatives.¹⁷ Despite the substantial sums spent on counseling prior to the crisis, there is little evidence that such dissuaded potential borrowers from either obtaining a mortgage or purchasing a home.

When borrowers are not required to put much or any equity into a home purchase, and the loans are generally non-recourse, such borrowers will display increased defaults when prices decline. In fact, there is evidence that borrowers who had received counseling were more likely to engage in strategic default, ultimately increasing the level of foreclosures, rather than reducing it.¹⁸ Given this (at best) mixed record for housing counseling, Subtitle D should be repealed, along with the remainder of Title XIV.

Getting the Incentives Right. The reforms of Title XIV are driven by a belief that predatory lending drove the financial crisis. Objective empirical analysis, including by the U.S. Government Accountability Office¹⁹ and other evaluators,²⁰ demonstrates, however, that defaults were driven primarily by lack of borrower equity (often resulting from a lack of down payment) and low-borrower credit quality, combined with house price declines, and often a negative shock to income, such as that resulting from job loss.²¹ Title XIV does not address the most significant drivers of mortgage default. At best, they may reduce defaults by around 1 percentage point, but are just as likely to *increase* defaults.

Sections 1413 and 1414, for instance, make it easier for borrowers to avoid repayment, which would likely increase strategic defaults. The implicit assumption behind Title XIV is that all borrowers are victims, who would gladly pay their mortgage if only the lender would “work with them.” There is little doubt that lenders could and should do a better job at loss mitigation, but an extensive empirical and theoretical literature exists demonstrating that borrower incentives matter for loan performance.²² As Title XIV does not directly address the primary drivers of default and actually incentivizes increased default, it may well end up making the next housing downturn even worse.

Ultimately, poor underwriting on the part of lenders should be constrained by monitoring and discipline by mortgage investors. For that to work, however, those investors would have to be subject to market discipline themselves and be driven primarily by economic concerns, not political ones. Due to

the vast array of government mortgage guarantees, investors in the mortgage market are largely protected from loss—by the taxpayer. Even what appeared to be largely a private market for PLMBS was ultimately driven largely by government-backed funders. Given such perverse incentives, it is no wonder that underwriting quality has so dramatically declined in recent decades.²³ One could easily conclude that such is the actual objective of federal mortgage policy. If one truly wants to improve the performance of mortgages one will need to greatly reduce, if not eliminate, federal mortgage guarantees. At a minimum, lenders should bear a greater amount of first-loss risk on federally backed mortgages.

Conclusion. Dodd–Frank’s Title XIV institutes the most significant changes to the federal oversight of mortgages in at least 20 years. Many of the details, however, have been left up to financial regulators, with the Consumer Financial Protection Bureau playing a leading role. Although the QM rules and QRM rules will likely increase the cost of mortgage credit (particularly due to increased litigation, compliance, and foreclosure costs), their effects on reducing foreclosures during the next housing bust are likely to be modest and may even increase foreclosures. Despite the significant changes in Dodd–Frank to the mortgage market, those features of the U.S. mortgage market that are most relevant to the financial crisis, such as lack of market discipline, remain unaddressed and in many cases have been made worse.

Any views expressed here are those of the author, not necessarily of The Heritage Foundation.

ENDNOTES:

1. Taylor Begley and Amiyatosh Purnanandam, "Design of Financial Securities: Empirical Evidence from Private-Label RMBS Deals," University of Southern California *Working Paper*, 2013, http://www.usc.edu/schools/business/FBE/seminars/papers/F_11-1-13_PURNANANDAM.pdf (accessed February 24, 2016).
2. Cem Demiroglu and Christopher James, "The Dodd-Frank Act and the Regulation of Risk Retention in Mortgage-Backed Securities," in Paul H. Schultz, ed., *Perspectives on Dodd-Frank and Finance* (Cambridge, MA: MIT Press, 2014).
3. Cem Demiroglu and Christopher James, "How Important Is Having Skin in the Game? Originator-Sponsor Affiliation and Losses on Mortgage-Backed Securities," *Review of Financial Studies*, 2012.
4. *Ibid.*
5. *Ibid.*
6. Mark A. Calabria, "Fannie, Freddie, and the Subprime Mortgage Market," Cato Institute *Briefing Paper* No. 120, March 7, 2011, <http://www.cato.org/publications/briefing-paper/fannie-freddie-subprime-mortgage-market> (accessed February 24, 2015).
7. Mark A. Calabria, "EU Demand for US Subprime: The Case of Germany," Cato at Liberty, January 6, 2015, <http://www.cato.org/blog/eu-demand-us-subprime-case-germany> (accessed February 24, 2016).
8. Steven Schwarcz, "Protecting Investors in Securitization Transactions: Does Dodd-Frank Help, or Hurt?" *Louisiana Law Review*, Vol. 72 (2012), p. 593.
9. For overview of case and issue, see Seven Pillars Institute, "Goldman Sachs and the ABACUS Deal," <http://sevenpillarsinstitute.org/case-studies/goldman-sachs-and-the-abacus-deal> (accessed February 24, 2016).
10. Mark A. Calabria, "Mortgage Reform Under the Dodd-Frank Act," in Paul H. Schultz, ed., *Perspectives on Dodd-Frank and Finance* (Cambridge, MA: MIT Press, 2014), pp. 183-200.
11. Demiroglu and James, "How Important Is Having Skin in the Game?"
12. Kevin Dowd, "Capital Inadequacies: The Dismal Failure of the Basel Regime of Bank Capital Regulation," Cato Institute *Policy Analysis* No. 681, July 29, 2011, <http://www.cato.org/publications/policy-analysis/capital-inadequacies-dismal-failure-basel-regime-bank-capital-regulation> (accessed February 24, 2016).
13. Emily Ekins and Mark A. Calabria, "Regulation, Market Structure, and Role of the Credit Rating Agencies," Cato Institute *Policy Analysis* No. 704, August 1, 2012, <http://www.cato.org/publications/policy-analysis/regulation-market-structure-role-credit-rating-agencies> (accessed February 24, 2016).
14. Kevin Down, "Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve," Cato Institute *Policy Analysis* No. 754, September 3, 2014, <http://www.cato.org/publications/policy-analysis/math-gone-mad> (accessed February 24, 2016).
15. Mark A. Calabria, "A Call for Model Modesty in Banking and Insurance," Cato Institute *Commentary*, April 21, 2015, <http://www.cato.org/publications/commentary/call-model-modesty-banking-insurance> (accessed February 24, 2015).
16. Mark A. Calabria, "The Role of Mortgage Finance in Financial (In)Stability," in Eric S. Belsky, Christopher E. Herbert, and Jennifer H. Molinsky, eds., *Homeownership Built to Last: Balancing Access, Affordability, and Risk After the Housing Crisis* (Washington, DC: Brookings Institution Press, 2014), pp. 372-394.
17. See generally, Mark Calabria, "Financial Literacy: Empowering Americans to Prevent the Next Financial Crisis," Cato Institute, testimony before the Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Committee on Homeland Security and Governmental Affairs, U.S. Senate, April 30, 2012, <http://www.cato.org/publications/congressional-testimony/financial-literacy-empowering-americans-prevent-next-financial-crisis> (accessed February 24, 2016).
18. Valentina Hartarska and Claudio Gonzales-Vega, "Credit Counseling and Mortgage Termination by Low-Income Households," *Journal of Real Estate Economics and Finance*, Vol. 30 (2005).
19. U.S. Government Accountability Office, "Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources," Congressional Research Service *Report to Congress*, GAO-10-805, 2010.
20. See, for instance, Bajari, Patrick, Sean Chu, and Minjung Park, "An Empirical Model of Subprime Mortgage Default from 2000 to 2007," Federal Reserve Board of Governors *Working Paper*, 2010.
21. Calabria, "Mortgage Reform Under the Dodd-Frank Act."
22. See, for instance, Juan Carlos Hatchondo, Leonardo Martinez, and Juan Sanchez, "Mortgage Defaults," Federal Reserve Bank of St. Louis *Working Paper* No. 2011-019A, 2011; Kartik Athreya, Xuan Tam, and Eric Young, "Are Harsh Penalties for Default Really Better?" Federal Reserve Bank of Richmond *Working Paper* No. 09-11, 2009; and Kristopher Gerardi, Lauren Lambie-Hanson, and Paul S. Willen, "Do Borrower Rights Improve Borrower Outcomes? Evidence from the Foreclosure Process," Federal Reserve Bank of Boston *Public Policy Discussion Paper* No. 11-9, 2011.
23. Peter Elmer and Steven Seelig, "The Rising Long-Term Trend of Single-Family Mortgage Foreclosure Rates," FDIC *Working Paper* No. 98-2, 1998.

CHAPTER 15

How Title XV Mandated Disclosures Harm, Rather than Protect, Investors

David R. Burton

Title XV of the Dodd-Frank Wall Street Reform and Consumer Protection Act¹ contains three provisions requiring public companies to report in their disclosure documents with respect to conflict minerals, mine safety, and resource extraction. In addition, Dodd-Frank Title IX Section 953(b) requires disclosure of the ratio between a company's CEO pay and the median pay of all other employees. The primary purpose of these requirements is to further political objectives. They are unrelated to the purpose of the securities laws and the mission of the Securities and Exchange Commission (SEC).

SEVERING DISCLOSURE FROM VALUATION IS A BAD IDEA

The SEC defines its mission as “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”² The statutory charge to the SEC is:

Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.³

The politically motivated requirements in Title XV distract, or in the case of the proposals for new disclosure requirements would distract, the SEC from its mission. Moreover, the requirements do nothing to further the securities laws' purpose of protecting shareholders or providing them with information that is material to their investment decisions. Shareholders, when presented with an

opportunity to vote on whether to require such disclosure, have usually voted not to do so.⁴

These requirements impose unwarranted costs on issuers that reduce the return on shareholder investments.⁵ The SEC estimates that the conflict minerals, mine safety, resource extraction, and CEO pay-ratio requirements combined will have initial compliance costs of approximately \$5 billion, and ongoing costs of \$1.5 billion annually. (See the discussion of each rule below for more detailed information about costs and citations.) Furthermore, by adding to already voluminous disclosure requirements, they tend to make it more difficult for investors to find material information in disclosure documents. By obfuscating rather than informing, these requirements can be expected to actually harm investors.⁶

Once the connection between SEC-mandated disclosure and investment valuation is severed, the potential disclosure requirements that may be imposed on public corporations are virtually limitless. These mandates increase costs and harm the ability of companies to innovate, grow, and create jobs. They reduce the return to investors. They therefore harm rather than protect investors.

THE PURPOSE OF SECURITIES DISCLOSURE LAWS

The primary purpose of securities law is to deter and punish fraud.⁷ Fraud is the misrepresentation of material facts or the misleading omission of material facts for the purpose of inducing another to act, or to refrain from action, in reliance upon the misrepresentation or omission. The second purpose of securities laws is to foster disclosure by firms that sell securities to investors of material facts about the company needed to make informed investment decisions.⁸ Appropriate mandatory disclosure requirements can promote capital formation, the efficient allocation of capital and the maintenance of a robust, public, and liquid secondary market for securities.⁹ The reasons for this include (1) that the issuer is in the best position to accurately and cost-effectively produce information about the issuer;¹⁰ (2) that information disclosure promotes better allocation of scarce capital resources or has other positive externalities;¹¹ (3) that the cost of capital may decline because investors will demand a lower risk premium;¹² (4) that disclosure makes it easier for shareholders to monitor management;¹³ and (5) that disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.¹⁴

The conflict minerals, mine safety, resource extraction, and CEO pay-ratio disclosure requirements do nothing to further any aspect of the SEC mission or the underlying purpose of the securities laws. They neither protect investors from fraud nor improve investors' ability to value their investments. They neither facilitate capital formation, nor fair, orderly, and efficient markets. And the proposed political spending and gender-pay-ratio disclosure requirements share these defects. All of these provisions, however, increase firms' costs and reduce shareholder returns and make it more difficult for investors to find the information in disclosure documents that is material to their investment decisions. They harm rather than protect shareholders.

CONFLICT MINERALS FROM THE DEMOCRATIC REPUBLIC OF THE CONGO

In compliance with Dodd–Frank Section 1502, the 93-page SEC final conflict-minerals rule¹⁵ requires any issuer for which conflict minerals¹⁶ are necessary to the functionality or production of a product manufactured, or contracted to be manufactured, by that issuer to disclose in the body of its annual report whether its conflict minerals originated

in the Democratic Republic of the Congo (DRC) or an adjoining country. If so, that issuer is required to furnish a separate report as an exhibit to its annual report that includes a description of the measures taken by the issuer to exercise due diligence on the source and chain of custody of its conflict minerals. These due diligence measures would include an independent private-sector audit of the issuer's report conducted in accordance with standards established by the Comptroller General of the United States. There are additional requirements. In its economic analysis in the final rule, the SEC estimated that the initial cost of compliance with the conflict minerals rule “is between approximately \$3 billion to \$4 billion, while the annual cost of ongoing compliance will be between \$207 million and \$609 million.”¹⁷

On April 14, 2014, the United States Court of Appeals for the District of Columbia Circuit issued a decision in *National Association of Manufacturers v. SEC* finding that provisions in the rule violated the First Amendment to the extent they required a company to state that its products have not been found to be DRC conflict-free.¹⁸ Accordingly, the rule has been partially stayed by the SEC.¹⁹ In general, however, companies remain subject to the conflict-minerals disclosure regime.²⁰ The case was reheard and the decision was reaffirmed on August 18, 2015. On February 22, 2016, the Supreme Court granted the SEC's request for an extension of time to file a petition for a *writ of certiorari* to April 7, 2016.²¹

There is strong reason to doubt whether the provision is even helping to achieve its policy objective. The Government Accountability Office (GAO) found that “[c]ompany filings indicate companies exercised due diligence but most were unable to determine whether or not conflict minerals used came from covered countries, or whether they financed or benefited armed groups.”²² Furthermore, a recent empirical analysis found that “[i]nstead of reducing violence, the evidence here indicates the policies increased the incidents in which armed groups looted civilians and committed violence against them.”²³ This is because Dodd–Frank created an incentive for armed groups to find alternative sources of revenue. They moved away from conflict minerals to unregulated sources of mineral revenue or to violent looting of civilians.

MINING SAFETY

In compliance with Dodd–Frank Section 1503, the 25-page SEC final mining safety rule²⁴ requires

issuers that are operators of a mine to disclose information regarding specified health and safety violations, orders, citations, legal actions, and mining-related fatalities. Much of this information must be reported in a different format to the Mine Safety and Health Administration. The SEC estimates that approximately 100 companies will be affected and that compliance with the rule will involve 5,775 hours of company personnel time and approximately \$1.1 million for the services of outside professionals.²⁵ Valuing the internal hours at a conservative \$100 per hour (fully burdened), that would amount to \$577,500 cost for internal personnel time for a total cost of approximately \$1.7 million annually or \$17,000 per issuer.

RESOURCE EXTRACTION

In compliance with Dodd–Frank Section 1504, the 55-page SEC final resource-extraction rule²⁶ requires resource-extraction issuers to disclose information relating to any payment made by the issuer to a foreign government (including companies owned by a foreign government) or the U.S. federal government for the purpose of the commercial development of oil, natural gas, or minerals. This information must disclose all payments including taxes, royalties, fees, production entitlements, bonuses, and other payments. In its economic analysis in the final rule, the SEC estimated that the ongoing compliance costs of the rule would be in the range of \$173 million to \$385 million annually.²⁷

CEO PAY-RATIO DISCLOSURE

In compliance with Title IX Section 953(b), the 85-page SEC final CEO pay-ratio disclosure rule²⁸ requires disclosure of the median of the annual total compensation for all employees of a company (excluding the CEO but including all foreign employees); the annual total compensation for the company’s CEO; and the ratio of the median of the annual total compensation for all employees to the annual total compensation for the CEO. The rule exempts smaller reporting companies, emerging growth companies, and some other issuers from the requirements. The SEC estimates that 3,571 companies will be subject to the rule, that the total initial cost of compliance for all 3,571 registrants affected by the rule will be approximately \$1.3 billion, and that ongoing compliance costs will be approximately \$526 million per year.²⁹

EFFORTS TO INCREASE POLITICALLY MOTIVATED DISCLOSURE REQUIREMENTS

The Dodd–Frank provisions are part of a continuing trend of using the securities laws to mandate disclosures that are not material to assessing the expected return from investing in a company (that is, its valuation) to further political objectives. For example, there is a major effort underway to pressure the SEC into issuing a rule requiring disclosure of corporate “political spending.”³⁰ The campaign promoting this rulemaking has generated over one million comments to the SEC.³¹ The information disclosed in compliance with this rule would not be used by investors to assess the value of their investments, but by activists to pressure corporation management with respect to political issues. Issuance of such a rule has been temporarily barred by Congress.³²

Legislation has also been introduced in Congress to require both disclosure and a shareholder vote before public corporations can make political expenditures, including independent expenditures, or give money to a trade association for certain purposes. Spending made in contravention of the rules set forth in the legislation would give rise to joint and several liability by a corporation’s officers and directors equal to treble the amount of the amount spent.³³ The requirements would not apply to private corporations, labor unions, or tax-exempt organizations. There is also a recent petition that asks the SEC to require public companies to disclose “gender pay ratios.”³⁴

CONCLUSION

The politically motivated conflict minerals, mine safety, resource extraction, and CEO pay-ratio disclosure requirements in Dodd–Frank harm rather than protect investors, and reduce firms’ ability to innovate, grow, and create jobs. They should be repealed.

This chapter was originally published as a Heritage Foundation Issue Brief—“How Dodd–Frank Mandated Disclosures Harm, Rather than Protect, Investors”—on March 10, 2016.

ENDNOTES:

1. Public Law 111-203, July 21, 2010.
2. U.S. Securities and Exchange Commission, "About: What We Do—Introduction," <http://www.sec.gov/about/whatwedo.shtml> (accessed March 4, 2016).
3. See §3(f) of the Securities Exchange Act of 1934 and §2(b) of the Securities Act of 1933.
4. The Conference Board, "Corporate Political Spending: Shareholder Activity," <https://www.conference-board.org/politicalspending/index.cfm?id=6256> (accessed March 4, 2016), and As you Sow, "Proxy Preview," 2014, <http://www.asyousow.org/wp-content/uploads/2014/03/ProxyPreview2014.pdf?width=100> (accessed March 4, 2016).
5. For example, the U.S. Chamber of Commerce estimates, based on survey data, that the CEO pay-disclosure-rule compliance costs \$711 million annually, substantially more than the SEC estimate. See Ike Brannon, "The Egregious Costs of the SEC's Pay-Ratio Disclosure Rule," May 2014, <http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Egregious-Cost-of-Pay-Ratio-5.14.pdf> (accessed March 4, 2016). The SEC estimated that the initial cost of compliance with the conflict-minerals rule "is between approximately \$3 billion to \$4 billion, while the annual cost of ongoing compliance will be between \$207 million and \$609 million." See "Conflict Minerals," Final Rule, *Federal Register*, Vol. 77, No. 177, September 12, 2012, p. 56351, <https://www.gpo.gov/fdsys/pkg/FR-2012-09-12/pdf/2012-21153.pdf> (accessed March 4, 2016).
6. Troy A. Paredes, "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation," *Washington University Law Quarterly*, Vol. 81 (2003), pp. 417–485, and Commissioner Troy A. Paredes, "Remarks at The SEC Speaks in 2013," Securities and Exchange Commission, February 22, 2013, http://www.sec.gov/News/Speech/Detail/Speech/1365171492408#_Ut2WJbROmM8 (accessed March 4, 2016). See also Keith F. Higgins, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting," Securities and Exchange Commission, April 11, 2014, <https://www.sec.gov/News/Speech/Detail/Speech/1370541479332> (accessed March 4, 2016), and Ernst & Young, "Now Is the Time to Address Disclosure Overload," *To the Point* No. 2012-18, June 21, 2012 [http://www.ey.com/Publication/vwLUAssets/ToThePoint_BB2367_DisclosureOverload_21June2012/\\$FILE/ToThePoint_BB2367_DisclosureOverload_21June2012.pdf](http://www.ey.com/Publication/vwLUAssets/ToThePoint_BB2367_DisclosureOverload_21June2012/$FILE/ToThePoint_BB2367_DisclosureOverload_21June2012.pdf) (accessed March 4, 2016).
7. A transaction induced by fraud (misrepresentation) is not voluntary or welfare-enhancing, in that it would not be entered into in the absence of the fraud (or would be entered into at a different price). This principle has been recognized at common law since time immemorial and is recognized by virtually all political theorists. Securities fraud was illegal long before New Deal securities laws or blue sky laws were enacted. Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690–1860* (Cambridge University Press, 2002). See also Frank H. Easterbrook and Daniel R. Fischel, "Mandatory Disclosure and the Protection of Investors," *Virginia Law Review*, Vol. 70 (1984), p. 669; Gordon Walker, "Securities Regulation, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy," *Hong Kong Law Journal*, Vol. 36, No. 3 (2006); and Paul G. Mahoney, *Wasting a Crisis: Why Securities Regulation Fails* (Chicago: University Of Chicago Press, 2015).
8. For a general introduction, see Richard A. Posner, "Financial Markets," in *Economic Analysis of the Law*, 9th ed. (Wolters Kluwer Law & Business, 2014), and Joel Seligman, "The Corporate Disclosure Debate," in *The SEC and the Future of Finance* (Prager: 1985).
9. Robert A. Prentice, "The Economic Value of Securities Regulation," *Cardozo Law Review*, Vol. 28, No. 1 (2006), pp. 333–389; Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review*, Vol. 48 (2001), pp. 781–855; and Luca Enriques and Sergio Gilotta, "Disclosure and Financial Market Regulation," Social Science Research Network, April 11, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423768 (accessed March 4, 2016).
10. Marcel Kahan, "Securities Laws and the Social Cost of "Inaccurate" Stock Prices," *Duke Law Journal*, Vol. 41, No. 5, (1992), pp. 977–1044; John C. Coffee Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System," *Virginia Law Review*, Vol. 70 (1984), pp. 717–753; and Joel Seligman, "The Historical Need for a Mandatory Corporate Disclosure System," *Journal of Corporation Law*, Vol. 9, No. 1 (1983), p. 1.
11. Jeffrey Wurgler, "Financial Markets and the Allocation of Capital," *Journal of Financial Economics*, Vol. 58, No. 187 (2000); R. David Mclean, Tianyu Zhang, and Mengxin Zhao, "Why Does the Law Matter? Investor Protection and its Effects on Investment, Finance, and Growth," *The Journal of Finance*, Vol. 67, No. 1, pp. 313–350 (2012); Ronald A. Dye, "Mandatory Versus Voluntary Disclosures: The Cases of Financial and Real Externalities," *The Accounting Review*, Vol. 65, No. 1 (1990), pp. 1–24; Brian J. Bushee and Christian Leuz, "Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board," *Journal of Accounting and Economics*, Vol. 39, No. 2 (2005), pp. 233–264; Joseph A. Franco, "Why Antifraud Provisions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure," *Columbia Business Law Review*, Vol. 2002, No. 2, pp. 223–362; Paul M. Healy and Krishna G. Palepu, "Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature," *Journal of Accounting and Economics*, Vol. 31 (2001), pp. 405–440; and Anat R. Admati and Paul C. Pfleiderer, "Forcing Firms to Talk: Financial Disclosure Regulation and Externalities," *The Review of Financial Studies*, Vol. 13, No. 3 (Fall 200), pp. 479–519 https://faculty-gsb.stanford.edu/admati/documents/Forcingfirmstotalk_research.pdf (accessed March 4, 2016).
12. Christine A. Botosan, "Evidence that Greater Disclosure Lowers the Cost of Equity Capital," *Journal of Applied Corporate Finance*, Vol. 12, No. 4 (2000), pp. 60–69, and Charles P. Himmelberg, R. Glenn Hubbard, and Inessa Love, "Investor Protection, Ownership, and the Cost of Capital," Social Science Research Network, April 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303969 (accessed March 4, 2016).

13. The interests of shareholders and management are often not coincident and may conflict to a considerable degree. This is often described as the agent-principal problem, or collective-action problem, and is significant in larger firms where ownership and management of the firm are separate. Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3, No. 4 (1976); Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems," *University of Chicago Law Review*, Vol. 62, No. 3 (1995), pp. 1047-1112; and Merritt B. Fox, "Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment," *Virginia Law Review*, Vol. 85, No. 7 (1999), pp. 1335-1419.
14. Requiring certain written affirmative representations in public disclosure documents deters fraud because proving fraud becomes easier if the public, written representations are later found by a trier of fact to be inconsistent with the facts.
15. "Conflict Minerals," Final Rule, *Federal Register*, pp. 56274-56365. See also Securities and Exchange Commission, "Dodd-Frank Wall Street Reform and Consumer Protection Act Frequently Asked Questions: Conflict Minerals," <https://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm> (accessed March 4, 2016).
16. The term conflict mineral means:
 - (i) Columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives, which are limited to tantalum, tin, and tungsten, unless the Secretary of State determines that additional derivatives are financing conflict in the Democratic Republic of the Congo or an adjoining country; or
 - (ii) Any other mineral or its derivatives determined by the Secretary of State to be financing conflict in the Democratic Republic of the Congo or an adjoining country.

SEC, "Form SD, Specialized Disclosure Report," Section 1 Conflict Minerals Disclosure, Item 1.01 Conflict Minerals Disclosure and Report, section (d)(3), <https://www.sec.gov/about/forms/formsd.pdf> (accessed March 4, 2016).
17. "Conflict Minerals," Final Rule, *Federal Register*, p. 56351.
18. For a procedural history and links to case documents, see U.S. Chamber of Commerce, *NAM, Chamber of Commerce, and BRT v. U.S. Securities and Exchange Commission (SEC)*, <http://www.chamberlitigation.com/nam-chamber-commerce-and-brt-v-us-securities-and-exchange-commission-sec> (accessed March 4, 2016).
19. Securities Exchange Act of 1934, Order Issuing Stay, May 2, 2014, <https://www.sec.gov/rules/other/2014/34-72079.pdf> (accessed March 4, 2016).
20. Keith F. Higgins, "Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule," Securities and Exchange Commission, April 29, 2014, <https://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370541681994> (accessed March 4, 2016).
21. *Securities and Exchange Commission v. National Association of Manufacturers et al.*, docketed January 29, 2016, <http://www.supremecourt.gov/search.aspx?filename=/docketfiles/15a792.htm> (accessed March 4, 2016).
22. Government Accountability Office, "SEC Conflict Minerals Rule: Initial Disclosures Indicate Most Companies Were Unable to Determine the Source of Their Conflict Minerals," GAO-15-561, August 2015, p. 24, <http://www.gao.gov/assets/680/672051.pdf> (accessed March 4, 2016).
23. Dominic P. Parker and Bryan Vadheim, "Resource Cursed or Policy Cursed? U.S. Regulation of Conflict Minerals and the Rise of Violence in the Congo," University of Wisconsin, November 24, 2015, p. 31, <http://aae.wisc.edu/dparker5/papers/DRCCConflictWP2015.pdf> (accessed March 4, 2016).
24. "Mine Safety Disclosure," Final Rule, *Federal Register*, Vol. 76, No. 249, December 28, 2011, pp. 81762-81785, <https://www.gpo.gov/fdsys/pkg/FR-2011-12-28/pdf/2011-33148.pdf> (accessed March 4, 2016).
25. *Ibid.*, p. 81778.
26. "Disclosure of Payments by Resource Extraction Issuers," Final Rule, *Federal Register*, Vol. 77, No. 177, September 12, 2012, pp. 56365-56419, <https://www.gpo.gov/fdsys/pkg/FR-2012-09-12/pdf/2012-21155.pdf> (accessed March 4, 2016). See also Securities and Exchange Commission, "Dodd-Frank Wall Street Reform and Consumer Protection Act Frequently Asked Questions: Disclosure of Payments by Resource Extraction Issuers," May 30, 2013, <https://www.sec.gov/divisions/corpfin/guidance/resourceextraction-faq.htm> (accessed March 4, 2016).
27. "Disclosure of Payments by Resource Extraction Issuers," Final Rule, *Federal Register*, pp. 56410-56411.
28. "Pay Ratio Disclosure," Final Rule, *Federal Register*, Vol. 80, No. 159, August 18, 2015, pp. 50104-50187, <https://www.gpo.gov/fdsys/pkg/FR-2015-08-18/pdf/2015-19600.pdf> (accessed March 4, 2016).
29. *Ibid.*, p. 50161.
30. Dave Michaels, "Democrats Pressure SEC to Force Disclosure of Political Spending," Bloomberg, August 31, 2015, <http://www.bloomberg.com/politics/articles/2015-08-31/democrats-pressure-sec-to-force-disclosure-of-political-spending> (accessed March 4, 2016), and Congressional letter to SEC Chair Mary Jo White, December 22, 2015, signed by 94 Senators and Representatives, <http://www.menendez.senate.gov/imo/media/doc/Letter%20to%20SEC%20on%20omnibus%20provision%202015-12-22%20FINAL1.pdf> (accessed March 4, 2016).

31. “Petition for Rulemaking on Disclosure by Public Companies of Corporate Resources Used for Political Activities,” File No. 4-637-2, April 15, 2014, <https://www.sec.gov/rules/petitions/2014/petn4-637-2.pdf> (accessed March 4, 2016); and Securities and Exchange Commission, “Comments on Rulemaking Petition: Petition to Require Public Companies to Disclose to Shareholders the Use of Corporate Resources for Political Activities,” File No. 4-637, <https://www.sec.gov/comments/4-637/4-637.shtml> (accessed March 4, 2016).
32. Consolidated Appropriations Act, 2016, Public Law No: 114-113, December 18, 2015, Section 707, Title VII, Division O. (“None of the funds made available by any division of this Act shall be used by the Securities and Exchange Commission to finalize, issue, or implement any rule, regulation, or order regarding the disclosure of political contributions, contributions to tax exempt organizations, or dues paid to trade associations.”) This act governs spending through the end of FY 2016, which ends September 30, 2016.
33. The Shareholder Protection Act of 2015, S. 214, H. R. 446, 114th Congress.
34. “Request for rulemaking to require public companies to disclose gender pay ratios on an annual basis, or in the alternative, to provide guidance to companies regarding voluntary reporting on pay equity to their investors,” submitted by PAX Ellevest Management LLC, File No.4-696, February 1, 2016, <https://www.sec.gov/rules/petitions/2016/petn4-696.pdf> (accessed March 4, 2016).



Founded in 1973, The Heritage Foundation is a research and educational institution—a think tank—whose mission is to formulate and promote conservative public policies based on the principles of free enterprise, limited government, individual freedom, traditional American values, and a strong national defense.

We believe the principles and ideas of the American Founding are worth conserving and renewing. As policy entrepreneurs, we believe the most effective solutions are consistent with those ideas and principles. Our vision is to build an America where freedom, opportunity, prosperity, and civil society flourish.

Heritage’s staff pursues this mission by performing timely, accurate research on key policy issues and effectively marketing these findings to our primary audiences: members of Congress, key congressional staff members, policymakers in the executive branch, the nation’s news media, and the academic and policy communities.

Governed by an independent Board of Trustees, The Heritage Foundation is an independent, tax-exempt institution. Heritage relies on the private financial support of the general public—individuals, foundations, and corporations—for its income, and accepts no government funds and performs no contract work. Heritage is one of the nation’s largest public policy research organizations. Hundreds of thousands of individual members make it one of the most broadly supported think tanks in America.

For more information, or to support our work, please contact The Heritage Foundation at (800) 544-4843 or visit heritage.org.



214 Massachusetts Avenue, NE
Washington, DC 20002
(800) 546-2843 | heritage.org