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The Dodd-Frank Act:
Goals and Progress

The too-big-to-fail debate has taken some strange turns over the course of the past several months.

Some are arguing that the Dodd-Frank Act (Dodd-Frank), signed in to law in 2010, will not do what it claims, and others are trying to divine from credit rating agencies what the law will or won't be able to do. For all the back and forth, the implementation of the law is still in process, and the truth of the debate will only be settled when the law is put into action.

In the meantime, lost in much of the debate is what the law actually says and why the different pieces were written. There are many criticisms of Dodd-Frank on both sides, but it is worth revisiting the main components of the law as policy-makers continue to debate the issue. The law addressed many issues, but a main goal was solving the problem of too-big-to-fail in the banking sector.

The Goals of Dodd-Frank for Solving Too-Big-to-Fail

Dodd-Frank had three main policy objectives for solving too-big-to-fail coming out of the financial crisis (See Dudley 2012):

1. Reduce the likelihood of an individual firm's failure.
2. Lower a failure's cost to the broader economy.
3. Reduce the spread of financial contagion in the event of a future crisis.

What follows is an outline of each policy objective, and the ways Dodd-Frank works to achieve these objectives based on recent lessons from the financial crisis. This is not intended to be a comprehensive outline of the entire reform bill, and as has been noted, implementation of these reforms remains a work in progress.

The Dodd-Frank Act's goals are to:

1. Reduce the likelihood of an individual firm's failure.

2. Lower a failure's cost to the broader economy.

3. Reduce the spread of financial contagion in the event of a future crisis.

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Policy Objective #1: Reduce The Likelihood Of An Individual Firm's Failure

Capital levels

Dodd-Frank requires banks to hold more and higher quality capital. This was done by converging with Basel III international standards to set minimum levels for risk-weighted capital, liquidity, and leverage (FRB 2012).

Since the crisis, banks of all sizes have increased regulatory capital, while the 18 largest firms have more than doubled their aggregate Tier 1 Common Equity Ratio from 5.6 percent as of the fourth quarter of 2008 to 11.3 percent as of 2012 year-end. In dollar terms, that translates to a net increase of nearly $400 billion, for a group total of nearly $800 billion as of year-end (Bernanke 2013).

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Furthermore, Basel capital standards require capital surcharges for the largest firms based on their perceived systemic risk. The exact amount of the surcharge will range from one to 2.5 percent, depending on size, complexity, and interconnectedness. The minimum amount of capital plus the conservation buffer amounts to 10.5 percent, and according to a study by financial regulatory law firm Davis Polk, additional countercyclical and systemic-related buffers could see it increase further (Davis Polk 2013).

Supervision and annual stress tests

The Fed instituted stress tests in the depths of the crisis to provide transparency and increase confidence in the markets (Bernanke 2009). Dodd-Frank continued this process by requiring banks to undergo annual capital planning and analysis through stress tests. Recently, the Fed completed its third annual stress test, in which a large majority of participants was determined to have sufficient capital (Bernanke 2013).

While the stress tests do not prevent firms from failing, they provide the market the necessary information to know which firms are healthy or not. Therefore, stress tests promote healthy market behavior based on increased transparency rather than herd mentality and speculation.

Agency restructuring and oversight

Dodd-Frank restructured federal agencies and facilitated the monitoring of the financial system as whole rather than individual pieces. Congress eliminated the Office of Thrift Supervision (OTC) and merged its duties within the Federal

Reserve, Office of the Comptroller of Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), giving the Fed a majority of regulatory powers over the largest firms. In addition, Congress created both the Consumer Financial Protection Bureau (CFPB) within the Fed and the Financial Stability Oversight Council (FSOC) within the Treasury.

FSOC compromises a board of 10 voting members, which are the various regulatory heads of all the major agencies. FSOC, along with the Fed, are responsible for identifying and monitoring non-bank financial firms deemed systemically risky, along with general risks to the financial system. If it's determined that a firm poses a "grave threat" to financial stability, FSOC and the Fed can require a firm to limit mergers, restrict sales of products, terminate activities, and sell or otherwise transfer assets.

The Volcker Rule

Dodd-Frank instituted a ban on proprietary trading through the Volcker Rule, though exceptions and timing are still debated (Patterson 2013). Paul Volcker's rationale for the rule stemmed from the fact that commercial banks receive federal insurance for deposits and have access to the Fed's discount window. Advocates argue it's unfair for deposit insurance to act as insurance for other "speculative" activities (Volcker 2010).

Dodd-Frank required banks to sell off, shut down, or restructure their proprietary trading desks. For example, although there's no decision on when the rule will become law, several of the largest institutions have already downsized units or exited them completely after Dodd-Frank was signed in to law (FSOC 2011).

Policy Objective #2: Lower A Failure's Cost To Society

Living Wills

Dodd-Frank ended bailouts in the text of the law. Section 214 of Dodd-Frank clearly states, "Taxpayers shall bear no losses from liquidating any financial company under this title and any losses shall be the responsibility of the financial sector, recovered through assessments."

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But the key to ending bailouts is not outlawing them; it is having a plausible alternative. Dodd Frank tries to address this by providing regulators with new mechanisms to wind-down a failing firm.

The law requires large banks to submit comprehensive liquidation plans, known as Living Wills, to both the Federal Reserve and FDIC for resolvability under bankruptcy (Title 1). If these plans are determined

inadequate or not credible, institutions must resubmit. If the resubmitted plans are rejected, regulators reserve the power to place restrictions on capital, leverage, liquidity, and general business activities.

Like many parts of Dodd-Frank, this is a work in process, especially on cross-border coordination. However, Moody's recently announced their plan to update the credit ratings of large banks to adjust for a greater likelihood that the government will let banks fail (Mead 2013).

FDIC Orderly Liquidation Authority

Bankruptcy using Living Wills as a "glide path" is the preferred method for resolving institutions. However, Dodd-Frank also created a backstop for more extreme scenarios. This more technical process is known as FDIC Orderly Liquidation Authority (OLA or Title II). OLA adopts a "single point of entry" approach, whereby regulators takeover a holding company or top-tier parent and create a bridge company. Shareholders of the parent are wiped-out and creditors take losses up to the point necessary to fund the subsidiaries and bridge company. This re-capitalization process will recur for as long as needed. According to Dodd-Frank, if public funds are necessary, they "shall be the responsibility of the financial sector, through assessments."

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In effect, OLA is best compared to a bail-in of shareholders and creditors. While it is very similar to Chapter 11 bankruptcy, its speed of resolution and effectiveness in stabilizing markets make it a superior method in times of crises (Powell 2013).

Policy Objective #3: Reduce The Spread Of Financial Contagion In The Event Of A Future Crisis

Reform in the wholesale funding markets

Dodd-Frank is reforming the "shadow banking" sector after realizing liquidity problems during the crisis. This applies to things like overnight loans and money market mutual funds that provide short term lending to large businesses.

Reform of shadow banking is happening in two ways. First, FSOC is now in charge of nominating and monitoring non-bank financial firms that have greater than $50 billion in assets, better known as Systemically Important Financial Institutions (SIFIs). If in existence today, troubled broker-dealers such as Lehman Brothers, Bear Stearns, and the mortgage-brokerage houses such as New Century Mortgage and

Countrywide would face greater regulatory scrutiny and potentially be forced to hold higher capital (Tarullo 2011).

Second, FSOC is also in charge of monitoring systemically risky financial activities, not just the individual firms. Late last year, FSOC recommended heightened standards for money market mutual fund regulatory reform under the powers of the SEC (FSOC 2012).

Still, there's more work on the way. Eric Rosengren of the Federal Reserve Bank of Boston recently stated that additional reform in the area of liquidity was necessary to complete the objectives of Dodd-Frank, and expected it to take place in the future (Rosengren (2013) and Tarullo (2013)).

Reform of the derivatives market

A major component of the crisis was lack of transparency around derivatives contracts. Dodd-Frank transformed the derivatives market by changing how the instruments are traded.

As of March, the $639 trillion over-the-counter (OTC) derivatives market began its largest transformation in its 30-year history (Fernholtz 2013). As a part of rulemaking, swaps are now required to go through central counterparties (CCPs), thereby reducing the aggregate amount of risk between dealers. Essentially, CCPs standardize derivative trades by bolstering market infrastructure that seeks to protect participants themselves. It also requires financial institutions to post daily collateral for their positions (Dudley 2012).

Conclusion

Some critics of too-big-to-fail (and let's be clear, it has no defenders) talk about the issue as if Dodd-Frank never happened, the plan for a future crisis hasn't changed since 2008, and we'll revert to more bailouts. In reality, that is the least likely outcome.

If the last crisis taught Congress anything, it taught that voting for bailouts is not popular. The likelihood that a blank check will be forthcoming from Congress to save banks (large or small) is approximately zero.

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And in the absence of a bailout, regulators are going to turn to the tools they have at their disposal, the tools of Dodd Frank. If a large systemically important institution were to fail, we are much more likely to see it carved up under OLA than saved.

Admittedly, we're still far from the completion of the largest regulatory overhaul of the financial system since Great Depression. But as regulators work through Dodd-Frank, it doesn't make sense to pretend like it doesn't exist.

About Hamilton Place Strategies

Hamilton Place Strategies is a policy, advocacy, and communications consulting firm based in Washington. As a firm, our focus and expertise lie at the intersection of government, business and media. This report was prepared independently and its conclusions are our own. HPS' clients include large financial institutions affected by the legislation discussed in this report.

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