DOOMED TO REPEAT

Debunking the Conservative Story About the Financial Crisis and Dodd-Frank

REPORT BY **MIKE KONCZAL, ANDREW HWANG, AND KATY MILANI**
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Executive Summary

In response to the 2007-08 Financial Crisis that cost the United States more than $20 trillion, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010 with the aim of overhauling the dysfunctional regulatory regime. In the years since, the wide-reaching reforms mandated by Dodd-Frank have provided key protections to consumers and stability to the banking system. Thanks to such reforms, banks and the US capital markets have emerged from the Financial Crisis more resilient than before and regulators are now better equipped to respond to future crises and regulatory challenges.

Yet, according to conservative narrative, there is simply no need for financial reform. The Trump Administration and conservatives in Congress have actively pursued ways to unravel Dodd-Frank based on an account of the Financial Crisis that differs drastically from the conventional wisdom. The conservative worldview is shaped by a series of arguments generated by conservative think tanks, media, political action groups, and industry lobbyists. This paper provides a broad outline of their arguments and how they differ from what has actually happened.

In taking on the conservative worldview, this report directly addresses misconceptions on the following topics:

- **The origins of the Financial Crisis: The Financial Crisis was real, and Wall Street caused it.** Conservatives argue that the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, and government affordable housing goals were at fault for the Financial Crisis. Studies show no connection between government affordability goals and the subprime mortgage crisis. Furthermore, the GSEs' market share of mortgage origination fell from 50 percent to 30 percent from 2002 to 2005, and their losses were lower than those of deposit banks and private-label mortgage securities.
- **Replacing Fragmented Consumer Protection: Creating the Consumer Financial Protection Bureau.** Conservatives argue the CFPB is unaccountable and enjoys an unlimited budget and unique structure. The Bureau has the same structure and accountability mechanisms as the Office of Comptroller Currency and other independent regulatory agencies. The Bureau's budget is hardcoded as a percent of the Federal Reserve's budget.

- **Setting Industry Standards: Mortgage Lending Reform.** Conservatives argue standardizing mortgage products through the Ability-to-Repay and Qualified Mortgage (QM) rules limits consumer choice. This argument mischaracterizes the problem. Poor underwriting and predatory product features needed to be tackled to prevent predatory mortgage lending and protect the financial well being of consumers.

- **Making Exemptions for Community Banks: A Tiered Regulatory Approach.** Conservatives argue that community banks are subjected to the same regulations as large banks and high compliance costs, which is leading to massive market consolidation. Community banking is stronger than ever. In 2016, community banks' net income increased 11.8 percent from the previous year, to $5.6 billion, despite the supposed burden of increased compliance costs.

- **Returning to Banking: the Volcker Rule.** Conservatives argue the Volcker Rule reduces banks' market-making abilities and hence negatively impacts liquidity, increasing compliance costs. However, recent studies find there has not been a noticeable change in liquidity from pre-Crisis periods and the rule is having the intended effects on Wall Street.

- **Ending Government Bailouts: The Orderly Liquidation Authority.** Conservatives argue that OLA allows financial institutions to be bailed out by the government and the bankruptcy process is better suited to handle failing banks. Bankruptcy is a blunt and slow process, and it is unsuitable for the fast paced nature of financial crises. OLA ensures banks can fail through the 'living will' process, which puts in place the necessary planning in the event of a crisis.

- **Bringing Transparency to Shadow Banking: A New Approach to Derivatives Trading.** Conservatives argue the centralized clearing requirement makes clearing houses systemically risky and puts in place high "barriers to entry" for new market entrants. However, the centralized clearing mandate actually reduces systemic risk by bringing transparency to these transactions, and the regulatory agencies have flexibility to respond to any unforeseen challenges that may threaten the soundness of the US financial system.

This paper demonstrates that the Dodd-Frank Act is comprised of a series of reforms designed to tackle the immediate problems exposed by the Financial Crisis. It is imperative that policymakers protect the progress made through Dodd-Frank, and push for further reforms to tackle emerging issues and newly concentrated risk in the financial system. Future reform should build on Dodd-Frank, rather than repeal it based on ideological narratives that try to rewrite history.

Introduction

With costs estimated at more than $20 trillion, the 2007–08 Financial Crisis dealt a devastating blow to the United States economy (Epstein 2016). In response to a financial crash of unprecedented severity since the Great Depression, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (referred to below interchangeably as "Dodd-Frank," "DFA," or "the Act") on July 21, 2010, with the aim of overhauling the dysfunctional regulatory regime. In the years since, the wide-reaching reforms mandated by Dodd-Frank have provided key protections to consumers and stability to the banking system. Thanks to such reforms, banks and the US capital markets have emerged from the Financial Crisis more resilient than before and regulators are now better equipped to respond to future crises and regulatory challenges.

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Laws, regulations, and institutions shape the way financial markets function and ensure the finance sector is a productive intermediary to promote real economic growth. Dodd-Frank made important strides in tackling the structural problems in the financial sector that surfaced during the Crisis. Significant progress was made to reduce systemic banking risk and end Too-Big-to-Fail through enhanced macroprudential regulations. There is a process for winding down failing financial institutions so that doing so does not disrupt the market, and derivatives are now traded in the open on public exchanges. Bets placed by major financial institutions that were once kept off the balance sheets have been put back on the books, restoring greater transparency and ensuring that banks are sufficiently capitalized to handle risk. Consumers have a dedicated cop on the beat with the establishment of the Consumer Financial Protection Bureau (CFPB) to protect them from predatory practices in the financial markets.

Conservatives have a different story of what happened in the Crisis compared to the conventional wisdom. In the conservative story there is simply no need for reform. Thus the Trump Administration and conservatives in Congress are actively pursuing ways to unravel Dodd-Frank. There are three paths to achieve this—through executive orders, regulatory inaction, and legislation. In the first path, the administration can cripple financial reform through executive action, as evidenced by Executive Order No. 13772, which calls for a review of the financial regulations put in place through Dodd-Frank. Unless combined with other executive actions or a legislative push, the impact is expected to be limited. Second, the administration can weaken Dodd-Frank through regulatory inaction. This means that the president's appointed regulators can, and likely will, choose not to enforce rules put in place through Dodd-Frank. Congress can render Dodd-Frank ineffective by continuing to underfund the agencies tasked with executing and enforcing financial regulation through the budget process. Lastly, the Republicans in the House of Representatives are pushing for a direct repeal of Dodd-Frank by throwing their weight behind the CHOICE Act, which would repeal most of Dodd-Frank. However, passing legislation appears unlikely, given the need for a non-trivial level of support from Senate Democrats.

Any effort to dismantle Dodd-Frank is premised upon the same set of ideological and economic arguments. For instance, it is impossible to understand why the CHOICE Act has the structure it has unless you understand the underlying conservative economic arguments about what has happened in the financial sector. The conservative worldview is shaped by a series of arguments generated by conservative think tanks, media, political action groups, and industry lobbying. This paper provides a broad outline of their arguments and how they differ from what has happened. Foundational to these arguments, however, is the fictional account of the cause of the Financial Crisis concocted by conservatives. Therefore, before we address the specific conservative critiques, it is imperative that we set the record straight on the origins of the Financial Crisis.

ORIGINS OF THE CRISIS: THE FINANCIAL CRISIS WAS REAL, AND WALL STREET CAUSED IT

Conservatives have created a story about the Financial Crisis that asserts that the market panic in 2008 posed no problems to the economy, and that the large number of bad mortgages was created through affirmative government policy rather than the financial markets. It is worth comparing the conventional narrative with their story to show how the former does a better job of explaining what actually happened.

In the conventional account, the housing bubble grew alongside growing demand and supply for mortgage-backed securities. Subprime mortgages became the fuel for these securities, and mortgage originators sought out loans as aggressively as they could in order to keep the securities going. This was done outside the traditional commercial, FDIC-insured banking system designed to hold mortgages. Instead, new institutions, including affiliates of traditional banks, filled this gap using access to capital markets rather than the traditional deposit base. Over time, credit default swaps were used to insure these mortgage-backed securities, and these securities themselves were bundled into another layer of securities called collateralized debt obligations (CDOs). Many instruments were purposely designed to fail, created by people who had taken out insurance—basically bets—on the instrument failing.

Collateralized Debt Obligations (CDOs): CDOs are financial products that "pool" fixed income assets, such as home mortgages, and slices them into pieces, called "tranches," that are each assigned a different payment priority and interest rate and carry different risk profiles. That is, loans that are considered to have the same likelihood of default are pooled together and available for investors who can decide what level of risk they are willing to take on.

Financial regulators played a role in allowing this system to grow. This occurred through both action and inaction. Some regulators, such as the Office of the Comptroller of the Currency (OCC), overruled state-level actions against mortgage fraud through a process called preemption. Other regulators, such as the Federal Reserve, simply refused to enforce or investigate the problems as they grew.

> ***Many players in the financial system point to others to avert blame. Yet the entire chain of transactions and market players participated in the failure.***

Many players in the financial system point to others to avert blame. Yet the entire chain of transactions and market players participated in the failure. Examine the case of Lehman Brothers: Lehman Brothers, an investment bank, played a direct role in the mortgage lending market. During the US housing boom in the 2000s, Lehman acquired five mortgage lenders, including the subprime lender BNC Mortgage, which lent to homeowners with poor credit, and Aurora Loan Services, which specialized in a type of home loan (known as Alt-A) that did not require full documentation.

These subsidiaries issued consumer loans secured by mortgages. The mortgages were then turned into mortgage-backed securities through the securitization process, and were ultimately bought, sold, and traded by investment banks such as Lehman Brothers. Due to pervasive fraud and predatory lending activities in the 2000s, the CFPB now regulates retail mortgage lenders such as Lehman's subsidiaries. But prior to the crisis, they were largely unregulated. At that time, the Securities and Exchange Commission (SEC) was charged with regulating global investment banks, including Lehman Brothers, under the Consolidated

Securitization: Securitization is a process that allows traditional banks to transform and move illiquid assets, such as mortgages and other consumer loans, off their balance sheets. These assets are pooled in a security that is sold to investors. Investors who buy the security earn interest from the incoming debt payments of the underlying loan, mortgage, or credit card payment. This process allows banks to receive cash in exchange for selling the security to investors. With this liquidity, banks can issue more loans to consumers, which can effectively stimulate economic growth.

Supervised Entities (CSE) program. However, industry participation in this program was voluntary, and the mandate lacked the necessary teeth. Former SEC Chair Mary Schapiro testified in 2010, "The program lacked sufficient resources and staffing, was under-managed, and at least in certain respects lacked a clear vision as to its scope and mandate."

SHADOW BANKING ENTITIES AND SERVICES

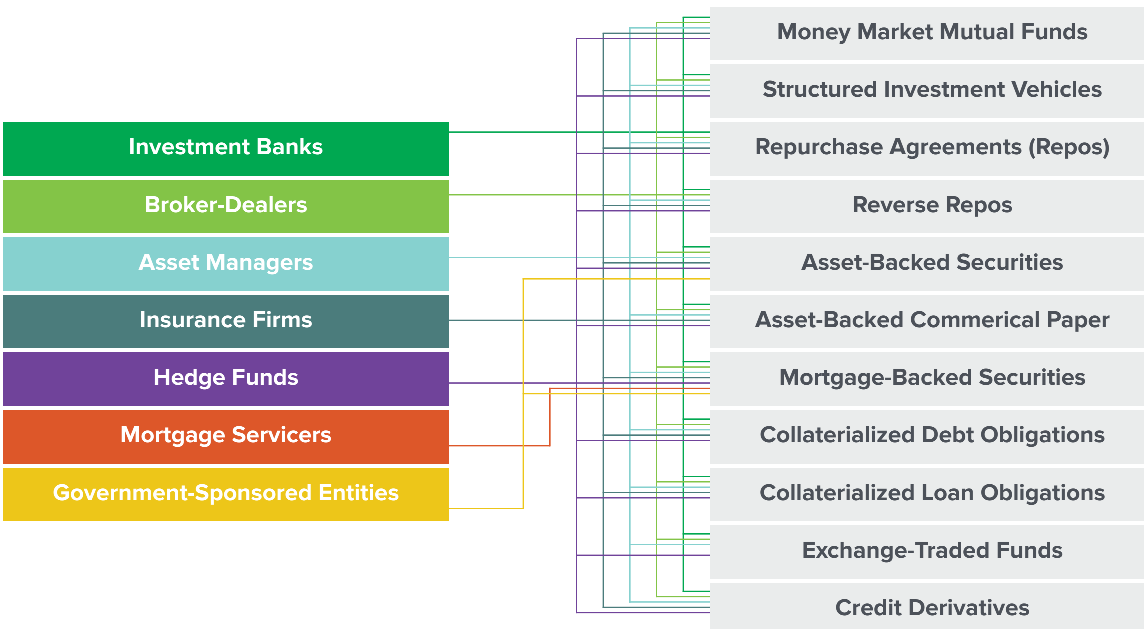

FIGURE 1 Note: This is not an exhaustive list, but is intended to demonstrate the extent of these activities. Chartered banks and bank holding companies also conduct shadow banking activities; however, they are closely regulated entities.

Lehman was a major player in the mortgage market, specifically through its role in underwriting and securitizing these financial assets—which is to say, repackaging assets such as mortgages into products for investors. In 2007, Lehman issued, and had on its balance sheet, more mortgage-backed securities than any other firm. As housing prices fell, the value of the securities backed by failing mortgages eroded. With these depreciated securities on Lehman's books—along with other assets that fell in tandem with mortgage-backed securities—the firm's value quickly plummeted, making it insolvent. As in any banking panic, the shock in mortgage-backed securities spread to other asset classes, such as securities backed by corporate debt. The failures occurred up and down the chain of the financial sector (Abernathy 2016).

INTERBANK LENDING SPREADS

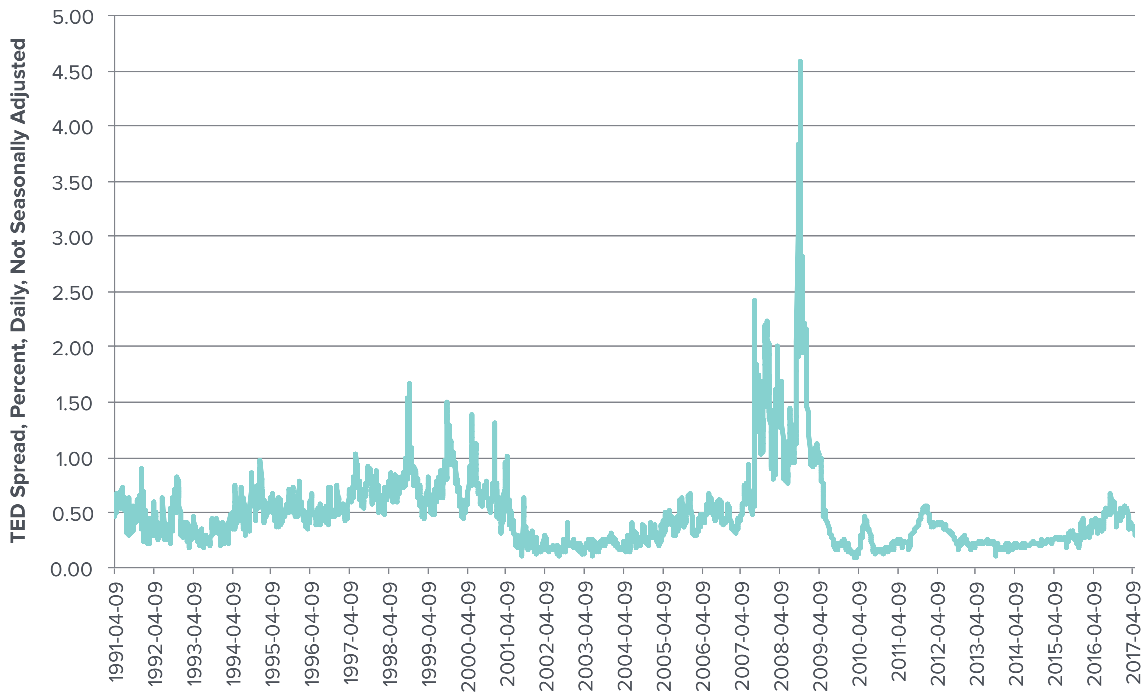

FIGURE 2 *Source: Federal Reserve Bank of St. Louis (https://fred.stlouisfed.org)*

All these instruments started to fail, with large defaults and poor recoveries. Starting in 2007, there was a slow-motion panic in the financial sector, with interbank lending spreads increasing. As earlier loans began to go bad, it became increasingly clear that there wasn't enough capital in the system to cushion the disruption. Finance had relied too heavily on short-term lending, and this began to set up a major crisis. The failure of Bear Stearns in early 2008 caused an immediate panic that was subsumed by the bailouts and emergency mergers executed by the Federal Reserve. Yet the panic, as measured in lending spreads, continued to build across that summer. You can also see this concern growing in the increasing repurchase agreement (repo) haircut rates. This was also seen in loan spreads between banks (see Figure 2), which represent the amount of worry and concern that lenders have about their ability to be repaid.

Haircut Requirement for Repos: Typically, in a repurchase agreement, the total amount deposited from the lender will be some amount less than the value of the asset used as collateral. The difference is called a "haircut." For example, if an asset has a market value of $100 and a bank sells it for $80 to another financial institution, say a hedge fund, with an agreement to repurchase it for $88, the repo rate is 10 percent and the haircut is 20 percent. If the bank defaults on its promise to repurchase the asset, the investor keeps the collateral.

However, with the failure of Lehman Brothers in September 2008, the slow-motion crisis exploded. The Money Market Mutual Fund (MMF) Reserve Fund "broke the buck," causing people invested in it to race to take out their money. This led to panics in funds without any exposure to Lehman Brothers. When Lehman declared bankruptcy on September 15, 2008, the MMF Reserve Primary Fund held 1.2 percent of the fund's total $62.4 billion assets in Lehman. That morning, the fund had $10.8 billion in redemption requests. State Street, the custodial bank, stopped an existing overdraft facility previously designed to help meet those requests within hours. Investors requested an additional $29 billion throughout the rest of that day and the next.

After the Primary Fund "broke the buck," MMFs with no known Lehman exposure experienced runs. This interconnectedness and contagious panic spread rapidly across MMFs. Within a week, investors in prime MMFs withdrew $349 billion, and with that sum they headed for funds invested in Treasuries. Those funds had to turn people away. This panic, in turn, dramatically increased the costs of short-term borrowing, which disrupted payments and companies dependent on commercial paper markets (Financial Crisis Inquiry Commission 2011).

> ***Finance became more profitable: between 1980 and 2006, GDP quintupled while financial profits grew 16 times larger. Even though the sector grew larger and more profitable, it did not become more efficient.***

This happened against a 30-year background in which the financial sector grew rapidly. Though services were increasing generally, the financial services sector's rate of growth doubled after 1980. It became more profitable: between 1980 and 2006, GDP quintupled while financial profits grew 16 times larger (Abernathy 2015). However, though the sector grew larger and more profitable, it grew no more efficient. The income of the financial industry divided by the quantity of intermediated financial assets, a unit cost of finance, is just as high now as it was in 1900. If anything, there have been efficiency losses since the 1970s (Phillipon 2012). These changes grow alongside a dramatic increase in the complexity and leverage of the financial sector as a whole.

There are many elements of the housing bubble and the financial crisis that are debated among academics and experts. Why were so many complex financial assets created during this time? Some argue that it was a sense of irrational exuberance on the part of society as a whole when it came to housing prices. This interpretation is difficult to square with the evidence that the price of mortgage debt and risk fell while the quantity expanded, consistent with an increase in supply rather than demand (Levitin 2011).

There is also extensive debate about why Wall Street increased the supply of mortgage-backed securities. Some argue that there was a safe-asset shortage (Caballero 2006); others look to a "global savings glut" driving down interest rates and pushing up asset prices (Bernanke 2005). Still others contend that Wall Street's expansion of the supply through changing business practices and willingness to weaken underwriting standards played a part. The role of weakened and subprime lending standards is also debated (Mian 2015). But the academic debate nonetheless takes place within the framework of the foregoing conventional account of the Financial Crisis.

Addressing Conservative Criticism

The GSEs and Government Housing Affordability Goals Are to Blame. *Conservatives argue the GSEs, Fannie Mae and Freddie Mac, and government affordable housing goals were at fault for the Financial Crisis.*

Conservatives argue that mortgages backed and securitized by the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac caused the crisis. Furthermore, government affordability goals, most notably the Community Reinvestment Act (CRA), drove Wall Street and banks to make and securitize mortgages that went bad. Therefore, there was also no crisis according to this telling. The panic following Lehman Brothers was simply the result of the government showing favoritism by bailing out Bear Stearns while allowing Lehman Brothers to fail (Wallison 2011).

The problems in financial markets were a Wall Street creation through private-label securitization and the financial engineering that went with it, something that grew outside of the GSEs. The GSEs' market share actually fell from about 50 percent to just under 30 percent of all mortgage originations during the peak bubble years from 2002 to 2005. The losses at the GSEs from 2006 to 2012 were only about 2.7 percent, compared to 5.8 percent at deposit banks and, crucially, 20.3 percent for private-label mortgage securities (Zandi 2013).

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The Federal Reserve Board found "no connection between CRA and the subprime mortgage problems." A subsequent Federal Reserve study found "lender tests indicate that areas disproportionately served by lenders covered by the CRA experienced lower delinquency rates and less risky lending" (Avery 2015). Per the Minneapolis Fed: "The available evidence seems to run counter to the contention that the CRA contributed in any substantive way to the current mortgage crisis," which were echoed by the Richmond Federal Reserve (Bhutta 2009 and Haltom 2010).

The St. Louis Federal Reserve posed a question: "Did Affordable Housing Legislation Contribute to the Subprime Securities Boom?" And the data offered a clear-cut answer: "No....We find no evidence that lenders increased subprime originations or altered pricing around the discrete eligibility cutoffs for the Government Sponsored Enterprises' (GSEs) affordable housing goals or the Community Reinvestment Act" (Ghent 2015).

Conservative arguments diverge on what exactly the GSEs were meant to do. Usually, they state that the GSEs made subprime or subprime-like mortgages directly. But at other times conservatives argue that the GSEs' purchasing of private-label securities provided an important customer for Wall Street, one that drove down standards for the market as a whole. However, the data do not bear this out. The GSEs never bought more than 15 percent of that market. Importantly, it didn't impact their affordability goals, so the practice was driven more by catch-up to market players than by moves to act as a leader. The GSEs also bought the most senior slices and avoided the CDOs where losses were concentrated, as we see from the aggregate loss numbers mentioned above (Fiderer 2015).

The conservative narrative simply has no basis in reality. It would be easier if it did, as it would mean that there was no need for reform. However, that is not the reality we are dealing with.

The counter narrative presented here extends beyond the origins of the crisis. The rest of this paper challenges the conservative worldview concerning financial reform and directly addresses its misconceptions. We do this in two sections. The first section demonstrates how Dodd-Frank protects Main Street and consumer interests. The second section outlines how Dodd-Frank has reined in the accumulation of systemic risk in the financial sector and has laid out a road map to tackle "Too-Big-to-Fail," making our financial system more resilient.

SECTION ONE

How Dodd-Frank Protects Main Street and Consumer Interests

The Financial Crisis demonstrated the need to overhaul financial regulation, especially pertaining to consumer financial protection and the safeguarding of Main Street interests. Wall Street speculation in the home mortgage market, one that is closely associated with the welfare of everyday Americans, was left unchecked. When it all came tumbling down, American families, not the big banks, were left carrying the costs. Therefore, it should be of little surprise that central to Dodd-Frank are reforms that directly address consumers.

Dodd-Frank clarifies who within the federal government is to champion consumer interests in financial markets by consolidating oversight within a single consumer agency. In response to what was previously a diffuse network of consumer protection mandates disseminated among a variety of agencies with, in some cases, conflicting missions, Dodd-Frank created a dedicated consumer protection agency: the Consumer Financial Protection Bureau. We will show how the agency directly addresses the failure of the previous regulatory regime. Conservatives argue that the new agency is uniquely unaccountable compared to other financial regulators. However, the CFPB not only has the same structure as its regulatory counterparts, but the agency's mandate places additional levels of accountability beyond those pertaining to its peers.

Dodd-Frank sets out how financial institutions should interact with consumers. Given the damage dealt by Wall Street to the home mortgage market and the resulting destruction of US family wealth, unfair or abusive lending practices landed squarely within Dodd-Frank's sights. New regulations make clear that banks are obligated to perform sound mortgage underwriting and must bear the costs for shoddy practices. While conservatives argue such regulations reduce access to credit, they instead provide a reliable framework for families to access credit they can afford.

Finally, Dodd-Frank seeks to limit the unintended impact that regulation may pose to everyday Americans by tailoring regulatory requirements to better accommodate the smaller financial institutions that interface the most with everyday Americans and are most critical to real economic activities. In other words, Dodd-Frank is designed to scale, so that the regulatory scrutiny falls on the riskiest and largest financial institutions. Yet community banks continue to lobby against Dodd-Frank. They make three major claims against the Act: it is a one-size-fits-all approach that subjects community banks to the same regulations as large banks; it creates burdensome and high compliance costs, making community banks unprofitable; and the reform has led to market concentration and a rapid decline of the industry. When we look at the facts, these claims from industry are unfounded.

1.1 REPLACING FRAGMENTED CONSUMER PROTECTION: CREATING THE CONSUMER FINANCIAL PROTECTION BUREAU

A key piece of consumer financial protection reform under Dodd-Frank is the establishment of the Consumer Financial Protection Bureau (CFPB or the Bureau). Conservatives view the new agency as an unnecessary expansion of government that will only make consumers worse off. They view the agency as not only unaccountable, but an historic overreach. Rep. Jeb Hensarling (R-TX), chairman of the House Financial Services Committee, for instance, called the CFPB the "most powerful and least accountable" agency in American history, which mirrors statements from Republicans over the past six years.

What Went Wrong During the Financial Crisis and How Dodd-Frank Addressed It

When conservatives attack the CFPB, it is important to understand why the push for the Bureau was so important in the wake of the Financial Crisis. One of the central failures of financial regulation in the lead-up to the crisis was that of consumer financial protection. Rampant abuses in financial products exposed several systemic failures of the way the regulatory system was structured. There were three structural flaws in the system of consumer financial protection.

> ***With the mission housed in 10 different agencies, no single body had direct responsibility over it, and consumers were left with no place to turn to when facing a confusing or deceptive financial product.***

Consumer protection was, in the words of Georgetown law professor Adam Levitin, an "orphan mission." It was the responsibility of 10 different agencies: Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Association (NCUA), Federal Reserve Board, Federal Deposit Insurance

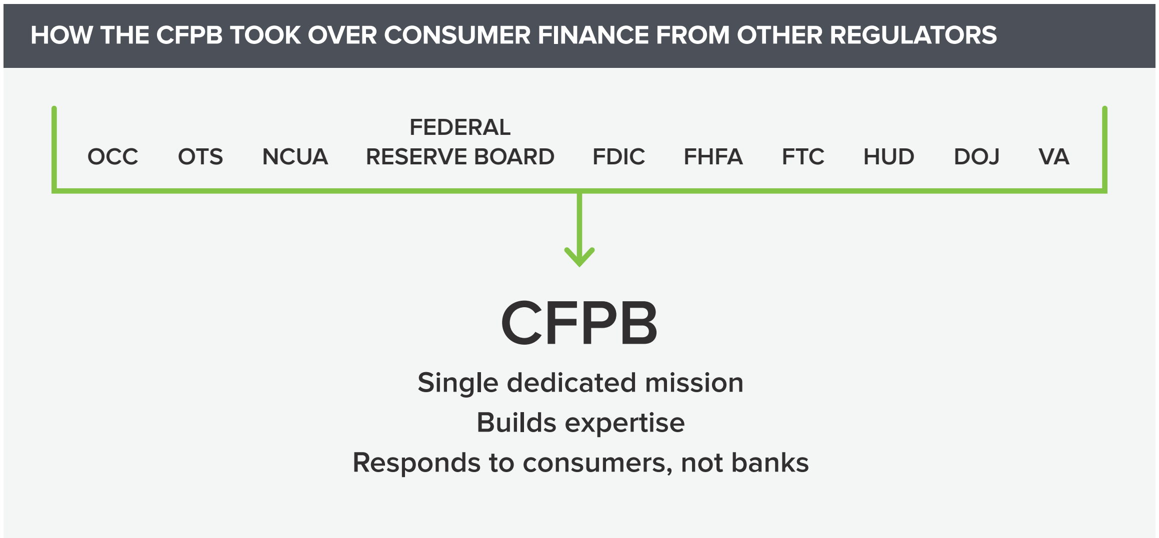

FIGURE 3 *Source: Konczal 2015.*

Corporation (FDIC), Federal Housing Finance Agency (FHFA), Department of Housing and Urban Development (HUD), Department of Veterans Affairs (VA), Federal Trade Commission (FTC), and Department of Justice (DOJ) (see Figure 3). With the mission housed in 10 different agencies, no single body had direct responsibility over it, and consumers were left with no place to turn to when facing a confusing or deceptive financial product.

Moreover, consumer protection was not the primary responsibility of these agencies, and was thus subordinated to other institutional priorities. As a result, there was no incentive to build consumer-focused expertise among the professional staff, and little reason to build a process to address consumers and their problems directly (Levitin 2013).

> ***For regulators who wanted to keep banks solvent, profitability overrode other concerns, like consumer protection.***

Not only was consumer protection not a priority, it was consistently subordinated to the safety and soundness of the financial system. For regulators who wanted to keep banks solvent, profitability overrode other concerns, like consumer protection. Fraud and deceptive practices are, at least in the short term, profitable activities, ones that can increase the solvency of banks. There was an inherent tension between these two missions, and consumer protection typically was not the priority (Bar-Gill 2008). As Heidi Mandanis Schooner noted before the crisis, “The Federal Reserve’s...regulatory role remains focused on safety and soundness and not on other goals of financial regulation, such as consumer protection" (Schooner 2002). At times, agencies like the OCC actively impeded states that tried to protect families from predatory mortgages, siding with the institutions that they were responsible for overseeing. The shared consumer protection mission across various agencies led to a regulatory race to the bottom, resulting in lax regulation and pushing consumer financial products to least-regulated entities (Engel 2016).

That the CFPB is an answer to the problems listed above is clear from the markets in which it has been able to provide transparency and accountability. The CFPB has had major enforcement actions in for-profit higher education, debt servicing for mortgages and student loans, and consumer credit reporting markets. Its rule-writing process has brought clarity and stricter enforcement to prepaid cards and other financial products.

Addressing Conservative Criticism

The CFPB Is Uniquely Unaccountable. *Conservatives argue that the CFPB is structured to avoid accountability and uniquely designed in comparison to its peer agencies.*

The CFPB is structured exactly like the OCC, and is designed to counter-balance the OCC's mandate to protect bank safety and soundness with an agency dedicated to protecting consumers. Like the OCC, the Bureau has a single director, a dedicated funding stream, and a clear mission. A Senate Report on the Dodd-Frank Act found that the CFPB's policies and "provisions are modeled on similar statutes governing the Office of the Comptroller." The OCC and other regulators put bank profitability over safeguards for consumers in the lead-up to the crisis, and the CFPB, by being a dedicated defender and protector of consumers with a similar level of powers, rectifies that. Other independent agencies—e.g., the Social Security Administration and the Federal Housing Finance Agency—are also structured with a single director whose term lasts longer than four years for similar reasons.

The CFPB Has No Additional Accountability and Enjoys an Unlimited Budget. *Conservatives argue the CFPB's budget is uniquely unaccountable to Congress.*

The CFPB has a number of interlocking accountability measures. Like all other regulators, the Bureau is subject to the rulemaking procedure mandated by the Administrative Procedure Act (APA), but unlike other agencies, the CFPB's regulations can be vetoed by a collection of regulators. The CFPB has an annual Government Accountability Office (GAO) audit, and the director must testify semiannually before Congress. The CFPB's budget is hardcoded as a percent of the Federal Reserve's budget, whereas other banking regulators, such as the OCC and FDIC, can increase their assessments to raise additional revenues as needed for their jobs. As Congressional Research Services (CRS) notes, “The statutory caps on the funds that may be transferred to the CFPB give the Bureau less flexibility than the OCC, FDIC, and other banking regulators that are able to increase assessments on the institutions within their jurisdiction to raise revenue, as needed to carry out their responsibilities” (Carpenter 2012).

1.2 SETTING INDUSTRY STANDARDS: MORTGAGE LENDING REFORM

Wall Street’s craze for mortgage-backed securities came ultimately at the expense of the American family. Despite the devastating impact on the average American and Dodd-Frank’s attempt to solve this, conservatives consistently claim the mortgage lending reforms mandated in Dodd-Frank restrict access to credit and limit the customizability of mortgage products to meet consumer demands. As noted in the introduction, those making such arguments often downplay the role that predatory lending played in the Financial Crisis and instead assign the blame to GSEs. Yet despite being contradicted by market data, conservatives have pushed a false narrative that mortgage reform under Dodd-Frank constitutes an overcorrection.

> ***Despite being contradicted by market data, conservatives have pushed a false narrative that mortgage reform under Dodd-Frank constitutes an overcorrection.***

What has been overlooked under the conservative narrative is the fact that prior to Dodd-Frank and the creation of the CFPB, the mortgage lending market was largely unregulated. Consumer financial protection and regulatory oversight of the mortgage lending market was previously scattered among various agencies that often had conflicting missions. Lacking this oversight, lenders engaged in the most extreme form of “race to the bottom,” which ultimately crippled the US economy in 2008.

What Went Wrong During the Financial Crisis and How Dodd-Frank Addressed It

Following the events of the Financial Crisis, experts and policymakers were largely in agreement that out of the numerous causes, excessive residential mortgage lending combined with subpar underwriting standards served as the catalyst that triggered the worst financial crisis since the Great Depression of 1929 (Dodd 2010; Dunbar 2009). As documented by news articles and government reports, firms like Countrywide and Washington Mutual engaged in rampant predatory lending, greatly increasing the default risk in the financial system (Angelides 2011; Heath 2009; Bruck 2009).

Specifically, home loans were often extended to homeowners with predatory features such as exploding interest rates and prepayment penalties. This and the effects of unsound mortgage underwriting practices that ranged from extending "no- or low-documentation loans" to tampering with appraisals were further amplified through securitization of debt obligations. Subprime mortgages were packaged as mortgage-backed securities and then further packaged as collateralized debt obligations, a structured product that "pools" fixed income assets and slices them into "tranches" that are each assigned a different payment priority and interest rate, carrying different risk profiles. Through this process, securities issuers were able to mask the underlying risk of the mortgages and secure favorable credit ratings. These financially engineered products were then passed off to investors, effectively contaminating the broader financial market with concealed credit risks. The resulting interconnectedness among Wall Street firms and market participants created what was in effect a house of cards.

Reforms under Dodd-Frank: Ability-To-Repay and Qualified Mortgage Provisions

One of the key objectives of Dodd-Frank was to correct the rampant market abuses that led to the failure described above. Sections 1411 and 1412 of the Act outlined in broad strokes the regulatory framework for mortgages, which would be implemented by the CFPB. At its core, Dodd-Frank requires lenders to verify a borrower's ability-to-repay (ATR) the loan they are taking out as part of their underwriting process. This is supposed to address things like the "NINJA" (no income, no job, no asset) loans that banks offered leading up to the Financial Crisis. The ATR rule has significant teeth to back up this mandate, since (1) creditors may be liable for monetary damages if they are found to have violated ATR provisions and legal action is brought by borrowers within three years of the violation, and (2) creditors may not be able to foreclose on a property since an ATR violation can be used as a defense by defaulting borrowers (Bhutta and Ringo 2015). This means that if banks engage in sloppy underwriting, not only can they lose their claim to the underlying collateral (i.e., title to the real property), they are also opening themselves up to the risk of litigation and damages.

As a complementary measure to further incentivize lenders to underwrite mortgages with low credit risks, Dodd-Frank establishes "Qualified Mortgage" (QM) loans that are subject to more stringent underwriting and pricing requirements. The benefit is that, QM loans are deemed to be ATR-compliant and allow lenders to minimize potential exposure to liability. QM loans in general benefit from a lower-tier “rebuttable” presumption of ATR-compliance, meaning that at the onset of legal proceedings, the loans will be deemed compliant with ATR provisions unless the borrower shows that they did not in fact have the ability to repay. For QM loans that are not “higher-priced” pursuant to the regulations, the lenders are protected by a “safe harbor,” which is a stronger level of protection such that upon finding that the originated mortgage was a QM compliant, it is then conclusively established that the lender was in compliance with ATR (CFPB 2016, 33–34).

KEY CHARACTERISTICS OF ATR, QM REBUTTABLE PRESUMPTION, AND QM SAFE HARBOR

ATR	QM Rebuttable Presumption	QM Safe Harbor
A lender must make a “reasonable, good-faith determination” that a borrower has a “reasonable ability to repay the loan” based on the following 8 criteria: 1. Income & assets 2. Employment status 3. Monthly mortgage payment for loan in question 4. Monthly payment on any simultaneous loans secured by the same property 5. Property tax, insurance fees, and common charges 6. Other debt, alimony, and child support payments 7. Monthly “debt-to-income” ratio 8. Credit history **Failure to comply with the ATR provision carries the following penalties:** 1. The lender may be sued by the borrower for monetary damages on the grounds of violating ATR provisions 2. The lender may not be able to foreclose on a property, since violation of ATR provisions can be used as a defense by defaulting borrowers	**To be recognized as a “Qualified Mortgage,” the residential mortgage loan must have the following characteristics:** 1. No negative amortization 2. No interest-only payments 3. Term of loan less than or equal to 30 years 4. Points and fees generally no more than 3% of the loan amount	**For a lender to benefit from the QM safe harbor, the residential mortgage loan must meet the following criteria:** 1. The general requirements for a “Qualified Mortgage,” *plus* 2. Cannot be *higher-priced*, which generally means that the loan carries an annual percentage rate that is higher than a benchmark rate called the Average Prime Offer Rate (see 12 CFR §1026.43 for details).

FIGURE 4 *Sources: CFPB 2016; CFPB 2017.*

To be recognized as a qualified mortgage, it must abide by regulations adopted by the CFPB outlining the following requirements: limits on points and fees (e.g., 3 percent of the loan amount for loans greater than or equal to $100,000); and certain restrictions on risky loan terms and features, including, among others, prohibition of negative amortization (where unpaid interest is added to outstanding principal, which increases the total amount owed by the borrower), interest-only payment period (when the borrower does not pay down the principal), and loan terms of more than 30 years (CFPB 2013, 46).

The CFPB regulations also require that the borrower's total debt-to-income (DTI) ratio be less than or equal to 43 percent, meaning that your monthly debt payment should be less than or equal to 43 percent of your gross monthly income (CFPB 2013, 6). It should be noted, however, that the following three types of loans are temporarily exempted from the 43 percent DTI cap: (1) loans with government-backed insurance or guarantees (e.g., Federal Housing Administration and Veterans Administration loans); (2) loans that are eligible for purchase by GSEs like Fannie Mae and Freddie Mac, and (3) portfolio loans by "small creditors." The first two exemptions are set to expire in 2021.

The explicit objective of the combined ATR provisions and QM safe harbor is to reduce the "no/low-doc" or "no- or low-documentation" loans that were prevalent prior to the onset of the 2008 financial crisis, where little to no verification of the borrower's financial position was conducted by creditors.

The explicit objective of the combined ATR provisions and QM safe harbor is to reduce the "no/low-doc" or "no- or low-documentation" loans that were prevalent prior to the onset of the 2008 financial crisis, where little to no verification of the borrower's financial position was conducted by creditors. The ATR verification mandate serves as the underpinning of this regulatory mechanism and is supported by the negative incentive of potential creditor liability. A positive incentive is added to this construct via the QM safe harbor, which prompts creditors to engage in best practices so as to eliminate the legal risks.

Addressing Conservative Criticism

Regulations Restrict Credit Availability. *Conservatives argue Dodd-Frank's underwriting standards and lender liability for violating ATR provisions increases compliance costs and restricts credit availability, which specifically impacts community banks and smaller financial institutions.*

> ***Policymakers and regulators took care to tailor Dodd-Frank and the corresponding rules and regulations to the needs of varying forms of financial institutions.***

First off, if should be noted that community banks are posting healthy loan balance growth outpacing that of larger institutions (see Section 1.3 for details). This runs counter to the conservative narrative that community banks are overburdened by regulations and thereby forced to cut back on their mortgage operations. It is important to note that policymakers and regulators took care to tailor Dodd-Frank and the corresponding rules and regulations to the needs of varying forms of financial institutions. Regulators are well aware of the challenges for community banks, so small financial institutions are treated as "small creditors" and are exempt from the DTI percentage cap that would apply to larger banks. A small bank can leverage this exemption to more easily avail itself of the protection of the QM safe harbor, even without the scale of compliance resources held by big banks (Doffling 2014).

Secondly, there is no strong market data support for this line of critique. Even analysis by the conservative American Enterprise Institute's own International Center on Housing Risk shows that credit remains readily available for first-time buyers and that the long-term trend has shown in large part an easing of credit (International Center on Housing Risk 2017). A study by two Federal Reserve Board economists found that while there was a marginal shift in the industry toward loans that are structured and underwritten to meet the safe-harbor requirements, the ATR and QM rules had no material effects on the mortgage market (Bhutta and Ringo 2015). Rather, as shown in Figure 5 below, the Home Mortgage Disclosure Act data for 2014 and 2015 (the first two years since the final rules went into effect) show an uptick in number of home-purchase loans, continuing an upward trend that began in 2011 (Bhutta and Ringo 2016).

NUMBER OF HOME-PURCHASE MORTGAGE ORIGINATIONS REPORTED UNDER THE HOME MORTGAGE DISCLOSURE ACT, 2005-2015

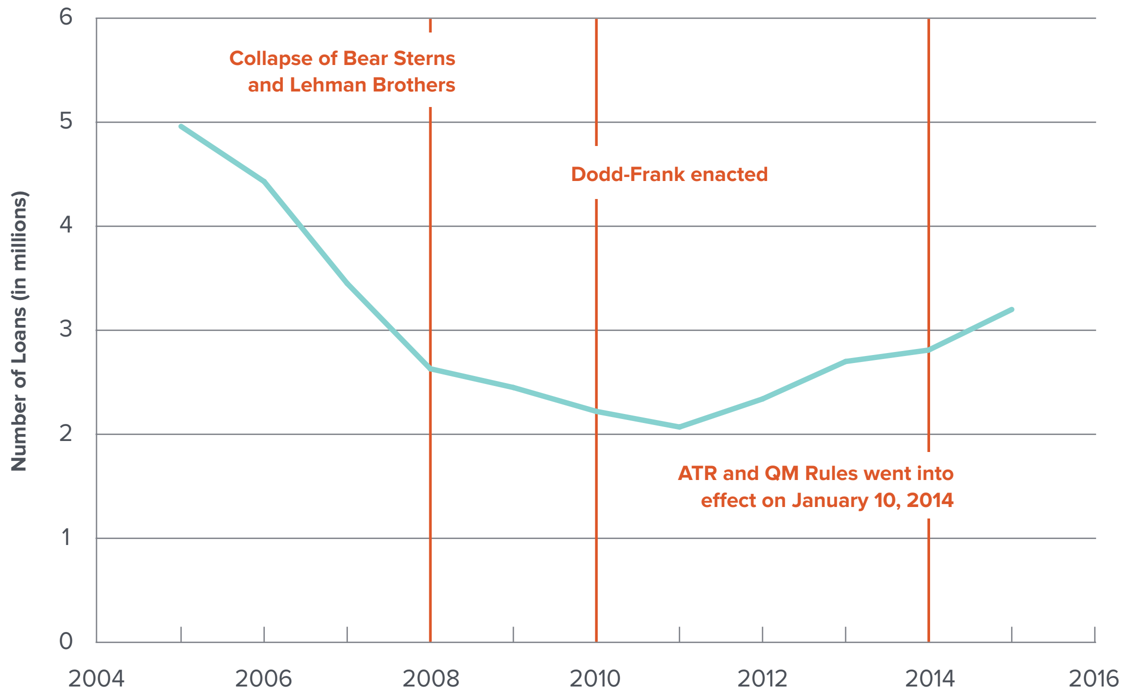

FIGURE 5 *Source: Bhutta, Neil and Daniel R. Ringo. 2016. "Residential Mortgage Lending from 2004 to 2015." Federal Reserve Bulletin 102:6 (November). Board of Governors of the Federal Reserve System. https://www.federalreserve.gov/pubs/bulletin/2016/articles/hmda/dlink/2015-dlink.htm#t1 (May 2, 2017). (data from HMDA disclosure)*

With respect to data showing constrained credit availability relative to the years before the onset of the Financial Crisis, Dodd-Frank was not the key driver. It was more a result of the pricing of GSE loans, Department of Justice enforcement of the False Claims Act against FHA mortgage lenders, and the fact that private investors have extremely low tolerance for credit risk at the moment (Urban Institute 2016).

Regulations Limit Consumer Choice. *Conservatives argue standardizing mortgage products through the ATR and QM rules limits consumer choice.*

This line of argument, advocating for the benefits and flexibility of "unconventional" mortgage products, mischaracterizes the problem that actually requires the attention of policymakers. While on a theoretical level it is true that mortgages can be tailored to better suit the borrower's financial situation, which may change over time, it is important to keep in mind that this is based on the assumptions that (1) the lender has conducted proper due diligence as part of its underwriting process and (2) the borrower and lender are both able to develop an accurate projection of the borrower's future financial condition and the lending terms.

This means that banks and borrowers need to have a strong handle on their current and future financial conditions and the implications of different mortgage products. Should either party miscalculate or misrepresent any of the foregoing, however slightly, the borrower could end up assuming risk that exceeds his or her level of tolerance, thereby increasing the likelihood of default. Conservatives have unfairly pointed to "predatory borrowing" as a cause, but this explanation unreasonably shifts the burden away from banks that control the lending terms and fails to account for the inherent information asymmetry of the borrowing relationship.

Again, conservatives making this argument are missing the forest for the trees. The factors that did lie at the heart of the Financial Crisis and needed to be addressed were poor underwriting standards and predatory product features. The fact that regulations aimed to correct this resulted in a marginally higher concentration of more conservative or "conventional" loans carries little negative impact, especially since the alternative contributed to financial instability in the financial market. Moreover, the actual effects claimed by conservatives are overblown. The 2016 study conducted by Bai et al. of the Urban Institute showed that Dodd-Frank had no impact on interest-only mortgages or loans that carry prepayment penalties.

Regulations favor GSEs. *Conservatives claim the exemption granted to government-based insurance and GSEs from the DTI cap creates moral hazards.*

As noted above, the exemption of GSE-purchased mortgages and government-backed insurance from the 43 percent DTI cap is only temporary. Set to expire in 2021, the exemption functions to acclimate the mortgage market to the new ATR and QM rules. Additionally, the fact that such financial obligations fall under some form of government or agency oversight means that corrective prudential measures can be taken more quickly. Having learned from the Financial Crisis, the relevant agencies and GSEs should be able to take the necessary risk-mitigating actions in a timely manner.

The fallout from the 2008 Financial Crisis brought to light the scope of predatory lending and its corresponding impact. A combination of reckless disregard of underwriting standards and ability to obfuscate credit risks through securitization resulted in far-reaching financial contagion. Under Dodd-Frank, ATR, together with QM safe harbor, impose a floor (minimum) on diligence that is enforced via threat of litigation and loss of collateral. In designing this set of regulations, policymakers have identified the appropriate factors to use as levers to correct lender incentives. At the same time, the regulations are tailored to the varying needs and conditions of different financial institutions and have been adequately relaxed when applied to smaller financial institutions.

Credit availability and quality of underwriting are inversely proportional, and Dodd-Frank has struck an appropriate balance. The main criticism from the conservative—that the regulations impede credit extension and limit product flexibility—fails to provide a good reason why we should loosen credit and freely allow "exotic" mortgage products at the expense of sound underwriting practices. At the end of the day, ATR and QM safe harbor address the root of the 2008 Financial Crisis and herald the return of sound financial practices.

1.3 MAKING EXEMPTIONS FOR COMMUNITY BANKS: A TIERED REGULATORY APPROACH

Complementary to Dodd-Frank's consumer protection agenda, policymakers have been attuned to the impact the reform has on community banking. Community banks play an important role in the ecosystem of nearly 6,000 financial institutions insured by the FDIC. More than nine out of 10 FDIC-insured banks are community banks, and their geographic web reaches across the country into some of the least populated non-metropolitan and rural areas that typically suffer from economic divestment and underemployment. For many counties across the country, community banks are the only source of banking services, and play a direct role in fostering real economic growth and job creation (CEA 2016). Given these financial institutions' important function in the US economy, it is critical that the rules that shape our banking system enable small and midsize banks to thrive.

These banks are important economically and politically because they play a fundamental role in fostering real economic growth and job creation. According to the FDIC Community Bank Study, these banks held 14 percent of banking industry assets, but 46 percent of the industry's small loans to farms and businesses, which makes them a key provider of the small business credit that leads to new business starts, growth, and job creation (FDIC 2012). According to the GAO, about 20 percent of community bank lending is small business lending, as opposed to about 5 percent for bigger banks (GAO 2015). Because of this, regulators and policymakers have taken their concerns with Dodd-Frank seriously, and a range of exemptions and privileges has been put in place to preserve community banking.

The preeminent criticism of Dodd-Frank from the industry and conservatives can be summed up as a set of cascading concerns. It starts with the notion that Dodd-Frank is a "one-size-fits-all" reform that treats large banks the same as small, community banks, even though community banks are not systemically risky like their large counterparts. The one-size-fits-all reform prohibitively increases compliance costs for community banks, which are not in a position to absorb higher fixed regulatory costs in comparison to large banks. Higher compliance costs contribute to the rapid disappearance of small community banks that are forced to merge or be acquired by larger banks because they cannot compete. These talking points may sound reasonable; however, the facts paint a different picture of community banking in the United States.

> ***Despite exemptions in the original bill, community banks continue to push for more, and there is a case to be made that they are never satisfied. For defenders of Dodd-Frank, community banks are seen as a Trojan horse for deregulation across the industry.***

In political terms, local banks exist in every congressional jurisdiction and have built trust with local communities. Being on the wrong side of community banks can have serious consequences for politicians (Konczal 2017). Community banks amassed a powerful lobby against Dodd-Frank. Despite exemptions in the original bill, they continue to push for more, and there is a case to be made that community banks are never satisfied. For defenders of Dodd-Frank, community banks are seen as a Trojan horse for deregulation across the industry. However, it is necessary to get the facts straight on the actual constraints Dodd-Frank places on community banks to provide services in their communities. This is especially important as opponents push a deregulatory agenda against arguably the most important financial reform in our recent history in the name of protecting and preserving community banking.

What Went Wrong During the Financial Crisis and How Dodd-Frank Addressed It

Community banks argue they did not cause the financial crisis. Instead, systemically important and interconnected banks that were engaged in risky, speculative financial activities were the culprits that should be held accountable. Community banks were not typically engaged in the activities that were the primary driver of the crisis, but that does not mean they should be off the hook for a wide range of regulatory measures. As such, community banks must comply with targeted Dodd-Frank provisions, such as consumer protection provisions, safety and soundness, among others.

Defining what is a community bank is critical to understanding which banks must comply with particular Dodd-Frank provisions and how the compliance impacts them. There is not a single definition for a community bank, but there is general consensus on their characteristics. Community banks tend to provide traditional banking services, i.e., deposit-taking and lending, in their local communities (FDIC 2014). Commonly referred to as "relationship bankers," these banks are characterized by "local ownership, local control, and local decision-making" (FDIC 2014). That is to say, these banks obtain most of their deposits locally and make their loans to local businesses. What makes these financial institutions unique is the specialized knowledge they possess about their community and their customers. With this expertise, community banks are more likely to make credit decisions based on local knowledge and long-term relationships than to rely on financial models for underwriting, as the larger financial institutions do (FDIC 2014). They also tend to generate their profits from traditional banking activities, such as taking deposits and lending, while other banks are often engaged in trading, investment banking, and securitization (Sanchez, Edelman and Gordon 2015). Most financial analysts define community banking by the size of the bank's assets, ranging from $1 billion to $10 billion, but the $10 billion metric has become the dominant size defining a community bank.

Defining a community bank solely on size is problematic, because not all banks between $1 billion and $10 billion in assets look like a community bank if you assess their characteristics; i.e., they do not "obtain most of their deposits locally and make their loans to local businesses." As noted by the FDIC, there are banks with more than $10 billion in assets that look like a community bank if you evaluate their activities and where they conduct business. However, there are banks with less than $10 billion in assets engaged in risky, unsustainable activities. While the FDIC uses a definition that takes into consideration the size and business model, most regulatory exemptions, including those in Dodd-Frank, use size ($10 billion) to identify institutions that qualify for special treatment and exemptions.

Addressing Conservative Criticism

One-size-fits-all approach. *Industry insiders and conservatives argue that community banks are subjected to the same regulations as large banks.*

Bank regulation has historically been tailored to the size of the institution. As documented by CRS, "what has changed recently is that exemptions and tailoring are being applied with greater frequency" (CRS 2015). Targeted exemptions are important, and in many cases justified, in order to enable small banks to meet the credit needs of their communities. Regulators must perform a balancing act: they must identify the line where the exemption is justified without weakening consumer protections or endangering the safety and soundness of the US banking sector. Community banks should not be let off the hook for consumer financial protection regulations.

Regulators must perform a balancing act: they must identify the line where the exemption is justified without weakening consumer protections or endangering the safety and soundness of the US banking sector.

There are a range of Dodd-Frank rules that account for the special needs of community banks, and certain parts of the statute require regulators to consider the regulatory burden on small banks. The exemptions range from specific consumer lending provisions, such as the qualified mortgage rule, to enhanced macroprudential regulation, including stress testing and capital requirements. For example, only two out of the more than 5,000 community banks in existence are subject to the stress tests that monitor a bank's ability to withstand a dramatic change in economic conditions (Sanchez, Edelman, and Gordon 2015). Furthermore, Dodd-Frank enacted a surcharge on large financial institutions, effectively ensuring that larger banks paid higher FDIC insurance premiums than community banks to recapitalize the FDIC fund (FDIC 2016).

Another example is the mortgage-lending rule, which accounts for the unique needs of community banks and their borrowers. The CFPB's promulgation of the rule identified a number of exemptions for community banks, including greater underwriting flexibility, among other protections. This is just one example of many regulatory exemptions—ranging from the Volcker Rule to Liquidity Coverage Ratio. Furthermore, non-bank mortgage lenders were brought under the umbrella of the CFPB's regulatory authority, putting community banks and non-bank mortgage lenders on the same regulatory footing.

Beyond exemptions, regulatory agencies have formed community bank–specific councils to better understand and account for the impact their rules have on small banks' operations. The CFPB voluntarily created community bank advisory councils, enabling these institutions to provide input during rulemaking, supervision, and enforcement. The FDIC and the Federal Reserve Board of Governors have also formed community bank advisory councils since the financial crisis. The range of exemptions and regulatory bodies designed to ensure the representation of community banks' needs in the rulemaking and supervision processes demonstrates that Dodd-Frank has not resulted in a one-size-fits-all regulatory approach. As new exemptions are put forth, community banks should not be let off the hook for rules that ensure they are not engaging in predatory and/or risky activities.

Burdensome and high compliance costs make community banks unprofitable.
Conservatives argue Dodd-Frank created burdensome compliance costs that are a drag on profits.

Small community banks do not have the advantage of size or scale that enable large banks to absorb higher compliance costs that follow more regulation. It is important to remember that banks of all sizes, from small community banking institutions to megabanks, have always had compliance costs, and it is difficult to assess the actual costs the banks have incurred because of Dodd-Frank (CRS 2015). This is because compliance cost reporting is opaque and not comprehensive.

> ***While small banks use a greater share of resources than large banks for regulatory compliance, the data show community banking is healthy and continues to gain economic strength.***

While small banks use a greater share of resources than large banks for regulatory compliance, the data show community banking is healthy and continues to gain economic strength. In fact, the Wall Street Journal reported in 2015 that “community banks are the picture of health” (Davidson 2015). According to the FDIC, community bank revenue and loan growth outpace the rest of the industry. Loan balances at community banks grew 8.3 percent in 2016, while bigger banks posted only a 5.3 percent increase (FDIC 2016). As mentioned above, Dodd-Frank also enacted a direct benefit by lowering compliance costs for community banks since the legislation mandated a higher FDIC-premium for large financial institutions to recapitalize the FDIC fund (FDIC 2016).

The Council of Economic Advisors (CEA) published a report in 2016 showing robust access to community banking services. The report also finds their services continued to grow in the years since Dodd-Frank was enacted. However, this trend has not been uniform. Midsize and larger community banks have seen stronger growth than the smallest banks (CEA 2016). Camden Fine, president of the Independent Community Bankers of America, which represents thousands of small banks, recently stated, “Dodd-Frank...became the poster child for every regulatory ill that’s been foisted onto community banks...There are regulatory burdens that community banks face today that are real, but had nothing to do with Dodd-Frank” (Davidson 2015). Many community banks argue that the low rates are a bigger issue since they make lending less profitable. As interest rates increase, community banks can expect to become more profitable.

Dodd-Frank caused mass mergers, market concentration and the rapid decline of community banks. *Conservatives argue Dodd-Frank led to rapid market consolidation among community banks.*

The decline in the number of community banks started long before Dodd-Frank. In fact, the total number of banks in the United States has been dropping for decades because of deregulation of interstate banking laws. The CEA's 2016 report documents how deregulatory measures around interstate banking in the 1980s and 1990s led to market concentration that specifically impacted community banks. After select states began to deregulate interstate banking, Congress passed the Riegle-Neal Act of 1994, which nationalized interstate banking and branching deregulation, allowing banks to set up new branches across state borders without the need to acquire a subsidiary bank (CEA 2016). What followed was bank consolidation as a result of bank failures, mergers, or acquisitions (see Figure 6).

TOTAL NUMBER OF BANKS IN U.S. (1988 – PRESENT)

FIGURE 6 *Source: Federal Reserve FRED Economic Data (https://fred.stlouisfed.org/series/FREQ)*

The total number of banks in the United States has been dropping for decades because of deregulation of interstate banking laws.

Community bank failures increased as a result of the Financial Crisis. The GAO (2013) found small bank failures (those with less than $1 billion in assets) were largely driven by credit losses on commercial real estate loans, and many of these banks had pursued nontraditional, riskier funding sources and exhibited weak underwriting and credit administration practices. This exacerbated consolidation in the market.

The FDIC (2014) found that most community banks remained resilient amid long-term industry consolidation. However, its research shows that consolidation has been confined to banks with under $100 million in assets: from 1985 to 2013, the number of institutions with assets under $100 million declined by 85 percent, while the number and total asset size of banks with $100 million–$10 billion in assets increased.

This is not to say that community banks do not face real challenges. These challenges are well documented, and are, in part, associated with their inability to take advantage of economies of scale for fixed regulatory costs in the same way that large banks do. However, other factors contribute their decline. Community banks are also grappling with changing technology and consumer preferences. Banks find that the digital approaches that worked at the dawn of a digital era do not meet customer expectations, which are set by more sophisticated digital experiences and new platform-based financial technologies (Fishback 2016). An additional challenge is the fact that the locations where community banks do business are more likely to be areas with disproportional underemployment and economic divestment.

These factors make it difficult for community banks to compete with large financial institutions. Still, it is important to know the facts about community banking when considering the criticisms made by the industry and conservatives, and as regulatory rollback proposals are introduced in the name of preserving community banking. The data show the industry is strong, and any future exemptions should not let banks off the hook for regulations that keep consumers safe and keep the financial services industry accountable.

SECTION TWO

How Dodd-Frank Addresses Systemic Risk, Government Bailouts, and Too-Big-To-Fail

In addition to addressing the consumer market, Dodd-Frank took on the important task of addressing systemic risks posed by the largest banks. It instituted a widespread overhaul of regulations ranging from those governing capital ratios to those that apply to private equity to credit rating agencies. To enable regulators to effectively monitor and assess the systemic impact of financial activities, the Financial Stability Oversight Council (FSOC) was established to coordinate regulatory efforts. The FSOC, with its voting members drawn from the different regulatory agencies, was given the authority to designate large non-banks, such as insurance companies and hedge funds, as non-bank systemically important financial institutions (SIFIs), which, alongside their bank counterparts, would be subject to heightened prudential oversight by the Federal Reserve.[1] This tailored approach serves to tackle head-on the risks posed by these gargantuan institutions. This section addresses three specific structural reforms made possible by Dodd-Frank that conservatives target for criticism.

First, we discuss the Volcker Rule. Conservatives argue the Volcker Rule reduces liquidity and provides little value to protect the safety and soundness of the financial system. In touting industry talking points, critics overlook the crucial objectives of the Volcker Rule, which are (1) to refocus the priorities of banks to service the real economy, as opposed to boosting their trading books; and (2) to eliminate the conflicts of interest that necessarily arise when banks trade on their own accounts, often at the expense of their clients. The Volcker Rule is direct in both its goals and its mechanics, and should make clear sense to average Americans. And, contrary to criticism, it is showing results, with banks significantly reducing their investments in hedge funds and private equity as well as proprietary trading operations.

Next we look at the Orderly Liquidation Authority (OLA), a new authority under Dodd-Frank that aims to end Too-Big-to-Fail by enabling regulators to take over and wind down a failing financial institution if bankruptcy would be too disruptive or cause a panic in financial markets. Conservatives argue this is a permanent bailout and that bankruptcy

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1 The nine independent financial regulators whose chairs are voting members of the FSOC are the Department of the Treasury, the Commodity Futures Trading Commission (CFTC), the Consumer Financial Protection Bureau (CFPB), the FDIC, the Federal Housing Finance Agency (FHFA), the Federal Reserve, the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the SEC.

alone can handle the process; however, the evolution of the process since then shows OLA is a useful framework and alternative to address bank failures.

Lastly, we look at the widespread reforms in the derivatives market. Conservatives argue that moving the over-the-counter market toward centralized clearing and exchanges has created its own system risks; in other words, clearinghouses have been added to the list of Too-Big-to-Fail institutions. Yet centralized clearing has brought transparency to a once opaque market, which benefits consumers and end-users.

2.1 RETURNING TO BANKING: THE VOLCKER RULE

Since Dodd-Frank's enactment, the Volcker Rule has come into the crosshairs of big bank lobbyists. Claiming adverse effects on liquidity and cost of compliance, critics of the Volcker Rule have prioritized the institutional interests of big banks above the stability of the financial system. At its core, the Volcker Rule is designed to tackle Too-Big-to-Fail by prohibiting FDIC-insured banks from engaging in inherently speculative and non-traditional banking activities, which should appeal to the conservative concern that Dodd-Frank institutionalizes government bailouts. By making clear to big banks that their social utility only extends as far as their core commercial banking functions and does not include any of their speculative undertakings, the Volcker Rule serves to defeat big banks' expectations that regardless of their own actions, the government will always bail them out in times of crisis.

> ***The Volcker Rule is designed to tackle Too-Big-to-Fail by prohibiting FDIC-insured banks from engaging in inherently speculative and non-traditional banking activities, which should appeal to the conservative concern that Dodd-Frank institutionalizes government bailouts.***

What Went Wrong During the Financial Crisis and How Dodd-Frank Addressed It

Named after former Chair of the Federal Reserve Paul Volcker, the Volcker Rule refers collectively to §619 of Dodd-Frank as well as the final implementing rules and regulations promulgated jointly by relevant regulators. In 2009, Volcker was appointed by President Obama to chair the President's Economic Recovery Advisory Board, which was tasked with, among other things, advising the President on financial regulatory reform in the wake of the 2007–08 Financial Crisis. In this role, Volcker fought vigorously to ban banks from engaging in proprietary trading and holding ownership interest in hedge funds and private equity funds, the two pillars of his namesake rule.

The reason behind the prohibition is straightforward. First, big banks can place bets for their own trading accounts and profit, often on risky and complex assets. The accumulated systemic risks as well as the resulting losses exacerbated the fallout from the Financial Crisis (Merkley and Levin 2011). Moreover, there is a predictive element to the rule, in that such speculative activities could easily result in future crises (Irwin 2013). Second, having commercial banks engage in proprietary trading raises considerable conflict-of-interest concerns (Volcker 2010). Functionally acting as their own "customer" when trading for their own accounts, the banks were prioritizing their own pursuit for profits and revenue above their fiduciary obligations to their clients. This ultimately meant that by structuring financial transactions that most benefited their own trading books or taking advantage of access to their clients' trading information, they were able to reap profits at the expense of their clients' interests (Merkley and Levin 2011).

To Volcker, commercial banks serve the crucial function of providing credit to consumers and companies. Thus, to ensure economic stability in times of crisis, it makes sense for government assistance, in the form of emergency credit via the Federal Reserve Discount Window, to be extended to commercial banks. At the same time, banks should not see this as a blank check guaranteeing all their actions. In exchange for the aforementioned assurance, commercial banks should be barred from taking on unnecessary risks that stem from proprietary trading as well as hedge fund and private equity fund investments. This should restore the primacy of client interests in the eyes of banks and refocus the banks toward lending to the real economy (Volcker 2010). Simply put, according to Volcker in an interview for a New Yorker article, "If you are going to be a commercial bank, with all the protections that implies, you shouldn't be doing this stuff. If you are doing this stuff, you shouldn't be a commercial bank" (Cassidy 2012).

How Does the Volcker Rule Fit in with Other Reform Efforts under Dodd-Frank?

As a component of Dodd-Frank, the Volcker Rule can perhaps best be understood as one part of two complementary approaches. The first was increasing the amount of capital that banks need to maintain, so that they are better able to survive a liquidity crunch caused by economic shocks. However, this approach requires an enhanced or more stringent regulatory treatment for large banks, which some interpreted as the affirmation and institutionalization of Too-Big-to-Fail. The Volcker Rule, the core component of the second prong, is meant to mitigate this effect.

To undo Too-Big-to-Fail, the banks' expectation of blanket government assistance must necessarily be corrected (Cassidy 2012). Specifically, it must be made clear to banks that government support only applies to bank activities that yield public utility. As noted above, there is value for the government and taxpayers to backstop risks associated with the credit function of commercial banks. Therefore, the Volcker Rule serves to delineate the scope of risk worthy of government backstop by carving out speculative investment activities. Put differently, the "obvious potential benefit of the Volcker Rule is the ban of risky trades by institutions that could eventually seek government support if their risky trades led to significant losses" (Bao et al. 2016).

Following the enactment of Dodd-Frank, the financial market presented why the Volcker Rule was needed. In what became known as the "London Whale" incident, JPMorgan Chase & Co. lost more than $6 billion as a result of a trader's large positions in credit derivatives (Patterson and Trindle 2013). When the Final Rule was rolled out in 2013 by the OCC, Federal Reserve, FDIC, Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC)—collectively, the Volcker Agencies—former Treasury Secretary Jack Lew pointed to the London Whale incident as its prime target (Katz and Klimasinska 2013).

How Does the Volcker Rule Work?

In drafting the Final Rule, the Volcker Agencies needed to come up with two critical definitions given the lack of specificity in the language of §619: (1) what constitutes proprietary trading, and (2) what constitutes prohibited ownership interest in hedge fund and private equity funds.

In framing the first definition, the Volcker Agencies established in the Final Rule a rebuttable presumption that the purchase or sale of an instrument by a bank, when held for less than 60 days, is deemed to be for the trading account of the bank, but the bank may engage in interdealer trading to meet "the reasonably expected near term demands of its clients, customers, or counterparties" (12 CFR 248.4[a][2][ii]).

With regard to the second definition, the Volcker Agencies set the prohibited level of ownership interest in hedge funds or private equity funds (collectively called "covered funds") at greater than 3 percent (12 CFR 248.12[a][2][ii]). At the same time, it is important to note that the Volcker Rule does not explicitly bar banks from making direct merchant banking investments, despite Paul Volcker's belief that it should. Following debate on this issue, the Volcker Agencies allowed such investments, which means that banks can either invest up to 3 percent in covered funds or engage in direct merchant banking investment (with 100 percent ownership interest).

The Volcker Agencies had to ensure that the Final Rule had sufficient built-in flexibility to allow for actual market-making and risk-mitigating hedging that are important to the stable operation of banking functions.

When formulating the Final Rule, the Volcker Agencies had to wrestle with several considerations. There was widespread acceptance that bright-line rules would reduce regulatory uncertainty and minimize compliance costs. However, Volcker Agencies were also wary that such an approach could induce "gaming and avoidance" by banks and ultimately undermine the effectiveness of the Final Rule (Volcker Agencies 2014). Lastly, the Volcker Agencies had to ensure that the Final Rule had sufficient built-in flexibility to allow for actual market-making and risk-mitigating hedging that are important to the stable operation of banking functions.

The resulting Final Rule reflected the consensus among the Volcker Agencies on how best to balance these considerations. Without sacrificing regulatory flexibility and effectiveness, the Final Rule provided, to the extent possible, defined presumptions and limits. At the same time, permissible activities were taken into account under the Final Rule, but subjected to internal monitoring and control as well as recordkeeping and reporting requirements, so as to keep them in line with "the expected near term demand" and the corresponding risk limits (Ramsay 2014).

Addressing Conservative Criticism

Reduced Liquidity. *The Volcker Rule reduces banks' market-making abilities and hence negatively impacts liquidity.*

The most common criticism leveled at the Volcker Rule by bank lobbyists and conservatives is that it reduces banks' market-making abilities, thus negatively impacting liquidity (Reiners 2017). The argument is that the ban on proprietary trading would result in a cooling effect on banks' willingness to engage in market-making, thereby making it harder for market participants to buy and sell securities. However, market data and recent studies point to the conclusion that there has not been a noticeable change in liquidity from pre-Crisis periods (Jarsulic 2017; Volcker 2017).

High Compliance Costs. *The difficulty in distinguishing proprietary trading from routine market-making and risk-mitigating hedge leads to overly burdensome compliance costs.*

While the aforementioned distinction may be nuanced and challenging to parse, this should not justify scrapping the Volcker Rule, especially when there is bipartisan support for the objective of the rule, which is to address Too-Big-to-Fail. It is also important to note that more than six years into the enactment of Dodd-Frank and more than three years following the promulgation of the Final Rule, banks have already put billions of dollars into compliance (Carney 2016). Setting aside the fact that the banks probably would not want to let all the time and investment that they have devoted to the Volcker Rule compliance simply go to waste, what the "London Whale" incident made clear was that the banks had little idea what was going at their trading desks and some form of activity-based regulation was required. At a minimum, the Volcker Rule has forced banks to pay attention and implement appropriate risk-management practices. The compliance metrics outlined by the Volcker Agencies in the Final Rule build upon risk limits that trading desks at banks already have in place. The required reporting of such metrics by banks to Volcker Agencies ensures that banks are actually scrutinizing their trading activities, as they should have been all along.

> ***What the "London Whale" incident made clear was that the banks had little idea what was going at their trading desks and some form of activity-based regulation was required.***

What critics often fail to point out is that the Volcker Rule is having the intended effects on Wall Street. As shown in Figure 7, over the past five years, Goldman Sachs has reduced its non-Volcker-compliant holding in "covered funds" by 60 percent (Tracy 2016). Faced with the ban on proprietary trading, banks have closed up their trading units or otherwise sold them to hedge funds (Popper 2016). By all measures, we are seeing big banks focusing on their less-risky core competencies.

FAIR VALUE OF BIG BANK FUND INVESTMENTS

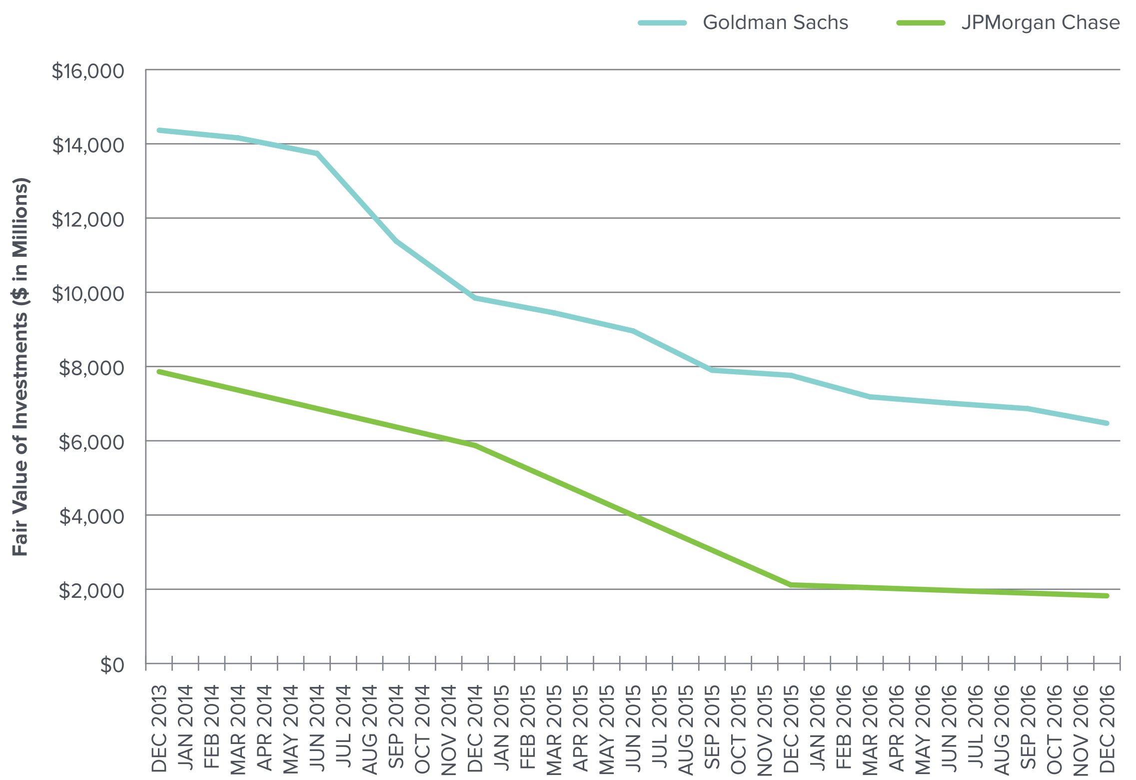


FIGURE 7 *Source: SEC Periodic Reporting on Forms 10-K and 10-Q*

In many ways, out of all the measures in the comprehensive regulatory overhaul that is Dodd-Frank, the Volcker Rule may be the simplest and most direct in its purpose, and one that should make clear sense to average Americans (Jenkins 2017). Banning proprietary trading and investment in hedge funds and private equity funds allows for banks' operations to be more transparent and spells out clearly that the government has no intention of backing reckless gambles that serve little purpose in supporting the economy.

Given the positive effects of the Volcker Rule, there is little reason for its repeal, especially in light of its complementary role to other provisions under Dodd-Frank. Even from a conservative standpoint, the Volcker Rule serves as an important measure in checking Too-Big-to-Fail. The only interest group that would benefit from the rule's repeal is industry lobbyists. The Volcker Rule is a key buttress against our largest financial institutions engaging in rampant speculation on complex and risky assets against the interest of their clients.

The only interest group that would benefit from the rule's repeal is industry lobbyists.

Rather than providing key financial services to the real economy, what we witnessed prior to Dodd-Frank and the Volcker Rule were big banks that prioritized profits above all other concerns. We want banks to be in the business of making loans to small businesses and families; and we want investors to be taking the risks—both getting the upside and bearing the downsides—in our capital markets. The Volcker Rule effectively prevents banks from continuing to operate as investors while forsaking the primary purpose of extending loans.

2.2 ENDING GOVERNMENT BAILOUTS: THE ORDERLY LIQUIDATION AUTHORITY

Conservatives believe the panic following the collapse of Lehman Brothers in September 2009 was caused by the government's inconsistent response to and treatment of failing systemically important banks. This is far from the normal reading of the crisis. During a Q&A following the unveiling of the CHOICE Act to roll back Dodd-Frank, House Financial Services Committee Chairman Jeb Hensarling (R-TX) gave a surprising answer to a question on whether his plan would prevent Congress from bailing out banks in the event of crisis. Hensarling responded that "regulators essentially bailed out Bear but let Lehman fail. Although it was painful, and somewhat chaotic, in many respects, those in the bankruptcy arena would tell you, the Lehman bankruptcy, to some extent, worked as it should have worked." This is the widespread belief among conservatives. Summarizing this belief, the Heritage Foundation argues that rescuing Bear Stearns caused managers at Lehman and other financial firms to not take any additional actions throughout the summer of 2008. "In September 2008 the government reversed its policy...thus upending the assumptions of all market participants, creating a market panic, and causing banks to hoard cash" (Michel 2016).

Most experts believe the crisis began in 2007, and was only brought to a peak with Lehman's failure. The Lehman failure caused a run on money market mutual funds, a run that reached far beyond funds that had exposures to Lehman Brothers itself. The government found itself without clear options to cleanly take down Lehman Brothers. Lehman also went into bankruptcy in the most aggressive manner, without any clear planning. Lehman manipulated its balance sheet to make itself look more liquid than it was, forcing a crisis to happen faster, and on worse terms, than the market would have previously believed possible.

What Went Wrong During the Financial Crisis and How Dodd-Frank Addressed It

The collapse of Lehman Brothers, the inability of regulators to address it, and the subsequent chaos in the financial markets constitute one of the driving forces behind Dodd-Frank. Let's start with the three changes that Dodd-Frank put into place to deal with the failure of a financial firm in this way.

The first line of defense is to have increased regulations on the firm itself, with a focus on requiring banks to fund themselves with more capital. There is a special focus on firms being able to make payments during stressed times. If the firm starts to have problems, regulators require "prompt corrective action" to bring the firms back into a strong position. Though these powers existed before Dodd-Frank, they are expanded and codified in a way that comprehensively tackles large financial institutions as consolidated entities.

THE STAGES OF TACKLING TOO-BIG-TO-FAIL

Stronger Capital

- More Capital
- Liquidity Capital
- Graduated Requirements
- Stress Testing

→

Bankruptcy Preparation

- Living Wills
- Total Loss Absorption Capital

→

Liquidation Authority

If bankruptcy would cause panic, regulators can initiate a liquidation:

- Single-Point of Entry
- Emergency Funding
- Executed on Eve of Failure

FIGURE 8

Let's say that the financial firm fails. The next line of defense is putting the firm into bankruptcy. Normally we don't care if a firm goes into bankruptcy; however, there are several reasons why bankruptcy may not be appropriate for a financial firm. Bankruptcy is slow, while a financial crisis is quick. Bankruptcy isn't designed to stop financial runs and keep the financial system moving. The process has trouble coordinating across the vast complexity of financial firms that exist in dozens of countries. A random bankruptcy judge will not have enough experience with the financial firm in advance, and will face huge political pressure to prevent a crisis. Having access to a secure line of funding is necessary to keep crucial banking functions running and may be difficult to secure in a crisis. With all these problems, Congress may choose to bail out the firm instead, as it did in 2008.

> ***Bankruptcy isn't designed to stop financial runs and keep the financial system moving.***

Dodd-Frank does two things to deal with this situation. The first is to force banks to create living wills that explain how they can go through a bankruptcy without taking down the entire economy. Just the act of having to figure this process out, something not normally on the minds of businesses, helps create a safer financial market. It requires that banks reorganize themselves internally to deal with a failure, and gives regulators the power to break up firms that aren't able to provide a credible plan. Regulators are currently forcing banks to provide stricter plans, one of the avenues in which important structural changes are happening.

The second is the piece conservatives would like to repeal. Dodd-Frank provides the FDIC with a special power to take over and wind down financial firms, much like what it does with FDIC-insured commercial banks. This backup option is called "orderly liquidation authority" (OLA) but is easier to understand as what Barney Frank calls "death panels for banks." It's a backup option because it requires several steps to activate, including two-thirds of the Federal Reserve's members and the FDIC (or relevant regulator) agreeing with the Treasury Secretary. The regulators are required to present "an evaluation of the likelihood of a private sector alternative to prevent the default of the financial company" as well as "an evaluation of why a case under the Bankruptcy Code is not appropriate for the financial company," so OLA will apply only in emergencies.

The goals of bankruptcy are clear: shareholders and creditors should lose their investments, management should be fired, and the firm should be reorganized. These goals are hardcoded into this power. Yet OLA has advantages over traditional bankruptcy. It has a dedicated funding stream that allows the FDIC to borrow against the failing firm's assets. Having this stream is essential in times of financial panic, when credit markets are dry, as is likely when this power is considered. (Though taxpayer money is always recovered first by statute, the Congressional Budget Office [CBO] gave this power a controversial score, because CBO assumed money could be lent within the 10-year period but not recovered until afterward. This score allows it to be considered under budget reconciliation.)

OLA is executed by regulators, who, unlike a random bankruptcy judge, have a familiarity with the firm in advance. It can be executed on the eve of a failure, which prevents managers from gambling to try to fix their own interests at risk to the financial system. It can adjudicate claims quickly under this receivership, including putting a hold on derivatives and other complicated financial instruments. It creates a bridge company that allows for the transfer of important entities to a new company.

> ***OLA is executed by regulators, who, unlike a random bankruptcy judge, have a familiarity with bank operations in advance.***

To tackle the complex structure of big banks, whereby the bank holding company oversees operating subsidiaries, FDIC carries out OLA through a feature called single-point-of-entry. Regulators step into the failing bank's corporate structure as the receiver at a single point—the highest bank holding company level. As Michael Barr, Howell Jackson, and Margaret Tahyar note in their new Financial Regulations casebook, single-point-of-entry "presents an elegant solution to two major obstacles that made an orderly resolution of a failed financial conglomerate impossible in 2008," both the international aspect and the complex but essential scope of major financial institutions. By intervening at the topmost level, regulators can avoid the scramble of different national regulators trying to protect their own local interests at the expense of the overall markets. Meanwhile the failure of a financial firm can throw payment processing, recordkeeping, custody, and other services necessary to the market economy into disarray. By keeping the subsidiaries running, OLA minimizes the threat to a failing major financial firm that is "posed by a disruption in critical services whose smoothing functioning is normally taken for granted." It also helps make the capital requirements more credible, by making clearer the level and purpose of higher capital for a time of crisis (Barr 2016).

> ***By keeping the subsidiaries running, OLA minimizes the threat to a failing major financial firm that is "posed by a disruption in critical services whose smoothing functioning is normally taken for granted."***

There's a reason this has evolved as financial markets engage in more banking activities. As noted by James Wigand, formerly of the FDIC, "Every type of financial company has its own insolvency process: insurance companies have state receiverships; banks have FDIC receiverships; credit unions have CUA receiverships; broker-dealers have SIPC trustees. It's that way for a reason. Policy makers over decades have recognized that the bankruptcy code is ill-suited for large financial companies. However, revising the code so that it is better-suited for resolving a large financial company wouldn't hurt, provided OLA remains."

Addressing Conservative Criticism

OLA Is a Bailout. *Conservatives argue that OLA allows financial institutions to be bailed out by the government. As a result, their ability to borrow in financial markets will become easier, creating a permanent Too-Big-to-Fail subsidy.*

Conservatives claim this is a bailout. Yet the OLA power is designed explicitly to make private actors bear the costs. If there is a liquidation, the FDIC has to wipe out shareholders if necessary ("ensure that the shareholders of a covered financial company do not receive payment until after all other claims and the Fund are fully paid") and hit creditors ("ensure that unsecured creditors bear losses in accordance with the priority of claim provisions"). The government isn't allowed to redo TARP or AIG and buy equity in the firm to keep it alive (will "not take an equity interest in or become a shareholder of any covered financial company or any covered subsidiary"). The FDIC can't act for "the purpose of preserving the covered financial company." (All quotes are from Sec. 206 of Dodd-Frank.)

There's explicit legal language to allow the FDIC to claw back compensation (Sec. 210: "may recover from any current or former senior executive or director substantially responsible for the failed condition of the covered financial company any compensation received during the 2-year period preceding"). By law, the FDIC also has to fire bank management ("ensure that management responsible for the failed condition of the covered financial company is removed") and board members ("ensure that the members of the board of directors...are removed"). As former Federal Reserve chairman Ben Bernanke notes, "An OLA resolution during a crisis would hardly feel like a bailout to the firm's owners and managers, who would see the extinction of the firm's equity and the wholesale replacement of its board and management" (Bernanke 2017).

As a result, we've seen the Too-Big-to-Fail subsidy fall substantially since the crisis. Measured both as the interest rate spread versus smaller banks (CBO) and as credit default swaps versus models of credit risk (IMF), this subsidy is lower than it was during the crisis and bailouts. There's significant debate over whether it is at zero, and there are arguments that it should be negative (a higher cost to being bigger) given the non-market-priced risks these banks pose to the economy as a whole. And even if the subsidy were zero, it would not mean these banks don't pose a risk. However the idea that the OLA process provides a permanent subsidy doesn't show up in the market data.

A Special Bankruptcy Code Would Work Better. *Conservatives believe that a bankruptcy code could better handle the failure of a large firm.*

How do conservatives attempt to tackle the problems described here? Their solution is to create a special bankruptcy code to try to tackle these problems for financial firms. Many people in financial reform circles support this, though they disagree with eliminating OLA at the same time, especially before a specific bankruptcy plan has had its tires kicked. The GOP would eliminate OLA, perhaps even before passing a new bankruptcy plan.

Yet no matter how the plan is structured, there are several problems bankruptcy courts are incapable of solving. They have no means of coordinating internationally. Rather than having some experience with the firm and the international regulatory community, a bankruptcy judge would be randomly assigned to adjudicate this major failure some day, after most of the damage has been done. There's no financing, which in times of a crisis means it may be impossible to credibly keep essential finance operations running.

> ***It is guaranteed that a random bankruptcy judge, chosen as a bankruptcy process begins, will have no experience at all.***

The problems that OLA potentially faces would be far worse under bankruptcy. It is possible that OLA won't coordinate well internationally. Bankruptcy can't do this at all, however. Regulators might not be able to anticipate a failure under OLA and start the process earlier. Bankruptcy can't do this no matter what; it must wait until a failure has begun to do anything, at which point there will already be market chaos. Regulators may also have a poor sense of how a firm functions as an OLA takeover begins. But it is guaranteed that a random bankruptcy judge, chosen as a bankruptcy process begins, will have no experience at all (Barr 2016).

Conservatives' Bankruptcy Idea Is Harder on Financial Firms. *Conservatives plan on a bankruptcy code that worries bankers, showing how tough they are on Wall Street compared to the bailout-friendly OLA regime.*

Bankruptcy regime for financial firms would also likely be structured by a GOP Congress to be very favorable to the banks. As Georgetown law professor Adam Levitin noted in testimony about the CHOICE Act, bankruptcy "absolves directors of any liability for actions taken in contemplation of or in connection with" a bankruptcy petition or asset transfer to the bridge company (Levitin 2016). In contrast, Dodd-Frank requires the clawback of salaries. As Mark Roe and David Skeel argue, "The bill broadly exempts bank executives from lawsuits and liability for pre-bankruptcy actions." Worse, the bankruptcy "must be completed in 48 hours—faster than almost any bankruptcy on record" (Roe 2016).

Would businesses benefit from a repeal of Title II? For one, it would likely bring back the Too-Big-to-Fail market subsidy and the corresponding advantage for being seen as having a government backstop, which has declined substantially since the crisis. Ratings agency Moody's lowered the credit rating of big banks in 2013, arguing that "US bank regulators have made substantive progress in establishing a credible framework to resolve a large, failing bank. Rather than relying on public funds to bail-out one of these institutions, we expect that bank holding company creditors will be bailed-in and thereby shoulder much of the burden to help recapitalize a failing bank." Removing this progress with an untested, to-be-determined solution with major known problems is a signal to the market to expect bailouts.

Another issue is that instead of forcing banks to adhere to our bankruptcy regime, a repeal of Title II would adjust our bankruptcy regime to adhere to the structure of our banks. It would thus immediately make moot the fight over living wills, currently one of the key regulatory avenues for forcing Wall Street to take stock of its own risks. It would remove the responsibility to resolve bank failures out of the hands of regulators who can force changes necessary for compliance. It's also part of an overall plan to weaken rules, regulations, and capital, which is what finance prefers. It is telling that the CHOICE 2.0 proposed bill would remove the FDIC from the living wills process, as the FDIC is one of the few agencies that want to take on restructuring firms to handle bankruptcies without bringing down the financial sector.

2.3 DODD-FRANK'S DERIVATIVES RULES ARE UNNECESSARY AND AREN'T WORKING, INCREASING FINANCIAL INSTABILITY.

Shadow banking, meaning the unregulated functions of the financial markets, was instrumental in disseminating the risks generated by subprime mortgages and mortgage-backed securities throughout the entire financial system. A significant component of shadow banking is derivatives trading. Hence, to introduce much-needed transparency and rein in the systemic risk generated by this segment of the financial market, Dodd-Frank has overhauled the regulatory regime for derivatives. Conservatives are convinced that Dodd-Frank's focus on derivatives is largely unnecessary. By downplaying the role that derivatives played in the 2007–08 Financial Crisis, conservative commentators argue that reform of the derivatives market under Dodd-Frank is an overreaction by Congress aimed at fixing something that was not broken. The resulting regulations, so goes the narrative, have increased systemic risk and reduced market competition. As a result, conservatives want to remove many, if not all, of the derivative market regulations promulgated pursuant to Dodd-Frank.

What Went Wrong During the Financial Crisis and How Dodd-Frank Addressed This

The state of the derivatives market regulation (or lack thereof) prior to Dodd-Frank reform was an important contributing factor to the Financial Crisis. Derivatives can be broadly defined as financial instruments or contracts whose values depend on those of the underlying assets. Within the spectrum of financial products that fall under this definition, the specific derivative products that the Dodd-Frank Act seeks to regulate are called swaps, or agreements whereby "two parties exchange future cash flows that have the same net present value" (Zoch 2011, 102). Swaps can be an effective risk-management tool, used by firms to hedge, or offset, real business risks. Alternatively, they can be used as a vehicle to engage in speculation and take on additional risks (Figlewski et al. 2009). An example is a credit default swap. In reference to a particular fixed-income asset (debt), the buyer of a credit default swap agrees to make fixed payments to the swap seller in exchange for the payout of principal plus interest should the issuer of the reference asset default.

Derivatives trading enjoyed a long period of lax regulatory oversight. The Commodities Futures Modernization Act of 2000 exempted swaps and certain derivative products from the purview of the CFTC and the SEC. Instead of being trading through an exchange where there is greater market transparency, these derivatives were allowed to be traded "over-the-counter" (OTC) privately between two parties (Dodd 2010, 29). So during the run-up to the Financial Crisis, OTC derivatives trading remained largely private transactions that evaded monitoring and regulation. As an aside, it should be noted that OTC derivatives and the term "swaps" as referenced in the context of Dodd-Frank will be used interchangeably in this section, since, unlike industry usage, the statutory definition of the latter is sufficiently broad that the two categories overlap.

Because of the private and bilateral nature of OTC derivative trades, there exists, for every transaction, counterparty credit risk, or the risk of one party to the contract failing to meet its obligations. While the specific counterparty risk from one-off transactions would likely have limited impact upon the financial system, real-life trades are never conducted as "one-offs." Instead, there are typically chains of transactions that pass on risk from party to party. In addition, the market was global, and prior to reforms under Dodd-Frank, this meant that financial institutions could take advantage of regulatory gaps by having their foreign subsidiaries speculate in derivatives while relying on the support of US parent companies and leaving regulators in the dark. Given the actual size and complexity of the OTC market, which we will discuss further below, counterparty risk was far greater and more interconnected than both the market participants and regulators had anticipated.

At the onset of the 2008 Financial Crisis, the total size of the derivatives market was $592 trillion. Of this amount, 59 percent had flowed into unregulated OTC derivatives, up from 41 percent in 1998 (Dodd 2010, 29). Moreover, the bilateral nature of the transaction meant that five dealers were able to cordon off the market (Dodd 2010, 29). To put these figures into perspective, the global GDP in 2008 was $63.345 trillion (World Bank 2017).

When the Financial Crisis struck, the notional value of the OTC derivatives market was five and a half times larger than the world's economic output.

In other words, when the Financial Crisis struck, the notional value of the OTC derivatives market was five and a half times larger than the world's economic output. The magnitude of the systemic risk was never clearly understood by any of the market participants or the regulators, since it was extremely difficult to map out the counterparty risk implicated in each transaction without some form of centralized oversight.

There are two additional factors that contributed to the opaqueness of the OTC derivatives market. First, recalling that swaps are used to hedge risks, the party that assumes the risk in one transaction can similarly seek to offset it by entering into a separate swap agreement with a third party, and the third party with a fourth. This creates a "web of interconnected counterparty risk" that is hard to accurately trace, particularly, as noted above, when all transactions are conducted on a bilateral basis with little transparency. Without any pre-trade price information that would otherwise be derived from exchange trading, parties had to rely on modeling devices to assign value to their positions. In effect, such valuation could be so far removed from the actual trading or market price as to be described as "mark-to-myth" (Johnson and Stiglitz 2012).

The opaque web of interconnected counterparty credit risk, exacerbated by under-collateralization, fueled a bubble of colossal proportions that was susceptible to systemic shocks.

Second, the lack of margin or capital requirement for OTC derivatives left the market under-collateralized (Dodd 2010, 30). This means that investors or speculators can take on large derivatives positions without needing to post a significant amount of cash up front, which in turn greatly increases the overall leverage of the financial system (Dodd 2010, 30). This creates an environment prone to "runs," because "when instability arrives, all banks rush to collect what they are owed on derivatives—and delay paying out what they themselves owe" (Eavis 2010). Ultimately, the opaque web of interconnected counterparty credit risk, exacerbated by under-collateralization, fueled a bubble of colossal proportions that was susceptible to systemic shocks.

This was how the Financial Crisis played out. Following the Bear Stearns bailout, the collapse of Lehman Brothers and AIG in September 2008 sent a shock wave throughout the financial market, prompting a system-wide "run" (Eavis 2010). With AIG being a key player in the OTC derivatives market before its collapse, firms with derivatives positions plunged into uncertainty as they had little idea how to accurately determine the degree to which their counterparties were levered, and, in turn, the corresponding counterparty credit risks (Sender 2009). This quandary effectively rendered credit ratings completely unreliable (Dodd 2010, 36). Credit quickly dried up, as evidenced by the rocketing rates for credit default swaps, and capital flooded markets for low-risk instruments such as short-term Treasury notes (New York Times 2011). The structural failures of the OTC derivatives market amplified and transmitted the market shocks that resulted in a financial crisis that has cost the United States more than $20 trillion (Better Markets 2015).

Reform under Dodd-Frank

As part of the sweeping reform of the US financial system, Titles VII and VIII of the Dodd-Frank Act were drawn up to tackle the shortcomings of the derivatives market described above. Title VII, as passed, aimed to create a regulatory architecture for OTC derivatives by (1) imposing regulatory oversight upon swap dealers and market participants by requiring, among others, registration as well as mandatory posting of capital and margin, (2) establishing swap execution facilities (SEFs), which serve as exchange equivalents for the swaps market by providing transparency on trade price and volume, as well as requiring central clearing of OTC derivative trades, meaning that a clearinghouse will act as the focal point or "central counterparty" (CCP) to all trades, and (3) requiring that speculative trading of swaps be "pushed out" of banks backed by the FDIC (Zoch 2011, 102). The last component, known as the Lincoln Amendment, was repealed in December 2014 as part of the ongoing effort by Republicans to curtail the scope of the DFA.

While Title VIII of Dodd-Frank pertains to the Federal Reserve's broader authority to regulate systemically important components of the financial market infrastructure, derivatives trading is also implicated, since clearing agencies can be found by the Financial Stability Oversight Council (FSOC) to be "systemically important" financial market utilities, or FMUs. Title VIII grants the Federal Reserve a broader role, in coordination with the SEC and CFTC, "in the supervision, examination and rule enforcement" of FMU activities (Nordenberg and Labonte 2010).

Addressing Conservative Criticism

Centralized Clearing Mandate Creates Systemic Risks. *Conservatives predict an increase in systemic risk stemming from the mandate because (1) it incentivizes market participants to clear riskier derivatives, since CCPs can absorb risks; (2) it creates more interconnections since derivative trades must now be funneled through CCPs; and (3) it locks up capital, since CCPs require additional margin and collateral that would otherwise have been used by market participants.*

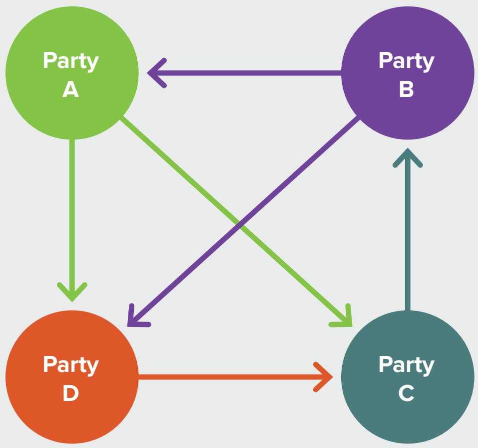
Unfortunately, the conservative critique misses the importance of centralized clearing and its role in regulating the post-crisis derivatives market. The functions of CCPs, together with those of SEFs, level the playing field that once lacked transparency and carried significant uncertainty stemming from delayed bilateral clearing (Gensler 2013). When properly managed by regulators, CCPs offer "an important tool for managing counterparty credit risk…thus reducing risk to market participants and to the financial system" (Tarullo 2011).

Centralized clearing accomplishes this in three ways (Kiff et al. 2010, 6–7). First, CCPs are interposed between the parties to all regulated OTC derivative trades, effectively rationalizing and obviating the complex network of interrelated counterparty risks that was previously in place (Kress 2011, 66–67). Second, counterparty risk in the OTC derivatives market can be better monitored and mitigated, since it can now simply be tracked relative to CCPs as opposed to all counterparties. This streamlining allows CCPs and market participants to pool resources to absorb the impact of defaults (Kress 2011, 65–66). Lastly, and very much related to the previous point, centralized clearing enhances market transparency, since CCPs must keep a record of transaction details such as the notional amounts and counterparty information (Kiff et al. 2010, 7–9). Complementing the trading information made available through SEFs, this provides regulators with much-needed information on the OTC derivatives market.

With this in mind, we can now examine how the conservative narrative fails to provide any viable alternatives to achieving the aim of the DFA, which is to mitigate the shortcomings of the US financial system that brought about the 2008 Financial Crisis.

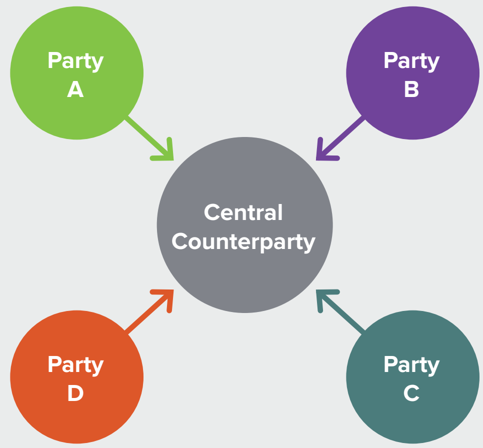
CENTRALIZED CLEARING IN THE POST-DODD-FRANK WORLD

Pre-Dodd-Frank Bilateral World



- Complex counter party risk network where there is a lack of clarity on second-order counterparty risks (e.g. Party A has little knowledge of the exposer that Party D carries relative to Party C and Party B).
- Related to above, it is difficult for each party to determine adequate levels of margin and capital to maintain given hidden second-order counterparty risks.
- Reduced information available to the market given bilateral nature of relationships.

Central Counterparty



- Greater transparency on counterparty risk relationship, allowing accurate determination of necessary margin and capital levels needed to be carried by counterparties.
- CCPs are in a stronger position to pool resources to absorb risk of default by counterparty.
- Regulators in a better position to assess and regulate systemic risks given the existence of CCPs.

FIGURE 9 *Source: The Economist 2010.*

Turning to the three-pronged conservative critique and the notion that requiring centralized clearing would incentivize greater risk-taking, it is important to recall that it was the under-collateralization of OTC derivatives positions leading up to the Financial Crisis that was inducing rampant speculation. Requiring centralized clearing should rein in risk-taking when compared to a system without such a requirement. Centralized clearing will provide participants in the OTC derivatives market with a much clearer picture of the associated risks and allow CCPs and regulators to respond to such risks with appropriate capital and margin buffers as well as other prudential requirements. It is unclear how an effective price and data reporting system could be formulated if the OTC derivatives market were to return to its pre-Dodd-Frank bilateral state.

It is equally unclear how the additional interconnections created by centralized clearing would amount to an increase of systemic risk when compared to the pre-Dodd-Frank system. Credit generation was brought to a screeching halt in 2008 due to the under-collateralization of derivatives positions and industry-wide uncertainty over outstanding counterparty risks. The transparency gained from SEF-based or exchange-based trading combined with centralized clearing addresses these issues head on. Trading volume and pricing information generated by SEFs as well as the clarity on counterparty risk relationships are crucial pieces of information needed to determine an adequate level of collateralization. It is hard to fathom how scrapping centralized clearing altogether would be a more sensible way of addressing the liquidity risks resulting from increased interconnectivity than simply implementing a more rigorous margin and capital buffer.

Lastly, to say that the centralized clearing mandate and the corresponding margin and collateral posting requirements would lock up capital is almost tantamount to amnesia, forgetting the events leading up to the 2008 Financial Crisis. The shock to the financial system was as strong as it was because the OTC derivatives market lacked adequate capital and margin buffer. "Freeing up" credit for use by financial firms by forgoing adequate margin and collateral was exactly what was going on before the Financial Crisis.

Regulations Create "Barriers-to-Entry." *Registration and reporting requirements for swap dealers and market participants constitute "barriers to entry" for market entrants, reducing competition while increasing market concentration.*

Forgetting that the derivatives market is already concentrated, conservatives espousing this view fail to balance the claimed harm against the need for such regulations. Swap market participants are required to register with regulators and must abide by regulations relating to, among other things, "minimum capital, marginal capital, bookkeeping, reporting, [and] conduct standards" (Zoch 2011, 104). These requirements provide regulators with more accurate grasp of market activity and associated risks, allowing them to in turn promulgate appropriate baseline prudential measures. While all regulations may in varying degrees pose challenges to market entrants, Dodd-Frank detractors have presented no viable alternative for how an appropriate level of capital and margin buffer is to be maintained by market participants.

SEFs are also instrumental to promoting competition. As shown above, prior to Dodd-Frank reform measures establishing SEFs, the overall opacity and bilateral nature of the OTC derivatives trading had resulted in a highly concentrated market. As noted by the former CFTC Chairman Gary Gensler, "The more transparent a market is...the more competitive it is and the lower the costs for hedgers, borrowers and ultimately, their customers" (2011). It is only through the availability of pre-trade pricing made possible by SEF trading that an opportunity for meaningful competition can arise.

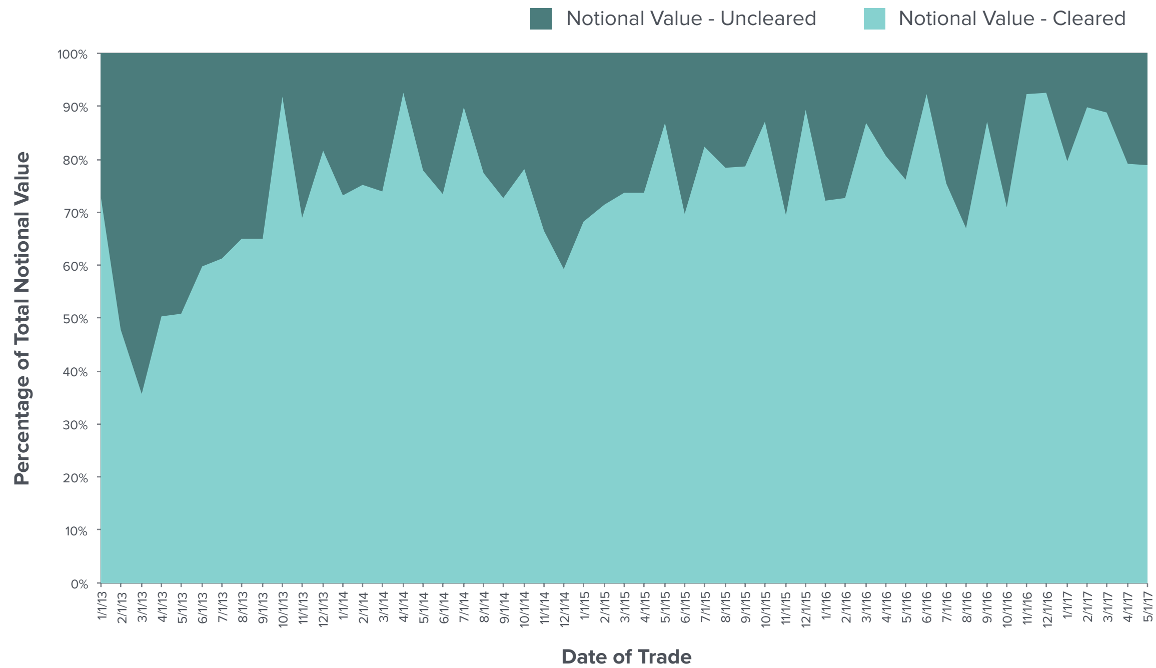
Overbroad Prudential Regulatory Authority. *The prudential regulatory authority granted to the Federal Reserve, SEC, and CFTC over non-banking financial institutions under Title VIII, when combined with FSOC's SIFI designation authority is overbroad and allows federal regulators to extend their reach to every aspect of the financial market.*

One of the key aims of the OTC derivatives regulatory reform under the DFA is to rein in systemic risks. To achieve this, it is necessary for regulators to respond nimbly to changing market practices and interconnections, and requires broad oversight and regulatory authority from Congress. As stated in 2011 by Daniel Tarullo, a member of the Board of Governors of the Federal Reserve Board, "Title VIII of the act complements the role of central clearing in Title VII through heightened supervisory oversight of systemically important financial market utilities, including systemically important facilities that clear swaps. This heightened oversight is important because financial market utilities such as central counterparties concentrate risk and thus have the potential to transmit shocks throughout the financial markets."

What the 2008 Financial Crisis demonstrated was that thanks to deregulation in the early 2000s, the market participants and regulators had next to no information on the scope of the OTC derivatives market and its corresponding counterparty and systemic risks. Lawmakers and regulators sought to undertake, through Titles VII and VIII of the DFA and their corresponding rules and regulations, to fabricate a new and comprehensive regulatory framework. The original three components of Title VII—swap dealers and market participant regulations; SEF trading and centralized clearing requirements; and the swap push-out rule—were supposed to work together to ensure greater transparency and to mitigate systemic risk.

The Title VII rules are thus paired with the Title VIII prudential regulatory authority over CCPs to ensure that in all circumstances regulators will have the flexibility to take necessary actions to safeguard the soundness of the US financial system.

PERCENTAGE SHARE OF NOTIONAL VALUE OF CENTRALLY-CLEARED INTEREST RATE DERIVATIVES



PERCENTAGE SHARE OF NOTIONAL VALUE OF CENTRALLY-CLEARED CREDIT DEFAULT SWAPS

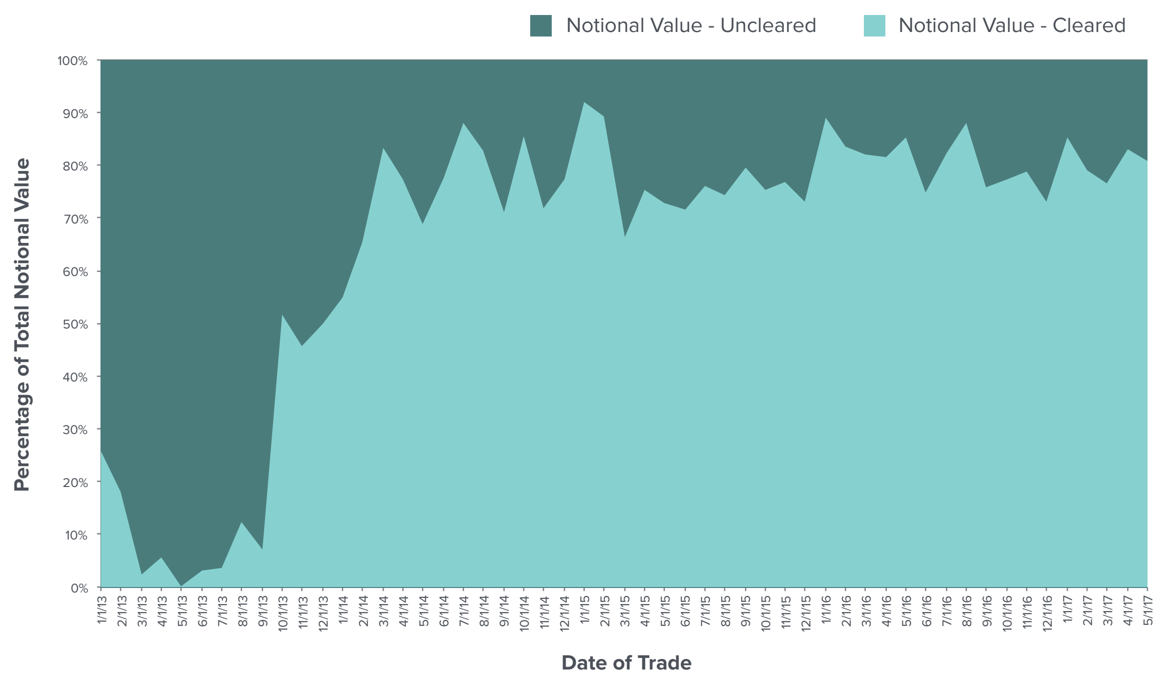


FIGURE 10 (above) and **FIGURE 11** (below) *Source: ISDA SwapsInfo (using publicly-reported data from DTCC and Bloomberg SDRs)*

As demonstrated in Figures 10 and 11, reform of the OTC derivatives market under Dodd-Frank has shown positive results. Yet, instead of proposing viable alternatives to address risks that stemmed from rampant speculation and a lack of market transparency, opponents to Dodd-Frank have sought to simply pare down the financial regulatory structure without a replacement. Looking at the events leading up to the Financial Crisis, this is not the appropriate policy direction for the US financial system and economy. Instead, policymakers should seek to strengthen the existing OTC derivatives regulatory structure, starting with reinstating the original Lincoln Amendment. Efforts should also be made to explore innovative forms of liquidity reserves to tackle potential systemic risks (see Capponi et al. 2015).

Instead of proposing viable alternatives to address risks that stemmed from rampant speculation and a lack of market transparency, opponents to Dodd-Frank have sought to simply pare down the financial regulatory structure without a replacement.

Admittedly, the OTC derivatives regulations under DFA are not perfect and they could be further improved and updated. However, to scrap Titles VII and VIII based on the conservative arguments discussed above would be to ignore the forest for the trees. Until Dodd-Frank detractors can present a more effective alternative to tackle the risks inherent in the pre-Dodd-Frank OTC derivatives market, deregulatory efforts would simply return it to a "financial Wild West."

Conclusion

The Financial Crisis was real. So too was the unhealthy growth of the financial sector in the decades that preceded it. Finance grew more rapidly, more profitable, but less efficient and through taking systemic risks that lead to the largest downturn since the Great Depression. As we've shown, the Dodd-Frank Act is a series of reforms designed to tackle the most immediate problems that were exposed by the Financial Crisis.

The greatest immediate concerns about the role of investment and the financial sector have to do with finance taking resources out of the real economy. Stock buybacks and dividends have added up to over a trillion dollars a year at points during the Great Recession. Finance takes out roughly six times the amount of resources compared to what it invests in initial public offerings, venture capital and other equity investments in the real economy (Mason 2015). This concern over "short-termism" in financial markets has brought together a wide variety of stakeholders and should be investigated further to understand why investment remains weak in this economy.

Future reforms should build on Dodd-Frank, rather than repealing it based on ideological narratives that seek to alter historical facts.

Beyond this, there remains reasonable concerns about the low level of capital banks fund themselves with, the accountability for financial sector fraud, increasing market concentration across size and activities, and the need to channel society's resources to productive activities. Future reforms should build on Dodd-Frank, rather than repealing it based on ideological narratives that seek to alter historical facts.

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Conclusion

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