Did we tame the beast: views on the US Financial Reform Bill

Duke University's Prof Lawrence Baxter takes a microscope to the 'Dodd-Frank' Bill finding a veritable 'Micrographia' of doubt.

THIS paper was written in anticipation of the US Financial Reform Bill's final passage through Congress prior to being signed into law by President Obama on July 5 – obviously this is now not the case. The Bill currently before Congress was devised to address problems associated with the global financial crisis (GFC) of 2007-2009.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, which by its very title indicates the complicated nature of the reforms, is actually not yet law. The Bill, which I will refer to as "Dodd-Frank" for the rest of this paper, now hangs in limbo, having been passed by the House of Representatives and the Senate, subsequently reported out of Conference Committee and finally approved by the House, but not quite yet enacted by Congress.

Two more votes remain in the Senate. The first will be whether to stop with a cloture vote an attempted filibuster by the Republican minority, which would prevent the bill from coming to a floor vote. If the Senate votes for cloture a second vote will then approve the legislation by a likely margin of about 59 votes to 40. Only then can the Bill go to the President for signature. These final votes are scheduled for next week when Congress returns from the July Fourth recess. So we will not know until next week whether 12 months of intense effort in Congress and two years of aftershocks from the GFC will actually lead to financial reform in the United States. If, however, Dodd-Frank is signed into law, the United States will become the first major nation to honour its commitment to the G20 to reform its financial system.

Dodd-Frank in general

This legislation is neither uncontroversial nor sure to be effective. The Bill has engendered a range of reactions, ranging from savage criticism to effusive self-promotion by Congressional leaders and the President. At the conservative end of the spectrum, a professor at Stanford writes that Dodd-Frank is a "financial fiasco." The ubiquitous Judge Richard Posner, having recently turned his attention to the subject of banking regulation and become a Keynesian after years in the Milton Friedman camp, has described the bill as "politics in the worst sense." Liberal commentators have mixed reactions too, with Lynn Parramore declaring the bill to be"both disappointing and inspiring" and Chris Bowers, co-founder of the organisation known as OpenLeft, advocating that despite its shortcomings it is still worth supporting and the last chance to "really take on the banks." Even Paul Volcker, former chairman of the Fed and after whom one of the major new activity restrictions in Dodd-Frank is named, is said to be disappointed with how that restriction – the Volcker Rule – was watered down in order to secure Republican votes. There is indeed enough in the massive 2,307-page bill to delight, anger and/or befuddle everybody to some extent.

Not a complete bill

Dodd-Frank also conspicuously avoids two major areas of greatly needed reform, namely regulatory consolidation among the nation's illogical morass of financial regulators, and restructuring of the GSE system designed to promote easy access to home mortgages, such as Fannie Mae and Freddy Mac. These dysfunctional organisations, in the view of many, were among the significant contributors to the GFC.

Finally, implementation of the Bill awaits over 200 rule-making processes by the implementing agencies! These regulatory elaborations will add considerable depth to the legislative framework and their outcome, far from predictable, will depend on further intense lobbying by all the stakeholders at the less visible level of the administrative process.

Yet there is no doubt that Dodd-Frank will profoundly reshape financial services for decades to come. There is much in it that I would praise.

What's hot

Consumers have received short shrift in recent years as financial products have become more byzantine, and only a predatory lender, auto dealer, or Washington lobbyist would argue that is it acceptable that ordinary consumers should have to engage professional assistance merely to understand the terms of their mortgages or credit card agreements. As the damage incurred by complex – some would say unnecessary – products sold aggressively to investors has escalated it is also important that the professionals in the business be placed under increasing standards of care in their disclosures and conduct; this, too, is partly addressed in the legislation.

The derivatives market is presently rather like the foreign exchange market of a decade ago: money is made as much through the privileged access to information as through actual value added, and in the case of derivatives which can have such massive contingencies the strengthening of the exchange infrastructure and market transparency is an urgent necessity. The introduction of proper supervision is also to be welcomed.

Mission accomplished?

Given space restrictions, it is impossible to give a wide-ranging summary of the Dodd-Frank reforms. Instead, one's intent is to focus on a single important question; namely, does the legislation squarely face and adequately address the problem of financial instability so as to significantly reduce the risk of another collapse in the financial system? The threat of destabilisation is the beast that lurks under the gigantic, volatile and labile financial system upon which global prosperity and security depends. Have we in the United States done our part to challenge this beast?

My view is that we have not. We have made a partial and reasonably good faith attempt, but we have not truly come to grips with one of the central causes of financial instability, namely the massive global financial institutions now roaming the planet. I will adopt the term in regulatory use for these institutions: large, complex financial institutions, or LCFIs. Just as we saw with the failure of Lehman Brothers and the near collapse of AIG, Citigroup, Merrill Lynch, Royal Bank of Scotland, Lloyds and others in 2008, the failure of any one LCFI would inflict serious disruption on the entire financial system.

Issue of 'too-big-to-fail'

These and many other financial institutions are now more or less openly acknowledged to be"too important to fail,""too big to fail"or, more euphemistically, "systemically important." Despite bold declarations and efforts in the legislation to restrict future government assistance, the Dodd-Frank legislation does not do enough to address this problem and, for as long as these LCFIs operate at their current scale and complexity, the financial system will remain fragile and vulnerable to massive sudden shocks.

It is true that Dodd-Frank purports to deal with the problem and has been sold as having dealt with it. But in the ultimate analysis it has not. This is because Dodd-Frank assumes that LCFIs can be safely operated, regulated and, if necessary, liquidated. However, as long as LCFIs are permitted to operate at their current scale and complexity they will not and cannot in practice be allowed to fail, no matter what the legislation permits or prohibits and no matter what Senator Dodd, Congressman Frank or officials at the Treasury Department declare to the contrary.

Financial stability

Of all the anxiety stemming from the GFC, perhaps the greatest is fear of widespread domestic and international financial instability. While specific and localised bank failures are surely always painful, they seem to be part of the normal functioning of economic systems – a manifestation of the Schumpeterian "creative destruction" that ensures the very survival of capitalism itself. It is not such specific failures but rather widespread breakdowns of the kind we experienced with the GFC that instil the real fear.

Prevalence of financial crises

This fear is well founded. The GFC is only the latest in a long line of similar crises. Many earlier crises are well known, including: the Dutch Tulip Mania of 1637; South Sea Bubble of 1720 ; Mississippi Company in 1720; Great Crash of 1929; and, of course, Asian Financial Crisis of 1997.

Crashes have occurred in almost every economic region of the globe. It might come as a surprise to learn that there have been more than 112 systemic-scale financial crises in over 90 countries over the past 30 years. Indeed, such crises are now twice as prevalent today than they were a century ago. And we don't seem to be making much progress in eliminating them. Systemic risk has really only recently attracted much attention.

The first glimmers of concern arose in 1974 when a relatively small financial institution in Germany, Bankhaus Herstatt, failed unexpectedly, generating overnight shocks to financial institutions in other countries that were exposed to losses resulting from their inability to settle currency trades with Herstatt in the later time zones.

A much more massive version of the systemic phenomenon occurred when Lehman Brothers was allowed to fail on September 15, 2008. Lehman became the largest bankruptcy in US history even though the investment bank was by no means the largest US financial institution. Credit markets froze overnight as financial institutions took defensive action to mitigate their exposures and anticipate potential losses. This was the event that effectively plunged the world into the GFC.

Founding of Basel Committee

The Herstatt failure prompted the creation by the G10 of a Committee on Banking Regulations and Supervisory Practices, known as the "Basel Committee." Over the past three decades the Basel Committee and another committee working out of its offices and created by the G20, the Financial Stability Board (FSB) (before 2009 the Financial Stability Forum), have worked on various ways to reduce the vulnerability of the global financial system.

Obviously these institutions failed miserably in preventing or even anticipating the current crisis – a story too complicated to investigate here today. Nevertheless, our dim understanding of what leads to such crises, if not our ability to stop them, has actually improved. We have better economic data at both the global and domestic levels and regarding the histories of specific financial institutions. Clear patterns do seem to emerge in the cycle from boom to bust. In recent months governments and markets have been reacting apprehensively to all kinds of signals of possible systemic failure, ranging from the risk of sovereign defaults in Dubai and the Eurozone to possible asset bubbles in Beijing and Shanghai.

Financial scale and scope

Fluctuating with the ebb and flow of economic globalisation are the fortunes of financial institutions themselves. Their scope and interconnectedness are increasing as fast as the spread of global finance, and their individual sizes have escalated at spectacular rates in recent years. There are now 180 financial institutions with assets greater than $50 billion, with 39 each having more than $500 billion in assets. The largest (currently BNP Paribas) holds just under $3 trillion. Many of these institutions have been kept alive only through massive injections of public funding. Among these financial institutions, many, including some of the biggest, have grown rapidly, more than doubling in size over the past five to 10 years.

Bank of England study

Despite their assertions of efficiencies of scale, these financial conglomerates have long ceased to be as efficient as their smaller counterparts. So their economic value is questionable. What is worse is that the value of the *de facto* public subsidies they enjoy is substantial.

A respected study by the Bank of England recently suggested that the public subsidy of the five largest banks in the United Kingdom has been running at $30 billion per year. A similar study in the United States suggests that the subsidy derived from the US Treasury's TARP programme for the top 18 banks is approximately $34 billion/ year. In both studies the largest banks take the lion's share of this public subsidy. Furthermore, both studies look at only one aspect of various state-backed advantages large financial institutions enjoy; there are indeed various other forms of support that generate a broader aggregate subsidy.

The international financial system is greatly dependent on the fortunes of these ultra large financial institutions. Difficulties experienced by any one such institution leads to one of two inevitable results: either additional public subsidies are required to keep the institution open, or letting it go into bankruptcy will lead to widespread financial disruption and even general instability – as witnessed during the GFC. This is why such institutions that have become known in the United States as TBTF.

Dodd-Frank solution

How does the Dodd-Frank Bill address this problem? One obvious way would have been to impose limitations on the size of financial institutions. An amendment proposed by two senators did indeed place such an option squarely before the Senate. Their amendment, however, met fierce opposition from the large banks and the Treasury Department and was eventually defeated. Instead Dodd-Frank delegated the problem to the regulators. The regulatory approach to the problem is to: supervise the health of the individual institutions themselves (so-called "microprudential" regulation); monitor the systemic inter-dependence of each financial institution as they interact within the broader financial system (so-called "macroprudential" regulation); and promote, through the medium of the G20, Basle Committee and FSB, greater international co-operation in order to address the transborder interconnections among LCFIs.

Regulatory approach

Consistent with this regulatory oriented approach, and accepting the position of the US Treasury Secretary that regulators should possess the discretion to act appropriately when dangers arise, Dodd-Frank creates an elaborate and graduated framework for regulatory action.

1.) The Bill creates sophisticated machinery designed to anticipate and react to the buildup of systemic risk. This consists of the new Financial Stability Oversight Council, informed by a new Office of Financial Research in the Treasury Department, which has the responsibility of collecting economic data and producing analysis to identify and monitor emerging systemic risks. Dodd-Frank also casts a wide net over any financial institution that might contribute to this risk, whether it be a bank or not.

2.) Regulators are empowered to implement progressively tougher standards, ranging from capital requirements to activity restrictions to limits on single counterparty exposures, in order to prevent such systemically significant institutions from becoming more risky. The Bill prohibits certain types of conduct *ex ante,* though the implementation periods are lengthy and it is far from clear that such activities, for example proprietary trading which will be banned by the so-called Volcker Rule, are really all that important in generating systemic risk, particularly given the exemptions created by the Bill and the lengthy implementation periods.

The regulators can also extend this framework of supervision and limitations to financial institutions designated "systemically significant," even if they are not banks. Such systemically significant institutions will also be required to develop their own "funeral plans" which would provide blueprints for their orderly shutdown when things go wrong.

3.) Dodd-Frank prohibits direct bailouts, either by the lender of last resort or deposit insurer, that benefit an individual bank. The Fed may only provide emergency lending on a broad basis, and not solely for a specific institution, and then only with the approval of the Treasury Secretary. The FDIC, which protects the deposit insurance funds and depositors, has to get special – ultimately Presidential and Congressional – approval in order to guarantee debt in order to prevent a bank run.

4.) New speedy resolution or liquidation procedures, similar to those that already apply to banks, are created for any financial institution deemed systemically significant. The FDIC, which is already the receiver for failed banks, will wind up financial institutions forced into this bankruptcy system.

Yet the final iterations of Dodd-Frank have been met with many headlines declaring that the bill will not in fact have killed TBTF. Gretchen Morgenson of the *New York Times* identified "cutting big and interconnected financial entities down to size" as one of the most important objectives for successful reform. In her assessment "the bill fails completely."

Dodd-Frank failings

I believe Morgenson's evaluation is correct. We will have another crisis soon enough; indeed such crises seem ultimately unavoidable. If Congress, after the kind of crisis we have just been through, cannot itself impose scale limitations on very large financial institutions, I don't think the regulators will ever be in a position to shut them down. And if financial institutions of current scale and complexity continue to operate, I don't think that they can be shut down when a crisis occurs.

Complexity of LCFIs

The primary reason for this gloomy outlook is that financial institutions have evolved to a degree of complexity and size where it is not only more likely that they will fail. It is also practically impossible to let them do so without the cure being worse than the disease.It is more likely that financial Leviathans will run into serious difficulties because:
(a) they are now beyond the level of complexity at which risk can safely and reliably be managed; and, (b) it is unrealistic to think that current resources and techniques of regulation can meaningfully monitor them; and, (c) their sheer scale and complexity of operations spawns such deep mutual interconnectedness that the failure of any one creates the serious risk of failure by many others, as well as schools of smaller financial institutions.

Such companies, let alone their

regulators, are still learning the skills of and developing the tools for the complex risk management necessary to operate on a large, global scale in a highly labile global financial market.

It is not just credit and market risks that they must master (they have acquired considerable experience at addressing these types of risk); it is also an increasingly complicated level of operational risk, in which the diversity of such companies, coupled with the escalating sources of unexpected dangers – both functional and geographic – creates a situation with which BP would surely now identify: you simply will not see the lightning that hits you. I have yet to see a serious risk management or regulatory plan that adequately or reassuringly addresses such risk complexity.

Intervention paradox

It is less likely than ever that regulators will use their powers to shut down a large, systemically risky institution because of what one might label the intervention paradox: just when the need to precipitate terminal action to seize a financial institution is greatest, the incentives not to do so, and the ability of the institution itself to resist seizure, are also highest.

The result is that such institutions are kept open to the point where they either become zombies – publicly subsidised and ultimately non-productive (i.e. not sustainably profitable) wards of the state – or their collapse creates far greater damage on other institutions than should have been allowed.

To elaborate on this paradox, when financial institutions get into difficulty, financial agencies have two main responsibilities. If the problem for the institution is essentially one of liquidity then the central bank's job is to act as a lender of last resort.

Paradox elaborated

If, on the other hand, there is a risk of a run on the bank, or if there is a danger that the bank's failure will dissipate more capital than will be sufficient to cover repayment of the deposits, then the deposit insurer's job is to take "prompt corrective action" to pre-empt the failure or, if this action is already too late, to seize the bank and put it through fast-track receivership. When the bank is very large and systemically significant, the temptation for both a central bank and deposit insurer is to try to keep the financial institution open in the hope that it will make it through the crisis and be able to rebuild.

Small banks are relatively easy to close, and in the US the FDIC regularly closes failing banks with little disruption. But the closure of a complex large bank is both costly to the federal insurance funds and carries the risk of systemic damage to other financial institutions.

IMF observations

As a recent study by the International Monetary Fund concluded: "The failure of a systemically important institution increases the likelihood of failures among non-systemic institutions. This means that any regulator will be more lenient with a systemically important institution." Furthermore, the actions of both types of regulators (lender of last resort and prompt corrective actor) become mutually reinforcing and likely to perpetuate the survival of weak but very large institutions. And this is before even taking into account the intense lobbying power that such large institutions possess, which will almost certainly be deployed as a political barricade against any regulatory aspirations to the contrary.

The Dodd-Frank system would appear to eliminate the "too big to fail" possibility by prohibiting bailouts in all but the most restricted circumstances.

But consider why the possibility of a bailout exists in the first place: the institutions we are talking about would generate all the conditions necessary for both emergency loans from the Fed and debt guarantees by the FDIC, precisely because their failure would have major systemic consequences the world over.

Restructuring TBTFs

So while the prudential measures developed by Dodd-Frank might in theory help reduce the threat of systemic danger, the continued existence of LCFIs, the failure of which would have major systemic consequences, makes another major disruption to financial stability and another bailout all but inevitable.

There is, in my view (and the view of many others) only one way to install systemic blowout preventers so as to mitigate, at least, the scale of damage caused by the next financial crisis. This is to limit the size of, or substantially restructure into safer, more self-sealing subcomponents, the denizens that operate within the system. Limiting bank size will not entirely reduce complexity (which generates operational risk and the possibility of institution failure) or interconnectedness (which generates systemic risk). Indeed an industry paper makes the argument that size is not the problem; rather it is interconnectedness, a feature shared by smaller as well as larger institutions.

Big equals unmanageable

Interconnectedness is indeed the capillary network of systemic risk. But the argument that size is irrelevant misses the point: interconnectedness increases exponentially with size and above a certain scale risks start to become unmanageable.

So limiting financial institution size would be not for the purpose of improving safety. Large scale virtually guarantees the presence of excessively complex risk. More important, the systemic impacts of failure are magnified by size.

The managerial culture of banking exacerbates the risks generated by scale. The advocates of large-scale banking, including most of the executives, tend to favour the centralised, branch and integrated model of universal banking because this model is perceived to be more efficient.

Over-centralisation risk

A unified corporate structure enables the organisation to leverage its capital over all of its operations and avoid the intra-affiliate legal, accounting and operational impediments among subsidiaries. Yet this same operational consolidation also conducts risk more freely across the corporate entitity. Some national regulators require foreign banks to establish local, separately capitalised and operated subsidiaries precisely in order to facilitate more effective domestic supervision. This is part of the attraction of the non-operating holding company (NOHC) structure favoured by the United

States and some other countries. Affiliate transaction restrictions help to prevent transmission of risk between the operating subsidiaries, and it might be possible to refine structurally separate components further to produce safer conglomerates that can be managed more coherently and that contain stronger internal insulations when risks get out of control.

Dodd-Frank indeed uses this technique to address the risks posed by hedge fund activity for banks by requiring that such activities be "pushed out" into separate subsidiaries. Whether the LCFIs would welcome this approach is another matter, since the inter-affiliate restrictions would necessarily reduce the "efficiencies" enjoyed by folding diverse operations into more monolithic corporate entities.

Rethinking the framework

In the absence of sound policy reasons for assuming the greater risks that such institutions add to the system, it is therefore hard to see why it makes sense to continue, like deer in the headlights, to watch financial institutions reach new scales that are beyond the capacity of regulators to supervise properly, at least with techniques currently available, and their own capacity to provide credible guarantees that they can be operated safely.

Perhaps a combination of learning and technology will ultimately render very large-scale banking safe. Yet even if this were the case, Dodd-Frank ultimately relies upon an outdated framework for matching the new world of finance.

This is because, in my opinion, Dodd-Frank is conceptually misconceived as a vehicle for promoting systemic financial safety. The global financial system is evolving so rapidly, is so volatile and so labile that it possesses the characteristics of a complex adaptive system – one that more resembles the weather than a product of intelligent central design.

Prof Arner *et al*

If the global financial system is really more accurately understood as a truly complex environment in the scientific sense, then trying to regulate modern global finance will require more nuanced, skilled and rapidly reactive regulation than commands, prohibitions or greater enforcement powers. New techniques of adaptive regulation must be developed to meet the fast-paced world of payments, financial dealing and innovation.

Douglas Arner and his co-authors have recently completed major studies directed toward comprehensive redesign of the global financial system and its regulation, so I would direct the audience to that study for a fuller understanding of the overall issues that must be addressed.

Closing remarks

I will content myself by noting, in closing, that there are some elements of the financial ecosystem that can be controlled upfront. One of them is the size of the participants, so that at least the environmental damage caused by these players does not destroy the habitat for other creatures.

In this important respect the Dodd-Frank Bill has avoided dealing with a central vulnerability to the financial system. This reform will almost certainly be back on the table after the next disaster, the odds of which, if history is any guide, are very high. •