



Did Policymakers Get Post-Crisis Financial Regulation Right?

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BIPARTISAN POLICY CENTER

ABOUT THE FINANCIAL REGULATORY REFORM INITIATIVE

This paper is a product of the Financial Regulatory Reform Initiative (FRRI) at the Bipartisan Policy Center. FRRI was created to assess the Dodd-Frank Act and the progress of post-financial crisis reform to determine what is and what is not working and to make recommendations to improve the financial regulatory system.

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ACKNOWLEDGMENTS

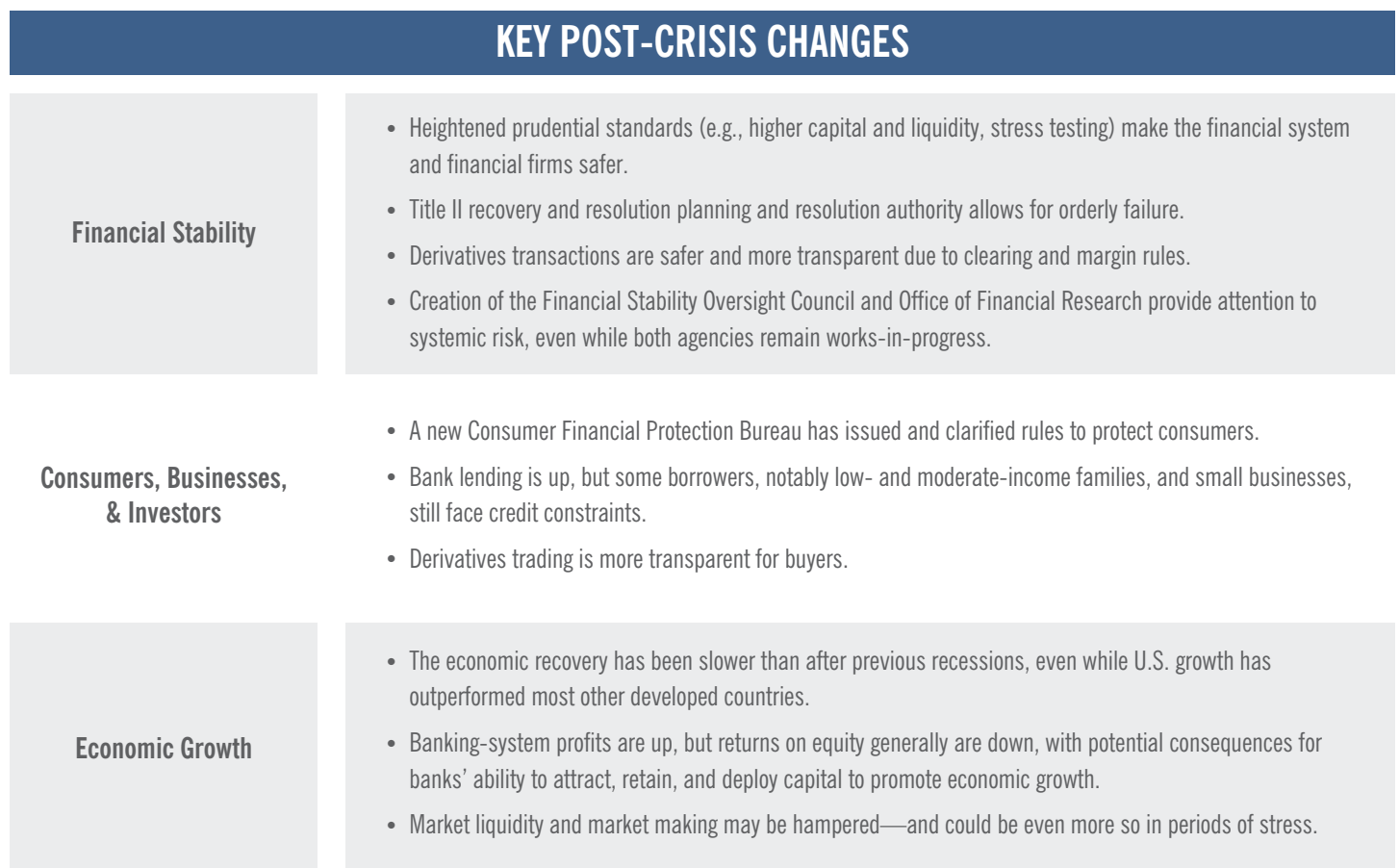
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Executive Summary

Eight years after the worst of the financial crisis, the new U.S. financial regulatory structure is largely in place. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and a set of standards negotiated by global regulators have produced new rules and regulations that policymakers can now observe empirically to determine how this new structure is working. It is time for policymakers to assess the cumulative impact of the regulations on the condition of the financial system, economic growth, and all end-users of financial services, including consumers, small and large businesses, and investors. In implementing the new regulatory framework, did policymakers strike the right balance among these three factors? The Bipartisan Policy Center’s Financial Regulatory Reform Initiative’s answer, in summary, is that Americans have a safer financial regulatory system than before the crisis, but there are some less-than-optimal outcomes and unintended consequences of post-crisis reform that warrant attention.

The financial system is safer than before the crisis. Financial institutions are better prepared to withstand future disruptions with higher capital, liquidity, and risk governance standards; and regulators are better able to manage the failure of large financial firms. Consumers, especially mortgage borrowers, are better protected from risky financial products through a series of new rules and actions by the new Consumer Financial Protection Bureau. Derivatives transactions are more transparent and safer due to margin and clearing requirements. **(See: Figure 1.)**

Figure 1: The consequences to financial stability, consumers, and economic growth of post-crisis regulatory changes.



At the same time, developing and implementing hundreds of new rules has produced some outcomes that are not ideal. This is to be expected, but such cases merit review and reform. That is the point of this paper. Rules devised by several agencies with multiple internal teams will sometimes not be coordinated well or might even conflict with each other. Other rules may be duplicative, or not optimally calibrated. Still other rules may work mostly as intended but also produce unintended consequences. Such outcomes and unintended consequences can affect access to credit and costs for consumers, and they can impede economic growth and financial innovation. In addition, there may be gaps in regulation that either have not been adequately addressed by post-crisis reforms or have emerged since the crisis that could negatively impact financial stability in addition to consumers and the economy.

Over the past few months, BPC's Financial Regulatory Reform Initiative has examined this question, paying attention to financial conditions for the consumers and businesses who rely on the financial system. We reviewed data on the condition of the financial system, credit flows, and economic growth. We complemented our research with more than 30 interviews of current and former regulators, consumer groups, market analysts, bankers, labor advocates, asset managers, and other experts to gauge the impact of post-crisis financial regulations.

The research and outreach has yielded the following initial conclusions and recommendations to the next president and Congress—and to financial regulators:

1. There is evidence that certain financial regulations are leading to some unintended consequences:
 - a. The migration of certain activities from banks to nonbanks or across borders, and the curtailment of other activities.
 - b. A lack of coordination, and unnecessary duplication and conflict in rules, reflecting the fragmentation of the U.S. financial regulatory structure.
 - c. The existence of binding constraints on the business decisions of firms, sometimes resulting in “cliff effects” in which the provision of financial services or products to certain consumers and businesses experiences a sudden and steep reduction due to one or more regulations rather than competitive market factors.
 - d. Continuing gaps in regulation.
2. Both regulators and an independent commission should conduct formal and periodic assessments of the effects of the financial regulatory system on financial stability, consumers, and economic growth. Such assessments should include an examination of both the intended consequences of financial regulation and unintended consequences outlined above. In addition, we call for further analysis on access to credit for small businesses and low-income consumers.
3. A series of short-term, “no regret” measures could be taken to improve the financial regulatory system without jeopardizing financial stability. Among these measures are:
 - a. Giving the Office of Financial Research (OFR) the authority to evaluate the impact of regulation on economic growth.
 - b. Requiring a pilot project for a consolidated bank exam force.
 - c. Having the Consumer Financial Protection Bureau evaluate alternative credit-scoring models.

- d. Recommending an agency review of the leverage ratio requirement.

BPC plans to build on these findings to further explore these critical issues.

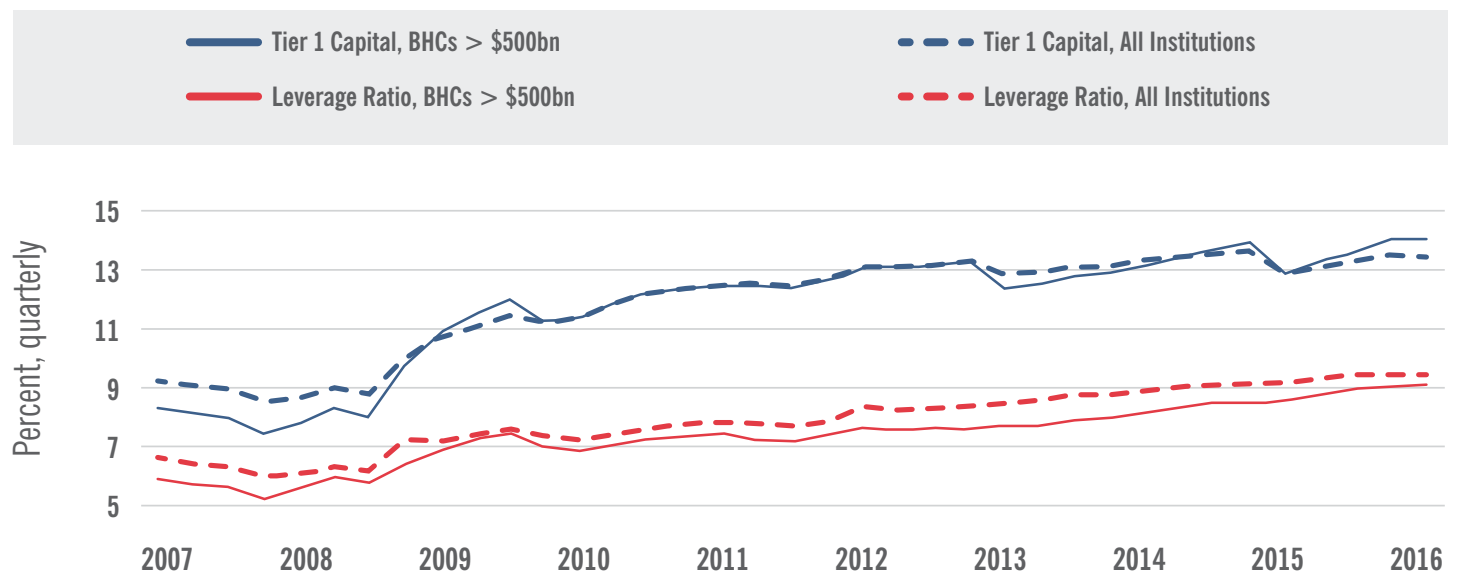
Changes in the Post-Crisis Landscape

The financial system is safer than before the crisis and regulators have useful new legal authorities to manage a crisis. American policymakers and regulators responded to the financial crisis with new rules that included increased capital standards and higher-quality capital, stress testing of the largest banks, more liquidity, and requirements to increase margin on derivatives transactions and run those transactions through central counterparty clearinghouses (CCPs). **Figure 2** shows the increase in capital ratios since the crisis across all banking organizations and those with assets of more than \$500 billion. Dodd-Frank provided new authorities meant to allow large, complex financial institutions to fail in an orderly manner without transmitting risk to the rest of the financial system, while also addressing the “too big to fail” problem that caused such institutions to be bailed out during the financial crisis. Large, complex firms are subject to recovery and resolution planning, and they are required to fund themselves with an extra layer of debt that can be converted to equity to absorb losses. Regulators have access to a new Orderly Liquidation Authority and an Orderly Liquidation Fund when a resolution through bankruptcy would threaten financial stability.

Consumers are better protected, but some face credit constraints. Policymakers shielded consumers from risky financial products, in part by creating the Consumer Financial Protection Bureau (CFPB) to focus exclusively on consumer protection. Regulators mandated greater transparency in bank balance sheets, activities, and products.

Figure 2: Since the crisis, banks have increased their capital and leverage ratios.

Tier 1 Capital and Leverage Ratios



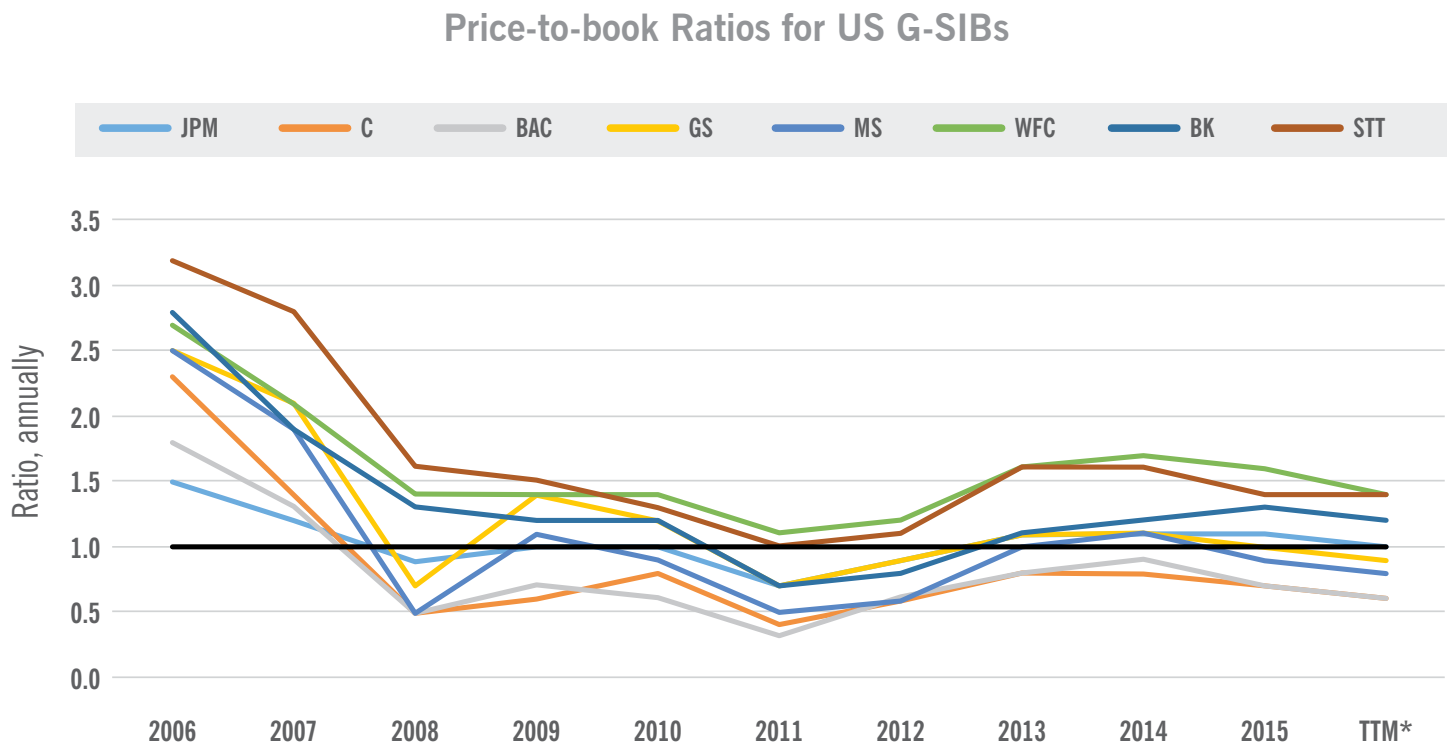
Source: Federal Reserve Bank of New York.¹

Transparency also gives investors better information on financial markets, trends, and products, which lets them better evaluate and manage the risks of their investments and allows market discipline to incentivize good risk management. Overall bank lending is up, but, as discussed in detail below, certain segments of borrowers face increased barriers to, and costs for, credit.

Regulatory changes that improve safety and stability are likely to affect growth and innovation.

U.S. GDP growth has been slow relative to past post-recession recoveries, even though the U.S. economy has outperformed many other developed countries in the same period. While U.S. banks have increased their capital ratios and strengthened their balance sheets, price-to-book ratios for large banks are low relative to pre-crisis norms. **(See: Figures 2-3.)**^a Economic growth requires a banking system that is able to attract, retain, and deploy capital. Banks trading at a discount to book value for extended periods face questions about their long-term ability to allocate capital productively, potentially affecting economic growth. For example, one recent study suggested that lower valuation can make banks more vulnerable to shocks, counteracting improvements to financial stability made

Figure 3: Average price-to-book ratios for large U.S. banks have been lower since the crisis, and in some cases are below one.



Source: Morningstar, accessed August 18, 2016.

*TTM = Trailing Twelve Months. JPM is JPMorgan Chase & Co., C is Citigroup Inc., BAC is Bank of America Corp., GS is Goldman Sachs Group Inc., MS is Morgan Stanley, WFC is Wells Fargo & Co., BK is Bank of New York Mellon Corp., STT is State Street Corp.

a. The largest banks' price-to-book ratios remain low post-crisis and, in some cases, below one, an indication that investors are discounting the firms' market capitalizations below the value of their actual equity.

in other areas.² Yet, isolating the impact of financial regulation on economic growth from other factors, including prevailing monetary policy, is difficult.

Global policymakers have expressed the need to think through these issues. In 2015, the European Commission issued a call for evidence to better understand the combined impact of new regulations and to determine whether action is required to promote jobs and growth in the European Union.³ The Basel Committee's oversight body has said it will "focus on not significantly increasing overall capital requirements" this year while it conducts a quantitative-impact assessment.⁴ In September 2016, the G20 leaders mentioned the importance of financial stability to economic growth, and also the need to address any unintended consequences of financial reforms.⁵

BPC's Interviews Found Common Themes

Our survey of diverse stakeholders yielded considerable agreement regarding the most helpful post-crisis changes. Interviewees often cited higher capital requirements, stress testing, the new failure-resolution regime, and improved transparency in the clearing of derivatives trades as reforms that had contributed to improved safety and stability. These provisions intentionally impose costs to consumers of financial services. Prior to the crisis, credit was extended at times to borrowers who could not afford it. Some costs of financial activities were borne by taxpayers rather than firms, such as when taxpayers bailed out failing firms. Raising costs and affecting behavior was an intended consequence of post-crisis reform.

While praising many post-crisis changes, interviewees were divided on what they considered the most harmful regulations. A common theme of industry respondents was that regulators had gone too far in implementing some otherwise beneficial reforms. Some argued that capital requirements have become too high and that too many requirements are binding on different activities. Some said that regulation is creating binding constraints that are reducing access to credit for some consumers and businesses. Similarly, they expressed concern that the liquidity rules and other prudential requirements are overlapping and duplicative, and that stress testing is unnecessarily opaque and has become a binding constraint on banks' efforts to meet the needs of customers.

Industry respondents also raised particular concerns about the Volcker Rule's implications for market making and market liquidity. Other interviewees, however, maintained that continued affiliations between banks and securities firms could draw credit away from small businesses if banks allocate more resources to capital markets activities than lending. That could result in a reduction in access to credit to small businesses given their relative lack of ability to access capital markets for funding.

Several interviewees cited rules that have centralized risk in CCPs as a danger that regulators have not yet adequately addressed. These interviewees suggested that CCPs have become a class of too big to fail institution and that regulators should consider a range of solutions, including subjecting CCPs to stress testing and other prudential requirements to make them less prone to the failure of member firms, altering governance practices and incentives that may make CCPs more systemically risky, ensuring that cybersecurity risk is mitigated, and considering using a utility model for central clearing rather than a for-profit model.

Other interviewees stressed that continued reliance on short-term funding can spark destabilizing runs in the bank and nonbank sectors. These interviewees were concerned that liquidity regulations are insufficient to stop runs, especially for the less-regulated nonbank sector, and might encourage firms to hoard high-quality liquid assets during periods of stress, a reaction that would worsen financial market strains. They recommended a range of

options, from increasing the deposit insurance threshold, to taxing the use of such funding by nonbanks, to even banning the issuance of short-term liabilities by all firms except regulated banking institutions.

Assessing the merits of these and other opinions is complex in part because measuring the costs and benefits of financial regulation is difficult and, in some cases, perhaps impossible. The compliance costs of rules are relatively straightforward to quantify, but other costs, and especially the benefits of regulation to financial stability and consumers, do not lend themselves to simple metrics. Conducting cost-benefit analyses of financial regulations may be a helpful tool for policymakers, but it has limitations.

Post-Crisis Regulations have Unintended Consequences

Even while recognizing the intended consequences of Dodd-Frank and other global financial reforms, such as reducing bank leverage, BPC interviews and research suggest that a number of unintended consequences of the post-crisis reforms warrant greater scrutiny, including activity migration or cessation, fragmentation leading to duplication and conflict, multiple binding constraints, and regulatory gaps.

Migration or Cessation of Activities

A range of activities are migrating from banks or being curtailed. Some changes, such as the Volcker Rule's ban on proprietary trading by banks, were intended by policymakers. However, some of the changes were unintended and may have economic costs—the Volcker Rule itself, for example, continues to impose uncertainty and costs as institutions (and perhaps the regulators themselves) are still figuring out what is permissible and what is not with respect to making markets. The migration of activities to nonbanks raises financial-stability concerns if those moves mean that some activities or providers of products and services elude prudential regulation. Migration also could make these activities more expensive or more difficult to procure for consumers.

1. Some activities, such as lending and mortgage servicing, have been moving to nonbanks, which typically face a lower regulatory burden. Such risk-shifting is expected, but it may have negative implications for financial stability if riskier activities shift to unregulated nonbanks. Risk-shifting also could affect consumers. For example, in the run-up to the financial crisis, mortgage lending shifted into less regulated nonbank originators, which maintained lower underwriting standards and ultimately had worse-performing loans.⁶
2. Other activities, particularly those with low margins and those that require high volume or balance sheet space, are being discontinued or offered by fewer institutions. This may reduce competition or make it more difficult for certain segments of consumers to obtain services. Examples include:
 - Market making on relatively illiquid assets that are not routinely and actively traded, such as venture-capital and real-estate investments.
 - Low-margin services like Treasury clearing for repurchase agreements.
 - Nonoperating and wholesale deposits.
 - Financial services for customers deemed “high risk” under anti-money-laundering and know-your-customer rules. As banks de-risk for reputational and regulatory purposes, they can stop doing business with some clients.
3. Certain activities are moving across borders, or affecting institutions headquartered in other countries. Some global banks are reducing their activities across a range of countries. Some are ending correspondent banking

relationships because of anti-money-laundering risk. Some foreign banks are reducing their presence in the United States because of the Federal Reserve's intermediate-holding-company rule. The intermediate-holding-company rule increases the costs for foreign banks operating in the United States to engage in certain activities, since such firms are now subject to enhanced U.S. prudential and capital requirements relative to those they were subject to before the crisis. These structural adjustments could result in markets with fewer competitors, while increased concentration can hurt consumers and leave remaining firms more systemically important.

Fragmentation and Duplication

The pre-crisis fragmentation of the U.S. financial regulatory structure remains and, in some cases, was made worse by Dodd-Frank. Functionally similar financial regulatory responsibilities are spread across multiple federal agencies. Dodd-Frank created the Financial Stability Oversight Council (FSOC) in part to help coordinate among regulators, but FSOC lacks the authority to require action by its member agencies. The fragmented U.S. structure has resulted in the unnecessary duplication of and a lack of coordination and conflicts in regulatory efforts, such as:

1. Difficulties and delays in developing, implementing, and interpreting rules assigned to multiple agencies. For example, Dodd-Frank assigned five agencies to develop the Volcker Rule. Rather than improving coordination, this joint rulemaking process significantly delayed the issuance of the final Volcker Rule and has inhibited the ability of the agencies to provide uniform and timely feedback and guidance to firms subject to that rule.^b
2. A lack of coordination among agencies due to competing approaches. For example, the Commodity Futures Trading Commission and the Securities and Exchange Commission have experienced delays in developing cross-border rules and have promulgated conflicting definitions of a "U.S. person."^c
3. A lack of coordination among agencies reflecting the development of rules by different agencies. Individual regulators developing specific rules may lack an appreciation for the interaction of different rules or lack a holistic view of the regulatory environment. Some financial-industry interviewees cited the combined impact of prudential rules—such as the Liquidity Coverage Ratio, the Net Stable Funding Ratio, and the Supplementary Leverage Ratio, and rules for Total Loss Absorbing Capacity, stress testing, and capital planning—all of which were created to enhance bank resiliency but which were written and evaluated as separate rules over time.

Rulemaking by agencies in separate silos can lead to unintended problems. For example, some interviewees noted that many rules require or incentivize firms to hold the same high-quality liquid assets, such as Treasuries. In a stressed scenario in which there is a flight to quality, banks might maintain a strong cash position and hoard high-quality liquid assets. This understandable response by individual institutions could spark system-wide liquidity shortages as other institutions cannot access liquid assets. High private-sector demand for safe, short-term assets, intensified by new bank regulations, is one reason that former Federal Reserve Board Chairman Ben Bernanke has called for the Federal Reserve to maintain a larger balance sheet. With more securities holdings, the Federal Reserve could expand its overnight reverse-repurchase program and provide markets with more risk-free short-term securities when needed.⁷

b. The agencies adopted their final rules in December 2013 (and later made additional changes), after Dodd-Frank's deadline of July 2012. For an overview of firms' issues with regulatory feedback and the Volcker Rule, see: Davis Polk, "Volcker Rule: Observations on Interagency FAQs, OCC Interim Examination Guidelines," *DavisPolk.com*, June 18, 2014. Available at: http://www.davispolk.com/sites/default/files/06.18.14.Observations.on_.Interagency.FAQs_.OCC_.Interim.Examination.Guidelines.pdf.

c. In 2013, the Commodity Futures Trading Commission adopted a more expansive definition of a "U.S. person" than had been used by markets regulators and which did not match the definition used by the Securities and Exchange Commission. In 2014, the Securities and Exchange Commission issued a new rule that updated its definition of a "U.S. person" to more closely match the Commodity Futures Trading Commission definition, though some differences remain.

Multiple Binding Constraints

Many interviewees said that several rules act as binding constraints on their business decisions. These binding constraints can result in cliff effects, in which the supply of a service or product to certain groups of consumers experiences a sudden and steep reduction due to one or more regulatory provisions rather than competitive market factors. Interviewees cited the following as binding constraints:

1. In the aggregate, businesses and consumers have maintained access to credit. Overall bank lending has been increasing in most categories. **(See: Figures 4-5.)** However, a number of factors—such as the CFPB’s Qualified Mortgage rule, requirements to repurchase certain loans, and litigation fears—have tightened standards for mortgage credit and increased the cost of consumer banking. According to one estimate, another 5.2 million mortgage loans would have been made between 2009 and 2014 if credit standards had been similar to those that prevailed in 2001, well before the crisis. Rather than a gradual decrease in lending as credit risk increases, consumer lending has dropped off more precipitously, at FICO scores of 660 and 700.⁸ **(See: Figure 6.)** This suggests that regulation is a significant factor in mortgage-lending decisions. There is evidence of cliff effects in credit card lending, where consumers with lower FICO scores have opened a smaller share of new accounts since the crisis. **(See: Figure 7.)** Small-business lending started declining as a proportion of total commercial lending before the crisis. **(See: Figure 8.)** Small businesses may face higher borrowing costs in part because they often lack substitutes for loans. Meanwhile, auto lending has seen a kind of cliff effect in the opposite direction; subprime auto lending has increased since the crisis, which may be the result of auto dealers having been exempted from the CFPB’s jurisdiction.^d **(See: Figure 9.)**

One issue that contributes to the cliff effect for consumer lending is the reliance in lending decisions on FICO scores as a guide to a borrower’s creditworthiness. Especially with the rise of “big data,” alternative means of credit evaluation could be useful to gauge the ability of borrowers to repay loans. Such approaches will need to be acceptable to regulators. Consumer advocates have expressed legitimate concerns that such approaches might be used to the disadvantage of certain groups or that using such data may compromise consumers’ privacy.

2. Large businesses can raise funds through capital markets to take advantage of historically low interest rates. However, most small businesses lack access to the capital markets and must either rely on banks for credit or use internal funding sources. While credit to small businesses has experienced a long-term decline, new capital and liquidity regulations may amplify the trend. If stricter bank regulation increases the costs of bank lending, large businesses can access credit through the capital markets. Small businesses that are unable to access the markets will face higher costs or borrow less. Small business lending also tends to require higher up-front investments in credit underwriting than lending to larger businesses or consumers. Facing capital constraints, banks might not be willing to devote valuable balance-sheet capacity to loans with higher fixed costs. If these regulations increase banks’ costs, then small businesses may face higher borrowing costs, since they often lack substitutes for loans.
3. While market liquidity is generally adequate today, both historical precedents and empirical evidence suggest liquidity could disappear in a stressed scenario.⁹ Reasons include the Volcker Rule’s reduction of both permitted

d. Auto lending was not covered by an act equivalent to the CARD Act on credit cards or the CFPB’s Qualified Mortgage rule and interagency Qualified Residential Mortgage rule for mortgages. Section 1029 of Dodd-Frank exempts auto dealers from the CFPB’s jurisdiction, although the bureau has issued guidance on indirect auto lending and has recently said they will be monitoring auto lending, especially subprime.

market-making activity and firms' trading inventories of relatively illiquid assets, higher capital charges, and the migration of liquidity provision to nonbanks like hedge funds, which might be quick to withdraw liquidity at an early sign of market stress. While official analyses downplay concerns with the current level and provision of liquidity, they typically have looked at current market conditions rather than the impact of hypothetical stress scenarios.¹⁰

4. The Supplementary Leverage Ratio (SLR) was intended to function as a backstop to risk-based capital requirements, but U.S. regulators have raised it above the minimum standard agreed to by global regulators.^e This has made the SLR a binding constraint for some banks. The SLR applies capital charges to all assets, even those that are risk-free such as cash held at the Federal Reserve, creating incentives to hold riskier assets. In some cases, the capital charges are duplicative. Clients post initial collateral (margin) for derivatives to offset potential future exposures for those transactions. Banks are not allowed to net customers' margin for capital purposes, even when the positions are made through a CCP. Over time, these constraints may impact credit extension. In response to similar concerns, the Bank of England announced this summer that the United Kingdom's leverage-ratio requirement would exclude central bank claims, including cash and reserve deposits, from the leverage-ratio denominator. The Bank of England further said there would be merit in the Basel Committee allowing for client margin to reduce dealers' potential future default exposures in centrally cleared derivatives transactions.^f
5. The tiering of bank regulation can result in sudden large increases in prudential and other requirements. For example, the Federal Reserve's Comprehensive Capital Assessment and Review and supervisory stress testing is required for all firms with at least \$50 billion in assets. Such cutoffs provide an incentive for banks to artificially stay below a threshold or, once they have crossed it, to grow even larger to spread out the costs associated with ascending to a higher regulatory tier.^g Most of the thresholds were chosen arbitrarily; the \$50 billion threshold was defined by statute, without a formal analysis. A bank with \$51 billion in assets does not abruptly become systemically risky in a way that a firm with \$49 billion in assets is not. Additional regulatory thresholds exist at \$10 billion and \$250 billion, among other levels. Gradual thresholds would be more effective than sharp cutoffs. In addition, such asset thresholds as do exist should be indexed to a measure of economic growth, so that they do not cover more institutions over time.

Moreover, certain changes have been implemented in a way that could be procyclical and amplify future stress events. For example, as noted above, the increased holdings of high-quality liquid assets by banks appears to improve their liquidity positions,^h but in a stress event, banks might hoard such assets to a degree that could lead to market-wide shortages.ⁱ In stressed conditions, capital and liquidity rules may reduce lending and impair market liquidity.

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- e. The Basel Committee on Banking Supervision set a minimum leverage-ratio requirement at 3 percent. The U.S. Enhanced Supplementary Leverage Ratio adds an additional 2 percent buffer for U.S. global systemically important banks (G-SIBs), for a total minimum of 5 percent. Insured depository institution subsidiaries (typically the bank itself) of G-SIB bank holding companies must maintain a 6 percent minimum leverage ratio. The Basel Committee on Banking Supervision is exploring adding an additional surcharge for G-SIBs similar to the U.S. standard.
 - f. Since reducing the denominator increases the total ratio, this action would reduce minimum capital requirements. To prevent this loosening, the Bank of England announced it plans to "gross up" its leverage-ratio requirement elsewhere. See: Bank of England Financial Policy Committee, "Record of the Financial Policy Committee Meeting," July 25, 2016. Available at: <http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2016/record1608.pdf>.
 - g. As an example, CIT Group has divested assets and is now close to the \$50 billion threshold. It is under pressure from some investors to shrink below that threshold to shed the systemically important status. See: Kristin Broughton, "All Eyes on Alemany as CIT Pressed to Shrink Below \$50B Asset Mark," *American Banker*, September 7, 2016. Available at: <http://www.americanbanker.com/news/national-regional/all-eyes-on-alemany-as-cit-pressed-to-shrink-below-50b-asset-mark-1091166-1.html>.

Regulatory Gaps

Interviewees also noted that some regulatory gaps have either not been adequately addressed or have arisen since the crisis. For example:

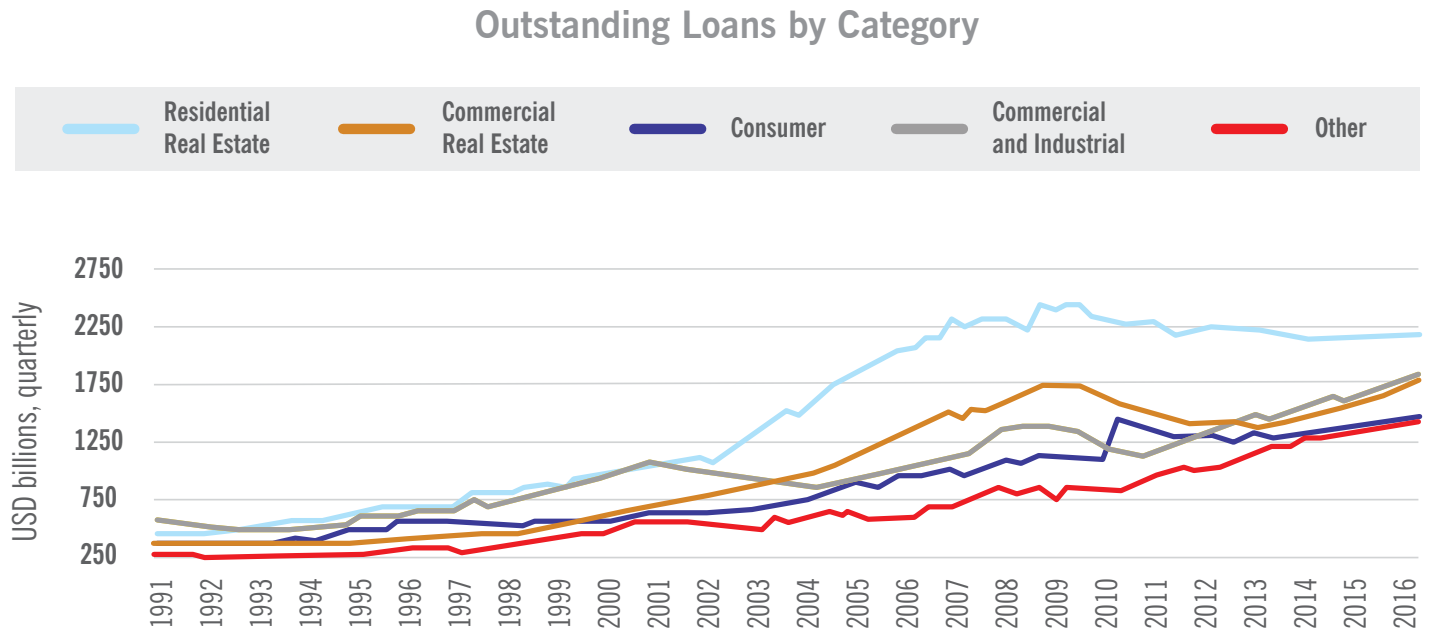
1. Following the crisis, regulatory agencies took actions such as reducing potential runs on money-market mutual funds to better regulate activities originating in the nonbank sector. Dodd-Frank gave regulators additional tools to address nonbank risk, but these tools are not comprehensive. FSOC can designate large, complex financial institutions as SIFIs (systemically important financial institutions), but designation is an either/or decision and somewhat subjective, since no threshold defines systemic importance. The SIFI process also encourages designated firms to shift their riskier activities to non-designated firms, which may be less regulated. The designation process is lengthy and thus not well suited to responding quickly to emerging risks. Regulators also lack detailed data on certain nonbanks.

Regulating risky activities would be more effective than designating individual firms as SIFIs, but FSOC was given only limited authority to pursue such an activities-based approach. The more activities migrate to the nonbank sector, encouraged in part by new bank regulation, the greater the potential that this lack of regulatory tools will become a problem.

2. The use of short-term wholesale funding has decreased since the crisis. A number of prudential regulations have played a role in this shift, including stress testing; the Liquidity Coverage Ratio and the Net Stable Funding Ratio, which reduce liquidity risk; and rules such as the Global Systemically Important Bank (G-SIB) surcharge, which acts as an implicit tax on short-term funding. Financial-sector outstanding commercial paper has declined from its pre-crisis peak of \$850 billion, but more than \$500 billion remains.¹¹ This funding is useful but gives rise to risks. Intraday credit from the clearing banks, which used to fund 100 percent of tri-party repos, now funds only 3 to 5 percent.¹² The clearing banks, dealers, and investors worked with regulators such as the Federal Reserve Bank of New York to reduce such credit, which presented potential systemic risk (as was seen in the events surrounding the demise of Bear Stearns). While the largest banks are subject to a set of new prudential requirements, many nonbanks continue to issue short-term liabilities, without access to the FDIC's deposit insurance or the Federal Reserve's lender-of-last-resort capabilities. Risk has been substantially mitigated, but short-term funding remains a potential source of future runs.
3. Dodd-Frank made progress in subjecting the trading of derivatives to regulation and requiring that most such transactions be centrally cleared and margined with high-quality collateral. An unintended side effect of these changes, however, was to concentrate derivatives risk and turn CCPs into a set of "too big to fail" institutions.

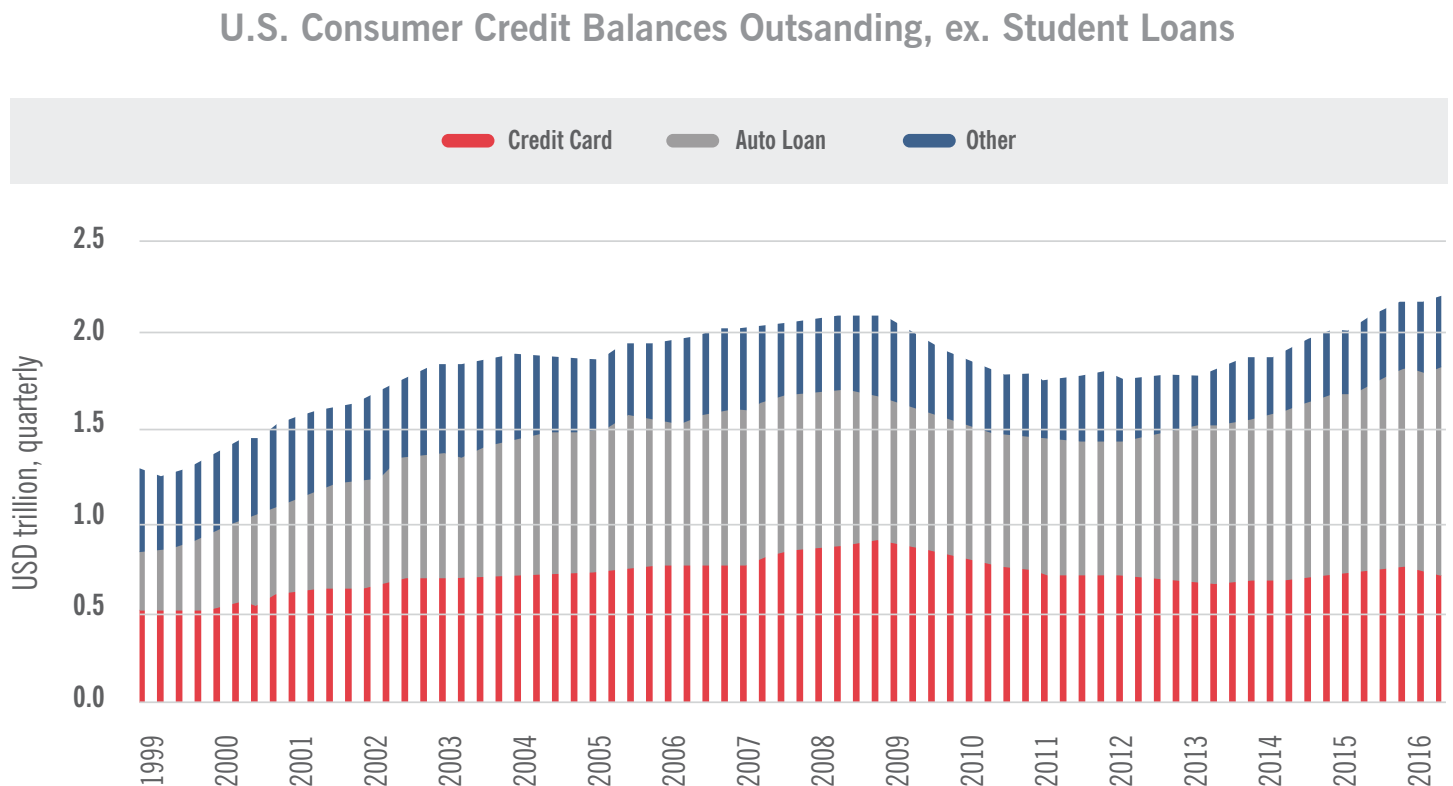
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- h. High-quality liquid assets (HQLA) was defined by the Basel Committee on Banking Supervision as part of the Basel III reforms. Generally, central bank reserves, U.S. Treasuries, and some claims on international organizations are considered top-tier HQLA. Agency securities and certain investment-grade corporate bonds and equities count as lower-tier HQLA. For more details, see: Davis Polk & Wardwell LLP, "U.S. Basel III Liquidity Coverage Ratio Final Rule," *DavisPolk.com*, September 23, 2015. Available at: <http://usbase13.com/docs/Final%20LCR%20Visual%20Memo.pdf>.
 - i. Other post-crisis reforms, however, have been counter-cyclical. The Counter-Cyclical Capital buffer can be adjusted across the credit cycle, while recovery and resolution planning reduces the likelihood of asset fire sales.

Figure 4: Bank lending has increased in most categories since the crisis, with the exception of residential real estate.



Source: Federal Reserve Bank of New York¹³ and BPC calculations.

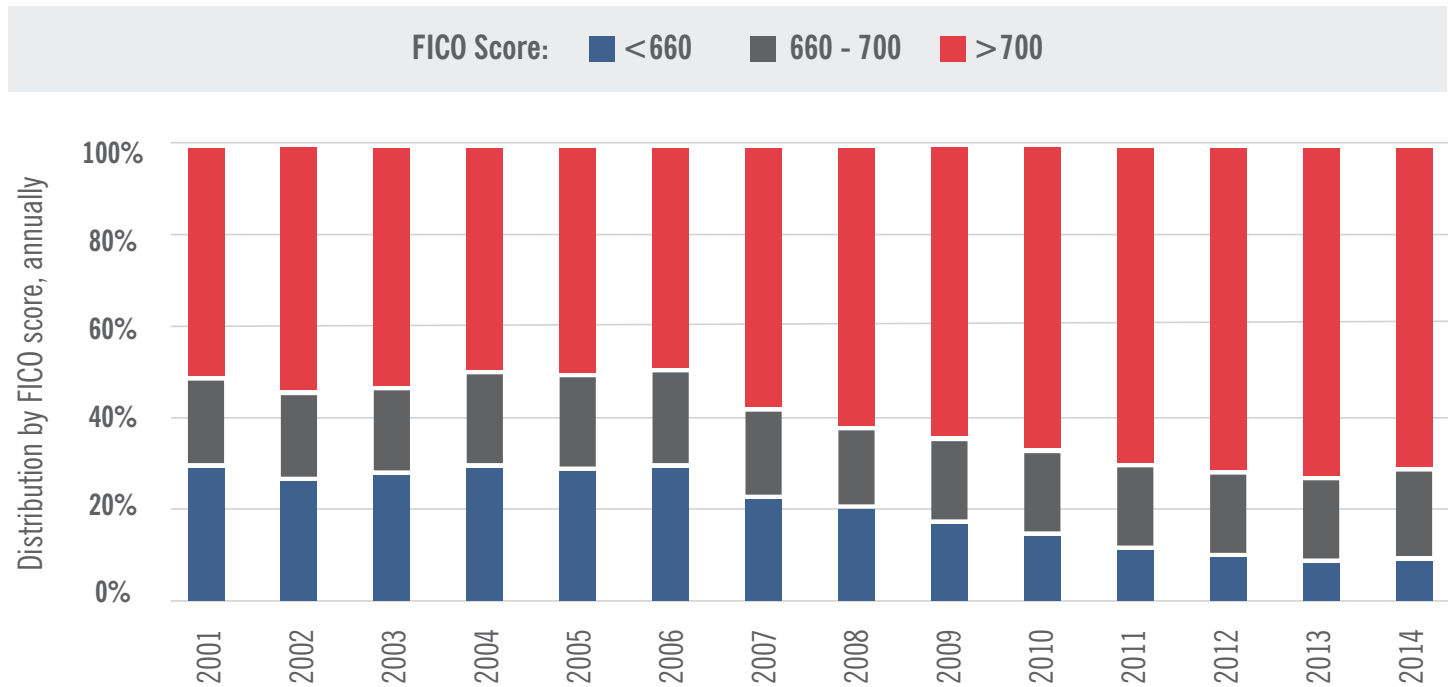
Figure 5: Consumer lending has also been increasing, except for credit card lending.



Source: Federal Reserve Bank of New York¹⁴ and based on chart in Lux and Green.¹⁵

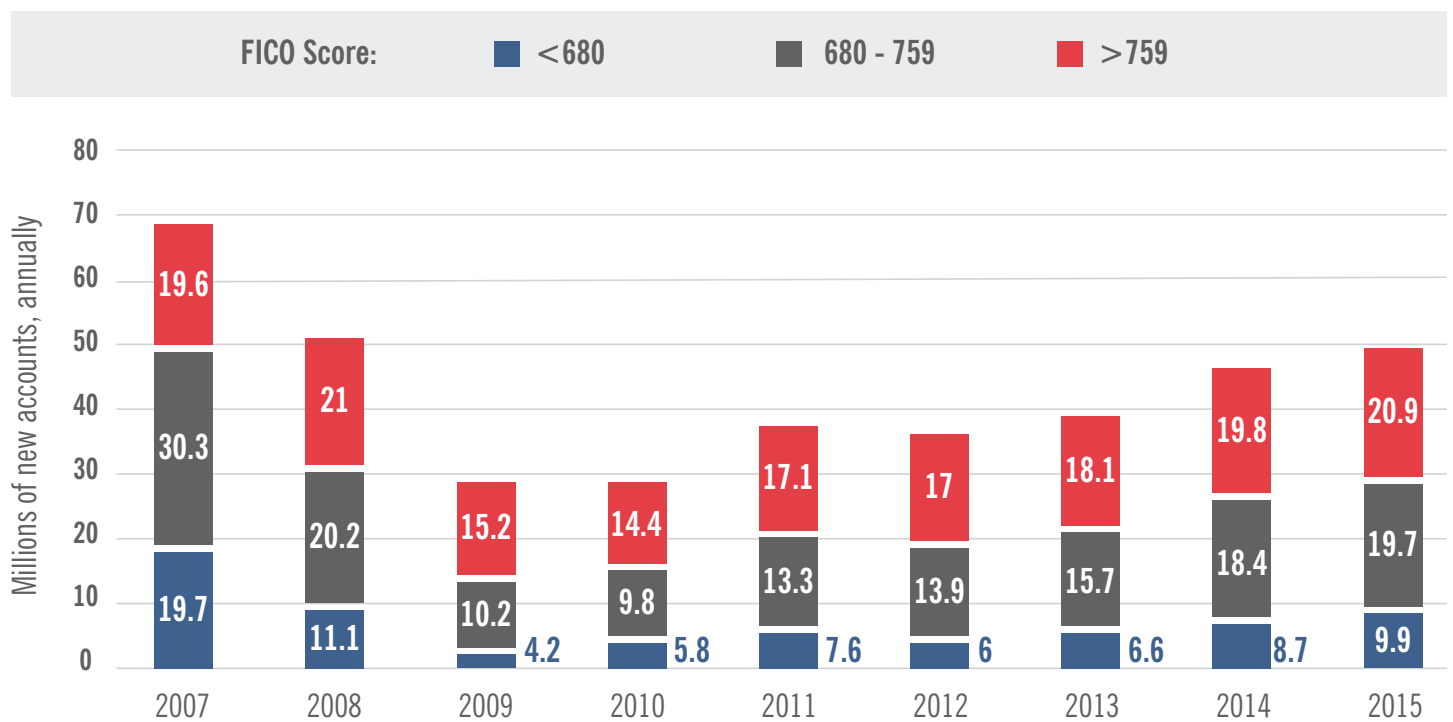
Figure 6-9: Bank regulation and supervision may have tightened credit standards for mortgages and credit cards. Small-business loans (approximated by commercial and industrial loans of less than \$1 million), which have been declining as a share of total business loans, have had a slower post-crisis recovery than overall commercial lending. There are not similar effects for auto lending.

Figure 6: New-Purchase Mortgage Borrowers



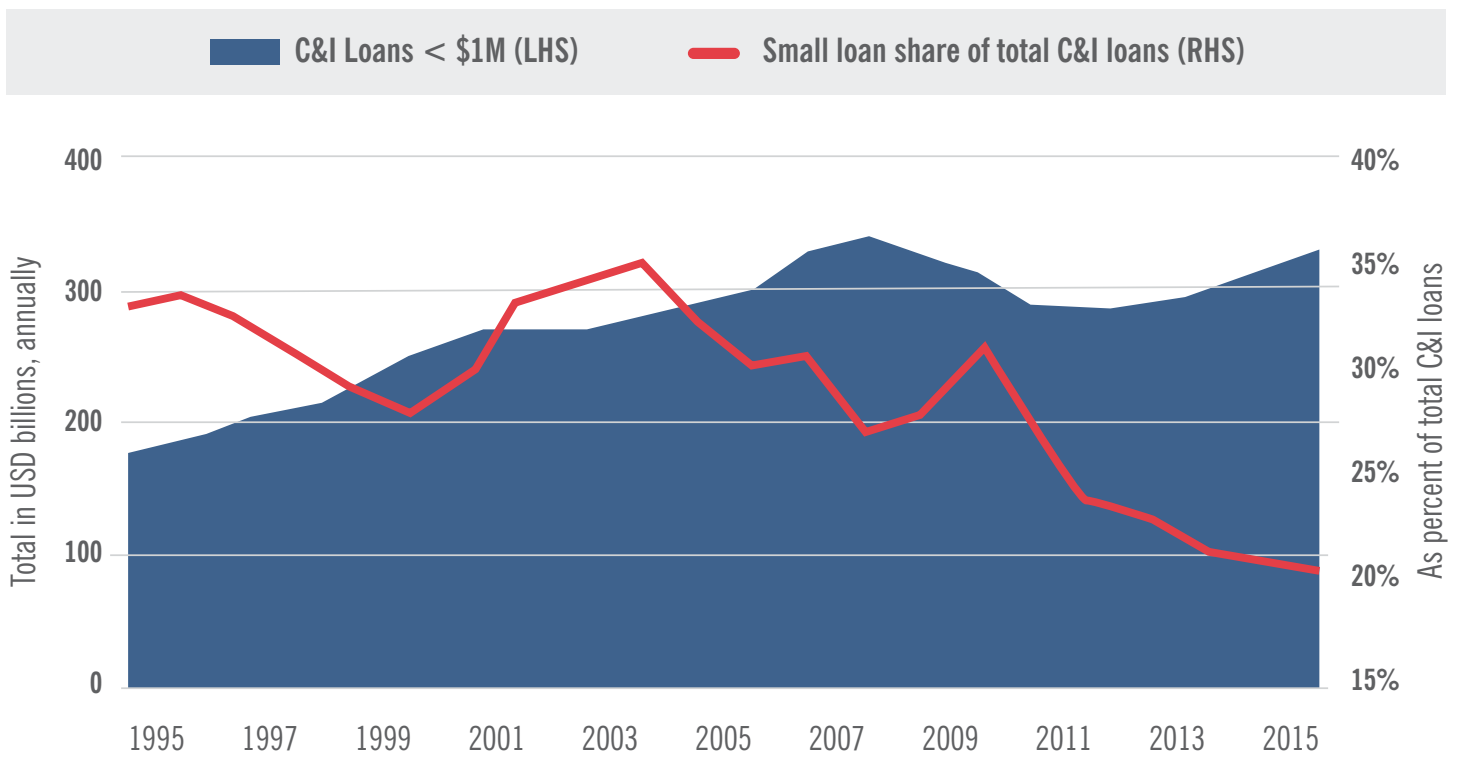
Source: Bai, Goodman, and Zhu.¹⁶

Figure 7: New General Purpose Credit Card Accounts Originated by Risk Score Group



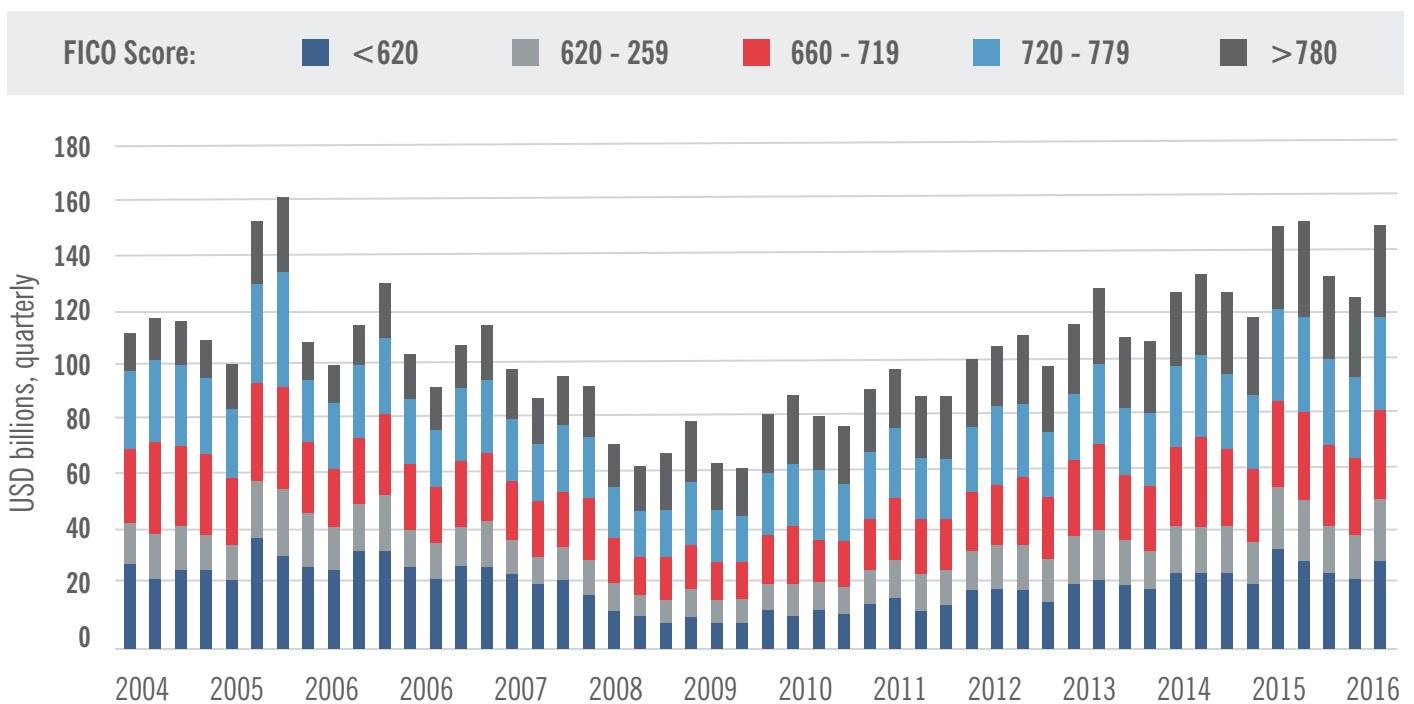
Source: Chart copied from Lux and Green.¹⁷

Figure 8: Commercial and Industrial (C&I) Loans Less Than \$1M



Source: FDIC.¹⁸

Figure 9: Auto Loan Originations by Credit Score



Source: Federal Reserve Bank of New York.¹⁹

Initial Recommendations

Based on our survey and review of existing literature, we have developed the following preliminary recommendations to improve the financial system's ability to encourage economic growth and meet the needs of consumers and businesses without compromising financial stability.

1. A periodic, formal assessment of the U.S. financial regulatory system should be conducted. Now that most post-crisis changes have been implemented, financial regulatory agencies should work together to regularly assess the financial regulatory environment. They should evaluate both the intended and unintended consequences of regulation, including activity migration or cessation, regulatory fragmentation, multiple binding constraints, and regulatory gaps. Given the continued fragmentation of the U.S. financial regulatory architecture, FSOC should aid in such assessments as part of its duty to facilitate coordination among member agencies. This regulatory assessment should include a public call for evidence along the lines of the one initiated by the European Commission in 2015.

There would be additional benefit in a separate, independent analysis. The next president and Congress should establish a commission to develop a formal and periodic process to assess whether the financial regulatory system appropriately balances financial stability, economic growth, and the needs of consumers. The analysis should consider whether additional changes are needed, and evaluate the marginal benefits of those changes. Such an assessment should be conducted by an independent commission, with regular reporting to Congress and the public. The independent review should develop a framework that considers the following questions and makes recommendations.

- Are consumers, small and large businesses, and investors well served by the current financial regulatory framework and rules? Do consumers and other potential borrowers have access to affordable credit? What are the economic costs and benefits of regulation, including the impact on access to credit?
- How are different groups of consumers, businesses, and investors being affected differently by financial regulation, and can changes be made to ameliorate any significant negative effects?
- Are there rules that are unnecessarily duplicative, in conflict with each other, or otherwise causing unintended negative consequences?
- Are there significant gaps in regulation?
- Does the U.S. financial regulatory structure unnecessarily limit coordination among regulatory agencies or otherwise result in less-than-optimal outcomes?
- Do policymakers have the data and tools they need to assess (quantitatively and qualitatively) stability, growth, and the needs of consumers, businesses, and investors? Are they encouraged to do so?
- Do regulators have the data and tools necessary to address risky activities, particularly outside of the regulated banking sector?
- To what extent can the costs and benefits of regulation be measured empirically, and when is it appropriate to conduct a cost-benefit analysis?

2. “No regret” moves. In addition to the recommendations above, there are several “no regret” moves that policymakers and/or regulators can take to improve financial regulation and supervision, especially with capital and

liquidity at record levels since the crisis, and an adequate capital buffer at systemic banks.

1. In addition to the periodic formal assessments recommended above, the OFR should be authorized to independently evaluate and report to Congress on the impact of regulation on economic growth as well as the impacts of the financial system and financial regulation on consumers and businesses. Currently, the OFR's mandate focuses only on financial stability. Congress should ensure that the OFR has access to all relevant data to conduct these reviews, including access to data collected by other regulators.
2. The CFPB should evaluate the potential effectiveness of alternative credit-scoring models to assess the creditworthiness of consumers, giving due consideration to concerns about privacy and the potential disparate impacts on different groups of borrowers.
3. The Federal Reserve, coordinating with the FDIC and the Office of the Comptroller of the Currency, should review the SLR definitions to assess whether to exempt certain types of nearly risk-free assets—such as reserves held at the Federal Reserve and client margin for derivatives transactions—from their currently required capital charges.
4. Congress (or in its absence, FSOC) should specify a lead agency for interagency rulemakings. The lead agency would have responsibility for advancing the discussions, coordinating initial drafting, and communicating with the affected firms and the other agencies assigned to the rulemaking.
5. Congress should require a pilot program for a consolidated bank exam force as outlined in BPC's paper on the U.S. financial regulatory structure.²⁰ Each task force would include examiners from multiple agencies that supervise a single bank, with the bank's primary regulator as the lead of the team. Each team would issue a single set of exam questions, write a single exam report, and simultaneously make the findings available to each participating agency. Such a program should improve communication and coordination among agencies, better leverage scarce resources, and streamline the examination process.

Next Steps

This initial report is the beginning of work that BPC's Financial Regulatory Reform Initiative plans to continue in 2017. We envision working with a diverse group of stakeholders to further explore the following propositions, among others:

1. Not surprisingly, post-crisis regulatory changes have resulted in some unintended consequences. Now that most of the new regulatory structure is in place, the time is right to conduct a formal assessment of both the intended and unintended consequences of these changes and whether the new rules have been appropriately calibrated.
2. Higher capital and other prudential requirements can raise costs for borrowers, but the evidence on whether this has already happened, and at what magnitude, is limited. On balance, the benefits gained from these changes outweigh the costs. However, regulators should strive to ensure that each rule confers net benefits.
3. Dodd-Frank missed an opportunity to consolidate the U.S. financial regulatory architecture and, in some ways, made the problem worse. The remaining fragmentation has led to coordination problems as well as conflicting and duplicative rules, which in turn creates potential future risk to financial stability.
4. Rules that improve financial stability have led to the migration of certain activities from banks to nonbanks and to the curtailment of other activities. Since Dodd-Frank left gaps in the ability of regulators to conduct effective oversight of risky activities outside the regulated banking sector, migration could increase systemic risk over time.
5. Certain rules have been implemented such that they act as binding constraints on decisions that regulators intend for firms to make based on market factors and business priorities. The existence of too many binding constraints could lead to more homogeneous decision-making by firms and herd-like behavior.

Endnotes

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Notes





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