Economic Policy Program

Financial Regulatory Reform Initiative

Promoting Financial Stability and Economic Growth:

An Introduction to the Bipartisan Policy Center's Financial Regulatory Reform Initiative

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BIPARTISAN POLICY CENTER

ABOUT BPC

Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole and George Mitchell, the Bipartisan Policy Center (BPC) is a non-profit organization that drives principled solutions through rigorous analysis, reasoned negotiation and respectful dialogue. With projects in multiple issue areas, BPC combines politically balanced policymaking with strong, proactive advocacy and outreach.

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Co-Chairs

Dr. Martin Neil Baily

Dr. Phillip Swagel

Director

Aaron Klein

Introduction

The financial crisis exposed fundamental problems in U.S. financial markets and in the regulatory system tasked with overseeing those markets. The Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law in July 2010 seeks to make the financial system more transparent and resilient, while providing government regulators with new authority to oversee market participants and to respond to future crises.

Many of the changes in the Dodd-Frank Act are already in place (if perhaps untested), with a host of other rules and regulations still in process. While the cumulative impact of the legislation will play out over years to come, an initial analysis can be made of aspects of the legislation that seem likely to help lend stability to the financial system. At the same time, it remains important to gauge the potential costs of the increased regulation in terms of its impact on end-users of financial services and any impact on lending and investment, and thus on economic growth. The reckoning between the benefits and costs of Dodd-Frank on our economy is not yet fully understood by policy makers and regulators.

Several key aspects of financial regulatory policy were left untouched or unfinished in Dodd-Frank, notably reform of the housing finance system, regulation of credit-rating agencies, and regulation of important participants in the so-called shadow banking system such as money-market mutual funds. Each of these areas played a significant role in the prior financial crisis and each is thus an important issue for further policy consideration. The legislation makes multiple changes to the regulatory system but stops short of more fundamental structural transformations to the regulatory system. For example, Dodd-Frank eliminates one regulatory agency, the Office of Thrift Supervision, but creates others: the Consumer Financial Protection Bureau, the Office of Financial Research, and the Financial Stability Oversight Council. The legislation also leaves in place a fragmented system of supervision across financial institutions when more regulatory consolidation and greater accountability might well have been desirable.

An unfortunate legacy of the financial crisis has been a long and difficult recession, with unemployment remaining over 8 percent for three years since the end of the economic decline—dipping below that mark only in September 2012. There are doubtless many reasons why the recovery has been slow, including the continuing impact from the bubble in the housing sector and the associated loss of household wealth. But lingering credit strains and general uncertainty have also been contributing factors for slow growth, including through the reduced availability of funding for business expansion, especially for small businesses. No one wants to return to the days of bubble lending, but at the same time U.S. businesses and families depend on the financial sector to provide the fuel for economic growth and recovery. Naturally perhaps, the focus of the

Dodd-Frank legislation is to make sure a crisis of this magnitude never happens again and to take steps intended to ensure the financial system is as safe as possible. Now that the legislation has been in place—at least for an initial period—it is possible to assess the extent to which the legislation meets this goal. In doing so, it is useful to make sure that growth and innovation are given due weight in setting the rules.

The objective of financial regulation in the United States should be to promote financial stability, economic growth, and consumer protection. The purpose of the Bipartisan Policy Center's (BPC) Financial Regulatory Reform Initiative is to evaluate the financial regulatory system in the wake of Dodd-Frank and to propose reforms that will improve financial regulation and supervision while still preserving the intent of Dodd-Frank to prevent systemic risks and to help consumers. The initiative will assess what is working well and what is not working so well, and it will elaborate on areas that remain unclear, such as on the practical implementation and implications of the Volcker Rule and of the non-bank resolution authority included in Dodd-Frank. The initiative will propose fine-tuning that involves incremental improvements as well as more substantial reforms that address gaps that remain in the wake of Dodd-Frank. We see these latter suggestions as useful even if currently there are only modest legislative prospects for large-scale changes—such as a fundamental consolidation of the regulatory agencies. In the meantime, the initiative will propose concrete and actionable steps for policy makers and regulators to consider.

Just as important are the rules for implementing the legislation. Many important aspects of Dodd-Frank are left to the various financial regulators to determine through rulemaking. The Financial Regulatory Reform Initiative will review the landscape of regulatory actions and inactions in the two years since Dodd-Frank's enactment. According to the widely cited analysis of the law firm of Davis Polk & Wardwell, Dodd-Frank includes a total of 398 required rulemakings, of which 127 have been finalized (some before their statutory deadline), but 136 rules have not yet been proposed (though some of these have not yet reached the deadline). Of these 398 required rules, the deadline has been reached for 237, of which 88 have been met with finalized rules, leaving 149 rules that have missed the statutory deadlines set by Dodd-Frank itself.

Some rules have been finalized only to be rejected by court decisions, including the recent action on the U.S. Commodity Futures Trading Commission's (CFTC) final rule on position limits for commodities. The Financial Regulatory Reform Initiative will assess whether further legislative reforms are needed, especially in light of the regulators' slower-than-anticipated progress on implementation. Another intent of the law was to enhance regulatory coordination. A corollary of increased coordination should be a uniform vision, one shared by the various financial regulators and evident in their individual regulations.

Without pre-judging what this initiative will find, it is obvious that there are important areas that need review. For example, the clear intent of Congress in the legislation was to move derivatives trading onto exchanges or to involve clearinghouses, and yet the

proposed rules limiting counterparty credit risk would make it harder for institutions to do so. In addition, there does not appear to have been any significant evaluation of how the proposed regulations for implementing the Volcker rule would interact with other regulations on derivatives.

Evaluating financial regulatory reform requires consideration of the inevitable tradeoff between market stability and the combination of innovation, risk-taking, and growth. Steps to foster stability, such as through increased regulation, will generally have some cost. This is not at all to say that regulation is thus bad per se—far from it. The point is that both the costs and benefits to end-users and the economy must be taken into account. An evaluation of Dodd-Frank will also be useful to provide an initial assessment of areas in which the legislation does and does not achieve the desired balance.

Financial markets in a capitalist system have a tendency to undergo cycles, ultimately resulting in periods of market instability, bubbles, and crashes. Ensuring that private-market participants have adequate amounts of their own capital at risk (a form of self-regulation) provides incentives for prudent behavior and reduces the likelihood of failures by firms that will lead to costs for taxpayers. Other forms of regulation and governmental supervision can further reduce the tendency toward instability and can lessen the consequent impacts on the economy. Even so, realistically, it is neither possible nor desirable to eliminate all future financial turbulence through rules and regulations. Achieving such complete stability would likely have serious negative consequences for growth. Dodd-Frank does not aim at complete stability; rather it seeks to minimize future systemic threats to our economy. Yet, the government also needs to promote greater capital formation and to improve the flow of capital from savers and investors to entrepreneurs and creditworthy individuals and firms. Striking the appropriate balance—while recognizing that this balance will evolve over time with financial and technological innovation and growth—should be the objective of policy makers in determining regulatory policy.

The Financial Regulatory Reform Initiative will use the lens of the stability-growth tradeoff in assessing Dodd-Frank. Measures that foster stability and promote economic growth can be labeled as "good," while steps that fail to increase stability—or that promote instability—while also imposing significant costs or limiting economic growth can be labeled "bad." Many measures will promote stability at a reasonable cost to the economy (both to market participants and to the overall economy); these will also be deemed beneficial. Others that impose significant costs and seem likely to provide little enhanced stability will be deemed detrimental. The tradeoff involved in other parts of Dodd-Frank is still difficult to calculate, including cases in which a quantification of the costs and/or benefits is not yet available. Moreover, with so much of the implementation of Dodd-Frank still a work in progress, it is inevitable as well that the evaluation considers aspects of the law that are still uncertain. Finally, the initiative will also consider the cumulative effects of various measures. There is a potential for interactive

effects between various rules and regulations that requires a broader analysis than simply considering the rule in regulation.

In choosing to analyze the effects of Dodd-Frank through a stability-growth tradeoff, the Financial Regulatory Reform Initiative is not explicitly rejecting the cost-benefit approach. When dealing with questions of how to reduce the likelihood of a financial crisis, however, traditional cost-benefit analysis is difficult. A natural measure of the benefit of a regulation meant to prevent a crisis is the product of the incremental contributions made toward reducing the likelihood for crisis and the expected cost of a crisis—that is, the probability-weighted benefit of the regulation. The marginal ability of any one regulation to avoid a crisis is by definition extremely small. And the cost of a potential crisis is by definition extremely large. Thus, the potential benefit of any one regulation would change drastically with even the smallest change to its projected ability to avoid a crisis. The initiative's evaluation of Dodd-Frank will keep this challenge firmly in mind and will use a variety of metrics and dimensions with which to evaluate the financial regulatory system.

The Organization of the Initiative

Previous BPC projects generally have operated as a single group working through the issues together, with one final report providing findings and recommendations that all participants, or nearly all, sign on to. There are clear merits to this approach, but the Financial Regulatory Reform Initiative has decided to operate its panel differently, because these issues are so complex and interrelated. The initiative has therefore divided the initiative members into five substantive areas, with at least two members of the panel, both Republican and Democrat, assigned to a working group that covers each segment. Initiative members have deep expertise and experience in the issues at hand from their roles as former regulators, policy advocates, and practitioners. Together, the participants in the initiative bring forward the experience and expertise needed to delve into the technical aspects of each segment of financial regulatory reform.

The five substantive areas for consideration by the Financial Regulatory Reform Initiative are:

1. Systemic Risk
2. Failure Resolution
3. Capital Markets and the Volcker Rule
4. Consumer Financial Protection
5. Regulatory Architecture

The three authors of this paper will be involved across all five topics, and any initiative member who wishes to comment on or give help to any of the other working groups is free to do so. There will be meetings of the full panel at which ideas and proposals will

be aired and debated. The initiative will issue a series of five white papers starting in the spring of 2013, with each paper signed by its specific authors—as opposed to the entire initiative. That way, other panel members will feel free to express disagreements with the white papers. The initiative's aim is for the papers to help guide Congress, the executive branch, and regulators as they work to develop and fine-tune financial supervision and regulation to ensure a balanced approach to financial stability, economic growth, and consumer protection.

Financial services is truly a global activity, which is why financial regulatory decisions made in the United States have global consequences. The Financial Regulatory Reform Initiative will consider the international implications of regulatory reform within and across all five subject areas listed above. The United States has developed a valuable international comparative advantage in providing financial services; in part, this is based on having a reputable and strong financial regulatory system (even if this reputation was called into question by the events of the recent crisis). According to the Bureau of Economic Analysis, value added in the finance and insurance sector in 2011 was $1.256 trillion, having grown at 3.7 percent a year since 1998, adjusted for inflation. Exports of financial services in 2010, the most recent data point, were $66.4 billion and imports were $13.8 billion, generating a trade surplus of $52.6 billion, making it one of the most successful U.S. industries in international trade. Technology developments and a global move to financial openness have meant that there are many more potential competitors to provide these services. Most of the large U.S.-based financial institutions have overseas operations and serve both U.S. clients globally and foreign companies in the United States and in other markets. If U.S. regulations are too onerous or if American regulators are too capricious or ineffective, then it is quite possible that important financial activities will migrate to foreign financial centers. While American officials work closely with foreign financial regulators on international efforts such as the ongoing Basel III process, changes in the location of global financial services activities will still have implications for economic growth. Moreover, international factors will affect the U.S. regulatory system. The Basel III agreement on bank regulation, for example, will have considerable influence on the regulatory rules in the United States. The initiative will assess these international implications within each of the five areas of consideration.

Systemic Risk

Financial Stability and Oversight Council

Dodd-Frank created the Financial Stability and Oversight Council (FSOC) to bring together federal and state regulators in a single body to consider crosscutting issues that affect financial stability and economic growth. In many ways, the creation of the FSOC has the potential to be the crown jewel of Dodd-Frank. Previously, there was no statutory mechanism for all of the appropriate financial regulators to consistently meet and resolve differences between them. The consequences of this lack of regulatory coordination were staggering. Regulators were slow to issue joint guidance, often failing to reach agreement until too late, such as waiting until 2006 to weigh in on sub-prime mortgages. Even then, there was no mechanism to hold various regulators accountable to each other for following through on decisions. The FSOC also provides a useful mechanism to make sure that no institution falls through the cracks in the regulatory system, which was the case with AIG. AIG had an insurance subsidiary that was regulated by state insurance officials, as is the regulatory norm for life, property, and casualty insurers. The part of AIG that issued large volumes of credit-default swaps (CDS) on risky mortgage-backed assets (CDOs), however, was located in London and operated under the "light touch" regulatory scheme that the United Kingdom's Financial Services Authority prided itself on at that time. Beyond its conventional insurance operations, AIG's principal U.S. federal regulator was the Office of Thrift Supervision (OTS), reflecting the Unitary Thrift Charter held by the firm. It does not appear, however, that the OTS was actively regulating the risky activity or that it appreciated the implications of the problems arising from the company's CDS business as a whole. (Indeed, some press accounts suggest that executives within AIG itself did not appreciate these implications.)

It is unclear, however, exactly how the FSOC will run or what it will do. The case of money-market mutual funds will provide an illustration: The FSOC is now engaged in an effort to overcome an impasse within the Securities and Exchange Commission (SEC) regarding regulation of this industry. The FSOC as presently constituted has limited power to enforce coordination among different regulators in implementing the rules under Dodd-Frank. These considerations lead to a number of questions: Will the FSOC continue to be run out of the Treasury Department using a combination of Treasury's own internal staff and staff detailed from various regulators, or will it become a more independent (and less political) entity? Is the composition of the FSOC correct? Is it too big and unwieldy, or were there any key participants omitted? Thus far, there is a lack of transparency on the FSOC's strategy and agenda, according to the General Accountability Office (GAO), and there is no official commitment to balance the twin

national policy objectives of economic growth and financial stability. These are among many questions that will be examined within the Financial Regulatory Reform Initiative.

Systemically Important Financial Institutions

Dodd-Frank requires that systemically important financial institutions (SIFIs) be designated as such and made subject to special enhanced requirements and regulation. While most agree that it is appropriate to set risk-based standards and recognize the potential dangers to the system posed by large or complex institutions, there is controversy around the value of designating a set of institutions as SIFIs. On one hand, there is the possibility that any institution designated as a SIFI will automatically be considered too big to fail and thus given both a funding advantage and an incentive to take on too much risk—secure in the expectation of a taxpayer bailout. The initiative will evaluate this argument, in the context of both systemic risk and failure resolution. On the other hand, it appears that in practice institutions do not want to be designated as SIFIs under the current regime. Indeed, banks and other financial firms appear to view a SIFI designation as a disadvantage, because it increases capital requirements and other provisions. Some of the proposed rulemaking would indeed create sharp constraints on large financial institutions, even while not going all the way to breaking up the big banks. This disproportionate impact of regulation on large financial institutions is certainly responsive to public pressure, but this was not explicitly stated as an intent of Dodd-Frank. (Indeed, these impacts were specifically considered in the context of several amendments that were *not* adopted.)

The impact of regulatory reform on financial institutions of all sizes is an important topic for assessment and debate. The diversity of the U.S. financial system is a key feature and provides benefits to businesses and families. Regulatory changes that affect this diversity could be disruptive for financial markets and the broad economy. Smaller banks in particular face challenges competing in an industry dominated by larger institutions. The Financial Regulatory Reform Initiative will assess the implications of financial regulatory reform on smaller banks and propose changes that balance the positive benefits of greater stability against the potential costs. For banks in between, there is considerable debate about the $50 billion threshold for designation as a SIFI. This threshold seems low; it is not obvious that any U.S. banks that are just below or just above this limit are truly systemic. Contributing to the uncertainty is the reality that many non-bank SIFIs have not yet been designated as such, and many of the rules intended to promote stability are not yet finalized.

As noted above, the changes put in place under Dodd-Frank have important effects on U.S. interactions with the Basel III process, which has proposed systemic capital buffers, countercyclical buffers, and contingent capital. These rules are not yet final, however, and the relationship between the Basel rules and the Dodd-Frank rules has not yet been worked out.

The creation of the Office of Financial Research (OFR) to support the work of the FSOC and to provide regular reports on the state of financial markets seems potentially helpful. The OFR was given wide latitude in the legislation and has already grown to include a staff of almost 100. Yet, Dodd-Frank is more than two years old and still there is no Senate-confirmed director. Also, it will be useful to consider any possible excessive overlaps in the gathering and analysis of data across federal regulating bodies. In fact, the Fed appears to have created an internal unit that mirrors the role of the OFR. Overlapping efforts should be made efficient.

Failure Resolution

One of the most fundamental aspects of Dodd-Frank is how it addresses the problem of institutions that are seen as "too big to fail" (TBTF) or too interconnected to fail. Rejecting the extremes of either breaking up large financial institutions or creating a permanent government role in the largest institutions, Dodd-Frank seeks a middle ground in which market forces would dictate the size of the largest financial institutions with several explicit understandings:

- The government would institute increasing capital surcharges as size grew.
- Increased regulatory scrutiny would accompany institutions large enough and interconnected enough to be deemed systemically important.
- These large and interconnected institutions would be required to produce their own plans for insolvency and resolution. These plans are called living wills.
- The orderly liquidation authority would provide a mechanism by which large firms could fail without taking down the rest of the financial system and without imposing costs on taxpayers.

Together, these elements are meant to address the problem of TBTF, first by increasing regulatory scrutiny and capital charges for such firms while they operate in normal times and then by making it possible for them to be put out of business in a crisis. Given the political reality that there will not be another Troubled Asset Relief Program, it is likely that Americans will only find out in the *next* crisis whether or not this approach can succeed. Additionally, the TBTF regime is meant to balance between intervention and market forces. The orderly liquidation authority gives the government vast power to put resources into a failing institution, but any losses must eventually be imposed on shareholders and creditors rather than on taxpayers.

Living Wills

The theory behind living wills is generally considered sound. Institutions that can demonstrate to their regulators and to the public that they are capable of being wound down in an orderly manner cannot be considered TBTF. Further, it seems likely that additional insight will be gained by the creation and maintenance of living wills. The exercise will impose burdens but also generate useful knowledge if taken seriously. One of the major weaknesses of the prior regulatory regime was exposed when it became clear that regulators had no plan as to how to deal with the failure of a large, systematically important institution; this was in large part because the then-extant legal authority provided limited options in cases such as AIG and Bear Stearns. The

combination of orderly liquidation authority and living wills is meant to address this. Another potential benefit is that firms will react to their own living wills by strengthening their ability to survive financial distress. That is, creating these plans will hopefully reduce the likelihood of having to use them. One concern about living wills is whether or not they have to be approved on an annual basis. Together with other new requirements, annual review of living wills may provide an excessive regulatory burden on large institutions when better regulatory outcomes and more efficient use of scarce regulatory and financial institution resources are possible.

Orderly Liquidation Authority

The orderly liquidation authority (OLA) has the potential to provide a better way in which to handle a crisis—by allowing large firms to fail without taking down the entire financial system—and to reduce the funding advantages of these firms in normal times. A key element is that the OLA makes it possible for counterparties of failing institutions to face haircuts in an orderly fashion; indeed, the legislation essentially mandates that these haircuts will be imposed. If the new authority works properly, government officials will not be forced to provide a blanket bailout to creditors in order to avoid a financial-market calamity. Instead, resources can be put into a failing firm to prop it up temporarily, with costs recouped from counterparties such as bondholders. This would ensure that investors who fund large banks have "skin in the game" as well as an incentive to actively monitor the state of the bank and its safety and soundness. This would impose some market discipline in normal times, ahead of a problem, since bondholders know they will face a haircut if things go bad, rather than lining up for a bailout. Indeed, an effective OLA could help to reverse the pre-crisis presumption that TBTF institutions had a funding advantage.

At the same time, serious concerns remain about the OLA. First, it is possible that the provision of federal funds to maintain the activities of a failing institution could result in a return to TBTF, even though the legislation specifies that taxpayers would not be liable for failing institutions since any funds provided would have to be paid back by counterparties (and then eventually other firms in the financial sector).

A second concern pertains to the trigger mechanisms for invoking orderly liquidation. The OLA has been housed at the Federal Deposit Insurance Corporation (FDIC) under the Dodd-Frank legislation. Initially, there was some concern about the capability of the FDIC to resolve a large global institution. However, the FDIC has invested heavily in staff and expertise in order to be able to tackle the SIFIs. Now there is somewhat of the opposite concern: Not only has the FDIC staffed up to deal with large institutions, so has the Federal Reserve and the Office of the Comptroller of the Currency. If the next major crisis does not come for several years, one wonders what will happen to all of these parallel bureaucracies.

A further concern is that Dodd-Frank limits the power of the Federal Reserve and the FDIC to step in and deal with a crisis. In the case of the Fed, Dodd-Frank limits its Section 13(3) authority, which could make it more difficult to take the necessary steps to stave off a market meltdown. Finally, the existence of the OLA and impending haircuts on bondholders could make such funders more "trigger happy" in terms of reducing funding as a large institution becomes distressed. If firms are not to be bailed out, it could be that they collapse more rapidly than in the past. These concerns among others will be addressed in the Financial Regulatory Reform Initiative.

Capital Markets Regulation

Dodd-Frank makes a strong push to reduce excessive risk-taking in capital markets, particularly by institutions that are funded with deposits insured by federal guarantees. Some observers argue that derivatives markets contributed heavily to the crisis itself, either in their own right or by facilitating the poor lending decisions ultimately at the core of the crisis. CDOs, for example, are derivatives because their value is derived from the performance of other assets. Their true risks and value were not well-understood by many who purchased these securities during the run-up to the financial crisis. Dodd-Frank pushes for greater transparency in the use and trading of derivatives, notably through the requirement that most derivative contracts be cleared through an exchange or clearinghouse. One of the important institutional failures in the crisis was AIG, which issued large amounts of CDS to other institutions that had bought CDOs and were becoming concerned that their value might fall. Many CDOs did indeed collapse in value, with the resulting collateral calls driving AIG into financial distress and forcing the Federal Reserve and subsequently the Treasury to come to the rescue. In retrospect, it appears that AIG faced a liquidity problem but less clearly a solvency problem. (Though the firm's solvency was ensured only by massive government support.) Even so, the failure of AIG motivated key provisions in Dodd-Frank, including those on derivatives.

Volcker Rule

The Obama administration's regulatory white paper issued in 2009 served substantially as the blueprint for the Dodd-Frank legislation. One important feature in Dodd-Frank but not in the original white paper is the Volcker rule. Former Federal Reserve Chairman Paul Volcker spoke forcefully about what he saw as the need to prohibit banks from proprietary trading in derivatives. The definition of "proprietary trading" is not made clear in the legislation, but the intent is to prevent banks from buying and selling from their own account to make profits. Volcker was not alone; for example, Bank of England Governor Mervyn King spoke of the need to get the "casinos" out of the banks. In response to the political pressure generated by Volcker and others, President Obama spoke at the White House with Paul Volcker at his side and argued that reform legislation must put restrictions on proprietary trading.

The rule is thus a legislative reality, but its provisions have not yet been finalized as of October 2012. (Though there are promises from the regulatory community that a final rule will be proposed by the end of 2012.) Concerns about the Volcker rule start with the question of whether proprietary trading was actually a significant cause of the crisis.

Many people believe that the crisis is better understood in terms of financial institutions, both banks and other firms making bad loans. While CDOs are derivatives, they were built off holdings of residential mortgages and, when real-estate prices leveled off and started to decline, the mortgages defaulted in large numbers. Historically, banking crises have been the result of banks making risky loans, often in a housing bubble. This crisis is notable for the scale of the bad lending and the size of the decline in housing prices. It is important to note that the bulk of derivatives are interest rate swaps, credit-default swaps, and foreign-exchange futures contracts, and each of these markets continued to function without major problems through the crisis. Yes, some CDS led to costly losses for some firms (and hefty gains for their counterparties), but this reflects developments in the underlying assets rather than a malfunction in the market itself. The second issue with the rule is that what emerged in legislative language appears to be unworkable in practice. Initial efforts by the various regulators produced a draft rule that has confounded financial institutions, regulators, and even and former Chairman Volcker himself.

The Financial Regulatory Reform Initiative will examine the ways in which the Volcker rule can be implemented to increase the stability of the financial system without an undue cost in terms of market liquidity. A possibility is that the rule could give rise to a formalized process by which financial institutions ensure that they are carrying out proper risk management when their activities come close to the line between acting as an intermediary (broker-dealer) and undertaking proprietary trading.

Clearinghouses and Single Counterpart Credit Limits

Dodd-Frank pushes for derivatives trading to be cleared through clearinghouses to make them more transparent to regulators and to the public. In addition to the added transparency, there is also a potential risk advantage in using clearinghouses to the extent that risks can be offset within the clearinghouse. For example, company financial officers often borrow in the market at a fixed interest rate, but in order to balance their overall portfolios, they want to swap these fixed interest rate payments for variable interest rate payments. An interest rate derivative makes this possible. At the same time, other investors may want to swap a variable interest for a fixed-yield interest. The large banks already try to net out their positions as far as possible to reduce risks, often trading with other large banks. A clearinghouse that was taking derivative positions from the broad market could potentially reduce their risk to a very low level through netting. The proposed rules on clearinghouses and on single counterpart credit limits (SCCLs), however, would make it difficult for banks to have large positions with any one clearinghouse, which would either limit the extent to which they would use a clearinghouse or would encourage the entry of multiple clearinghouses, none of which would be able to net out risks as effectively. Such rules could actually make the financial sector more risky.

Another provision in Dodd-Frank required banks to push out certain derivative contracts. The Lincoln Amendment, for example, was an attempt to restrict insured depository institutions from using their access to federal support to fund certain types of derivatives. There are significant concerns regarding both the potential effects and effectiveness of this amendment in achieving its stated goals. Among the concerns is that implementation of the amendment could reduce liquidity in affected markets and thus have negative impacts on economic activity without a concomitant benefit of increased stability. While this portion of the law does not become effective until the summer of 2013, it has already become the subject of debate. The Financial Regulatory Reform Initiative will examine whether or not this provision fosters financial stability and look at potential impacts on economic growth.

The proposed rules on capital markets and derivatives trading would have the effect of sharply reducing the role of the large banks as market makers and global competitors. Critics of large banks may support that outcome, but the stated intention of Dodd-Frank does not include breaking up or eliminating the large banks. Policy makers should evaluate the impact of the proposed implementation of Dodd-Frank and decide if they do or do not want the outcome that seems likely to occur. A key reality is that multinational companies have the choice of doing their derivatives business anywhere in the world and do not need to operate in New York or Chicago. Regulation that has mainly symbolic appeal might well displace the regulated activity to a different location—at a cost to the United States, both in economic activity and stability.

The Consumer Financial Protection Bureau

Prior to Dodd-Frank, the enforcement of federal consumer protection laws was scattered across multiple regulators. Historically, federal banking regulators were asked to both protect consumers and to ensure that financial institutions were operating safely and avoiding excessive risks. A notable change included in Dodd-Frank is the transfer of consumer financial protection responsibilities from the federal banking regulators to a new federal regulator, the Consumer Financial Protection Bureau (CFPB). An agency with this mission was proposed by a broad consensus of policy makers, including both Treasury Secretaries Hank Paulson and Timothy Geithner in their public proposals for financial reform.

The CFPB is formally housed within the Federal Reserve but operates independently from the Fed. The CFPB has great potential to improve on the regulation of financial markets and on the practices that directly affect the lives of all American families.

The CFPB is in many respects still a work in progress, having only opened its doors and assumed its full legal authority on July 21, 2011. One view of the CFPB is as a much-needed "cop on the beat," advancing transparency, ensuring that consumers have the ability to make informed choices, and perhaps even promoting the availability of better financial products for consumers (while recognizing that the appropriate financial product inevitably will be different for everyone). At the same time, serious concerns have been raised regarding the direction, structure, and work of the CFPB. The Financial Regulatory Reform Initiative intends to evaluate the consumer financial issues that inform the bureau's work, as well as the bureau itself, to the extent possible.

Similar to other financial regulators, the CFPB is led by a director who is appointed by the president and confirmed by the Senate. The governance structure provides substantial authority to the appointed director, who serves a five-year term with protections from presidential removal. The president waited almost a full year before nominating an initial director, Richard Cordray. His nomination did not receive a full vote before the Senate and was ultimately given a recess appointment by the president in January 2012. The failure to nominate someone quickly and the corresponding inability to have a confirmed head of the agency created significant problems, as would be expected for any new agency.

In response to the financial crisis, which began in the housing market, Congress enacted two significant regulatory reform bills. The first was the 2008 Housing and Economic Recovery Act (HERA), which consolidated regulatory responsibility for the GSEs (Fannie,

Freddie, and the Federal Home Loan Banks) from a variety of disparate regulators (the Office of Federal Housing Enterprise Oversight, the Federal Home Loan Bank Board, the Department of Housing and Urban Development) into a single regulatory agency with enhanced powers (the Federal Housing Finance Agency). The second was the Dodd-Frank Act, which created the CFPB. In both instances, the legislation created new, powerful regulatory bodies governed by a single appointed director. Since these two regulators were created under legislation signed by both a Republican president and a Democratic president, an argument can be made that this governance structure with a single director has received bipartisan support. At the same time, an argument can be made on the other side—that there is value in taking a timeless view of government, recognizing that, at some point, there will be a new president and a new head of the CFPB with different policy preferences than those of the people in charge today. Under a timeless view of government, agency missions and actions should be resilient to these changes. After all, the purpose of giving financial regulatory agencies significant independence is precisely to create a separation to the political process. The Financial Regulatory Reform Initiative will explore whether changes to the governance of the CFPB would be beneficial to the mission of the bureau.

The CFPB is also unique in that it is the first creation of an independent regulatory agency housed within another independent regulator. This raises additional questions regarding not only the structure of the CFPB, but also the precedent for the creation of alternative regulatory regimes and the interactions between regulators who are housed in the same bureau or who serve on each other's boards. When originally chartered, the Federal Reserve had both the Treasury secretary and the comptroller serving on its board. Likewise, the FDIC board includes other federal regulators, including now the director of the CFPB.

The Financial Regulatory Reform Initiative will also examine the impact of the consumer-related provisions of Dodd-Frank on the availability of credit. For example, the details of the qualified mortgage standard (QM) and the rules for the risk-retention exemption for qualified residential mortgages (QRM) will both have important implications for the availability and terms of housing credit. QM and QRM are still uncertain and could potentially be either duplicative or in conflict with each other. This is a prime example of when analysis of one regulation will also require analysis of another regulation.

Regulatory Architecture

Dodd-Frank significantly altered the government's financial regulatory structure. In the end, however, Dodd-Frank created more new regulators than it eliminated. Rather than achieving net regulatory consolidation, Dodd-Frank focused on improving regulatory coordination. This was attempted primarily through requirements for joint rule writing between various regulators, such as the SEC and the CFTC, and by the establishment of the FSOC as a regulatory coordinator of sorts. There are real issues about the FSOC's current and future efforts to coordinate regulatory policy, and there are real limits to the FSOC's statutory authority to ultimately resolve differences among otherwise independent regulators. It worth noting that membership in the FSOC includes regulatory agencies that otherwise did not receive significant attention in Dodd-Frank, such as the National Credit Union Association, which oversees federally insured credit unions.

The financial crisis exposed important gaps within the federal regulatory regime. This includes gaps in prudential regulation, as discussed earlier in the case of AIG; gaps in entire areas of the financial system, such as the shadow-banking system and money-market mutual funds; and gaps in consumer regulation, such as in the oversight of non-bank consumer lenders. The initiative will consider whether Dodd-Frank sufficiently covered the various gaps that were exposed during the crisis, examine whether new regulatory gaps were created, and assess the costs and benefits of the changes made in the legislation.

The Financial Regulatory Reform Initiative will also examine both changes to the regulatory architecture that were achieved as well those that were not. The initiative will consider whether additional regulatory consolidation would be advisable and ask whether the system as currently constructed provides adequate opportunity for regulatory disagreement while still limiting the scope for potential harmful "regulator shopping" by affected firms. Finally, the initiative will examine the cumulative effects of regulatory changes throughout the financial crisis as it affects the overall regulatory architecture.

Conclusion

Starting the Financial Regulatory Reform Initiative is an act of faith in the political process. A concern by supporters of Dodd-Frank is that opening up the legislation will result in the undermining of its key provisions and the sacrifice of the progress already made toward making the financial sector more stable. A concern within the financial industry is that the current political climate is so hostile to the industry that further public discussion of the Act's provisions, or of the way these provisions are being implemented, will force companies to contract or to move activities overseas. We believe that revisiting the issues of financial reform will be a productive and an important step forward.

BPC's Debt Reduction Task Force—chaired by former Senator Pete Domenici and former head of both the Office of Management and Budget and the Congressional Budget Office Dr. Alice Rivlin—has been extraordinarily valuable in setting the terms of the debate and framing the critical tradeoffs as Congress and the administration grapple with budget issues. Similarly, regardless of who wins the November elections for president and for Congress, policy makers will have to continue to deal with financial regulation. Outright repeal of Dodd-Frank seems unlikely, but there is a great need for fine-tuning the legislation to adjust or to correct some of the Act's provisions. There are ways in which financial regulation can be more efficient without sacrificing safety and stability—and, in some instances both efficiency and safety can be improved at the same time. Even without additional legislation, the implementation of Dodd-Frank has raised crucial questions, notably the issue of how well or how badly the different rules will interact together.