Dodd-Frank Wall Street Reform and Consumer Protection Act

Federal Reserve Bank of Minneapolis

Public Information Session

May 9, 2013

Agenda

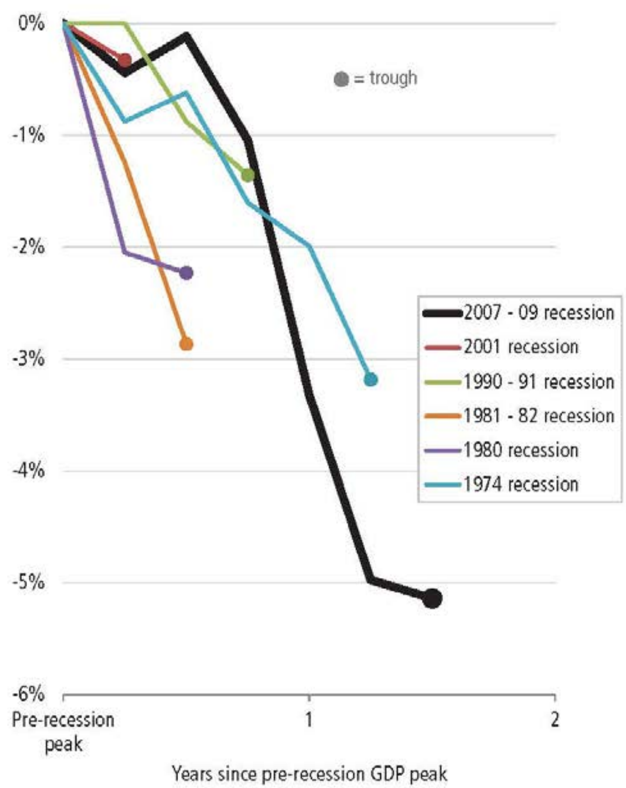
- Overview of the financial crisis
- Legislative response – Dodd Frank Act
  - Focus on five key issues
- Overall status of implementation efforts
- Questions

Summary of Financial Crisis

Response

1 This recession was the worst since the Great Depression

Real GDP, percent fall from pre-recession peak



Metrics of the '07 - '09 financial crisis, peak-to-trough:

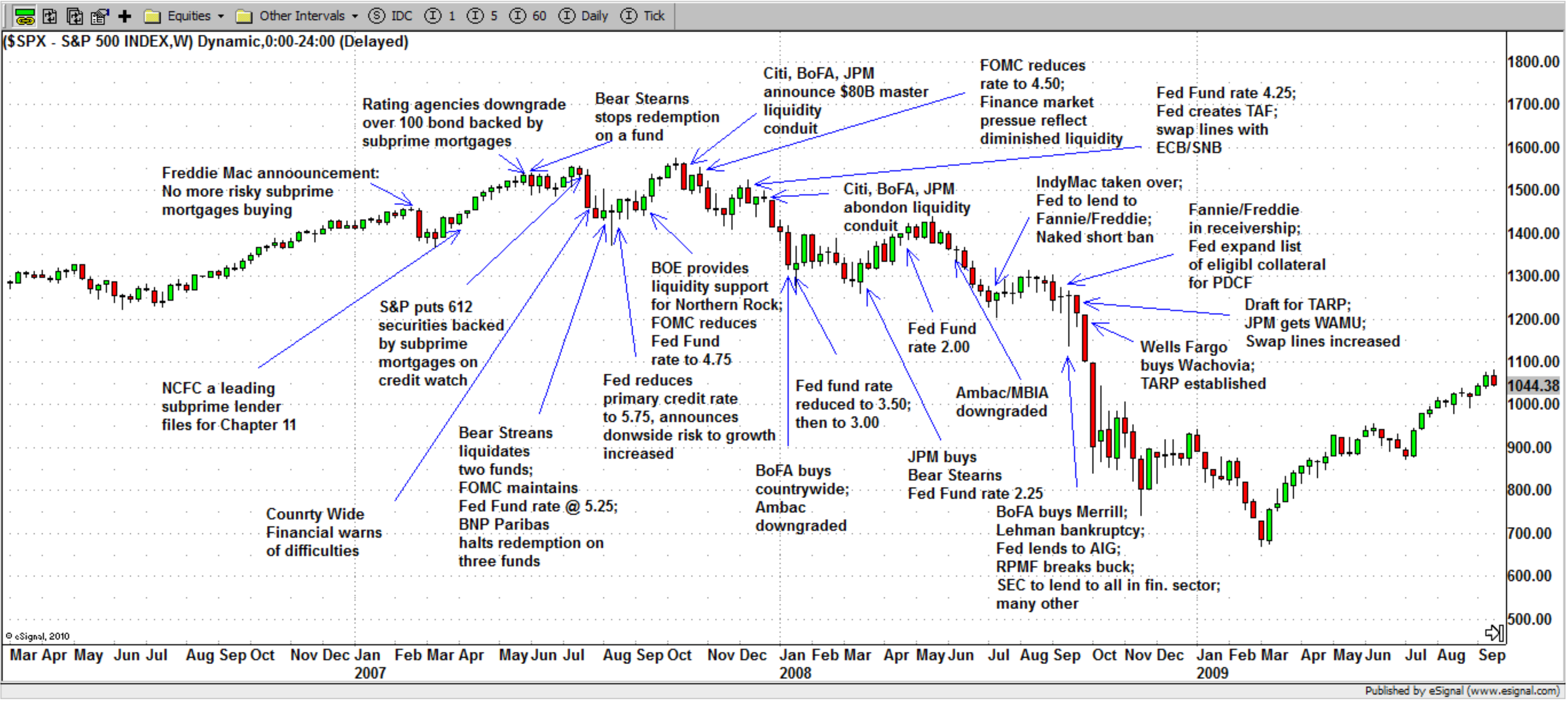
8.8 million
jobs lost

$19.2 trillion
lost household wealth
(2011 dollars)

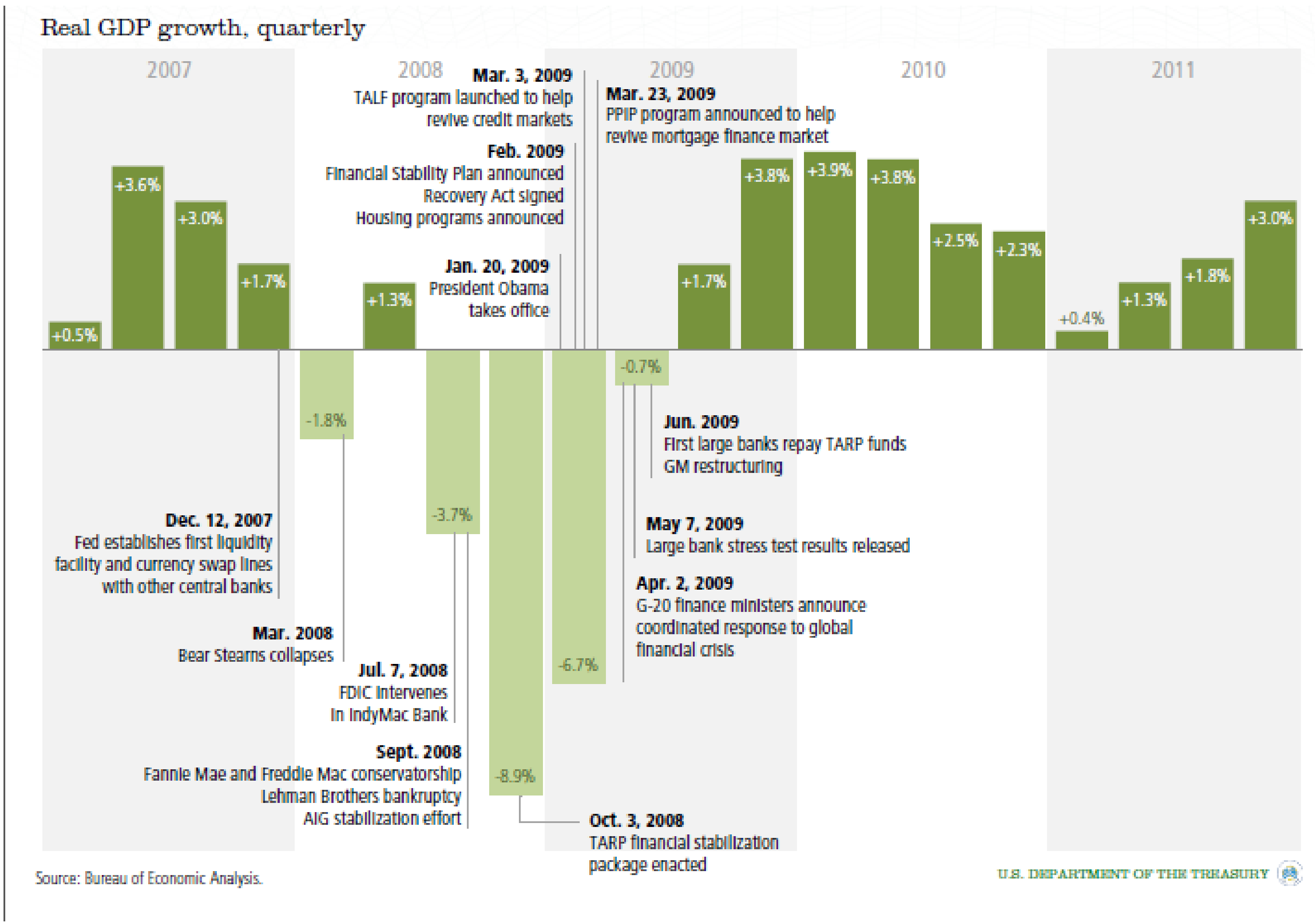
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Flow of Funds.

U.S. DEPARTMENT OF THE TREASURY

Summary of Financial Crisis



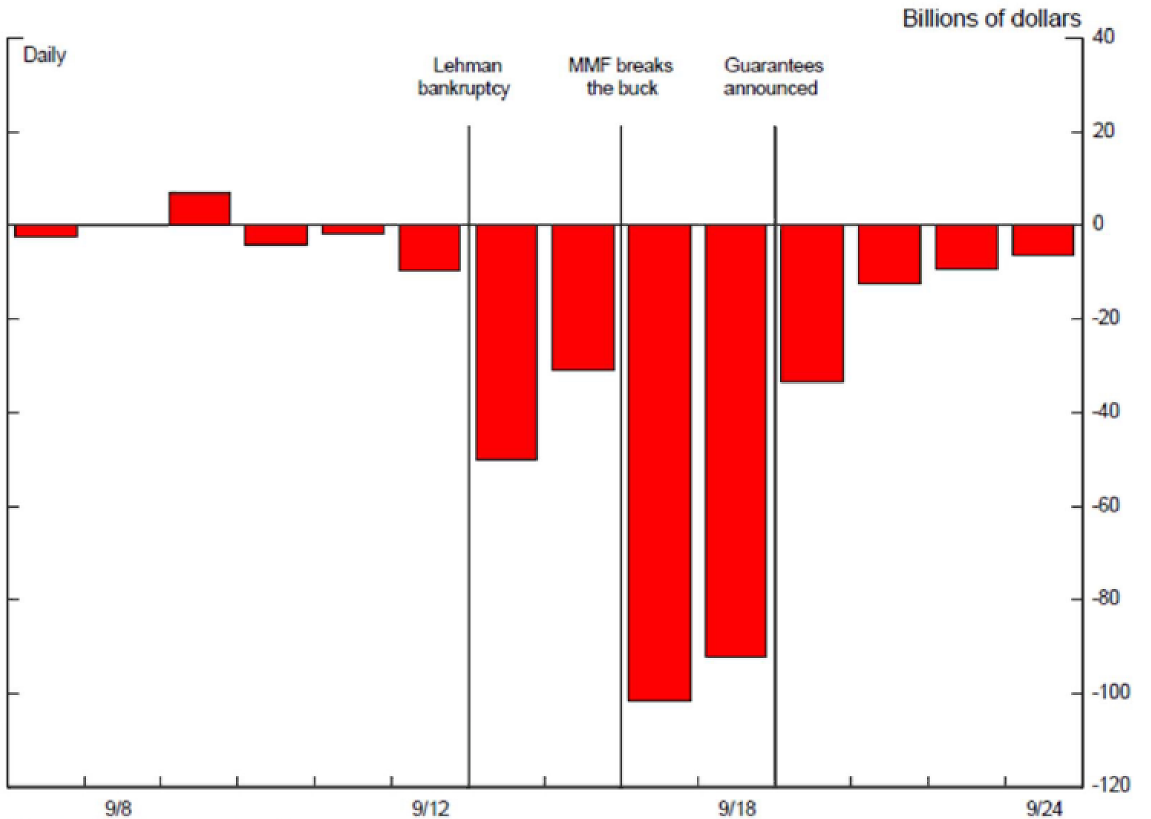
Summary of Financial Crisis



Summary of Financial Crisis

The Run on MMFs

Net Flows to Prime Money Market Funds

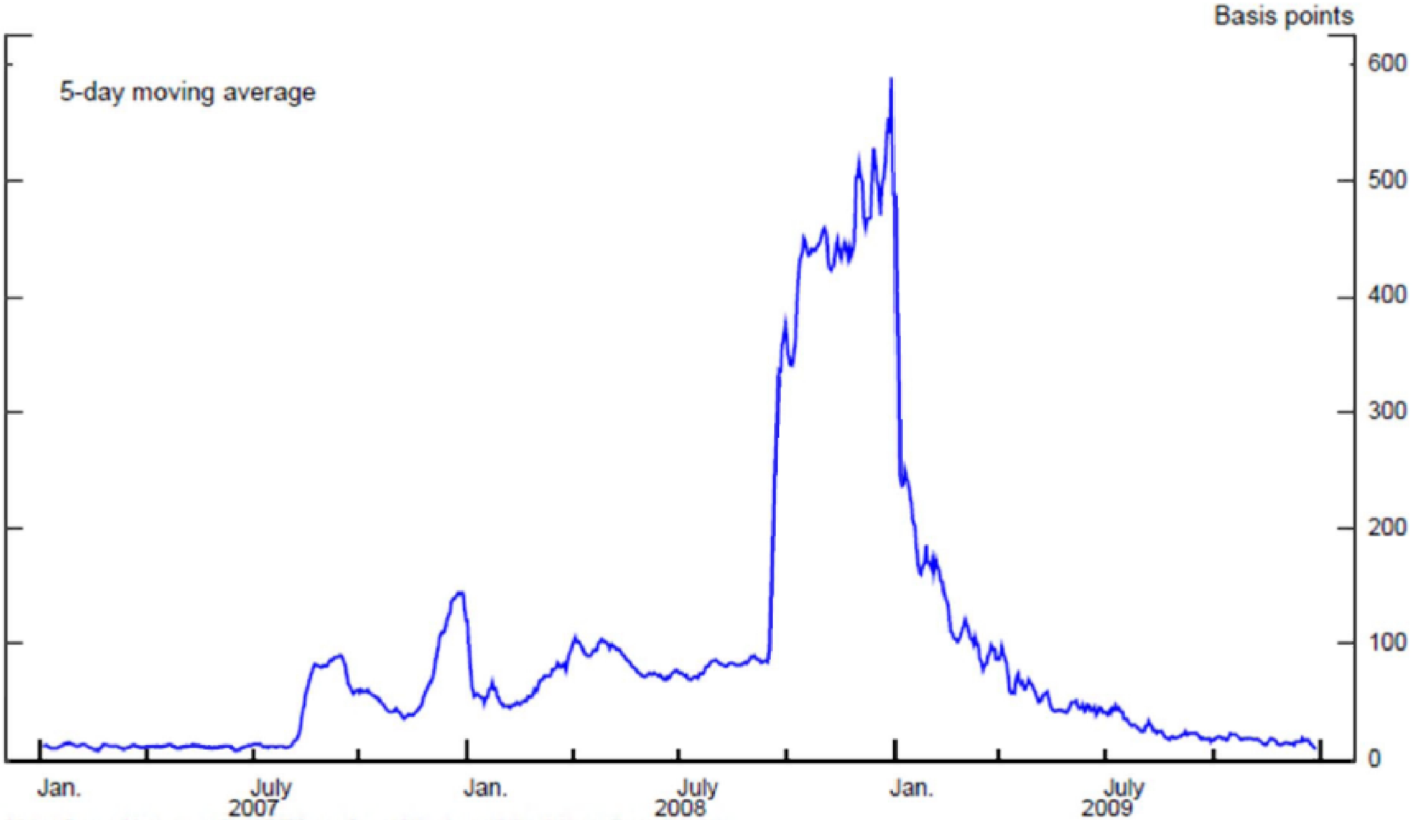


Source: iMoneyNet and FRB staff adjustments.

Summary of the Financial Crisis

CP Rates Soared during the Crisis

Cost of Short-term Borrowing'



Note: Spread between the A2/P2 nonfinancial rate and the AA nonfinancial rate.
Source: Depository Trust & Clearing Corporation.

Summary of Financial Crisis - Causes

- There are multiple narratives on the cause(s) of the financial crisis:
  1. Primary cause was government intervention in the housing market
  2. Primary cause was Wall Street’s greed and stupidity
  3. The cause was a messy, complex mix of multiple factors

Summary of Financial Crisis - Causes

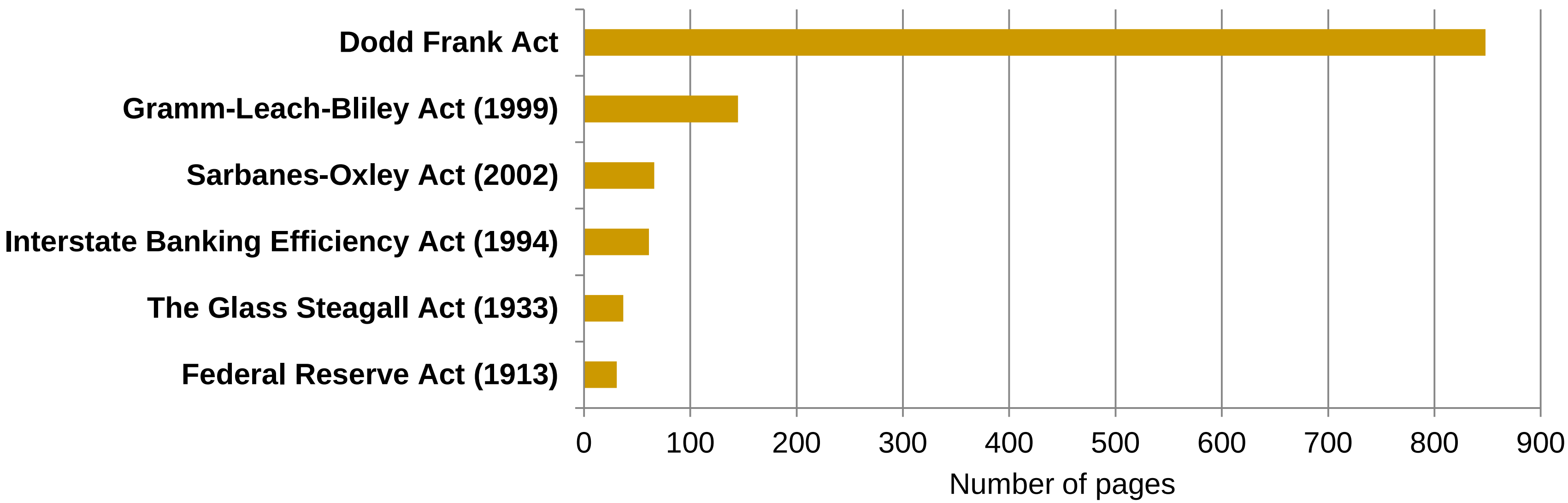
3. The cause was a messy, complex mix of multiple factors:
   a. Broad credit bubble in U.S. and Europe beginning in 1990s
   b. Housing bubble in U.S.
   c. Excess liquidity, rising house prices, and ineffective regulation led to increase in nontraditional mortgages
   d. Failures in credit rating and securitization turned bad mortgages into toxic financial assets
   e. Credit rating agencies rated securities as safe even as credit quality fell, buyers didn’t do their own research
   f. Many financial firms loaded up on products exposed to the housing sector, funded the assets with short term debt, and held too little capital
   g. Fallacy of assumption that short term funding would always be available caused problems for a number of firms
   h. Some firms had large counterparty credit exposures which spread losses
   i. Rapid failure/restructuring of 10 firms in September 2008 caused financial panic
   j. Financial panic caused a severe contraction in the real economy.

Legislative Response

- Dodd Frank Wall Street Reform and Consumer Financial Protection Act (DFA) best understood as political compromise based on different narratives of financial crisis
  - Passed 237 to 192 by House on June 30, 2010
  - Passed 60 to 39 by Senate on July 15, 2010
  - Signed into law July 21, 2010
- Most significant change to financial regulation since the Great Depression

DFA Overview

- DFA is an enormous piece of legislation
  - 2,319 pages long
  - Required over 240 new regulations
  - Mandated 67 studies



Overview of Act

Title I	Financial Stability
Title II	Orderly Liquidation Authority
Title III	Transfer of OTS Powers
Title IV	Regulation of Private Fund Advisors
Title V	Insurance
Title VI	Regulation of Bank and Savings and Loan Holding Companies and Depository Institutions
Title VII	Over-the-Counter Derivatives
Title VIII	Payment, Clearing, and Settlement Supervision
Title IX	Investor Protection
Title X	Bureau of Consumer Financial Protection
Title XI	Federal Reserve Provisions: 13(3), GAO Audit Disclosure, and Governance
Title XII	Access to Mainstream Financial Institutions
Title XIII	Pay it Back Act
Title XIV	Mortgage Reform and Predatory Lending
Title XV	Miscellaneous Provisions
Title XVI	Financial Crisis Assessment and Fund

Overview

- Selected Issues:
  - Systemic Risk and “Too Big to Fail”
  - Volcker Rule
  - Fed Lending (Section 13(3))
  - Consumer Financial Protection Bureau
  - Debit Interchange Fees
- Discussion
  - What is the issue?
  - How does DFA address it?
  - What is the status of implementing the DFA provisions?
  - Is the issue resolved?

Systemic Risk and Too Big to Fail

- Banking activity in U.S. is increasingly concentrated in a small number of very large, interconnected firms
  - In 1970, top 5 banks held 17% of total banking assets
  - In 2010, top 5 banks held 52% of total banking assets
- Failure of one firm can jeopardize the viability of other firms (systemic risk)
- As a result, these large firms have been rescued with government assistance rather allowed to fail
- The market perception that these firms are “too big to fail” lowers their funding costs thus giving them an advantage over smaller competitors
- During the financial crisis multiple large financial firms received government support due to concerns about the potential impact of their failure on other firms

DFA Titles I and II

- Expanded supervision of systemically important firms
  - Financial Stability Oversight Council
  - Fed's supervision authority expanded
    - Heightened prudential standards
    - Stress tests
- Enhanced resolution capabilities
  - Orderly resolution authority for nonbank financial firms
  - Living wills

Systemic Risk and Too Big to Fail
Status of Implementation

- FSOC issued its 2013 Annual Report on 4/25/13
- FSOC hasn't designated any nonbank SIFIs yet
  - Media reports indicate initial designations soon
- Fed issued proposed enhanced prudential standards for comment in December 2011; final rule not issued yet
- Stress tests
  - On March 7, 2013, the Fed announced the summary results of the first year of stress tests pursuant to DFA
- FDIC has issued some detail on orderly liquidation authority process, but acknowledged more is needed
- Living wills
  - Final regulation issued November 2011
    - Largest firms (over $250 billion) filed initial plans 7/1/2012
      - Fed and FDIC issued additional guidance on 4/15/13 and extended deadline for 2013 filing to 10/1/13
    - Firms over $100 billion – plans due 7/1/2013
    - Firms over $50 billion – plans due 7/1/2014

System Risk and Too Big to Fail
Is the Issue Resolved?

- Depends on who you ask, but…
  - Some argue DFA perpetuates the problem while others question whether DFA living wills and orderly liquidation process will really work for largest firms
  - Seems to be a growing consensus that more needs to done; less consensus on what to do
    - DFA didn’t address resolution of globally active firms nor problem of multiple simultaneous failures
    - Growing calls to break up big banks
      - Given degree of concentration, largest firms would have to be broken into many pieces
      - Breaking up firms doesn’t resolve problem of interconnectedness

Volcker Rule

- Paul Volcker, chair of President's Economic Recovery Advisory Board, argued that speculative activity by banks played a key role in the financial crisis
  - Commercial banking system essential to stability of broader financial system
  - Speculative investments by banks that do not benefit their customers increased systemic risk to an unacceptable level
  - Extensive use of derivatives increased, rather than mitigated, risk
- Volcker advocated:
  - Ban on "proprietary" trading
  - Ban on investments or ownership of hedge funds or private equity
  - Concentration limits

Title VI - Regulation of Bank and Savings & Loan Holding Companies and Depository Institutions

- "Volcker Rule" activity restrictions
  - Subject to certain exceptions and a transition period, the Volcker Rule prohibits any "banking entity" from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund
    - It also requires systemically important nonbank financial companies to carry additional capital and comply with certain other quantitative limits on such activities, although it does not expressly prohibit them
- "Volcker Rule" concentration limits
  - A financial company may not merge or acquire all or substantially all of the assets of another firm if upon consummation the acquiring firm's total liabilities would exceed 10% of the aggregate consolidated liabilities of all financial companies at the end of the prior calendar year

Volcker Rule
Status of Implementation

- Compliance period
  - In April 2012, Fed said big banks would have until at least July 2014 to conform to the Volcker Rule
- Status of rulemaking
  - Draft rule published for comment October 2011
    - Over 17,000 comments received
  - Final rule has not been published
    - Hopeful final rule will be finished in 2013 (Governor Daniel Tarullo 4/3/13)

Volcker Rule

Is the Issue Resolved?

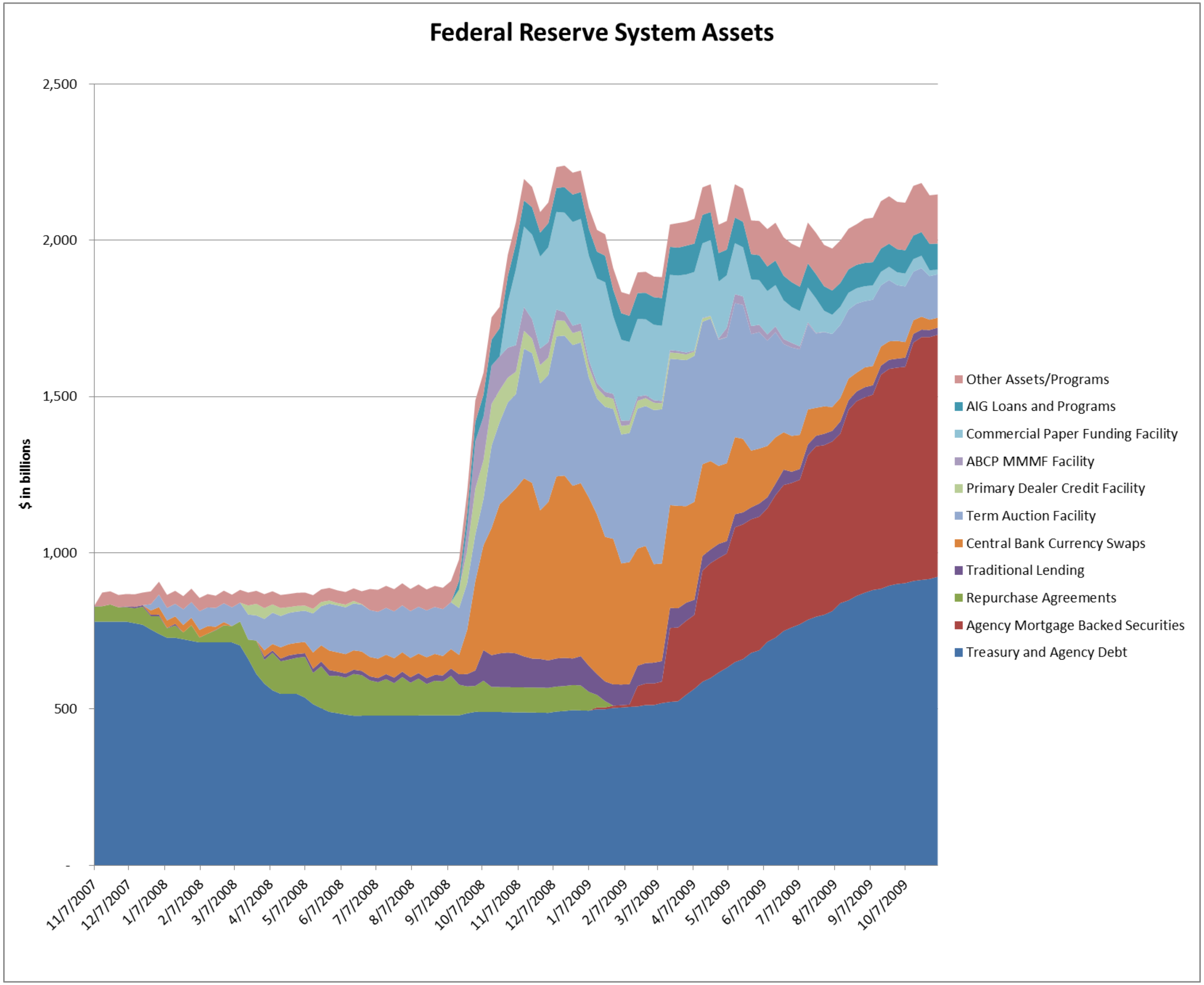
- No, final rule not issued yet
- Debate continues on how significant proprietary trading risks were to the financial crisis and how effectively the implementation of the Volcker Rule will address these risks
  - Number of exceptions in DFA
  - Challenges of definitions – “proprietary”

Federal Reserve Lending (Section 13(3)) What is the Issue?

- Fed's Pre-Crisis Lending Authority
  - Discount Window
    - Lending to banks that hold reserves with the Fed
    - Loans are fully collateralized
    - Historically, most lending was overnight
  - Section 13(3)
    - In "unusual and exigent" circumstances, Fed can lend to anyone that can't otherwise get adequate credit
    - Prior to the crisis, this provision virtually never used

Fed Lending During the Crisis

- During crisis Fed used its Section 13(3) lending authority to address severe liquidity strains in key financial markets as well as to provide credit to troubled systemically important firms
  - Special Liquidity and Credit Facilities
    - Broker-dealers (financial firms that deal in securities and derivatives)
    - Commercial paper borrowers
    - Money market funds
    - Asset-backed securities market
  - Individual Firms
    - Bear Stearns, AIG, Citigroup, BofA


Federal Reserve System Assets
$ in billions
2,500
2,000
1,500
1,000
500
-
11/7/2007
12/7/2007
1/7/2008
2/7/2008
3/7/2008
4/7/2008
5/7/2008
6/7/2008
7/7/2008
8/7/2008
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2/7/2009
3/7/2009
4/7/2009
5/7/2009
6/7/2009
7/7/2009
8/7/2009
9/7/2009
10/7/2009
Other Assets/Programs
AIG Loans and Programs
Commercial Paper Funding Facility
ABCP MMMF Facility
Primary Dealer Credit Facility
Term Auction Facility
Central Bank Currency Swaps
Traditional Lending
Repurchase Agreements
Agency Mortgage Backed Securities
Treasury and Agency Debt

Title XI - Limits Section 13(3) Authority and Requires Additional Disclosures

- Section 13(3)
  - Eliminates authority to extend credit to specific individual, partnership, or corporation. Credit can only be provided as part of a program or facility with broad eligibility and only with Treasury Secretary approval.
    - Board must report details of borrowing (i.e., names, amounts, collateral) to Congress every 30 days
      - Can be confidential (limited to ranking members of banking committees) upon Fed request
  - By 12/1/10 Fed required to publicly disclose details about participants in all facilities established since 12/1/07

Federal Reserve Lending (Section 13(3)) Status of Implementation

- Consistent with DFA provisions, on 12/1/10 the Fed published details about all participants in the special liquidity facilities since 12/1/07
  - *http://www.federalreserve.gov/newsevents/reform_transaction.htm*

Federal Reserve Lending (Section 13(3)) Is the Issue Resolved?

- Depends…
  - Fed no longer has authority under Section 13(3) to facilitate the resolution of a systemically important financial firm
  - DFA provides increased regulatory and supervisory oversight of systemically important firms as well as a new orderly resolution process
  - Real issue is whether curtailment of Fed’s lending authority will reduce TBTF and leave adequate tools to resolve future financial crises

Consumer Financial Protection Bureau
What is the Issue?

- Idea for Consumer Financial Protection Bureau (CFPB) originated with 2008 Law Review article co-authored by Senator Elizabeth Warren
  - Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. Pa. L. Rev. 1 (2008)
- CFPB was proposed by Obama Administration in June 2009:
  - Federal oversight of consumer finance was spread among seven different federal agencies
    - Fragmentation made policy coordination difficult
    - Consumer financial protection was not the central task of any of these agencies
    - Important sectors of some markets operated without any meaningful federal oversight
    - Subprime and nontraditional mortgage lending products were not effectively regulated prior to the financial crisis

Title X - Bureau of Consumer Financial Protection

- New <u>independent</u> bureau in Fed
  - Deemed an Executive agency with Director appointed by President and confirmed by Senate for a 5 year term
  - Bureau is truly autonomous “within” Fed
    - Has own authority to hire and fire staff, set salaries and benefits, organize itself, contract, and perform any other agency function
  - Fed required to transfer fixed percentage of total System operating expenses to Bureau:
    - 2013 and beyond – 12%
    - Designed to shield the Bureau from the appropriations process

Title X - Bureau of Consumer Financial Protection

- Scope of authority
  - With limited exceptions, all rule-writing, examination, reporting and enforcement authority under Federal consumer protection statutes transferred to the Bureau
  - Exceptions
    - Authority for the Community Reinvestment Act remains with the Federal banking agencies
    - Fed and FTC retain authority under Federal consumer protection laws as they apply to auto dealers
    - For insured DIs with $10 billion or less in total assets, banking agencies will continue to conduct exams
      - Bureau may participate in these exams to assess compliance, but has no enforcement authority

Consumer Financial Protection Bureau
Status of Implementation

- Implementation of the CFPB provisions has been a particularly contentious aspect of DFA implementation
  - Interagency transfers of authority and staff went smoothly
  - CFPB began operations on 7/12/11
  - Congressional sparring over structure of CFPB has continued

Consumer Financial Protection Bureau
Is the Issue Resolved?

- In December 2011 Senate Republicans blocked Richard Cordray's nomination as Director
  - Republicans want Director replaced with a 5 member board and CFPB subject to appropriations process
- President Obama made recess appointment 1/4/12
  - Federal Appeals Court has since invalidated recess appointments made to the NLRB at the same time
  - On April 23rd Rep. Hensarling, chair of the House Financial Services Committee, banned Director Cordray from appearing before his committee saying he wasn't the CFPB's legitimate head

Debit Interchange Fees
What is the Issue?

- Interchange fee is paid by merchant when purchase is made with credit or debit card
  - Fees set by credit card networks (e.g., Visa/Mastercard)
  - Subject of significant controversy between merchants and banks/card networks
    - Many merchants lack ability to negotiate
    - Antitrust litigation
    - Regulatory initiatives in other countries
- What does this have to do with financial crisis?
  - Nothing…
  - DFA is simply a vehicle for legislative initiative to address this long running dispute between merchants and banks over card fees
    - Proposed as an amendment to DFA by Senator Durbin

Title X - Debit Interchange

- Debit card interchange fees
  - Fed required to establish rules for interchange transaction fees for debit card transactions
    - Interchange fees must be “reasonable and proportional” to actual costs incurred for the transaction
    - Final rules due 9 months after enactment
    - Debit card issuers with total assets of less than $10 billion are exempt

Debit Interchange Fees
Status of Implementation

- Fed issued final debit interchange regulation on 6/29/11
  - Effective date of 10/1/2011

Debit Interchange Fees
Is the Issue Resolved?

- DFA only applies to debit card transactions
- Bank/merchant controversy over interchange fees continues
  - Last November judge issued preliminary approval of a settlement agreement in a class action anti-trust lawsuit brought by merchants against Visa, MasterCard, and many card-issuing financial institutions
    - Settlement valued at over $7 billion
    - Merchants have until 5/28/13 to opt out of settlement

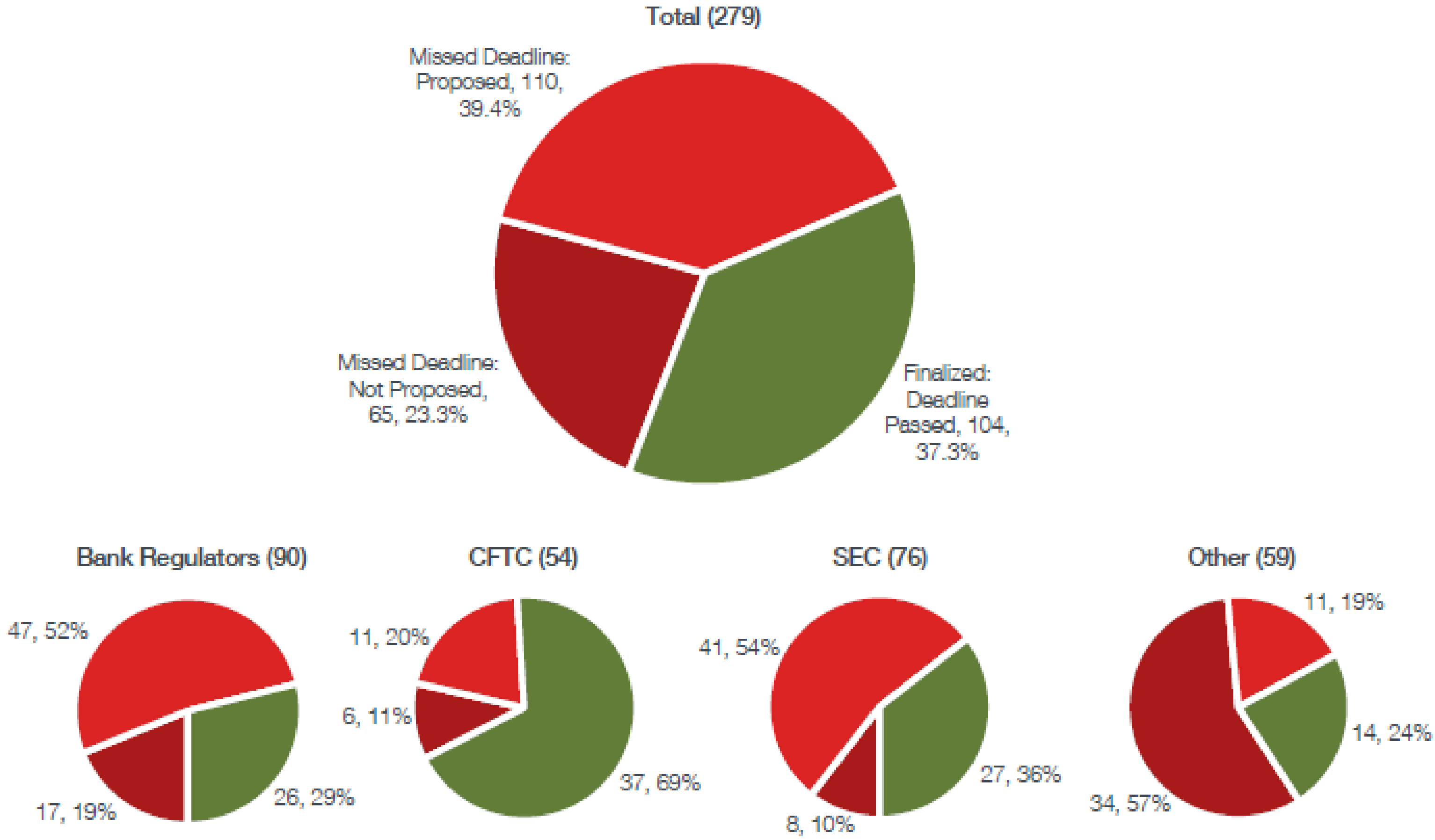
DFA Implementation Challenges

- Scale and complexity of implementation effort enormous
  - Large volume of comments on draft rules
- Interagency nature of many rulemakings complicated process
- Legal challenges
  - Cost-benefit analysis litigation
  - Appointment process litigation
- Legislative challenges
  - Proposals to rollback some or all provisions
  - Appropriations
  - Oversight hearings

Davis Polk

Dodd-Frank Rulemaking Progress on Passed Deadlines

As of May 1, 2013



Rulemaking counts are based on estimates and require judgment.

Values Refer to Number of Rulemaking Requirements

Questions?