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

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)

Summary of Financial Crisis

- Rating agencies downgrade over 100 bond backed by subprime mortgages.
- Bear Stearns stops redemption on a fund.
- Freddie Mac announcement: No more risky subprime mortgages buying.
- S&P puts 612 securities backed by subprime mortgages on credit watch.
- NCFC a leading subprime lender files for Chapter 11.
- Country Wide Financial warns of difficulties.
- Fed reduces primary credit rate to 5.75%, announces downside risk to growth increased.
- Bear Stearns liquidates two funds; FOMC maintains Fed Fund rate at 5.25%.
- BNP Paribas halts redemption on three funds.
- FOMC reduces rate to 4.50%; Finance market pressure reflect diminished liquidity.
- Citi, BoFA, JPM announce $80B master liquidity conduit.
- Fed Fund rate 2.00.
- Fed fund rate reduced to 3.50%; then to 3.00.
- Citi, BoFA, JPM abandon liquidity conduit.
- Fannie/Freddie in receivership; Fed expand list of eligible collateral for PDCF.
- IndyMac taken over; Fed to lend to Fannie/Freddie; Naked short ban.
- Wells Fargo buys Wachovia; TARP established.
- BoFA buys Bear Stearns; Fed Fund rate 2.25.
- JPM buys Bear Stearns.
- Draft for TARP; JPM gets WAMU; Swap lines increased.
- Ambac/MBIA downgraded.
- BoFA buys Merrill; Lehman bankruptcy; Fed lends to AIG; RPMF breaks buck; SEC to lend to all in fin. sector; many other.
Summary of Financial Crisis

The Run on MMFs

Net Flows to Prime Money Market Funds

Source: MoneyNet 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

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

- 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 independent 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
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
Dodd-Frank Rulemaking Progress on Passed Deadlines
As of May 1, 2013

Total (279)
- Missed Deadline: Proposed, 110, 39.4%
- Finalized: Not Proposed, 65, 23.3%
- Finalized: Deadline Passed, 104, 37.3%

Bank Regulators (90)
- Missed Deadline: Proposed, 47, 52%
- Finalized: Not Proposed, 26, 29%
- Finalized: Deadline Passed, 17, 19%

CFTC (54)
- Missed Deadline: Proposed, 11, 20%
- Finalized: Not Proposed, 6, 11%
- Finalized: Deadline Passed, 41, 76%

SEC (76)
- Missed Deadline: Proposed, 37, 69%
- Finalized: Not Proposed, 8, 10%
- Finalized: Deadline Passed, 27, 36%

Other (59)
- Missed Deadline: Proposed, 34, 57%
- Finalized: Not Proposed, 14, 24%
- Finalized: Deadline Passed, 11, 19%

Rulemaking counts are based on estimates and require judgment.
Values Refer to Number of Rulemaking Requirements
Questions?