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Dodd Financial Regulation Bill: Super Regulators Not the Answer

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There are many valid reasons to be angry with bankers, and supporters of Senator Chris Dodd's (D–CT) latest rewrite of his financial regulatory bill, the Restoring American Financial Stability Act, have mentioned them all. Americans have heard all about greedy bankers, huge bonuses, shady accounting practices, and outright greed. But the reason for this rhetoric is nothing less than an attempt to seize control of the financial services industry and to micromanage it.

Unfortunately, if this ploy succeeds, the result would be an all-powerful bureaucracy that would do little to address the real problems in the industry and actually make future crises—and bailouts—more likely. The first step has already been taken after the Senate Banking Committee amended the 1,336-page original text with a 114-page manager's amendment and sent the bill to the full Senate after a 22-minute markup on March 22.

The Consumer Financial Protection Bureau. According to the media, the most controversial issue is Dodd's decision to create a Consumer Financial Protection Bureau (CFPB) within the Federal Reserve rather than creating a new independent agency. The new CFPB would have its own staff, autonomous rule-making authority, and the ability to examine financial institutions with more than $10 billion in assets.

It makes little difference where the agency is housed if, as Dodd proposes, it is effectively a completely independent agency that can ignore questions about whether its proposals could destabilize the industry. The bill approved by the Senate Banking Committee enhances those concerns, because although safety-and-soundness regulators would be able to appeal draft CFPB regulations that could endanger the stability of the financial system, they would not have the ability to veto them in advance.

A Permanent TARP for Failing Financial Institutions. The Senate Banking bill proposes to create a new $50 billion fund to be used in "emergencies" to close or restructure failing financial institutions or those perceived as being in danger of default. This fund is certain to be used for bailing out any politically significant financial institution and is nothing less than a permanent TARP program.

If the Treasury, Federal Reserve, and FDIC agree, failing financial institutions would be turned over to the FDIC for resolution. Three bankruptcy judges must also agree, but this appears to be more window-dressing than any substantive requirement, since the closing or restructuring would be handled by the FDIC and not through bankruptcy courts.

Despite rhetoric about using bankruptcy for most failures, the draft makes it clear that this is to be handled through a bureaucracy subject to political pressures, since the bill also does not include

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language adapting the bankruptcy process to the special needs of complex international financial institutions.

A far better approach would be to create a special section of the bankruptcy code and use it to handle the failures of all major financial institutions.[1] In addition, the FDIC has neither experience with complex international financial failures nor the expertise to handle the failure of these financial institutions.

An Extremely Powerful Financial Stability Oversight Council (FSOC). Dodd's bill would create a new nine-member council of regulators designed to identify and protect the overall financial system against the kinds of threats that appeared in 2008. The bill would allow this new entity to "draft" any financial institution that it deems a risk to the overall financial system into regulation by the Federal Reserve and then enable the Fed to order that financial institution or any other to break itself up, stop selling certain products, or even go out of business.

The FSOC would "recommend" to the Fed that it increase rules dealing with capital standards, liquidity, leverage, risk management, and a host of other areas. It could also require major financial services firms to have a pre-existing plan for closing the firm in the event that it runs into trouble. Unfortunately, these extensive new powers would not in themselves make the system safer, and the uncertainty about how they would be applied may actually destabilize the financial system. Instead of open-ended regulatory powers, Congress should use higher capital and liquidity standards[2] to strengthen the financial services system.

Even More Power for the Federal Reserve. Ironically—since the debate started with a stated desire to trim back the regulatory powers of the Federal Reserve—the Senate Banking bill ends up giving it even greater powers over major financial services firms than it has now (even though it does strip the Fed of its jurisdiction over small banks). Although the new council of regulators is given the power to recommend and approve Fed actions, the actual power to design and implement such actions goes to the Federal Reserve.

Rearranging Bank Regulators. Dodd's original draft would have created a single new bank regulator that would have combined the regulatory functions of the Federal Reserve, FDIC, Office of Thrift Supervision (OTS), and Office of the Comptroller of the Currency (OCC). His second attempt—the committee-passed version—goes in the opposite direction by only eliminating the OTS but rearranging the existing structure by changing jurisdictions. The Fed would end up regulating only financial services firms with over $50 billion in assets. The FDIC would regulate all state-chartered banks and thrifts and holding companies with assets of under $50 billion, while the OCC would regulate nationally chartered banks, thrifts, and holding companies with assets of under $50 billion.

It is hard to see what if any benefits would come from this wholesale rearrangement of responsibilities. Since most major holding companies still contain subsidiaries that would be regulated by the SEC, Commodity Futures Trading Commission, or another regulator, the overall financial regulatory system would remain about as complex as it is now. Gaps that remain in the existing system would continue to exist, so there would be little benefit to thousands of financial institutions shifting to new regulators that may interpret existing rules differently from their existing overseers.

Unrealistic Restrictions on Financial Activities. Unexpectedly, the Senate Banking bill also includes a form of the Volcker rule,[3] which would allow regulators to micromanage financial institutions but

1. See David C. John, "Using Bankruptcy and Capital Standards to Address Financial Institutions That Are 'Too Big to Fail,'" Heritage Foundation *WebMemo* No. 2343, November 24, 2009, at *http://www.heritage.org/Research/Reports/2009/11/Using-Bankruptcy-and-Capital-Standards-to-Address-Financial-Institutions-That-Are-Too-Big-to-Fail.*
2. See *ibid.*
3. For more information, see David C. John, "The Volcker Rule: Not the Solution to Reducing Financial Risk," Heritage Foundation *WebMemo* No. 2810, February 22, 2010, at *http://www.heritage.org/Research/Reports/2010/02/The-Volcker-Rule-Not-the-Solution-to-Reducing-Financial-Risk.*

would do nothing to reduce systemic risk. The provision would prohibit any bank or other institution with FDIC-insured deposits from undertaking any proprietary trading—that is, trading for the banks' own behalf rather than for the benefit of a client—or from owning or sponsoring hedge funds or private equity funds. The rule would go into effect only after a study by the FSOC.

Certainly, no one wants banks to engage in risky practices, but the details are critical to determining what a risky practice is and what is an important part of a bank's normal customer service and management of its own liquidity. Banks have always served their customers by arranging trades of customer assets, and this extends to buying assets that a customer seeks to sell and holding them for short periods until the bank can find a buyer. In addition, a bank needs to invest its own capital and other assets to ensure that it has enough cash on hand for periods of high demand without reducing its earnings.

The difference between these legitimate and traditional activities and those the Volcker rule seeks to ban would be difficult if not impossible to determine. Attempting to do so would require an intrusive, expensive regulatory compliance system that by its nature would micromanage day-to-day activities without any significant reduction in systemic risk.

A Bill This Complex Should Be Considered Slowly. The Senate Banking Committee bill has many other sections as well, any one of which could cause serious damage to the economy, consumers, and the financial services industry. As with any long and complex financial regulatory bill, the bill should be closely and thoroughly reviewed. Sadly, committee Members from both parties failed to meet this challenge by approving a huge bill in only 22 minutes, and supporters of the Senate Banking bill would like floor consideration to be equally fast.

The handling of this critical legislation appears to be one more instance where legislators want to push through major bills without subjecting them to close scrutiny. Rhetoric can be a powerful motivator in politics, but quick action on all but the simplest areas almost always results in bad decisions that can have lasting effects.

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