COMMITTEE ON CAPITAL MARKETS REGULATION

July 21, 2011

The Honorable Tim Johnson
Chairman
United States Senate Committee on Banking,
Housing, and Urban Affairs
Washington, DC 20510

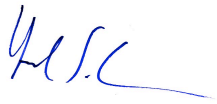
The Honorable Richard C. Shelby
Ranking Member
United States Senate Committee on Banking,
Housing, and Urban Affairs
Washington, DC 20510

Re: Enhanced Oversight After the Financial Crisis: The Wall Street Reform Act at One Year

Dear Chairman Johnson and Ranking Member Shelby:

I am pleased that you are holding a hearing on the anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Please see my attached statement concerning progress toward achieving the goals of the Act. I would appreciate if you could distribute this to the members of the Committee in advance of your July 21 hearing and include it in the hearing record.

Respectfully submitted,



Hal S. Scott
President & Director
Committee on Capital Markets Regulation

Statement of

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Director of the Committee on Capital Markets Regulation;
Nomura Professor and Director of the Program on International Financial Systems
at Harvard Law School

to the

Committee on Banking, Housing, and Urban Affairs
United States Senate

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One year ago today, the Dodd-Frank Act was signed into law. I would like to take this opportunity to review progress toward achieving the goals of the Act. I will begin by giving a brief update on the regulators' actions to date, followed by additional comments on the implementation process. I will also discuss what are, in my view, the best and worst substantive features of Dodd-Frank and their effects on the financial system and the U.S. economy, concluding with a warning about how Dodd-Frank affects the competitive position of the U.S. markets. Although much of this statement is based on the past work of the Committee on Capital Markets Regulation (CCMR), these represent my own views, not the views of the Committee.

I. Dodd-Frank Progress

The Dodd-Frank Act requires federal regulators, including the Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation (FDIC), Commodity Futures Trading Commission (CFTC), Board of Governors of the Federal Reserve System (Federal Reserve), and the new Financial Stability Oversight Council (FSOC), to write and implement

[1] Biography with disclosures on compensated activities available at http://www.law.harvard.edu/faculty/hscott.

over 300 new rules.[2] The Act requires 122 of these rules to be finalized either today, the one-year anniversary of the Dodd-Frank Act, or sometime last week.[3] It is clear that most of these deadlines will be missed. Some rules with looming deadlines have yet even to be proposed, much less finalized. By tomorrow the regulators will very likely have more than 100 overdue rules. These are just the rules with deadlines before or during July. More than half of the required rules have a deadline after July or no deadline at all, and very few of those have even been proposed yet.

This is not to say the regulators have not been busy—far from it. In the last year the financial regulators have written more than 3 million words published in over 3,500 three-column, small-type pages of the Federal Register.[4] Nor do I mean to criticize the agencies for missing the deadlines. In fact, in testimony I delivered in January before the House Committee on Financial Services, I said, "the most important objective should be to get the rules right, not to act quickly."[5]

Rather, these statistics illustrate that the original statutory deadlines were unrealistic. As I noted in January, the SEC typically issued fewer than 10 new substantive rules a year before Dodd-Frank, and the CFTC issued fewer than 6 a year. Yet the Dodd-Frank Act gave the SEC only a year to write nearly 60 rules, and the CFTC nearly 40.[6] The agencies were not prepared to run a record-setting 2-hour marathon. They were not even prepared to run a 5-hour marathon,

[2] Sec. Industry & Fin. Mkts. Ass'n, *Regulatory Action Database*, http://www.sifma.org/members/dodd-frank.aspx. Note that this count and the ones that follow include multiple instances of a rule if it involves multiple regulators.
[3] DAVIS POLK & WARDWELL, LLP, DODD-FRANK PROGRESS REPORT 4 (July 2011).
[4] Jean Eaglesham, *Overhaul Grows and Slows,* WALL ST. J., May 2, 2011, at http://online.wsj.com/article/SB10001424052748703346704576295873060349068.html.
[5] *Promoting Economic Recovery and Job Creation: The Road Forward: Hearing Before the H. Comm. On Finc. Servs.*, 112th Cong. 14–15 (Jan. 26, 2011) (testimony of Hal S. Scott) (hereinafter January Testimony).
[6] January Testimony, *supra* note 5 at 102.

considering that the rules, which involve a fundamental reshaping of our financial markets, are very complicated and frequently require the coordination of multiple agencies.

II. Implementation Process

It is clear from the regulators' progress that the statutory deadlines were, on the whole, unrealistic. But the implementation problems were not limited to the unrealistic deadlines. The rulemaking process as a whole was opaque, causing uncertainty among market participants. Most regulators did not create a public rulemaking schedule; the public was generally left to guess about which rules were coming when. It does not seem that the regulators really thought much about a sensible schedule, because they proposed rules in scattershot fashion: many important rules came after less important ones, and proposals frequently relied upon rules that had yet to be proposed, such as definitions. Nor did the various regulators coordinate their rulemaking schedules, much less the substance of rules. Under the Dodd-Frank Act, the CFTC is charged with regulating the swaps market and the SEC with the security-based swap market. Yet time and again, the comment period on a proposed rule from one Commission would close before the other had issued its own proposal on the same topic. The timing differences are made more problematic by the divergence between the agencies on substance. The SEC and CFTC have frequently proposed rules on the same topic that are very different, without justifying the differences.

These sequencing and coordination deficiencies made it unnecessarily difficult for the public to comment in a meaningful way. The CFTC helpfully opened up most of its rules for another 30 days of comments, but this was, as they say, a day late and a dollar short. The new comment window was announced only near the end of the process, so it did nothing to assuage

the pressures on the public during the initial comment windows, when they were left to comment on an incomplete set of rules without even knowing whether a particular firm or product would be covered by the rules. Moreover, only the CFTC reopened the rules for comments; the SEC and the other regulators have not done so. What should be done is that many of these rules, particularly those relating to derivatives, should have been reproposed as a package, and a further comment period allowed. In retrospect, the CFTC would have been better off proposing a comprehensive set of rules to begin with, taking more time to get the package right rather than operating piecemeal.

For some time now I have been calling attention to the lack of cost-benefit analysis performed by the financial regulators in the rulemaking process. In January of this year, the President issued an Executive Order requiring governmental agencies to issue rules only when their benefits exceed their costs.[7] This Order reiterated the principles from a series of Executive Orders dating back to President Reagan. By its terms, however, the Obama Executive Order does not apply to independent agencies such as the CFTC and SEC. Although the heads of both of those agencies contemporaneously suggested they would comply with the Order's principles, it is clear that they have not.[8]

Just last week the President issued another Executive Order, this time specifically targeted at independent agencies.[9] But it is not binding in any way. Moreover, it is a watered-

[7] Exec. Order No. 13,563, § 1(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).
[8] *See Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the H. Comm. On Agric.*, 112th Cong. (Feb. 10, 2011) (testimony of Chairman Gary Gensler), http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html (CFTC Chairman Gary Gensler: "the CFTC's practices are consistent with the executive order's principles."); *Testimony of Chairman Mary Schapiro Before the Subcomm. on Fin. Servs.: Hearing Before the H. Appropriations Comm.*, 112th Congress (Mar. 15, 2011), http://appropriations.house.gov/_files/031511SECFY12BudgetTestimonyFINAL.pdf (SEC Chairman Mary Schapiro: "while the Executive Order doesn't apply to us, we're trying to act as though it does.").
[9] Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 11, 2011).

down version of the January Order, requiring only a "consideration" of a rule's costs and benefits, rather than a requirement that the rule's benefits exceed its costs.[10] This limited action from the Executive branch may be traced to a concern that branch exercising too much control over "independent agencies."[11] But Congress created these agencies, and it can mandate by statute more thorough cost-benefit analysis. I encourage it to do so.

III. Best and Worst Features of the Dodd-Frank Act

A. Best Features

The Dodd-Frank Act made several needed corrections in financial regulation. To start, it contains a broad mandate to centrally clear derivatives.[12] CCMR strongly supported mandatory central clearing in its May 2009 Report.[13] Centralized clearing reduces the potential chain reaction effect of failure by a major counterparty by collectivizing those risks through clearinghouse. Together with the Dodd-Frank Act's execution and reporting provisions,[14] they also contribute to enhancing the liquidity and transparency of the derivatives markets, as well as addressing several processing, settlement, and margining and collateral issues.

The Dodd-Frank Act also made improvements to asset-backed securitizations (ABS). Notably, it improves the disclosure regime to investors and requires securitizers to retain "skin in

[10] *Id.* at § 1(a).
[11] *See* Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. REV. 1489, 1531–37 (2002); Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2319–31 (2001); Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 24–33 (1995).
[12] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 723, Pub. L. No. 111-203, 124 Stat. 1376 (hereinafter Dodd-Frank Act).
[13] *See* COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 42 (May 2009), http://www.capmktsreg.org/research.html.
[14] *See* Dodd-Frank Act §§ 727, 729, 733.

the game"—an economic interest in the credit risk of the assets.[15] The regulators are currently accepting comments on a proposal to require 5% risk retention.[16] As proposed, it allows a securitizer to retain risk in a number of different ways, including a first-loss position, a "vertical" slice of each tranche, a mixture of both, and a representative sample. The Dodd-Frank Act also contains an exception from the risk retention provision for "Qualified Residential Mortgages," the definition of which is also out for comment. I believe the housing price bubble was the root cause of the financial crisis, and the bubble depended on easily securitized mortgages. It is therefore appropriate that the Dodd-Frank Act address this process, but do so in a sensible way. We need to revitalize this market if housing finance is to revive.

Credit ratings are of course closely tied to the securitization market and thus to the financial crisis. The Dodd-Frank Act sought to improve the regulation of the credit ratings agencies as well.[17] Many of these improvements, notably increasing transparency about ratings methodology, are steps in the right direction. However, the Act prohibits federal agencies from referencing credit ratings at all. The regulators have yet to divine how to accomplish this in a sound fashion. I think a better approach would be to prohibit *undue reliance* on the ratings. This is a simple statutory fix.[18]

[15] *See id.* §§ 941–46.
[16] Credit Risk Retention, 76 Fed. Reg. 24,090 (proposed Apr. 29, 2011).
[17] *See* Dodd-Frank Act §§ 931–939H.
[18] The fix would replace "reference to or requirement of reliance on credit ratings and" in § 939A(b) with "undue reliance on credit ratings and, if necessary,".

B. Worst Features

1. No consolidation of regulators and lack of co-operation among regulators

In 2009, CCMR called for the reorganization of the U.S. regulatory structure, calling it "an outmoded, overlapping sectoral model."[19] Although other countries have moved toward integrated regulatory structures, the Dodd-Frank Act actually made things worse. Although it did eliminate the Office of Thrift Supervision,[20] it created new regulators, the Bureau of Consumer Financial Protection, the Federal Insurance Office, and the Financial Stability Oversight Council (FSOC).

A fragmented regulatory structure makes supervision and regulation difficult. A single firm may be subject to supervision by several different regulators, each of which has its own priorities and expertise. Each regulator also has its own set of regulations, which are sometimes at odds with those of other regulators. Dodd-Frank did not help in this respect. A total of 43 of the Dodd-Frank rulemaking provisions involve two or more agencies, and a handful involve half a dozen or more.[21] If the agencies' rules about the same topic diverge from each other, as is frequently the case with the SEC's and the CFTC's proposals, market participants who are subject to two different regimes will have to comply with different rules governing similar conduct. Without proper coordination, it will not always be clear whether a particular swap falls within the jurisdiction of the CFTC or SEC—different rules will provide an incentive and opportunity for participants to design derivatives to fit into the scheme that they prefer.

[19] COMM. ON CAPITAL MKTS. REG., *supra* note 13 at 203.
[20] *See* Dodd-Frank Act § 312(b).
[21] *See* Curtis W. Copeland, Cong. Research Serv., R41472, *Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act* 7 (Nov. 3, 2010).

The newly created FSOC is no solution to this problem, even though Title I of the Dodd-Frank Act empowered it with broad authority to identify and monitor excessive risks to the U.S. financial system. FSOC's ability to effectively reduce systemic risk is limited. First, its members primarily come from other independent federal regulatory agencies, and each will have his or her own agenda. The power of the Secretary of the Treasury as Chairperson is limited. FSOC itself has little direct supervisory authority—authority remains dispersed among the other agencies. For example, although it has the authority to designate nonbank financial institutions as systemically important (with a 2/3 vote), Dodd-Frank places enhanced supervisory authority in the hands of the Federal Reserve.[22] The Council can make recommendations to the Federal Reserve, but it cannot force it to act.[23] Even when serving as an arbiter for disputes between certain agencies, its recommendations are generally nonbinding.[24] In addition, the two-thirds supermajority vote required for many of its actions may be difficult to achieve. To date it has done little.

2. Emergency Action

Several aspects of the Dodd-Frank Act make it more difficult to act in a crisis. The sudden drop in housing prices in 2008 prompted a contagious liquidity crisis, which was stabilized only through the actions of the Fed, FDIC, and Treasury. Yet after the Dodd-Frank Act, none of them can do again what they did in the crisis.

[22] *See* Dodd-Frank Act § 113.
[23] *See id*. § 115.
[24] *See id*. § 119.

Under Dodd-Frank, the Federal Reserve may establish an emergency lending facility only with "the prior approval of the Secretary of the Treasury."[25] CCMR previously explained that this approach "imposes unnecessary procedural hurdles on the Federal Reserve, potentially hampering its ability to act decisively in a crisis."[26] The Federal Reserve should make decisions about emergency lending both because it has the necessary expertise and because it can act quickly and decisively, and is independent. The Secretary of the Treasury may fear the political consequences of his or her decision, particularly if it can be characterized as a bailout. Of course an emergency facility under the Dodd-Frank Act is not a bailout; it must be adequately collateralized (a requirement legitimately strengthened by Dodd-Frank) and is subject to audits by the Comptroller General.[27]

Similarly, under the Dodd-Frank Act the FDIC cannot guarantee deposits above $250,000 (including certain transaction accounts after 2012), or other senior debt, without a joint resolution of Congress.[28] These are actions that can be important in staving off runs. During the crisis, the Treasury used funds from the Economic Stabilization Fund to guarantee money market funds in order to prevent a contagious run after the Primary Reserve Fund broke the buck. The Treasury can no longer do this, this power was removed by the TARP legislation and was not restored by Dodd-Frank Act.[29]

The Dodd-Frank Act also established a new "Orderly Liquidation Authority," which includes a receivership process for the FDIC to use in resolving non-bank financial companies.

[25] Dodd-Frank Act § 1101(a)(6)(B)(iv).
[26] Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. 6 (June 14, 2010), http://www.capmktsreg.org/pdfs/2010.06.14_CCMR_Reconciliation_Letter.pdf.
[27] Dodd-Frank Act §§ 1101(a)(6), 1102(a).
[28] *See id.* § 335.
[29] *See* 12 U.S.C.A. § 5236(b).

In the process, however, the Dodd-Frank eliminated one of the FDIC's existing powers to act in a crisis, namely the open bank assistance program for banks, and did not provide such a capability for non-banks. It also makes it difficult to preference short-term creditors in a resolution.

All of these changes may actually make the problem of contagion worse because the government will be less able to stop it by injecting much-needed liquidity or support. The changes are largely the result of a popularly inspired bipartisan anti-bailout consensus, although even the consensus is puzzling. On the one hand, the Republicans have characterized the Dodd-Frank Act as a bailout bill,[30] which it is not, and on the other hand the Democrats have asserted that they have ended bailouts,[31] when the hard reality is that in the future, some form of a bailout may very well be necessary. The statutory changes, primarily from the Dodd-Frank Act, will seriously constrain the government's ability to respond effectively to a future crisis. Moreover, they are unnecessary to protect taxpayers. Shortfalls can always be made up in taxes on the industry, and increased deposit insurance costs can be paid for through higher premiums.

3. Funding/Management of CFPB

Under the Dodd-Frank Act, the newly created Bureau of Consumer Financial Protection (CFPB) is funded from the profits of the Federal Reserve.[32] The CFPB receives the amount of funding that its Director determines is "reasonably necessary to carry out [its] authorities,"

[30] THE FIN. SERVS. COMM., ONE YEAR LATER: THE CONSEQUENCES OF THE DODD-FRANK ACT 15–22 (2011), http://financialservices.house.gov/UploadedFiles/FinancialServices-DoddFrank-REPORT.pdf.
[31] Represenative Barney Frank (D-MA), National Press Club Newsmaker Series: A Report from the Front Line of Financial Reform (July 11, 2011), http://press.org/news-multimedia/videos/npc-newsmaker-rep-barney-frank.
[32] *See* Dodd-Frank Act § 1017(a)(1).

subject to a cap of about $550 million.[33] Funding the CFPB through the Fed's profits sets a bad precedent. There is no review or control of the justifications for the money request; budget determinations should be made through the normal appropriations process.

A full year after the Dodd-Frank Act was enacted, the Bureau still does not have an official Director, although President Obama nominated Richard Cordray earlier this week. In the interim the Dodd-Frank Act allows the Secretary of the Treasury to perform certain functions of the Bureau. Secretary Geithner had delegated this responsibility to Elizabeth Warren, who is now serving as Special Advisor to the Secretary.[34] That interim authority is limited, however, particularly after today's "transfer date." The Inspectors General for both the Treasury and the Federal Reserve have concluded that after this date, the Secretary of the Treasury or his delegate can only exercise the CFPB's functions under subtitle F of Title X of the Dodd-Frank Act, which includes the existing authority of *other* regulators that will be transferred to the CFPB. Only a Senate-confirmed Director may exercise the CFPB's new authorities, including the powers to prohibit unfair, deceptive, or abusive practices and to control disclosures about consumer financial products.[35] It is clear that the CFPB needs a confirmed head that is capable of executing the full powers of the office. This is true more than ever now that the transfer date has arrived.

Congress recognized that a tension can arise between the overall goals of safety and soundness of the financial system and the CFPB's goal of consumer protection. As a result, it

[33] *Id*. § 1017(a); *Annual Report, 2009, Board of Governors of the Federal Reserve System* at 475, 491. Note that this cap, which increases slightly for fiscal years 2012 and 2013 and is adjusted for inflation thereafter, does not include the additional appropriations through fiscal year 2014 provided by § 1017(e).

[34] *See id.* § 1066(a); Letter from Eric M. Thorson, Inspector General, Department of the Treasury, and Elizabeth A. Coleman, Inspector General, Board of Governors of the Federal Reserve System, to Hon. Spencer Bachus, Chairman, Committee on Financial Services, and Hon. Judy Biggert, Chairman, Committee on Financial Services, Subcommittee on Insurance, Housing, and Community Opportunity, OIG-CA-11-004, FRB OIG 2011-01 Enclosure at 2 (Jan. 10, 2011) (hereinafter OIG Letter).

[35] OIG Letter at 5–7; *see* Dodd-Frank Act §§ 1066(a) ("The Secretary is authorized to perform the functions of the Bureau under this subtitle until the Director of the Bureau is confirmed by the Senate."), 1031 ("prohibiting unfair, deceptive, or abusive acts or practices"), 1032 (disclosures).

created a review process and veto power over the CFPB's regulations. Unfortunately, this veto power may only be exercised upon a 2/3 vote of FSOC's members.[36] From the perspective of protecting the safety of the financial system, it would be far better to give the Secretary of the Treasury the powers of review and veto. He or she can act decisively, unlike the supermajority of a council of regulators, and has a broader view of the problem.

IV. Competitiveness

The Dodd-Frank Act and new international regulatory standards, including the Basel III capital requirements, are likely to harm the international competitiveness of U.S. financial institutions. International coordination by financial regulators is necessary in order to prevent regulatory arbitrage and competitive inequalities. Although the Dodd-Frank Act wisely allowed U.S. regulators a lot of discretion to minimize some competitive disadvantages, the necessary co-ordination with international regulators and among U.S. regulators has been insufficient.

A. Volcker Rule

The so-called Volcker Rule bans "proprietary trading" in U.S. banking organizations, here and abroad, and limits their sponsorship of private equity and hedge funds to 3% of any fund and 3% of their capital.[37] As I have emphasized many times, proprietary trading was not a cause of the financial crisis and can serve to make banks more financially secure by diversifying their activities beyond risky lending. Indeed, the GAO recently found that the proprietary trading desks of four out of the six biggest banks posted profits during the period 2006–2010.[38] Large

[36] *See* Dodd-Frank Act § 1023.
[37] Dodd-Frank Act § 619.
[38] United States Government Accountability Office, Report to Congressional Committees, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented* 14 (July 2011), http://www.gao.gov/new.items/d11529.pdf.

bank losses during the financial crisis primarily came not from proprietary trading, but rather from traditional banking activities such as bad housing loans and investments in pools of those loans. With regard to systemic risk, the Volcker rule is both over-inclusive and under-inclusive as not all banks engaged in proprietary trading contribute to systemic risk, and some non-banks engaged in proprietary trading may contribute to systemic risk.[39]

The scope of the Volcker rule is unclear because the term "proprietary trading" and the various exceptions in § 619 of the Dodd-Frank Act are ambiguous and have yet to be defined by rule. This is of particular importance because the line between permissible market making and possibly impermissible proprietary trading is difficult to draw. Implementation of the Volcker Rule will require extensive agency coordination. As drafted, the Dodd-Frank Act requires the Fed, SEC, CFTC, and certain banking regulators to implement the Volcker Rule, but unlike other sections of the Dodd-Frank Act, which require joint rulemaking, the Dodd-Frank Act requires only "coordinated rulemaking" for the Volcker Rule, with the Secretary of the Treasury, as Chairman of FSOC, having unclear responsibility to coordinate. So far this coordination role has been fruitless.

The Volcker Rule's impact on covered institutions' revenues and profitability is already significant. In order to prepare for the Volcker Rule's implementation, Morgan Stanley, Goldman Sachs, and Bank of America have already made significant business decisions regarding their proprietary trading desks and hedge/private equity fund investments.[40] For

[39] *Implications of the 'Volcker Rules' For Financial Stability: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 2, 5 (Feb. 4, 2010) (testimony of Hal S. Scott).

[40] FIN. STABILITY OVERSIGHT COUNCIL, STUDY AND RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS 2 (Jan. 2011), http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf. While the study suggests that banks are presently shutting down dedicated proprietary trading desks, hedge funds, and private equity funds "that were a source of losses during the crisis," it is not clear, however, that

example, Goldman Sachs has dismantled almost all of its proprietary trading operations, which analysts estimate will erase about $3.7 billion in revenue and $1.5 billion in profit annually—over 50% of revenues and 15% of earnings per share.[41] Morgan Stanley's divestitures are expected to result in a 14% loss of earnings per share[42] while Citigroup will have to divest its interest in various hedge funds. Such divestitures could force the closing of certain hedge funds despite their strong absolute performances. For example, Citigroup's Mortgage/Credit Opportunity Fund climbed 16% in the first four months of 2011[43] but because 90% of the $395 million invested in the fund is Citibank's own capital, the Fund may have to unwind.

It is important to recognize that the United States is acting alone in banning proprietary trading. Despite Chairman Volcker's hope that other countries would follow, none have done so. Our solitary stand puts our markets and our firms at a competitive disadvantage. Under the Volcker Rule, a U.S. banking organization cannot engage in proprietary trading abroad, but its foreign competitors can.

After the Volcker rule was introduced as part of the Dodd-Frank Act, the U.K. Independent Commission on Banking rejected a similar approach.[44] Rather than limit a banking organization's activities, the U.K. Commission set forth a plan for internal ring-fencing, whereby

banking entities have shut down only money-losing operations.

[41] Lauren T. LaCapra, *Goldman Lobbying Hard to Weaken Volcker Rule,* REUTERS (May 4, 2011), http://www.reuters.com/article/2011/05/04/goldman-volcker-idUSN0418474320110504.

[42] Philip van Doorn, *Fed Issues Volcker Proposal*, THE STREET, http://www.thestreet.com/story/11002447/1/fed-issues-volcker-proposal.html.

[43] "The fund, run by Rajesh Kumar, 41, has posted profits every year since it began in 2008… Kumar's hedge fund is part of Citi Capital Advisors, which oversees about $16 billion in so-called alternative funds, including private equity and venture capital funds…" Donal Griffin, *Citigroup's Hedge-Fund Returns Jump as Volcker Rule Looms*, BLOOMBERG, May 18, 2011, http://www.bloomberg.com/news/2011-05-18/citigroup-hedge-fund-returns-jump-as-ban-on-prop-trading-looms.html; *see also* Donal Griffin, *Citigroup Said to Shut $400 Million Proprietary Fund as Ahmed Has New Role*, BLOOMBERG, June 2, 2011, http://www.bloomberg.com/news/2011-06-02/citigroup-said-to-shut-proprietary-fund-as-manager-has-new-role.html.

[44] INDEP. COMM'N ON BANKING, INTERIM REPORT CONSULTING ON REFORM OPTIONS (Apr. 2011), http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf.

wholesale and investment banking activities would be separated from retail banking activities, which will be supported by insured deposits. The retail bank will be required to have higher capital requirements. This is a far better approach than the Volcker rules, an approach already reflected in our approach to Glass-Steagall reform in 1999 when we required that most securities activities be conducted in the holding company rather than the bank.[45]

B. Derivatives Regulation

As I explained earlier, I regard some of the derivatives provisions to be among the best features of the Dodd-Frank Act, especially those pertaining to central clearing and transparency. We are not alone in those endeavors; Europe is enacting similar changes.[46] But the devil is in the details, and it is important to avoid diverging too much on the implementation details in order to avoid disrupting cross-border transactions and creating an opportunity for regulatory arbitrage.

Both the U.S. and E.U. will permit their institutions to participate in a foreign clearinghouse only if the regulations pertaining to that foreign clearinghouse are equivalent to those of clearinghouses in the home country.[47] We may run into problems if the two regimes diverge on important issues. For example, the CFTC has proposed capping minimum capital requirements for clearinghouse membership at $50 million,[48] but the E.U. may set either a higher threshold or none at all. It is not clear whether the E.U. will then permit an E.U. firm to use a U.S. clearinghouse with lower minimum limits because it may be considered riskier. Conversely,

[45] Gramm-Leach-Bliley Act § 111, Pub. L. No. 106-102, 113 Stat. 1338 (1999).
[46] For the E.U. effort, *see Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories*, COM (2010) 484 final (Sept. 15, 2010) (hereinafter E.U. Proposal).
[47] *See* Dodd-Frank Act § 738(a); E.U. Proposal, Article 23.
[48] *See* Risk Management Requirements for Derivatives Clearing Organizations § 39.12, 76 Fed. Reg. 3,698, 3,719 (proposed Jan. 20, 2011) ($50 million requirement); Katy Burne, *U.K.'s FSA Warns US Against Lowering Barriers to Swap Clearing*, FOX BUSINESS, Mar. 25, 2011, http://www.foxbusiness.com/industries/2011/03/25/uks-fsa-warns-lowering-barriers-swap-clearing/.

the CFTC has proposed limiting ownership of clearinghouses by dealers, banks, and other types of institutions, to a combined 40%.[49] Will the CFTC allow a U.S. institution to use an E.U. clearinghouse that is completely owned by dealers? Other differences include the end-user exception, which is narrower in the U.S. than in the E.U. because the U.S. exception applies only to hedging activities, and possible differences between margin required for cleared swaps.

In addition, the U.S. and the E.U. are not moving at the same pace. Although the U.S. regulators will undoubtedly miss today's deadline for the bulk of their rules, they may finish by the end of the year. The E.U., on the other hand, is unlikely to complete its rules before late 2012 or 2013. Different implementation schedules may also create arbitrage opportunities.

To be clear, I am not advocating merely following Europe. Rather, I think it is important to emphasize the need for coordination. It may be that we need to make some changes to our rules, and that the Europeans will have to make some changes to theirs.

C. Capital Requirements

Capital requirements are presently undergoing major changes. The Dodd-Frank Act requires "systemically important financial institutions," or SIFIs to hold as much capital as Basel I required,[50] and the Basel III rules adopted in December 2010, will also have to be implemented. Capital requirements are among the most important regulations for the banking industry, and changes to them will have very large effects. Even though the Basel rules are designed to be international standards, the effects may not be uniform across countries. Indeed, implementing

[49] *See* Dodd-Frank Act § 726(a); *see also* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest § 39.25, 75 Fed. Reg. 63,732, 63,750 (proposed Oct. 18, 2010) (imposing limits on ownership).
[50] *See* Dodd-Frank Act § 171.

Basel III (by 2019, as planned) may have uneven competitive effects, as will the additional capital requirements in the Dodd-Frank Act that do not apply in other countries.

Basel III makes several changes. It will require banks to hold 4.5% of common equity and 6% of Tier I capital (up from 4%) of risk-weighted assets (RWAs). Basel III will also introduce capital buffers, including a mandatory capital conservation buffer of 2.5% and a discretionary countercyclical buffer of an amount to be decided by national regulators, up to 2.5%. It will also introduce a leverage ratio and two mandatory liquidity ratios. The introduction of the leverage requirement (and its retention in the U.S.) is somewhat odd since the whole Basel capital initiative is premised on the idea that capital should be held in proportion to the riskiness of assets and that leverage ratios (the system *before* Basel) could not achieve this. If a bank has AAA liquid assets, we should care a lot less about leverage. Nonetheless, Chairman Bair and others trumpeted the leverage requirement as the partial savior of the banking system since it in practice required banks to hold more capital than the risk-weighted capital requirements.[51] But this is only an indictment of the Basel's risk-weighted requirements—as before, it makes no sense to judge the adequacy of capital without taking into account the riskiness of assets.

It is impossible to accurately predict how the banking industry will respond to these changes, or how the response will affect the real economy. Indeed, Chairman Bernanke recently admitted that it is too complicated to do an accurate, comprehensive study of the impact of the new capital requirements, Dodd-Frank rules, and other changes.[52]

[51] *See The Interagency Proposal Regarding the Basel Capital Accord: Hearing Before the S.Comm. on Banking, Hous., and Urban Affairs*, 109th Cong. (Sept. 26, 2006) (statement of Sheila C. Blair, Chairman, Fed. Deposit Ins. Corp.).; *see also* Sheila Blair, *Road to Safer Banks Runs Through Basel*, FIN. TIMES, Aug. 23, 2010, http://www.ft.com/intl/cms/s/0/a1dfbd02-aee8-11df-8e45-00144feabdc0.html#axzz1STdI5B8c.

[52] Dealbook, *What Dimon Told Bernake*, NEW YORK TIMES, June 8, 2011, http://dealbook.nytimes.com/2011/06/08/what-dimon-told-bernanke/.

Several organizations have tried to assess the impact of the capital rules. The studies are from groups including the Macroeconomic Assessment Group (MAG), established by the Basel Committee, along with the Financial Stability Board; the Institute of International Finance (IIF); the International Monetary Fund (IMF); the Organization for Economic Co-operation and Development (OECD); and a panel including staff from the Federal Reserve Bank of New York, Bank of Italy, BIS, European Central Bank, European Commission, and IMF.[53] The studies agree on one thing, the direction of the impact on GDP: down. The peak effect of the impact on global GDP of each 1 percentage point increase in bank common equity is expected to have a negative effect of up to 1.1% of global GDP, or up to $748 billion by 2019. IIF estimated the cumulative effects of all of the various provisions in Basel III; they could lead to a decline in U.S. GDP alone of up to $951 billion over the period 2011–2015.

Whether all countries will fully implement the Basel III requirements remains to be seen. Not all countries fully implemented Basel II (including the U.S.), so there is reason to question the commitment of all countries to do so. If they do not, then the decline in output will be larger in some countries than in others. The same is true if countries implement the rules on a different timeline. Further, even if all countries have the same nominal rules, they might enforce them differently. Moreover, some countries may see different effects due to the structure of their economies and importance of banks. For example, the OECD study found that bank lending

[53] MACROECONOMIC ASSESSMENT GROUP, FINAL REPORT: ASSESSING THE MACROECONOMIC IMPACT OF THE TRANSITION TO STRONGER CAPITAL AND LIQUIDITY REQUIREMENTS (Dec. 2010), http://www.bis.org/publ/othp12.pdf; INST. OF INT'L FIN., THE NET CUMULATIVE ECONOMIC IMPACT OF BANKING SECTOR REGULATION: SOME NEW PERSPECTIVES (Oct. 2010), http://www.iif.com/download.php?id=/0eTxourA+A=; SCOTT ROGER & JAN VLCEK, INT'L MONETARY FUND, MACROECONOMIC COSTS OF HIGHER BANK CAPITAL AND LIQUIDITY REQUIREMENTS (May 2011), http://www.imf.org/external/pubs/ft/wp/2011/wp11103.pdf; Patrick Slovik & Boris Cournède, *Macroeconomic Impact of Basel III* (Org. for Econ. Cooperation and Dev., Econ. Dep't Working Paper No. 844, 2011), http://dx.doi.org/10.1787/5kghwnhkkjs8-en; PAOLO ANGELINI ET AL, BANK OF INT'L SETTLMEENTS, BASEL III: LONG-TERM IMPACT ON ECONOMIC PERFORMANCE AND FLUCTUATIONS (Feb. 2011).

spreads in the U.S. are more sensitive to changes in capital ratios than in Japan.[54] Different accounting rules and tax rules can also lead to different outcomes.[55]

D. Systemically Important Financial Institutions

The world's regulators and legislators have come to agree that the largest and most important financial institutions deserve special attention. The failure of any of these SIFIs could seriously damage the economy. The process of designating firms as SIFIs and determining how to regulate them has now begun.

In the U.S., the Dodd-Frank Act subjects banking organizations with total consolidated assets of $50 billion or greater to supervision by the Federal Reserve. In addition, FSOC is charged with designating non-bank financial institutions that should also be supervised by the Fed. The statutory criteria are:

> (A) the extent of the leverage of the company;
>
> (B) the extent and nature of the off-balance-sheet exposures of the company;
>
> (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
>
> (D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;

[54] Slovik & Cournède, *supra* note 53, at 7–8.
[55] *See* Hal S. Scott & Shinsaku Iwahara, *In Search of A Level Playing Field: The Implementation of the Basle Capital Accord in Japan and the United States* (Group of Thirty Occasional Paper 46, 1994).

(E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

(F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;

(G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;

(H) the degree to which the company is already regulated by one or more primary financial regulatory agencies;

(I) the amount and nature of the financial assets of the company;

(J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and

(K) any other risk-related factors that the Council deems appropriate.[56]

FSOC is required to issue rules concerning how it will designate firms,[57] but it has yet to do so, and has even reportedly postponed its own deadline for making a proposal.[58] Similarly, the Federal Reserve has yet to announce how it will supervise these firms. It is difficult to judge who should be systemically important without knowing the full consequences of a designation.

[56] Dodd-Frank Act § 113.
[57] *See* Advance Notice of Proposed Rulemaking, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653 (proposed Oct. 6, 2010); *see also* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4,555 (proposed Jan. 26, 2011).
[58] Deborah Soloman & Victoria McGrane, *Financial Oversight Panel to Delay Guidance,* WALL ST. J., July 14, 2011, http://professional.wsj.com/article/SB10001424052702304223804576444192780997846.html.

This process is also proceeding internationally. Last November the G-20 endorsed a framework designed by the Financial Stability Board (FSB), which proposes additional supervision and regulation of SIFIs, and different resolution procedures.[59] Earlier this week, the FSB and the Basel Committee released a Consultive Document proposing a methodology for designating "global systemically important banks (G-SIBs)."[60] The proposed methodology would evaluate five categories:

1. size,
2. interconnectedness,
3. lack of substitutability,
4. global (cross-jurisdictional) activity, and
5. complexity.[61]

The proposal also includes a "SIFI surcharge" in the form of enhanced capital requirements. Designated firms would be required to hold an additional 1% to 2.5% common equity capital, with the possibility of an additional 1% requirement if a bank's systemic importance increases over time.[62]

Although this is only a proposal, the notion of a SIFI surcharge has been gaining momentum and some want to impose higher surcharges than proposed by Basel. The U.K.

[59] FIN. STABILITY BD., INTENSITY AND EFFECTIVENESS OF SIFI SUPERVISION: RECOMMENDATION FOR ENHANCED SUPERVISION (Nov. 2, 2010), http://www.financialstabilityboard.org/publications/r_101101.pdf.
[60] BASEL COMMITTEE ON BANKING SUPERVISION, GLOBAL SYSTEMICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT 1 (July 2011), http://www.bis.org/publ/bcbs201.pdf.
[61] *Id.* at 5.
[62] *Id.* at 15.

Independent Commission on Banking previously said that 3% is the "minimum credible" SIFI surcharge.[63] Switzerland has proposed that its two largest banks have capital ratios of 19%, more than half of which must be common equity. In a June speech, Fed Governor Daniel Tarullo asserted that the Federal Reserve is contemplating using a methodology that could result in a U.S. SIFI surcharge of up to 7%.[64]

As with capital requirements generally, it is unlikely that SIFI surcharges will be implemented on a uniform basis across countries. If some countries impose higher surcharges than others, then banks in countries with lower SIFI surcharges will have an advantage. Similarly, the approach to designating SIFIs will likely differ across countries, with some countries choosing to designate more firms than others. Indeed, the Dodd-Frank Act considers many things the GHOS criteria do not cover, including leverage, off-balance-sheet exposures, source of credit for low-income and minority communities, and activity mix. Moreover, the GHOS criteria apply only to banks, but the Dodd-Frank criteria apply exclusively to nonbanks. All of these differences will distort competition.

V. Conclusion

The political debate that produced the Dodd-Frank Act was largely shaped by the popular and understandable desire to avoid bailouts of irresponsible financial institutions. The record shows, however, that increased Fed lending and TARP injections were profitable. Shortfalls can always be covered by a tax on financial institutions (as the Obama Administration has proposed)

[63] INDEP. COMM'N ON BANKING, *supra* note 44, at 70–71.
[64] Daniel K. Tarullo, Governor, Fed. Reserve Sys. Bd. of Governors, Speech at the Peter G. Peterson Institute for International Economics: Regulating Systemically Important Financial Firms (June 3, 2011), http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm.

or, in the case of deposit insurance, by an increase in premiums. Thus, taxpayers need not be put at risk by bailouts.

Of course, this does not deal with the issue of moral hazard, the fact that institutions knowing they will be bailed out will take more risk. To some extent, this will be controlled by analysts and the ratings agencies whose negative evaluations will increase the cost of funds for banks. While no bank may be "too big to fail," no creditor can be assured of being made entirely whole in the event of a failure, thus the debt of even the largest banks (and countries) will become more expensive if the market perceives increased risk.[65] While this may not be ideal, since the *full* cost of risk will not be imposed on creditors, it may be as good as we can do. We should do everything in our power to help the market impose penalties on overly risky banks, such as requiring more disclosure and more accurate accounting.

In the end, however, the hard reality is that bubble-induced and other financial crises will unfortunately continue—and regrettably Dodd-Frank makes containing them more difficult. The hope that Dodd-Frank and Basel will avoid future crises is merely that, a hope. When the next crisis quickly leads to severe depression, due to our inability to stop contagion, will we all congratulate ourselves because we did not bailout irresponsible financial institutions? We need a Plan B.

[65] *See* Julapa Jagtiani, George Kaufman, & Catharine Lemieux, *Do Markets Discipline Banks and Bank Holding Companies? Evidence From Debt Pricing* (Emerging Issues Series, Supervision and Regulation, Department Federal Reserve Bank of Chicago, S&R-99-3R, June 2000).