Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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What Should Change and What Will Change*

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Our panel has been asked to discuss what should change in financial regulation and supervision and what will change. I will address what should change and we can discuss what will change during the question and answer period.

For the past three years I have been advising the Bipartisan Policy Center in a review of the Dodd-Frank Act. That project has involved several people who are attending this conference, including Chuck Muckenfuss, Randy Guynn, Richard Neiman, and especially Aaron Klein, who oversaw the project before he joined Brookings.

BPC has concluded that Congress got a lot of things right in the Dodd-Frank Act. Not everything, but more than Congress is given credit for. I share that conclusion, so my proposed changes for financial regulation are more along the lines of refinements to current policies rather than repeal.

The calls for repeal are based upon an assumption that Dodd-Frank has inhibited economic growth. BPC has looked into this issue a bit, and plans to do more. There is not much hard evidence to indicate that Dodd-Frank has been a significant impediment to growth. Small business lending, for example, has been on a decline that predates Dodd-Frank. Surveys by the National Federation for Independent Businesses indicate that it is other regulatory requirements, not financing, that are a problem for small businesses. Where we have seen some impact of Dodd-Frank is in housing finance. The Urban Institute has found that over 5 million consumers have been unable to get mortgage laws based upon a combination of Dodd-Frank rules and litigation risk.

I have grouped my proposed changes into 3 buckets: (1) prudential supervision; (2) rulemaking; and (3) regulatory structure.

Prudential Supervision

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CCAR and Stress Testing — Arguably the most important policy change in response to the crisis was the capital planning and stress testing regime put in place by the Federal Reserve Board after the agency realized that large banks had paid out over $8 billion in dividends during the crisis. This process, however, could benefit from some greater transparency, which could be achieved by subjecting scenarios and other standards to public notice and comment. There also is room for some simplification in stress testing. In the Dodd Frank Act, Congress imposed a statutory stress test regime in addition to the CCAR regime created by the Federal Reserve. Arguably all we need is a single annual company test and a single annual supervisory test, both based upon a severely adverse scenario. Additionally, we should be able achieve some reduction in the documentation related to this process. Last week the Federal Reserve finalized a rule for regional banks that is a step in that direction.

Prudential Standards — Heightened prudential standards for companies based upon the risk they pose to the financial system are appropriate. It is clear, however, that the asset threshold used in the Dodd-Frank Act should be raised. BPC's proposal for a $250 billion threshold that could be rebutted based upon risk seems reasonable.

Living Wills — I was fairly skeptical about the living will process, but have concluded that there is some merit in the process. It is useful for a firm to think through a complete collapse and to have policies and procedures in place to address that. However, the process could be improved. There is no need for annual filings; the Dodd Frank Act requires "periodic" filings and once a firm has an acceptable plan in place that plan should be good for more than a year. Annual filings also have been a burden on the agencies; the regional banks have yet to receive feedback on their 2015 plans. Having two agencies responsible for this process is part of the problem; pick one.

Recovery Planning — In addition to the living wills, the Federal Reserve and the OCC have imposed recovery planning requirements for some firms. There is a lot of overlap in the documentation associated with living wills, recovery planning, and capital planning. Much of this documentation could be consolidated.

Capital — We probably have reached an appropriate level of capital in the system. The debate over leverage versus risk based should come to an end. We should have both. The agencies – or FSOC – should settle on levels that provide security and promote economic growth.

Volcker Rule — Some of the negative effects of the Volcker Rule are starting to be seen on liquidity in corporate debt market. I would replace the Volcker rule and its complexity with capital surcharges on firms that wish to engage in trading activities.

Designation of Non-Banks — The designation of non-banks for supervision by the Federal Reserve Board has not worked well. I would not eliminate FSOC's authority to designate, but would deemphasize its use in favor of expanding FSOC's power to address risky activities and practices that run across an industry.

Lender of Last Resort — The restrictions on the Federal Reserve Board's role as a source of liquidity in a crisis may be one of the more troublesome features of the Dodd Frank Act. I would give the Federal Reserve Board the authority to support individual firms, subject to appropriate collateral, and would agree with the BPC that consideration should be given to extending that authority to securities firms.

BSA/AML — Our BSA/AML system is broken. The system is outdated, costly, produces unintended consequences, and is not out-come based. It should be replaced with some sort of public/private partnership between the industry and governmental authorities that based upon modern technology.

Short-term Funding — Since the crisis, some former regulators have suggested that more attention needs to be paid to the risk associated with short-term funding throughout the financial system. This is an issue that deserves some consideration – and maybe the answer is to extend Marty Lowy's call for stress testing to all types of financial firms.

Loss Reserves — Finally, there is an accounting change on the horizon that deserves some attention. Starting as early as next year for some of the larger banks, the Financial Accounting Standards Board is requiring that loan losses be recognized at origination to cover the life of the loan rather than have losses recognized when they occur. This could have a major impact on some lending activities, and that impact should be assessed.

Regulations

My second category of policies that deserve some changes is rulemaking. The CHOICE Act, if enacted, would make some pretty dramatic changes in rulemaking.

Cost-Benefit — New rules should be subject to some form of cost benefit analysis.

Guidance — Agencies, especially the CFPB, should follow public notice and comment procedures in setting policy rather than issuing informal guidance.

No-Action and Pilot Programs — Given the significant technological changes underway in financial services, it would be useful to have clearer policies on no-action rulings and the authority for firms to engage in pilot programs.

Judicial Deference — Finally, I have reservations with the proposed limitations on judicial deference contained in the CHOICE Act. I do think that the independent agencies have a level of substantive knowledge that deserves some notice by a court. Back in the day, deference was a crucial protection for the OCC's and Federal Reserve Board's ability to expand bank powers in the face of challenges from competitors and state AGs. I also wonder if any attempt by Congress to curtail judicial deference is constitutional.

Regulatory Structure

My final category of what should change is regulatory structure. Again, I agree with much of what BPC has recommended in this space.

Consolidation — I favor the consolidation of financial agencies, but I find it hard to see how that will happen given all of the competing interests at play.

Financial Stability Oversight Council (FSOC) — As long as we have so many regulators, FSOC should remain in place, but as I mentioned, it should be given some broader authority to force agencies to adopt any reforms recommended by the Committee.

Office of Financial Research (OFR) – OFR should be taken out of Treasury and funded by the financial services sector, not just large banks.

Federal Insurance Office (FIO)– FIO should be elevated in stature and given a some oversight role over the National Association of Insurance Commissioners (NAIC). The NAIC does a good job, but given cutbacks in budgets for state insurance offices it is becoming the de facto insurance regulator for the industry. It should be subject to some oversight.

Appropriations — Finally, I agree with BPC that the independent regulators should not be subject to congressional appropriations process. We are still living with Congress's failure to fully fund the agency that supervised Fannie and Freddie.

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