Executive Summary

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When a large part of the financial sector is funded with fragile, short-term debt and is hit by a common shock to its long-term assets, there can be en masse failures of financial firms and disruption of intermediation to households and firms. This occurred in the fall and winter of 2008–2009, following the collapse (or near collapse) of many of the largest financial institutions. Over the next six months, the economy and financial markets worldwide tumbled.

In the aftermath of this disaster, governments and regulators cast about for ways to prevent—or render less likely—its recurrence. The existing regulatory framework was wholly unsuited to deal with *systemic risk*: the widespread failure of financial institutions and freezing up of capital markets that impair financial intermediation. In the United States, this recognition led to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

In an earlier book, ***Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance***, faculty at the NYU Stern School of Business and the NYU School of Law provided a detailed analysis of the strengths and weaknesses of Dodd-Frank.

On the positive side, Dodd-Frank aimed to reduce systemic risk. It called for higher capital and liquidity requirements for banks; the establishment of the Financial Stability Oversight Council (FSOC) to focus regulatory attention on monitoring and containing systemic risk, including designation of new entities called *systemically important financial intermediaries* (SIFIs); the creation of a resolution authority for failing SIFIs; and the formation of the

Consumer Finance Protection Bureau (CFPB), among numerous other regulations.

On one level, Dodd-Frank has been successful. The NYU Stern Volatility Lab produces systemic risk rankings of financial firms and sectors worldwide (see **https://vlab.stern.nyu.edu/en/welcome/risk/**). The evidence clearly points not only to much lower systemic risk in the U.S. financial system today relative to the crisis, but also relative to other regions in the world, especially the large countries (and their financial systems) in Europe and Asia. This improvement in safety has been associated with (rather than prevented) relatively good business performance of U.S. banks compared with others.

On the negative side, for all its good intentions, Dodd-Frank arguably does not fully address either the emergence or full-blown onset of systemic risk, suggesting the need to rethink the legislation. Moreover, Dodd-Frank's approach to regulation is more burdensome than necessary for containing systemic risk. In effect, Dodd-Frank threw the proverbial kitchen sink at the financial system. In trying to address problem areas, Dodd-Frank offers multiple regulations, with accumulating costs matched against the same benefit.

Against this background, and with the change in power in Washington, DC, both Congress and the Administration seek to repeal parts of Dodd-Frank, streamline regulation, and reduce compliance costs. The goal of this White Paper is to comment on these potential changes, and, by doing so, promote regulatory changes that make the financial system *both safer and more efficient*. With this in mind, the authors of the essays that follow assessed the strengths and weaknesses of the most complete alternative proposed to Dodd-Frank—namely, the Financial CHOICE Act—by comparing it section by section to the current regulatory regime of Dodd-Frank.

In brief, while many aspects of the CHOICE Act are consistent with improving efficiency, in our judgment the CHOICE Act would make the financial system notably less safe, because it does not properly address systemic risk. Some of the main highlights are:

- The CHOICE Act's "off-ramp" provision trades off higher capital requirements against an exemption from much of the Dodd-Frank regulation. We applaud the push toward higher capital and away from Dodd-Frank's regulatory burdens. Nevertheless, while this off-ramp should be available for more than 99% of the banks, up to a few dozen large, complex, and highly interconnected intermediaries should still be subject to the key systemic risk regulations of Dodd-Frank. Otherwise, the financial system will be significantly less safe:

    - In conjunction with the heightened leverage ratio (the CHOICE Act's proposal of 10% is at the low end to be considered), there should also be a risk-weighted capital requirement to control excess risk-taking. In addition, banks' off-balance sheet positions need to be incorporated into both capital ratios.

    - The only true systemic risk assessment tool included in Dodd-Frank is the annual stress test that is applied to SIFIs. Since stress tests can reveal what happens to the system when all large banks and other SIFIs are simultaneously under duress, reducing their frequency would make the financial system substantially less safe. Eliminating them could be catastrophic.

    - Whether the "Orderly Liquidation Authority" (OLA) of Dodd-Frank or the CHOICE Act's alternative bankruptcy procedure is employed when a SIFI fails, it is crucial that these SIFIs have supplied credible resolution plans (“Living Wills”) to the regulatory bodies. This way, the failure of the SIFI can be better managed, reducing the likelihood of any bailout and helping to bring back market discipline. Authority for federal funding also would be needed under either alternative (for example, to provide debtor-in-possession finance in a bankruptcy procedure).

- General market conditions will encourage regulatory circumvention, for example, by incentivizing nonbanks to perform *de facto* banking activities, exacerbated further by higher capital requirements on banks. The CHOICE Act eliminates the authority of the FSOC to designate SIFIs, thus worsening the tendency (already evident in Dodd-Frank) to regulate by legal form, rather than by economic function. For example, had the CHOICE Act been in place prior to the last crisis, the very large investment banks such as Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley would not have been subject to enhanced prudential supervision. Given their large-scale financial intermediation activities and very high leverage, it is not clear why these nonbanks should be regulated less rigorously than the large, complex, and interconnected banks. Rather, they (and other systemic nonbanks) should be subject to minimum capital requirements, stress tests, and Living Wills, and should be put through a credible resolution process if failing.

- Dodd-Frank imposes a range of new and complex rules on the regulation of banks and financial products, many of which have little to do with the management of systemic risk. Along with the costs of compliance, these rules tend to reduce competition and restrict innovation. Some of these new rules impact “Main Street” banks by drawing them into the regulation net. The CHOICE Act takes aim at many of these regulations. Some examples are:

- Requiring cost-benefit analyses in financial regulation. We argue that a more effective cost-benefit approach would be a targeted one that requires such analyses only in specific areas that are most likely to be amenable. The goal should be to promote a culture of analysis within the agencies rather than to throw sand in the gears of the regulatory system.

- Repeal of a number of regulations, most notably, the Volcker Rule. We share the view that systemic risk reduction resulting from the Volcker Rule does not warrant the costs that it imposes.

- Restructuring the CFPB to be a more accountable agency, focused on economic efficiency, enforcement and financial literacy, rather than approval and/or banning of financial products. We offer a nuanced assessment of this proposal.

Importantly, this summary reflects just a portion of the findings of the essays that follow. In addition to comparing aspects of the CHOICE Act with the Dodd-Frank regime, a sizable part of the White Paper focuses on key financial areas addressed by neither, including the government-sponsored enterprises (GSEs), the burdensome and ineffective complexity of the U.S. regulatory structure, and nonbanks' *de facto* ("shadow") banking activities.