Introduction

By Thomas F. Cooley

The financial crisis of 2007-2009 and the accompanying contraction in the global economy made it clear that the safety and soundness of the world financial system was seriously impaired and required attention. For the United States, this was a wake up call. The regulatory framework that had functioned well enough since the 1930s had failed.

In response, the United States was the first mover among the world's leading economies in outlining a new regulatory architecture for financial markets. The result was the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act of 2010, the most comprehensive regulatory plan for financial markets since the 1930s. The Dodd-Frank Act was not a fully formed set of rules or even a coherent new regulatory architecture for the United States. Rather it was an attempt to create some common mechanisms for communication and collaboration within the existing regulatory system through a newly created multi-agency organization—the Financial Stability Oversight Council (FSOC)—and a roadmap for rulemaking to address the obvious flaws in the system. It outlined a path for addressing the flaws in the existing regulatory architecture.

The scope of Dodd-Frank is vast, covering everything from consumer financial protection to executive compensation in the financial sector, to the origins of "conflict minerals." It outlined 390 rulemaking requirements, of which roughly 80% have been met. The resulting increase in regulatory complexity, compliance costs for financial institutions and coordination costs for the regulators has, not surprisingly, led to a backlash against the excesses of the Dodd-Frank regulations.

This backlash is manifest most clearly in President Trump's Executive Order of February 3, 2017, outlining "core principles" that

are to guide financial regulation in the United States and directing the Treasury Secretary and the FSOC to report on how current regulations fit those core principles. That order is a shot across the bow for financial regulators. More direct is the draft legislation that has been proposed by the House Committee on Financial Services: The Financial CHOICE Act. This broad-based legislation is seemingly aimed at dismembering much of the regulation that resulted from the Dodd-Frank Act and it offers financial market participants an enticing path to escape the more onerous aspects of Dodd-Frank.

Faculty at the NYU Stern School of Business and the NYU School of Law have collaborated on two previous books about the Dodd-Frank Act, as well as books about housing finance and regulation of the insurance industry, all topics that were ripe for examination in the aftermath of the financial crisis.[2] In this White Paper, we offer a critical assessment of the Financial CHOICE Act, discuss its strengths and weaknesses, and analyze whether it represents a step in the right direction for financial regulation, an improvement in regulatory architecture, and a constructive amendment to Dodd-Frank.

Our early assessments of Dodd-Frank found much to criticize in the legislation, but we viewed it as an important step in the direction of making the financial system less risky. It was important because it correctly identified the overarching threat to financial stability and the root cause of the 2008 crisis as the accumulation of systemic risk—risk of collapse because of the interconnected financial risks—in the financial system.

An objective of Dodd-Frank was to identify sources of systemic risk, identify systemically risky institutions, establish ways of monitoring

[2] Acharya et al., eds., *Regulating Wall Street:* The Dodd Frank Act and the New Architecture of Global Finance, Wiley, 2011. Acharya et al, *Dodd-Frank One Year On,* VoxEu 2012. Acharya et al., *Guaranteed to Fail,* Princeton University Press, 2011, Biggs, John and M. Richardson, eds., *Modernizing Insurance Regulation,* Wiley 2014.

systemic risk in the financial system, limit excessive risk-taking by financial institutions, and provide a roadmap for resolving insolvent institutions. To achieve these goals, Dodd-Frank created the FSOC to monitor systemic risk and identify "systemically important financial institutions" (SIFIs). The legislation required annual stress tests to monitor the adequacy of bank capital in volatile markets. It increased capital requirements (with additional requirements imposed on SIFIs) and required them to conduct regular stress tests to assess the robustness of bank capital in a crisis. It tried to limit the accumulation of systemic risk via the Volcker Rule. It required firms to file resolution plans (Living Wills) and outlined an Orderly Liquidation Authority (OLA) to provide a roadmap and a mechanism for unwinding insolvent firms with minimal disruption to the system.

But the shortcomings of Dodd-Frank were many, and they are at the root of the current backlash. The strengths and weaknesses as we viewed them at the time are discussed in detail in our earlier books.

With nearly seven years of additional perspective, the weaknesses are clearer. Dodd-Frank missed a golden opportunity to simplify and rationalize the very balkanized U.S. regulatory architecture, where responsibility is spread across many institutions, some with overlapping authority. Dodd-Frank did not sufficiently address the issue of the capital adequacy of financial institutions. Its proposals for the orderly liquidation of insolvent institutions were questionable. The proposed Volcker Rule was complicated and difficult to implement, and it became clear that proprietary trading and investing activities were not at the root of the financial crisis. Dodd-Frank did not address the problems of the Government-Sponsored Enterprises (GSEs) or housing finance. It did not address the problem of pricing government guarantees (deposit insurance, lender of last resort access, too-big-to-fail guarantees). It limited the lender of last resort (LOLR) authority of the Fed, constraining its ability to respond in a crisis. The result of the regulatory reform

process that Dodd-Frank initiated, to date, has been a vastly more complicated regulatory structure that many doubt is adequate to forestall the next crisis and that some blame for the demise of many small community banks (institutions that are not viewed as part of the systemic problem) and a decline in bank lending.

Given these concerns, the time was ripe for a challenge, and the CHOICE Act does exactly that. In the following essays, we offer an assessment of the components of the CHOICE Act and consider whether they will lead to a safer, more functional financial system.

The essays find constructive elements in the CHOICE Act, and in places we agree with its conclusions and policy recommendations. We also agree with the need to streamline and prune the overly complex regulations that have emerged in the wake of Dodd-Frank.[3] However, the most glaring shortcoming of the CHOICE Act is that it does not recognize the central role of systemic risk. In the end, the CHOICE Act would exacerbate the too-big-to-fail problem by eliminating both the designation of SIFIs and financial market utilities (FMUs), and by prohibiting temporary government lending for resolving failed SIFIs.

Among the Act's false premises are that: (1) SIFIs exist solely because of the implicit government guarantees associated with designating them; and (2) eliminating SIFI designation means that the government will not bail out the creditors of a systemic intermediary in a crisis even if that would induce another economic collapse. Other parts of the Act are overreaching. For example, it would not only restrict the power of the Fed to respond to crises, but also would undercut its ability to conduct monetary policy independently in response to the needs of the economy. It would not only reform the structure and financing of the Consumer Financial Protection Bureau (CFPB) but also would undercut its core

[3] Nowhere is this more evident than in the set of rules deemed necessary to implement the Volcker Rule.

mission to encourage educated consumers, promote transparency of financial products and handle consumer complaints.

Of at least equal concern are the issues that the CHOICE Act does not touch: housing finance, *de facto* (shadow) banking, the complex structure of U.S. regulators, and cross-border regulatory issues.

In the end, one has to evaluate the CHOICE Act by asking whether the future of the financial system would be safer and more stable under it or with Dodd-Frank—even in its current form. We think the CHOICE Act would increase the riskiness of our financial system.

Bank Capital

The CHOICE Act begins with a premise that we endorse: Financial institutions that are well capitalized relative to their risk exposure pose less risk to the financial system and make the possibility of a systemic crisis much smaller. It is widely agreed that the financial system was undercapitalized prior to 2008. But Dodd-Frank did not directly address the idea of ensuring financial stability directly through capital requirements, or at least it did not do it very well. The CHOICE Act offers a very enticing prospect: Financial institutions that are "well managed and well capitalized—those with a simple leverage ratio of greater than 10%" would be offered an "off-ramp" from the Dodd-Frank regulations.

The CHOICE Act offers an extensive argument in favor of a simple leverage ratio as a measure of capital adequacy and a critique of the Basel risk-based capital approach. We generally support these arguments. The Act also offers a defense of the estimate of 10% as an adequate "safe" level. The essays in this White Paper address this issue in detail. The relevant empirical and quantitative evidence suggest that 10% is at the very low end of what might be an adequate level of capital to forestall a crisis. An indicator of how far

off it may be is the "Minneapolis Plan."[4] This alternative proposal for ending Too-Big-To-Fail—based largely on higher capital cushions—envisions leverage ratios more than twice the CHOICE Act's 10%.

There is also an issue with how the CHOICE Act measures the leverage ratio. It uses Generally Accepted Accounting Principles (GAAP). Under GAAP, the average leverage ratio of the U.S. globally systemically important banks (G-SIBs) already is 8.24%. But, under International Financial Reporting Standards (IFRS), which do not net out derivative positions but use gross derivatives positions, their average leverage ratio is 5.75%. For systemic risk, the latter measurement system is more appropriate, because netting of offsetting derivatives positions may not be feasible in a crisis.

There is a deeper problem than just having the level of capital wrong. The CHOICE Act does not address the critical issue of what happens to the value of that capital when the economy and capital markets are in distress. It simply fails to recognize the nature and importance of systemic risk.

The CHOICE Act argues that the regulatory burdens and the costs of compliance with Dodd-Frank fall most heavily on small community banks that provide much of the funding for small business in the United States. This argument is misplaced. Small banks are exempt from stress tests, systemic capital surcharges, Living Wills and other aspects of Dodd-Frank that apply to the few large, systemically important banks. But the fixed costs of basic regulatory compliance do pose a higher *proportional* burden on small banks relative to their size. The CHOICE Act argues that the regulatory burden on small banks has led a decline in the number of banks, in funding for small firms and a rise in the cost of credit for small business. These assertions require some scrutiny, but the notion that the increased

[4] https://www.minneapolisfed.org/publications/special-studies/endingtbtf/the-minneapolis-plan-to-end-too-big-to-fail

cost of compliance is a burden for small banks is not in dispute. So, the idea of an off-ramp for small banks is appealing.[5]

What about big banks? The CHOICE Act thinks the same logic applies to big banks. It does a good job of disputing the notion that higher capital requirements will lead to less lending. It also takes on the arguments that “equity is expensive.” However, because the Act misunderstands the nature of systemic risk, it understates the necessity for large banks to have sufficient capital to withstand systemic problems, and it ignores the role that stress tests can play in identifying those systemic problems.

Systemic Risk

The CHOICE Act is plagued by a problem that beleaguered the Dodd-Frank drafters: It confuses legal form and economic function and, in the process, shows a lack of understanding of the sources of the crisis. One of the more strident sections of the Act would repeal the authority of the FSOC to designate financial institutions as SIFIs and payments, clearing, and settlements companies as FMUs. It would also abolish the research arm of the Treasury (Office of Financial Research, OFR) that supports the FSOC’s work. The framers of the CHOICE Act view the FSOC’s authority as regulatory overreach that uses arbitrary and capricious standards and that enshrines the firms designated as too-big-to-fail.

However, it is not the designation that makes firms risky; it is their activities. As a result, it is critical to monitor that risk. A key part of that monitoring is to know exactly the nature of a firm’s capital and liabilities and to understand how a firm’s capital and liquidity will

[5] The suggestion that Dodd-Frank is responsible for a decline in the number of banks or the decline in lending is open to debate. See Cecchetti and Schoenholtz: http://www.moneyandbanking.com/commentary/2016/12/12/dodd-frank-the-choice-act-and-small-banks

perform in a crisis. That is what systemic risk monitoring is all about, and that is the role of the FSOC and SIFI designation.[6]

The CHOICE Act is completely misguided in wanting to eliminate the oversight of systemic risk and the use of stress tests to understand how capital holds up in a crisis. The Act legitimately decries the "form" of the FSOC. But, that is a legacy of the complex regulatory system that we still have. The inelegant form does not undercut the importance of the function of the FSOC, or its OFR research arm, which is to monitor system risk and the institutions, practices and mechanisms that make the financial system vulnerable.

Stress tests are the critical means to ensure that the capital requirements are enforced and not circumvented (say, through off-balance sheet or derivatives exposure). They allow better insight into the banks' own risk models and management to see where the system as a whole may be vulnerable. They are the only mechanism for examining the well-being of a systemic intermediary when the financial system as a whole may be in distress. Offering an off-ramp from stress tests would seriously undermine the effectiveness of capital regulation for the most systemic intermediaries.

The CHOICE Act also attacks the FSOC for concerning itself with the migration of risk to the "shadow banking system"—what we refer to as *de facto banking activities*—activities that involve transformations of liquidity, maturity, and credit that "take place without direct and explicit access to public sources of liquidity or credit backstops." Instead, the Act's drafters should applaud this focus. Perhaps the view is that, since shadow banking is often the result of regulatory arbitrage, in a "regulation lite" world, it will not be a problem. Dodd-Frank did not concern itself enough with the shadow banking system—again focusing on form rather than

[6] It is also why we at Stern have pioneered the development of systemic risk measures.

function—even though much of the financial crisis first showed up in the shadow banking system.

Dodd-Frank also sought to limit the possibilities for the buildup of systemic risks by incorporating the Volcker Rule. The rule prohibits bank holding companies or their subsidiaries from engaging in proprietary trading and sponsoring hedge funds or private equity funds. The rule was intended to limit the accumulation of difficult-to-assess risk on banks' books through these activities.

The Volcker Rule, although simply stated at the outset, turned into many pages of regulations and, in the end, seems wholly impractical. Compliance is a nightmare for many institutions. There is also little evidence that proprietary trading or banks' relationships with hedge funds played a significant role in the financial crisis. There is also some evidence that liquidity provision has fallen and that the Volcker Rule could be one of the reasons.

For these reasons, this is a case where we agree with the conclusion of the CHOICE Act that the Volcker Rule should be scrapped.

Resolution

The key goal of Dodd-Frank was to end the notion of too-big-to-fail—to save future regulators from facing the terrible choice of bailing out insolvent institutions or letting them collapse in a disorderly way with lots of collateral damage, as with Lehman Brothers. The Dodd-Frank solution was to require banks to provide Living Wills specifying exactly how they will be restructured in the event of failure and to create an OLA within the FDIC for insolvent firms. The Dodd-Frank architects envisioned the OLA as a way of replacing taxpayer-funded bailouts by laying out a procedure for the FDIC, an institution with a long history of resolving and restructuring insolvent institutions, to restructure large systemic institutions.

Many have expressed doubts about whether the OLA framework is the right conceptual framework for resolving systemically important firms. The CHOICE Act cites our previous critique[7] of the plan. Conceptual gaps and distorted incentives in the design of Dodd-Frank's OLA raise concerns that—in the next financial crisis, as in the last—regulatory discretion and forbearance might take hold as the preferred route of crisis resolution.

The CHOICE Act argues that insolvent institutions should be addressed instead using the Federal Bankruptcy Code. This is a position that has been the subject of lively debate in the academic and legal literature. Of course, this would require a new Chapter of the Bankruptcy Code to address the unique problems of large systemic financial institutions. Advocates of the bankruptcy approach argue that: it is administered through the judicial system and is less subject to regulatory discretion; it provides more certainty about how creditors will be treated in bankruptcy; and it does not require taxpayer funds to reorganize or liquidate a failed institution. These are all valid points. However, some of these may seem like a distinction without a difference, as the OLA was always intended to adhere as closely as possible to the Bankruptcy Code. It is also the case that in bankruptcy, someone has to provide debtor-in-possession financing, and this is not spelled out by the CHOICE Act. Further, bankruptcy can be a slow, grinding process, which can create extended value-destroying uncertainty for the liability holders who may have claims on a beleaguered financial institution that total in the hundreds of billions of dollars.[8]

The alternative route to resolving insolvent institutions—not addressed by the CHOICE Act—is to build rule-based recapitalization directly into the capital structure, as well as imposing upfront capital requirements that are tied to systemic risk. This alternative uses bail-in-able debt that can be converted to

[7] Acharya et al., *Regulating Wall Street*.
[8] This was all-too-well illustrated in the case of the Lehman bankruptcy.

equity if a firm becomes insolvent. Bail-in-able debt has been enthusiastically embraced in Europe in the form of contingent-convertible (Co-Co) bonds and total loss absorbing capacity (TLAC) debt. There are many issues raised by this approach as well, including triggers for conversion, accounting standards for the assessment of equity, and valuations in a distressed environment. The first line of defense against insolvency is always higher equity. But the appeal of automatic recapitalization is that it relies less on external funding and administrative discretion.

Whether any of these different approaches to resolution can effectively deal with a systemic crisis or not will be known only the next time we do have a crisis.

The Federal Reserve

Many observers were concerned about the role of the Federal Reserve in the financial crisis. The Fed made liberal use of its authority under section 13(3) of Federal Reserve Act to lend to "any individual, partnership or corporation" under unusual and exigent circumstances.

Critics of some of the choices made by the Fed at the time of the crisis argued that the Fed had overreached and, by extending its lender of last resort facility to so many actors, had increased moral hazard. Dodd-Frank responded by limiting the ability of the Fed to use its 13(3) authority, for example by prohibiting loans to individual nonbanks outside of a pre-approved program of broad access. In our earlier books, we expressed concern that this limited the ability of the Fed to respond in a crisis.

The CHOICE Act seeks to limit the Fed's role even further by restricting how the Fed conducts its monetary policy, how it functions as the LOLR, and how it exercises its regulatory responsibilities.

The Act's calls to constrain monetary policy ignore a large and persuasive body of evidence that supports the importance of independent central banks and monetary policy. This is discussed in detail in these essays. Aside from that blind spot, the CHOICE Act's limitations on LOLR lending and attacks on the Fed's stress testing and other regulatory functions again displays a failure to understand the critical role of systemic risk.

The Federal Reserve played a critical role in the financial crisis and its aftermath. If anything, the experience of the past decade underscores how important it is to have an independent and agile central bank. In the aftermath of the crisis, we have a better understanding of the extent of systemic risk and the important role it plays in financial stability.

The difficult choice for Fed policy is how it deploys its LOLR facility in a crisis. The CHOICE Act deploys a lot of rhetoric about how the Fed should adhere to Bagehot's dictums to lend only to solvent borrowers, on good collateral, at penalty rates. Clearly the Fed should be open to all systemic institutions and lend only to those that are solvent. To lend knowingly to insolvent institutions would vastly increase the moral hazard in the financial system. It would also undermine the LOLR role—which requires lending broadly to solvent, but illiquid firms—because any firm that "went to the window" would have a potential stigma. Lending to an insolvent firm also would subordinate private creditors in the ultimate bankruptcy process.

But deciding who is solvent or insolvent in a crisis is extremely difficult. That was the great quandary surrounding Lehman Brothers in September of 2008. And that is exactly why the institutions that Dodd-Frank put in place to assess systemic risk—institutions that the CHOICE Act would dismantle—are so important.

Consumer Financial Protection

The Consumer Financial Protection Bureau (CFPB) has been controversial since its inception. The framers of Dodd-Frank did not do the CFPB a service by giving it the unique structure that the agency has within the regulatory bureaucracy. The CFPB is governed by a single director, appointed by the President and confirmed by Congress, who serves a five-year term. Once appointed, the director cannot be removed except for cause. The CFPB is funded directly from the Federal Reserve. The CFPB need only submit a budget to the Fed certifying what it needs to finance operations. This structure is unorthodox to say the least. Funding any government agency directly from the profits of the Fed is a bad idea because it undermines the independence of the Fed and it can hinder appropriate oversight by elected officials. Most of the other regulatory agencies are funded from fees related to their regulatory functions (e.g., examination fees) and/or Congressional appropriations.

The original remit of the CFPB was to help consumers understand and use relevant information about financial products. It aimed to shield them from abuse, deception, and fraud by ensuring that disclosures for financial products are accurate and easy to understand. The CFPB has adopted a broad interpretation of that mandate.

The CHOICE Act proposes to overhaul the structure and financing of the CFPB to bring it more in line with other regulatory institutions. It also would restrict the authority of the CFPB to limit consumers' access to products that it deemed "abusive" and would require that product safety regulations be justified by a cost-benefit analysis. It is encouraging that the CHOICE Act does not recommend abolishing the CFPB. That is implicit recognition that there are "product safety" issues with financial products and thus the need for education, standards and transparency. At the same time, the CHOICE Act seems determined to limit the flow and public

dissemination of information from consumers about their issues with financial products.

Some Gaping Holes in the Financial CHOICE Act

The CHOICE Act is notable for the issues it did not touch. Like Dodd-Frank, it does not address the problems of the GSEs—Fannie Mae and Freddie Mac—that remain at the heart of the U.S. mortgage market. The GSEs are not a regulatory priority because they remain in conservatorship, are currently profitable and have limited their downside risk. Any attempt to reform them and limit the government's exposure from guarantees would raise the cost of mortgage finance—something that is politically unpalatable. Nevertheless, reform of housing finance is both feasible and desirable.

Another important gap is the neglect of the "shadow banking" sector. Neither Dodd-Frank nor the CHOICE Act addresses the systemic risks arising from *de facto banking activities* per se. But this sector was hugely important in the crisis. The growth of the "shadow banking" system permitted financial institutions to engage in maturity transformation with too little transparency, capital, or oversight. Large, short-term funded, substantially interconnected financial firms came to dominate key credit markets. Huge amounts of risk moved outside the more regulated parts of the banking system to where it was easier to increase leverage. Legal loopholes allowed large parts of the financial industry to operate without oversight or transparency. Entities that perform the same market functions as banks escaped meaningful regulation solely because of their corporate form.

Yet by focusing on measuring and monitoring systemic risk, by designating systemically risky institutions, and by insisting on stress tests, Dodd-Frank at least has a foot in the door of addressing the problems that can arise from these *de facto* banks. And the FSOC has been actively engaged in the debate over how to regulate them.

The CHOICE Act has nothing to say about this important sector of the financial system.

Conclusion

Dodd-Frank was not the perfect remedy for all of the problems of the U.S. financial sector that came together to form the "perfect storm" of the financial crisis of 2007-2009. Many faculty authors at Stern have previously criticized the shortcomings of the Dodd-Frank, and in this White Paper we again criticize many of these shortcomings with the advantage of a few more years of experience. But, to its credit, the Dodd-Frank did recognize the importance and pernicious nature of systemic risk in the U.S. financial system and created prudential regulatory institutions and procedures to address and reduce that risk. Again, those institutions and procedures are far from perfect and could surely be made better. But, on balance, Dodd-Frank represented a positive step in lessening the risk in our financial system.

The Financial CHOICE Act espouses some principles that we heartily endorse. Chief among them is that the more well-capitalized institutions are, the less threat they pose to financial stability. And we endorse removing many inefficient parts of the Dodd-Frank. But at the end of the day, the CHOICE Act is fatally flawed by a failure to recognize systemic risk and to understand the dangers that it poses for the financial system and thus for the healthy functioning of the U.S. economy. Because of this failure, the CHOICE Act represents a potential step backward in the establishment of a prudential regulatory system that would ensure a safer and better functioning financial sector for the U.S. economy.

Because the Financial CHOICE Act is still at the stage of proposed legislation, there is adequate time and opportunity for its drafters to reach a better understanding of these issues. We hope that the chapters in this White Paper will help in this process.