

Home Stretch for Financial Regulation? Almost – Not Quite! The Dodd-Frank Wall Street Reform and Consumer Protection Act

The move to write a new financial regulatory bill formally began with the 88 page comprehensive Treasury Department proposal introduced by President Obama in a news conference on June 17, 2009. Since that time, with the help of costly lobbying efforts by a multitude of interested parties, fiery partisan political debate and the normal Washington demagoguery, the end product is being painfully squeezed out of the other end of the “sausage machine.” The 2,300+ page bill, which has passed a House vote but still has to pass in the Senate, is still fluid at this time, but seems to be mostly, if not completely finalized.

In its description of the processes instituted by the bill, the Treasury Department lists ten things that Financial Reform should accomplish:

- ◆ End “Too-Big-To-Fail”
- ◆ Close Loopholes in Regulation of Major Financial Firms
- ◆ Bring Transparency to Hedge Funds
- ◆ Constrain the Size of the Largest Firms
- ◆ Reform Executive Pay and Strengthen Shareholder Protections
- ◆ Separate Banking and Speculative Trading (The Volker Rule)
- ◆ Strongest Consumer Protections Ever
- ◆ Crack Down on the Abuses in the Mortgage Markets at the Center of the Crisis
- ◆ Safer, More Transparent Derivatives Market to Help Main Street Businesses
- ◆ Support Long Term Job Growth by Helping Prevent Future Crises

The rhetoric describing each of these aspects is many pages long and includes new agencies, studies and oversight committees. Senator Chris Dodd (D.-Conn.) stated “This is about as important as it gets, because it deals with every single aspect of our lives.”

The operating details of the bill’s legislative-speak and the associated costs will become clearer as ensuing regulations are written by the various controlling agencies. The bill does accomplish some of its goals as it attempts to control abuse in the system, but also is an aggressive extension of regulatory reach, bureaucratic rulemaking and Governmental control. Lobbying by some focused groups, especially the larger banks, has muted the possible beneficial effects in some areas. Growing bi-partisan opposition is making a last ditch effort before the bill is passed by the Senate, and the list is growing of “fixes” that will need to be addressed soon after passage. Following are some of the concerns voiced by a number of prominent financial publications and experts regarding the bill:

- ◆ On June 25th the New York Times Business Day section reported that the new bill was “awash in so much minutiae that its impact on the financial services industry was still unclear.” It went on to say that when it is signed into law, “the financial industry will still be dominated by a handful of institutions that are too large, too interconnected and too politically powerful to be allowed to go bankrupt if they make unwise decisions or make huge wrong-way bets.” It also pointed out that Fannie Mae and Freddie Mac are back to growing their balance sheets, and not part of the reform bill. The Treasury Secretary stated afterwards that the Fannie and Freddie resolution was too complex to be a part of this bill but will be addressed separately at a later time.

- ◆ In an opinion piece on June 24th, Arthur Levitt, the former chairman of the Securities and Exchange Commission, wrote that “The bill, already weakened by deal-making as it emerged from the Senate, has been bled dry of nearly every meaningful protection of investors.” Levitt goes on to focus on investor safeguards by saying that the bill will allow more public companies to avoid doing internal audits and expands the number of smaller companies exempt from Sarbanes-Oxley audit requirements. The bill also failed to revoke the 1975 law that prevents municipal bond issuers from being subject to the same kind of regulation and scrutiny required of corporate bond issuers. In addition, proxy access was tightened, favoring larger groups such as labor unions. The bill also leaves the SEC and the Commodity Futures Trading Commission as two separately regulated entities, with confusing differences in operating rules and on-going turf battles.
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 - ∨ The Wall Street Journal on June 26th stated that in the final bill, the biggest banks “appeared to have dodged some of the harshest provisions of the Senate version....adopted in May.” The “Volker Rule,” which would have prohibited banks investing their own capital in riskier assets, was neutered to the degree that banks can now invest 3% of their assets in risky hedge or private equity funds and continue to manage them as they generate hefty fees. The banks are allowed seven years to phase out excess risky holdings that are liquid, and even longer for more illiquid investments. Provisions of the Volker Rule barring proprietary trading in derivatives ended up not requiring banks to provide more collateral for “less risky” interest rate and foreign exchange based derivatives. Derivative trading in “riskier” commodities, stocks and credit default swaps on non-investment grade debt will have to be moved to separate subsidiaries, along with newly regulated levels of collateral that will be raised in most cases from the bank’s balance sheet. The good news to banks was that the new bill’s definition of “risky derivatives” only affects 10%-20% of the banks’ derivatives, and they again have a several year grace period to spin off or sell the subsidiary. The big banks echoed that this was “better than expected.”
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 - ∨ As more of the bill is understood, unintended consequences are beginning to rise to the surface. One is the requirement that all corporations purchasing and holding commodity derivatives will have to collateralize them, even if they are used to reduce business and pricing risk. This means that companies who use commodity derivatives in the normal course of business - i.e. agricultural, energy, manufacturing companies, etc. – will now have to set aside liquid assets as collateral instead of using them to grow or finance their business. The International Swaps and Derivative Association estimates this will require close to one trillion dollars of liquid assets be escrowed by American corporations, lowering returns and making them less competitive internationally.

This legislation will hopefully begin to address some of the loopholes and regulatory shortfalls that led to the recent financial crisis. The Wall Street Journal says the bill will redraw how money flows through our system, and touch every company and person who has a bank account or credit card. A consumer protection agency in the Federal Reserve will monitor financial products and a new council of regulators will monitor broader systemic risk. Derivatives will be pushed to trade on exchanges and be scrutinized by regulators. Much of this could be positive, helping to rebuild confidence in the system and ensure integrity. As some of the aforementioned omissions are addressed and “fixes” enacted, the system could be even stronger. However, the creeping bureaucracy has to guard against the negative feedback loop of over-regulation. In the midst of this evolution, the financial sector will again gradually begin to modify its operations and offer new products to seek greater profitability outside of the slow-moving regulatory net. Historically, that is the cycle our system has typically experienced over and over again. Will this time be different?