



THE DODD-FRANK ACT AND REGULATORY OVERREACH

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Chairman Duffy, Ranking Member Green, and members of the Subcommittee: thank you for the opportunity to appear before you today.

The financial crisis of 2007 to 2009 shook this country deeply. It upended the lives of Americans, many of whom found themselves without jobs and homes. As the crisis unfolded, the desire to do *something* in response was thick in the air in Washington, DC. The general sentiment in favor of action was *not* matched with specifics about what the problems were and how they could best be solved. People were angry and scared and understandably wanted to do what was necessary to prevent a similar crisis from happening again. The hastily crafted response—the Dodd-Frank Wall Street Reform and Consumer Protection Act¹—does not make another crisis less likely. To the contrary, it sets the stage for another, worse crisis in the future.

Government regulation—from bank regulation to housing policy to credit rating agency regulation—played a key role in the crisis.² These policies shaped market participants' behavior in destructive ways. Dodd-Frank continues that pattern.

I will focus on three principal problems of Dodd-Frank:

- First, Dodd-Frank—built on the premise that markets fail, but regulators do not—places great faith in regulators to identify and stop problems before they develop into a crisis. Regulators have an important

1. Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

2. See, e.g., Emily McClintock Ekins & Mark A. Calabria, *Regulation, Market Structure, and the Role of Credit Rating Agencies* (Cato Policy Analysis, Aug. 1, 2012), available at <http://object.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf>; Arnold Kling, *Not What They Had in Mind* (Mercatus Ctr. at George Mason Univ. Working Paper, Sept. 2009), available at [http://mercatus.org/sites/default/files/NotWhatTheyHadInMind\(1\).pdf](http://mercatus.org/sites/default/files/NotWhatTheyHadInMind(1).pdf); Stephen Matteo Miller, *Why Are CDOs and Structured Notes Making a Comeback?*, U.S. NEWS & WORLD REPORT, June 23, 2014, available at http://mercatus.org/expert_commentary/why-are-cdos-and-structured-notes-making-comeback; Russell Roberts, *Gambling with Other People's Money: How Perverted Incentives Caused the Financial Crisis* (Mercatus Ctr. at George Mason Univ. Working Paper, Apr. 28, 2010), available at <http://mercatus.org/publication/gambling-other-peoples-money>; PETER J. WALLISON, HIDDEN IN PLAIN SIGHT: WHAT REALLY CAUSED THE WORLD'S WORST FINANCIAL CRISIS AND WHY IT COULD HAPPEN AGAIN (2015) (discusses of the role of government regulation in other areas).

role to play in establishing and maintaining the financial markets' regulatory parameters, but centralizing financial market decision-making in regulatory agencies risks sparking an even deeper future crisis.

- Second, Dodd-Frank, despite language to the contrary, keeps the door open for future bailouts.³
- Third, Dodd-Frank includes many provisions that are not related to financial stability, but fails to deal with key problems made evident by the crisis.

The flaws of Dodd-Frank are not surprising; the drafters were working quickly under difficult circumstances without full information. Rather than relying on its own investigative powers, Congress delegated much of the legwork for determining what had gone wrong to the Financial Crisis Inquiry Commission.⁴ That commission produced its report six months after Dodd-Frank became law.⁵ Commission member Peter Wallison points out in his dissent to that report that “the Commission’s investigation was limited to validating the standard narrative about the financial crisis—that it was caused by deregulation or lack of regulation, weak risk management, predatory lending, unregulated derivatives and greed on Wall Street.”⁶ That popular but inaccurate narrative⁷ undergirds Dodd-Frank and continues to misinform debates about whether Dodd-Frank is working.

DODD-FRANK’S DANGEROUS RELIANCE ON REGULATORS

Partly as a matter of expedience, Dodd-Frank’s drafters chose to leave many key decisions to regulators. The contours of systemic risk, for example, were left to regulators to define. Moreover, because the prevailing narrative of the crisis focused on market failure, Dodd-Frank expanded regulators’ authority to shape the financial system. In addition to their substantial rule-writing responsibilities, under Dodd-Frank regulators now play a central role in monitoring, planning, and managing the financial markets. Relying on regulators in this way is unlikely to prevent another financial crisis and, in fact, threatens to destabilize the financial system.

Dodd-Frank responded to concerns that regulators were not properly coordinating with one another before the crisis with the formation of the Financial Stability Oversight Council (FSOC). Along with the Office of Financial Research (OFR), FSOC reflects an expectation that regulators, working together and armed with adequate information, will be able to spot and respond to “emerging threats to the stability of the United States financial system.”⁸ OFR and FSOC can play a helpful role in regulatory coordination,⁹ standardizing government information collections, and keeping regulators informed of developing trends in the financial markets. No matter how well run, however, OFR and FSOC will never be as effective at collecting, analyzing, and reacting to information

3. These concerns are laid out in more detail in *DODD-FRANK: WHAT IT DOES AND WHY IT’S FLAWED* (Hester Peirce and James Broughel eds., 2012), available at <http://mercatus.org/sites/default/files/publication/dodd-frank-FINAL.pdf>.

4. Fraud Enforcement and Recovery Act, Pub. L. No. 111-21, § 5, 123 Stat. 1617, 1625–31 (May 20, 2009).

5. FINANCIAL CRISIS INQUIRY COMMISSION, *THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES* (Jan. 2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

6. *Id.* at 452 (Peter J. Wallison, Dissenting Statement).

7. For a graphic illustration of the growth—not decline—of regulation leading up to the financial crisis, see Patrick McLaughlin & Robert Greene, *Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank* (Mercatus Ctr. at George Mason Univ., July 19, 2013), available at <http://mercatus.org/publication/did-deregulation-cause-financial-crisis-examining-common-justification-dodd-frank>. See also Mark A. Calabria, *Did Deregulation Cause the Financial Crisis?*, 31 *CATO POLICY REPORT* 1 (July/Aug 2009), available at www.cato.org/pubs/policy_report/v31n4/cpr31n4-1.pdf.

8. Dodd-Frank § 112(a)(1)(C).

9. Even with regard to regulatory coordination, there are potential pitfalls. Dodd-Frank’s drafters did not adequately consider the implications for the independence of financial regulators of allowing FSOC effectively to force the hand of independent regulators through the issuance of recommendations that demand an agency response. Dodd-Frank § 120. For an example of how this has worked in practice, see Hester Peirce & Robert Greene, *Money Market Maneuvering* (Mercatus Ctr. at George Mason Univ. Expert Commentary, Sept. 19, 2012), available at http://mercatus.org/expert_commentary/money-market-maneuvering.

as competitive markets.¹⁰ Instead, if the existence of these super-regulators provides false confidence, FSOC and OFR could be detrimental to financial stability.

Dodd-Frank gives FSOC broad powers to designate nonbank financial institutions and financial market utilities (such as derivatives clearinghouses) systemically important.¹¹ These systemically important entities are subject to special regulatory oversight. Upon designation, the Board of Governors of the Federal Reserve System steps in to supervise the designated nonbank financial institutions alongside their existing regulators.¹² The Federal Reserve Board also plays a primary or backup role in regulating designated financial market utilities.¹³

Dodd-Frank thus empowers FSOC to create a two-tier system—systemically important entities are subject to an additional layer of regulation, but they are also likely to enjoy funding and competitive advantages. It is too early to tell whether the additional regulatory costs will outweigh the benefits to designated firms. Designated firms are likely to be perceived as the firms the government is likely to rescue, should that be necessary.

In addition to its new responsibility for systemically important nonbanks, Dodd-Frank otherwise expands the role of the Federal Reserve Board. It has supervisory authority over, among others, a large array of bank holding companies, savings and loan holding companies, and insurance companies.¹⁴ FSOC is looking closely at the asset management industry, so the Board’s supervisory mandate could expand further.

A consequence of the Federal Reserve Board’s broad authority over a wide range of institutions is homogenization across the financial industry. Although the Board likely will make some adjustments to accommodate industry differences, similar liquidity, capital, and risk management requirements could lead firms to hold similar assets. This homogenization could increase the likelihood that a problem at one firm would spread to other firms. Stress testing and resolution plans may further enforce a system-wide uniformity, which could prove harmful, particularly in a time of market stress.

Dodd-Frank stress testing and resolution planning, while useful mechanisms to help firms identify and plan for potential difficulties, can also be a dangerous distraction. Regulated firms may divert resources from their own risk management efforts to respond to regulatory stress tests, revise resolution plans, and comply with other regulatory demands. Firms can tailor their risk management programs to their unique circumstances and risks, while regulators are likely to employ more standardized approaches that are comparable across multiple firms. Firm-specific information is likely to be missed.

Firms’ ability to act to safeguard themselves is further constrained by regulators’ post-Dodd-Frank embrace of macroprudential regulation. Under this approach, regulators think holistically about the financial system;¹⁵ they

10. Friedrich A. Hayek’s explanation in his Nobel Prize lecture makes the point:

We are only beginning to understand on how subtle a communication system the functioning of an advanced industrial society is based—a communications system which we call the market and which turns out to be a more efficient mechanism for digesting dispersed information than any that man has deliberately designed.

Friedrich A. Hayek, *Nobel Prize Lecture: The Pretence of Knowledge* (Dec. 11, 1974), available at http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html.

11. In addition to designated financial market utilities, the “SIFIs” designated to date are American International Group, GE Capital, Prudential, and MetLife. FSOC, Designations, <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx#nonbank> (last visited May 6, 2015).

12. Dodd-Frank §§ 113 and 115.

13. Dodd-Frank § 805.

14. See, e.g., Bipartisan Policy Center, *How the Federal Reserve Became the De Facto Insurance Regulator* (July 30, 2014), available at <http://bipartisanpolicy.org/blog/how-federal-reserve-became-de-facto-federal-insurance-regulator/>; Hester Peirce & Robert Greene, *The Federal Reserve’s Expanding Regulatory Authority Initiated by Dodd-Frank* (Nov. 13, 2013), available at <http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank>.

15. See, e.g., Andrew Crockett, General Manager, Bank for International Settlements, Chairman, Financial Stability Forum, *Marrying the Micro- and Macro-prudential Dimensions of Financial Stability, Remarks Before the Eleventh International Conference of Banking Supervisors* (Sept. 21, 2000) (transcript available at <http://www.bis.org/speeches/sp000921.htm>). Crockett explains, “To bring out

may override a firm's decision, for example, to protect itself from exposure to a counterparty, if they believe that the counterparty should be protected. Thus, firms are hamstrung in their efforts to protect themselves. This macroprudential approach places too much confidence in the regulators to always get things right, and it inhibits market mechanisms from responding organically to problems as they arise. The last crisis taught us that regulators do not always get things right, and markets absorbed in regulatory compliance are very poor at disciplining themselves. The result is a less stable financial system.

DODD-FRANK'S OPEN DOOR TO BAILOUTS

Dodd-Frank was supposed to mark the end of taxpayer bailouts of financial firms. This pledge is undermined in several ways by the statute's other provisions and the regulatory-centric approach that cuts across the whole statute.

First, the intensive, post-Dodd-Frank role that regulators are playing in managing financial stability means that when there is a problem, firms will feel justified in asking the regulators that caused—or at least did not prevent—those problems to bail them out. The pressure on regulators to conduct bailouts is likely to be particularly strong with respect to systemically important institutions. By announcing that these institutions are important to the financial system, the government implies that it will step in to prevent them from failing.

Second, Title II of Dodd-Frank establishes the Orderly Liquidation Authority (OLA) as an alternative to bankruptcy for financial institutions. Regulators have broad discretion to choose this alternative to wind down troubled financial companies. Once regulators have decided that a company will be resolved under the OLA, the company or its creditors have little power to prevent the use of this alternative, and the Federal Deposit Insurance Corporation (FDIC) has broad authority to manage this alternative resolution process. Depending on how the FDIC exercises its authority, the OLA could be used to bail out favored creditors of the company.¹⁶

Another key pillar of Dodd-Frank that raises the possibility of a future bailout is Title VII, which imposes a detailed regulatory framework on the over-the-counter derivatives markets. The new regime forces many derivatives into central counterparties (also known as clearinghouses). As a result, large financial firms will no longer be exposed to one another through these derivatives transactions, but to the clearinghouse. The hope is that these clearinghouses will be consistently strong counterparties, even during a period of financial stress. Dodd-Frank makes the already difficult task of managing clearinghouses more difficult by increasing the number and type of products they must clear and constraining the steps they can take to manage their risk. Failing clearinghouses would be likely candidates for bailouts because of their central role in the financial system and ties to large financial firms. Dodd-Frank allows for the possibility of a bailout by authorizing the Board of Governors to give systemically important clearinghouses access to the discount window and deposit account and payment services.¹⁷

The Board of Governors also retains its emergency lending authority under section 13(3) of the Federal Reserve Act, which it used to bail out American International Group. Dodd-Frank pared back this authority by requiring any lending to be through a broad-based program rather than an institution-specific program.¹⁸ This limitation will not serve as a much of a constraint on emergency lending unless it is also paired with other limitations, such as tighter solvency requirements.¹⁹

the contrast, think of the financial system as a portfolio of securities, i.e., the individual institutions. The macro-prudential perspective would focus on the overall performance of the portfolio; the micro-prudential vision would give equal and separate weight to the performance of each of its constituent securities.”

16. Dodd-Frank § 214 prohibits taxpayer losses under the OLA, but the opacity of the process will make this difficult to enforce.

17. Dodd-Frank § 806. For a discussion of the implications of this authority, see Norbert J. Michel, *Financial Market Utilities: One More Dangerous Concept in Dodd-Frank* (Heritage Found. Backgrounder, Mar. 20, 2015), available at <http://www.heritage.org/research/reports/2015/03/financial-market-utilities-one-more-dangerous-concept-in-doddfrank>.

18. Dodd-Frank § 1101.

19. The Board of Governors has proposed, but not adopted, a rule, as required by Dodd-Frank, to “prohibit borrowing from programs and facilities by borrowers that are insolvent.” Dodd-Frank § 1101(a) [amending 12 U.S.C. § 343(3)(B)(ii)]. Commenters are concerned

DODD-FRANK'S MISPLACED FOCUS

As further evidence that Dodd-Frank does not effectively shore up financial stability, it covers the wrong topics. On the one hand, Dodd-Frank fails to deal with issues central to the last crisis. On the other hand, many Dodd-Frank provisions have nothing to do with addressing the past crisis or averting a future financial crisis.

An issue central to the crisis—the government's role in housing finance—is almost entirely absent from Dodd-Frank. Fannie Mae and Freddie Mac remain intact in conservatorship. Dodd-Frank deferred the issue by directing the Secretary of the Treasury to conduct a study of reforming the housing finance system.²⁰ Congress missed an opportunity to address the government's role in housing finance, and the government continues to crowd out the private market in this space.²¹

Items unrelated to the crisis got more pages in Dodd-Frank than housing finance, even though the consequences of some of these provisions were not fully evaluated. An egregious example is the conflict minerals provision, which requires the Securities and Exchange Commission (SEC) to draft rules governing disclosure by public companies of their use of minerals such as coltan, cassiterite, gold, and wolframite.²² A similar example is a provision requiring public companies that engage in resource extraction to disclose payments made to further commercial development.²³ Both provisions are costly to public companies (and, by extension, their shareholders) and have consumed considerable SEC resources.²⁴ Neither relates to the stability of the financial system.

Another provision unrelated to financial stability authorizes the SEC to introduce a fiduciary duty for broker-dealers.²⁵ The debate over the proper standard of conduct for broker-dealers working with retail customers, particularly as it compares to the standard for investment advisers, predates the financial crisis.²⁶ The controversial issue warrants careful congressional consideration because its resolution will affect many retail investors. The issue did not get adequate attention since it was only a small part of the much larger Dodd-Frank deliberations and was not a contributor to the crisis.

CONCLUSION

As the failures and bailouts of the financial crisis accumulated, so too did the calls for a quick and thorough rewriting of the financial regulatory rulebook. The resulting Act was the product of fear and fury, not of careful analysis. Grounded in an inaccurate market failure narrative, Dodd-Frank expands regulators' authority to enable them to play a more central role in managing the financial system and identifying and mitigating systemic risks. This approach to financial regulation, while a natural response to a market failure narrative, only increases the vulnerability of financial system to regulatory failure.

that the Board's proposed approach is too lax. See, e.g., Marcus Stanley & Mark Calabria, *Fed Proposal to End Bailouts Falls Short*, THE HILL, CONGRESS BLOG, July 24, 2014, *available at* <http://thehill.com/blogs/congress-blog/economy-budget/213175-fed-proposal-to-end-bailouts-falls-short>.

20. Dodd-Frank § 1074. That report came out in February 2011. DEPARTMENT OF THE TREASURY AND DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, *REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS* (Feb. 2011).

21. At the end of 2014, the Congressional Budget Office reported that, through Fannie Mae, Freddie Mac, and the Federal Housing Administration, "the federal government now directly or indirectly insures over 70 percent of all new residential mortgages." CONGRESSIONAL BUDGET OFFICE, *TRANSITIONING TO ALTERNATIVE STRUCTURES FOR HOUSING FINANCE*, at 2 (Dec. 2014), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/49765-Housing_Finance_0.pdf.

22. Dodd-Frank § 1502 [15 U.S.C. § 78 m].

23. Dodd-Frank § 1504 [15 U.S.C. § 78 m].

24. See, e.g., Daniel M. Gallagher, Commissioner, SEC, *The Importance of the SEC's Rulemaking Agenda—You Are What You Prioritize*, Remarks at the 47th Annual Securities Regulation Seminar of the Los Angeles County Bar Association (Oct. 24, 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370543283858>.

25. Dodd-Frank § 913 [15 U.S.C. § 78 o note].

26. For example, the SEC commissioned a study in 2006 of how investment advisers and broker-dealers interact with their customers. See Angela A. Hung et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (RAND Inst. for Civil Justice Report 2008), *available at* https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

Regulatory failure played an important role in the last crisis by concentrating resources in the housing sector, encouraging reliance on credit-rating agencies, and driving financial institutions to concentrate their holdings in mortgage-backed securities. Dodd-Frank gives regulators more authority and broad discretion to shape the financial sector and the firms operating within it. When the regulators fail at this ambitious mission, they will again face internal and external pressure to cover those failures with a taxpayer-funded bailout.