Assessment of Dodd-Frank Financial Regulatory Reform: Strengths, Challenges, and Opportunities for a Stronger Regulatory System

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This Essay examines the key strengths and limitations of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the U.S. financial reform legislation written in the aftermath of the 2008 financial crisis under considerable political pressure. The legislation’s strengths include an emphasis on stress testing, the creation of the Office of Financial Research, and a focus on the regulation of the largest nonbank financial institutions. The Act, however, does have several weaknesses. The legislation neither solves the regulatory arbitrage problem, nor simplifies supervision, by increasing—not decreasing—the number of regulators. It does not go nearly far enough in terms of regulatory requirements for nonbanks. The legislation is overly complex and uneven, resulting in weak to nonexistent supervision of certain activities and excessive regulation of others. Also problematic is that the legislation neither advances the quality of supervision and educational opportunities for supervisors, nor provides sufficient governance when the application of regulation becomes arbitrary. This Essay offers reforms to help repair the Act’s shortcomings, including strengthening the business and audit lines of defense, creating more formal academic supervisory education programs for supervisors, and instituting more effective ombudsman programs within regulatory agencies.

Introduction ...................................................................................................................................................... 182
I. Strengths of Dodd-Frank .................................................................................................................................. 184
   A. Office of Financial Research ....................................................................................................................... 184

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Introduction

The recent financial crisis wreaked havoc on the economies of developed countries. In the United States, $17 trillion of household wealth was lost. From 2008 to 2009, the U.S. economy shed 8.3 million jobs,1 roughly equivalent to the entire population of New York City.2 In an effort to stem the crisis, the federal government created a $700 billion relief package, the Troubled Assets Relief Program (TARP),3 and then provided an additional $787 billion in economic stimulus through the American Recovery and Reinvestment Act.4

Europe continues to experience serious losses as the crisis continues. In May 2011, the International Monetary Fund and the European Union agreed to bail out Portugal with a $116 billion assistance package.5 Portugal’s deal

followed a $146 billion package for Greece in May 2010, $110 billion for Ireland in November 2010, and $4.6 billion for Iceland in 2008. While the United Kingdom has not requested assistance from its peers, during the height of the financial crisis, U.K. taxpayers made estimated gross commitments of approximately $1.4 trillion to British banks.

With these kinds of losses and severe financial-industry disruptions, it is not surprising that political leaders felt compelled to enact far-reaching regulatory change. On January 7, 2009, merely four days into the 111th Congress and before President Obama was sworn into office, a New York Times editorial called for drastic change in the regulation of the financial services industry, stating that “[a]nything less than a new rules-based regime would be inadequate to the task of restoring confidence and, eventually, reviving the economy.” Even earlier, at the height of the crisis in 2008, U.S. congressional hearings also elicited calls for change.

It was in this environment—one of political urgency and economic anxiety—that Congress and President Obama enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Crises and the pressure of political expediency, however, rarely result in carefully considered legislation. Accordingly, while Dodd-Frank provides some beneficial reforms to the financial system, the legislation is uneven and does not sufficiently address longstanding financial-services regulatory challenges.

This Essay will examine Dodd-Frank’s key strengths and limitations and offer suggestions for additional regulatory and supervisory reforms that could

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10. The net figures will not be known for several years but are expected to be a very small fraction of the gross, similar to TARP.


14. Indeed, the legislation was passed six months before the congressionally-mandated Financial Crisis Inquiry Report, an examination into the domestic and global causes of the crisis, was published. The Financial Crisis Inquiry Commission (FCIC) Report was published in January 2011. See FIN. CRISIS INQUIRY COMM’N, supra note 1.
further improve post-crisis financial stability. Specifically, Part II details the following strengths of Dodd-Frank: the creation of the Office of Financial Research (OFR), the regulation of nonbank, systemically important financial institutions, and Dodd-Frank’s emphasis on stress testing. Part III critiques the legislation’s limitations, including: regulatory arbitrage and supervisory weakness; the exclusion of shadow banks from regulatory oversight reforms; excessive and uneven regulation; and weakness in systemic regulation. Part IV offers three additional avenues for reform that could make a positive difference: strengthening the first and third lines of defense; creating more formalized, academic supervisory education programs; and instituting ombudsman programs in regulatory agencies. Part V concludes.

I. Strengths of Dodd-Frank

The strengths of Dodd-Frank lie primarily in three areas: the creation of the OFR, the regulation of nonbank, systemically important financial institutions, and the legislation’s emphasis on stress testing.

A. Office of Financial Research

Conceptually, the single greatest advancement of Dodd-Frank is the creation of the OFR. The establishment of the OFR brings together—for the first time—a strong group of economists outside of the Federal Reserve for the primary purpose of studying, modeling, and warning, against systemic events. Previously, no governmental or private entity has had the primary mission of identifying systemic events that could damage the U.S. economy. Arguably, the Federal Reserve, with its army of talented economists, implicitly has this responsibility; it certainly has the ability to do it. Irrespective of the Federal Reserve’s responsibilities in this area, however, having a team outside the traditional bureaucracy focus on these important problems will add considerable value. Indeed, even if the OFR duplicates what the Federal Reserve can and should accomplish, creating some healthy competition with the Federal Reserve to identify hazards in the sea lanes should make a positive difference for the creation of sound U.S. policy.

16. See, e.g., Sewell Chan, Agreement Is Near on New Overseer of Banking Risks, N.Y. Times, Feb. 17, 2010, http://www.nytimes.com/2010/02/18/business/18regulate.html (“‘There will be an entity in charge of systemic risk—which no one now has the responsibility to do—and the consequence of identifying systemic risk will be immediate remedial action to put that institution out of its misery,’ [Representative Barney] Frank said.” (emphasis added)).
It is important to note, however, that while the creation of the OFR on the whole is a positive development, there are additional ways to improve its design. Ideally, the OFR should be an independent agency, not an office in the U.S. Department of the Treasury ("Treasury"). Dodd-Frank’s placement of the OFR within Treasury creates the possibility that the OFR’s mission will be compromised due to Treasury’s inescapably political nature. The Treasury Secretary represents the President’s interests in the financial arena, and is not an independent actor. Accordingly, one could question whether, in a presidential election year, the OFR will be able to express its views freely as to the dangers ahead, particularly if those dangers may have been caused by a President’s policies. Therefore, while it should be stressed that the OFR represents an improvement over the status quo, policymakers should realize that its placement within the Treasury could limit its overall effectiveness.

B. Regulation of Nonbank Systemically Important Financial Institutions

Section 113 of Dodd-Frank brings nonbank, systemically important financial institutions into the bank supervisory framework—a development of potentially enormous significance. Historically, most nonbank financial companies have operated within a much lighter regulatory environment. For example, many of the mortgage lenders at the heart of the financial crisis were unregulated or underregulated, state-licensed entities. These entities, in part because they are underregulated, need not adhere to the strict underwriting standards bank regulators would require, and can slip through the patchwork of state banking regulations that might otherwise constrain them. Such practices, along with lower costs due to a lack of regulation, make mortgage brokers very competitive and tend to lead the marketplace in a more aggressive direction, undercutting consumer wellbeing and safe operation. Moreover, very large nonbank financial enterprises could cause a systemic event, as was the case with American International Group (AIG). Therefore, the ability of government now to place at least the largest of these nonbank financial entities within a bank regulatory envelope should help to stabilize the financial system.

Specifically, section 113 of Dodd-Frank grants the Financial Stability Oversight Council (FSOC)—another creation of the legislation, discussed in Section II.E—the authority to designate large nonbank financial institutions as "systemically important" and bring them into the systemic supervisory

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framework of the Federal Reserve. Bringing these large and systemically important firms into this supervisory framework will enable them to be regulated for safety and soundness purposes, thereby helping to prevent them from landing at the center of a future financial crisis.

Section 113 is, overall, a positive step forward for strengthening the regulatory system post-crisis. It is important to note, however, that it is not a complete remedy; challenges remain regarding the supervision of nonbank financial institutions. First, smaller nonbank financial entities will continue to be able to exist in an unregulated or underregulated environment, creating a potential systemic trigger, as was the case with the unregulated mortgage brokers that drove the overall market toward laxity and instability.

Second, while the FSOC has broad latitude to determine which financial enterprises qualify as systemic, it appears that the FSOC may exclude many sizable nonbank financial companies from the systemic supervisory net (although Dodd-Frank does allow the FSOC to regulate some smaller entities in part by designating an "activity" as systemic). The FSOC is likely to be conservative in using its authority for three reasons. First, as discussed later in this Essay, the FSOC is a creature of Treasury, which is an extension of the President, who is a political actor. Designating an institution as systemically important could have undesirable political consequences. Second, it is oftentimes easier not to act than to gain consensus of a body, such as the FSOC, that has a variety of constituencies, each with its own agenda. Third, federal regulators and state supervisors may lose considerable regulatory power over financial institutions that the FSOC deems to be systemically important, as such institutions are then placed under enhanced Federal Reserve supervision.

C. Emphasis on Stress Testing

Dodd-Frank requires the Federal Reserve Board to conduct annual stress tests of bank holding companies with more than $50 billion in assets. Banks must also conduct their own stress tests. Specifically, banks with assets greater than $10 billion must conduct annual stress tests, and those with more than $50 billion must conduct semi-annual stress tests. This emphasis on stress testing is a critical step forward. Prior to the crisis, surprisingly few financial institutions put themselves through stress testing exercises. In the depths of the crisis, however, regulators conducted stress tests on the largest U.S. banks with what seems to have been great success both for the health of the institutions and the marketplace.

20. Dodd-Frank Act § 165, 124 Stat. at 1423 (codified at 12 U.S.C. § 5365). Note that there is a redundancy in the stress testing; one should keep in mind, however, that in conducting its stress tests, the Federal Reserve has an eye toward macroprudential responsibilities, whereas the bank largely focuses on microprudential issues.

21. A U.S. Government Accountability Office's September 2010 report found that "[t]he SCAP process appeared to have been mostly successful in promoting coordination, transparency, and
Assessment of Dodd-Frank

Specifically, from February to April 2009, federal bank regulatory agencies conducted the Supervisory Capital Assessment Program (SCAP) on the nineteen domestic bank holding companies with assets over $100 billion. The SCAP estimated losses, revenues, and reserve needs for the nineteen companies in 2009 and 2010 under two macroeconomic scenarios—baseline and more adverse—with the goal of ensuring that each bank would be well-capitalized under both scenarios. Upon releasing the results of the SCAP, Federal Reserve Chairman Ben Bernanke used the opportunity as a way to calm markets, stating:

The results released today should provide considerable comfort to investors and the public. The examiners found that nearly all the banks that were evaluated have enough Tier 1 capital to absorb the higher losses envisioned under the hypothetical adverse scenario. Roughly half the firms, though, need to enhance their capital structure to put greater emphasis on common equity, which provides institutions the best protection during periods of stress. Many of the institutions have already taken actions to bolster their capital buffers and are well-positioned to raise capital from private sources over the next six months.

The direct impact of the SCAP on the markets is difficult to discern. The results were released at the same time as a relatively positive employment report and a disappointing U.S. government bond auction. However, a CNN report on May 8, 2009, the day after the release of the SCAP results, simply stated, "[s]tocks rallied as investors breathed a sigh of relief that the results weren’t worse."

The key lesson from the SCAP on the importance of stress testing is that markets gave credence to the results of the tests. This point is evident from coverage of financial markets on May 6, 2009, just prior to the release of the results. For example, as reported in the Financial Times:

U.S. stocks slipped yesterday as investors worried about the government’s stress tests on banks took profits following a stellar previous session that took the benchmark S&P 500 index into positive territory for the year. Speculation about the results of the tests on banks’ balance capital adequacy. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-861, BANK STRESS TEST OFFERS LESSONS AS REGULATORS TAKE FURTHER ACTIONS TO STRENGTHEN SUPERVISORY OVERSIGHT (2010), available at http://www.gao.gov/new.items/d10861.pdf.


Critically, Treasury and the Federal Reserve also made clear that Treasury was prepared to fill the void pending the results of the tests. As Chairman Bernanke stated, "Our government, through the Treasury Department, stands ready to provide whatever additional capital may be necessary to ensure that our banking system is able to navigate a challenging economic downturn."28

Accordingly, the SCAP strongly suggests that stress tests, if done properly, are able to build important market confidence and stability. In a speech reflecting on the SCAP one year after its conclusion, Chairman Bernanke pointed to several factors as evidence of its success: the majority of the nineteen firms that needed capital following the stress tests were able to raise the capital in the market (as opposed to receiving assistance from Treasury); most of the nineteen firms had repaid TARP money that they had received during the crisis; share prices of the nineteen firms had generally increased; and banks’ access to debt markets and interbank and short-term funding markets had improved.29 Chairman Bernanke also noted that the average ratio of Tier 1 common capital to risk-weighted assets rose from 6.7 percent to 8.5 percent.30

It is important to note that stress testing per se is not a panacea. Indeed, poorly performed stress tests may lead to a false sense of complacency or undercut market confidence. The way stress tests are conducted is critical.31 For example, it appears that the European stress tests have not been effective or helpful supervisory tools. In fact, one commentator has even gone so far as to call them "farcical,"32 as the Irish banking system collapsed just four months after the country’s banks passed their stress tests.33 Additionally, a requirement for frequent, periodic stress testing runs the risk that the tests will become rote over time and, accordingly, less useful. It is critical that both regulators and financial institutions take each and every stress test seriously. As the world

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27. Kiran Stacey, Stress Test Concerns Motivate Investors To Take Their Profits, FIN. TIMES (May 6, 2009), http://www.ft.com/cms/s/0/9af8a5f8-39d7-11de-b82d-00144feabad0.html.
29. Id.
30. Id.
31. The Federal Reserve System has listed four principles key to effective stress testing. These principles include: 1) A banking organization’s stress testing framework should include activities and exercises that are tailored to and sufficiently capture the banking organization’s exposures, activities, and risks; 2) An effective stress testing framework employs multiple conceptually sound stress testing activities and approaches; 3) An effective stress testing framework is forward-looking and flexible; and 4) Stress test results should be clear, actionable, well supported, and inform decision-making. See Proposed Guidance on Stress Testing for Banking Organizations with More than $10 Billion in Total Consolidated Assets, 76 Fed. Reg. 35,072, 35,074 (June 15, 2011).
33. Id.
continues to become more interconnected and volatile, the risk rises that unforeseen events that could have major impacts on the financial system.

II. Limitations of Dodd-Frank

As discussed above, Dodd-Frank makes several important contributions to financial stability; however, it also has some significant limitations. Some of these limitations were evident at conception, and others will emerge over time. The most critical limitations include: provisions that continue to allow for regulatory arbitrage and supervisory weakness; exclusions of shadow banks from regulatory oversight; a tendency towards excessive regulation; excessive and uneven regulation of trading activities; and limitations regarding systemic oversight.

A. Regulatory Arbitrage and Supervisory Weakness

Regulatory arbitrage, the ability of a financial institution to select and/or change its charter to avoid tough regulation and supervision, was part of the witches’ brew from which the financial crisis emerged. Regulatory arbitrage undercuts sound regulation and supervision.

Regulatory arbitrage may lead to a race-to-the-bottom among regulators seeking to expand the scope of their oversight. As financial institutions flock to the least stringent enforcer of regulations generally, the institutions themselves may begin to exhibit greater volatility, thus leading to a higher failure rate. Indeed, countries that tended to do better in the crisis have unified prudential supervisory systems. In jurisdictions where a professionalized prudential supervisor existed, such as Canada, Australia, and Japan, institutions caught in the crisis fared better. The bank failure rate provides startling evidence to support this assertion. In comparison to the multitude of bank failures across the United States during the financial crisis—25 in 2008,34 140 in 2009,35 and 157 in 201036—no banks of significant size failed during this time period in Canada,37 Australia,38 or Japan.39

Dodd-Frank, however, does not sufficiently address this type of regulatory arbitrage and weak supervision. While the legislation eliminates the OTS, thus reducing the number of U.S. bank regulators from four to three, possibilities for regulatory arbitrage still remain. These opportunities are particularly available to smaller institutions, which can avoid regulation by not including a bank in their financial organization.

To rectify these challenges, financial reformers should explore best practices from the largely successful regulatory models in Canada, Australia, and Japan, as discussed above. Supervisory systems in these countries are almost entirely focused on prudential issues related to financial services companies; they do not engage in securities or consumer issues, or in the case of Australia, even compliance issues. Also important, supervisory entities in these countries do not compete with one another. For all of these reasons, especially the efficacy of a unified prudential regulator, the United States has much to learn to improve its own regulatory system.

B. Exclusion of Shadow Banks from Regulatory Oversight Reforms

While several institutions in the “shadow banking system” landed at the center of the financial crisis, Dodd-Frank excludes the shadow banking system from some of its key provisions and from bank-like regulation and supervision. The shadow banking system includes investment banks, mortgage brokers, hedge funds, and other financial institutions that operate freely in capital markets beyond the reach of traditional regulatory mechanisms. While bank deposit-taking and lending are important to the U.S. economy, prior to the financial crisis, the shadow banking system provided even more funding. Excluding shadow banking institutions from tough regulation and supervision poses several challenges.

First, the exclusion creates entire classes of institutions that can fail and create a systemic or near-systemic crisis, like thrift institutions in the late 1980s. Second, institutions subject to lower regulatory burdens will have a considerable competitive advantage vis-à-vis banks in the short run. This advantage will inevitably drive traditionally-regulated institutions to engage in

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39. Shigeru Sato & Shingo Kawamoto, Incubator Bank Failure Triggers Deposit Insurance Cap, BUSINESSWEEK (Sept. 10, 2010), http://www.businessweek.com/news/2010-09-10/incubator-bank-failure-triggers-deposit-insurance-cap.html. The failure of Japan’s Incubator Bank was the first failure to trigger the Japanese government’s insurance cap in forty years. Analysts point to this failure as being separate from the “bubble collapse” and due to the bank’s breach of Japanese banking rules.


41. FIN. CRISIS INQUIRY COMM’N, supra note 1, at 32.

riskier activities to earn greater rates of return on capital. Third, banks engaging in financial activities with shadow banking organizations may face more counterparty risk than when dealing with covered institutions.

Ultimately, history has shown that if a large shadow institution gets into serious trouble, regulators will feel pressure to resolve the matter at the expense of the regulated sector, the government, or both, as exemplified by the bailout of Long Term Capital Management (LTCM) in 1998. Prior to its receiving assistance, LTCM had “amassed more than $1 trillion in notional amount of OTC derivatives and $125 billion of securities on $4.8 billion of capital without the knowledge of its major derivatives counterparties or federal regulators.”

In the Federal Reserve’s belief, a failure of LTCM would have had a “systemic” impact. Accordingly, when the hedge fund faced near collapse, the Federal Reserve coordinated LTCM’s $3.6 billion recapitalization by fourteen major over-the-counter derivatives dealers. AIG is another example of this phenomenon. AIG, which operated, in large part, in the shadow banking system, received one of the largest bailouts—over $47 billion—from Treasury during the financial crisis. As reforms move forward, policymakers should keep a close eye on the shadow banking system and move towards the proper regulation of this sector.

C. Excessive Regulation

Many would argue that the lax regulatory environment of recent decades was one of the primary drivers of the financial crisis. During this period, key economic policymakers believed that the free market was the best—if not the only—useful regulator. As a result of inadequate regulation arising from misplaced faith in the power of free markets, the leverage ratios of some broker-dealers in the shadow banking sector rose to levels as high as 40:1. As Senate Banking Chairman Christopher Dodd stated to Chairman Bernanke during his 2009 confirmation hearing:

I admire what you’ve done over the last two years. But we shouldn’t have had to go through what we did for the last two years had there been cops on the street, doing their jobs, telling us what was going on and allowing us to avoid the problems in the first place.

43. Fin. Crisis Inquiry Comm’n, supra note 1, at 48.
44. Id.
45. Id. at 47-48.
47. Fin. Crisis Inquiry Comm’n, supra note 1, at 65.
Dodd-Frank, however, severely overcompensates for lax regulation. Too many of the legislation’s components are largely unnecessary, and its sheer magnitude could actually challenge safety and soundness by focusing an excessive amount of management attention on less critical issues.

Had regulators exercised their authority robustly prior to the financial crisis, many of the challenges Dodd-Frank addresses could have been avoided. For example, bank regulators had expansive powers under their general and comprehensive safety and soundness authority to limit poor banking practices. The Federal Reserve, under the Home Owner’s Equity Protection Act, could have done more to control the home mortgage crisis. Likewise, the Office of Federal Housing Enterprise Oversight, the regulator charged with overseeing Fannie Mae and Freddie Mac, could have more closely monitored the GSEs with the proper resources from Congress. In addition, the SEC and the Federal Reserve could have controlled excess leverage and liquidity with their authority to impose additional capital requirements on institutions for the purposes of promoting safety and soundness.

In short, there is a very real danger that the regulatory explosion coming out of Dodd-Frank will so distract the regulated entities and regulators that they will not have the time or focus to address real safety and soundness matters. Moreover, the weight of this regulatory barrage threatens to depress the earnings potential of financial services companies, creating the risk they will be unable to deal with inevitable financial downturns.

D. Excessive and Uneven Regulation of Trading

Two components of Dodd-Frank require particularly expensive and complicated changes concerning bank trading activities, which only tangentially contributed to the crisis. Section 619 of Dodd-Frank, the “Volcker Rule,” amends the Bank Holding Company Act of 1956 to prohibit any “banking entity” from engaging in proprietary trading and from sponsoring or investing in a hedge or private equity fund. It also requires systemically important nonbank financial companies to carry additional capital and comply with other quantitative limits on such activities. Section 716, the “Lincoln Amendment,” requires that certain derivatives activities be conducted outside the bank and instead in an affiliate of the bank.

50. FIN. CRISIS INQUIRY COMM’N, supra note 1, at 40.
52. Id. § 619(a), 124 Stat. at 1376-77 (codified at 12 U.S.C. § 1851).
It is not clear that these activities are inherently unsafe. Furthermore, they have added to bank profitability. The degree to which the Volcker Rule and the Lincoln Amendment prove to be troublesome will depend upon how they are ultimately regulated. Dodd-Frank gives the regulators considerable latitude to narrow or expand the prescriptive nature of these amendments. However, even relatively narrow regulations that effectuate these provisions will most likely undercut the health of the affected institutions.

This is not to say that all trading activity is safe, just like all lending is not safe. Some activities are new, some are less well-controlled than is desirable, and some are not entirely fair to counterparties. It should, therefore, be the decision of the supervisor to draw careful rules to differentiate between safe and unsafe practices. Regulators should be encouraged to promulgate proper requirements to make sure banks act in a prudent manner. Both the Volcker Rule and the Lincoln Amendment risk making banks less safe and sound by using wide-ranging prohibitions and convoluted “solutions” where the supervisor’s targeted interventions are more appropriate.

The Volcker Rule and the Lincoln Amendment suggest a misunderstanding of the importance of trading activities in modern finance in several ways. First, both of these Dodd-Frank components make an underlying assumption that the “banking book” (also known as the “accrual book”), which is essentially a bank’s loans, is safe and stable. This, however, is not always the case. The stability of the banking book, the heart of a banking organization, depends upon underwriting standards and the state of the economy. Whether the loans held within the banking book are safer or riskier than trading activities remains to be seen. Most importantly, today there are considerable pressures on banks to mark the banking book to market. Regardless of requirements for the bank to mark these books to market, the marketplace increasingly reviews a bank’s accrual statements and tends to value the banking organization based on perceptions of mark-to-market valuations with respect to the accrual book. Accordingly, the banking book can serve as the leading cause of volatility for banks and thrifts, as the market makes its own judgment about the quality of the predominately whole loan assets that comprise their banking books, with concerns about low quality banking books feeding liquidity and solvency concerns that are reflected through increased volatility in institutions’ stock prices and funding costs.


56. But see Franklin Allen & Elena Carletti, Mark-to-Market Accounting and Liquidity Pricing, 45 J. ACCT. & ECON. 358, 377 (2008) (showing that mark-to-market accounting can lead to “distortions and contagion... in illiquid markets in times of crisis”, and so should be a disfavored form of valuation during such times).
Second, banks overcome the inherent volatility in their banking books through their trading activities, particularly today through their derivatives activities conducted in their treasury operations. By making these activities more complicated if not impossible to conduct, restrictions on trading activities mandated by Dodd-Frank actually undercut the safety and soundness of banking operations. In addition, proprietary trading activities can add to a bank's understanding of the marketplace. These activities help to ensure that banks can attract top talent and help it innovate by creating trading activities for risk management purposes.

Third and specifically regarding the Volcker Rule, while removing proprietary trading activities from banking entities might be a good idea in theory, in practice, these restrictions pose considerable challenges to the financial system. While bank deposit taking and lending activity is important to the U.S. economy, in today's marketplace, financial institutions' business customers must utilize capital markets to meet their financial needs. For example, through trading, banks make financial products available to customers, provide liquidity to the financial system, and mitigate their own risk exposures. By restricting trading activities, the Volcker Rule risks inhibiting U.S. competitiveness in global financial markets and banks' ability to innovate and stay relevant. No longer do customers use banks simply for making deposits and taking loans; today, customers use banks for currency hedging, management of interest-rate risk, the elimination of an unwanted credit risk, or fixing the price of a commodity, among other services. These activities necessitate trading and market-making activities. Accordingly, banks have developed an array of financial products and services to meet customer demand.

Finally, to use these complex financial products, a bank must manage its own risk exposures. Banks are able to manage such exposures by trading in anticipation of customer flow, such as through the purchase of commodities or currencies. In some cases, banks can even hold inventory in anticipation of customer demands. While one may argue that banks could hedge exposure at the time the trade is initiated by the customer, it is often impractical in terms of risk management to hedge a customer's exposure in the spot market due to market illiquidity or a competitor's trading against a bank's open position. Regulations, such as the Volcker Rule and the Lincoln Amendment, limit the number of tools to which banks have access to manage their internal risk, and may correspondingly make the banks' performance more volatile.

In its 2011 study of the Volcker Rule, the FSOC asserted that it is challenging to differentiate clearly between market-making and proprietary trading, stating that market-making trades "often evidence outwardly similar characteristics to proprietary trading, even as they pursue different
Assessment of Dodd-Frank

objectives. Therefore, regulators must be extremely careful in interpreting the Volcker Rule so as to not cause huge obstacles to the financial intermediation system.

E. Weakness in Systemic Regulation

While not perfect, coordination among federal agencies during the financial crisis was respectable. The President’s Working Group on Financial Markets, created by Executive Order 12631 following the 1987 stock market crash, worked well. Dodd-Frank correctly recognizes the importance of governmental coordination in respect to systemic issues and formalizes the Working Group into the FSOC. The FSOC is chaired by the Secretary of the Treasury and consists of an additional nine voting members, including the principals of the federal regulatory agencies, and five non-voting members. The FSOC has a myriad of authorities; many are new to financial supervision, including the power to decide which non-financial firms are to be considered systemic. In and of itself, the FSOC is a positive step in the direction of a more


60. According to its website, the FSOC’s voting members include:

The Secretary of the Treasury, who serves as the Chairperson of the FSOC, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, the Chairman of the Securities and Exchange Commission, the Chairperson of the Federal Deposit Insurance Corporation, the Chairperson of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board, and an independent member with insurance expertise that is appointed by the President and confirmed by the Senate for a six-year term.


The Director of the OFR, the Director of the Federal Insurance Office, a state insurance commissioner selected by the state insurance commissioners, a state banking supervisor chosen by the state banking supervisors, and a state securities commissioner designated by the state securities supervisors. The state nonvoting members have two-year terms.

Id.
clearly organized and comprehensive regulatory environment for the largest financial enterprises.\textsuperscript{61} The construction of the FSOC, however, has two key challenges that are likely to impede its effectiveness.

The first potential challenge to the FSOC’s status as an apolitical regulator is that the Treasury Secretary, as its chair, has a great deal of power—more so than ever before—in regulatory and supervisory matters.\textsuperscript{62} In prior decades, Congress, as a matter of public policy, had been deeply wary of giving this kind of authority to a Treasury Secretary, a member of the President’s Cabinet whose position is inherently political in nature. While Congress in Dodd-Frank appears to have overlooked this potential politicization of the regulatory process, the power of the Treasury Secretary over the FSOC will likely give rise to some levels of controversy in the years ahead.

A second challenge is that because the FSOC does not encompass all of the federal government agencies involved in the financial industry, such as the U.S. Department of Housing and Urban Development (HUD) and the U.S. Department of Labor, it may not feel empowered to deal with issues that are important and financial in nature, but involve non-FSOC agencies. For example, the FSOC has not acted regarding the controversy over the so-called foreclosure “robo-signing” techniques used by some mortgage servicers. Yet, HUD, a key stakeholder in this issue, will not be able to use the FSOC platform to deal with this issue. Foreclosure techniques, including robo-signing, are of systemic importance to the U.S. housing market and are arguably something the FSOC should examine. Therefore, the FSOC may not address significant financial matters, perhaps because it sees its jurisdiction as limited to its member agencies.

Finally, the formality and high profile of the FSOC could result in a less useful forum for debate and resolution of important issues. One can predict that more substantively important matters will be decided in small groups behind closed doors than will be decided by the FSOC.

III. What Else Could Be Done To Make a Positive Difference

Although Dodd-Frank is a massive piece of financial regulatory reform legislation, there are still several additional measures that could genuinely further improve U.S. regulatory and supervisory systems and financial stability. These measures include the following: strengthening the first and third lines of


\textsuperscript{62} Interesting to note, as well, is that the FSOC is staffed by and physically located within the Treasury.

\textsuperscript{63} Robo-signing is the process by which foreclosure documents are signed without actually being reviewed by the individual granting the signature.
defense of the risk management model; capturing nonbanks in a supervisory net;\(^6\) creating a single prudential supervisory mechanism;\(^6\) increasing the educational excellence of our regulatory and supervisory personnel; and enhancing ombudsman programs at the federal financial supervisory agencies. Below are three expanded suggestions for improving financial stability: strengthening management and auditing standards; creating more formalized supervisory education programs; and instituting ombudsman programs in all regulatory agencies.

A. **Strengthening the First and Third Lines of Defense**

Risk management in the financial sector consists of three lines of defense: (1) quality of management, (2) risk and compliance, and (3) audit. As with many defensive strategies, the first line is the most important. While Dodd-Frank addresses the first line of defense through regulations on executive compensation,\(^6\) which will enable shareholders to cast advisory votes on compensation and “golden parachute” arrangements,\(^6\) more can be done. Governance, culture, professional credentials, and succession planning, are all critical to ensuring strong management. In fact, much of Dodd-Frank’s elaborate regulatory structure and requirements could be simplified if a stronger first line of defense were required.

Policymakers should also focus on improving the third line of defense: audit. Both external and internal audits are critical to protecting a financial institution. External audits provide a basis for corporate boards and investors to ensure that asset valuations and accounting are correct. Indeed, oftentimes the failures of financial firms are closely intertwined with lapses in the oversight of their external auditors. Following the collapse of Lehman Brothers, investigations have been launched into the role of its auditor, Ernst & Young. In March 2010, a court-appointed examiner issued a report analyzing the shortcomings in Ernst & Young’s audit of Lehman Brothers:

Ernst & Young took no steps to question or challenge the non-disclosure by Lehman of its use of $50 billion of temporary, off-balance sheet transactions. Colorable claims exist that Ernst & Young did not meet professional standards, both in investigating Lee’s allegations and in connection with its audit and review of Lehman’s financial statements.\(^6\)

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\(^{64}\) See supra notes 43-46 and accompanying text.  
\(^{65}\) See supra Part II.A.  
Internal audits are used to ensure that risk management and compliance systems are working properly and that businesses are operating within the law. This function will become even more essential as financial and designated non-financial companies strive to implement the myriad of new regulations imposed by Dodd-Frank, especially those regarding the newly emerging regulatory area of systemic risk. It is likely that some of the newly imposed regulatory examinations on systemically important institutions could spread to smaller entities.\textsuperscript{69} Internal auditors are critical to ensuring that institutions meet all of these changes.

Remarkably, auditing remains conspicuously absent from post-financial crisis analysis and legislative reform, even though valuations approved by external audit turned out to be wrong in many cases. In fact, nowhere in Dodd-Frank is there a single reference to internal auditing.\textsuperscript{70} Going forward, policymakers should place a renewed emphasis on audit—both external and internal—and the deep value that it adds to the safety and soundness of financial institutions.

B. Supervisory Education

Education is critical to producing competent, thorough, and serious supervisors. Today, it is possible to get advanced degrees in dozens of subjects. There is, however, no U.S. advanced degree program or undergraduate program in regulation and supervision.\textsuperscript{71} Financial supervisors still learn mostly on the job in an apprenticeship model that is similar to that of legal and medical training a century ago. Establishing formal academic training programs for financial institution supervisors needs to be a priority for governments around the world. Educational programs and academia can provide deep resources of factual information for solutions to challenges within financial market supervision and regulation. Professionalizing academic training in this area would surely result in substantial benefits to the global supervisory system.

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\textsuperscript{70} Id.

C. Ombudsman Programs

With greater regulatory and supervisory involvement in financial institutions’ day-to-day operations, the chances for error grow. Financial regulatory agencies should institute ombudsman programs globally. Ombudsman programs hold the promise to minimize problems that arise from unintended mistakes. It should be noted, however, that ombudsman programs should not be a way for weaker enterprises to avoid supervisory rigor—and the success of such programs at other regulatory agencies suggests that this will not be the case. Well-run ombudsman programs have the benefit of both ensuring fairness—thereby raising respect for the supervisory service—and elevating supervisory rigor, as one often learns best from one’s own mistakes.

Conclusion

In sum, the regulatory framework emerging from the financial crisis is a hodgepodge, created in a legislative environment of extreme stress. Dodd-Frank provides tools to strengthen the stability of the financial system, namely through the OFR, the regulation of nonbank systemically important financial institutions, and the emphasis on stress testing. But there is still more work to be done. Dodd-Frank’s limitations center on its inability to address regulatory arbitrage and weak supervision sufficiently, its exclusion of shadow banks from regulatory oversight reforms (the dangers of which were shown by the virtual collapses of both LTCM and AIG), and its overzealous regulation of other financial institutions; excessive and uneven regulation of trading, as exemplified by the Volcker Rule and Lincoln Amendment; and its weakness in systemic regulation, as illustrated by the structure of the FSOC. All, however, is not lost. There are numerous opportunities to improve, namely by focusing regulatory efforts on three main goals: ensuring strong management and effective auditing of financial institutions; improving supervisory education; and instituting ombudsman programs within financial institutions globally.
