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Dodd Frank is Five

And still not allowed out of the house

Acknowledgments

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Introduction

Congress approved the Dodd-Frank Wall Street Reform and Consumer Protection Act following the worst financial crisis since the 1929 crash caused the Great Depression. The 2008 crash deleted $12 trillion from the economy, costing millions of Americans their jobs, their homes, their savings.

The reform law did not promise to repair this damage. What the architects did promise is that reckless banking would end and that we'd never bail out mega-banks again. [1]

That promise became law on July 21, 2010. Five years later, however, this law remains largely incomplete—either yet un-codified into specific rules, enforcement dates set into the future, or rules not fully advantaged.

In humorous terms, it seems that Dodd-Frank is 5 years old and still not allowed outside the house.

Of the 398 rules designed to deliver the promise that Americans will never again be held hostage to a bank that's too big to fail, here is the status of key provisions.

Volcker Rule

The Volcker Rule is the name for Section 619 of the Wall Street Reform Act. In brief, it declares that banks may not engage in proprietary trading. That means the bank cannot attempt to gain a profit the way speculators do-- through the frequent purchase and sale of a security.

The rule is named for Paul Volcker, former chair of the Federal Reserve. Volcker argues that banks should restrict themselves to traditional loan-making with funds they borrow from depositors, which is an inexpensive, abundant source of money since the government guarantees repayment even if the bank fails. Using that cheap, taxpayer-subsidized money to gamble is inappropriate.

One of the complexities imbedded in the rule is that while banks may not make proprietary trades, they may still purchase and sell securities provided that these transactions are in the service of their customers, known as market making. Regulators are establishing metrics intended to reveal the difference between proprietary trading and market-making. The proprietary trading ban goes into effect in July 2015. For the public however, it will be difficult to determine whether the banks are complying.

[1] See President Obama's remarks at signing ceremony, available at:http://www.gpo.gov/fdsys/pkg/DCPD-201000617/pdf/DCPD-201000617.pdf

For example, Goldman Sachs CEO Lloyd Blankfein claimed in 2013 that “we shut off that activity” of proprietary trading.[2] However, Goldman Sachs lists “market making” as one of six major sources of revenue, along with such other items as “investment banking,” and “commissions and fees.” In 2014, it reported $8.3 billion in revenue from market making. This is down from 2013, where it reported $9.3 billion, and from 2012, when it reported $11.3 billion. [3] Before these years, Goldman Sachs did not describe revenue from market making at all. Instead, it described such activities as “trading and principal investments.” These values varied widely in the years around the financial crash, but were similar to those now reported under “market making. In 2007, for example, Goldman reported a pre-tax gain of $13 billion.[4] It’s hard not to suspect that all that has changed is the terminology.

JP Morgan claimed its derivatives trading in London simply served as a hedge, which is permitted under the Volcker Rule. A hedge is a type of insurance, such as a position that will pay off in the case that the primary investment does not. A Senate investigation, however, found that the bank could produce no document to show what, precisely, was being hedged. [5]

One of the blatant arenas where banks engage in proprietary trading is through their hedge funds. Hedge funds are investment vehicles that pool capital from investors and are augmented with borrowed money. Unlike mutual funds, the investments can be complicated and are usually much riskier. The Volcker Rule declared that banks must shed these funds. The statute allowed that banks could own as much as 3% of the funds, provided that this ownership was separate from the equity levels needed to satisfy regulatory requirements. Yet in December, 2014, regulators gave banks two additional years beyond the time already permitted to shed these funds. This actually gives the banks until 2022 to exit this gambling arena. Volcker himself resorted to thinly veiled sarcasm following announcement of this reprieve: “It is striking that the world’s leading investment bankers, noted for their cleverness and agility in advising clients on how to restructure companies and even industries however complicated, apparently can’t manage the orderly reorganization of their own activities in more than five years.”[6]

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[2] “Secret Goldman Team Sidesteps Volcker after Blankfein Vow,” by Max Abelson, Bloomberg (January 2013), available at: http://www.bloomberg.com/news/articles/2013-01-08/secret-goldman-team-sidesteps-volcker-after-blankfein-vow

[3] Goldman Sachs, 10-k, (2015), available at: http://www.sec.gov/Archives/edgar/data/886982/000119312515056785/d840464d10k.htm#toc840464_4

[4] Goldman Sachs, 10-k, (2009), available at: http://www.sec.gov/Archives/edgar/data/886982/000095012310018464/y81914e10vk.htm#158

[5] See “London Whale” investigation by the US Senate Permanent Subcommittee on Investigations, (113th Congress), available at: http://www.hsgac.senate.gov/search/?q=london+whale&search-button=Search&access=p&as_dt=i&as_epq=&as_eq=&as_lq=&as_occt=any&as_oq=&as_q=&as_sitesearch=&client=hsgac&sntsp=0&filter=0&getfields=&lr=&num=15&numgm=3&oe=UTF8&output=xml_no_dtd&partialfields=&proxycustom=&proxyreload=0&proxystylesheet=default_frontend&requiredfields=&sitesearch=&sort=date%3AD%3AS%3Ad1&start=0&ud=1

[6] “Fed Delays Volcker Rule,” by Peter Eavis, New York Times (December 2014) Available at: http://dealbook.nytimes.com/2014/12/19/feds-delay-of-parts-of-volcker-rule-is-another-victory-for-banks/?_r=0

Because proprietary trading has been a source of great profit for the banks, the industry lobbied fiercely to soften the implementation of the statute by the regulators. This full-court press included meetings with regulators and congressional hearings.

Naturally, the banks did not argue that they should be allowed to continue taxpayer-backstopped gambling. Instead, they warned that exiting the market would lead to problems in "liquidity." Liquidity refers to the ability to sell an asset quickly without reducing the price of that asset. The most liquid asset is cash, and this can be exchanged in an instant for a product that is priced accordingly. A house is not liquid; if the owner insists on selling it in one day or one hour, the true value might need to be reduced sharply to gain such a speedy sale.

The Investment Company Institute , one of the many financial industry trade associations, referred to "liquidity" 87 times in its 48 page comment letter to the Federal Reserve on the Volcker Rule.[7] The Securities Industry and Financial Markets Association refers to liquidity 21 times in just one of its letters on the Volcker Rule.[8]

While it may be intuitive that the presence of liquidity is preferable to its absence, it isn't clear that promoting maximum liquidity is a goal that should displace all others. There can even be problems with a too-liquid market, such as creating a false sense of security. A frothy stock market might invite too many investors, creating a bubble that, when it bursts, suddenly becomes illiquid. "It's a very good thing we don't have AIGs that are willing to provide lots of liquidity and are buying this stuff now, so we won't have to bail them out one day," said Barney Frank, former chair of the House financial services committee, and prime author of the Wall Street Reform Act. [9]

In practice, the threat of liquidity problems from the Volcker Rule have proven hollow as evinced by market vitality. In 2014, for example, corporate bond issuances hit a high of $1 trillion, surely contradicting any claims that desiccation would harm the ability of business to raise funds.[10] And even if the Volcker Rule isn't implemented yet, any sophisticated bond investor must account for future rules.

Yet warnings about liquidity abound. On July 13, 2015 for example, Rep. Randy Neugebauer (R-Texas) convened a roundtable to explore this issue once again.[11]

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[7] Comment on Volcker Rule, ICI, (February 13, 2012),available at: http://www.federalreserve.gov/SECRS/2012/May/20120510/R-1432/R-1432_021312_104980_555632790183_1.pdf

[8] Comment on Volcker Rule,SIFMA (February 13, 2012) available at: http://www.federalreserve.gov/SECRS/2012/April/20120417/R-1432/R-1432_021312_104701_532360984930_1.pdf

[9] "Did Dodd-Frank Kill Liquidity," by Yalman Onaran, Bloomberg, (October 2014) available at: http://www.bloomberg.com/news/articles/2014-10-20/did-bank-rules-kill-liquidity-volcker-frank-respond

[10] Data on new U.S. corporate debt offerings are taken from Securities Data Corporation's New Issues database (Thomson Financial). Data on new non-U.S. corporate debt offerings are taken from the World Federation of Exchanges monthly statistics reports.

[11] See press release from office of Randy Neugebauer, available at: https://randy.house.gov/press-release/media-advisory-neugebauer-host-fixed-income-liquidity-roundtable-july-13

Swaps Push Out

In tandem with the Volcker Rule, another section of the Wall Street Reform Act restricted derivatives speculation. Section 716, known as the Lincoln Amendment for former Arkansas Senator Blanche Lincoln, a Democrat, declared that financial firms could not engage in some of the more exotic derivatives contracts, or swaps, within their FDIC-insurance banks. Instead, they must execute these contracts in separately capitalized affiliates. The swaps must be "pushed out" of the bank.

High volume speculators prefer derivatives trading because transaction costs are minimal. Speculation involving real property, such as a house or a share in a corporation, involve the legal transfer of ownership rights. That requires clerical cost. The value of a derivative derives from something real, such as the price of an asset at a certain time. A derivative might involve the cost of oil in three months. The winner pays the loser of the bet. Money changes hands, not real property.

The financial crisis revealed excessive speculation in the derivatives market . Not only did much of this serve no economic utility, it exacerbated risk. Credit default swaps, for example, are a type of bond insurance. It pays the holder of the CDS if the bond defaults. This might make sense if the CDS holder owned the bond, which is a requirement for any legally regulated insurance. (One cannot buy fire insurance on a neighbor's house, lest one be incentivized to burn it down and collect the premium.) But CDS holders often had no underlying interest being insured. The amount of CDS contracts far exceed the value of the bonds to which they are linked. In other words, the default of one bond might trigger payments many times the value of that bond. In the case of AIG, US taxpayers paid more than $180 billion to the CDS holders of contracts written by the insurance giant, the largest single bailout of the financial crisis.

Lincoln's proposal drew fierce opposition from the banking industry. Swaps trading within the FDIC-insured bank, especially with cheap deposits that weren't deployed as loans, could be extremely lucrative. Lincoln and her supporters were forced to compromise as the Wall Street Reform bill reached a final vote, and allowed some swaps to be conducted by the FDIC-insured bank, instead of a separately capitalized affiliate.

In public, advocates of unrestricted swaps gambling and other risky bank activities hide behind the argument that US banks must remain "competitive" with international rivals. Such a concept might apply to the US Olympic or soccer team. An American naturally cheers for an American victory in international competition. Why should an American cheer for the success of a bank headquartered in the United States? That might make sense if the bank employees were American, if it paid dividends only to American investors, and paid taxes only to Uncle Sam. In fact, the mega-banks are international firms. The CEO of Morgan Stanley is Australian. Much of the derivatives trading takes place in London by non-US nationals. One of Citigroup's largest shareholders is the Abu Dhabi Investment Authority.[12] Hundreds of JP Morgan's subsidiaries are incorporated outside the United States, such as England,

[12] See Citigroup 10-k, p. 291, (2014), available at: http://www.citigroup.com/citi/investor/data/k14c.pdf

Luxembourg, and Mexico. [13] Regulator policy that promotes the "competitiveness" of such banks effectively promotes employment of non-US nationals working outside the United States, or dividends paid to Abu Dhabi.

Yet mired in such fatuous claims about "competitiveness, " four and a half years after passage of Dodd-Frank, the regulators had taken no steps to implement the swaps push out. In fact, as with other Wall Street reform statutes, pro-Wall Street members of Congress attempted to advance legislation to repeal this statute. Then, in December 2014, with the government facing another shutdown, Citigroup lobbyists successfully inserted a near repeal of the Lincoln amendment in a must-pass spending bill. [14] Wall Street reformers such as Sen. Elizabeth Warren (D-Mass) and Rep. Maxine Waters (D-Calif), the ranking member of the House financial services committee, rallied to remove this provision.[15] But Wall Street deployed its most influential voices as well, with JP Morgan CEO Jamie Dimon personally calling members. Warren eulogized: "And now we're watching as Congress passes yet another provision that was written by lobbyists for [Citigroup] and it's attached to a bill that needs to pass or else the entire federal government will grind to a halt. Think about this kind of power. A financial institution has become so big and so powerful that it can hold the entire country hostage. *That alone* is a reason enough for us break them up. Enough is enough."

Living Wills

The Wall Street Reform act did not break up the largest banks, one of the many short-comings of this reform law. But it did provide a mechanism for the regulators to achieve the same result should they exercise regulatory zeal. In Section 165, known as the "living will" provision, large banks must provide a "credible" plan for an orderly resolution under the bankruptcy code should they fail. Failure means that their liabilities exceed the value of their assets. The bankruptcy of Lehman Brothers on September 15, 2008 precipitated contagion throughout the financial system. That bankruptcy led to massive bailouts of the entire financial system.

If such a living will is not deemed credible, if a mega-bank failure would spark financial contagion, the Federal Reserve and Federal Deposit Insurance Corp can order changes, including the sale of assets.

One of the most serious problems with bankruptcy for major banks involves the exceptions for derivative swaps. Unlike most debt, where bankruptcy allows the debtor to temporarily halt payment while a judge decides how to allot the remaining assets to the various creditors, swaps can be settled immediately. Winners collect their cash, which is often held with third party institutions. [16]

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[13] See JP Morgan subsidiaries, (2014), available at: http://www.sec.gov/Archives/edgar/data/19617/000119312508043536/dex211.htm
[14] "Citigroup Wrote the Wall Street Giveaway," by Erika Eichelberger, Mother Jones (December 2014) Available at: http://www.motherjones.com/politics/2014/12/spending-bill-992-derivatives-citigroup-lobbyists
[15] Speech, Elizabeth Warren, (December 12, 2014) available at: http://www.warren.senate.gov/?p=press_release&id=686
[16] Mayer Brown member (January 2014), Available at: http://www.mondaq.com/unitedstates/x/285456/Insolvency+Bankruptcy/Lehman+Bankruptcy+Court+Addresses+

Another problem involves the global nature of mega-banks. More than 80 courts around the globe continue to sort through the Lehman bankruptcy. Each of these courts are bound by their own national laws and loyalties.[17]

Indeed, the major banks have failed to submit living wills that the regulators have deemed "credible." In the latest round, Bank of America confided that it would not be able to submit a complete plan until sometime in 2017. JP Morgan's latest plan spans 200,000 pages. Alone, such a vast length defies the concept that the assets and liabilities of each of this mega-bank's subsidiaries could be understood in tranquil times, let alone a period when the bank is unable to make good on its debts.

Yet the regulators have yet to exercise their authority under the statute and order a break-up of these banks.

Banker Pay

There's an obvious reason that bankers choose to make risky swaps bets instead of loans, to prefer cheap, taxpayer-subsidized money for this gambling-- they make personal fortunes. The top executives of Bear Stearns and Lehman Brothers received a collective $2.5 thousand million in the years preceding their failure, and repaid none of it.[18] More than 1,500 employees of JP Morgan take home more than $1 million each. A Goldman Sachs, with about 10 percent of JP Morgan's 220,000 employees, nearly 1,000 workers enjoy yearly compensation of more than $1 million each.[19] The Financial Crisis Inquiry Commission found that pay systems too often encouraged "big bets" and rewarded short-term gains without proper consideration of long-term consequences.[20] Multiple surveys have found that more than 80 percent of financial market participants believe that compensation practices played a role in promoting the excessive risk accumulation that led to the financial crisis.[21]

Scope+Of+The+Bankruptcy+Codes+Safe+Harbor+For+Liquidation+Termination+And+Acceleration+Of+Swap+Agreements

[17] See "The Failure Resolution of Lehman Brothers," Federal Reserve Bank/New York (December 2014) available at: http://www.newyorkfed.org/research/epr/2014/1412flem.pdf ; also "German Lehman Brothers Affiliate Flies for Ch. 15," Leigh Cardaer, Law360 (April 2009) Available at: http://www.law360.com/articles/99213/german-lehman-bros-affiliate-files-for-ch-15

[18] Bebchuk, Lucian A. and Cohen, Alma and Spamann, Holger, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008" ; Yale Journal on Regulation, Vol. 27, 2010, pp. 257-282; Harvard Law and Economics Discussion Paper No. 657; ECGI - Finance Working Paper No. 287.

[19] Cuomo, Andrew, "No Rhyme or Reason: The Heads I Win Tails You Lose Bank Bonus Culture", Attorney General of the State of New York, 2008.

22European Banking Authority, "Regulatory

[20] Financial Crisis Inquiry Commission, "Financial Crisis Inquiry Report", February 25, 2011.

[21] Financial Stability Forum, "FSF Principles for Sound Compensation Practices", April 2, 2009. See page 4, footnote 2, for a review of these surveys.

To address this problem, Congress approved Section 956 of the Wall Street Reform act. This provides broad authority to the regulators to curb "inappropriate risk" incentives in pay structures. Congress further declared that the regulators must finalize this rule by the spring of 2011. Four years after this deadline, five years after Congress approved the law, seven years after these pay-for-gambling compensation schemes led to a world financial meltdown, the regulators have yet to finalize a rule. Again, Wall Street's prodigious number of lobbyists have contested implementation of this foundational rule.

As with other delayed rule-makings, inattentive regulators may be blamed. This rule requires five separate agencies to complete the rule. One of these is the Securities and Exchange Commission. Public Citizen has documented the tardy record of rulemaking at this agency under current Chair Mary Jo White.[22]

Conclusion

Why regulators fail to adopt and enforce strong regulations is often attributed to regulatory capture. This refers to the ties between Wall Street and Washington police. Wall Street spends $1.5 million a day on 3,000 lobbyists in Washington.[23] Most directly, it involves the revolving door between Wall Street firms and Washington agencies. Citigroup alumni fill numerous leading Washington offices, such as Jack Lew, who is Treasury Secretary. Law firms that defend Wall Street firms serve as a stable for the Securities and Exchange Commission, such as Chair White, who led the white collar defense team at Debevoise & Plimpton which defends Wall Street firms.

Despite this revolving door and the fatuous arguments from Wall Street apologists, Washington's record to implement the Wall Street Reform Act is not a complete failure. The Consumer Financial Protection Bureau, a hallmark new agency created by this this act, is up and running, providing material, measurable relief to consumers abused by malicious creditors. Several regulators deserve credit, such as Federal Reserve Gov. Daniel Tarullo, FDIC officers Thomas Hoenig and Martin Gruenberg, SEC Commissioners Kara Stein and Luis Aguilar, and Commodity Futures Trading Commissioner Sharon Bowen, along with former CFTC Chair Gary Gensler. In speeches and votes, these public agents have sought to place the public citizen ahead of the private interests of Wall Street.

The Wall Street reform law, even if well implemented, was not a complete answer to financial challenges. It stemmed from compromise. The largest bank that required bailouts actually became larger during the crisis, with JP Morgan acquiring Bear Stearns and Washington Mutual, Bank of America swallowing Merrill Lynch, and Wells Fargo acquiring Wachovia. These banks should be broken up.

[22] See "Efficiency Nut," by Bartlett Naylor, Public Citizen, (June 2014), available at: http://www.citizen.org/documents/sec-rulemaking-efficiency-report.pdf
[23] "Wall Street Spending $1.5 million a day," Benjamin Goad, The Hill (January 2014), available at: http://thehill.com/regulation/finance/213342-wall-street-spending-15m-a-day-on-lobbying-politics

Commercial and investment banking should be divorced, along the lines of the 1933 Banking Act intended to prevent depositor funds from use in speculative activity.

But some of the major promises of Dodd-Frank remains unfulfilled. With banks able to maintain hedge funds, speculate through complex swaps with taxpayer-backed funding, with pay that promotes "inappropriate" risk-taking, Americans cannot be comforted that Wall Street will not wreak havoc again. Five years have passed, we can only hope that at age 6, Dodd-Frank will finally be allowed out.