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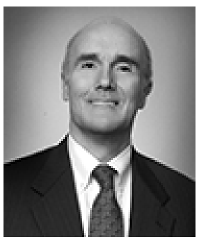
REGULATORY REFORM

Dodd-Frank and the Advantages of Border Collie Regulation



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Two Bank of England officials (Andrew Haldane of the Financial Policy Committee and economist Vasileios Madouros) presented an interesting paper, ''The Dog and the Frisbee,'' this past summer at the Federal Reserve Bank of Kansas City's economic symposium in Jackson Hole, Wyoming. In it, they argue for a ''less is more'' approach to financial regulation, asserting that the increasing complexity in financial regulation, including increasing regulatory capital requirements, complex and burdensome financial regulation, and complicated but ineffective financial risk management, has not improved the efficacy of financial services regulation. Using the metaphor of a dog's simple but effective frisbee-catching skills (with an approving reference to border collies), Messrs. Haldane and Madouros argue, using economic data to support their claims, that competent simplicity in financial regulation — what we will call ''border collie regulation'' for now — would improve crisis control and financial regulatory outcomes.

Although the Dodd-Frank Act was not a principal focus of their arguments, the authors did refer on several occasions to Dodd-Frank to support their conclusions. Their message of ''less is more'' in financial regulation may not find many takers in some quarters of the current regulation-happy U.S. financial environment. A closer examination of the impact and efficacy of our present state of financial regulation in the wake of the Dodd-Frank Act, however, and whether an alternative regulatory approach that relies on streamlined clarity and direction to accomplish its objectives would be better, may be instructive and timely.

Dodd-Frank's proponents would argue that great crises require bold action, and that the Dodd-Frank Act was the necessary cure for the failure of regulation that contributed to the financial crisis. A crisis it certainly was, but oh, what a cure! Looking at the current state of our financial regulatory system, it is hard to see how we have materially improved the clarity and quality of financial regulation since 2010. Yes, conditions in the banking industry have improved, but the FDIC's industry statistics indicate that the improvement is primarily, if not solely, the result of more equity capital held by banks, fewer bad loans on the banks' books, and more bank liquidity.

By contrast, Dodd-Frank's stupefying size and scope of coverage, its thousands of provisions and prescriptions, and its hundreds of required rulemakings and studies, have placed enormous burdens and costs on the financial industry and regulators alike. It creates requirements that may be impervious to good prescriptive regulation (e.g., the Volcker Rule) or have nothing to do with financial regulation (e.g., conflicts minerals). Its principal vehicle for coordinated interagency financial regulation, the FSOC, is an overlarge, unwieldy committee populated by competing regulatory constituencies, and whose structural ability to act quickly and effectively in a true financial crisis is suspect and untested. Due to Dodd-Frank's sheer size and scope, and the fact that it prevents the financial regulators from setting their own priorities, the regulatory implementation timeline has slipped badly and will continue to do so. Many of its core provisions — systemic regulation, regulatory capital, the Volcker Rule, derivatives oversight and consumer regulation, to name just a few – are mired in controversy. So, on top of the burden and complexity of Dodd-Frank that is making life difficult for financial institutions and regulators alike, we can now add a high level of regulatory uncertainty that does not build the confidence of bankers who want to lend more money and do more business, or businesses or consumers who otherwise would want to borrow more.

So what is the alternative? As superficially appealing as it may be to "repeal Dodd-Frank" as a number of politicians are proclaiming, the events of the past several years exposed material lapses in financial institutions supervision and regulation that needed to be fixed. But just perhaps, the border collie principle of "less is more" might lead the way to a more manageable and effective regulatory system.

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In their paper, Messrs. Haldane and Madouros target the Basel Committee's risk-based capital regime, in particular the more recent Basel 2 and Basel 3 iterations, as an example of excessively complex and less-than-effective regulation. Basel 2 proved to be generally irrelevant as a determinant of whether the large, global banking organizations had sufficient capital resources to weather the recent financial crisis; fortunately, Basel II was not fully effective in the U.S. in 2008. Further, Basel 2 (and even Basel 1) indisputably encouraged capital arbitrage among different classes of assets, which had the effect of, among other things, encouraging banking organizations to book concentrations of assets on the banking book that, in hindsight, were not as "safe" as they appeared to be. Instead, the authors argue that what proved to be the best cushion against losses in the crisis was good, old-fashioned leverage equity capital: not complicated, transparent, and — most importantly — more effective in cushioning financial firms against loss.

Ironically, regulatory capital may be one area where Dodd-Frank started to get it right, by creating a firm capital floor, including a leverage capital floor (albeit a low floor), for all depository institutions and their holding companies. In turn, it would be a relatively simple matter to reorient the U.S. regulatory capital regime towards these more straightforward capital benchmarks, and according to Messrs. Haldane and Madouros, that might well result in stronger and more effective regulatory capital requirements. To do so, however, the U.S. regulatory agencies would have to disaffirm most of the current Basel capital accord, and last summer's U.S. regulatory capital proposals suggest that the regulators are not inclined to move in that direction at this time, although several informed sources, including certain high-placed regulators (e.g., FDIC Vice-Chair Thomas Hoenig) recently have questioned the efficacy and continued utility of the current Basel framework.

The regulatory disadvantages of complexity, however, extend well beyond capital, and this is where the structural difficulties of the Dodd-Frank Act present themselves most acutely. One need only look at the level of complexity, and the attendant difficulties in comprehension and implementation, that have bedeviled many of the major regulatory initiatives under Dodd-Frank: systemic regulation, regulation of OTC derivatives, risk-retention in securitizations (a requirement, which, perhaps not coincidentally, has effectively throttled the reemergence of structured finance in many asset classes), and the Volcker Rule, to name just a few. Dodd-Frank will also lead to a veritable avalanche of new required financial reporting and data collection, starting with the data collection mandates of the Treasury Department's Office of Financial Research, and including a vast array of financial reporting and data inputting (systemic regulation reporting, stress testing, proprietary trading reporting — the list goes on and on).

Complex Models Cloud the Crystal Ball

If we could be confident that this complexity would lead to a better financial regulatory structure and a safer, more stable financial system, *and* that this approach is the most effective way to strengthen our financial system, there would be more reason to accept the increased costs and burdens that come along with this process. But will this massive new regulatory superstructure really work? Putting on their statisticians' hats, Messrs. Haldane and Madouros argue that the ability of complex financial models to forecast financial outcomes decreases with the complexity of the model, unless the data sampling universe from which the model draws its information encompasses an impossibly large sample size. We certainly saw this phenomenon loom large in the financial crisis, where financial institutions' internal financial models (including those based on value at risk, or VaR), as well as external models — most notably credit ratings — failed to predict the impact of tail ("black swan") events and proved insufficient to capture the scope of financial risk accumulating not only on the books of many leading financial institu-

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tions, but also in the banking system itself. Further, the complexity of the developing Dodd-Frank Act regulatory framework inevitably will increase the incidence of compliance failures and inaccurate financial reporting, along with very substantial increases in compliance and reporting costs, without any demonstrative indication at this time that the regulatory structure will promote a safer financial system.

Students of bank regulation may recall that the Federal Home Loan Bank Board (the predecessor to the Office of Thrift Supervision) took a highly rules-based approach to the supervision and regulation of the U.S. thrift industry, an approach which failed to prevent the savings and loan industry crisis in the late 1980's. By contrast, the Office of the Comptroller of the Currency relied significantly more on principles-based supervision of national banks during the same period, and the overall regulatory outcome for national banks during that same period of time, while not ideal, was certainly a lot better.

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From another perspective, the Dodd-Frank regime unfortunately is demonstrating the economic ''theory of the second best,'' first conceptualized in 1956 by Canadian economist Richard Lipsey and Australian economist Kelvin Lancaster. Briefly, the theory holds in relevant part that, when faced with a complex system that is imperfect, legislators and regulators are unlikely to create a better system by trying to fix specific defects. The superior approach is to look at the system on a macro basis, which is likely to reveal other changes that would have the desired effect. The financial system in 2008 undoubtedly was imperfect, but developing specific metrics to determine whether trading is allowed or forbidden under the Volcker Rule, or deciding whether a mortgage loan should be risk-weighted at 35 percent, 50 percent, or 75 percent, will not provide any sort of bulwark against future banking crises. Title I starts off well enough—basically, regulators should regulate large complex financial institutions more rigorously and horizontally (not that the regulators necessarily needed a new statute to tell them that) — but it has led to, for example, a process for identifying risky nonbanks that is complicated and opaque, and an elaborate and cumbersome set of procedures for evaluating and benchmarking liquidity.

So, there is ample reason to question the value of the current Dodd-Frank (and regulatory capital) approach, and consider perhaps a more straightforward and effective alternative. And what is that alternative? A system that relies on straightforward rules and requirements in core areas, clear and strong regulatory capital requirements, thoughtful and effective supervision, and transparency in reporting and disclosure: smart regulation, or border collie regulation, if you will. These are not creative or unique insights, and they have been advocated by a number of informed sources, Messrs. Haldane and Madouros among them, as well as certain regulators (including Mr. Hoenig). They also are at the core of the recently-published revised Basel Committee *Core Principles for Effective Banking Supervision*, which somehow is able to condense its ''best practices'' regulatory framework into 29 basic principles (not several thousand) covering supervisory powers and activities, and key prudential requirements.

In their collective efforts to put into place a congressionally-mandated regulatory architecture that is breathtaking in scope and burden, the U.S. regulatory agencies may be at risk of not seeing the forest for the trees, even though Dodd-Frank is supposed to be all about the forest. Further, the time being spent on regulatory tasks to implement Dodd-Frank is diverting valuable regulatory resources from the essential task of supervision, and helping to create a climate of regulatory uncertainty that, any way one looks at the matter, cannot be good for the current business environment. In turn, we could well end up with a complex and costly regulatory scheme that is no more effective than what we now have in place, and may not reliably achieve its most important objective – improving our collective ability to reduce the likelihood of a future financial crisis, while giving us the tools to respond effectively to such a crisis when (not if) one next occurs.

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The argument for reduced regulatory complexity is not an argument in favor of simplicity for simplicity's sake, nor is it an argument for ''deregulation.'' Contrary to the prevailing narrative that ''deregulation'' was a cause of the financial crisis, there was plenty of additional regulation in the 1990s and 2000s, beginning with the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991, Sarbanes-Oxley in 2001 and continuing with a host of new or increased regulatory requirements spanning the full range of regulated bank and investment bank activity and oversight. All these initiatives added serious weight and volume to the library of federal financial regulations, but were of little use in preventing the 2008 financial meltdown. Instead, reduced regulatory complexity, combined with smart regulation, may instead improve regulatory outcomes by (i) focusing legislative and regulatory resources on the most important financial issues and problems, (ii) increasing the level of regulatory compliance, (iii) avoiding overreliance on financial information, data and systems that are not necessarily predictive of future events, and (iv) better achieving the most important goals of Dodd-Frank.

The timing for this new approach happens to be auspicious. Dodd-Frank does not allow the regulators to act unilaterally here, but in a month, a new Congress will convene, and indications at this time point to another look at Dodd-Frank in 2013, if only because the Republicans, who have retained control of the House of Representatives, will insist on that reexamination. Whether the Republicans would do so for the right or wrong reasons is irrelevant: ''Repeal Dodd-Frank'' is not a viable, or even necessary, political option at this time, but what is so wrong with ''improve Dodd-Frank''?

Under the Theme of Keeping Things Simple

There is a great deal about Dodd-Frank that would benefit from improvement along these lines, but in keeping with the overall theme of keeping things simple, here are a few ideas (big and little) that could materially reduce the regulatory complexities and inefficiencies of Dodd-Frank without disrupting the basic objective of improving financial regulation and our collective ability to respond to financial crises:

Change the systemic regulation framework from a prescriptive to a principles-based framework.

Dodd-Frank Title I is a cumbersome amalgamation of systemic regulation to-do items and a large host of specific requirements; other titles of Dodd-Frank take the same approach in other regulatory areas. That is a principal reason why the regulators are having problems in writing the rules, and why the industry is pushing back on many aspects of the proposed rulemaking. Better for Dodd-Frank to lay out the objectives of systemic regulation, the qualitative elements of that regulatory scheme, and what Congress broadly expects the regulators to do in accomplishing these regulatory objectives. In turn, the regulators — who really are the experts here — will have the flexibility to develop and apply these principles on a macro as well as a micro level.

Move FSOC functions to the Federal Reserve.

The one regulatory body that has the organizational capabilities and experience in systemic supervision is the Federal Reserve Board. A large, multi-member supervisory body like FSOC is at real risk of being unable to respond adroitly to a financial crisis, and if there is one thing we learned from the 2008 crisis, is that when things fall apart, they do so at an alarming speed. If there are worries about giving the Federal Reserve too much unilateral authority, it always can be directed to get Treasury's permission to act, or consult with other agencies. And, move the OFR information-collection functions into the Federal Reserve as well, because once again the Federal Reserve long has been in the business of collecting macrofinancial and microeconomic data and statistics. The OFR is a fine idea in principle, but what does it tell us about how it has been conceived that, over two years after it was created, it doesn't yet have a permanent head and has not fully ramped up its core information-collecting activities?

Remove all rulemaking deadlines in Dodd-Frank.

In our view, this is an easy one: give the regulatory agencies the ability to establish their own priorities without burdening them with multiple and artificial deadlines.

Save systemic regulation for systemic risk.

There are a number of Dodd-Frank requirements that arise from concerns about the systemic risks presented by large financial institutions and certain activities, but that are being applied to a broader community of banks and other financial institutions. The Volcker Rule is one prime example – there simply is no need to apply this requirement to the entire banking community – but there are others (bank derivatives trading and the like) where the principle is the same.

Do not micromanage financial institution activities.

There is far too much in Dodd-Frank – the Volcker Rule, risk retention in securitizations, and much of Title VII derivative regulation, to name just a few areas — where Congress has tried to micromanage financial institution activity and how it is regulated. Straightforward core principles, standards and requirements would give the regulators adequate direction and flexibility to create and apply clear and attainable requirements.

Give regulators real authority to address too-big-to-fail.

Too-big-to-fail remains a high-importance issue — one that was not eliminated under Dodd-Frank — and it continues to pose a material risk to the financial system. There are various legislative solutions that have been proposed to address this issue, including bringing back Glass-Steagall or putting absolute size limits on U.S. financial institutions, but given the highly contextual nature of systemic risk — stated simply, not every trillion-dollar financial services organization presents the same level of systemic risk — any legislative solution would risk hitting wide of the mark and potentially have unintended and potentially undesirable effects on legitimate business activity. Allowing the regulatory agencies, with clear qualitative benchmarks and adequate due process protections for financial institutions, the authority to make these determinations and take appropriate actions, whether through limits on business lines, divestitures or other means, may have more positive results.

Capital is king – but do we need risk-based capital?

This may not be an issue for Congress, but it is one for the regulatory agencies. Just as the financial crisis demonstrated the superior loss-absorbing value of real equity capital, it also laid bare the deficiencies of Basel 2 and its highly complex models-based framework. A move towards clear and strong capital requirements, and less reliance on the concept of risk-weightings, could do a better job of maintaining the financial strength of financial institutions and discourage the types of capital arbitrage that aided in the accumulation of excessive asset risk during the last crisis. We also would urge a clear, principles-based and transparent adaption of the Basel 3 liquidity requirements here in the U.S.

Emphasize corporate governance, oversight and accountability.

The existence and enforcement of strong corporate governance, management oversight and accountability

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standards are key elements of a sound financial system. These standards should be qualitative, they should be clear, and they should be enforced by each financial institution and its supervisory agency.

Streamline regulatory accountability.

The level of detail, the deadlines, and the multiple reports to Congress in Dodd-Frank reflect in large part congressional frustration with lax regulation during the financial crisis. Traditional congressional oversight through hearings and informal communications proved inadequate, at least as Congress saw it, and so Congress went about the task of increasing regulatory accountability through a highly granular and prescriptive legislative framework.

We agree that greater accountability on the part of government agencies with broad discretion is an important objective, but overall Dodd-Frank's system of accountability may be failing of its own weight. Is there a more efficient way? A single monitor (but not one with its own financial supervisory powers) is one possibility. The Treasury Department could be one place to start, with a limited number of high-level and direct (rather than many) reporting obligations that discuss the work of the agencies, and provide arguably a higher level of political accountability than an independent agency. Alternatively, the Government Accountability Office could be given a direct substantive mandate to review the supervisory performance of the financial regulatory agencies and periodically report to Congress its findings and recommendations. In the final analysis, what Congress needs is enough information to understand its own policy choices and to have reasonable assurances that the regulatory agencies are performing their tasks.

These are just a few ideas — others can offer up many more good ones, we are sure. Real progress on genuine and effective regulatory reform, however, can be made if, come January, the two political parties can agree to come together to examine these issues, and begin thinking like border collies. We all would be the better off for it.