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25TH ANNIVERSARY

Dodd-Frank – The End Game

The rule-making process with the Dodd-Frank Act is causing considerable angst among banks.

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The Dodd-Frank Act (DFA) is the biggest and most controversial regulation to have impacted the industry recently. The coverage and breadth of its impact is being unraveled as the detailed rules are being specified by regulators. Most of its provisions exert a significant pressure on profitability through increased capital requirements and numerous rules to ensure system stability.

"Many believe that regulators may simplify the current act."
—Balaji Yellavalli

While increased capital requirements have been accepted by the industry, it is the rule-making process that is causing significant angst. Many banks feel that the rule-making process hasn't been able to remove the ambiguity, complexity and negative perception associated with these regulations. It doesn't help the cause when rule makers continue to squabble, define contradictory approaches to common issues, and make it quite difficult for market participants to navigate DFA's minefield.

The battle for Dodd-Frank is being fought at two levels - political and regulatory. Politically, the focus has been on placing peers in agencies created under DFA. Republicans have refused to increase the SEC's budget to protest DFA and impede its implementation, while Democrats continue to paint the regulations as a panacea to "bankers-gone-wild."

At the regulatory level, battle lines are drawn around the implementation of the Volcker rule, identification of systemically important financial institutions (SIFI), and the creation of banks' 'living wills' with un-wind provisions for tackling the "too big to fail" perception. While the impact of Volcker on market-making and some hedging activities by non-financial players is being debated, banks are gearing up for protracted legal battles surrounding SIFI designations and meeting the requisite criteria.

COMPLEXITY AND PROGRESS

The sheer complexity of this regulation can be gauged by the fact that the act is 2,319 pages and adds 13 new oversight agencies. Slow progress on establishing rules has fuelled questions around their usefulness. The SEC's rule-making has slowed from about nine rules per month in the first year following DFA's passage to five ever since. Of the 222 rules that should have been completed, only 67 have been finalized.

The U.S Chamber of Commerce's sluggish implementation of DFA and the ambiguity surrounding those reforms have made it difficult for businesses to comply with provisions. The SEC missed its December 31, 2011 deadline, for finalizing four key elements: 1) mandatory claw-back policies, 2) pay vs. performance disclosure, 3) CEO pay ratio disclosure, and 4) disclosure of hedging by employees.

The Federal Reserve's crusade against the compulsory break-up of big banks through the Volcker Rule is facing a lot of flak. Even if banks consent to being broken up, regulators are unclear how to do it. It's incumbent on the regulators to provide guidance. There is a possibility that regulators will miss the July 21 deadline for framing the final rules. Regulators may simplify the current proposal by moving away from being prescriptive, toward broader risk-based measures.

POTENTIAL IMPACT

DFA is a reaction to the credit crisis which caused a few large banks to fail while putting the whole financial system in turmoil. DFA's four-tiered intent is directed toward con-

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—Satish Swaminathan

taining systemic risk and averting financial disaster.

1. The government’s intervention with taxpayer bail-out money pushed the thought process to the extreme of “over-regulation” being better than “no regulation.”

2. Risk to the whole financial system would be reduced by banning proprietary trading (i.e., firms taking bets with its own capital), reigning in bank leverage with increased capital requirements, and gauging if plans are in place for an ‘unwind’, in case of a financial firm’s collapse.

3. DFA will establish market structures for over-the-counter (OTC) derivatives, which pushed the economy to the brink of collapse. The idea is to ensure that OTC transactions are standardized with increased transparency, regulation and guidelines.

4. To bring oversight of some non- bank financial firms - specifically the firms that juggle insurance and capital market activities that are impacted negligibly by regulations in either industry.

These are lofty goals but they contribute to preventing economic disaster and quelling a resurgent crisis.

The biggest concerns stem from watering down the derivatives regulatory provisions introduced in two bills. The Swap Execution Facility Clarification Act would preserve the ability of firms to conduct phone trades—as opposed to Commodities Futures Trading Commission’s (CFTC) rules pushing transparent price disclosure by market participants via a “centralized electronic screen”. The act would cut most derivative reforms regardless of how they are conducted. The second bill, the Swap Jurisdiction Certainty Act, prevents the CFTC and the SEC from regulating derivative trades by overseas subsidiaries of American companies—even if the regulators determine those trades threatened the stability of the U.S. economy. Combined, these two bills weaken much of DFA’s efforts to rein in dangerous derivatives.

“Transparency is critical and there needs to be a requisite infrastructure for a strong clearing mechanism.”
—Debashis Pradhan

The other concern is the industry response to the ambiguous Volcker Rule. Many believe that regulators will simplify the current act while instituting a two year implementation moratorium. This may be done by moving away from the detailed prescriptive rules to a broader measure leading to issues of interpretations.

Every large regulation despite its ambiguity and challenges also has pockets of opportunities for banks to capitalize upon. With DFA, the creation of a market for SWAP execution with transparent pricing and price discovery is a definite opportunity. Additionally, banks will institute stronger policies and procedures focusing on clients rather than themselves. This is a sea change from focusing on principal investments which contributed to revenues. The onerous reporting requirements of DFA to the multiple markets and a slew of new regulators will contribute to overall efficiency because of massive requirements on data availability, aggregation and collation. Finally, DFA forces banks to focus on risk & compliance and re-ignites proactive compliance.

CONCLUSION

Even if it’s diluted, DFA is here to stay. It is a fact that transparency is critical and there needs to be a requisite infrastructure for a strong clearing mechanism. Such a mechanism helps with aggregation of data to give a counterparty views on exposure and it helps regulators police for misuse. The path to a better and controlled marketplace with tighter risk measures, where the customer is king, and bailouts are not implemented again, is fraught with risks.

The biggest technical issues have been differentiating between proprietary trading and transactional hedging. A paper by Posner and Weyl et al, provides foundational work in distinguishing good speculation from bad.

There are political roadblocks as well. Repealing DFA has been the campaign rhetoric for Republican presidential candidates. Moreover, the regulators themselves have uncovered technical problems at this late hour and also struggle to finalize rules while avoiding unintended consequences. As the debate continues, the key question that comes to our mind is, “can political intent ensure that history does not repeat itself?” Is DFA a case of the regulators taking a step forward while Congress pushes three steps back? Can we really trust this Congress to make risk-taking less easy for the banks? The fact that we are still without effective regulation of credit derivatives after a severe financial crisis is an indicator that laying the path forward is not easy.