Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Five Years of Dodd-Frank — A Brief Assessment*

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At the five year point in the history of the Dodd Frank Act, much is being written about its successes and failures. While it is probably too early to make such judgments, to do so is irresistible. Here are my observations.

1. In some areas it was successful. For example, it gave the country a feeling that order had been restored, and satisfied at least part of the societal drive for retribution against large participants in the market. Citizens are generally confused and angry when the economy falters seriously, and have no real basis for blaming any particular person or action. It is frustrating. DFA and the speeches and comments it generated, were they by the media, legislators, regulators or blogs of thousands of relatively uninformed persons, let them satisfy the lust for blood that follows disorder, particularly since the target was large banks. Many still argue that the real criminals got away, but by and large, the worst of the bad guys no longer are in existence or have paid dearly for their missteps.

Capital and liquid assets in the system have been increased, and to an extent that is a positive result. Only time will tell whether liquidity in the system has been substantially hampered by the need to meet the new standards, or whether the capital itself has been mandated to be so large that it has reduced the energetic use of capital accounts to fuel the nation's economy.

Theoretically, the Act created an entity in FSOC that, if those involved could work well together, would scan the horizon for systemic risks and communicate those in a way that would permit the economy to avoid some of the larger dislocations that otherwise might occur. That could be very useful. So far, however, it is not clear that the Financial Stability Oversight Council has

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accomplished what its creators hoped for, and the placement of it in the "successful" category is limited to the idea, not the implementation of the idea. It may be that FSOC needs to be reconsidered to discover why a good idea just isn't working

2. In some areas it was neither completely successful nor completely unsuccessful. CFPB is probably the best example of that.

The Act established the Consumer Financial Protection Bureau to separate the regulation and supervision of the consumer protection laws from the prudential regulators and place them in a free standing agency independent of the control of any other agency. The Bureau has accepted that opportunity to focus exclusively on the consumer and to ensure that laws and regulations pertaining to consumers place consideration of the consumer before other entities in the process. They have successfully made the consumer the focus of their regulation and supervision to the exclusion, in some cases, of prudential practices. Parties dealing with consumers now realize that they must meet certain standards when doing so.

At the same time, the Bureau has had a tendency to utilize strong words in its speeches and press releases to stigmatize groups of industries and to make it clear that they would bring lawsuits to enforce their regulations and not work through the examination and non-litigative supervision process. One of the results of that, probably unintended, is that the Bureau has added a reputation risk to the other risks with which those entities must deal, in many cases so serious that the lenders have withdrawn from the market. In many cases the heightened risk has resulted in lenders in these transactions increasing the protections it needs in any transaction. Mortgage lenders, for example, have layered on a need for additional protection beyond that which would take them to the limits of the credit box that has been provided in the regulations. That, of course, reduces the number of persons that can get credit. It appears that the Bureau has misjudged the effect of the constant negative drumbeat, as it misjudged the actual credit limitations in the regulations as real barriers to lending.[1]

The Bureau also has evidenced what one might expect in a new agency — namely, a need to quickly staff up with persons that are as experienced as possible when many who would meet that standard are already gainfully and satisfactorily employed elsewhere...[2] Notwithstanding that many supervisory personnel transferred from the prudential regulators to CFPB, and therefore carried some institutional understanding of the industry to the Bureau, many of the new personnel do not fit into that category, and a number come from positions that have already adopted a point of view hostile to the lending industry. It is difficult to abandon biases that may have become deeply

[1] No one has successfully provided a major pool of lending to low credit rated customers outside the confines of the QM limitations, notwithstanding many speeches by Bureau officials that they would. It appears as though the officials actually believed that.

[2] An extraordinary example of this was the early practice, since discontinued, that the Bureau exercised in sending young lawyers on examinations in order to give them experience and exposure to the industry. Yet, in the scheme of things, lawyers and enforcement personnel are as important in the Bureau examination as field examiners.

ingrained, no matter how hard they might try to be objective and neutral in reviewing an issue. Finally, many of the groups being regulated are facing regulation for the first time, and neither they nor the regulators at the Bureau have experience regulating them or the customers and markets that they serve.

The decision by the CFPB to establish a fixed DTI ratio of 43% and to include a barrier of points and fees of 3% of the loan for qualification of a mortgage loan as a Qualified Mortgage did in fact strengthen the underwriting of mortgage loans generally.[3] As a result, the quality of mortgages made since that time will produce fewer defaults and less difficulty for most borrowers who obtained those mortgages. At the same time, it is said to have reduced the amount of credit available. The percentage of homeowners in the U.S. is dropping and is now at a level comparable to what it was in the period between the mid-1980s and the early 1990s. As part of that analysis, the homeownership rates for minorities is now lower than it was in 1995[4] and has plummeted both from an all-time high in 2004 and from the rate when DFA was passed.[5] Much of that is due to the tight QM standards and the penalties provided for violating the Ability to Repay rules, although it is not clear that the market itself would have financed the most risky loans even if the rules were less strict. Effectively, the only non-QM loans now being made are those to borrowers with substantial wealth and prior relationships with the lender, and some special purpose loans designed to meet CRA or other similar requirements.

3. <u>It has been unsuccessful in some areas</u>. It is hard to say which area has been the greatest disappointment.

One obvious candidate for that title would be the total lack of resolution of the housing enterprise problems. The GSEs structure and operation were one of the core reasons the housing sector and then the general economy collapsed. Nevertheless, Congress failed to resolve the problem in the Act. That is a major failure.

While the concept of the Office of Financial Research is an excellent one, it has not functioned well yet. Probably the most glaring disappointment has been the inability of that office to produce anything useful for the public to review. What are the systemic risks that we must avoid and how near are they to creating a downturn in our economy? There is no answer from the OFR. It may be that there is a treasure trove of information that has been created that helps the FSOC do its job. But that seems unlikely since there are substantial complaints about the job that the Council is doing. For an office that carries an $86 million a year price tag, the public should see some substantial results that it can review.

There are some others, generally in Title II of the Act, that should also be considered as

[3]The market had already made most of the adjustments required under QM by the time QM rules were promulgated. The QM rules, however, memorialized them.

[4]1995 47%; 1Q15 41.9%.

[5]2004 49.4%; 2010 45.4%

poor choices. The best example of spending someone else's money willingly is the Living Wills provisions. The Act required that important institutions (as defined by the Act) determine how their bankruptcy would be resolved at the least expense and trouble to the government at some time in the future based on economic conditions that are unstated. The concept is itself questionable, but large institutions spend millions of dollars trying to decipher the undisclosed thinking of the agencies as they work on their living wills.[6] Wouldn't the economy be better off if they spent the same time and resources trying to conduct their businesses profitably instead of trying to figure out how a third party should dispose of their parts if they fail? But the Act requires this exercise, which is extremely costly since the scenarios that should be considered are both unrealistic and not certain to satisfy the regulators as the correct ones for the institution to have analyzed. The chances that any specific scenario actually chosen and plotted against is remote, and all can only hope that the solutions suggested for those meet the problems encountered if there really is a break down in the institution in the future.

The Act was backward looking in that it tried to deal with issues created by the existing system for producing and delivering financial products. Those systems are rapidly becoming dated, yet the Act does nothing to address the complexities surrounding the new systems. Virtual currency and extensive use of peer to peer risk sharing are living parts of the current system only five years after the adoption of DFA. The explosion in IT promises even greater changes in the years ahead.

Finally, the Act takes what may turn out to be an unrealistic view of what really will happen if it looks as though the entire system is going to tank because of some unnoticed and uncontrolled risk coming to fruition. It has made major assistance from the lender of last resort nearly impossible, and has left the situation in the hands of a preplanned system for resolution. Who will trust that untried system when the result of it being inadequate is another Great Depression? Yet to do otherwise may now be impossible.

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[6] One large institution said it spent over $1 million in work hours annually to prepare the document.