

Point of View

The Dodd-Frank Act

What it does, what it means, and
what happens next

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After much partisan wrangling, the Dodd-Frank Wall Street Reform and Consumer Protection Act has been signed into law. It is the most significant change to US financial regulation since the New Deal. Regulators will gain new powers, financial firms will be subject to new demands, and every financial market will be affected.

Enactment of Dodd-Frank, though, marks only a new stage of financial reform, as the debate shifts to the rulemaking efforts of federal agencies. The complexity of the law and the many decisions delegated to regulators makes it difficult to predict which of the law's many provisions will come to be the most significant. Ultimately, it will be regulators who determine the true impact of the law.

What Dodd-Frank does

The bill that finally emerged from Congress is a compromise that allows most sides of the debate to take comfort. It is tougher on big banks than the House version first passed seven months ago but less punitive than what could have emerged, given the recent run of bad publicity for major financial firms. A number of harsher provisions were introduced but ultimately softened or excluded from the final bill.

Many of the law's provisions are aimed at large banks and other firms deemed to be systemically important. Headline banking-related provisions in the act include:

- **Oversight for systemic risk:** The bill establishes a council of regulators tasked with monitoring and managing systemic risks. Systemically important firms will be supervised by the Federal Reserve regardless of their legal charter, closing the regulatory gap that AIG fell into. The new Financial Stability Oversight Council and the Fed will have enhanced powers to regulate such firms' safety, size, and range of activities
- **Regulatory consolidation:** The Office of Thrift Supervision (OTS) will be eliminated, and its powers distributed among the Fed, the Office of the Comptroller of the Currency (OCC), and the FDIC
- **New resolution regime for too-big-to-fail firms:** In cases where a financial firm's failure would imperil financial stability, the law provides a legal mechanism outside of bankruptcy for the FDIC to take over the failing firm, sell off its assets, and impose losses on shareholders and creditors. The provision also mandates that the financial industry pay (after the fact) for the costs of any such

failure. The absence of this authority is part of what made the failures of Bear Stearns, Lehman Brothers, and AIG so unpredictable and troubling

- **Living wills:** The Fed and FDIC will require banks and other major financial firms to prepare resolution plans that try to map out how they could be safely wound down in the case of failure
- **Prudential standards:** Systemically important firms can be subject to higher standards, with wide discretion given to regulators. Capital requirements are to be countercyclical, and can include contingent capital instruments. The Fed has signaled its intent to implement new capital, leverage, and liquidity standards through the Basel III process, to the extent feasible
- **Collins amendment:** This set of provisions, favored by FDIC Chairman Bair, sets today's risk-based capital and leverage standards for insured depository institutions as a floor for future standards for bank holding companies and systemically important nonbanks. Importantly, these standards will apply to the intermediate holding company subsidiaries of foreign banking organizations. Trust preferred securities are no longer part of Tier 1 capital for larger banks
- **Concentration limit:** No bank or systemically important firm's consolidated liabilities can exceed 10% of the national total of such firms' liabilities. This falls well short of the break-up of the biggest firms many progressives called for, and may in fact be a less binding constraint than the existing 10% cap on a bank's national share of deposits
- **Risk governance:** Larger financial firms must have Board risk committees with at least one expert with risk management experience at a large, complex firm. (Retired risk officers can expect to begin receiving many offers to become board members – a job whose workload has gone up and desirability gone down)

Another major set of provisions affect consumer financial products, with significant implications for retail banks. These provisions include:

- **Consumer financial protection:** The bill establishes the Bureau of Consumer Financial Protection, a largely independent regulator housed within the Fed, to enforce existing rules and write new ones across all consumer products, regardless of what type of company offers them. States can become much greater participants in consumer protection, as they can enforce federal laws and are likely to face less federal preemption of state laws

- **Debit fees:** Debit transaction fees must be proportional to the cost of the service, according to standards set by the Fed. This will likely shrink this source of retail bank revenue considerably. Debit cards issued by small banks and prepaid reloadable cards (GPRs) are exempt from the rules, potentially making their products more profitable than those of the larger banks

Many other provisions address perceived failings of the capital markets, which include:

- **Derivatives regulation:** The bill places the largely unregulated OTC derivatives market under federal oversight, with supervision divided between the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Most derivatives will be required to be cleared through central clearing agencies. This is intended to reduce the build-up of enormous, highly interconnected, and often unfunded counterparty risk exposures, which during the crisis were a major transmission mechanism for systemic risk and a contributor to generalized panic conditions. The opaque swaps market will also operate under new light: trades must be publicly reported in real time with price and volume information. The law also makes swap dealers and “major swap participants” subject to new regulation of capital and margining, potentially affecting many hedge funds
- **Swaps pushout:** The bill effectively forces banks to spin off some of their swaps trading operations into separately capitalized affiliates. The original version of this provision was widely criticized; the final version has been tempered and will likely only “push out” a relatively small portion of swaps trading
- **Volcker rule:** The much-debated Volcker rule has two parts. The first bans banking entities from proprietary trading activities. Despite language in the act defining proprietary trading and explicitly allowing trading connected to market making and hedging, the actual effect of the ban will critically depend on regulators’ rule-making implementation. The second part of the Volcker rule limits banks’ investments in hedge funds or private equity funds to 3% of Tier 1 capital
- **Skin in the game on securitizations:** Issuers of securitized loan pools are required to retain 5% of the credit risk of the transaction. High quality mortgages will be exempted from retention requirements, and the requirement can be relaxed for certain other asset classes
- **Office of Financial Research:** A new and self-funded office within the Treasury is empowered to collect vast amounts of data

from financial firms. It is directed to collect individual financial transaction and position data from firms, including counterparties' identities and sufficient detail to enable independent valuation of positions. It is also charged with establishing standards for the scope and format of data collected both by itself and by other federal regulators

- **Regulation of private funds:** Private equity and hedge fund (but not venture capital) managers with more than \$150 MM of assets under management must register with the SEC. Larger funds face increased record keeping, filing, and examination requirements, and more funds will be subject to state regulation
- **Fiduciary duty:** After study, the SEC may at its discretion impose a fiduciary duty on broker-dealers and investment advisors providing investment advice to retail customers
- **Rating agencies:** The bill subjects rating agencies to significant oversight by the SEC, requires more transparency on the assumptions and methodologies behind ratings, and exposes rating agencies to increased legal liability. After study, the SEC can ban the issuer-pays business model for structured credit securities
- **Say on pay:** Shareholders get a non-binding vote on executive compensation. Board compensation committees must also be made up of independent directors

Insurance regulation is left relatively untouched. However, the bill does establish an Office of National Insurance, a federal group within the Treasury Department empowered to negotiate international insurance regulation agreements and to study national insurance issues.

What Dodd-Frank means – an initial evaluation

With appropriate humility, here are a few preliminary assessments of the impact of Dodd-Frank:

1. **Promotes a safer system.** The new law addresses many of the most glaring regulatory shortcomings. It reduces the potential costs of crises by providing at least the legal framework for taking over failing firms of systemic importance – though much is needed to make this practicable. It gives regulators broader powers and mandates higher prudential standards, which should reduce the risk of crisis occurring

2. **Some innovations may not work.** The law endorses several new tools that are untested. Only time will tell whether ideas such as countercyclical capital and living wills are useful or not in making the financial system safer. Some innovations may fail outright. For example, the popular notion of contingent capital requires finding investors who are willing to accept bond-like returns in good times (limiting upside) and equity-like exposure in bad times
3. **Will shift, but not fundamentally alter the industry's economics.** In the medium term, banks will face somewhat lower revenue and higher compliance costs. A few specific income sources will be more dramatically affected, such as debit interchange fees and proprietary trading. The level of acceptable leverage is likely to be permanently lower for most large institutions
4. **Extreme impacts on the broader economy from the law itself are unlikely.** Policymakers are left with a wide range of economic levers, including monetary policy, supervision of firms' risk taking and credit creation, and oversight of investment markets. By no means does the law force policymakers to accept permanently impaired economic growth. It will be up to policymakers to balance growth and safety with the tools available
5. **Unintended consequences are a real concern.** Some fears attached to the new law are overblown. Claims, for example, that the law will institutionalize taxpayer-funded bailouts are simply disingenuous. But the possibility of large and adverse unintended consequences is, as always, a real danger

What happens next

In many areas, the law marks the beginning of a new stage of regulatory reform rather than an endpoint. Many provisions will take effect only over months and years. Some major questions, such as the fate of Fannie Mae and Freddie Mac, are left to future lawmaking. More importantly, large parts of Dodd-Frank explicitly or implicitly depend on rulemaking by federal agencies, and much of the specific impact of the law will become clear only as regulators interpret and implement it. (Such rulemaking will doubtless be informed by the more than 60 studies the law requires federal agencies to undertake.) Critical issues – such as the level of new prudential standards and their applicability to large non-banks, the severity of the proprietary trading ban, and the scope of new consumer protection rules – are largely left to regulators' discretion.

Given that so much is up to regulators, how are they likely to proceed? There remains plenty of room for lobbying, now in the more private and technical forums of federal rule makers. For many issues, though, external lobbying will be less important than two competing forces among regulators themselves. First is the sincere desire, especially among senior policymakers, to effect meaningful, thoughtful, and progressive regulatory change. The crisis caused many within the agencies to rethink the priorities and processes of regulation, and has strengthened the hand of those most inclined to ask difficult questions, challenge the status quo, and try new ideas.

Set against this progressive force is the deep conservatism of the agencies themselves. The federal agencies that supervise banks and oversee capital markets are highly regimented and bureaucratic. Information, insight, and warning signs are often not acted on or shared without first being reviewed and approved at each level of the organizational hierarchy. Among different agencies, competing agendas can sometimes win out over close cooperation. New rules will of course be developed as required, but new attitudes and new ways of working will be harder to come by.

Ultimately, it will be up to the leadership of the major regulatory agencies to rise to the challenge of re-shaping their institutions, and thereby determine the lasting impact of financial regulatory reform.

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