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Statement of the Shadow Financial Regulatory Committee

Missed Opportunities in the Dodd-Frank Act

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Although Congress established the Financial Crisis Inquiry Commission to identify the causes of the financial crisis, it legislated reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act long before the Commission has concluded its hearings, much less written its report. As a result, Congress has failed to deal with many of the underlying causes of the crisis that the Commission is likely to identify. The Shadow Financial Regulatory Committee identifies some of these omissions below:

1. The Act fails to deal with Fannie Mae and Freddie Mac, which many people believe have been major contributors to the housing bubble that led to the crisis. They continue to bleed the taxpayers day by day, and forestall the resurrection of a sustainable private securitization market. Indeed, prospective homeowners have become more dependent on Fannie and Freddie than ever before.

2. Although regulators claimed to lack authority to deal with many of the problems, many of them before and during the crisis can be attributed to the unwillingness or inability of regulators to enforce existing laws. For example, prompt corrective action was dilatory at best and in several cases delayed as long as possible. Despite this pattern, no provisions have been included in the Act to establish incentives for regulators to enforce regulations more faithfully in the future or to be held accountable for failing to do so.

3. Despite the pronouncements of regulators and legislators, the Act has not put an end to the too-big-to fail problem. Indeed, it broadened it by permitting the authorities to extend the systemic risk exception to the creditors of a broader range of large financial institutions. Moreover, the process through which the systemic risk exception is applied generates uncertainty about which nonbank financial institutions will be granted the systemic risk exception and about which creditors may be saved. Both uncertainties increase the overall cost of capital for large financial firms.

4. The legislation also fails to deal with the excess complexity of large financial institutions that are the greatest concern from a systemic risk perspective. Indeed, the Act has multiplied affiliates at the largest institutions by forcing proprietary trading and some derivatives transactions into separate affiliates. It is possible that this increase in complexity could be remedied by wise application of an institution's own resolution plan (which is sometimes called a "living will"), but it remains to be seen how the idea will be implemented by the Fed and FDIC.

5. There has long been a logical disconnect between the supervision of the safety and soundness of large complex financial institutions and the resolution processes applied to them. Although such institutions are supervised on a consolidated basis, the bank is subject to resolution by the FDIC, while the holding company is subject to a judicial bankruptcy process. Although this approach has not caused major problems at smaller banks, it would demand enormous coordination between the two processes in the case of a large, complex bank in which the bank holding company and its non-bank subsidiaries each hold a substantial proportion of the group's assets. The Act failed to explore the possibility of resolving the banking group in the same way. Hopefully this will be considered in a mandated study to be undertaken by the Fed about making a new bankruptcy law more efficient for resolving financial institutions, but that is by no means clear.

6. Many of the financial regulatory agencies have overlapping and ill-defined authorities. Although the legislation did dispose of one agency, the Office of Thrift Supervision (OTS), the Financial Stability Oversight Council (FSOC) was added. The Council has 10 voting members, which include agencies that have no competency or experience with systemic risk and may have very narrow mandates and perspectives. In addition, several other agencies will be sitting in as observers. Thus it is unlikely that FSOC can move either as quickly or as decisively as may be necessary. The regulatory structure has also become even more complex and duplicative because of shared responsibilities. For example, the FDIC has created both a large bank holding company division and a consumer protection division.

7. Congress acted in the belief that the lack of consumer protection was a major cause of the crisis. But the new Consumer Financial Protection Bureau omits two of the three largest financial decisions most individuals make—auto lending and the purchases of securities. Both were granted exemptions from its purview.

The Shadow Committee hopes that when Congress receives the report of its Commission on the causes of the crisis and finally confronts the problem of Fannie Mae and Freddie Mac, it will address these and other omissions in the effort to ensure the stability of the financial system in the future