Thinking About Dodd-Frank Reform
February 6, 2017
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Recent statements from the Trump Administration regarding reform of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 have generated a number of questions from investors. Kroll Bond Rating Agency (KBRA) opined last November (“Will the CHOICE Act be the First Trump Reform Legislation?”) that our view of the likely reform agenda includes congressional passage of the Financial CHOICE Act sponsored by House Financial Services Committee Chairman Jeb Hensarling (R-TX). That view has not changed. However, the dynamic political environment has generated some specific reform proposals.

- **The Volcker Rule**: The Volcker Rule refers to the part of the Dodd-Frank Act originally proposed by former Federal Reserve Chairman Paul Volcker to restrict United States banks from making certain kinds of speculative investments for their own accounts. More important, the Volcker Rule addresses the conflict of interest that arises when a bank acts on behalf of a customer, on the one hand, and trades for its own account, on the other. KBRA believes that the basic goal of the Volcker Rule remains sound, but needs to be amended in two respects:
  - First, the administrative requirements of the Volcker Rule are byzantine and should be greatly simplified as part of a larger review of rules regarding liquidity and other Dodd-Frank and Basel III regulations. The process for implementing and reviewing compliance with the Volcker Rule is excessively complex, costly, and burdensome for banks.
  - Second, we believe for reasons related to market liquidity that the restrictions of the Volcker Rule should be confined to the depository and that affiliates of bank holding companies such as broker dealers and funds should be allowed to trade for their own accounts. Given adequate safeguards to isolate the depository from conflicts between the duty to the customer and the organization, allowing broker-dealers and other affiliates to trade for their own accounts will alleviate the market liquidity concerns that have existed since the Volcker Rule was implemented.

- **Non-bank SIFI Designation**: National Economic Council Director Gary Cohn, who is evolving into the Trump Administration’s point man for regulatory reform, has suggested modification to the Financial Stability Oversight Council’s (FSOC) authority to designate non-banks as systemically important financial institutions (SIFI), and to the Dodd-Frank Act’s Orderly Liquidation Authority (OLA). Cohn told the Wall Street Journal that both FSOC and the OLA would be reviewed. Perhaps most notably, Cohn stated: "We don’t think nonbanks should be SIFIs."

- CompassPoint LLC writes: “These comments reinforce our belief that the non-bank SIFI insurers—[Prudential, AIG, and MetLife]—will be de-designated and that the odds of additional non-bank SIFI designations in this administration are effectively zero.” KBRA agrees and believes that whether or not legislation is passed, the FSOC process is essentially moribund from today onward. Indeed, we expect that the litigation involving the SIFI designation of MetLife will likely be dropped by the Trump Treasury.
  - Regarding the OLA, we believe that as with the Volcker Rule, the big problem with the OLA is the overhead involved in compliance, including “living wills” and other onerous regulatory requirements. As KBRA has noted previously, the Federal Deposit Insurance Corporation is under no requirement to utilize living wills in resolving a large financial institution under Dodd-Frank. While the legal authority to take over a troubled financial institution is very important to avoiding a repeat of the Lehman Brothers debacle, the FDIC and other regulators should do any planning unilaterally and in private.

Perhaps the biggest change for all financial services companies and professionals in 2017 is that the political narrative regarding financial regulation has shifted from a punitive focus with anti-business effects to a more traditionally conservative agenda focused on growth and jobs. By easing the political headwinds against banks and non-banks alike, the Trump Administration can greatly improve liquidity in the financial markets and enhance the opportunities for economic growth.

An important point to make regarding the regulatory response to the 2008 crisis is that a lack of liquidity, not capital, was
the proximate cause of the catastrophe. Yet since 2008, regulators and policymakers have focused on increased capital for banks and restrictions on risk taking as a general panacea for preventing a future crisis. Many of these requirements have been accompanied by regulatory requirements such as those of the Volcker Rule and the FSOC SIFI designation that, in our view, fail to address the problems that spawned them.

In general, KBRA believes that modifications to the Dodd-Frank law that lessen the regulatory burden but address the underlying causes of the crisis will be positive for investors. Any changes to the current regulatory system need to de-emphasize the mechanistic use of capital as a catch-all response to the financial crisis and instead construct policies to prevent the reoccurrence of acts of financial deception, particularly the use of hidden leverage to enhance short-term financial returns, that ultimately caused the 2008 financial crisis to occur in the first place.

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