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Financial Regulation: A Primer on the Dodd-Frank Act

May 2011

Classroom Edition

An informative and accessible economic essay with a classroom application.

Includes the full version of the Liber8 Newsletter, *plus questions for students and an answer key for classroom use.*

Prepared by the Economic Education Group of the Federal Reserve Bank of St. Louis

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Economic Information Newsletter
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Financial Regulation: A Primer on the Dodd-Frank Act

May 2011

"Knowledge will forever govern ignorance, and a people who mean to be their own Governors must arm themselves with the power knowledge gives."
—James Madison

Last July, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 brought the most sweeping financial regulatory reform since the Great Depression. Created in response to the financial crisis of 2008, the Act will affect how financial institutions operate individually and interact with each other and their customers. Two key areas of focus in the Act are consumer protection and the risk posed to the overall financial system from activities of large financial institutions.

Financial services are usually provided by (i) banks (e.g., traditional commercial banks, savings and loans associations, and credit unions), which take deposits and make loans, or (ii) nonbank institutions (e.g., investment banks, hedge funds, and insurance companies), which do not take deposits but provide a variety of financial services such as mortgage loans. Historically, banks have been supervised by a variety of federal and state agencies. In contrast, there has been far less government oversight of nonbank institutions. The recent financial crisis had a severe impact on the financial condition of many of the largest U.S. financial institutions. Because of their size and interconnectedness, failure of one or more of these large companies could have caused a domino effect throughout the U.S. financial system and further weakened the U.S. economy. These institutions were considered *systemically important*—that is, "too big to fail"—and, consequently, some (e.g., AIG) were assisted by the Federal Reserve and the Treasury to prevent their failure. The need to identify and supervise such important institutions, as well as eliminate too big to fail, was an overriding reason for the Dodd-Frank Act.

In reviewing the causes of the financial crisis, it became apparent that regulators lacked some necessary tools required to manage an economy-wide crisis involving large *nonbank* financial institutions.[1] In this sense, the Act was intended to address these gaps in the authority and structure of regulators, which became evident during the mortgage crisis and ensuing financial instability.

One provision of the Act established the 15-member Financial Stability Oversight Council (FSOC) to identify systemically important institutions—those with the potential to cause another financial crisis. Bank holding companies with more than $50 billion are automatically classified as systematically important. Nonbank institutions may be deemed systematically important if the FSOC determines that they meet certain criteria. Firms with this distinction may require supervision by the Federal Reserve.[2] The FSOC also may recommend that the Fed strengthen particular standards on designated bank or nonbank institutions. For example, these institutions must now submit "living wills" outlining how they would resolve their affairs in the event of failure.[3]

Beyond the oversight of individual institutions, the FSOC will monitor financial markets for threats, identify gaps in regulation, advise governmental agencies and Congress, and suggest enhancements to regulatory

[1] Regulators were not completely without resources to deal with the financial crisis. For example, Section 13(3) of the Federal Reserve Act gives the Federal Reserve power in "unusual and exigent circumstances" to set up broad lending facilities if banks are unable to obtain credit through traditional channels. See Fettig, David. "The History of a Powerful Paragraph." Federal Reserve Bank of Minneapolis *Region*, June 2008.

[2] The Federal Reserve and the Office of the Comptroller of the Currency already regulate and supervise large banks.

[3] See Feldman, Ron J. "Forcing Financial Institution Change Through Credible Recovery/Resolution Plans: An Alternative to Plan-Now/Implement-Later Living Wills." Economic Policy Paper No. 10-2, Federal Reserve Bank of Minneapolis, May 2010.

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and supervisory standards. To help in this endeavor, the Act established the Office of Financial Research to gather the data and perform the analysis necessary for the FSOC to operate. The goal of these measures is to provide advance warning of potential financial market risks in order to avoid a crisis or at least minimize its severity.

The Act also includes provisions to minimize losses if a systemically important nonbank institution does fail—the government may now step in and "unwind" the institution in a way that minimizes the impact of its failure on the economy. According to Title II of the Act, the Federal Deposit Insurance Corporation (FDIC) has "orderly liquidation authority" to intervene when such financial institutions risk insolvency. Formerly the FDIC only had authority to manage the closing of banks. In order for the FDIC to act on this new authority, the FDIC, Federal Reserve, and Treasury must agree that a nonbank institution is in danger of failing. FDIC actions may include providing loans to the firm, selling or transferring the firm's assets and operations, or imposing losses on shareholders. This new authority preempts existing bankruptcy law and is intended to reduce the after-effects of failures on financial markets.

In order to improve safeguards for consumers, the Act established the Consumer Financial Protection Bureau (CFPB), an independent bureau housed within and funded by the Federal Reserve. Prior to the Act, responsibility for consumer protection was spread among several regulatory and law enforcement agencies. Many of these responsibilities now rest with the CFPB. The CFPB's primary focus will be consumer protection and education related to consumer financial products (e.g., mortgages and credit cards). Its activities will include the following: providing broad consumer education and individual counseling about financial products through the creation of the Office of Financial Literacy; investigating consumer complaints (accepted via a hotline and online); identifying risks to consumers from financial products; supervising consumer financial services offered by large financial institutions (with the exception of community banks[4]); and issuing rules to implement consumer financial law. The Bureau will also, for the first time, implement federal oversight of nonbank financial institutions such as payday lenders and check cashers.

The CFPB consumer protection rules will govern all banks, credit unions, and nonbank institutions offering consumer financial products. However, its role in supervision and enforcement will differ for banks according to their size. For large banks, it will be the primary examiner and will have the authority to enforce consumer financial rules. For smaller banks (those with less than $10 billion in assets), it may participate in examinations with these banks' current regulators but will not enforce any consumer financial rules because this authority will remain with their primary regulators. Overall, the CFPB will have broad authority in regulating and supervising the provision of consumer financial products and services.

Other provisions of the Act widely discussed in the media include the Durbin Amendment and the Volcker rule. The Durbin Amendment limits the *interchange fee*, which is the fee a business pays to a card issuer for each consumer transaction that uses a debit card. The new law requires that these fees, specifically those charged by card issuers with more than $10 billion in assets, be reasonable and proportional to the actual cost incurred by the card issuer. The Federal Reserve is required to establish criteria for the appropriate fees that may be charged. The Volcker rule limits banks from engaging in certain activities that are generally viewed as risky. Specifically, it limits the types of investments that banks may make and their relationships with hedge funds and private equity funds because of the risks these funds generally take.

The recent financial crisis highlighted weaknesses with the U.S. approach to financial regulation. The Dodd-Frank Wall Street Reform and Consumer Protection Act (more than 2,000 pages long) will result in roughly 250 new rules being written by federal agencies. Changes of this magnitude will have both intended and unintended consequences. Only in time will a clear picture emerge of its full effects on the broader economy.

—By Bryan J. Noeth, Research Associate

[4] Community banks are defined as those with less than $10 billion in total assets.

Recent Articles and Further Reading on Financial Regulatory Reform

"Rules and Regulations: How the Details Take Shape," by April McClellan-Copeland, Federal Reserve Bank of Cleveland *Forefront*, *2*(1), Winter 2011, pp. 6-9.

New regulations based on the 250+ rules in the Dodd-Frank Wall Street Reform and Consumer Protection Act will affect every aspect of the financial markets. This article briefly describes some of the key provisions of the Act and how new regulations take shape, which includes the opportunity for public input.

"Enhancing Financial Stability: The Case of Financial Market Utilities," by Anna L. Paulson and Kirstin Wells, Federal Reserve Bank of Chicago *Chicago Fed Letter*, No. 279, October 2010.

This article focuses on provisions in the Dodd-Frank Act that affect "financial market utilities," critical behind-the-scenes institutions, and arrangements that ensure the smooth functioning of financial markets.

"Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act," by the United States Senate Committee on Banking, Housing, and Urban Affairs, July 2010.

This article provides a short summary of the Act.

Free Resources

Resource: Dodd-Frank Act Regulatory Reform Rules
Description: This website will track from start to finish the ongoing progress of the proposals and rules being written by various federal agencies to implement the Dodd-Frank Act. It includes these categories: latest updates, open for comment (with directions for how to submit comments on rules to the proper agency), proposed (rules awaiting approval), interim final (rules having the full force and effect of the law but still under study), and final (rules approved).
Published by: Federal Reserve Bank of St. Louis
Location: http://stlouisfed.org/regreformrules/

Resource: Reforming the Nation's Financial System: A Timeline
Description: This website tracks U.S. financial regulatory reform from June 2009 to date and links to the text of the final legislation.
Published by: Federal Reserve Bank of St. Louis
Location: http://regtimeline.stlouisfed.org/

Resource: Regulatory Reform Acronym and Abbreviation Glossary
Description: Defines acronyms and abbreviations used in the Dodd-Frank Act.
Published by: Board of Governors of the Federal Reserve System
Location: http://www.federalreserve.gov/newsevents/reform_acronym.htm

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Federal Reserve Bank of St. Louis *Liber8*:
"Financial Regulation: A Primer on the Dodd-Frank Act"

After reading the article "Financial Regulation: A Primer on the Dodd-Frank Act," answer the following questions.

1. What is the Dodd-Frank Act?

2. What two key areas of focus are addressed by the Dodd-Frank Act?

- ____
- ____

3. Why were non-bank institutions assisted by the Federal Reserve and Treasury during the financial crisis?

4. Enter the specified information for each organization created by the Dodd-Frank Act.

Organization	Purpose	Responsibilities
Financial Stability Oversight Council (FSOC)		
Consumer Financial Protection Bureau (CFPB)		

5. What actions might the FDIC take if a systemically important institution is in danger of failing?

6. An interchange fee is the fee a business pays a card issuer for each customer transaction that uses a debit card. What does the Durbin Amendment specify about this fee?

7. What is the Volcker Rule?

Teacher's Guide

Federal Reserve Bank of St. Louis *Liber8*:
"Financial Regulation: A Primer on the Dodd-Frank Act"

After reading the article "Financial Regulation: A Primer on the Dodd-Frank Act," answer the following questions.

1. **What is the Dodd-Frank Act?**

   The Act, created in response to the financial crisis of 2008, is the most sweeping financial regulatory reform since the Great Depression. It will affect how financial institutions operate individually and interact with each other and their customers.

2. **What two key areas of focus are addressed by the Dodd-Frank Act?**
   - Consumer protection
   - Risk to the overall financial system from large financial institutions

3. **Why were non-bank institutions assisted by the Federal Reserve and Treasury during the financial crisis?**

   Because of their size and interconnectedness, their failure could have caused a domino effect throughout the U.S. financial system and further weakened the U.S. economy.

4. **Enter the specified information for each organization created by the Dodd-Frank Act.**

Organization	Purpose	Responsibilities
Financial Stability Oversight Council (FSOC)	To identify systemically important institutions	Determine whether firms need to be supervised by the Federal Reserve; recommend that the Federal Reserve strengthen standards; monitor financial markets for threats; identify gaps in regulation; advise governmental agencies and Congress; and suggest enhancements to regulatory and supervisory standards
Consumer Financial Protection Bureau (CFPB)	To provide consumer protection and education related to consumer financial products	Provide consumer education and counseling on financial products; investigate consumer complaints; identify risks to consumers on financial products; issue rules to implement consumer financial law; and implement federal oversight of nonbank institutions such as payday lenders and check cashers

5. **What actions might the FDIC take if a systemically important institution is in danger of failing?**

   It may provide loans to the firm, sell or transfer the firm's assets and operations, or impose losses on shareholders.

6. **An interchange fee is the fee a business pays a card issuer for each customer transaction that uses a debit card. What does the Durbin Amendment specify about this fee?**

   The amendment (i) requires the interchange fee to be reasonable and proportional to the actual cost incurred by the card issuer and (ii) requires the Federal Reserve to establish criteria for the appropriate fees that may be charged.

7. **What is the Volcker Rule?**

   The rule limits banks from engaging in certain activities that are generally viewed as risky. Specifically, it limits the types of investments that banks may make and their relationships with hedge funds and private equity funds because of the risks these funds generally take.

For Further Discussion

The issues of "too big to fail" and moral hazard have long been discussed in economics. Lead your students in a discussion of these topics using the following questions and notes.

- **Would trapeze artists do the same stunts if there were no "safety net" below them?**
  No. They are more willing to take risks with a safety net in place.
- **Consider driving. How might people with auto insurance with a low deductible drive differently from people with a high deductible? Why?**
  Because drivers with a low deductible don't have as much at risk—they will not bear the full cost of auto repair after an accident—they might not drive as carefully and possibly drive faster and make riskier driving moves. Drivers with a high deductible have more to lose—their own money.
- **If the deductible is low, who bears the majority of the cost of an accident?**
  The insurance company—more specifically, the people in the pool who pay premiums.

Economists say that moral hazard occurs when a party insulated from risk behaves differently than when fully exposed to the risk.

- **How, then, might low car insurance deductibles create moral hazard?**
  People might be less careful than they otherwise would be and ultimately have more accidents.

Financial Institutions are considered systemically important if their failure would cause devastating effects for the entire financial system. For example, because banks are often financially intertwined, letting a systemically important bank fail might cause the failure of other banks. This could lead to a financial crisis and cause the entire economy to suffer. In this case, the benefits of saving the institution might outweigh the costs to the overall economy of letting it fail. These banks are sometimes labeled "too big to fail."

- **If I told you on the first day of class that you were a "systemically important" group of students and that you *would not* be allowed to fail, what might that imply?**
  It might imply that (i) even if your academic performance was below standard, you would not be allowed to fail, (ii) you might be given extra help, or (iii) lower standards might be set if you were having trouble.
- **If you knew you would not be allowed to fail, how might your behavior change?**
  You might be less likely to attend class, do homework, and study for tests.
- **How might the students not considered "systemically important"—those that *would* be allowed to fail—feel about the situation?**
  They would likely feel the system is unfair because they alone would be responsible for their success or failure and perhaps have to work harder and in general feel that you have it easier. Too, they might fear they would not receive needed help because they weren't deemed important enough.

Just as it might be for students, defining an institution as systemically important—or too big to fail—could lead the institution to believe that if it's in danger of failing, it *would* be bailed out—that it would not be *allowed* to fail. This knowledge could cause the institution to take more risks than it would otherwise. The Dodd-Frank Act attempts to address this potential moral hazard by, among other things, supervising institutions more closely, reducing the risks institutions are allowed to take, and requiring "living wills" that allow them to fail without causing major disruption to the financial system. Also, it gives the FDIC authority to oversee their "orderly liquidation" if failure is imminent. That is, financial firms *would* be allowed to fail, but in a manner than poses fewer threats to the broader economy.