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Written Testimony of

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"The Dodd-Frank Act's Effects on Financial Services Competition"

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Witness Background Statement

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Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

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Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony, and he is not testifying on behalf of any organization.

Mr. Chairman Goodlatte, Ranking Member Watt, Members of the Subcommittee:

Good afternoon. Thank you for inviting me to testify at this hearing. While the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has affected financial services competition in a number of ways, I am confining my prepared remarks to two issues:

(1) the impact of the continued existence of too-big-to-fail (TBTF) financial institutions on competition in the financial services industry, and

(2) the impact of the Dodd-Frank Act's regulatory burdens on smaller financial institutions' ability to compete.

I. Too-Big-To-Fail and Competition in Financial Services

The TBTF long pre-dates the Dodd-Frank Act. The Dodd-Frank Act is a first step in addressing the TBTF problem. The Dodd-Frank Act's approach to the TBTF problem is to identify systemically important financial institutions (SIFIs), and then subject them to increased regulatory scrutiny. Critically, this identification does not make financial institutions systemically important; instead, it is a recognition of a pre-existing reality.

The goal of the increased regulation of SIFIs is two-fold. First, it aims to ensure that there is better regulation of the financial institutions that pose the most risk. And second, increased regulation of SIFIs may ultimately discourage financial institutions from being TBTF by counterbalancing the funding benefits of being TBTF with increased regulatory costs. This is a conceptually sound approach that should have the collateral effect of leveling the competitive playing field between SIFIs and smaller financial institutions.

A. The Too-Big-To-Fail Problem

TBTF is a major problem for financial regulation in at least three distinct ways. First, the existence of TBTF financial institutions makes our economy vulnerable to the mismanagement of private firms that are capable of losing billions of dollars from a single miscalculation. The recent trading losses at JPMorgan Chase illustrate how even a bank that is supposedly well-run can lose a tremendous amount of money very rapidly.[1]

Second, the knowledge that TBTF institutions will be bailed out by the government if they run into trouble encourages these institutions to take greater risks. The upside of these risks is privatized, while the downside is socialized, creating a "heads I win, tails you lose" situation that encourages excessive risk-taking.

Third, TBTF institutions have competitive advantage over small financial institutions by virtue of their functional guarantee from the United States government. This guarantee makes TBTF institutions more credit-worthy and thus lowers their cost of funding. This means that TBTF institutions can pay lower interest rates or post less collateral than their smaller brethren. TBTF institutions receive this implicit guarantee from the United States government without paying any premium for it. In other words, TBTF institutions are unofficially subsidized by the

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[1] *See, e.g.*, Steve Schaefer, *JPMorgan's London Whale Losses Could Hit $9 billion, Bank's Shares Slump*, FORBES.COM, June 28, 2012, *at* http://www.forbes.com/sites/steveschaefer/2012/06/28/jpmorgans-london-whale-losses-may-hit-9b-impact-earnings-and-capital-return/.

federal government. The result is a distinct competitive advantage over smaller institutions. It is estimated that in 2008 this advantage was nearly $84 billion.[2]

B. Dodd-Frank Act and the TBTF Problem

The Dodd-Frank Act attempts to address the TBTF problem by identifying systemically important institutions and imposing greater regulatory scrutiny and costs on them. At the least, this approach should mean that the Federal government is better able to regulate the risks taken by systemically important institutions, and at best, it will discourage bigness (by which I mean systemic importance, not necessarily asset size) by making it too costly.

The Dodd-Frank Act focuses primarily on holding company level regulation. The Federal Reserve Board already regulated all bank holding companies before Dodd-Frank. Dodd-Frank gives the Federal Reserve Board regulatory authority over those nonbank financial holding companies and their subsidiaries designated as systemically important ("designated nonbanks") by a 2/3-majority vote of the newly created Financial Stability Oversight Council (FSOC), including the affirmative vote of the Treasury Secretary as FSOC Chairperson.[3] To date, the FSOC has not designated any firms as systemically important; it has only published a final rule detailing how it will determine such a designation.[4]

The Dodd-Frank Act subjects designated nonbanks and large bank holding companies—those with total consolidated assets of over $50 billion—to heightened regulatory requirements.[5] The Act requires the Federal Reserve Board to "establish prudential standards for [these entities] that…are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States".[6] These more stringent prudential standards are required to include risk-based capital requirements (with inclusion of off-balance sheet exposures), leverage limits, liquidity requirements, overall risk management requirements, development of resolution plans ("living wills"), credit exposure report requirements, and concentration limits.[7] They may also include contingent capital requirements, enhanced public disclosures, and short-term debt limits, or other requirements the Federal Reserve Board believes are appropriate.[8] All of this will have the effect of increasing regulatory costs for TBTF firms.

Final rules under the heightened regulatory requirements provision have not yet been promulgated. The Federal Reserve Board has proposed a set of standards based on the Basel III capital accord and the recommendations of the Basel Committee of Bank Supervisors that includes a 100-350 basis point capital surcharge comprised solely of common equity for

[2] Deniz Anginer & A. Joseph Warburton, *The End of Market Disicpline? Investor Expectations of Implicit State Guarantees*, Nov. 2011, *at* http://ssrn.com/abstract=1961656 at 33.

[3] Dodd-Frank Act § 113, *codified at* 12 U.S.C. § 5323.

[4] Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 et seq., *codified at* 12 C.F.R. § 1310, April 11, 2012.

[5] The Dodd-Frank Act also requires heightened regulation of Systemically Important Financial Market Utilities (SIFMUs), such as clearinghouses and exchanges, and payment, clearing, and settlement activities. Dodd-Frank Act, §§ 804-810, *codified at* 12 U.S.C. §§ 5463-69.

[6] Dodd-Frank Act, § 165, *codified at* 12 U.S.C. § 5365.

[7] Dodd-Frank Act, § 165(b)(1), *codified at* 12 U.S.C. § 5365(b)(1).

[8] Dodd-Frank Act, § 165(b)(2), *codified at* 12 U.S.C. § 5365(b)(2).

designated nonbanks and bank holding companies with over $50 billion in consolidated assets.[9] Additionally, large bank holding companies and designated nonbanks are subject to an assessment to cover the costs of the Financial Research Fund.[10]

The Dodd-Frank Act's approach to TBTF is not the one I myself would have counseled; I continue to urge more direct action, specifically breaking up some of the TBTF institutions. Yet the Dodd-Frank Act may well achieve this result through its own methods, depending on whether TBTF institutions are subjected to sufficient additional regulatory burdens so as to deprive them of the benefits of bigness.

Some commentators have criticized the Dodd-Frank Act's approach as unworkable because regulators are unlikely to exactly balance regulatory costs with the TBTF funding benefits.[11] The result, these commentators claim, will either be that regulatory costs are too low, so SIFIs will continue to enjoy a TBTF funding advantage or too high, thereby resulting in the failure of SIFIs.

These commentators misconstrue Dodd-Frank's approach to TBTF. The goal of Dodd-Frank is not to balance out the TBTF funding advantage with increased regulatory costs. Such a balance would be impractical to achieve, but more importantly, it would produce the wrong equilibrium because it would not account for the systemic externalities created by TBTF institutions. Merely balancing out funding advantages with regulatory costs only negates the advantage of being TBTF to the SIFI. While this may help level the competitive playing field with smaller institutions, it does not compensate for the costs the SIFI imposes on the economy and political system by being TBTF. The primary purpose of the SIFI designation is to identify, regulate, and discourage systemic risk; leveling the competitive playing field is a collateral benefit.

Ideally, then, the Dodd-Frank Act's regulatory costs should *overwhelm*, not balance the funding advantage of being TBTF. Doing so would make being TBTF unprofitable; SIFI regulation, if done right, will impose a competitive *disadvantage* on TBTF firms. This would not result in the immediate failure of TBTF firms. Instead, their investors would demand that the TBTF be broken up. We would see spin-offs of different business lines until none of the spun-off firms would be TBTF and thus subject to SIFI regulation. In short, Dodd-Frank aims to make the whole of TBTF firms less profitable than the sum of their parts.

There is, of course, the possibility that regulators will not apply the SIFI designation and hence SIFI regulation correctly. There is the possibility of both Type I (false positive) and Type II (false negative) errors. Some entities that are not in fact systemically important could be labeled as SIFIs and subjected to greater regulatory costs, while some entities that are systemically important might escape SIFI designation and enjoy the benefits of being TBTF without incurring the regulatory costs.

While we should recognize the possibility of these errors in regulatory application, they are not a reason to shy away from this regulatory approach. Type I and Type II errors are inherent in any kind of regulatory selection process, and failure to regulate is guaranteed to result in Type II errors, as we know there are systemically important firms. Put another way, although

[9] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, Jan. 5, 2012.

[10] 77 Fed. Reg. 29884-29895, *codified at* 31 C.F.R. § 150, May 21, 2012.

[11] *See, e.g.*, Peter J. Wallison, *Dodd-Frank's Too-Big-To-Fail Dystopia*, WALL ST. J., May 23, 2012.

the Dodd-Frank Act's approach to SIFIs is conceptually sound; we can only hope that its implementation will be too, but it is too early to reach conclusions about implementation.

II. Regulatory Burdens

The Dodd-Frank Act unquestionably increases regulatory burdens throughout the financial services industry, and these burdens may be harder for smaller institutions to absorb because they lack economies of scale for compliance purposes. Nonetheless, it is important not to overstate the regulatory costs created for small institutions by Dodd-Frank.

Often commentators concerned about the Dodd-Frank Act's regulatory costs point to sheer number of pages of the Dodd-Frank Act or the number of regulations required to be passed thereunder. These figures are grossly misleading, however, as most of the Dodd-Frank Act has little if any relation to the activities of smaller financial institutions. Thirteen of the Act's sixteen titles have little or no bearing on small banks and credit unions (collectively "small banks").[12] Only three titles, titles VI, X, and XIV, are likely to bear on small banks. Yet there is little in these titles that has increased small banks' regulatory burdens, and in some cases the Dodd-Frank Act could actually help to *decrease* these burdens.

Title VI of Dodd-Frank makes changes to the regulation of bank holding companies. By and large these changes are incremental; they do not add major new compliance costs. Instead, title VI does things like expand the limitation on loans to insiders to include derivative transactions that may be economically equivalent to a loan exposure.[13] While there is some increased compliance cost to determining if a derivative transaction with an insider qualifies, this is not a likely scenario for small banks.

Title X of Dodd-Frank creates the Consumer Financial Protection Bureau (CFPB). While the CFPB has been the focus of a great deal of angst from the financial services industry, it has not materialized as the boogeyman that was feared. To date, the CFPB has not undertaken any action that would warrant alarm except from those opposed to consumer protection as an ideological matter. The most immediate impact of the creation of the CFPB is to level the regulatory playing field between depositaries and nonbanks engaged in consumer finance. Nonbanks are now subject to the same regulator and must undergo examinations like banks. The very existence of the CFPB is a boon for community banks and credit unions vis-à-vis nonbank finance companies.

Beyond this, CFPB has had little effect on small banks thus far. First, the CFPB does not have examination authority over small banks.[14] That authority remains with the small banks' prudential regulators. Second, other than a rulemaking on remittances required by Dodd-Frank,[15] the CFPB has not yet engaged in a rulemaking under any new power created by Dodd-Frank. All other CFPB rulemaking activity has been under *pre-existing* federal consumer protection laws that were merely transferred to CFPB as part of Dodd-Frank. Therefore, it is

[12] These thirteen titles are titles I (financial stability), II (orderly liquidation authority), III (changes to bank regulators), IV (investment advisors for hedge funds), V (insurance), VII (swaps), VIII (clearinghouses), IX (securities investor protection), XI (Federal Reserve system changes), XII (authorizing grants for experimental small dollar loan programs) XIII (TARP fund repayment), XV (miscellaneous issues like conflicts minerals), and XVI (section 1256 contracts).

[13] Dodd-Frank Act § 611, *codified at* 12 U.S.C. §1828(y).

[14] Dodd-Frank Act § 1026, *codified at* 12 U.S.C. § 5516.

[15] Dodd-Frank Act § 1073, *codified at* 15 U.S.C. § 1693o-1.

hard to point to Dodd-Frank as having already created additional regulatory burdens for small banks via the CFPB, with one exception: section 1071's requirement that the CFPB collect data on small business loans, to facilitate the application of the Equal Credit Opportunity Act, particularly to protect women-owned and minority-owned small businesses from discriminatory lending.[16]

Section 1071 requires all financial institutions that make loans to obtain and record some very basic information about a borrower and to keep it separate from the loan underwriting process: the date of the loan application, the type and purpose of the loan being applied for, the amount of credit applied for and approved, the bank's action on the loan (grant, deny, etc.), the census tract of the residence of the applicant's principal place of business[17], the applicant's gross annual income in the preceding year, and the applicant's race, sex, and ethnicity. This is less than a page of information to be requested from a borrower. Obtaining this information, recording it into an electronic record, and storing that record so that it cannot be accessed by the loan's underwriters involves some minor initial costs and then *de minimis* on-going compliance costs.

Thus far the creation of the CFPB has resulted in minimal regulatory costs for financial institutions, and the CFPB is structured to be particularly solicitous of the concerns of small financial institutions. The CFPB, unlike other federal financial regulators, is required to submit its rulemakings to small business panels for preliminary review under the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA).[18] The SBREFA process mandates that the CFPB solicit input from small businesses on its major rulemakings and account for their feedback. This process gives small financial institutions a greater voice in the regulatory process than they have had before.

If and when the CFPB starts to use its Dodd-Frank rulemaking powers other than under the "enumerated consumer laws" transferred to the agency, this situation may change, but until that point, it is premature to point to title X or the CFPB as a source of increased regulatory burdens. So far, however, the transfer of existing federal laws to the CFPB is likely to reduce, rather than increase regulatory burdens as the result of rulemaking activity.

Finally, title XIV of the Dodd-Frank Act, the Mortgage Reform and Anti-Predatory Lending Act, creates a range of new requirements for mortgage lending. The CFPB has been charged with implementing title XIV via regulations. To date the CFPB has not promulgated any regulations under title XIV.

Most of the prohibitions in title XIV have limited impact on small banks; the prohibitions are aimed at the most exotic and aggressive mortgage products, namely those that fueled the housing bubble. These products were not generally part of small depositaries' offerings. (They were frequently offered by small finance companies.)

Title XIV actually offers an opening for *reducing* compliance costs for small banks. A major pre-Dodd-Frank Act compliance cost for small banks was the Reg Z escrow requirement

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[16] Dodd-Frank Act § 1071, *codified at* 15 U.S.C. § 1691o-2.

[17] Census tract conversion is fairly simple, as the Federal Financial Institutions Examination Council's website enables free conversion of street addresses to census tracts. *See* http://www.ffiec.gov/Geocode/default.aspx.

[18] 5 U.S.C. § 609(d).

for high-cost Home Ownership and Equity Protection Act of 1994 (HOEPA) loans.[19] In July 2008, the Federal Reserve promulgated its first rulemaking under HOEPA. The rulemaking required that borrowers have the ability to repay, prohibiting some prepayment penalties, and requiring escrowing of taxes and insurance.[20] The escrow provision did not go into effect until April 2010, in response to community bank concerns about the difficulties and costs in setting up escrows.[21]

The reach of the escrow requirement is quite broad in a low interest rate environment. Higher priced loans are currently defined as those with APRs at least 1.5 percentage points higher than the prime rate for loans within the GSE conforming loan limit or at least 2.5 percentage points higher than the prime rate for loans larger than the conforming loan limit.[22]

Section 1461 of the Dodd-Frank Act authorizes the CFPB to exempt small originators or those in rural and underserved areas from escrow requirements.[23] While an understanding of the particular cost problems involved in escrowing would seem essential to any rulemaking,[24] it seems reasonable for the CFPB to exercise its authority to exempt some depositaries from the escrow requirement. The CFPB has not yet passed regulations under title XIV or on HOEPA loans, but it is important to recognize that CFPB regulatory action can *decrease* as well as increase regulatory burdens.

While many small banks and credit unions believe that their regulatory burden is too great, it has little to do with the Dodd-Frank Act. Therefore, concerns about the regulatory burdens on small banks do not provide a good justification for altering or repealing provisions of the Dodd-Frank Act. If there is a problem with the burdens created by specific regulations, then by all means, we should reexamine those regulations and decide if they make sense, but they do not provide a basis for a general assault on Dodd-Frank.

<u>CONCLUSION</u>

The Dodd-Frank Act focuses primarily on financial stability, not competitive equality among financial institutions. Nonetheless, it is likely to improve competitive fairness in the financial services market place. It helps level the playing field between large and small institutions by imposing regulatory costs on TBTF firms that will help offset their funding advantage from their implicit government guarantee. Moreover, the creation of the CFPB means that banks and nonbanks will be subject to the same regulations, including examinations, in consumer finance, and the SBREFA process ensures that small businesses voices will be heard in the regulatory process. To be sure, any general regulatory costs imposed by Dodd-Frank are likely to be harder for smaller institutions to absorb, but overall, it would seem that the Dodd-Frank Act helps level the playing field between large and small financial institutions.

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[19] 12 C.F.R. § 226.35(b)(3).

[20] 73 Fed. Reg. 44522-44614 (July 30, 2008). If the Federal Reserve Board had acted on its regulatory authority between 1994 and 2008 rather than deliberately refraining from regulation because of an ideological antipathy toward regulation, the housing bubble and ensuring financial crisis would have been much less severe.

[21] 73 Fed. Reg. 44562 (July 30, 2008).

[22] 15 U.S.C. § 1639d(b)(3)(A)-(B).

[23] Dodd-Frank Act § 1461, *codified at* 15 U.S.C. § 1639d(c).

[24] In the original HOEPA rulemaking, the Federal Reserve Board noted that "A few small lenders commented that the costs of setting up escrow accounts are prohibitively expensive but did not disclose what such costs are." 73 Fed. Reg. 44597 (July 30, 2008). Fact-based rulemaking requires a close analytic look at regulatory costs, rather than blithe acceptance of statements of interested parties.