



Dodd-Frank Financial Reform After Two Years

5 Successes and 5 Things That Will Make Our Markets Stronger

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July 20, 2012

Introduction

Strong and stable capital markets are critical to America's economic success. The U.S. financial sector is the largest in the world and is one of the pillars of our economy. But the 2008 financial crisis also laid bare weaknesses in the sector—weaknesses that had severe consequences for American workers and their families. Millions of Americans lost their jobs and \$17 trillion in household wealth was destroyed.¹ On a more personal scale, the average net worth for American households dropped from \$126,400 in 2007 to \$77,300 in 2010 after the financial crisis,² wiping out almost two decades of gains and dramatically weakening the middle class that is so crucial to economic growth.

Two years ago this week, in response to the financial crisis, Congress passed landmark reform to strengthen the U.S. financial sector and protect taxpayers from a repeat of the 2008 crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act was the most sweeping legislative reform in the financial sector since the passage of President Franklin D. Roosevelt's suite of reforms in the 1930s. But passing Dodd-Frank through Congress was simply the first step in a process of shoring up the financial system that continues to this day, with critical decisions still to come in the months and years ahead, both to implement this key law, and also to ensure the financial sector is serving the economy.

Dodd-Frank gave regulators key new tools and a mandate to do a difficult job. Part of the challenge is technical: to use those tools, regulators must create and implement specific rules designed to make markets safer, keep our companies competitive, and protect U.S. taxpayers and consumers. But part of the challenge is also political: ensuring that opponents who have sought to weaken and delay key measures do not ultimately shelve progress.

Two years after President Barack Obama signed Dodd-Frank into law, we have seen some notable successes. Our financial markets are stronger than they were before the

crisis, and Americans can count on better consumer finance protection in their day-to-day interactions with financial services institutions.

This issue brief presents five concrete ways that our financial markets are stronger today than two years ago alongside five concrete things that can be done to make them even stronger. Specifically, here are five ways financial reform has strengthened our markets:

- A consumer watchdog is now on the beat.
- Every financial institution now must play by the rules.
- Increased capital requirements are now in place.
- A new resolution authority for failing financial institutions now exists.
- New rules will help rein in executive compensation.

Yet we also know that in any task this big there is still more to be done. While this is not an exhaustive list, here are five concrete things that can be done to make our markets even stronger:

- Implement the Volcker Rule to protect taxpayers from excessive risk-taking by financial institutions.
- Finalize derivatives reform to protect our markets from overspeculation in this hundred-trillion-dollar market.
- Ensure financial regulators have the resources to protect taxpayers by adequately funding the Commodity Futures Trading Commission.
- Hold the line on mortgage origination and securitization to protect homeowners, investors and taxpayers.
- Continue to ensure coordinated global financial reform and strong international minimum capital standards are enacted.

So let's delve into the details of Dodd-Frank two years on with much still to accomplish.

Five ways financial reform has strengthened our markets

A consumer watchdog is now on the beat

"If we had had this agency six years ago, eight years ago, we would not be in the mess we are today."

—Elizabeth Warren, testifying before House Financial Services subcommittee,
March 16, 2011³

Perhaps the most visible and immediate result of the Dodd-Frank Act has been the establishment of the Consumer Financial Protection Bureau, which was created to protect con-

sumers from confusing, and sometimes deceptive, financial products and lending practices that contributed to the collapse of the financial markets. Prior to the bureau's creation, the federal government's authority to write and implement rules aimed at protecting consumers had been dispersed between states and several different federal agencies. Not surprisingly, consumer protection was often a relatively low priority for these regulators, who were charged with monitoring a wide range of financial activities.

The bureau has broad authority to oversee financial products and services, including credit cards, mortgages, payday lenders, private student loans, and credit-reporting agencies. Since the appointment of Richard Cordray as the head of the bureau in early 2012, the Consumer Financial Protection Bureau has assumed its full rulemaking and oversight authority and has already starting to do its important work.⁴

Earlier this week, the new consumer protection agency announced its first public enforcement action with an order requiring Capital One Financial Corp. to refund approximately \$140 million to 2 million customers and pay an additional \$25 million penalty for allowing vendors to pressure or mislead consumers into paying for “add-on products” such as payment protection and credit monitoring when they activated their credit cards.⁵ Cordray said, “We are putting companies on notice that these deceptive practices are against the law and will not be tolerated.”⁶

Promoting financial education is also part of the bureau's work. One of its first initiatives was designed to make sure that people taking out mortgages know what they are getting into. In the years leading up to the 2008 financial collapse, too many Americans didn't fully understand the terms of their mortgages, which contributed to increased foreclosures and the housing market collapse. In the “Know Before You Owe” initiative, the bureau recently proposed redesigning the federal mortgage form to make it easier for consumers to understand their anticipated interest rates, monthly payments, loan amounts, and closing costs.⁷

Through practical measures to protect consumers, the Consumer Financial Protection Bureau can have a real and lasting impact on the long-term financial health of our economy.

Every financial institution now must play by the rules

“Before Dodd-Frank, major financial firms were essentially regulated by what they called themselves rather than what they did, with the legal name often determining regulation by the least stringent supervisory agency or no supervision at all.”

—Michael Barr, former assistant secretary of the Treasury for financial institutions⁸

One of the biggest contributing factors to the financial crisis of 2008 was that in the run-up to the crisis the activities of a large number of financial services firms that weren't banks went largely unchecked. These so-called nonbanks or nonbank financial institutions range in

size from small entities, such as payday lenders or check cashing outlets, to massive “too big to fail” institutions, such as Wall Street investment banks and global insurance companies.

With the collapse of large nonbanks such as American International Group, Inc. and Lehman Brothers, it became clear that these firms needed much better regulation to keep them from dragging down the economy. Similarly, in the wake of the financial crisis it became abundantly clear that some small mortgage-finance brokerages were abusing prudential underwriting practices and placing many homebuyers in expensive and unsustainable loans.⁹

Dodd-Frank created the Financial Stability Oversight Council to monitor systemic risk in the financial system and coordinate several federal financial regulators. The council is empowered to identify “systemically important” bank and nonbank financial institutions, the failure of which might pose a risk to the U.S. economy. These institutions are subject to centralized regulatory oversight by the Federal Reserve, which is authorized to implement checks including limits on the amount of debt they can carry, enhanced capital standards to boost the amount of equity capital they hold, and restrictions from certain type of risky activities.

The Financial Stability Oversight Council issued its final rule on systemically important financial institutions in April 2012. Nonbank financial institutions will be designated “systemically important” if they have total assets of more than \$50 billion and meet one of five thresholds relating to credit default swaps, outstanding debt, derivatives, leverage ratio, and short-term debt.¹⁰ In July 2012, the council designated eight financial clearinghouses as systemically important.¹¹ These so-called financial market utilities are the first phase; it is expected that another three to four large nonbank financial institutions will be designated before the end of 2012.¹²

In the area of consumer financial products, small nonbanks were also largely outside of strong regulatory scrutiny. In January 2012 the Consumer Finance Protection Bureau took over the supervision of smaller nonbank companies that provide consumer financial products or services, including mortgage brokers and payday loan companies.¹³ By requiring the bureau to examine nonbanks, Dodd-Frank helps ensure that consumers get the benefit of federal consumer financial laws on a consistent basis.

Increased capital requirements are now in place

“The longer I taught and wrote in the area of financial regulation, the more convinced I became of the centrality of strong capital standards to a sound financial system.”

—Federal Reserve Governor Dan Tarullo, June 6, 2012¹⁴

Capital requirements are designed to decrease the probability of a financial institution failing by determining the type of capital they need to hold in reserve. Generally, these

requirements increase the use of equity (stocks) as a funding source for financial firms, so that if a firm gets into difficulties it is the shareholders and not the taxpayers that pick up the bill. But the 2008 financial crisis exposed the inadequacy of existing capital regulations as many financial institutions were vastly overleveraged and therefore unable to withstand financial distress. When Lehman Brothers failed, it had \$1 in equity for every \$30 it was borrowing.¹⁵

Dodd-Frank has not only directed regulators to increase minimum-capital requirements, but has also placed greater emphasis on the types of capital that qualify. Bank holding companies and nonbank financial institutions with assets of at least \$50 billion are now subject to greater regulatory oversight by the Federal Reserve, which can impose additional capital requirements on these institutions. The Federal Reserve is in the process of adopting rules, agreed at the global level, to further raise capital over the coming years.

Dodd-Frank also mandated the Federal Reserve to carry out annual stress tests on all banks with \$50 billion or more to determine if they have the capital needed to absorb losses under various scenarios. The Federal Reserve has carried out three stress tests so far, with the latest results in March 2012 showing that 15 of the 19 largest financial firms operating in the United States have enough capital to withstand a severe recession.¹⁶ This reflected a significant increase in capital since the 2009 test, when 10 of the banks were found to have insufficient capital to withstand another crisis.¹⁷

Increased capital requirements and stress testing help make our financial system more resilient to economic shocks and future financial crises. This is critically important given continued financial market problems in Europe, which have created uncertainty and volatility in global markets.

A new resolution authority for failing financial institutions now exists

“In summary, the measures authorized under the Dodd-Frank Act to create a new, more effective SIFI [systemically Important Financial institutions] resolution authority will go far toward reducing leverage and risk-taking in our financial system by subjecting every financial institution, no matter its size or degree of interconnectedness, to the discipline of the marketplace.”

—Sheila C. Bair, former chair of the FDIC, testimony before the House Subcommittee on Financial Institutions and Consumer Credit, May 26, 2011¹⁸

The collapse of Lehman Brothers and the near collapse of global insurer American International Group and Wall Street investment bank Bear Sterns highlighted the need for a resolution process that would allow the wind-down of systemically important nonbank financial institutions without the need for taxpayer backed bailouts. The new resolution authority rules mandated in Dodd-Frank attempt to end this problem of “too

big to fail” and ensure U.S. taxpayers will no longer be asked to bail out failing banks and other nondepository institutions.

While the Federal Deposit Insurance Corporation is traditionally in charge of winding down failing depository banks, other nonbank financial institutions have been subject to the normal bankruptcy process. But bankruptcy is unsuitable for large financial institutions that are systemically important for a variety of reasons, especially because bankruptcy is not designed to keep credit flowing in the broader economy.

Dodd-Frank gives the Federal Deposit Insurance Corporation authority to wind down bank holding companies and nonbank financial institutions whose failure would be potentially damaging to the U.S. economy and financial stability. Resolution methods include selling assets and paying off depositors as well as the transfer of deposits to healthy banks. Under the process, management is fired and shareholders bear the losses.

Another key tool is the requirement for large banks and nonbank financial institutions to do advance preparation for failure by submitting plans to regulators. These so called “living wills” help prepare the institutions and regulators for a rapid and orderly wind-down in the event of financial distress.

Nine of the largest U.S. banks and the U.S. units of foreign banks with more than \$50 billion in assets or more than \$250 billion in nonbank assets, such as derivatives, submitted their plans to regulators on July 2, 2012.¹⁹ The Federal Reserve estimates that 124 institutions, including dozens of foreign banks, will need to submit living wills by the end of 2013.²⁰ If regulators believe that the resolution plans are not credible, Dodd-Frank gives them the authority to make the banks sell off business lines and restructure to become less complex.²¹ The granting of this resolution authority and the drafting of credible living wills provides increased visibility into complex institutions and helps ensure that corporations have the ability to wind down, under the supervision of regulators, in a way that minimizes the damage to taxpayers and the economy.

New rules will help rein in executive compensation

“In the half a dozen financial institutions that needed help the most during the crisis, that were too big to fail ... the managers which led them into the trouble in all cases went away very, very wealthy.”

—Warren Buffett, March 25, 2011²²

Public anger over rapidly escalating pay for corporate executives, regardless of their firms’ performance, led to the inclusion of several executive compensation provisions in the Dodd-Frank Act. These include requiring corporations to report the ratio of CEO to average worker pay and a measure to restrict pay at banks so as not to encourage and

reward excessive risk taking. Regulators continue to work through many of these important rules, but one notable provision already in affect is “say-on-pay,” which requires all publicly traded companies to submit their executive compensation plans to shareholder votes at least once every three years.

While these votes are non-binding, industry analysts agree that they are already having a significant impact on corporate compensation practices, as companies are taking these votes seriously.²³ Although a very small number of companies (less than 2 percent)²⁴ have actually failed their say-on-pay votes since the act’s implementation, firms have begun restructuring executive compensation packages to avoid embarrassing votes. Case in point: After its failed vote in 2011, Hewlett-Packard Co. eliminated its compensation formula that allowed the CEO to earn millions despite falling share prices.²⁵

While shareholder disapprovals remain uncommon, the impact of say-on-pay votes and the potential negative attention that accompanies them has resulted in a shift in industry practices that for too long allowed executive compensation to go unchecked.

Five things that will make markets stronger if we finish the job

Implement the Volcker Rule to protect taxpayers from excessive risk taking by financial institutions

“Banks benefiting from public support by means of access to the Federal Reserve and FDIC insurance should not engage in essentially speculative activity unrelated to essential bank services.”

—Five former secretaries of the Treasury: Michael Blumenthal, Nicholas Brady, Paul O’Neill, George Shultz and John Snow, in a letter to the Wall Street Journal, February 21, 2010²⁶

The Volcker Rule, named after former Federal Reserve Chairman Paul Volcker, prohibits federally insured banks and their affiliates from engaging in proprietary trading, defined as when a bank buys and sells certain investments for its own profit, instead of its clients.

Proprietary trading can add significant risk to banks. First, it could put a bank in a conflict of interest with clients. In the years leading up to the 2008 financial crisis, for example, some banks sold products to clients while at the same time their “prop desk” took positions on the opposite side of the same deal.

Second, if banks are trading with their own money then they run the risk of losing that money. If these speculative investments turn bad, and if the losses are substantial enough, then the federal government—and the taxpayer—may have to step in to bail out the bank.

In both cases, proprietary trading creates a culture of risk taking, which because of the importance of banks and other systemically significant financial institutions, puts the entire financial system at risk. JPMorgan Chase & Co.'s recent multibillion-dollar loss highlighted the need for a strong Volcker Rule²⁷—one not weakened by proprietary trading masked as hedging the bank's overall risk.

During the Senate Banking Committee hearing into what went wrong at JP Morgan, Sen. Jeff Merkley (D-OR) pointed out: “the basic concept of the Volcker rule is that banks are in the lending business, not the hedge fund business.”²⁸ In May of this year, President Obama underlined the importance of the Volcker Rule to ensure that taxpayers are not again forced to bail out a bank because of risky bets.²⁹

The final Volcker Rule is due to be published in July 2012, though it is likely the deadline will be missed as regulators work to get the final rule right.³⁰ Both clarity and timeliness are important in making sure that the taxpayers are protected from excessive risk.

Finalize derivatives reform to protect our markets from overspeculation in this hundred-trillion-dollar market

“Among the causes of the financial crisis was Wall Street’s use of extraordinarily complex derivatives—financial instruments that derive their value from other financial instruments. These derivatives were largely shielded from scrutiny in an opaque marketplace.”

—Sen. Carl Levin (D-MI) on Wall Street reform³¹

Derivatives are financial instruments whose value is derived from some underlying security or commodity. Derivatives have existed for centuries, and the futures and commodities markets in, say, corn or pork bellies have been regulated since the 1930s, but the rapid growth in often complex and opaque derivatives led Warren Buffett to famously describe them as “financial weapons of mass destruction.”³²

Derivatives such as financial futures, options, and swaps involving interest rates or credit defaults were developed to allow investors to hedge risks in financial markets—but quickly become a means of investment in their own right. This global market grew from \$88 trillion in 1999 to \$684 trillion before the crisis in 2008.³³

Leading up to the 2008 crisis, large financial institutions bought and sold trillions of dollars of over-the-counter swaps, meaning the trades were unregulated and outside the oversight of regulators. Although derivatives can play an important role allowing companies such as airlines to manage risk, a lot of the trading amounted to little more than speculative bets for profit—often with an inadequate level of capital to back up the trades.

Reforming the derivatives market became an important focus of regulatory reform after the 2008 financial crisis because of the role derivatives—credit default swaps specifically—played in the failure of American International Group, which required a bailout costing U.S. taxpayers \$182 billion.³⁴ AIG’s London affiliate, AIG Financial Products, sold billions in swaps without having to place capital to back up those bets. When the British unit of AIG failed in London, its U.S. parent had to be rescued by the U.S. taxpayers.³⁵

Dodd-Frank’s Title VII provisions significantly increase the mandate of the Commodity Futures Trading Commission to bring greater regulatory oversight and transparency to derivatives. The rules are detailed and highly technical, though broadly will have the effect of requiring most derivatives to be traded on a regulated exchange and cleared through a central clearinghouse. This means a counterparty—a clearinghouse whose main purpose is stability—will stand between the buyer and seller and guarantee that each party is able to make good on their obligations by collecting a proportion of the value contract, known as a margin.

The exchanges are regulated by the Commodity Futures Trading Commission, giving the regulator much more information about the market and allowing them to better monitor, and prevent, the type of excessive risk taking that ultimately led to the AIG bailout. Derivatives will in the future be traded through transparent platforms with real-time pricing information. This should create a more efficient and competitive marketplace, ensuring that end-users including Main Street businesses and local government can access the best prices.

Much progress has already been made, and recently the Commodity Futures Trading Commission and Securities and Exchange Commission, which regulates equity and debt markets, issued a definition of the type of swaps that will be subject to centralized clearing and exchange trading. This is a major milestone as a number of rules the commission has already finalized—such as new position limits, registration, real-time reporting, business conduct, and commodity options rules—will go into effect in a matter of weeks, now that the definition is finalized.³⁶ Both financial regulatory agencies have made a commitment to completing the rulemaking on Title VII by the end of 2012.

Ensure regulators have the resources to protect taxpayers by adequately funding the Commodity Futures Trading Commission

“The CFTC’s success in uncovering the outrageous manipulation of the Libor, and the consequent settlement which will bring to the U.S. Treasury hundreds of millions of dollars, demonstrates the value of that agency. The refusal by Republicans to meet the Obama administration’s request for \$308 million for the CFTC, when the agency has helped bring into the Treasury approximately that amount in one successful prosecution, demonstrates that the party is driven not by concern for the deficit but rather by ideological rigidity.”

— Rep. Barney Frank (D-MA), June 29, 2012³⁷

Laws need enforcers. To protect markets and consumers requires both sound regulations and adequate resources for regulators to see them through.

Some financial regulatory agencies, such as the Federal Reserve, Comptroller of the Currency, and the Federal Insurance Deposit Corporation are independently funded, insulating them from attempts to cut their budgets to the point where they can no longer do their jobs. The Securities and Exchange Commission is funded by a small user fee on all equities trading.

The Commodity Futures Trading Commission, however, relies entirely on the congressional appropriations process, making it vulnerable to partisan attempts to starve it of resources as it works to fulfill its enhanced responsibilities under Dodd-Frank. The House Appropriations Committee has reported to the floor a bill that provides only \$180 million to the derivatives regulator. This represents a cut of \$25 million (12 percent) from last year's appropriation, and is 41 percent below the agency's requested budget of \$308 million.³⁸

This cut would require the commission to cut staffing back to levels prevailing in the mid-1990s. Yet since then the combined impact of the growth in the futures market and the new responsibilities under Dodd-Frank means that the market the agency now oversees is 40 times to 50 times larger³⁹ and a notional value of \$300 trillion.⁴⁰

The Commodity Futures Trading Commission's two-year investigation into Barclays' rigging of the London Interbank Offered Rate, known as Libor, demonstrates the continued need to make sure there are enough cops on the beat to identify and punish financial misconduct. The settlement fine of \$200 million is almost equivalent to the agency's entire 2012 budget of \$205 million.⁴¹

President Obama's 2013 budget attempts to address some of the budgetary concerns around Dodd-Frank implementation by funding the Commodity Futures Trading Commission in part through "user fees."⁴² In a joint letter to Congress, organized by the public advocacy group Americans for Financial Reform, more than 50 consumer, labor, faith-based, nongovernment, and business organizations gave their support to a user fee funding model.⁴³

This is a sound idea, and one with precedent as seen in similar regulatory agencies.

Hold the line on mortgage origination and securitization to protect homeowners, investors, and taxpayers

"There were too many people in all of the functional component parts—mortgage brokers, loan originators, loan securitizers, sub-prime lenders, Wall Street investment bankers, and rating

agencies—who were interested only in making their own fast profits and were indifferent to the consequences of their actions for homeowners and communities, much less the nation as a whole.”

—Federal Reserve Governor Sarah Bloom-Raskin, February 11, 2011⁴⁴

The misalignment of incentives throughout the housing and housing finance market lies at the heart of the mortgage crisis. Brokers got paid at the closing table, leaving them no incentive to underwrite borrowers carefully. Lenders quickly flipped those loans into the secondary market, leaving them with no exposure to shoddy mortgages. Wall Street firms paid top dollar for the riskiest loans to sell to institutional investors worldwide who were looking for greater returns on their investments, leading brokers and lenders from whom they were buying the loans on a race to the bottom in terms of origination and compensation practices. Those investment banks, which never took ownership of the loans themselves, then sliced and diced the loans into securities, paid the ratings agencies to bless them, and passed them along to investors who were often misinformed of the underlying risks.

In short, every link in the production chain was insulated from the consequences of bad lending, leaving homeowners and investors holding the bag when the bubble burst. Dodd-Frank aims to realign these market incentives from top to bottom, thereby enabling the market to produce more sustainable mortgages for homeowners and safer securities for investors.

To ensure better mortgage origination, Dodd-Frank requires lenders to ensure homeowners have the ability to repay their mortgages. As the Consumer Finance Protection Bureau works to delineate the contours of this requirement by the end of 2012, it is important for it to resist industry pressure to water down its so-called qualified mortgage standard, which sets out the underwriting criteria for the safest category of mortgages and establishes an appropriate standard of legal review for ensuring that the criteria are followed.

Dodd-Frank also prohibits the perverse compensation practices that drove many mortgage brokers to steer borrowers into mortgages more expensive than those for which they qualified, particularly in African-American and Latino communities, and bans most prepayment penalties. The effective implementation of these provisions is also key to preventing predatory lending in the future.

On the securitization side, Dodd-Frank requires issuers of mortgage-backed securities to retain 5 percent of the credit risk for each security issued, giving those securitizers “skin in the game.” One of the most controversial parts of this provision is the exemption of “qualified residential mortgages” from the risk retention requirement, and market participants are anxiously awaiting a final rule. A broadly defined qualified residential mortgage will help ensure an optimum balance between access to credit and accountability.

Continue to ensure coordinated global financial reform and strong international minimum standards are enacted

“We all have a mutual responsibility to deliver on all our commitments to address the weaknesses that led to the financial crisis. Now is the time for the Leaders of the G20 both to recommit themselves and deliver on the ambitious reform objectives and agenda we have already agreed to and to explore cooperative approaches to meeting our common goals.”

—President Obama, open letter to the Group of 20, March 29, 2010⁴⁵

The financial crisis did not just affect the United States. Financial systems are interconnected and risks are spread across national borders. Recognizing this fact, global leaders at the Group of 20 Washington Summit in 2008 agreed to move toward international agreement on basic financial rules in order to ensure protections are in place to shield taxpayers from risks emerging from abroad, as well as to maintain an open and healthy international financial services sector.⁴⁶

The United States has led the way in setting the international reform agenda by overhauling its financial regulation through Dodd-Frank. Working alongside partners in the European Union and other G-20 nations, there has been substantial progress made on extending the framework for systemically important financial institutions to domestic banks and global insurance companies, and in preparing an integrated set of recommendations for more effective oversight and regulation of derivatives markets.⁴⁷

The leaders of the G-20 nations agreed to coordinate global standards in banking regulation in order to strengthen international financial stability. The Basel III banking reforms increase the minimum regulatory capital requirement from 2 percent to 7 percent, and subject globally systemically important banks to a 1 percent to 2.5 percent surcharge.⁴⁸

Although Basel III sets out a global standard, it is not legally binding as countries are required to implement the accords into their own laws.⁴⁹ The “Collins Amendment” of Dodd-Frank created the statutory basis for the implementation of Basel III in the United States. In June 2012 the Federal Reserve proposed final rules on a regulatory capital framework which incorporates the international Basel III standards.⁵⁰

The Obama administration is pushing through the G-20 process for more progress on the global implementation of bank capital requirements in other markets, particularly Asia, on rules regarding over-the-counter derivatives, and on the orderly resolution (winding down) of failing financial institutions.⁵¹

Creating minimum international rules is essential to protect financial stability globally, including U.S. economic growth, and to preserve the advantages of an open and globally integrated financial system and economy. Without confidence in the strength of finan-

cial institutions and markets in other countries, recent experience in Europe has shown that problems in one country can spread rapidly.⁵² A healthy global economy depends upon a stable and integrated global financial system.

The benefits of Dodd-Frank financial reform

How the Dodd-Frank Act protects the interests of consumers, businesses, investors, and our economy

Our financial markets	Before the financial and housing crises of the Great Recession	The consequences of the twin crises and the debilitating aftermath	After the progressive reforms that will make our financial markets work for everyone
Systemic supervision	The financial regulatory system is fragmented, with no single regulator responsible for the overall stability of the financial system or ability to oversee large nonbank financial institutions such as insurance companies and investment firms.	Nearly 10 million jobs are lost, ¹ and the average net worth of U.S. households drops to \$77,300 in 2010 from \$126,400 in 2007 after the financial crisis. ²	The new Financial Stability Oversight Council has responsibility for monitoring systemic risk and identifying systemically important financial institutions, including banks and nonbanks.
Capital requirements	Banks are subject to capital requirements, but in the lead up to the financial crisis, investment banks in particular became vastly over-leveraged with debt. ³	Financial institutions are unable to weather economic shocks because of inadequate capital buffers; in 2009, when the Federal Reserve carried out a test to measure the financial health of the 19 largest banks, it found that 10 would have needed to raise a total of \$75 billion to have adequate capital buffers to withstand an adverse economic shock. ⁴	new rules require banks to hold additional capital so that losses are absorbed by private sector investors, not taxpayers; in March 2012, 15 of the 19 largest banks are found by the Federal Reserve to have sufficient capital to absorb a new financial crisis. ⁵
Too big to fail	No clear resolution authority exists for banks considered too big to fail, leaving taxpayers unknowingly on the hook.	American taxpayers shell out billions of dollars in federal support to bail out financial institutions and restore confidence in the financial markets.	Measures in Dodd-Frank include a process to liquidate and sell off failing institutions without the need for bail outs; banks and nonbanks are required to submit "living wills" to assist in this process; nine of the world's largest banks presented their wills to regulators in July 2012. ⁶
Consumer protection	Fragmented responsibility delegated across several federal agencies enables predatory lending on a massive scale, with consumers vulnerable to confusing and sometimes deceptive products and lending practices.	Consumers bear the brunt of the housing and financial crises, as housing values plummeted and mortgage foreclosures ballooned. ⁷	The Consumer Finance Protection Bureau is created to enforce consumer financial protection laws, ensure consumer access to financial services, and promote consumer education.
Executive pay	Shareholders have only limited ability to affect executive compensation, even in the face of huge disconnects between pay and performance.	The ratio of CEO-to-worker pay in S&P 500 companies widened from 42-to-1 in 1980 to 380-to-1 in 2011. ⁸	The new say-on-pay rules offer the opportunity to reign in excessive executive pay by requiring publicly traded firms to submit executive compensation plans to shareholder votes at least once every three years, creating a stronger link between executive pay and performance.
Proprietary trading	The banks taking federally insured customer deposits are also making hundreds of billions of dollars of risky bets for their own accounts.	Banks hold hundreds of billions in mortgage securities on their trading books, contributing to the financial crisis. ⁹ JP Morgan Chase & Co.'s losses of \$5.8 billion on a directional bet ¹⁰ demonstrates that banks need strong rules to prevent them from taking risky bets to boost profits.	The Volcker Rule will prohibit federally insured banks from proprietary trading, ensuring that banks are no longer allowed to engage in speculative activities unrelated to essential banking services.

Our financial markets	Before the financial and housing crises of the Great Recession	The consequences of the twin crises and the debilitating aftermath	After the progressive reforms that will make our financial markets work for everyone
Over-the-counter derivatives	The unregulated over-the-counter derivatives market grows rapidly in the 1990s until it reached \$683 trillion in 2008, ¹¹ with complex and opaque products trading outside the scrutiny of regulations.	Large and opaque derivatives books contribute to excessive leverage, financial contagion, and panic during the crisis. For example, credit default swaps contributed to the fall of the global insurance giant American International Group Inc., which cost taxpayers \$182 billion. ¹²	Most derivatives will be traded on a regulated exchange and will be subject to more transparency and oversight by the regulatory agencies. Financial institutions that deal in these products will be required to hold more capital as a buffer against losses.
Mortgage origination and securitization	Securitization makes mortgages available to more Americans, but misaligned incentives encourage poor underwriting and dangerous broker compensation practices, resulting in the origination of risky mortgages that failed when the housing bubble burst.	There was a more than 30 percent peak-to-trough decline in home prices between 2006 and 2012, ¹³ and banks have sent foreclosure notices to more than 11 million properties since 2007. ¹⁴	Mortgage securitizers will now have to retain a 5 percent share of the risk of a security—except in the case of very safe mortgages—and they cannot hedge or sell the retained risk. Lenders will have to ensure that customers have the ability to repay their mortgage for the life of the loan, and originators cannot get paid more to put borrowers into unnecessarily risky or expensive mortgages.
Funding the financial regulators	Most of the financial regulators have funding streams. But the futures and commodities regulator—the Commodities and Futures Trading Commission—is funded solely through congressional appropriations.	The Commodity Futures Trading Commission has been vulnerable to budget cuts and congressional appropriations while it attempts to implement Dodd-Frank.	Ensuring the commission is adequately funded would provide a stable funding source for the agency, enabling it to implement Dodd-Frank and effectively police the derivatives markets.
Ensuring coordinated global financial reform and strong international minimum standards	Globally interconnected financial markets spread risks across national borders with minimal integrated global regulatory rules.	Continued problems in the Eurozone cast a long shadow over global growth. Many large financial institutions are still closely interconnected, so the impact of a breakup of the currency could spread to the U.S. economy.	There has been considerable progress toward globally agreed-upon rules, ¹⁵ but more needs to be done to protect global financial stability and to preserve the advantages of an open and globally integrated financial system.

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2 Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, June 2012 (Federal Reserve, 2012).

3 Stephen Labaton, "Agency's '04 Rule Let Banks Pile Up New Debt," New York Times, October 2, 2008, available at http://www.nytimes.com/2008/10/03/business/03sec.html?_r=1.

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Conclusion

In a letter to the leaders of the G-20 in advance of the Rio Summit, the members of the Financial Stability Board—the international body that monitors and makes recommendations on the global financial system—said continued financial reform was part of the solution to economic growth.⁵³

The stakes of seeing financial reforms through are huge. As Dennis Kelleher of the public advocacy group Better Markets pointed out in a recent testimony before a House committee, “The Dodd-Frank law is intended to protect the American people, taxpayers, and the U.S. Treasury from ever again having to suffer through and pay for another financial collapse and economic crisis.”⁵⁴

Dodd-Frank created a new set of tools for regulators to keep our financial markets more strong and secure. The task now is to finish the job that was started.

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