The Wall Street Reform and Consumer Protection Act

By Troy Anderson

Is More Regulation the Answer?

As Bob Cromwell sees it, the Dodd-Frank Wall Street Reform and Consumer Protection Act fails to address the very problem it's supposed to fix.

The 2,300-page bill, which President Obama recently signed into law, is supposed to correct flaws in the financial system that helped trigger the worst global economic crisis since the Great Depression.

But Cromwell, managing director of the Houston-based Moody Rambin Interests, a commercial real estate firm, says the act doesn't address the root causes of the global recession – the fact that Wall Street bundled risky home loans into mortgage-backed securities, obtained top credit

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ratings, and then sold them around the globe.

"Basically, what they did is took the risk out of real estate," says Cromwell. "What they created is a market that still has $600 billion in loan maturities that have to be worked out mostly between now and 2013. The financial reform act did not address this issue at all, and it didn't address the credit ratings. This financial reform act shows how close Wall Street and Washington are. It was basically written by ex-Wall Street guys who are now working in Washington."

The law, according to the U.S. Securities and Exchange Commission, creates a new, more effective regulatory structure, fills a host of regulatory gaps, brings greater market accountability to the financial system, and gives investors important protections and greater input into corporate governance.

Holding Wall Street Accountable

The act is designed to hold Wall Street accountable, provide Americans with stronger consumer protections, increase transparency in financial dealings – including the derivatives market – and end taxpayer bailouts, according to the White House.

"These reforms represent the strongest consumer financial protections in history," President Obama said when he recently signed the bill into law. "And these protections will be enforced by a new consumer watchdog with just one job – looking out for people – not big banks, not lenders, and not investment houses. That's not just good for consumers; that's good for the economy because reform will put a stop to a lot of the bad loans that fueled the debt-based bubble."

In the future, if a firm fails, it will be Wall Street – not the taxpayers – that pays the price, Obama says.

"Finally, because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes," Obama said. "There will be no more tax-funded bailouts – period. If a large financial institution should ever fail, this reform gives us the ability to wind it down without endangering the broader economy."

The act also calls for the creation of an independent Bureau of Consumer Financial Protection to enforce rules for the financial marketplace. The bureau is expected to provide oversight for non-bank companies and banks in the mortgage market, and to protect borrowers from unfair, deceptive, or other illegal mortgage lending practices. Under the act, mortgage brokers will be prohibited from making higher commissions by selling mortgages they know consumers can't afford. In an effort to address the "shadow banking system" – the financial firms that acted much like banks but operated without oversight – the act calls for the elimination of loopholes that allowed these firms to avoid federal scrutiny.

Finally, the bill will establish a set of rules and expectations without the current regulatory arbitrage opportunities that allow some firms to "game the system." It will provide stronger capital buffers to increase the ability of financial companies to weather the ups and downs of financial markets, and to lessen concentration of risk among the largest financial firms so that any one firm can fail without creating a domino effect throughout the entire financial system.

"The Dodd-Frank reforms will restore the banking system to its core purpose of helping Americans save for their future and channeling those savings to the entrepreneurs with the best ideas for building a stronger America," U.S. Treasury Secretary Timothy Geithner said recently. "The message of this bill is clear: banks – not the taxpayers – will pay for future bank failures, and consumers will be protected."

Does the Act Go Far Enough?

However, U.S. Rep. Jeb Hensarling (R-Tx), along with several Texas economics professors and others, says the act ignores the role that Fannie Mae and Freddie Mac played in the housing market crash and the subsequent financial meltdown.

"The act almost completely ignores all the problems that led up to the housing fiasco," says Stan Liebowitz, an economics professor at the University of Texas-Dallas. "There is almost nothing in the legislation that would have prevented the mortgage fiasco from occurring."

Steven Craig, a professor of economics at the University of Houston, says a bill this size has "a lot of specifics in it, and that's probably scary."

"To the extent that financial decisions are made in Washington, D.C., and not where business is occurring ... that for sure is going to be bad for our economy," Craig says.

Kumar Venkataraman, the Fabacher Endowed Professor of Alternative Asset Management at the Edwin L. Cox School of Business at Southern Methodist University in Dallas, says he's also not convinced the act goes far enough to prevent future bailouts of the "too large or too-big-to-fail firms."

Robert Romano, the senior editor at Americans for Limited Government in Fairfax, Virgina, says he's troubled that the act does not address the root cause of the financial crisis and explicitly exempts Fannie Mae and Freddie Mac, which sold $4.7 trillion worth of mortgage-backed securities and began to go bankrupt when the housing bubble popped.

In an ALG report entitled "Down a Rabbit Hole: The Threat Posed by the Dodd Bill to the Private Sector," the authors claim the act also includes provisions creating an "orderly liquidation fund" with unlimited bailout-takeover authority that is "rife for abuse." This federal authority will endanger companies

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across the nation with "unlimited government takeovers of their assets, operations and ownership," according to the report.

Under the act, the Federal Deposit Insurance Corporation, the Federal Reserve, and the U.S. Department of the Treasury are authorized to put into receivership any company that is deemed to be in danger of default and that is "predominantly engaged in activities … that are financial in nature," except for Fannie Mae, Freddie Mac, any other Federal Home Loan Bank, any government agency or a Farm Credit System Institution, according to the ALG report.

The act authorizes the FDIC to issue securities to be sold to the treasury of seized firms, and for the treasury to keep or sell those securities. Under the act, no congressional authorization is needed for firms to be seized and the funds to be spent, the ALG authors write.

"In order to be seized, a firm need not be in danger of failing," the report explains. "All that is required is that the firm be deemed by the FDIC, Federal Reserve and Treasury secretary to be in default or 'in danger of default.' Under these terms, a firm could be seized without just cause."

As a result, the report predicts that the government will likely nationalize some companies and sell the rest to the very financial institutions charged with financing the fund through indirect taxes on customers and savers.

"The only difference between this and the [Troubled Asset Relief Program] is this will be unlimited and there will be no votes in Congress required to seize the companies and redistribute their assets," Romano says. "Those who are politically favored will get bailed out, and those politically unfavored will be seized outright and given to more politically favored constituencies."

A Climate of Uncertainty

Romano says the act whitewashes the root cause of the financial crisis, and that the costs of future takeovers will be passed on to consumers. He expects the impact on Texas, as one of the nation's largest states, to be significant.

"I think it creates a lot of uncertainty," Romano says. "Businesses are already weary of government intervention in the economy."

Douglas Holtz-Eakin, president of the American Action Forum in Washington, D.C., says the mammoth act includes 234 new regulations. That compares to only a handful that were part of the Sarbanes-Oxley Act of 2002.

Good or Bad for Small Business?

"Borrowing costs are going to be higher, and that will pose specific difficulties for the small businesses that have already been hit badly," Holtz-Eakin says.

At the Houston Minority Supplier Development Council, a business organization of 221 major corporations and 1,000 minority-owned businesses, President Richard Huebner says he's concerned that the act will further inhibit the ability of banks to lend to small businesses, constricting their ability to recover economically from the recession.

"The small businesses are going to create the jobs, create the wealth, and create the spending power that will drive the economic recovery," says Huebner. "Today, that is seriously constrained by the lack of available cash to fund those businesses. My understanding is that banks are interested in making loans, but may not be permitted to do so by all these increased regulations. I understand that on the one hand we are trying to prevent the making of bad loans that could drive us back into recession; but on the other hand, if that money is not available to finance the growth of honest businesses, then we've cut off our opportunity to recover."

The American Bankers Association, a Washington, D.C.-based organization that represents the $13 trillion banking industry and its 2 million employees, is also concerned that the act contains a "tsunami of new rules and regulations." The act, the ABA says, contains numerous regulations that will create "years of uncertainty."

"The bottom line is we're not sure how it's going to affect businesses because so much of it is uncertain right now because most of the regulations have yet to be written," says ABA spokesman John Hall. "There are several things in the financial reform act the ABA supported and that was creating a systemic risk regulator – someone who will look out on the horizon and make sure there are no future disasters brewing. And while a lot of the regulations were aimed at Wall Street, your local community bank unfortunately is going to have to navigate all this red tape."

How Will It Affect Job Growth?

A recent report by the Institute of International Finance, a global association of banks created in 1983 in response to the international debt crisis of the early 1980s, estimates that the act will reduce Gross Domestic Product by 2.6 percent after five years, and will lower employment by 4.6 million jobs.

U.S. Senate Republican Leader Mitch McConnell says the bill was sold to the public as a way of reining in Wall Street, but "anyone who believes that didn't read beyond the cover sheet."

"Because if they did, they'd discover instead a far-reaching government intrusion that was endorsed by Wall Street and opposed by Main Street," says McConnell (R-Ky). "Citibank thinks it's great. Your local florist thinks it will undermine their business. When you cut through all the talking points about what the financial regulation will do, the practical, real-world effect of this bill in the near term will be job loss."

Liebowitz says the act will clearly reduce jobs to some extent.

"There is a whole tangle of new regulations," Liebowitz says. "When you have a couple of thousand of pages – that's much longer than a lot of these laws need to be – you end up with various special interest groups writing various parts. They put things in to help themselves."

New Lending Guidelines for Banks

Among other key provisions of the bill, according to the SEC, are those that will bring essential oversight to the over-the-counter derivatives market. Working with other regulators, the SEC plans to write rules that address capital and market requirements, mandatory clearing, the operation of execution facilities and data repositories, business conduct standards for swap dealers, and public transparency for transaction information.

"The big problem is in relation to what banks can do in derivative markets," Venkataraman says. "There was a rule proposed which said that the known lending activities of the banks need to be severely curtailed because the banks have access to subsidized capital from the Federal Reserve. So they were essentially borrowing from the Federal Reserve at a cheap rate, and they used the capital to speculate in the financial markets."

One of the main purposes of the act, Venkataraman says, was to constrain the banks from being involved in these types of lending activities.

"There are some provisions that have some of these restrictions, but banks can still be involved in these instruments, which in turn increases risks," says Venkataraman. "I think the regulations did not go far enough to address some of the key institutional problems that resulted in some of these institutions posing systemic risks to the economy."

David Byford, spokesman for Houston-based Dynegy Inc., a company that produces and sells electric energy, capacity and ancillary services in key U.S. markets, says the act offers the potential of new requirements for over-the-counter derivative transactions.

"We believe the legislation provides an end-user exemption that may excuse asset-based energy companies (like Dynegy) from independent exchange clearing and collateralization requirements that otherwise apply to OTC derivative transactions. Regardless of how end-user exemptions are ultimately determined, Dynegy uses a collateral clearing agent, with the majority of our transactions collateralized with cash, short-term investments, or availability under our term letter of credit facility, so we would not anticipate a substantial impact."

Texas Recovery Prognosis

The approval of the act comes as Texas has weathered the global recession better than most states have, but is experiencing economic lethargy from the Gulf oil spill and President Obama's proposed changes to the space program.

At a time like this, Cromwell says, the act upsets him because it shows how Wall Street and Washington are "scratching each others' backs at the expense of taxpayers."

"I think where we'll feel it in Texas is more from the lending standpoint with all these new regulations," Cromwell says. "Banks are not lending. You can't get a small business loan. In that regard, less capital equals less growth equals less development. I'm of the belief [the recovery] is going to be a long, slow improvement." N

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