BETTER MARKETS

– WHITE PAPER –

No Financial Crash Yet Thanks to Dodd-Frank and Banking Reforms

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Introduction

Attempts to address the pandemic health crisis have required a synchronized, global economic shutdown, leading to nearly Great Depression-levels of unemployment and economic contraction. The speed and depth of the economic downturn have been far worse than anything experienced during the Great Recession of 2007-2010. Fortunately, however, this has not (yet) led to a crash of the banking system, as happened in 2008. The question is why?

Part of the answer is that the banking and financial sectors are not the origins of this crisis as they were in 2008. Another part is that the Federal Reserve has taken even more extraordinary actions than those taken in 2008 to keep financial markets open and functioning, which has prominently benefited banks. However, a full answer requires a recognition that the Dodd-Frank Wall Street Reform and Consumer Protection Act and other post-crisis banking reforms forced the banks—particularly the too-big-to-fail banks on Wall Street that were bailed out in 2008—to take numerous actions and participate in reformed financial markets that have made the banking sector much more resilient and able to withstand shocks than it has been in the past.

Dodd-Frank and banking reforms have, so far, prevented a banking system crash, reduced the likelihood of taxpayer-funded bailouts, and lowered the cost should one be needed

Those critical post-2008 crisis banking reforms—stronger capital and liquidity rules, most notably—have worked largely as intended, strengthening the resiliency of the banking system as a whole and leaving it better prepared for disasters such as what we are now facing. Indeed, large banks are currently supporting the economy in important respects, rather than acting as a drain on it by requiring bailouts and withholding credit as happened in 2008. This relative success is in spite of the actions of the biggest banks over the last 10 years when they, their lobbyists and political allies opposed almost every financial reform that is now the foundation for their new-found strength.

While the too-big-to-fail problem is far from solved, and further work on banking and non-banking reforms is still required, we have a stronger U.S. banking system because of the Dodd-Frank Act and the implementation of banking and financial sector reforms. We now have a system in which the largest banks have been required to internalize more of the costs of making it safer. This has, at least so far, prevented a banking system crash, reduced the likelihood of taxpayer-funded bailouts, and lowered the cost should one be needed.

To be sure, the quick, massive and unprecedented actions taken by the Federal Reserve to support financial markets and the economy have been instrumental in staving off a rapid collapse. Through the tremendous growth in the Federal Reserve's balance sheet and a number of programs to support markets and lending to households and businesses, the Federal Reserve has provided liquidity to stabilize financial markets and asset prices, which have to date kept banks from experiencing the full brunt of this horrific downturn. Broader government (i.e., taxpayer-funded) support for the economy, including most prominently in the CARES Act, has also supported banks by reducing loan defaults among businesses and households.

Many of the Federal Reserve's actions to support financial markets call attention to the continued fragility of the financial system and highlight the extent of unfinished regulatory reforms, including in particular addressing those threats to financial stability that stem from the increased importance of large and growing non-bank financial institutions.[1] The Financial Stability Oversight Council's (FSOC) failure to perform the meaningful financial system oversight role envisioned by the Dodd-Frank Act has proven a major problem. This is dramatically illustrated by the fact that there is not one non-bank financial institution designated by the FSOC as systemically important, a designation that would require the firm to be placed under tighter rules and increased supervision.[2] This might be laughable were it not so dangerous. It is a preposterous reality created by Trump Administration (de)regulators to shield huge financial firms, many engaged in high-risk, dangerous activities, from appropriate oversight that would better protect the financial system and taxpayers.

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The point is not that we can declare victory on banking reforms at this stage. We are not even close to that. Unfortunately, we're still in the early stages of this severe and unpredictable downturn, and in any event, the banking reform story is not one of unmitigated success. But it is important to recognize and acknowledge some of the most important benefits achieved by the implementation of the Dodd-Frank Act and related post-crisis banking reforms.

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[1] In addition, this support and other programs under consideration again call attention to difficult and novel policy questions concerning the appropriate scope of direct Federal Reserve support for businesses within and outside of the financial sector.

[2] *See*, Better Markets' Comment Letter to FSOC on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, May 24, 2019, available at: https://bettermarkets.com/sites/default/files/CL_FSOC_Designation_Guidance%205-24-19.pdf

These reforms have bought policymakers time to act by making banks strong enough to at least not currently be a contributing or amplifying source of instability as they were in 2008. Rather than being the primary cause and source of the problem as was the case then, post-crisis reforms have made large U.S. banks stronger so they can serve as mechanisms to support the economy and through which government programs can provide much-needed assistance and credit to households and businesses.

Key Banking Sector Reforms that Have Strengthened the System

Due to the pandemic and economic downturn, for some time there will continue to be unprecedented uncertainty about the future path of the U.S. and global economies and the ultimate impact on the banking system. This is made worse by the fact that many of the post-crisis reforms and enhancements did not go far enough in the first place, and too many have been weakened by nearly four years of deregulatory actions.[3]

Nonetheless, it is important to recognize that progress has been made. This White Paper reviews some core pillars of banking sector reform that have made the system stronger, including higher capital and liquidity requirements, stronger and more effective banking supervision, reforms in the derivatives markets, and limitations on proprietary trading. Even on the difficult issue of resolving a systemically important bank without a disorderly collapse and contagion, one can point to some progress, although much more work remains to be done.

As is well-known, these and other reforms have been relentlessly and aggressively opposed by Wall Street's too-big-to-fail banks, their lobbyists and political allies. That opposition continued right up to the onset of the current crisis and propelled much of the significant and counterproductive deregulation that has occurred over the past several years, and strikingly if not surprisingly, is continuing even in the face of the pandemic.[4]

Once the current crisis eases, it will be imperative to return to the reform agenda and finish the job of protecting the financial system, the economy and Main Street families and businesses. That will require strengthening the rules and oversight of the non-bank financial sector and improving on the successes of post-crisis banking reforms as well as addressing the damage done by deregulation. The goal is not

[3] Enactment of the Stress Capital Buffer rule (including end of post-stress leverage, no longer requiring the prefunding of 9 quarters of dividends and share buybacks, and allowing firms to more easily game the stress test); raising the bar from $50B to $250, and gutting the CCAR qualitative objection. See, Better Markets' Comment Letter on Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, January 22, 2019, available at: https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20Capital%20and%20Liquidity%20Proposal.pdf

[4] *See*, e.g., "Wall Street's Biggest Banks Shamelessly Trying to Use Coronavirus to Get Federal Reserve to Weaken Rules," March 2, 2020, available at: https://bettermarkets.com/newsroom/wall-street-biggest-banks-shamelessly-trying-use-coronavirus-get-federal-reserve-weaken, and "Department of Labor Is Using the Pandemic as a Pretext to Open High-Risk, High-Fees, High-Leverage Predatory Private Equity Investments to Retirees," June 3, 2020, available at https://bettermarkets.com/newsroom/department-labor-using-pandemic-pretext-open-high-risk-high-fees-high-leverage-predatory.

to have the banking system just stronger than it used to be but to have one that is in fact strong enough to support the American people in good times and bad.

Strengthening Large Banks' Financial Resilience: Capital, Liquidity and Stress Testing

Substantially stronger U.S. capital and liquidity standards for the largest banks have unquestionably put them in a better financial position entering the pandemic-caused economic crisis. Targeted at enhancing financial stability, Section 165 of the Dodd-Frank Actdirected the Federal Reserve to establish "enhanced supervision and prudential standards" for bank-holding companies with more than $50 billion in assets and non-bank financial institutions designated as systemically important by the FSOC.[5] The standards were to be stronger than those applicable to smaller institutions and increase in strength based on each bank-holding company's unique business activities and associated risks. This included scaled requirements for more and higher-quality capital and greater liquidity to reduce the likelihood of destabilizing funding pressures and bank failures.

These and other standards were put in place by the Federal Reserve and other U.S. banking regulators. They were implemented largely in line with, and in some cases exceeded, the strengthened post-crisis international standards called for by the G20 and the Financial Stability Board, and agreed upon by the Basel Committee on Banking Supervision with the U.S. authorities playing a leading role in these efforts at all of these organizations.[6]

Capital and Stress Tests

The new standards included a number of steps to make capital requirements stronger for the largest banks, which were scaled up based on their potential systemic impact.[7] Regulatory capital was redefined to require more high-quality capital in the form of common equity. Previously game-able and weak, calculations of risk-weighted assets and minimum requirements for risk-based measures of capital were strengthened. Importantly, greater emphasis was also put on measures of leverage that provide a

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[5] For a full discussion, see "Better Markets Fact Sheet on Section 165 of the Dodd Frank Act: Everything You Need To Know About the $50 Billion Threshold," available at https://bettermarkets.com/sites/default/files/Fact%20Sheet%20%2450B%20Updated%20Long%20Version%20FINAL.pdf. In 2018 Congress passed the Economic Growth, Regulatory Relief and Consumer Protection Act, which revised the DFA definition of systemically important banks from those with $50 billion or more in assets to those with $250 billion or more in assets, which removed the enhanced prudential requirements for firms in this range. The banking regulators then, by rulemaking, revised those definitions further. *See* Better Markets' Comment Letter on Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, January 22, 2019, available at: https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20Capital%20and%20Liquidity%20Proposal.pdf.

[6] *See*, FSB Chair Letter to G20 Leaders on Progress of Financial Reforms, November, 9, 2010, available at: https://www.fsb.org/wp-content/uploads/r_101109.pdf.

[7] *See*, Better Markets' Comment Letter on Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, April 3, 2015, available at: https://bettermarkets.com/sites/default/files/FRS%20-%20CL%20-%20Risk-Based%20Capital%20Guidelines%20Implementation%20of%20Capital%20Requirements%20for%20Global%20Systemically%20Important%20Bank%20Holding%20Companies%20-%204-3-2015.pdf

simpler if still imperfect method of measuring capital adequacy as a complement to stronger risk-based capital rules.

U.S. capital standards for large banks were further strengthened by the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR), known as the "Fed stress tests." The CCAR regulatory framework and stress tests have multiple components, but they essentially are intended to measure a bank's capacity to absorb losses that may occur under severe stress. Stress test-based capital rules for large banks now require not only that large banks meet the new higher capital standards discussed above but also that they meet them even after accounting for losses they might experience during periods of severe stress. For example, if a bank's basic risk-based capital requirement is 8 percent, and the Fed's stress test shows the bank could see a 4 percent reduction of its capital under stress, the bank's *effective* capital requirement would be 12 percent.[8]

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In practice, what the stress test means is that a new supervisory definition of capital adequacy has been put in place that relies upon a forward-looking assessment of potential capital needed to withstand a period of deep stress. Banks are seen to have sufficient capital if, and only if, they could absorb substantial losses that could occur during a period of severe stress and continue to meet all minimum regulatory requirements. Meeting minimum regulatory capital requirements at even the worst point of a stressed environment provides a heightened level of confidence a bank could keep operating, meet all its obligations, and make loans to households and businesses **without** needing to be bailed out by taxpayers. This lessens the likelihood that there will be financial weaknesses at large banks that exacerbate an economic downturn and precipitate a financial crisis.

The relatively high level of transparency of the stress test compared to traditional supervisory exercises has also significantly supported the credibility of the program as a means to promote more resilient banks that can support the economy in times of stress. The scenarios used and the stress test results for each bank are disclosed in significant detail, providing an opportunity for the public to assess the credibility of the test and compare results across banks.[9]

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8 The initial penalty for falling below post-stress requirements is a restriction on dividend payments and discretionary bonuses to senior bank executives. If a bank falls far enough below this level, it can be required to raise new capital.

9 Of course, this is a balancing act: there needs to be sufficient transparency for the public to evaluate the quality of the tests and determine if they are credible, which also enables the public to hold the Fed accountable. However, the Fed cannot release so much information that the banks can reverse engineer the tests and game them. That balance was fairly well struck before 2017, but the balance has decidedly shifted since then to greater transparency for the banks with less transparency for the public. That is counterproductive and fails to learn the lessons of the effective stress tests carried out during the crisis in 2009 and afterwards. See, "The Fed Just Bungled Its Bank Stress Tests," Bloomberg, Natasha Sarin, June 2, 2020, available at https://www.bloomberg.com/?sref=mQvUqJZj.

Through the combination of stronger capital rules and the stress-testing program, the largest banks are substantially less leveraged today than in the years prior to the 2008 crisis. The banks' capital cushion—the amount of losses that these banks' equity investors would have to absorb before taxpayer support might be needed—has increased by hundreds of billions of dollars relative to pre-crisis levels. While significantly more high-quality capital is likely needed to provide a more appropriate level of confidence that the largest banks could withstand foreseeable stressed conditions without collapsing and causing contagion, we can at least take some comfort that there is reason to be more confident than we otherwise could have been.[10]

The question of how much bank capital is the "right" amount to have confidence that systemically important banks are not a threat to the financial system, the economy and taxpayers continues to be debated. The often-cited point that banks are now "stronger than 2008" is clearly not the right benchmark since requirements at the time were so weak that they contributed to an historic crash with devastating consequences for tens of millions of people.

As a group, the aggregate risk-based capital ratio for the largest U.S. banks was just over 12 percent at year-end 2019 and the tier 1 leverage ratio was 8.6 percent.[11] This is below even the very bottom of the range which numerous studies have found to be appropriate to protect the system from needing taxpayer-funded bailouts of dangerously overleveraged banks in the future.[12]

Finally, it is also worth noting that an important byproduct of the stress-testing program is the vast improvement in the data and information about banks' risks that the Federal Reserve requires all banks that are subject to the stress tests to gather and report to the Federal Reserve periodically. This enhances the banks' capacity to identify and measure their risks as well as both the Federal Reserve's ability to assess the financial strength of the banking system and its crisis management capabilities.

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[10] The stress test results announced on June 25, 2020, however, have eroded that comfort and confidence. That announcement was an exercise in bad decision-making by the Fed, which has undermined the credibility of the program at a particularly bad time. The stress test used a scenario designed prior to the pandemic and the economic crisis it caused. It used estimates for unemployment and a range of economic activity that were in some areas markedly better than what is actually occurring, though a critical purpose of the test is to assess banks' ability to withstand an environment sigficantly worse than what is anticipated. In other words, reality has far exceeded what was hypothesized as a severely adverse scenario. While the Fed did also run "sensitivity analyses" to test against worse conditions, it declined to release bank-by-bank results, creating unnecessary uncertainty. Most importantly, the Fed failed to use its clear authority under the stress testing rule to require the banks to stop all capital distributions and preserve capital in the face of unprecendented economic calamity and uncertainty. Instead, the Fed unwisely and potentially recklessly imposed largely meaningless "restrictions" that nonetheless allowed the banks to significantly reduce capital through dividend payouts. See, "Are We Seeing The Demise of Stress Testing?," Brookings, Daniel K. Tarullo, June 25, 2020, available at https://www.brookings.edu/blog/up-front/2020/06/25/stress-testing/.

[11] *See*, Dodd-Frank Act Stress Test 2019: Supervisory Stress Test Results, June 2019, available at: https://www.federalreserve.gov/publications/files/2019-dfast-results-20190621.pdf These figures will be updated when the Federal Reserve releases the 2019 year-end results.

[12] *See*, IMF study *Benefits and Costs of Bank Capital*, 2016 finds capital in the range of 15-23%; Federal Reserve Bank of Minneapolis, *Capital Requirements and Bailouts*, 2017 and *Ending Too Big to Fail*, 2016 both point to a range of 20-30% to prevent 'public recapitalizations'; Simon Firestone, Amy Lorenc and Ben Ranish, *An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US*, 2017, a study by three Federal Reserve Board economists who find the 'optimal range' is between 13-26 percent. See also Anat R. Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong With Banking and What to Do About It*, 2013

During the 2007 - 2009 crisis, the lack of such information at banks and regulators presented a big impediment to assessing just how bad things were at banks, and how bad they might get if the downward spiral continued, which impaired the ability to respond to the crisis.[13]

Liquidity

Minimum liquidity requirements for the largest banks were also enacted—largely in line with Basel standards—through the so-called Liquidity Coverage Ratio (LCR), one of the first truly meaningful quantitative minimum liquidity requirements to be put in place. This critical reform has been the focus of industry ire and lobbying because maintaining appropriate levels and quality of liquidity forces the banks to internalize a significant cost of their high-risk activities. Rather than externalizing these costs to taxpayers, the liquidity requirements, and the LCR in particular, make the banks pay the cost of reducing the chance they might quickly collapse due to a liquidity crunch in a crisis as happened to large banks in 2008.

The LCR rule requires the largest banks to hold enough high-quality liquid assets (HQLA)—such as cash, Treasury securities or other securities that can be quickly turned into cash—to withstand 30 days of substantially increased liquidity outflows such as might occur under stress. These HQLA are generally significantly lower yielding assets than less liquid ones, which inevitably reduces bank revenues. The LCR has been helpful by reducing the largest banks' reliance on the type of funding most likely to disappear in a crisis while providing for a cushion to support operations for at least a short period of time in the event liquidity evaporates.

Highlighting the failure of pre-crisis banking supervision, the financial crisis exposed dangerous deficiencies in fundamental risk management practices...

Stronger Post-Crisis Large Bank Supervision

The importance of stronger post-crisis supervision of the largest banks as a complement to enhanced regulatory requirements is often overlooked because it is not as visible and not generally well understood outside of those who work at the banks and their supervisors. To facilitate implementation of the Dodd-Frank Act's statutory requirement for enhanced prudential standards for systemically important banks, as well as its own plans for addressing the failures of its pre-crisis banking supervision, the Federal Reserve made significant changes to its supervision of the largest banks after the crisis. The Federal Reserve's Large Institution Supervision Coordinating Committee (LISCC) was created to coordinate

[13] For more on stress tests, *see* Fed Conference on "Stress Testing: A Discussion and Review," including in particular the remarks of Dennis Kelleher on the panel "Stress Tests as a Policy Tool," available at: https://bettermarkets.com/resources/conference-%E2%80%9Cstress-testing-discussion-and-review%E2%80%9D-panel-one-%E2%80%9Cstress-tests-policy-tool%E2%80%9D; Also *see* comments from this conference by Tim P. Clark on the panel "Dynamism and Transparency in Stress Testing", available at https://bettermarkets.com/sites/default/files/dynamism-and-transparency-in-stress-testing-paper-clark.pdf

the design, implementation and execution of a stronger banking supervision program for the most systemically important banks and any non-banks designated as systemically important by theFSOC.

Supervision of firms in the LISCC portfolio has focused extensively on requiring them to build up their financial resilience by strengthening capital and liquidity positions and developing the practices and data that banks need to manage themselves safely. Highlighting the failure of pre-crisis banking supervision, the financial crisis exposed dangerous deficiencies in fundamental risk management practices and in the information that banks had available on the risks they take, including information banks need to effectively measure their capital and liquidity needs. With meaningful progress on resolution preparedness for too-big-to-fail banks a long-term work in progress, the primary goal of the Federal Reserve's large bank supervision was to strengthen these banks' financial resilience to reduce the probability that an attempted resolution—or another round of taxpayer-funded bailouts—would be needed in a downturn.

Higher capital and liquidity requirements have been supported and complemented by this post-crisis strengthening of banking supervision practices for the largest banks. In addition to the higher quantitative requirements discussed above, bank supervisors qualitatively assess on a firm-by-firm basis the practices banks use to identify, manage and control the risks inherent in banking activities to determine whether a bank is being run safely.

Banking supervision serves several important functions. It is needed to complement rules that establish largely fixed and consistent quantitative requirements across banks. Rules cannot generally account adequately for all possible circumstances across groups of banks as each can have a different business model exposing it to risks in a differing way. The resulting gaps can be filled by in-depth, bank-by-bank assessments by supervisors. In addition, rules are generally not dynamic enough to adjust rapidly to account for how banks' products or practices may be evolving or even explicitly being changed to skirt the intent, if not the language of the rules. Finally, rules alone cannot effectively prescribe all practices banks should use to manage themselves. Supervisors' qualitative assessments of those practices are critically important to try to ensure banks are not being run dangerously. These functions are the necessary roles of bank supervisors and are particularly important for the largest banks where the margin for error is small given the damage they can cause and the potential for risks to slip through regulatory cracks is high, even under the best of circumstances.

An important post-crisis change has been the emphasis on requiring large banks to have more forward-looking internal practices. In addition to making banks improve their ability to identify, measure and manage their daily risks, bank supervisors have focused extensively on requiring the largest banks to develop and have in place the information and practices needed to assess their potential financial condition under stress. Large U.S. banks are now required to make such assessments of both capital and liquidity regularly and are expected to use these assessments in determining their internal view of their capital and liquidity needs. The Federal Reserve reviews these practices throughout the year and these assessments of banks' capital and liquidity planning practices are critical elements of post-crisis supervision for the largest banks.

The need for the largest banks to have strong practices to support their capital planning process was viewed by the Federal Reserve Board as important enough to warrant the possible restriction of banks' capital distributions to shareholders when practices were found to be so deficient as to render their capital plans simply not credible.[14] This direct link between supervisors' qualitative assessments and meaningful consequences for banks with dangerously weak practices was a huge change from the discredited lighter touch, "banks-generally-know-best" approach to pre-crisis supervision. That approach had mistakenly assumed that banks, acting in their own supposedly well-informed self-interest and constrained by the discipline of market forces, would not take on excessive risk that could threaten them or the entire system. The 2008 crash proved that spectacularly wrong.

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The more assertive post-crisis approach by supervisors of the largest banks has made the system stronger by strengthening incentives for banks to expend the necessary resources to improve their ability to manage themselves safely. Put differently, the threat that the Federal Reserve would order the banks to suspend or limit their capital distributions in the form of stock buybacks and dividends was an important incentive to get large banks to put in place better internal risk management practices that have helped make them significantly safer.

Unfortunately, the success of this incentive proved too great for its own good. The current Federal Reserve Board now argues that banks' progress in this regard has been so good that this strong incentive is no longer needed. In 2019, the Federal Reserve essentially abandoned this so-called CCAR "qualitative objection," undermining post-crisis progress in making supervision stronger and weakening the ability of its own bank supervisors to oversee the largest banks effectively.[15]

In broader efforts to revert to the less assertive approach that was exposed as a failure by the financial crisis, the Federal Reserve's Vice Chair for Supervision recently floated preliminary proposals for additional changes to supervision that could materially decrease its effectiveness and usefulness in holding banks accountable and preventing crashes.[16] This follows an earlier effort during which the Federal Reserve Vice Chair for Supervision and the Chair of the FDIC visited bank supervisors around the country, reportedly directing supervisors to lighten up on their approach to overseeing banks. All of which points quite clearly to the direction intended when, in an article entitled "Banks Get Kinder,

[14] *See*, Capital Plans, 76 Federal Register 74631, December 1, 2011, available at: https://www.federalregister.gov/documents/2011/12/01/2011-30665/capital-plans

[15] Tim P. Clark, Is the Fed in Retreat?, Politico (April 9, 2019), available at: https://www.politico.com/agenda/story/2019/04/09/federal-reserve-stress-tests-banks-000889/

[16] *See*, Better Markets' "In Delivering a Speech That Could Have Been Written by Wall Street's Biggest Banks, the Fed's Vice Chair for Supervision Fails to Mention 2008 Crash or the Fed's Widespread Supervisory Failures in Contributing to It," January 17, 2020, available at: https://bettermarkets.com/newsroom/delivering-speech-could-have-been-written-wall-streets-biggest-banks-federal-reserve-vice.

Gentler Treatment Under Trump,"[17] the Federal Reserve's Vice Chair for Supervision was quoted as saying "changing the supervision culture 'will be the least visible thing I do and it will be the most consequential thing I do.'"

These misguided efforts to weaken more assertive post-crisis banking supervision practices, incentives and culture risk reversing the significant progress made since the crisis. Together, tougher rules and stronger supervision have made the very largest banks less risky and have dramatically improved protection of the financial system, the economy and taxpayers.

Resolution of Systemically Important Financial Institutions

The effort to make large complex banks resolvable when they collapse without causing widespread financial disruption was a key element of the Dodd-Frank Act reforms and the attempt to end the too-big-to-fail problem. These efforts were critical complements to enhanced prudential standards required for systemically important firms. In short, enhanced prudential standards for too-big-to-fail firms—such as the standards discussed above—are designed to make it less likely these firms will get into the kind of trouble that can lead to their collapse. Resolution mechanisms are meant to be the backstop should it turn out those enhanced standards still weren't enough and a large bank fails anyway.

There are two main elements of this backstop strategy: (1) the Dodd-Frank Act Title I provisions for resolution plan ("living wills") requirements that try to force[18] the banks to be better prepared for the possibility of being resolved in bankruptcy, and (2) Title II Orderly Liquidation Authority (OLA)[19] which allows the FDIC, with agreement by the Treasury and the Federal Reserve, to take over a failing SIFI and resolve it if the bank's resolution plan did not or is not going to work.

As directed by the Dodd-Frank Act, the Federal Reserve and FDIC implemented rules requiring systemically important banks to submit annual plans detailing how each bank could be resolved in a non-disruptive way through a bankruptcy proceeding. To support this requirement, they issued guidance that details meaningful supervisory expectations for actions that too-big-to-fail banks could take to make themselves ostensibly more resolvable or perhaps, more accurately, at least somewhat less unresolvable.

Among the key expectations that have had some positive effect are: 1) reducing, somewhat, the complexity of the unwieldy legal structures of sprawling banking behemoths; 2) having capital and liquidity in place at, or readily available for, the key legal entities where it may be most needed in a resolution scenario; and, 3) preparing data and legal documentation in advance to allow for a relatively

[17] *See*, Wall Street Journal, December 12, 2018, Lalita Clozel, available at: https://www.wsj.com/articles/banks-get-kinder-gentler-treatment-under-trump-11544638267.

[18] See "Wall Street's Too-Big-to-Fail Banks Still Trying to Get Taxpayer Bailouts, available at: https://bettermarkets.com/blog/wall-streets-too-big-fail-banks-still-trying-get-taxpayer-bailouts.

[19] OLA Failsafe Is Necessary," available at: https://bettermarkets.com/newsroom/financial-reform-newsletter-better-markets-bites-dog-again.

rapid sale or unwind of key legal entities, if needed. This may have reduced the risk the largest banks present to the financial system during periods of economic stress, and the existence of resolution plans may have helped contribute to some confidence that during a period of stress, even if there is a significant failure of a financial firm, both financial institutions and regulators would be better prepared to take mitigating actions that make a Lehman-like catastrophic and disorderly failure possibly less likely.

As a failsafe, break-the-glass backstop in the event of a looming disorderly collapse of a large bank, the creation of OLA extended the FDIC's longstanding authority to resolve commercial banks to bank-holding companies and non-bank financial institutions designated as systemically important by the FSOC. Potential external funding needed to run the firm during the liquidation process is to be provided by the U.S. Treasury Department with any and all losses to be recouped after the fact via the imposition of fees levied by the FDIC on surviving SIFIs.[20]

While some progress has been made, there is reason to doubt the effectiveness of the mechanisms to eliminate too-big-to-fail banks by providing for the orderly resolution of the largest banks either in bankruptcy or by the FDIC. The largest banks appear to remain far from being resolvable[21] (in part, by design[22]), and the progress that was being made has lost all momentum during the Trump Administration. These huge banks will continue to be too-big-to-fail unless and until there is the political will to take more decisive action, which to be effective would likely need to include some combination of reducing their activities, size and/or complexity.

Given the current uncertainties surrounding bank resolution processes for large banks, it is difficult to imagine that U.S. officials would attempt to use either bankruptcy or OLA to try to resolve one in the midst of a crisis. In the event of solvency-threatening deterioration of one of these banks during a period of stress, the authorities, therefore, would probably again have to take actions to support the bank, which would most likely include taxpayer-funded bailouts.

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[20] This is similar to how the deposit insurance fund works.

[21] See, e.g., "The Too Big to Fail Problem Is Alive, Well and Getting Worse," Dennis Kelleher, Presentation to the Financial Stability Board, September 16, 2019, available at: https://bettermarkets.com/sites/default/files/documents/Better_Markets_Too-Big-To-Fail_FSB_Conference-9-16-2019.pdf.

[22] See, supra, n. 16.

Other Notable Banking Reforms

Derivatives Markets Reforms

The Dodd-Frank Act's over-the-counter derivatives market reforms have also contributed significantly to a safer banking system. Key enhancements include broader use of collateral and higher margin requirements, increased use of central clearinghouses/exchanges for less complex segments of derivatives markets, and higher capital and liquidity requirements for some critical banking entities with derivatives positions (discussed above regarding the U.S. implementation of the capital and liquidity standards). Furthermore, the registration of key derivatives dealing legal entities within bank holding companies or BHCs has required these entities to adopt risk management and compliance programs that comprehensively assess and manage derivatives-related risks. The supervision of these individual legal entities is likely to have instilled better market discipline and risk management practices.

To be sure, some of these improvements may have transformed or migrated risks in ways that demand ongoing market and regulatory attention. For example, the increased use of central counterparties has been a major post-crisis effort, and the increased share of over-the-counter (OTC) derivatives trades that are now centrally cleared has reduced bilateral derivatives-related credit exposures across banks and other market participants in interest rate, credit, and other asset classes. To date, this development has not been broadly tested in adverse market conditions, however, and it will therefore warrant close monitoring should further deterioration ultimately lead to defaults of large derivatives clearing members in clearinghouses. Such a default would test arrangements through which these clearinghouses/exchanges are supported by their member banks when they experience large losses and could potentially lead to substantial calls on financial resources of surviving member banks at a particularly bad time. That said, the Dodd-Frank Act instituted or authorized a number of enhancements to clearinghouse and clearing member practices that are widely believed to have improved the overall risk profile of the major derivatives clearinghouses and the banks themselves.

In addition to these reforms, there have been enhancements to transparency in derivatives markets, including through greater public reporting requirements by market participants. This improved transparency can provide for a clearer window into derivatives pricing and promote better risk management, less disagreement over who owes whom how much, and a clearer view into the market for banks and regulators. This also may reduce unwelcome surprises and lead banks to have better, more reliable valuation practices—all of which are critical in periods of economic stress, such as the one we are currently experiencing.

However, the Dodd Frank-Act required significant additional reforms that must be implemented before the U.S. financial system and economy are sufficiently protected from the dangers and threats from the derivatives dealings of a small number of too-big-to-fail banks. More than 87 percent of the reported $201 trillion notional in derivatives within the U.S. banking system continues to be controlled by dealers within just four U.S. BHCs.[23] Each of these four BHCs also facilitates trading in a significant percentage of the $640 trillion notional in global derivatives markets through multiple affiliated non-U.S. dealers.[24] This concentration of risk poses significant contagion and other risks to systemically important U.S. banks, and this has only been amplified by a recent rollback of interaffiliate margin requirements for U.S. banks involved in global derivatives dealing.[25]

The Dodd-Frank Act addressed this concentrated market power and the associated risks to banks in numerous ways, including capital and margin requirements, pre- and post-trade transparency, and governance limitations. However, those provisions have been implemented only in limited respects, and U.S. regulators have not yet developed an antitrust framework to address anti-competitive practices that increase firm-specific and systemic risks across the banking sector. The U.S. regulators also have, in certain respects, invited regulatory arbitrage through cross-border interpretations that permit, if not encourage, derivatives dealing in affiliates and foreign jurisdictions.

Morgan Stanley lost more than $9 billion in a single prop trade, which happened at the same time as it suffered gigantic losses from subprime mortgages, leading to its failure and taxpayer funded bailout.

Thus, as with the capital and liquidity improvements discussed above, there has been progress, but much more work needs to be done to end the taxpayer subsidy for the swap-dealing banks' derivatives activities, protect depositors' money and reduce the risk of taxpayer bailouts.

Banning High-Risk Proprietary Trading (The Volcker Rule)

Banks provide an essential service to the country by intermediating financial transactions between and among individuals and businesses, which finance education, homes, retirements, businesses of all sizes, jobs, economic growth and, ultimately, the American Dream. Those socially beneficial activities are why banks and the banking system are backstopped by the U.S. government and taxpayers in the form of, for example, FDIC deposit insurance and Federal Reserve "lender of last resort" activities. To reduce the inherent risks of

[23] Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, Third Quarter 2019, December, 2019, available at: https://www.occ.gov/publications-and-resources/publications/quarterly-report-on-bank-trading-and-derivatives-activities/files/pub-derivatives-quarterly-qtr3-2019.pdf (noting that "[a] small group of large financial institutions continues to dominate trading and derivatives activity in the U.S. commercial banking system" and that "four large commercial banks represented 87.2 percent of the total banking industry notional amounts and 83.2 percent of industry net current credit exposure").

[24] Bank for International Settlements, Statistical release: OTC derivative statistics at end-June 2019, November 8, 2019, available at: https://www.bis.org/publ/otc_hy1911.pdf (noting that "[l]arge dealers in advanced economies (AEs), who report data to the semiannual survey, accounted for the overwhelming majority (92% of notional amounts, 87% of gross market value) of outstanding positions at end-June 2019").

[25] *See* FDIC et al., Margin and Capital Requirements for Covered Swap Entities (adopted Jun. 25, 2020), available at https://www.fdic.gov/news/board/2020/2020-06-25-notice-dis-b-fr.pdf.

banking and the risks arising from the 'moral hazard' created by that backstop, banks are supposed to be highly regulated to prevent abuses, reduce failures, and protect taxpayers.

However, much riskier, but non- or anti-socially beneficial financial activities by banks frequently provide much greater returns and much bigger paychecks than traditional banking intermediation between savers and borrowers. One such activity is known as proprietary trading, which is when a bank makes a usually highly leveraged and complex financial bet for its own account (often using low- to no-cost federally insured deposits). Because the potential for quick, short-term rewards to the trader and the bank are often astronomically high, the incentive to engage in this trading is often irresistible. However, such trades are little more than gambling and have little, if any, socially useful or redeeming purpose. Indeed, they can threaten the safety, soundness and stability of the bank and the financial system itself if sufficiently pervasive.

Moreover, proprietary trading almost always involves conflicts of interest between the bank and its so-called customers, where the bank is advancing its own interests at the expense of whoever is on the other side of its "prop" trade. This perniciously gets reflected in the culture of the bank. Prop trading is zero sum: I win-you lose. That is the opposite of a traditional banking relationship where the customer's long-term success (and increased need for banking services) is the goal. With prop trading, customers become merely counterparties, wallets from which to extract as much profit as possible as fast as possible.[26] When the trading culture becomes the predominant one at a bank, outsized risk-taking, excessive leverage and an overall gambling attitude can come to be the norm and long-term customer relationships and customer-focused services become secondary at best. Put differently, a trading culture can dilute, if not eliminate, the very reason banks are backed by society in the first place.

That is what happened in the years before the 2008 financial crash when Goldman Sachs,[27] Lehman Brothers, Bear Stearns, Morgan Stanley, Citigroup and other systemically significant banks and nonbanks engaged in substantial amounts of proprietary trading. Indeed, Morgan Stanley lost more than $9 billion in a single proprietary trade, which happened at the worst possible time: when it was also taking huge losses due to the collapse of the subprime credit markets.[28] Such socially useless,

[26] *See*, e.g., "Senate Probe Alleges Goldman Mortgage Deception," MarketWatch, Ronald D. Orol, April 13, 2011, available at: https://www.marketwatch.com/story/senate-probe-alleges-goldman-mortgage-deception-2011-04-13.

[27] *See*, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, United States Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, pp. 376-635 ("Failing to Manage Conflicts of Interest: Case Study of Goldman Sachs"), April 13, 2011, available at: https://www.hsgac.senate.gov/imo/media/doc/PSI%20REPORT%20-%20Wall%20Street%20&%20the%20Financial%20Crisis-Anatomy%20of%20a%20Financial%20Collapse%20(FINAL%205-10-11).pdf, and "Senate Investigations Subcommittee Releases Levin-Coburn Report on the Financial Crisis", April 13, 2011, available at: https://www.hsgac.senate.gov/subcommittees/investigations/media/senate-investigations-subcommittee-releases-levin-coburn-report-on-the-financial-crisis.

[28] *See*, "$9.4 Billion Write-Down at Morgan Stanley," the New York Times, December 20, 2007, Landon Thomas, Jr., available at: https://www.nytimes.com/2007/12/20/business/20wall.html.

high-risk trading did not stop after the 2008 financial crash. JP Morgan Chase lost at least $6.2 billion in 2012 due to a massive, complex, highly leveraged CDS index best known as the "London Whale."[29]

To stop taxpayer-backed banks from engaging in such dangerous gambling, the DFA prohibited proprietary trading in a provision known as the "Volcker Rule,"[30] named after former Federal Reserve Chair Paul Volcker. This ban restricted banks' from engaging directly in proprietary trading both directly as well as indirectly by limiting investments in hedge funds and private equity. In addition to reducing the risk from these activities, the rule has had the added benefit of promoting greater scrutiny of trading activities on the part of banks' senior management and regulators. This has encouraged increased discipline over risk taking and risk measurement practices in banks' trading activities as well as better identification and monitoring of banks' trading positions and enhanced controls and governance—results which have almost certainly contributed to banks' ability to withstand the current period of stress.

Like other areas of progress discussed above, the Volcker Rule has been under attack from the industry since it was first proposed. After all, it was a huge and direct threat to the gigantic bonuses that traders and executives at Wall Street's biggest banks had come to expect. That opposition has unfortunately resulted in significant rollbacks of the Volcker Rule during the Trump Administration[31] which have been opposed by Better Markets[32]. Those rollbacks threaten to resurrect the trading culture and practices that brought the U.S. financial system to the brink of collapse only 10 short years ago.

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29 *See*, JP Morgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses, United States Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, April 11, 2013, available at: https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20JPMorgan%20Chase%20Whale%20Trades%20(4-12-13).pdf.

30 *See*, e.g., Better Markets' comment letters on proposed Volcker Rule, available at: https://bettermarkets.com/sites/default/files/documents/SEC-%20CL-%20Volcker%20Rule-%202-13-12_1.pdf and https://bettermarkets.com/sites/default/files/documents/CL%20CFTC%20FINAL%20Volcker%20Rule%204-16-12.pdf.

31 *See*, e.g., "Banks Get Easier Volcker Rule and $40 Billion Break on Swaps," Bloomberg, Jesse Hamilton, June 25, 2020, available at https://www.bloomberg.com/news/articles/2020-06-25/banks-get-easier-volcker-rule-and-40-billion-reprieve-on-swaps?sref=mQvUqJZj

32 *See*, e.g., Better Markets' Comment Letter on Proprietary Trading and Certain Interests in and Relationships With Covered Funds, September 21, 20117, available at: https://bettermarkets.com/sites/default/files/OCC%20-%20CL%20-%20Volcker%20Rule%20-%209-21-17.pdf, Better Markets' Comment Letter on Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, October 17, 2018, available at: https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20on%20New%20Volcker%20Rule%20Proposal.pdf, and Better Markets' Comment Letter on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, April 1, 2020, available at: https://bettermarkets.com/sites/default/files/Better_Markets_Inc._Comment_Letter_on_Prohibitions_and_Restrictions_on_Proprietary_Trading_and_Certain_Interests_in_and_Relationships_With_Hedge_Funds_and_Private_Equity_Funds.pdf.

Conclusion

There is no question that post-crisis banking reforms have put us in a significantly better place than we would have been without them, supported an unprecedented stretch of economic growth and have, so far, prevented a crisis or crash in the banking system as a result of the turmoil created by the COVID-19 pandemic. This is true even though virtually every reform discussed in this paper is either now weaker than it was when initially enacted or has been the subject of various formal or informal proposals and actions to weaken them over the past several years. Attempts to roll back the gains achieved through these reforms continue even as a pandemic leading to unprecedented uncertainty in the economic outlook rages on.

It is typical to note that memories of the last crisis have proved too short, and this is true to some extent, on the part of banks, regulators, policymakers, elected officials and the public at large. But more importantly, when economic times are good or at least better than they were, the political power of the banking industry increases and allows them to promote "forgetfulness." Banks, their lawyers, lobbyists, PR firms, political allies and sundry cheerleaders throughout the influence industry work hard to make people forget the devastation that can come from a banking system built upon a shaky, deregulated foundation.

Instead, they promote the ostensible benefits of what banks can do for the economy if they are not subject to the strong rules, oversight and enforcement that are needed to protect jobs, homes, savings, the financial system and the economy. And, they deny, downplay or ignore the critically important trade-offs between short-term benefits to economic activity (which are often illusory financial activities rather than real-economy benefits) and the inevitable devastating human costs of a financial crisis. When things are going well, in so-called "normal times," considerations of the potentially massive social costs posed by fragile banks that are financially weak or dangerously managed are subordinated to or eclipsed by the promoted view that good times are here again and will remain. Indeed, the banks spend vast resources pushing the myth that the good times would be even better if the rules were relaxed or eliminated as if there were no tradeoffs and there was a risk-free option available.

While the likelihood and potential costs of taxpayer-funded bailouts have decreased because of the Dodd-Frank Act and related banking reforms, it is still not by enough, and it is still relentlessly opposed by too many in the industry. Much work remains, but, thus far, key banking reforms have nonetheless worked to strengthen the financial system. This has enabled the banks to serve not as an accelerant of the current crisis, but rather to provide support to the economy, which is why they are backed by taxpayers in the first place.

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Better Banks | Better Businesses
Better Jobs | Better Economic Growth
Better Lives | Better Communities

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside, and protect investors and consumers.

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