Flexibility and Responsiveness in Financial Regulation:
The Design and Implementation of the Dodd-Frank Act

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Thank you Chairman Luetkemeyer and Ranking Member Clay, Committee Chairman Hensarling, Ranking Member Waters, and members of the Committee for the opportunity to be here today and to offer my perspective on the ongoing need for effective regulation and supervision of the banking system.

In the fall of 2008, a financial crisis of tremendous scale and severity left millions of Americans unemployed and resulted in trillions in lost wealth. Our broken financial regulatory system was a principal cause of that crisis. It was fragmented, antiquated, and allowed large parts of the financial system to operate with little or no oversight. The financial system had dramatically evolved over decades, with business models often intentionally designed to take advantage of regulatory gaps or unequal treatment of similar markets and institutions. For example, trillions of dollars in swaps were traded without transparency or oversight. Many bank-like institutions operated outside the regulatory view of bank agencies. This allowed some lenders to make irresponsible loans and then shed all the associated risks, often through securitization vehicles that both obscured and interconnected these risks, and use hidden fees and fine print to take advantage of consumers. When the crisis exposed these massive inadequacies, another became apparent -- regulators did not have the tools to safely wind down many of the system's largest, most complex institutions. Instead they were faced with the unpalatable choice of either intervening to prevent certain institutions from failing, or letting them fail at the risk of imperiling the entire financial system and plunging the country into a Second Great Depression.

Americans paid a high price in lost wealth, jobs and homes, delayed retirements and college educations. We all learned that in the end, our financial system only works –- our market is only free –- when there are clear rules and basic safeguards that prevent abuse, check excesses, and ensure that it is more profitable to play by the rules than to game the system. Dodd-Frank was passed to make sure that Americans could again put their trust in financial markets and institutions.

Dodd-Frank enacts a number of provisions that curb excessive risk taking and hold financial firms accountable. Our regulators also worked with international counterparts to refine capital and liquidity standards to ensure that U.S. firms face an even playing field at home and abroad. However, the policymakers that drafted Dodd-Frank recognized that our financial system is dynamic and risks cannot be adequately addressed by a one-size-fits all approach. The law therefore provides that regulatory requirements be tailored and commensurate with the risks they seek to regulate – including exempting smaller banks from most of its new requirements – and providing regulators with flexibility to address new risks as they arise.

I’ve organized my testimony today in two parts. First, I will begin with a brief discussion of the how the post-crisis Wall Street Reforms have strengthened our financial system and supported our economic recovery and offer a number of considerations that should be part of any evaluation of changes to financial regulation.

In the second section, I will discuss how the ability to deliver regulation that is appropriate to the risk is the central question for policy makers designing financial regulation-- both of individual institutions and for the constantly evolving financial system as a whole. In this section , I will discuss how the interplay between statute, regulation, guidance, and supervision can work together to provide appropriate regulation for the country’s wide diversity of banks and nonbanks. I will then discuss how the statutory architecture of Dodd-Frank is designed to help achieve that goal. In particular, Dodd-Frank uses clear exemptions, statutory requirements for tailoring, and market-based rules to help assure that regulators are focused on this central question. Finally, I will discuss how regulators have responded to statutory direction and used the statutory discretion that they have been given to be consistently responsive to legitimate concerns about regulatory burden and to create a tiered and tailored regime.

Before continuing, it is important to note that the goal of bank regulators must not be to satisfy the banking industry, but rather to satisfy the public interest. For that reason, the best test of how regulators are progressing through their work is whether financial markets are stable, loans are extended on clear and fair terms, and agencies demonstrate consistent openness to new approaches and an ability to flexibly apply their rules over time. And I will discuss how I believe our current economic backdrop provides evidence of that.

SECTION I: ECONOMIC STRENGTH AND EVALUATING CHANGES TO FINANCIAL REGULATION

ECONOMIC RECOVERY AND FINANCIAL SYSTEM HEALTH

The continued economic recovery since the financial crisis, particularly when viewed in comparison to other countries that were hard hit, demonstrates that the increased stability and resilience of our financial system have not come at the expense of economic growth. As financial reform was being implemented, the private sector added 15 million net new jobs and household wealth grew by $30 trillion. At the same time real GDP growth continued steadily since Dodd-Frank passed and remained positive, even as Europe weathered a sovereign debt crisis and the UK suffered a double dip recession.

Within the banking sector, recovery has been strong and widespread. Business lending has grown steadily since Dodd-Frank was passed, and corporate bond issuance in public markets has reached record highs. The banking system is currently delivering on its promise to provide credit to the economy. In the past two years, community bank lending and earnings growth has outpaced the industry as a whole -- with more than 10% income growth in 2016, and lending up nearly 9% -- both faster than the industry as a whole.[1] Examining these trends for segments of

1 FDIC, “Quarterly Banking Profile: Q4 2016,” February 28, 2017.

banks by size, bank performance data show that the annual growth rate of lending by community banks has been consistently positive across large and small community banks and recently has been in line with rates seen even in the pre-crisis period. In fact, the four years from 2011 to 2015 each set new, all-time records for aggregate earnings in the banking sector.[2]

The improvements within the fundamentals of the banking sector are coupled with improvements in capital markets -- asset managers and investors benefit from increased transparency and resiliency -- whether delivered by improvements to derivatives markets or clearer understanding of bank risk through stress testing. Market discipline is supported by clear rules and by additional transparency.

Of course, this aggregate strength masks local weakness in some markets, particularly in rural or underserved communities; and nationally for small businesses that do not have strong track records of profitability or assets to use as collateral. To address these issues, Treasury oversaw an expansion of the Community Development Financial Institutions fund -- and in particular worked closely with community development bankers to help them better serve their communities. Implementing the Small Business Jobs Act of 2010, Treasury created the Small Business Lending Fund, which invested $4 billion dollars in more than 300 community banks to spur small business lending, and partnered with states and cities to support local small business lending programs in the State Small Business Credit Initiative. The Small Business Lending Fund supported more than $18 billion in new small business lending. The State Small Business Credit Initiative has created an innovative network of partnerships between state and local governments and industry, and is on track to leverage the federal support for small business lending ten-fold. This network is working today and should be renewed, and I know that members of this Committee, including Ranking Member Waters have supported that legislation.

EVALUATING CHANGES IN FINANCIAL REGULATION

Briefly, I'd also like to point out a few considerations by which to evaluate the course and progress of our financial regulations.

As you know, while many non-controversial rules are finalized within a year, the process of a promulgating a major, new regulation from statutory direction to implementation can be 4-5 years. The time it takes a regulator to develop a final rule will depend a variety of factors, and is driven primarily by three interlocking forces: the analytical complexity of the rule and the number of agencies required to collaborate; the obligations to follow the Administrative Procedures Act, to follow agency authorizing statutes, and to make rules consistent with the specific statutory direction; and the need to consider the perspectives of all affected constituencies, including entities that will be directly regulated or indirectly affected, oversight bodies such as this committee, consumers and public interest groups, and industry groups. Importantly, the same care and attention that makes these rulemaking processes slow to complete, also make these rules slow to revise. One common criticism of the rulemaking process is the length of the number of pages of text in the final release. Yet in most cases, the length of releases is driven by the desire to explain the rule and in particular to explain how the

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2 FDIC, Historical Statistics on Banking, 2016.

final rule responded to each and every comment that was submitted during the process. The rule text itself is often less than 10% of the final release.

It also is critical to appreciate the difference between transition costs and long-run costs. Even for the most beneficial change in regulation there will be transition costs that any regulated entity will have to incur in order to move their systems and processes into line with the new approach. For example, the CFPB's move to an integrated disclosure form for TILA/RESPA compliance has shortened and simplified the forms needed for a mortgage closing, even though firms do face burdens in order to update their systems and processes for the simpler forms.[3] I would encourage any member of this committee to spend time looking at the new and the old forms. The clarity and simplicity of the new forms is striking. To take another example, asking firms to create living wills was something that no bank had ever been asked to do prior to Dodd-Frank. Developing those plans required significant new thinking and for many large firms, required them to make changes to their legal structure. However, these changes are largely transition costs of simplifying banks and of building systems necessary to keep their plans up to date. These transition costs can be managed through tiered transition timelines, guidance, and trainings from regulators; but they should not undermine the effort to change our financial system so that it can work better in the long run.

Comparisons of economic or financial statistics between the current day and the pre-crisis peak are both a misleading and dangerous way to evaluate the effects of a regulation. The period immediately preceding the global financial crisis, seemed at the time to be an era of positive economic growth and dynamism. Yet the outcomes of the crisis demonstrated that those years were actually driven by significant imbalances, unstable financial engineering, and systematically underappreciated risk. Therefore, any analysis of the current economic and financial environment must look very carefully to make sure that it does not compare current prices or levels of activity with the immense excess that led to the global financial crisis.

SECTION 2: REGULATION APPROPRIATE TO RISK

Financial stability benefits banks, insurance companies, and asset managers, as well as small businesses, tech startups, and families looking to refinance a home mortgage or save for retirement. Economists who have studied the banking system and financial markets have shown how market distortions and disruptions undermine financial stability. If those problems are left unaddressed, the consequences can be dire for everyone, as we saw in 2008. We must prevent the future instability by maintaining robust safeguards, which is what the Dodd Frank Act set out to do.

Let us start with the simple but central point: a $200 billion bank is not the same as a $2 trillion bank; nor is it the same as a $20 billion bank, a $2 billion bank, or a $200 million dollar bank. The U.S. banking system is far less concentrated than our peer developed nations, and this diversity is a strength. Moreover, the diversity in size among the 6,000 banks in the U.S. actually

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3 The TILA/RESPA forms before revision and after are available at https://www.consumerfinance.gov/know-before-you-owe/compare/

understates their differences, given the diversity in business models. From a community bank that focuses on serving one rural community, to a bank that focuses on banking medium-sized businesses across a region, to money center institution with enormous capital market operations stretching across the globe -- banks come in all stripes. Even among the very large banks, there are significant regional and business model differences, with different degrees of exposure to capital markets and to macroeconomic trends. Because of this diversity our regulatory approach needs laws, regulation, guidance, and supervision that are able to deliver appropriate oversight based on risk to financial stability.

Doing so is not simply a matter of having tiered regulation- moving numerical thresholds up and down to govern different kinds of regulation- it is a matter of both assessing risk and tailoring regulation to that risk. Therefore, Dodd-Frank takes both a tiered and tailored approach.

In order to deliver a regulatory system that is appropriate to the risk, we must be clear-eyed about the risks we face. This means acknowledging that tough standards must apply to the largest, most complex institutions; and that we must have the tools to handle their failure.

For the largest and most complex institutions, Dodd-Frank matched an increase in simple requirements, like the leverage ratio, with new quantitative standards on liquidity, and new tools to monitor and mitigate risk across the network of financial institutions. Dodd-Frank also recognizes that the financial system is changing all the time and that new nonbank firms can grow to be central to our financial system. That is why the Financial Stability Oversight Council is accountable for monitoring changes to the financial system and for making sure that any firm whose failure could disrupt financial stability is subject to strong oversight. From the perspective of being better prepared to handle a crisis, we now have a clear statutory framework for letting any financial firm fail without taxpayer support. It is only by having a clear plan and clear legal authority that we can avoid the awful choices that we faced in the fall of 2008, between the panic-inducing failure of Lehman Brothers and the bailout of AIG. Removing the authority to liquidate large, complex financial institutions the way that we have done for banks of all sizes would be a return to the policy of too big to fail.

DODD-FRANK PROVIDES A COHERENT FRAMEWORK TO CREATE RISK-APPROPRIATE REGULATIONS

The tiered and tailored approach uses a combination of different tools to fit carefully the risk posed by both types of activities and types of entities. In many cases, Dodd-Frank creates simple demarcations for where rules and standards do or do not apply, and even within these demarcations, Dodd-Frank uses clear and strong statutory language to require specific tailoring based on risk. In other cases, Dodd-Frank bases its statutory requirements on participation in particular markets and activities. Since the activities subject to these provisions, like comprehensive derivatives reform and disclosure and risk-retention requirements, are largely capital markets oriented, these markets and activity-based frameworks create natural tailoring and tiering to only the large, complex firms that engage in these activities. And importantly, Dodd-Frank distinguishes between the largest firms and the significantly different and simpler standards needed for community banks. It is important to note, however, that the principles of tiered and tailored regulation are also balanced with the needs and demands of citizens who

expect to have consistent and ethical treatment in their financial transactions. Therefore, the statutory framework governing the CFPB creates a supervisory and enforcement focus on the large participants, while also applying consumer rules broadly in the marketplace.

Title I of Dodd-Frank, lays out a statutory framework for applying the toughest regulations, so-called enhanced prudential standards, to the financial institutions that pose the most risk. These standards begin with a simple demarcation, they only apply to bank holding companies with more than $50B in assets and to nonbank financial firms designated by the FSOC. In addition, the Federal Reserve has a clear statutory mandate to adjust these regulations based on the risk and the business models of these firms.

I will make two observations relevant to the ongoing debate about changing this level. First, this threshold acts as a statutory requirement for where the Federal Reserve must begin to engage in enhanced oversight and monitoring of these firms -- it does not, either by statute or by regulation, imply that firms at this threshold are “systemically important.” Second, any movement of this threshold does not absolve policy makers from answering the central question -- given a bank of $50 billion or $75 billion or $100 billion, what are the capital and liquidity standards that should be applied based on the risk of that bank? Moreover, the Federal Reserve has already made significant modifications of their rules -- both to make the standards and their application significantly stricter for the largest, most complex banks, and to create lower standards with simpler application for smaller banks.

Another tailored aspect of the regime is the comprehensive reforms of the derivatives markets, which only apply to entities significantly engaged in derivatives markets. These new rules are a key pillar of Dodd-Frank’s efforts to protect the U.S. economy from the potential of another devastating financial crisis. In the crisis, derivatives were both a central accelerant of the market panic and implicated in many of the worst practices that characterized the sub-prime mortgage bubble. For example, Bear Stearns, Lehman Brothers and AIG had trillions of dollars in derivatives contracts that tied them tightly to other large, complex financial institutions around the globe. As these institutions neared failure in 2008, their derivatives exposures were unknown by general market participants, counterparties, and government officials. The question of who was bearing the risk dominated discussions in markets and accelerated the contagion to other financial firms. The overwhelming importance of derivatives in the midst of the crisis was not incidental. These same instruments played a key role in the original construction of sub-prime mortgage backed securities, as well as, the construction of collateralized debt obligations (CDOs). Of course, synthetic CDOs were constructed entirely of bundles of derivatives contracts.

From the perspective of Dodd-Frank implementation, community banks and small institutions can avoid any burden associated with regulating these enormous markets simply by continuing to avoid significant engagement in derivatives markets. Even among entities that engage routinely in derivatives markets, the statute directs the rules to apply more stringently to swap dealers and major speculative players in derivatives markets. It also sets out specific rules appropriate for clearing houses and trading venues, entities that have always been under the oversight of the SEC and CFTC -- and for whom, heightened scrutiny is needed given the importance and risk in

derivatives markets. Moreover, the statute provides exemptions for entities that use derivatives purely as end-users; and makes clear that banks with less than $10 billion in assets can be end users.

The application of the disclosure and risk retention requirements for securitizations follow a similar statutory framework. A securitization is a pool of financial assets grouped together into a security that can be sold off in pieces. This structure was central to the contagious panic that pervaded in the depths of the crisis. By pooling assets without clear and consistent disclosure -- investors could know the type of assets and the overall characteristics but not the way in which these assets would be affected by fast-developing market movements. Moreover, it was well known that the financial entities who created these securitizations did not have to hold on to the risk. When the assets started to underperform, these skewed incentives caused a significant rupture in the market and in the flow of credit to the economy. In particular, Dodd-Frank requires for the first time asset-level disclosure in all securitizations. Just as importantly, Dodd-Frank requires that entities that create securitizations retain a portion of the risk of the securitization -- a simple requirement that chefs must eat their own cooking.

While Congress was developing these statutory provisions, there were many advocates who believed that the incentives should be structured to require that the rules apply to anyone who originated an asset that would be included in a securitization. In Dodd-Frank, however, Congress did not apply these rules to originators of assets. Congress recognized that many smaller institutions and even non-financial institutions could be considered originators of assets that might be later securitized. Therefore, Dodd-Frank applies these rules to the entity that engages in the financial action to create a securitization -- this language means that the rules apply to the major financial players who are at the center of this market, not peripheral actors.

In the creation of the CFPB, Dodd-Frank uses both clear demarcations and statutory guidance to drive a tiered and tailored approach. Most importantly, Dodd-Frank maintains a single supervisor for all community banks with less than $10 billion in assets -- more than 90% of all banking institutions have no supervision from the CFPB.[4] This means that an FDIC supervised bank before Dodd-Frank remains supervised by the FDIC, and only the FDIC, for both consumer compliance and safety and soundness. For nonbanks, Dodd-Frank requires the CFPB to follow a similar principle. Before the CFPB can supervise a nonbank financial company, it must go through a notice and comment rulemaking to define the large participants in a consumer financial market -- and supervision only applies to those large participants. Importantly, the purpose of these large participant rules is that they provide the CFPB the ability to supervise nonbanks in the same way that community banks have been supervised by the bank regulators for decades.

Moreover, the CFPB's statutory purpose is tailored to making consumer financial markets "fair, transparent, and competitive." And the Bureau must consider the benefits and costs of its rulemaking, and has a specific requirement to consult with small businesses that could be affected by its rules.

Of course, the long standing consumer lending laws, such as the Truth in Lending Act are

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4 FDIC Community Banking Study. https://www.fdic.gov/regulations/resources/cbi/study.html

generally applicable to any entity that extends credit to a consumer. This breadth of application carries over into the CFPB's work, which now has authority to implement these consumer lending laws. It reflects Congressional judgment, dating back nearly 50 years, that consumers should not be subject to widely divergent statutory protections, based on whether they engage with a bank, nonbank, or other entity.

Finally, the work of Congress and the last Administration since the passage of Dodd-Frank reflected a commitment to the principles that changes should be broadly bipartisan, practical, and focused on the needs of smaller community banks. This is why statutory changes such as doubling the threshold for small bank holding companies, or increasing the exam cycle for well-managed and well-capitalized community banks from 12 to 18 months, passed both the House and Senate and were signed by President Obama without controversy.

REGULATORY FOLLOW THROUGH ON DODD-FRANK'S TIERED AND TAILORED APPROACH

Following the clear and coherent statutory framework in Dodd-Frank to apply a tiered and tailored approach, regulators have demonstrated commitment to design regulations that differentiate firms based on their risk as well as a consistent willingness to be responsive to legitimate concerns about overbearing regulatory standards both through regulation and guidance.

In the final text of the Volcker Rule, the agencies eliminated compliance burdens for any banking entity that does not engage in activities covered by the rule. The only requirement is that if any bank begins to engage in capital markets activities, only at that time must they develop compliance policies. With this approach, the rule-writing agencies sought to create an effective protection for community banks from the Volcker Rule's provisions which did not apply. However, when the rule was finalized -- certain capital instruments that were commonly held by community banks, known as Trust Preferred Securities or TruPS were caught up in the definition of private equity and hedge funds. When community banks and members of Congress brought this issue to the attention of regulators, they were able to issue guidance to resolve the issue within 5 weeks of promulgating the final rule.

In another example, as the CFPB was finalizing its mortgage rules, it recognized that rural lenders would likely require more latitude to comply with the requirements and would need to be exempt from key provisions. In the initial final rule, the CFPB adopted a definition of rural area used by the U.S. Department of Agriculture (USDA). However, many community banks determined that the USDA definition would not capture many small rural communities that were within geographical proximity of metropolitan areas. For example, the initial rule would have excluded some rural portions of Maryland's Eastern Shore from the definition of rural because of their distance to Baltimore. Because this definition was too significant to clarify with guidance, the CFPB worked quickly to re-propose and finalize a different and more expansive definition of rural area.

The Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA") requires the federal banking agencies to conduct a review of their regulations every ten years. The purpose is

to identify outdated or otherwise unnecessary regulatory requirements imposed on banks. On March 21, the banking agencies sent the latest report required under EGRPRA to Congress.[5] Governor Daniel Tarullo's accompanying letter to Congress restated his view that it is appropriate to tier regulatory requirements based on size, including with respect to capital, enhanced prudential standards, incentive compensation, and the Volcker Rule. Specifically, Governor Tarullo said that, "precisely because community banks were not at the source of the problems that led to the financial crisis, it has been easier to identify areas in which the burden associated with certain regulations seems incommensurate with any incremental gains to safety and soundness."[6]

The Report that the FFIEC agencies produced at the end of the EGRPRA process highlights several ways in which banking regulators have sought to simplify regulations and better tailor them to institutions. In thinking about differences of size, the bank regulators have introduced a new version of the Call Report for banks with less than $1 billion in assets, which will reduce the length from 85 pages to 61 pages. There are also other Call Report simplifications for larger banks that have just gone into effect. In addition, qualifying banks with less than $1 billion in total assets are now eligible for an 18-month (rather than a 12-month) examination cycle; subject to qualifications, this could cover 83% of insured depository institutions in the U.S. The regulators also recognize geographic differences; commentators raised the fact that in rural areas it is often difficult for banks to satisfy the appraisal requirements necessary for certain real estate transactions. In response, the regulators raised the threshold that triggers appraisal requirements and created a process for issuing waivers and allowing temporary practice permits. And the regulators have also shown a willingness to be responsive to general concerns raised by the industry. Specifically, the FFIEC announced that they will issue for notice and comment new, simplified capital rules for certain assets in direct response to comments received under EGRPRA on issues like high volatility commercial real estate, mortgage servicing assets and deferred tax assets.

CONCLUSION

A broad, diverse, and dynamic financial system is a benefit to the U.S. economy and to our citizens. But this strength can only be realized on the foundation of clear rules, appropriate oversight, and independent expertise. Here in Washington, the pain of the financial crisis may be receding from memory, but throughout the country the cost of lost jobs, lost homes, and the immeasurable cost of lost opportunities persist. This cost, above all,to the United States, our citizens and taxpayers, must be the central consideration when evaluating changes to our regulatory system.

In writing the Dodd-Frank Act, Congress sought to make our financial regulations both more protective and more responsive to changes in our economy and in finance. Since the passage of Dodd-Frank, the regulatory agencies and their staff have demonstrated immense capacity to

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5 EGRPRA Report Release and materials can be found at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170321a.htm.

6 https://www.federalreserve.gov/foia/files/crapo-brown-hensarling-waters-letter-20170321.pdf

listen to the concerns of industry, advocates, and citizens -- both to design and revise regulations and guidance that increase the stability and the fairness of our economy.

The result is that our financial firms, our financial system, and most importantly our economy is far stronger and more resilient today than it was preceding the crisis. Investors and counterparties have more faith in their financial transactions and investments, and the U.S. has continued to distinguish itself as the safest and most dynamic place to invest capital in the world. Our task is to build on that growth and stability to deliver benefits to more communities and more small businesses, not to roll back this progress and increase our risk of another crisis by bringing back the policies that led to panic and bailouts.