OnTheRecord

A Conversation with **Robert D. Hankins**

Dodd–Frank: Toward Greater Financial System Stability

Robert D. (Bob) Hankins is an executive vice president at the Federal Reserve Bank of Dallas, responsible for the Eleventh District's banking supervisory activities. In July 2010, Congress approved the Dodd–Frank Wall Street Reform and Consumer Protection Act in response to the global financial crisis. At almost 2,000 pages, the act spells out new laws and regulations whose ramifications for financial institutions are broad and complex. In this interview, Hankins fields questions about the act and its implications.

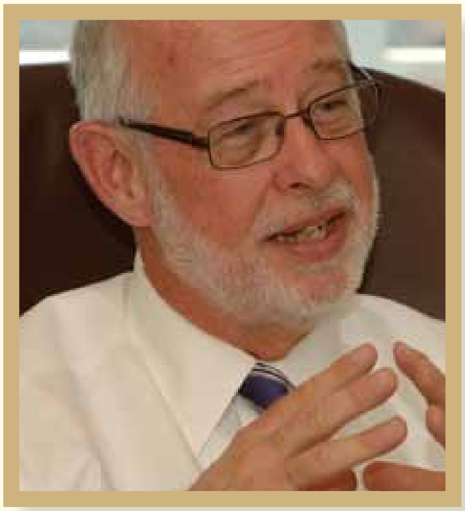
Q. What are the major goals of the financial reforms as laid out in the Dodd–Frank Act?

A. The best summary of Dodd–Frank's goals is found in its preamble, which states that the act aims to promote financial stability, end "too big to fail" (failing banks allowed to continue operating because they are considered too large to be closed), protect taxpayers by ending bailouts and protect consumers from abusive lending practices. Of course, whether it accomplishes these objectives has been the subject of a considerable debate.

Q. Dallas Fed President Richard Fisher has spoken at length about the dangers of financial institutions that are too big to fail. How does Dodd–Frank address this? Are the changes likely to be effective?

A. Protecting the financial system and taxpayers from the consequences of difficulties at large financial institutions was one of Dodd–Frank's main goals. The legislation contains a number of safeguards and changes to the supervisory apparatus intended to accomplish this. For instance, large, systemically important institutions—and not just banks, by the way—will be subjected to enhanced prudential supervision, which is to be more stringent and rigorous than what we do for smaller institutions.

The banking supervision function is also undergoing some fundamental changes. In addition to focusing on individual institutions, we are also taking a more macroprudential perspective that looks at threats to the stability of the entire financial system. Finally, Dodd–Frank implements a new resolution regime that allows failing financial firms such as large bank holding companies or other important financial firms to enter into receivership to facilitate an orderly wind down of operations. This option wasn't available during the crisis and should help deal with too big to fail.



Q. You said even nonbank firms that are designated as systemically important will now be subjected to enhanced supervision. How will this designation be made? Have any nonbank firms been identified yet?

A. The Financial Stability Oversight Council, composed of all major financial market regulators, will determine which nonbank firms are systemically important. Dodd–Frank lists 10 criteria that the council must consider. These include things such as size, leverage, interconnectedness and importance as a source of credit. The council issued an Advanced Notice of Proposed Rulemaking in October 2010 that sought input on developing a framework for making its designations. After getting public comment, the council issued a formal request for comment on its proposal of how to select nonbank firms for enhanced supervision. But, reflecting the importance and significance the council places on these decisions, it recently indicated that it will seek additional comment. So, no firms have yet been named. Any determination requires a two-thirds vote by the council, including the chairman's approval. Even after that, a company has the right to a hearing before the council, which is required to submit a report to Congress regarding the decision. The determination is also subject to judicial review.

Q. How are institutions going to be supervised? What changes, in particular, are in store for the Dallas Fed?

A. The Federal Reserve is now responsible for supervising all organizations that are deemed systemically important. This will include bank holding companies with $50 billion or more in assets and the nonbank financial firms that the Financial Stability Oversight Council decides are important to financial stability. The Fed will also be responsible for developing enhanced prudential standards for these institutions. The goal is to subject these systemically important financial institutions, or SIFIs, as they have come to be known, to greater oversight and more rigorous standards that reflect the heightened risks they may pose. Things such as capital requirements, liquidity requirements and overall risk-management strategies are going to be more stringent for the SIFIs.

As far as the Dallas Fed is concerned, we have one institution that meets the act's minimum-size requirement for enhanced supervision, Dallas-based Comerica Inc. Dodd–Frank also places the supervision of savings-and-loan holding companies under the Fed, since the act does away with the Office of Thrift Supervision. For us, that means supervision of about 25 extra organizations, one of which, San Antonio's USAA, is the largest financial institution based in Texas.

Q. During the crisis, the Federal Reserve introduced a number of emergency measures to help stabilize financial markets. Does Dodd–Frank affect the Fed's ability to respond to future crises?

A. In response to events that unfolded at an incredibly rapid pace during the crisis, the Fed

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mostly invoked Section 13(3) of the Federal Reserve Act, which allowed it to lend to any entity under "unusual and exigent circumstances" as long as five members of the Board of Governors approved. Dodd–Frank requires that any such aid program or facility be broad-based and not directed at any one institution. Also, while the Fed consulted with the Treasury before setting up the various programs, it wasn't required to do so. Now, the legislation requires that the Fed gain the Treasury's approval before establishing any similar programs or facilities.

Q. Since Dodd–Frank imposes additional regulation and fees on the banking industry, will these greater costs affect banks' ability to lend? Is there a difference between small and large banks?

A. Studies have shown that the cost and burden of regulation fall disproportionately on smaller banks. Larger banks can more easily absorb the increased expense, and that is why it is important that as much as possible be done to minimize the impact on smaller banks. And, of course, the potential impact on lending for banks of all sizes increases with rising cost structure and staff time devoted to ensuring compliance with laws and regulations. At the same time, we have seen the result of reckless lending practices and disregard for prudent risk management on credit availability as banks work to repair balance sheets and rebuild capital. So, I guess the real question is whether the cost of prevention—the intent of Dodd–Frank—is cheaper than the cure? I would argue for the former, but I certainly understand the frustration felt by those who played by the rules and who must now bear some of the burden for those who did not.

Q. What are you hearing from the Dallas Fed's district banks? What are the biggest changes they will confront?

A. As I participate on regulatory panels and with President Fisher in CEO forums around the district, the common theme is concern about the increased regulatory burden and associated cost. The Dallas district consists largely of community banks. While Dodd–Frank was aimed primarily at enhancing the supervision of the largest organizations that create the biggest risk to financial stability, community bankers are concerned about the trickle-down effect. They are anxious that Dodd–Frank regulations and policies adopted by the supervisory agencies will be written and applied as one-size-fits-all. The bankers I talk to are worried about how they will absorb increased compliance costs and remain profitable and viable, meeting the credit needs of their communities.

To allay these concerns, the Federal Reserve is trying to provide more guidance to bankers and examiners about what applies to community banks and what doesn't. Additionally, the Federal Reserve's Supervision Committee has established a subcommittee to focus on the effects of proposed rules on community banks. Each Federal Reserve district has also created a Community Bank Depository Institution Advisory Council. A representative from each of the councils meets twice a year with the Board of Governors to provide direct feedback on issues affecting community banks.

Q. If the supervisory structure and regulations in Dodd–Frank had been in effect during the recent housing boom and bust, do you think the financial market crisis that ensued would have been more limited in depth and breadth? Please explain.

A. You would certainly like to think so, but you will never know. The real question, I think, is whether Dodd–Frank will prevent another crisis. My response is, probably not. Responding to the savings-and-loan and banking crises of the 1980s and early '90s, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act of 1991 with the idea they would prevent a future crisis. Obviously, they did not. To quote my good friend Thomas Hoenig, who until Oct. 1 was president of the Kansas City Fed, "I have a crystal ball on my desk. It doesn't work."

Until someone invents a crystal ball that works, the best we can do is try to minimize the impact of the next crisis through effective, though not stifling, supervision and preservation of capital. Lessons have been learned and will be applied going forward. But by their nature, laws and regulations are backward-looking, designed to prevent the cause of the last crisis from being the cause of the next one.

Q. So, what is your overall assessment of Dodd–Frank?

A. Legislation this sweeping and comprehensive is bound to be controversial, and Dodd–Frank is no exception. We've certainly heard many doubts about whether it really ends taxpayer bailouts and too big to fail, and we've heard a number of complaints about increased regulatory burden. There is also concern about the inevitable unintended consequences. These are all valid. But instituting a more macroprudential approach to the supervisory process, along with a new resolution regime for failing firms, and extending regulatory oversight to important players within the financial system that aren't banks are important steps that hopefully will result in a safer and more sound financial system.