Testimony of the Honorable Barney Frank before the House Committee on Financial Services

Assessing the Impact of the Dodd-Frank Act Four Years Later

July 23, 2014

I was pleasantly surprised by the bipartisan tone of the Republican Staff report. I do believe that it was excessively critical of the actions of President Ronald Reagan and President George W. Bush, and I believe that the authors of the report are mistaken in thinking former Secretary Tim Geithner agrees with their interpretation of the Too Big To Fail (TBTF). Geithner's objection is that we made bail outs impossible, not that we continued to allow them. That is, I believe their reading of the law is the exact opposite of his.

In addition to this question of the laws TBTF provisions I am including the expressions of my views on two other central parts of the bill: the regulation of derivatives and the restriction on irresponsible mortgage practices. Additionally, I have added my views that Asset management firms should not automatically be designated systemic. And I believe the FSOC should be very clear in explaining its position on this, as the letter from my former colleagues Mike Capuano and Steve Lynch, correctly argues.

I am responding to on the proposal to equate QRM with QM.

I believe this is a grave error, and contrary to the assertion that it would best carry out the statutory intent, significantly repudiates it. Readers of the proposal will have a very hard time understanding why Congress would have created two separate categories, in two separate parts of the statute, if it intended they would be treated identically.

The statutory intent was to create 3 categories of mortgages: those that fell below QM standards and were subject to various legal constraints; the QM mortgages which would meet minimum standards and be subject to risk retention; and a separate sub-set of mortgages that were virtually certain to be repaid and would therefore be given an exemption from risk retention. The agency's main proposal renders the concept of an "exemption" from risk retention meaningless. The result would be two categories-those that fell below standards and probably shouldn't be made, and those that could be made and would not be subject to risk retention.

I am reinforced in the view that regulating the concept of risk retention out of the statute and out of the mortgage business is a mistake by the proposals acknowledgement "that the direct costs incurred by a sponsor for funding the retain portion should be small." The citation of "plausible estimates" that the additional cost would range from "0-30 basis point" argues for some category of mortgages being subject to risk retention, given the agencies acknowledgement that this does incentivize better practices. I am wholly unpersuaded by the agency's then citing "indirect cost" as a reason for regulating risk retention out of existence, especially since the proposal concedes that these are "difficult to quantify", even though in what frankly appears to be a reach for cover, the document does say that they "have the potential to be large." Reference to unquantifiable costs suggests that there are people who don't like risk retention and are looking for a way to justify its de facto abolition. Adding that they "have potential to be large" adds no weight to the proposal. Many things have the "potential" to be large; public policy should be grounded in what is likely, not what is merely possible.

I am not surprised that the overwhelming majority of commenters who are interested in building, selling or promoting the sale of housing to lower income people, support effectively abolishing risk retention I should note that if all of these people were correct in their collective judgment, we would not have had the crisis that we had. More importantly, what their arguments reflect, and what I believe unfortunately is carried over in proposal, is the view that things must always be exactly as they are today, I understand that since risk retention is a new concept, people in various phases of the business of housing are unused to it, and do not like the changes it will force in their operation. But the very purpose of the statute was in fact to bring about changes in a number of areas in our financial life, residential mortgages foremost among them.

Nothing in the agency's discussion-nor our experience-demonstrates that the people in this business are incapable of adjusting to a rule whose genesis was the reality of unwise mortgages that resulted from the ability to do 100% securitizations. This is especially true if loans made under the new rules set forth for mortgages are in fact as safe as they should be. Retaining the risk of mortgages that are highly likely to be paid in full over time is likely not to cost very much.

I am particularly troubled by the notion that QM/QRM should be merged. The statue calls for three classes of mortgages rather than the two that are effectively represented in the agency's proposal. The logic of the statute dictates that we retain the ability to treat these two categories of mortgages as distinct.

I earlier expressed my opposition to a flat 20% down payment requirement, I continue to believe that that is too rigid, but I also believe that the level of down payment and other factors, including loan to value, have a role to play in distinguishing between QM and QRM.

Finally, it is relevant to note that recent unrebutted newspaper reports demonstrate that the credit rating agencies which were so much a part of the problem in the past are reverting to those dangerous practices. That is, any notion that we can rely on the credit rating agencies to substitute for risk retention incentivizes good mortgage practices has no more justification than it did before. Those of us working on the legislation were eager to find ways to correct the credit rating agencies behavior, but I also confess that we were not very successful in doing that.

In summary, nothing in the discussion of the agency's proposal leads me to reconsider the views that I had when we drafted the legislation-mainly that we should have three categories of mortgages, not two, and that risk retention should be the rule, and 100% securitization the exception, only to be granted for mortgages far above the norm on the safety scale.

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I share the frustration that many feel about the rate of progress in adopting regulations and implementing the financial reform bill, but not the angst that often accompanies it. With the reelection of President Obama, and the filling of vacant regulatory slots, I have no doubt that a complete—and appropriate-set of rules will be in place in sufficient time. And by sufficient, I mean before the abuses the bill seeks to minimize cause serious problems.

Some of the factors responsible for the slowness were inherent in the task. Some critics have complained that we overloaded the circuits of the agencies by a law that was too long, comparing its length unfavorably with the thirty pages of Glass-Steagall. But the bill covered many more subjects than G-S.

The accurate comparison is with that law establishing, the FDIC law; the laws establishing and mandating the SEC; the Investment Company Acts, and many others. We decided to cover all of the interrelated set of issues in a financial system vastly more complex than that existing in the 1930's, and to do it in one bill that treated the system as an integrated whole.

A second complaint is that we left too much to the regulators. Trying to be specifically prescriptive would have required setting in statutory concrete rules that should be able to evolve with experience. And specificity without regulatory discretions would have been an invitation to evasion on the part of creative financial engines.

A third criticism is both wholly valid and was wholly unavoidable-the division of responsibility for regulation of derivatives between two separate agencies: the Securities and Exchange Commission, and the Commodity Futures Trading Commission. This division of responsibility is both irrational, and so deeply embedded in American social, economic, and political history as to be impossible to fix without a major, separate legislative fight that was beyond our ability to resolve while dealing with so many controversial substantive matters. The good news is there is a growing bipartisan interest in taking on this task. Until that is done, much important regulation will require two five-member commissions to agree on a single set of rules. But if the new SEC Chair is quickly confirmed, the requisite decisions will be made soon.

This brings us to the set of obstacles to filling out the rule book that represent not inherent difficulties, but decisions by opponents of increased regulation.

The first of these is the resistance by the financial community. This should be abating. The clear preference of many businesses new rules was not to have any, and from the signing of the bill in 2010 until last November, many hoped that a Republican President would rescue them from compliance, with that hope gone, their rational self-interest isn't getting rules adopted, as opposed to continued limbo. This will mean a shift from efforts to filibuster the administrative process to working seriously for the adoption of appropriate rules, of course with an effort to lighten them.

But this still means a heavy paper flow from regulatees to the regulators, and this has given those opposed to the new law (for a combination of partisan and ideological reasons their leverage.)

With Republican control of the House—which we had not anticipated when passing the bill, combined with defective right-wing Republican control of the DC Circuit Court of Appeals, regulators have been hit with what readers of the old Lil' Abner comic strip will recognize as the double whammy. The SEC and the CFTC, receive vast amount s of comments for each proposed rule, while the Republican House Appropriations Committee starves them of funding. This is possible because unlike the bank regulators, the SEC and CFTC have no independent funding, but are subject to annual appropriations.

This is where the DC Courts comes in. Not only do these agencies have to process vast amounts of comments, the Court then grades their work with a strictness that belies conservatives professed lop position to 'judicial activism'. On several occasions DC Courts have strickened SEC and CFTC rules, not because of any constitutional problem, but because the conservative judges think the agencies have given too little deference to the financial industry's argument. Documenting decisions to the degreed the Court requires would be difficult in any circumstance. Doing so with the lack of staff and other resources resulting from Republicans underfunding is impossible.

This was in part what was at stake when the Republican Senate minority filibustered to death an Obama appointee to the DC Circuit and it will be exacerbated the House Republicans blocking funding for the agencies going forward. (The amounts are too small to be caused by deficit concern. The CFTC funding is in the hundreds of millions of dollars, and the CFTC brings the Treasury in fines and fees as much as it costs.)

The rules will be completed—before any major crisis that they are intended to prevent, but later than they should be for the certainty that financial institutions deserve. But the fault for that will rest with Republican appropriators withholding adequate funding and Republican Senators filibustering to maintain the DC Circuit as a right-wing bastion.

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The legislation we supported in 2010 does create death panels. But they found them in the wrong place. The Federal Government now has the power to terminate the lives of large, heavily indebted financial institutions, not frail, gravely ill old people.

Nearly five years ago, Treasury Secretary Paulson and Fed Chairman Ben Bernanke informed the leaders of Congress, including us, that they needed hundreds of billions of taxpayer dollars to stave off a global economic meltdown. With the homes, retirements and jobs of millions of American at stake, we took action. But we also set out to reform our antiquated regulatory system and develop a new framework that provided regulators with the tools they needed to help prevent any future economic crisis, and end taxpayer bailouts and the concept of too big to fail.

The Dodd-Frank Act is clear: not only is there no legal authority to use public money to keep a failing entity in business, the law forbids it.

First, it repeals the power the Federal Reserve had possessed to extend funds to any financial institution. It was this authority that the Fed used to advance 85 billion dollars to keep AIG alive. That power no longer exists.

Second, we recognized that the failure of a large financial institution to pay its debts could cause problems in the economy, as the collapse of Lehman Brothers did. And we allow Federal regulators to deal with this.

But the first step they must take under the new law is to begin the process of liquidating the institution. The Board of Directors is abolished; the Executives are fired; and the entity is put into receivership, run by the Federal Deposit Insurance Corporation, which has experience putting insolvent banks out of their—and our—misery. The assets of the institution including all the equity of the shareholders are at the FDIC's disposal in winding things down.

If those assets are insufficient, the FDIC's only recourse is to draw from the Orderly Liquidation Fund the law established, which consists entirely of money raised from other large financial institutions.

Despite these explicit provisions, some critics complain that somehow we have left too big to fail in existence. We issue them two challenges.

First, go back to the financial bailouts of 2008 and 2009, and find any such action that is possible under the new rules. Second, explain to us how public money could be used under these rules to keep a highly indebted institution alive?

We have heard two rebuttals. One, which completely ignores political reality, is that should a large bank falter, the President would come under overwhelming pressure to find some way to avoid the law's provisions, and bail it out.

Is it seriously argued that a Congress which resists the routine job of paying our past debts would somehow adopt legislation reversing the anti-bailout restrictions to save a large, indebted, and very unpopular bank?

The other argument is that if several institutions were to fail simultaneously, we would be swamped, and a massive, multiple bail-out would be required. Even in the crisis of 2008, it wasn't true. Indeed, Secretary Paulson essentially had to compel several of the largest banks to accept TARP money even though some did not need it or want it, lest the intuitions that did require help be stigmatized.

Dodd-Frank includes many more provisions to deal with institutional failure. It blocks the granting of mortgage loans with a high likelihood of default; regulates derivatives trading with requirements of margin, capitol and transparency; requires securitizers of loans made by others to retain some of the risk of default; significantly increases capital requirements for these companies, and the large institutions whose failure might endanger stability are required to draw up plans to facilitate their liquidation.

We believe this combination of preventive measures—a comprehensive list that explains the bill's length—will work to avert disaster. But no one can be sure that the firms will not find other ways to get in trouble. If they do, the death panels take over, and the institutions die, with no taxpayer burial costs.

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