VII. The Federal Reserve andItts Expanded Authority under the Dodd-Frank Act

A. Introduction

In late 2007, the economic crisis, triggered by a lack of liquidity, resulted in the collapse of large financial institutions, bailouts of banks and large downturns in financial markets across the world. In the United States, the housing market has been one of the biggest casualties as prices have plummeted on houses and foreclosures have reached all-time highs.[1] As our country moves forward, it is hard to ignore the role that the Federal Reserve ("Fed") played in its implementation of monetary policy and in its role as a bank regulator. In July of 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act"). This broad legislation sets up guidelines for agencies and regulators involved with monitoring financial services, including the Fed, which is set to experience a makeover in its regulatory duties. One of the biggest changes to the Fed's authority is that it will now have expanded authority to regulate any systemically significant nonbank financial firm.[2] It is still too early to determine the impact the Dodd-Frank Act will have on economic recovery but there is no doubt that it will have an effect on the way the Fed operates.

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[1] *See Case-Shiller Index*, STANDARD AND POOR'S, http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us---- (last updated Oct. 26, 2010); *See also* 5 Yr. Bloomberg Mortgage Delinquency % Foreclosure, BLOOMBERG.com, http://www.bloomberg.com/apps/quote?ticker=BBMDFCL:IND#chart (last updated Oct. 31, 2010) (BBMDFCL:IND); 5 Yr. Bloomberg Mortgage Delinquency % Subprime Foreclosures, BLOOMBERG.COM, http://www.bloomberg.com/apps/quote?ticker=BBMDSFCL:IND#chart (last updated Oct. 31, 2010) (BBMDSFCL:IND); Les Christie, *Foreclosures: "Worst three months of all time,"* CNNMONEY.COM (Oct. 15, 2009, 7:34AM), http://money.cnn.com/2009/10/15/real_estate/foreclosure_crisis_deepens.

[2] Clients & Friends Memo, *Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act,* CADWALADER, WICKERSHAM, & TAFT LLP July 20, 2010, at 2, *available at* http://www.cadwalader.com/assets/client_friend/TheDoddFrankAct_Impacts.pdf.

B. The Federal Reserve System

The Federal Reserve Act of 1913 states that the Fed is responsible for formulating and executing the nation's monetary policy in order to "promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."[3] Since its enactment, the Fed has used three main tools to achieve its goals: the discount rate, reserve requirements and the federal funds rate.[4]

The federal funds rate is the most closely-monitored[5] and thus the most important tool to effectuate the Fed's monetary policy. Banks maintain deposits at the Fed, called federal funds, which are actively lent to other banks.[6] The rate charged on such loans is the federal funds rate, which is heavily influenced by the Fed's use of open market operations.[7] However, during the global financial crisis, the Fed has dropped rates to near zero and has needed to figure out new, controversial ways to stimulate lending.[8]

In addition to monetary policy, the Fed has a regulatory role as well. It has primary supervisory authority for state banks that want to become a part of the Federal Reserve System. It shares regulatory duties with the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") to help "ensure the safety and soundness of financial institutions."[9] The recent financial crisis clearly shows that the Federal Reserve failed in its regulatory duties because many banks in the Federal Reserve System became involved in risky consumer lending.[10] One of the aims of the Dodd-Frank Act is to revamp the Fed's regulatory duties

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[3]Credit Suisse Basis Points, *Federal Reserve Insights: Structure, Function, Decision Makers*, CREDIT SUISSE, Apr. 29, 2010, at 3.
[4]BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM PURPOSES AND FUNCTIONS 3 (9th ed. 2005).
[5]Credit Suisse, *supra* note 3.
[6]*Id.*
[7]*Id*.
[8]*See* i*d.* The Fed has adopted new controversial tools such as Asset Purchasing (also known as quantitative easing) and paying interest over excess reserves ("IOER") in order to help stimulate lending.
[9] BOARD OF GOVERNORS, *supra* note 4, at 59-60.
[10] ALAN GREENSPAN, THE CRISIS 7 (2010).

in order to prevent any future economic meltdowns from developing.[11]

C. The Federal Reserve's Role Leading Up to the Economic Crisis

Currently, there is much debate on the role of the Fed leading up the crisis and to what extent it should bear blame. Former Chairman of the Fed, Alan Greenspan, has said that the Fed's mistakes were regulatory in nature and not due to mismanagement of monetary policy.[12] Greenspan claimed that the Fed failed in its duty to regulate the subprime mortgage market but he also blamed government-sponsored enterprises such as Fannie Mae and Freddie Mac.[13] Others have contested this notion, arguing that low federal funds rates during the 2000s led to cheap mortgage financing, which in turn fueled the housing boom.[14] Regardless, the Fed has inherited the daunting task of navigating the U.S. monetary system through this recession.

D. The Federal Reserve's Expanded Authority as a Regulator under Dodd-Frank

In response to the Fed's failure to regulate, Congress enacted the Act with the purpose of promoting financial stability in the United States through improved accountability and transparency.[15] This Act is set to have a big impact on how the Fed operates in a few

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[11]Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010) ("An Act To promote the financial stability of the United States by improving accountability and transparency in the financial system…").
[12]GREENSPAN, *supra* note 10, at 7, 40.
[13]*See id.* at 6-7 (arguing that these firms drove up demand—which drives up prices—during the housing bubble by purchasing nearly half of all subprime mortgage securities); *See also* Jason M. Breslow, *Greenspan Defends Fed's Role in Run-up to Financial Crisis*, THE RUNDOWN (Apr. 7, 2010, 2:50 PM), http://www.pbs.org/newshour/rundown/2010/04/greenspan-defends-feds-role-in-run-up-to-crisis.html.
[14]*See* Jamus Lim, *How Exactly was the Fed Responsible for the Financial Crisis?,* PROSPECTS FOR DEVELOPMENT (March 19, 2010, 6:05PM), https://blogs.worldbank.org/prospects/how-exactly-was-the-fed-responsible-for-the-financial-crisis.
[15]Dodd-Frank Act, *supra* note 11.

key areas. The Fed will now have expanded authority as a regulator with the added responsibility of supervising all systemically significant nonbank financial firms and enforcing more stringent capital regulations.[16] The Act calls for the creation of the Financial Stability and Oversight Council ("FSOC") ,[17] which has general authority to issue recommendations to the primary financial regulatory agencies regarding standards and safeguards as well as the consequential ability to designate systemically significant nonbank financial firms.[18]

According to the guidelines, any nonbank firm deemed "predominantly engaged in activities that are financial in nature" and where "material financial distress exists or the nature, scope, size, scale, concentration, interconnectedness, or the mix of the activities" of the firm could "pose a threat to the financial stability" of the United States, will be under the Fed's supervision.[19] The first prong of this designation is clear as it is covers firms that have financial activities contributing 85 percent or more of its annual gross revenues or have financial activities accounting for 85 percent or more of the firm's total consolidated assets.[20] The second part of this designation is much more subjective as it attempts to address the prevailing concern of "too big to fail."[21] In addition, the Fed is now forced to maintain heightened prudential standards for these systemically significant nonbank financial firms and for bank holding companies with assets exceeding fifty billion dollars.[22] These heightened standards include risk-based capital and leverage requirements, liquidity requirements, risk management requirements and other requirements set up to ensure long-term stability in these firms.[23]

Along with this expanded authority, the Fed will have new powers that can affect the way systemically significant nonbank financial firms and bank holding companies are structured. One of the Fed's newfound powers is the ability to force these nonbank

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[16]CADWALADER, *supra* note 2, at 2.
[17]*Id.*
[18]*Id.* at 3.
[19]*Id.* at 3.
[20]*Id.* at 4.
[21]Dodd-Frank Act, *supra* note 11.
[22]CADWALADER, *supra* note 2, at 5.
[23]*See id.* at 5-7.

firms to "silo" all or part of their financial activities.[24] This power is predicated on the concept of "separation of banking and commerce" and would force nonbank firms to create intermediate holding companies for all of its activities deemed financial in nature.[25] Thus, this will create significant administrative burdens as some nonbank firms may need to undergo a serious corporate reorganization[26]. The Fed will now be able to limit certain acquisitions, including acquisition of shares or assets of a bank or BHC, of nonbank financial firms because they will be held to the approval requirements of the Bank Holding Company Act.[27] In addition, further notice must also be given to the Fed if a company being acquired has assets in excess of ten billion dollars.[28] This will give the Fed the authority to oversee the acquisition, imposing another regulatory hurdle on the firm.

Another significant power given to the Fed is the authority to require large bank holding companies and significant nonbank financial firms to terminate certain activities and divest certain assets if the Fed determines that these activities or assets pose a grave threat to U.S. financial stability.[29] This in essence allows the Fed to deny mergers or acquisitions, restrict the offering of certain financial products, force companies to terminate or impose conditions on certain activities and require the company to sell or transfer assets or off-balance-sheet items to unaffiliated entities. In addition, the Act includes a non de-banking provision that applies to entities that were bank holding companies with consolidated assets of fifty billion dollars or more and received assistance under the Capital Purchase Program as of January 1, 2010.[30] This provision states that the Fed will automatically regulate these entities and their successors if they ever cease to be bank holding companies,[31] meaning that they will remain subject to these provisions regardless of their size at any time or whether they remain bank holding companies. However, forcing these predetermined entities to face such stringent requirements could lead to inequitable results. For example, if a bank holding

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[24]*Id.* at 8-9.
[25]*Id.*
[26]*Id.*
[27]*Id.* at 10.
[28]*Id.*
[29]*Id.*
[30]*Id.*
[31]*Id.*

company decides to acquire a large amount of non-financial assets and is not subject to the same systemic risks of others in the industry, it will still need to be properly capitalized and subject to the Fed's authority.

E. Reactions and Future Outlook

Amidst all of these new provisions and changes lie two simple questions: are these new regulatory provisions necessary to provide financial stability and will they help our economy avoid another financial crisis?

1. Interpreting Dodd-Frank

The Act gives the Fed new authority that can have a large impact on the operations of many large financial firms. The criteria set out for the Fed is vague and subject to much interpretation. At this point, finding when a company's "nature, scope, size, scale, concentration, interconnectedness, or mix of activities . . . could pose a threat," is difficult and will lead to intense debate as these definitions could mean the difference between costly regulatory compliance as a systemically significant firm. It seems, however, that many of the large financial institutions in the shadow banking sector,[32] such as large hedge funds, money market funds, investment banks, Fannie Mae and Freddie Mac, will qualify as systemically significant and will thus be monitored by the Fed.[33] This will potentially double the size of the Fed's jurisdiction as nonbank financial firms make up about half of the assets in the financial sector.[34]

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[32] *See* PRELIMINARY STAFF REPORT, FINANCIAL CRISIS INQUIRY COMM'N, SHADOW BANKING AND THE FINANCIAL CRISIS 4 (2010). Shadow banking refers to bank-like financial activities that are conducted outside the traditional commercial banking system. This sector contributes to more than half of the financial activity in the U.S.

[33] *See* Peter Eavis, *A Harsher Regulatory Light Will Shine on GE Capital*, WALL ST. J., Aug. 16, 2010, at C6; s*ee* King & Spalding, *Client Alert: Effects of Dodd/Frank Act on the Regulation of Advisers to Private Equity and Hedge Funds* (2010).

[34] *See id.* at 7-8 (Figure 1 compares assets of those in the shadow banking sector versus those of depository institutions).

2. Past Reactions to Heightened Regulations

One concern is the Act's potential impact upon the profitability of financial institutions.[35] The Act will force significant upfront costs on many financial corporations attempting to comply with the new regulations.[36] Some corporations may need to restructure, which takes significant amounts of time and money. These changes, as adaption to the Sarbanes-Oxley Act has shown us, may have a negative impact on the profitability of these firms as restructuring and higher capitalization measures cost money.[37] In addition, corporations will be subject to new sets of fines and litigation costs. Combine this with the Fed's ability to prohibit products, services or activities labeled as "systemically risky" and it becomes clear that financial companies could be in for a costly transition. These heightened capitalization requirements and concentration limits may inhibit a financial company's ability to maximize its potential earnings and may even hinder recovery from the recent financial crisis.

While the Act will force these systemically significant firms to adhere to capitalization and transparency requirements, financial markets have always found ways around new regulations; for example, the shadow banking sector was created out of excess regulation during the early 1900s.[38] Financial institutions are constantly evolving and have always found ways to remain profitable in the face of stringent financial regulations. Shadow banking evolved in the face of the intense regulation of the new deal and the Glass-Steagall Act,[39] and recently, financial companies have been

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[35]*See* John B. Taylor, *The Dodd-Frank Financial Fiasco*, WALL ST. J., July 1, 2010, at A19.

[36]Cadwalader, *supra* note 2, at 9.

[37]*See* Michael R. Crittenden, *Financial Overhaul Stymies Top Regulators: New Law Might need Altering Already, as Implementing its Restrictions on the Use of Credit Ratings Stirs Concerns*, WALL ST. J., Aug. 11, 2010, at C3 (for many companies, complying with Sarbanes-Oxley significantly increased administrative costs); s*ee also* THOMAS E. HARTMAN, THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY, FOLEY & LARDNER LLP 1-3 (2007); Taylor, *supra* note 34.

[38]*See* FINANCIAL CRISIS INQUIRY COMM'N, *supra* note 32*,* at 11-13.

[39]*Id.* at 7-8; s*ee* Zoltan Pozsar et al., *Shadow Banking*, 458 FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS 1 (2010).

continuously developing new products and markets such as derivatives and mortgage-backed securities[40].

Historically, it seems that banking and finance companies will inevitably find a way around the FSOC requirements and work around the responsibilities of added regulations. For example, the non de-banking provision will prevent current bank holding companies from restructuring in order to escape these heightened standards; however, nothing in the Act bars nonbank firms from restructuring to avoid regulation. As history has shown, the banking and finance industry is quick to adapt to regulatory changes, much more so than its government counter parts, exemplified by the recent financial crisis.

3. Does Dodd-Frank Properly Address the Fed's Failures?

A third issue is the fact that the Act is predominantly concerned with the regulatory nature of the Federal Reserve. While many say that the meltdown was due to regulatory failures, many economists blame the mismanagement of the federal funds rate as a key factor in the housing bubble.[41] They argue that keeping the federal funds rate low during the early part of the 2000s caused a housing bubble because mortgage financing became extremely cheap.[42] Proponents of this argument show that while the Fed directly controls short term rates, it inevitably controls long term rates by bringing inflation expectations down[43].

The opposing thought, framed by Alan Greenspan and Ben Bernanke, is that the relationship between short- and long-term rates broke down in the 1990s.[44] Thus, because the Fed only controls short-term rates, they did not have an impact on long-term lending

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[40]*See* FINANCIAL CRISIS INQUIRY COMM'N, *supra* note 32, at 17-23.

[41]Lim, *supra* note 13.

[42]*Id.*

[43]*See* Angela Maddaloni & Jose-Luis Peydro, *Bank Risk-Taking, Securitization, Supervision and Low Interest Rates: Evidence from the Euro Area and the U.S. Lending Standards* 20-21 (Eur. Cent. Bank, Working Paper No. 1248, 2010). Infer that lower inflation rates are consequences of lower reserve (short-term) rates. Also, low short term rates soften standards for all types of loans.

[44]*See* GREENSPAN, *supra* note 10, at 40.

through mortgages.[45] Greenspan notes that the housing bubble was created by long-term lending rates and not the federal funds rate, as short-term rates are not used to determine capitalization rates of real estate.[46] He pointed to the surge in housing demand as the main reason that housing prices went up.[47] Due to the fact that the Board of Governors is appointed by the President, even if mismanagement of the federal funds rate was to blame, there does not seem to be much that Congress could do legislatively except to repeal or amend the Federal Reserve Act.

4. The Fed's Regulatory Failure during the Housing Bubble

One final concern is that the Fed previously failed in its regulatory duties. Enacting tougher legislation will be ineffective if the Fed fails to enforce it. In addition, many feel that the Fed's decision-making in the wake of the financial crisis has been poor.[48] Many critics point to the predictability of the Fed's actions with regards to the federal funds rate as an indication that it is not suited to serve as a regulatory agency.[49] Critics also refer to the bailout of Bear Stearns and the decision to not bail out Lehman Brothers as a dangerous sign of inconsistency that has injected significant uncertainty into the financial sector.[50]

Despite these criticisms, no agency is better able to handle this authority over the financial sector than the Fed. The FSOC, which determines which companies are systemically significant, makes decisions separate of Fed approval.[51] It consists of a diverse group of members, many of whom are not affiliated with the Fed.[52]

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[45]*See id.*
[46]*Id.* at 39.
[47]*Id.* at 41.
[48] *The Diviner of Systemic Risk*, WALL ST. J. Sept. 4, 2010, at A14, *available at* http://online.wsj.com/article/SB100014240527487042068045 75467872819971324.html; *see* Lim, *supra* note 14.
[49]JOHN B. CARLSON, ET AL., FOMC COMMUNICATIONS AND THE PREDICTABILITY OF NEAR-TERM POLICY DECISIONS, FEDERAL RESERVE BANK OF CLEVELAND (2006).
[50]John Ydstie, *Federal Reserve Mulls Its Role One Year After Crisis,* NPR, Sept. 14, 2009, http://www.npr.org/templates/story/story.php?storyId=112767144.
[51]*See* CADWALADER, *supra* note 2, at 2-3.
[52]*See id.*

In addition, while the Fed did fail in its regulatory duties during the financial crisis, there was much less transparency for the nonbank financial institutions. The Fed's regulatory authority was also considered by some as a secondary duty to its monetary policy.[53] In response to this, the Act calls for limitations on the Fed's ability as a lender of last resort, forcing it to consult with the Treasury before it is allowed to give assistance.[54] Additionally, the Act has set up an audit system for Special Federal Reserve System Credit Facilities and enhanced the transparency of the Fed.[55] This increase in the Fed's regulatory authority, along with increased transparency and limits on its lending powers, are clear attempts to elevate the importance of the Fed's regulatory duty.

F. Conclusion

The landmark Dodd-Frank Act will change the character of financial services, the face of the Fed and the way financial firms do business. Because the Act mostly delegates power to agencies to create regulations, the future outlook is vague and much is left to be decided. Much of the impact that this Act will ultimately have lies in the type of oversight that the Fed chooses to take on. If the Fed plays a hands-off role, it seems that the new transparency requirements will be a sufficient indicator of when the Fed has to step in and use its authority. If however, the Fed constantly or inconsistently invokes its ability to restrict acquisitions, prohibit novel financial activities and require divestiture of assets and off-balance-sheet items, the Act may undermine its desired effects. This could upset many financial institutions, potentially leading to intense litigation which no party wants.

The Fed has now been given the intimidating task of ensuring that our economy does not suffer another crisis. In addition, it will be forced to monitor a much wider array of financial services which will need to comply with much heavier regulation. While these will be the clear and immediate effects on the Fed and financial companies, the overall impact of the Act on the safety and soundness of our economy is left to be determined. It is quite clear that there is

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[53]Lim, *supra* note 13.

[54]MAYER BROWN LLP, UNDERSTANDING THE NEW FINANCIAL REFORM LEGISLATION: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 126-27 (2010).

[55]*Id.* at 130.

not one piece of legislation that will remedy our economy or protect us from future economic disasters, but the Act, if implemented properly, could become the foundation for sound economic reform that supports growth while curbing risk.

Robert DeLeon[56]

[56] Student, Boston University School of Law (J.D. 2012).