From Too Big to Fail to Too Costly to Comply
A Closer Look at How Financial Regulations Have Changed The Industry Over Time

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ABSTRACT

In response to the financial crisis of 2008, the United States Government established a new set of regulations for banks and other financial institutions with aims of reducing excessive risk and increasing stability in the economy. These banking regulations expand market limitations and involve more supervisory power, which increases the cost of operating and restricts certain types of business activity, therefore limits profitability. In the wake of the financial crisis, some companies and financial institutions were declared too-big-to-fail, thus warranted government bailouts to protect the U.S. and world economy from a larger collapse. The landscape of Wall Street changed as banks failed, merged, and restructured. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and increased Federal Reserve Supervision, banks are restructuring and adopting smart internal governance policies to comply with the regulations. This paper will examine how banks and other financial institutions operated prior to the 2008 financial crisis and compare it to how it operates currently. It will also discuss how banks are reacting to the increased regulations and changed regulatory environment, as well as internal controls for compliance.
Background To America’s Financial System

Throughout the decades since the 1929 stock market crash and the subsequent Great Depression, the Federal Government has adopted and reformed many financial regulations in an attempt to shape the structure of the industry and promote strong but safe growth. Prior to the stock market crash in 1929, the banking and securities industry prospered. During the post World War I era, commercial banks transformed to investment banking and a new type of bank structure emerged, the security affiliate. Incorporating security affiliates was an aggressive way for banks to expand their security operations with less governance. Instead of being regulated under state banking and trust laws, these affiliates were incorporated under the general laws, which meant that they could participate in practically any form of financial transaction not governed by banking or trust laws. Because this type of banking emerged as the stock market was booming, many resorted to blaming the security affiliates for the collapse of stock prices and the disruption of the banking system (White, 1986).

Bond and stockholders were shocked when the stock market crashed in 1929 and the securities prices declined dramatically. Later that year, the Senate approved hearings to examine the securities business of banks and to recommend legislation to correct any weaknesses in the banking system; the focus was on the widely perceived questionable financial activities by banks and their affiliates. “These included the issuance of unsound and speculative securities, disseminating untruthful and misleading information on new issues, pool operations, deals for the personal profit of corporate officers, and abuses arising specifically from mixing commercial and investment banking
functions” (White, 1986, p.37). Although the majority concluded that most of these problems can be attributed to all security firms, not just affiliates, and can be corrected with proper regulation, few contended that only the legal separation of commercial banking and investment banking could prohibit certain transgressions (White, 1986).

Not long after, Congress passed substantial reform through the Banking Act of 1933.

**Glass-Steagall Act**

In the wake of the 1929 stock market crash and the subsequent Great Depression, Congress was alarmed that commercial banking operations and the payments system were sustaining losses from unstable equity markets. Their goal was to limit bank credit used for risky speculation and to redirect the funds to a more productive use, such as in commerce or agriculture (Maues, 2013). Banks had been using depositors’ and the public’s money to feed their greed; they accepted large risks for the prospect of larger gains. Conflicts of interest arose as banks were giving loans to troubled companies that they already had invested in, then turned around and encouraged their clients to buy stock in those same struggling companies. Also, the political tension, originally brought on by unsuccessful attempts by the Federal government to regulate the financial markets in the early 1920s, escalated the situation. (Komai & Richardson, 2011).

On May 10, 1933, Congress introduced the Banking Act of 1933, commonly known as the Glass-Steagall Act. Senator Carter Glass and Representative Henry Steagall coauthored the legislation as “A Bill to Provide for the Safer and More Effective Use of the Assets of Federal Reserve Banks and of National Banking Associations, to
Regulate Interbank Control, to Prevent the Undue Diversion of Funds into Speculative Operations, and for Other Purposes” (U.S. Senate S.1631, 1933).

Glass initially presented his banking reform bill in January 1932, and because it carried the strictest restrictions of the time, separation of commercial and investment banking, it received strong opposition. Bankers, economists, and the Federal Reserve Board analyzed and critiqued it before the Senate passed the bill a month later. This legislation was one of the most widely discussed and debated initiatives in 1932 because it reshaped the American Banking system (Maues, 2013).

On June 16, 1933, President Roosevelt signed the bill into law. Within a year, all commercial and investment banking activities were separate. The act required commercial banks to sell their securities affiliates and restricted their bond department’s purchase and sale of securities to be exclusively for their customers. It was illegal for any firm that sold securities to take deposits. The Board of Directors of the fourteen commercial banks and securities companies were also barred from operating or coordinating together; plus officers and directors of member banks could not associate with corporations that loaned funds on the security of stocks and bonds (Komai & Richardson, 2011). These regulations were intended to reduce potential conflicts of interest.

In addition, as proposed by Henry Steagall, the Glass-Steagall Act established nationwide deposit insurance to protect American’s savings and rebuild trust in banks. Other regulations aimed to correct circumstances that led to bank failures, which mainly affected small banks. For example, increase minimum capital requirements, and
prohibit payments on demand deposits to reduce the cost of capital. Other parts of the
Act restricted the use of bank credit for speculation, authorized statewide branch
banking, expanded the Federal Reserve’s lending authorities, and improved supervision
from bank examiners to spot misconduct (Komai & Richardson, 2011).

For decades, the Glass-Steagall Act disadvantaged the U.S. banking industry in a
globalized financial market. Strong lobbying efforts, particularly in the 1970s and 1980s,
initially led to reinterpretation and liberalization of the Act before it was entirely
repealed by the Gramm-Leach-Bliley Act in 1999.

Laws That Currently Regulate The Securities And Financial Industry

Acts That Increased Government Authority

Securities Act of 1933

The first significant piece of federal legislation dealing with the sale of securities
was the Securities Act of 1933; formerly, it was the state laws that governed the sale of
securities. “Often referred to as the ‘truth in securities’ law, the Securities Act of 1933
has two basic objectives: require that investors receive financial and other significant
information concerning securities being offered for public sale; and prohibit deceit,
misrepresentations, and other fraud in the sale of securities” (U.S. Securities and
Exchange Commission, 2013). At the time of the Act, and still today, the purpose of
registering securities with the Federal Trade Commission and disclosing full and accurate
financial information is to aid potential investors in making informed decisions about
investments. However, there were a couple parts of the Act noteworthy of criticism at
the time. For example, the Act expands the scope of liability of an untrue or omitted statement to everyone who dealt with the registration statement; each and every person from a director, accountant, underwriter, or anyone who signed the registration statement may be liable and sued (James, 1934). Also, the Act did not affirm the standard exemptions made by the former state blue sky laws; however, today many small offerings are exempt from the registration process to promote capital formation by lowering the cost of offering securities to the public.

**Securities Exchange Act of 1934**

In 1934, Congress passed the Securities Exchange Act, which established the Securities and Exchange Commission (SEC) to regulate the issuance, purchase, and sale of securities on the secondary market. The SEC was formed to have the authority to oversee all aspects of the securities industry, particularly brokerage firms, transfer agents, clearing agencies and self-regulatory organizations. This Act also classifies certain types of activities, such as insider trading, as fraudulent and grants the SEC with disciplinary powers over regulated entities and persons associated with them. The legislation requires all public companies to file annual reports, other periodic statements, as well as any proxy materials used to solicit shareholders’ votes, in order to protect the investing public (U.S. Securities and Exchange Commission, 2013).

**Trust Indenture Act of 1939**

The Trust Indenture Act institutes standards and sets requirements for drafting indentures for certain types of debt securities, for instance bonds, debentures, certificates of interest, and notes that are offered for public sale. Although these
securities may be registered under the Securities Act, they may not be offered for sale to the public without an investment contract between the issuer of bonds and the bondholder, known as the trust indenture.

The objective at the time was to address the lack of disclosure and reporting requirements or evidence of an obligor’s performance, and the hindrances to collective bondholder action. The legislative history of the Trust Indenture Act began subsequent to the Securities Exchange Act of 1934, when the SEC interpreted its investigative powers to include indenture trustees (Howard, 1940).

**Investment Company Act of 1940**

“This Act regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public” (U.S. Securities and Exchange Commission, 2013). The Act was formed in the interest of investors; the various practices and potential conflicts of interest within the operations of the securities industry are prohibited or are regulated. Companies must disclose their financial condition and investment policies to the investor when the stock is first sold and regularly thereafter to inform the investor of the classification of the investment, such as a diversified trust, specialized company, or speculative venture, and the fund objectives he is investing in. The Investment Company Act regulates management practices, reporting, and personnel standards; however, its reach is limited by the long list of types of operations that are specifically exempt, which means it does not grant the SEC with authority to
directly supervise or judge the investment decisions or activities of those exempt companies (Bosland, 1941).

**Investment Advisers Act of 1940**

The Investment Advisers Act is one of the briefest Acts regulating the financial industry; it is generally regarded as a disclosure and recordkeeping statute for investment advisers. This Act is designed to protect investors from fraudulent conduct by requiring that firms or sole practitioners compensated as an investment advisor on securities must register with the SEC and comply with set regulations (Barbash, 2008). The Act was amended in 1996 and 2010 to require advisors who have at least $100 million under management to register with the Commission (U.S. Securities and Exchange Commission, 2013).

**Acts That Supported Self-Regulatory Authority**

**Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994**

The Riegle-Neal Interstate Banking and Branching Efficiency Act commenced a new era of banking deregulation. The Riegle-Neal Act eliminated several of the restrictions on opening bank branches across state lines. The former laws addressed the perpetual concerns about the consolidation of financial activity as well as the concern that large banking institutions operating in several states could not be adequately supervised. This Act allowed bank holding companies that are adequately capitalized and managed to acquire control of a bank located in another state under a uniform national standard. Also approved, bank holding companies could merge banks located in different states into a single branch. Though some oversight control did remain; a
bank holding company could not control more than ten percent of the nation’s total deposits or thirty percent of a state’s total deposits. President Bill Clinton applauded the new legislation, “Today this country took an historic step, one that had been delayed for much too long, to help American banks better meet the needs of our people, our communities and our economy” (Medley, 2013).

**National Securities Markets Improvement Act (NSMIA), 1996**

Congress passed NSMIA in 1996 to comprehensively amend the five former security acts and create one uniform code that companies and regulators could follow. NSMIA pertains to securities, brokers, advisors, and dealers. It restricts state enforced broker and dealer licensing that varies from federal requirements in specified areas such as net capital, bonding, and recordkeeping (Wisconsin Department of Financial Institutions). The goal of this Act was to create a set of federal standards rather than each individual state enacting their own rules and regulations.

**Securities Litigation Uniform Standards Act, 1998**

The Securities Litigation Uniform Standards Act was signed into law by President Clinton to amend the Securities Act of 1933 and the Securities Exchange Act of 1934. This Act prohibits the prosecution of class-action securities fraud suits in state courts and provides federal courts with the right to practice stay discovery in state courts for action that interferes with their jurisdiction (Securities Industry and Financial Markets Association, 2016). The Act is designed to prevent state securities lawsuits alleging fraud from being used to conflict with the Private Litigation Reform Act of 1995.
Gramm-Leach-Bliley Act, 1999

In 1999, the Senate voted 90-8 to approve the Gramm-Leach-Bliley Act, which repealed the Glass-Steagall Act that separated banking, insurance, and securities services from other operations of the institution. In the preceding decades, minor amendments had been made to lessen the restrictions on financial services organizations, and those that had been separated began to integrate their operations. The major change allowed in this Act was the creation of the financial holding company (FHC), which is close to the model of a bank holding company in that an organization could own subsidiaries involved in different financial activities. This legislation reshaped the financial regulation laws and gave the Fed new supervisory powers. Supporters of the legislation contended that the new holding companies would be more profitable, safer, more beneficial to consumers, and more competitive with large foreign banks. Opponents alerted the possibility that by permitting banks to organize with securities firms, who engage in unbalanced speculation, a financial crisis could be triggered. The intention was to foster healthy competition and increase the benefits of financial integration for consumers and investors, though still preserving the strength and stability of the financial systems (Mahon, 2013).

Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, which he characterized as "the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt" (U.S. Securities and Exchange Commission, 2013). The Act mandated several reforms on financial disclosures and
accounting practices to protect investors from fraudulent accounting activities by corporations and enhance corporate responsibility. The *Public Company Accounting Oversight Board* (PCAOB) was established to oversee and regulate auditing. SOX was a response to the accounting scandals and bankruptcies in the early 2000s at companies such as Enron, Arthur Andersen, Tyco, WorldCom, and Global Crossing. Corporate and investor losses amounted to billions of dollars, plus the general investor lost trust in financial reports. These huge losses contributed to the stock market indices of large capitalization stocks falling forty percent compared to thirty months prior (Coats, 2007).

The main rulings of Sarbanes-Oxley addressed corporate governance and reporting methods by requiring senior management to certify the accuracy of the reported financial statements, and requiring the management and auditors set up internal controls. These internal controls are very expensive for publicly traded companies to institute and uphold; SOX has been attacked as a costly regulatory overreaction.

**The Great Recession**

**Deregulation and the Expansion of Banking Activities**

The United States’ economy was booming in the decade preceding the recent financial crisis. By the mid-1990s, parallel banks, which are banks licensed in different jurisdictions that have the same owners and share common management but are not part of the same financial group for regulatory consolidation purposes, were flourishing and some of the largest commercial banks performed like large investment banks. All financial institutions were growing bigger, more complex, and more active in
securitization. Some scholars and industry analysts advocated for the larger financial institutions because they believed there would be a benefit in the economies of scale and scope in finance that were formed from advances in data processing, telecommunications, and information services. They thought larger would be more secure, diversified, efficient, and more suited to support the needs of an expanding economy. However, others challenged that position and said the largest banks may not be more efficient rather they had risen because of their dominant market positions and creditors’ opinion that they were too big to fail. As the banks advanced, the large banks successfully pressured regulators, state legislatures, and Congress to eliminate practically all the remaining regulations that blocked growth and competition. After the state-line restraints were lifted with the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, consolidation of the banking industry intensified. As megamergers ensued, the ten largest banks increased from owning 25% of the industry’s assets to 55%. From 1998 to 2007, the combined assets of the five largest banks more than tripled from $2.2 trillion to $6.8 trillion, and the assets of the five largest investment banks quadrupled from $1 trillion to $4 trillion (United States of America, Financial Crisis Inquiry Commission, 2011).

Deregulation was more than negating regulations; there was an overall reluctance to adopt new regulations or challenge industry practices on the risks of their security inventions. The Federal Reserve maintained the view that financial institutions, which had strong incentives to protect shareholders, would regulate themselves by sensibly controlling their own risks through the activities of analysts and investors. Fed
Chairman Alan Greenspan said in February 1997, “It is critically important to recognize that no market is ever truly unregulated, the self-interest of market participants generates private market regulation. Thus, the real question is not whether a market should be regulated. Rather, the real question is whether government intervention strengthens or weakens private regulation.” Also in 1994, Greenspan testified against proposals to consolidate bank regulation that were pushed by senior policy makers who wanted to keep multiple regulators as a form of checks and balances. After mounting efforts to lift the little regulation that remained from the Glass-Steagall-era, Congress passed and President Clinton signed the Gramm-Leach-Bliley Act in November 1999. Conditional on meeting certain safety and soundness standards, the Gramm-Leach-Bliley Act allowed bank holding companies to underwrite and sell banking, securities, and insurance products and services. Ironically, the supportive relationship between banking and securities markets that Greenspan sought to enhance as a foundation to stability, was actually weakened by the merging of banks and securities firms (United States of America, Financial Crisis Inquiry Commission, 2011).

**Credit Expansion Through Mortgage Lending**

In the years preceding the financial crisis, there was an excess of mortgage lending in America because the incentives for homeownership and fixed-income debt were out of balance. In the 1990s mortgage companies, banks, and Wall Street securities firms began securitizing mortgages, many of which were subprime. Some financial firms started bundling and marketing *non-agency* mortgages, which were loans that did not conform to Fannie Mae and Freddie Mac’s standards. Unlike the
securitizations structured by Fannie Mae and Freddie Mac, the non-agency securities did not have the same sense of guarantee that investors were going to get paid back. These unfamiliar securities were very complicated thus needed ratings by the rating agencies based on their riskiness.

The American housing market was booming because of lower interest rates for mortgage borrowers and greater access to mortgage credit for households that had traditionally been disqualified, such as subprime borrowers. Risky subprime loans were given to mortgagors who had bad credit history and did not meet the standards of a conventional prime mortgage. A prime mortgage is one which meets a set of rules that allows it to be included in a collection of mortgages guaranteed by a U.S. government agency or government-sponsored enterprise. Subprime loans do not meet the standards that are intended to reduce the likelihood of default and lower the
cost of its guarantee for the mortgage pool. The prime or subprime classification of a mortgage considered criteria such as the borrower’s income, accrued wealth, credit score, and the ratio of size of the mortgage to the price of the home. The ill-advised manner of subprime lending became so common that in both 2005 and 2006, over $600 billion of subprime loans were originated, the majority of which were securitized in mortgage-backed securities and collateralized debt obligations. Nearly a quarter share of the entire mortgage market was subprime in 2006, compared to just less than ten percent ten years earlier in 1996 (United States of America, Financial Crisis Inquiry Commission, 2011). The slang term NINJA Loan was coined for the riskiest loans that were extended to a borrower who had no income, no job, and no assets. A significant portion of NINJA loans were destined for default from the start because all that was required for the mortgage was a credit score, which does not necessarily correspond with capacity to pay.
Widespread low rates, consistent with a low federal funds rate, significantly decreased the cost of homeownership and drove up housing prices across the nation since more expensive houses were now more affordable. Homeownership rates increased consistently, peaking at 69.2% of households in 2004 (United States of America, Financial Crisis Inquiry Commission, 2011). With the steadily increasing home prices over the decades, many homebuyers were planning on refinancing their teaser low-interest rates on their mortgages when their adjustable-rate loans reset to a higher interest rate after the first few years. When house prices are rising, borrowers are able to refinance even when their ability to pay is low because the provider has the option to sell the house and recover the loan if payments are not made. However, when the value of their homes sharply decreased as the market rectified the overvalued house prices, homeowners were unable to refinance for a lower interest rate and as a result could not keep up with the higher monthly payment. Additionally, in this prevalent situation, homeowners often had negative equity and could not sell their homes.
because the sale price would not have been enough to pay off the mortgage debt, which made them highly vulnerable for foreclosure.

**Shifting the Risk**

Furthermore, a contributor to the glut of bad mortgages that concluded with default was the unbalanced incentives with risk of the mortgage brokers, underwriters, and securitizers. Brokers were encouraged to match as many lenders with borrowers as they could because their compensation was made in up-front fees from both ends. The underwriters, who were responsible for reviewing all documents and qualification criteria before approving the loan, were often lax in their judgments since they also wanted to push as many mortgages through as they could to turn a profit quickly. Many borrowers misguidedly thought the mortgage brokers acted in the borrower’s best interest. Mortgage brokers and underwriters, in reality, had little concern over the long-term capacity of the borrower to repay because they quickly transferred the risk of default when they sold the mortgages to other companies. Investment Banks bought the risky mortgages and grouped thousands of them together to make collateralized debt obligations, which were then marketed as safe securities and sold to other investors. The false-high ratings on these securities made by credit rating agencies, which the public trusted, fueled the demand for these risky securities with high yields. Essentially, the risk of the unsecure securities was quickly transferred from party to party, which created the false illusion of all gains and little risks.

A significant factor of the deceitful transfers of risk was a result of the firms securitizing mortgages, who did not adequately perform due diligence on the mortgages
they purchased and sometimes intentionally ignored compliance in underwriting standards. Prospective investors were uninformed or misdirected towards mortgage-related securities comprised of low-quality mortgages. The SEC did not effectively implement its disclosure requirements governing mortgage securities; it cleared suspicious sales of securities during review, and blocked states from applying state law to them, thus did not fulfill its foremost duty to protect investors from harmful practices (United States of America, Financial Crisis Inquiry Commission, 2011).

**Unsustainable Practices**

Nationally, there was unrestricted growth in risky mortgages; harmful loans drove the housing bubble and contributed to the consequent collapse. Major financial institutions erroneously supported subprime lending and regulators did not restrict risky home mortgage lending. The Federal Reserve did not fulfill its obligation to establish and uphold practical mortgage lending standards and to check predatory lending.

The monetary policy of the Federal Reserve as well as the influx of foreign capital in the U.S. markets assisted the development of the housing bubble, yet the crisis could have been averted if the Federal Reserve and other regulators exercised control. The Fed’s policies and statements promoted rather than constrained the growth of mortgage debt and the housing bubble. Lending standards had fallen and a substantial lack of accountability or responsibility was evident throughout each part of the lending system.

Federal and state policies mandated financial firms and institutional investors to make investments that relied on the rating of credit rating agencies and placed
excessive dependence on those ratings. However, the SEC or any other regulator did not satisfactorily regulate the rating agencies to certify the quality and accuracy of their ratings. To issue ratings on mortgage-related securities, the main rating agencies were knowingly relying on inaccurate and outdated models, and did not carry out important due diligence on the assets underlying the securities. Rating agencies were inaccurately awarding high ratings to junk-level securities because they felt pressure from their banking clients, who could take their business to the competition if the ratings were too low. There was apparent absence of corporate governance at some of the key credit rating agencies, which led to the poor quality of the ratings of mortgage-backed securities and collateralized-debt-obligations.

Shared Responsibility

The downfall of few systemically important banks in 2007-2008 triggered a global financial panic that stole confidence from the financial system, plummeted the stock market, and contracted the real economy. To stabilize the industry, the government’s fiscal programs cost taxpayers about $1 trillion for tax cuts and stimulus spending, plus $700 billion to purchase and guarantee troubled assets under TARP. The initial contraction of credit in the economy exacerbated into a recession that was the worst the country had seen in eighty years. The cause of the financial crisis should be attributed to many actors throughout industry; its wrong to say the big banks that recklessly gambled with our money caused the crash. The Federal Reserve, various financial institutions, rating agencies, and everyday Americans, all played a part in the unsustainable build up of the housing bubble and the ensuing massive defaults. Greed
was everywhere; from the Big Banks who over-leveraged assets and took too risky of bets, to the average homebuyer who bought a house they could barely afford and bought too much on credit. Central bankers and other regulators were also responsible, as years of low interest rates fostered complacency and risk-taking by making borrowing money too easy and cheap. The Securities and Exchange Commission’s lack of supervision over the five largest investment banks allowed them to take excessive risk in activities while holding inadequate capital and liquidity, which warranted the need for government bailouts.

A chain of actions, inactions, and inaccuracies created an austere situation that forced the federal government to choose between either risking an unrestrained collapse of the entire financial system or spending trillions of taxpayer dollars to stabilize the financial institutions and economy. Much of the government relief was allocated to the financial institutions considered too-big-to-fail, those that are too big and co-dependent with other institutions or are so significant in a certain market that their failure would have induced substantial losses in other institutions. A product of the bailouts and mergers during the crisis is now the U.S. financial industry is highly concentrated in the leadership of a small number of huge, systemically important institutions. This concentration requires the attention of regulators for effective oversight and is what drove the substance of the Dodd-Frank Wall Street Reform And Consumer Protection Act.
Dodd-Frank Wall Street Reform And Consumer Protection Act Of 2010

President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010. The legislation, the most extensive Wall Street reform in history, is intended to prevent excessive-risk taking that contributed to the financial crisis and to fully reshape the U.S. regulatory system in several spaces, such as consumer protection, trading restrictions, credit ratings, regulation of financial products, corporate governance and disclosure, and transparency. Dodd-Frank polices hold Wall Street's irresponsible risk-taking and Washington's lack of authority accountable for the financial crisis. The financial reform stresses one statute that ends too-big-to-fail and protects the American taxpayer by ending taxpayer-funded bailouts. Future growth of the largest financial firms will be controlled and the government will have the means to shut down failing financial companies before a panic (Wall Street Reform: The Dodd-Frank Act). In addition, section 619 of the Dodd-Frank Act, referred to as the “Volcker Rule”, added a new section to the Bank Holding Company Act. The Volcker Rule prohibits banking entities or insured depository institutions from proprietary trading for their own account, not serving clients, and limits bank ownership in hedge funds or private equity funds to just three percent. Also, the Act assigned responsibility of setting Enhanced Prudential Standards for non-bank institutions, bank holding companies, and foreign banking organizations to the Federal Reserve. However, some specified activities, including market making, hedging, securitization, and underwriting, are still permitted under the ruling for banks, their affiliates, and non-bank institutions identified as systemically

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important. Institutions were given a seven years to become compliant with the final regulations (Volcker Rule Resource Center Overview, 2016).

Consequences and Compliance of the New Regulation

Initial Reactions to the Dodd-Frank Act

Not long after the Dodd-Frank Act was passed, many experts presented varied responses. Some claimed that the Act would be unsuccessful in its goal to block another financial crisis because it did not include sufficient measures to protect consumers and fell short in limiting the too-big-to-fail existence. However, others argued that the legislation overburdened the financial system and was not the most appropriate answer to the recent financial crisis. The expansive amount of discretionary authority it gives to bureaucrats to control important segments of the economy, is unsettling to some. In spite of their convincing goal, politicians and regulators built an unproven regulatory framework that will have, without a doubt, unintended consequences for liquidity in the nation’s financial system. If taken too far, the new regulations could lead to another financial crisis or slow U.S. economic growth. Even with counter evidence and speculation, many experts remain supportive of the Dodd-Frank Act and feel it was a complete resolution that delivers transparency to simplify an overly complex financial system (Risell & Allayannis, 2011).

The Strains Of The Reformed Regulatory Environment

The Dodd-Frank Act was designed to reshape the regulatory environment and expand the powers of the Federal Reserve. The Act has the most significant impact on
the nation’s largest financial institutions; JPMorgan, among other companies, is
answerable to heightened regulatory oversight and more severe prudential standards.
The Financial Stability Oversight Council, an industry-wide regulator created under
Dodd-Frank, has the authority to collect information and examine financial firms it
deems systemically important in order to spot and track risks affecting the stability of
the financial system. Also, the FDIC now has the authority to diligently scrutinize
important firms that deal with its resolution authority (Risell & Allayannis, 2011). While
there are certainly benefits gained through each additional section of legislation
authorizing regulatory power, there are also financial costs and other strains to the
industry that must keep up with the demanding legislation.

The taxpayer pays for the cost of the personnel and resources needed to
implement this increased regulation, plus there are substantial expenses for the
institutions that comply. For instance, the largest bank holding companies are obliged
to submit expensive and labor intensive “living wills” to the FDIC and the Fed, which are
plans that detail how the company could be resolved through bankruptcy without
severe detrimental effects for the financial system or the U.S. economy. If regulators
reject a plan, the company could be forced to restructure, downsize, raise capital, or
divest. Essentially, financial institutions, large or small, are at the mercy of the
bureaucratic regulators who can impose sanctions or expensive fines and effectively
limit their operations at will.

Counterproductive to the goal of restraining Wall Street’s hold on the greater
financial industry, the overwhelmingly complex laws of Dodd-Frank are too expensive
for community banks or credit unions to keep up with and as a result, they are being bought by large resilient firms who can handle the legal fees. Even though the most difficult phase of financial crisis-related fines and settlements seems to be over, the recurring one-time expenses are still draining sizeable portions from retained earnings that could instead be allocated to meet regulatory requirements for higher capital holdings. “In 2015, the big four commercial lenders – J.P. Morgan Chase, Bank of America, Citigroup and Wells Fargo – had a combined $5.3 billion of litigation expenses, according to regulatory data. That was down sharply from $28.3 billion the previous year” (Back, 2016). It is not surprising some financial institutions are devoting ten percent of their workforce to compliance, as the Dodd-Frank Act is practically indecipherable because of its length and complex language written for regulators. Dodd-Frank is 848 pages long, whereas the law that established the U.S. banking system in 1864 was only 29 pages, the Federal Reserve Act of 1913 was 32 pages, and Glass-Steagall was concise enough to be 37 pages. (Dockery, 2016)

**Corporate Governance**

Corporate governance is the framework of processes, structures, and rules by which a company is directed and managed to attain their objective. Corporate governance is about balancing the interests of the variety of stakeholders in a company, including the shareholders, management, customers, financiers, community, and government, while maintaining transparency and accountability in all levels of the organization. Essentially, a company’s corporate governance framework set standards for good practices and manages the internal and external risks to the business.
Although there is no direct provision of corporate governance reform in the 2010 Dodd-Frank Act, under its initiative the Federal Reserve released a statement addressing its methodologies to supervising the risk in large financial institutions and included corporate governance as one focus in its approach. It explained different actions leadership boards should take in order to have effective corporate governance that would withstand under economic, operational, or legal pressures. The Dodd-Frank Act references corporate governance with the premise of empowering shareholders; however, this could oppose the regulators’ goal of controlled risk-taking. By granting shareholders more voice and responsibility in banks, the Act is enabling them to pressure bank executives to take larger risks, since the bank’s primary creditors lack reason to review shareholder-supported risk-taking due to their deposits being insured by the FDIC (Cheffins, 2014). Also, too much shareholder control could be a factor in irresponsible dividend policy that favors short-term returns over long-term sustainability of the company. Immaturely set dividend policy is a significant issue when it reduces the value of common equity that is needed as a reserve in case of hardship.

Furthermore, a shortcoming in the corporate governance of banks is of the matter of managers’ bonuses and compensation. The issue of bank managers’ compensation has been a leading outcry in the public rhetoric, as Federal bailout dollars seem to have made its way into managers’ pockets. The public protests have led to proposals of legislation limiting the bonus-style compensation; however, the perceived problems with the high bonus compensation may not necessarily deserve legitimate public concerns.
The most remarkable case of unsupported corporate governance came in 2008 when American International Group, or A.I.G., paid out about ninety-five percent of their $173 billion government bailout to executives as their bonuses. When news spread of this incidence, the A.I.G. CEO was pressure to rescind the bonuses; however, the CEO replied with “We cannot attract and retain the best and the brightest talent if employees believe their compensation is subject to continued and arbitrary adjustment by the U.S. Treasury” (Sandel, 2009, p.13). Though there was a resolution to the public and for future cases of such greed; fifteen of the top twenty A.I.G. executives succumbed to the public and government’s pressures and agreed to return their bonuses (Sandel, 2009).

In addition, there is repeated debate on whether the failures of corporate governance pre-2008 are due to the unethical nature of the financial system as a whole or rather the unethical practices within the system. The objective of enhanced corporate governance standards is to have the boards directing more than the everyday duties by making them responsible for advancing strategic management that will avoid causing damage to their firm and society. Highlighted in 2011, the *Occupy Wall Street* protests have revived the argument that corporations should make a conscious change to be more socially responsible and not only aim to have the largest financial gains (Cragg & Matten, 2011).
Conclusion

New regulatory restrictions are often passed in the aftermath of a financial crisis or in response to exposed corrupt practices, and the Dodd-Frank Act of 2010 was no exception. The U.S. Government response to the recent financial crisis has focused on the few banks that are considered too-big-to-fail and seem to negligent to address the other reasons for the cause of the crisis. The 2008 financial crisis did not originate in the executive suite of the nation’s largest banks, but rather from low interest rates and other incentives to take out excessive credit in the housing market. Previous Federal Reserve bailouts, such as the 1998 bailout for Long-Term Capital Management, relaxed the financial industry by creating the expectation that Washington could bail them out if losses amounted.

The big banks are not inherently dangerous or poorly managed because of their size, but because they are built on the belief that there is a government safety net underneath them. Moral hazard in risk taking is prompted because the risk of failure is significantly reduced by the expectation of bailout dollars in case of bankruptcy. It is ironic that the U.S. Government is currently trying to break up the big banks when they were only created because of the government’s previous actions. In 2008, the confidence crisis of a global financial collapse was mitigated by the guarantee of the largest financial institutions’ liabilities, which were added to the balance sheet through a lack of due diligence.

The Dodd-Frank Act’s strict and costly requirement of the ‘living wills’, which are meant to check how prepared a systematically important financial institution is to deal
with a bankruptcy without federal assistance, are immaterial to the circumstances that cause the insolvency of the banks prior to a panic. Plus, even with the ‘living will’ requirement and Dodd-Frank’s stance of an end to taxpayer-funded bailouts, the Federal Reserve Bank of Richmond’s “bailout barometer” shows that, “since the 2008 crisis, 61% of all liabilities in the U.S. financial system are now implicitly or explicitly guaranteed by government, up from 45% in 1999” (Jenkins, 2016).

Moreover, the increased federal regulations have not even done much to curtail the real reason that caused the global financial crisis, which was excessive borrowing. McKinsey researchers estimate that since the official end of the recent crisis, the visible global debt has increased by $57 trillion, but Europe, Japan, China, and especially the U.S.’s economic growth to pay back these liabilities has slowed or is stalled (Jenkins, 2016). Instead of the federal government’s regulations that increase capital requirements of banks or the central bank adding more money into the uncertain economy to protect the nation from another recession, the government’s role should be to restore confidence in the market through a hands-off approach. One of the main reasons for the gravity of the 2008 financial crisis was the lack of confidence in the economy to sustain growth to be able afford the tremendous debts; thus the government’s actions should be centered on providing opportunities for attainable growth rather than on restricting activities for growth by requiring banks to sit on large amounts of capital.

The history of the cycle of regulatory restrictions has proven that the intentions of the policy makers are not always realized and that often government manipulation of
the markets is the source of economic uncertainty. The prior U.S. Acts that were legislated to control the industry have shown to be not as effective at protecting Americans as were intended to be. Even when economic indicators signal that certain regulations are disadvantaging the economy, policy makers are more often than not too slow to lift the restrictions. As stated earlier, the Glass-Steagall Act of 1933 was only repealed in 1999, despite its effect of decreasing the competitiveness of the US banking industry in a global economy. It can be predicted that the Dodd-Frank Wall Street Reform And Consumer Protection Act Of 2010 will follow a similar path to the Glass-Steagall Act in being repealed after time proves its laws to be ineffective and negative to the U.S. financial industry.
References


