AT A GLANCE

Requested by the ECON committee

Study in focus

Financial Supervision and Regulation in the US

Dodd-Frank Reform

In response to the financial crisis of 2008 and the government-supported bailouts of financial institutions, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (DFA), signed into law in July 2010, was a massive, 2 300-page bill that represented the biggest overhaul to financial regulation in the US since the 1930s. The main goal of the reform was securing stability in the US financial system through the creation and reform of several agencies and other legal depositions.

The Consumer Financial Protection Bureau (CFPB), the new Financial Stability Oversight Council (FSOC), the Volcker Rule, the Dodd-Frank Act Stress Tests (DFAST), the US Comprehensive Capital Analysis and Review (CCAR), US supervision of Foreign Banking Organisations (FBOs) and the Current Expected Credit Losses (CECL) framework are the milestones that guided the implementation of the reform.

Focus of the study and key findings

The study provides a synopsis of key provisions of the Dodd-Frank Act from its enactment in July 2010 until the latest developments as of 24 October 2018. Following a presentation of key provisions and the general terms of the Act's required oversight rules, the rulemaking efforts of the regulatory agencies and attempts to implement these rules are discussed. Moreover, challenges of those implementation efforts and the current attempts to take back the legislation are addressed. To ease the overview key information of the study has been summarised in the table below.

Key Provisions Legal Act/ Institution	Implementation	Recent Developments
Consumer Financial Protection Bureau (CFPB) Implementation and enforcement of the federal consumer financial laws to ensure consumers' access to markets for consumer financial products and services that are fair, transparent, and competitive.	**Partially achieved: In 2016, the CFPB estimated that roughly 10 percent of examinations resulted in an enforcement investigation.** The CFPB performs its supervisory work by conducting examinations of financial firms such as mortgage companies, private education lenders, payday lenders etc. Since 2011 it has ordered almost USD 12 billion be returned to 29 million consumers and imposed about USD 600 million in civil penalties, most of which is attributable to its public enforcement actions.	**In 2018**, the newly appointed Director began his term by proclaiming that '*the days of aggressively "pushing the envelope" of the law in the name of the "mission" are over*'. On his proposal, enforcement actions were to be focused on '*quantifiable and unavoidable harm to the consumer*,' with an emphasis on formal rulemaking over what he termed '*regulation by enforcement*'.
Systemically important financial institutions The **Financial Stability Oversight Council** (FSOC) was formed as a consolidated, interagency body to monitor, manage, identify, and control any risks to the US financial system posed by nonbank financial companies and current or emerging financial products and services.	**Implementation subsequently through** a three-Stage Process for **Evaluating Nonbank Financial Companies**. **Stage 1**: the FSOC runs an initial evaluation of nonbank financial companies by applying six thresholds to identify companies that would require additional review. **Stage 2:** FSOC realises a robust analysis of the potential threat that each of those nonbank financial companies could pose to U.S. financial stability. **Stage 3:** the FSOC gathers considerable information directly from each of the companies evaluated on stage 2 to assess its potential threat.	**On 21 April 2017**, the US President issued a '*Presidential Memorandum for the Secretary of the Treasury*' **to review the FSOC's designation process and halt any further non-emergency designations**. **The Financial CHOICE Act of 2017** (CHOICE Act) intended to repeal the provisions of the DFA that created FSOC's systemically important financial institutions (SIFI) designation authority and standards.

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Volcker Rule: aims to establish rules to classify certain activities as commercial banking or investment banking. The Volcker Rule regulations define the types of trades and relationships that are acceptable. The regulations focus primarily on three key areas – proprietary trades, covered funds, and foreign exemptions.	Implementation of the Volcker Rule by the five regulatory agencies charged with this task has been a **lengthy process**. As a broad piece of regulation impacting many parts of banks, it has taken regulatory agencies years to build a practical approach to the rules. **Concerns were** raised about the **feasibility and effectiveness** of the Rule since it was initially passed. As banks often use hedge funds as a way to mitigate and hedge their own long-term risks, there is potential for losing visibility into the risky trading activities in which some hedge funds may engage.	The first action taken towards codifying the rules into regulations was **in 2011** when a study by the FSOC determined a need for new risk management frameworks in order to **measure the difference between prohibited and permitted trading activities**. The current US administration has called for a large rollback whose **goal is to simplify the rule and write it in such a way as to be enforceable** as well as to clarify on **what new exceptions should be accepted** in order to meet these similar goals.
Stress Tests: Used in order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions.	**The annual stress tests US Comprehensive Capital Analysis and Review (CCAR) and US Dodd-Frank Stress Test (DFAST)** are run to evaluate if the covered companies have the **capital** necessary to absorb losses during **hypothetical adverse economic conditions**. Likewise, **liquidity stress tests** are also intended to be implemented soon. **Criticism:** unintended effects on bank lending allegedly **reduced banks' ability to lend** to the public and stimulate economic growth.	**In December 2017**, the Federal Reserve proposed an amendment to its '*severely adverse*' scenario used in the annual stress tests. Other elements have been changed to **make the tests tougher**. The final rule makes '*certain technical changes to clarify the requirements of the* [Office of the Comptroller of the Currency] *OCC's stress testing regulation*' and removes obsolete language related to the adjustment in date ranges and timeframe for conforming to stress testing requirements.
Foreign Banking Organization Supervision was created to increase regulation of Foreign Banking Organizations (FBOs) and charged the Federal Reserve with the development of rulemaking and implementation in an attempt to avoid the potential impact of their significant presence in the US financial markets.	An FBO is defined as : **1)** A company that *'(a) operates a branch, agency, or commercial lending company subsidiary in the United States, (b) controls a bank in the United States; or (c) controls an Edge corporation acquired after March 5, 1987, and* **2)** *any company of which the foreign bank is a subsidiary'* Between **July 2016 and July 2017**, the Federal Reserve updated a series of **Enhanced Prudential Standards** (EPS standards) effective for domestic and foreign banking entities. The EPS standards, as they applied to foreign entities, marked a significant **enhancement of the US's role overseeing foreign banking institutions.**	**In December 2017,** the Board of Governors of the US Federal Reserve System (FRB) announced it would be **eliminating the Strength of Support Assessment (SOSA) from the FBO supervision program**. SOSA was designed to measure the extent that an FBO would be able to support its US branches, agencies, and subsidiary banks. The assessment was deemed to no longer be necessary based on the increase in access to other resources.
Current Expected Credit Losses Both the CCAR's adverse and severely adverse scenarios include loss rates applicable to credit valuation adjustments. Those loss rates are the parameters that will soon be reported under the Current Expected Credit Losses (CECL) framework.	**In June 2016**, the Financial Accounting Standards Board (FASB) released Accounting Standards Update No 2016-13, Topic 326, ***Financial Instruments – Credit Losses.*** This update provided the methodology for calculating CECL allowances for credit losses. **CECL is fundamentally different** from the current process and methodology which are based on an incurred loss concept. Instead, CECL is based on an **expected** loss concept and relies on life of loan or life of portfolio loss rates rather than annual loss rates under the current method.	**In April of 2018 the FRB** announced it accepted the **new method of CECL accounting standards** for adoption beginning in 2019. According to a report by the consultancy Deloitte, most of the heavily impacted organizations are planning to do a parallel run in 2019 and full adoption in 2020. This method will simplify regulatory capital treatment of credit loss allowances for measuring the assets of the bank and will have **large impact on recognition of bank assets**.

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