DRAWING LESSONS FROM US FINANCIAL REFORM EFFORTS
A CIVIL SOCIETY PERSPECTIVE

ASSESSMENT REPORT
FEBRUARY 2011
**CCFD-Terre Solidaire:** Founded in 1961, the purpose of CCFD-Terre Solidaire is to develop international solidarity in France and in countries of the South. To do this, it uses 3 complementary levers: support for development initiatives, a policy of education on development in France, and an advocacy strategy addressed to French, European and international political and economic decision-makers. CCFD-Terre Solidaire launched in September 2010, a campaign for public mobilization called « Help money leave tax havens » asking G20 countries to take effective action against financial secrecy. ([www.ccfd-terresolidaire.org](http://www.ccfd-terresolidaire.org))

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In 2007 the US financial system experienced a financial crisis that would, one year later, acquire global proportions, affecting the global economy. In June 2009, starting with a proposal for legislation sent by the US Administration, the US Congress began a process that led to the adoption, in the summer of 2010 of the “Dodd-Frank Wall Street Reform and Consumer Protection Act.”

Studying the features of this process and what can be characterized as successes and failures is important not just for those interested in financial reform in the US but also, particularly, abroad. This is because the financial regulations passed in the US are likely to become an unavoidable reference point in efforts to develop financial regulations elsewhere.

The Dodd-Frank Act is the most comprehensive overhaul of the US financial system since the 1930s. The legislation addresses a number of issues that became patent during the financial crisis and serves as a vehicle for issues and proposals that had been debated over the years preceding the crisis but, until then, had failed to gain much traction.

Its main and overarching focus was on mechanisms to avoid a repeat of the taxpayer-funded bailouts of private firms that policy-makers had to decide in the wake of the crisis, as the least harmful alternative to that of allowing the collapse of financial companies that had become “too big to fail.”

Other issues that were the focus of much debate during the legislative process were banking capital requirements, credit rating agencies, derivatives, hedge funds and private equity funds, taxation of the financial sector, consumer financial protection, financial transparency, the architecture for financial supervision, re-securitization, accountability of the Federal Reserve and investor protection.

The outcomes of US financial reform efforts have clear implications for international development concerns. The crisis repercussions on developing country efforts to raise development finance have made clear how critical it is to have in place effective financial regulation in advanced economies that can reduce the frequency and severity of such events – if not prevent them altogether. The financial legislation can also be disaggregated into a number of pieces each of which has traceable links to developing countries’ ability to raise development finance. Nonetheless, the financial reform was driven by domestic – and in some cases quite parochial – political concerns and dynamics, rather than such international development dimensions.

An observation of the experience of civil society in trying to influence the regulatory efforts offers important insights. The legislation is a far cry from the structural and far-reaching reform that progressive advocates in the US would have liked to see passed. But it should be kept in mind that the field of analysis is one that has traditionally been removed from public scrutiny and dominated by experts and lobbyists hired by the financial industry. From this perspective, one can appreciate the strides that the mobilization and organization of civil society and grassroots efforts made in generating an alternative lobby to that of the financial industry to represent workers’, consumers’, and a set of other not-for-profit, or public, interests. Likewise, the victories that were achieved against great odds come into bolder relief.

The tale that emerges is a hopeful one, one that also highlights how much of a difference could be made with greater resources, a longer-term perspective and the continuity that could allow advocates to build upon what has been achieved so far.
FOREWORD

There are reforms whose scope and historical significance is difficult to measure at the time of their promulgation. The 2010 US financial reform, also known as the “Dodd Frank Act”, is certainly one such reform.

The CCFD-Terre Solidaire had welcomed with much enthusiasm the promulgation of this reform by President Obama on 21 July 2010, particularly for its advances in three decisive areas that incorporated some proposals long called for by international solidarity and development organisations: financial transparency in the exploitation of natural resources of Southern countries, due diligence when these countries are in conflict, and efforts to prevent speculation on agricultural commodities (cf Box).

However, the purpose of this reform — the text of which runs for several hundred pages — is first and foremost to regulate financial markets and the main players in these markets, such as banks and other financial institutions, private equity funds, hedge funds and credit rating agencies. The Act covers a very broad spectrum that extends well beyond the three provisions cited above. It is the US response to questions raised by the financial crisis that began in the United States, with shock waves spreading widely to many other countries of the world: the regulation of banks, market supervision, the regulation of derivatives, protection for investors and savers, etc.

This is one good illustration of the fact that states — when they have political will — have the weapons to implement ambitious reforms on a domestic level at a time when many portray G20 summits as the only forum possible for providing answers. Admittedly, countries in the G20 must work together to structure their efforts in the regulation and management of the economy. However, it is first and foremost in relation to domestic and regional regulators and legislators where concrete initiatives can be implemented.

The Dodd Frank Act would never have existed without the mobilisation of US civil society. An unprecedented coalition of agents — Americans for Financial Reform - came together for this purpose that included organisations as diverse as consumer groups, investor groups, NGOs and anti-discrimination groups. Their main achievement is to have succeeded in creating interest among the public in financial questions that are normally neglected due to their complexity and a feeling that there is a disconnect between these questions and the day-to-day concerns of the population.

This experience of mobilisation of the public, with its successes and failures, is worthy of being capitalised on, shared, and even followed up beyond the mobilisation for the adoption of this Act: indeed, these organisations are now very heavily involved in consultations for the preparation of implementation rules. The results of the most recent US elections, which coincide with the debate moving onto a second, more technical phase, could give rise to fears of a lessening of the scope of the reform. Therefore, supporting the mobilisation of the US public on this issue is indispensable. Progress in the area of financial regulation that occurs in other countries will be likely to maintain pressure for improvements to the standards defined by the US process.

In France and Europe, this reform calls out to us as a civil society organisation for several reasons.
The European political agenda in the area of financial regulation is also full. Due to its anteriority, the US reform now constitutes the baseline reference for calibrating efforts on a European level. In addition, the United States will be sure to invite the European Union and its members to emulate a number of provisions of the Dodd Frank Act in order not to put banks and extractive industries located in the United States at a disadvantage. The European Union has already embarked on efforts in an important area, with the launch of the revision of the “markets in financial instruments Directive” in September 2010 and its proposed legislation on OTC Derivatives, central counterparties and trade repositories.

Nevertheless, the social, economic and cultural context of the EU remains very different from the US context; therefore, we cannot only think in terms of replication.

In Europe, one can notice the awakening of the citizenry on these issues, with a greater awareness, due to the crisis, of the deviations of the financial sector.

The question of the ability of European civil society organisations to produce expertise and a mobilisation of the public on the issue of financial regulation is also raised; hence the call by Euro MPs from different political parties in June 2010 for the creation of a counter-lobby group in the area of finance, “Finance Watch”. The months to come will reveal whether or not European civil society is up to the challenge. Henceforth, it will be important to strengthen the links between civil society in Europe and civil society in the United States on this issue to facilitate mobilisations on both sides of the Atlantic to feed off and reinforce each other.

In Europe, the Dodd Frank Act has opened an unprecedented window of opportunity to pursue and extend the efforts initiated by the US reform in order to build a more just, transparent and regulated financial system. Nevertheless, although the Act is often cited as an example by a multitude of agents, few of us are familiar with its precise outline.

For this reason, CCFD-Terre Solidaire and Center of Concern wanted to produce this admittedly non-exhaustive but also as complete as possible analysis in order to decipher the scope of the reform and the mobilisation of the public that sustained it.
Three decisive advances for international solidarity

- The introduction of a requirement for extractive companies listed on the New York Stock Exchange to declare payments made to governments of countries in which they have operations represents the fulfilment of a demand for transparency made by the international coalition “Publish what you pay” since 2002. It must give citizens of countries such as Burma and the two Congos a way to better monitor the activities of their respective governments and hold them accountable for the use of government revenues.

- The Act also requires multinational corporations that use or transform certain minerals extracted from the east of the Democratic Republic of Congo or neighbouring countries to carry out due diligence. This will help stop flows of finance to a 15-year conflict that has already claimed more than 5 million lives. According to the calculations of US NGO Enough Project, the exploitation of and trade in minerals from eastern DRC raised close to 185 million dollars for soldiers in 2008.

- Finally, as a result of the closer supervision of agricultural commodity futures markets it should be possible to more effectively combat speculation and ensure greater stability in prices for agricultural commodities worldwide, a measure that is absolutely indispensable for the most vulnerable producers and consumers. The deregulation of commodities markets was in part responsible for the food crisis of 2008, plunging another 200 million people into hunger.

The United States and the EU: Different approaches

The debate on the issue of taxes on financial transactions has never really taken place in the United States. This failure could be due to general and widespread reticence within public opinion on the issue of taxation. Conversely, in Europe, the cradle of this proposal born out of a mobilisation of civil society organisations in the 1990s, the debate has been in progress again for several long months. At the heart of the financial crisis, political statements followed on the subject. Different types of taxes on financial transactions could be conceived of on a European scale, in particular a tax on foreign exchange transactions involving the euro.

Another example is the approach favoured in the United States for the introduction of a requirement to publish information on a country-by-country, project-by-project basis in extractive industries is that of the fight against corruption. This provision increases transparency to control revenues for national governments from extractive industries in producer countries but does not allow verification that companies pay all taxes for which they are liable. European organisations, in particular CCFD-Terre Solidaire, are of the view that in order to effectively combat tax evasion by multinational corporations, in particular in countries of the South, country-by-country reporting must be extended to all sectors and, in particular, to request more complete information on intra-group transactions. Without this information, countries will not be able to avoid the artificial transfer of wealth produced by companies in other subsidiaries located in tax havens. On the fight against tax evasion, the debate is framed differently in Europe and Member States have the means to go further than the Dodd Frank Act.
INTRODUCTION

In 2007 the US financial system experienced a financial crisis that would, one year later, acquire global proportions affecting the global economy.

In June 2009, the US Department of Treasury released a white paper, U.S. Department of the Treasury released a white paper titled “Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation” and, subsequently, the US Administration submitted a series of legislation proposals to US Congress. On the basis of these proposals, Congress approved a bill in December 2009. In the US Senate, a bill was introduced in March 2010.

In July 2010, after a conference process to reconcile versions passed in both the House and Senate, the final legislation, “Dodd-Frank Wall Street Reform and Consumer Protection Act,” was approved.

General relevance of US financial reform to financial reform efforts abroad and globally

Coming after the largest financial crisis since the Great Depression, it is probably no surprise that the recently-passed US financial reform is, undoubtedly, the most important financial overhaul since the 1930s.

Studying its features and what can be characterized as successes and failures is important not just for those interested in financial reform in the US but also, particularly, abroad. Just as the financial crisis in the US had global impacts, the financial reform will be a central piece in the global response. This is for a number of reasons.

One reason is the “first mover” advantage. Increasingly since the onset of financial globalization, the tendency on financial regulation has been that regulatory standards are globally coordinated. Whether this is good or bad for regulation is beside the point. In the forums where standards are coordinated, countries typically tend to push, with heavy support from their private sectors, towards imposing their own models in order to ensure less disruption at home and for their own financial industry. The fact that a country develops a certain approach to a standard sets an important precedent that other countries are inclined to follow, unless there is a strong domestic pressure against. This is not only a function of

C. Dodd and B. Frank: democrat senator and congressman

Senator Mr. Christopher Dodd was elected to the U.S. Senate (Dem.) for the State of Connecticut in the 1980, and was subsequently reelected in 1986, 1992, 1998, and 2004. In 2010 he announced he would not seek re-election for a sixth term in the Senate. He has served as Chairman of the Banking, Housing and Urban Affairs since 2007.

House Representative Mr. Barney Frank was elected to the U.S. Congress (Dem.) for the Fourth District of the State of Massachusetts in 1980 and been reelected consecutively since then. In 2007 he became the Chairman of the House Financial Services Committee. Frank began his career in the Massachusetts State House where he served for eight years before becoming a representative to the U.S. Congress.
the power the standard-promoter may have, but also a matter of intellectual comfort: starting from an existing standard is always easier than having to start from scratch.

In the case of the US, two factors add to the special situation of every “first mover.” One is that it is well known that any standard that seeks to push beyond the US approach runs the risk of not being respected in the US, since domestic law has already been passed. So the American standards tend to act as a sort of “ceiling” for regulatory approaches elsewhere. Another is that with most globally operating banks housed in the US, the standards these banks have to adhere by in the home country have a larger impact than if they were just aimed at nationally-operating banks.

A second reason is that, once standards are set in a certain country – especially if the country has the largest financial sector in the world – to pretend that such debate is irrelevant to efforts in other countries and that debates there can start afresh is simply impractical. Inexorably, the adopted regulations frame the debate in other countries. This is what we are observing in regards to the regulatory efforts in Europe, which for better or for worse are evaluated in terms of how close or far from the US approach they are. The lobby of the financial industry and the constant threat that if standards are too strict it might migrate elsewhere, are an important aspect shaping this situation. Regardless of whether the threat is legitimate or not, it stands to simple observation that politicians trying to implement reforms are forced to ask questions in terms of whether standards are more or less favorable than those of the competing regulatory regime.
DODD–FRANK ACT: AREA BY AREA ASSESSMENT

1. Too big (as well as too complex, too interconnected) to fail

THE ISSUES:

The large financial institutions that were seen as the culprits of the financial crisis had to be bailed out with public funding in 2008. Ending the “Too big to fail” problem was, arguably, the main driver and the main issue in the push to reform the financial system in the US.

In the US, in the last 15 years, assets of the largest 5 financial institutions have gone from being 17 percent of GDP to 63 percent of GDP. The share of all banking industry assets held by the top 10 banks rose to 58 percent last year, from 44 percent in 2000 and 24 percent in 1990. When financial institutions get so large, in a situation of crisis the remedy that would correspond to any failing company—dissolution or transfer of ownership under a bankruptcy regime—cannot be applied without risking widespread disruption to vital financial intermediation activities. This is because the impact of the failure of the institution in the overall economy is arguably too large so policy-makers are in the situation of having to choose the lesser of two evils: face a catastrophic economic failure or use public funding to backstop the failing company.

Since large companies know this—even if governments will not necessarily make this as an explicit policy—they have an incentive to engage in excessive risk-taking to boost their profits.

Financial companies that are too complex or too interconnected to fail can also be equated, for these purposes, to the “too big to fail” ones. There was an intense debate, for instance, on whether deposit-taking institutions should be allowed to also engage on risky profit-making activities such as proprietary trading or investments in hedge funds or private equity funds. This practice was criticized because it creates moral hazard—banks could rely on public bailouts for reckless risk-taking operations that go wrong. It is in engaging in these practices that banks had become so complex and interconnected that they could bolster their claim to a bailout on the basis that it was hard to know what the actual ultimate impact of a failure could be.

The large banks in the US had a combination of both, too big and too interconnected. Banks that are considered so big that the government will not let them fail, enjoy improved credit rating. In turn, they can raise funds at lower rates to engage in risk—taking activities thus boosting their profits.


2. Ib.
Drawing lessons from US financial reform efforts
CCFD-Terre Solidaire, CoC - February 2011

DODD-FRANK APPROACH:

The legislation:

- Creates the Financial Stability Oversight Council (FSOC or “the Council”), a council comprising all regulators (chaired by the US Treasury) and charged with monitoring and responding to systemic risks posed by large, complex companies, products and activities. It can decide to extend the Fed jurisdiction to individual non-bank financial companies that may pose a threat to US financial stability. It may make to the Fed recommendations on prudential standards and reporting and disclosure requirements for i) nonbank financial companies supervised by the Fed and ii) large, interconnected bank-holding companies (bank-holding companies have to hold more than USD 50 billion in assets in order to be under jurisdiction of the Council, though the Council can recommend that companies below such asset threshold are also monitored).

The Council can order companies of more than USD 50 billion in assets, or other companies designated as systemically important by the Fed, that it deems pose a “grave threat to the financial stability of the United States”, to reduce their size (for example, by terminating one or more activities), or restrict their activities.

Banks that as a result of a merger or acquisition would grow to hold above 10 % of the aggregate consolidated liabilities of all financial companies are barred from consummating such operation. The Fed can authorize such banks to go ahead when the acquired bank is in default or in danger of default that is receiving assistance from the FDIC or that would result only in a “de minimis” increase of its liabilities. It is worth noting that federal law enacted in 1994 already restricted any bank from holding more than 10 percent of the nation’s deposits and, yet, several of the largest banks had been granted waivers from that requirement or used loopholes to evade its intent.

- Creates an Office of Financial Research, inside the Council, to monitor and study threats to systemic risk, also charged to report periodically to Congress.

- Adopts the so-called “Volcker Rule”: a requirement that banks do not engage in proprietary trading or invest in hedge funds or private equity funds. But with significant exceptions: the banks will be able to keep hedge funds and private equity fund units in house, they are allowed to invest up to 3 percent of bank capital in them, and to engage in proprietary trading of their own to hedge bank’s risk or facilitate clients’ needs.

- Creates Orderly Liquidation Authority for systemically important firms. In principle, this means the Federal Deposit Insurance Corporation can safely unwind failing nonbank financial firms or bank holding companies, no taxpayer funds can be used in their liquidation and shareholders and creditors would have to take losses. Each of the companies is required to keep a “living will,” detailing structure and a plan for unwinding in case of emergency and who whose claims would get priority in such case.

3. The rule has been termed “Volcker Rule” after its main proponent within the US Administration, Mr. Paul Volcker, who was appointed by President Barack Obama to serve as head an Economic Recovery Advisory Panel that he established in early 2009. Mr. Volcker has also been the Chairman of the Federal Reserve between 1979 and 1987.
CRITICAL ASSESSMENT:

The legislation offers an inadequate response to the “Too big to fail” issue, thereby maintaining the threat that public funding might be needed to bailout private firms in a future crisis. It is quite telling that credit rating agencies have not changed the rating of large banks, as they still factor in the government guarantee enjoyed by large banks.

Rather than a legal mandate to break up large financial institutions, the legislation prescribes a cumbersome process for the FSOC to order it. The concentration of the largest banks will be largely left unaffected. An amendment, Brown-Kaufman, that was ultimately not approved, would have set a) a limit on the non-deposit liabilities\(^4\) (including off-balance-sheet ones) of a bank holding company or thrift holding company of 2% of GDP and b) a limit on the non-deposit liabilities (including off-balance-sheet ones) of any non-bank financial institution that poses a risk to the financial system of 3% of GDP.

In fact, critics contend too much in the solution to “too big to fail” proposed by the law hinges upon the effective action by the FSOC in monitoring and taking action on systemic risk. In this regard, one could welcome the fact that the legislation has decided to grant authority for this Council to look beyond size to other factors such as leverage or interconnectedness and is able to assert jurisdiction over non-bank financial firms. But the characterization of a firm as “systemically important” can also be a double-edge sword, as it may give an explicit justification for government support if the company was to fail.

It is true that, in the law, the “systemically important” companies are supposed to never need government support because they would be dissolved. For this purpose, “systemically important” companies are required to produce information regarding their structure of assets and liabilities and plans for a dissolution that allow regulators to spot risks early on and provide for dissolution steps that isolate effects on the rest of the financial system. But critics find this is highly ideal and may call not just for excellent regulators to spot problems but also for highly diligent companies. Information that varies day by day is hard to effectively cover with the reporting that is prescribed.

Quite to the contrary, the FSOC is a Council of the same regulators that existed before, and thus not immune to regulatory capture. In addition, it gives pre-eminence to the Fed, especially for the most critical decisions (such as, for instance, determining whether a merger or acquisition that will make a firm too big can go ahead).

The Volcker Rule’s “pure” formulation, which would have banned banks from engaging in proprietary trading at all, was dismissed. The exceptions that were incorporated in the legislation largely undermine the objective of preventing banks from engaging in bets with taxpayer-insured funds. One example...
of this was starkly in evidence when some banks recently announced that, since the law defines “proprietary trading” as trading for the short term, principal investment – investments for the long term in companies, securities and assets – would not be covered under the scope of the rule. While the rule-making is still pending, some argue allowing banks to carry out these investments would contravene the spirit of the provision. Nonetheless, the letter of the law may give little chance to even the most activists of regulators.

In addition, the transition periods are too long. The rules to implement the Volcker rule have to be issued by September 2010, taking effect by mid-2011. Banks then have a period of two years – and can request an extension of 3 more – to implement them. All in all, a potential delay of 7 years until the rules are fully implemented.

Orderly liquidation is procedurally too cumbersome to work in the limited time that emergency crises allow. The Federal Deposit Insurance Corporation (FDIC) is unlikely to have the funds to respond to unwinding of a large institution of the type seen during the financial crisis. Because of the absence of a pre-funded “dissolution fund,” the idea of avoiding bailouts in the future is frustrated, and taxpayer funding will be required upfront for a resolution, even if it provisions are made for it to be recouped later on by levying fees. It is unclear that in every case all losses can be covered even by wiping out creditors and shareholders or that these will be forced to do so, as the provisions are relatively vague in this regard.

Proposals to reduce systemic risk or the size of banks via taxation of the financial sector did not receive serious attention. (See Section 6)
2. Bank capital requirements

THE ISSUES:

Capital requirements set the amount of capital that banks have to hold for every loan that they make. The Basel accord (see box) and, more recently, the Basel II Accord (issued in 2006 and that banks had barely begun to implement by the time of the crisis) prescribe a percentage of 8 percent ratio of capital to risk-weighted assets. Out of this 8 percent, however, only approximately 2% had to be common equity. The rest could be in other forms.

Bank capital requirements were insufficient and not well crafted to ensure that banks would be adequately capitalized to withstand severe shocks as occurred in the 2008-09 crisis.

The main standard in this regard was, at the time of the crisis, the Basel II agreement. However, at the time of the crisis, the US banks were capitalized above the requirements of such agreement, which further exposes the shortcomings of the standard. The real problem has to do not so much with the required level of capital as with the general approach taken by the Basel agreement. It grants to banks large amount of discretion to use their own risk measurement techniques to determine the risk of their assets. Basel was inspired by the belief that if the evaluation of risks was left to each individual firm, the minimization of the risk in the whole system would automatically follow. The crisis showed that, in fact, the opposite was true, with individual firms’ pursuit of incentives leading ultimately to a herd behavior in risk management that eventually made the whole system more vulnerable.

Other failures of the Basel agreement were that it attributed large weight to the determinations about credit risk made by credit rating agencies. There was limited consideration to the liquidity of assets and no limitations to the leverage that firms could undertake.

DODD-FRANK APPROACH:

Generally leaves capital requirements to be set according to the Basel III agreement. Subsequent to the passage of the Dodd Frank Act, the general lines of the Basel III agreement have been adopted. They
will raise the minimum capital requirements— and require a higher portion of these to be in the form of common equity—, includes a leverage ratio, liquidity requirements and a discretionary “countercyclical” ratio. Also higher requirements are expected for “systemically important” financial institutions.

**CRITICAL ASSESSMENT:**

The Basel III reforms will likely correct some of the excesses that the former Basel Agreement had given rise to. But critics contend the new agreement does not change the general principle of leaving risk management to the very financial entities that misjudged it last time.

The problem of aggregation of individually sound— but collectively wrong — risk appreciations remains a threat, and overcoming it requires a fine macroprudential regulator. There are reasons to not feel reassured by the prudential regulator the law intended to set up in the FSOC (see criticism of the FSOC in (1)).

Even as a limited approach, the capital requirements have far too long transition periods (into 2015 and 2019 in some cases).
3. Credit rating agencies

THE ISSUES:

Institutional investors (such as pension funds, mutual funds) and banks relied on credit rating agencies (CRAs) for the assessment of risk of assets in their portfolios. As a result, the risk of financial products such as Mortgage-Backed Securities and Collateralized Debt Obligations — was grossly underestimated. Importantly, without the blessing of such ratings, there would have been no market for many of the toxic products that were at the heart of the financial crisis.

In many cases, the reliance on CRAs assessments was due to legally-mandated requirements. In other words, the law would prescribe that only certain securities that were rated as Triple A could be subject of investment by certain funds. It is worth noting that ratings also matter for banks assessing the risks of their assets under the Basel II agreement on capital requirements. Even though Basel II was only issued in 2004 and at early stages of implementation in the US by the time the subprime crisis erupted, ratings were realistically the only option that could be applied for rating structured finance products, such as CDOs and other pools of risky assets that were central to the collapse.

A number of issues were identified as a problem by progressive advocates:

A ▶ The business model of Credit Rating agencies, which is based on the “issuer pays” — this is, the company issuing the securities pays the agency examining them — has a conflict of interest at heart. Companies could shop around to find the agency that would offer the most favorable rating, so CRAs access to business was actually dependent on their ability to keep clients by offering ratings that would satisfy them.

B ▶ Limited due diligence on the part of the CRAs when evaluating the products: the models used for risk assessment were not a product of a due diligence assessment of the loans they were actually rating

C ▶ Certain irregularities in the internal processes in CRAs were denounced early by their own staff but dismissed — in some cases staff who complained would be laid off.

D ▶ The almost unlimited protection from lawsuits enjoyed by CRAs. In spite of gross mistakes in ratings, CRAs could not be sued and their ratings were considered, under rulings of the Supreme Court, opinions entitled to freedom of speech protection. As a result, investors had no recourse to CRAs even when badly harmed by their negligence or incompetence.

DODD-FRANK APPROACH:

The legislation:

▶ Grants powers to the Securities and Exchanges Commission (SEC) to monitor and supervise CRAs, through the establishment of an Office of Credit Ratings housed in that agency.
Establishes a number of procedural safeguards that CRAs must adopt regarding disclosure of information (both with the SEC and with investors) on methodologies, performance of such methodologies, assumptions in ratings, requirements for Board members (e.g. that a certain number of members should have no interest in credit ratings, etc.

Determines that CRAs are no longer exempt from liability for their statements. So they can be sued for failing to “(i) conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or ‘(ii) to obtain reasonable verification of such factual elements …from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.”

Removes reference to CRA ratings in a number of legal instruments that required them. It also mandates regulators to review, within 1-year time, references to CRA ratings.

Calls for a study on how to avoid conflicts of interest generated by the “issuer pays” model. In a period of 2 years rules have to be issued on the assignment of CRAs to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the product from selecting a preferred agency. There is also a study requested on mechanisms for compensating CRAs so they have incentives to provide more accurate credit ratings. This study has to be acted upon within 18 months.

**CRITICAL ASSESSMENT:**

The CRA business model remains the same (even if it may be subject to change in the future on the basis of the commissioned studies).

The procedural safeguards are important but likely insufficient to address substantial problems in the models utilized to provide ratings. They expose the models to public scrutiny, but the capacity to turn that into more accuracy is, for something as obscure as credit rating frameworks, very limited.

In spite of abolition of mandatory requirements, it is unclear that investors will perform due diligence on their own without relying on CRAs. The immediate disembedding of CRAs from a number of rules means that, at the moment, there is no alternative mechanism for evaluating creditworthiness. A more gradual approach had been proposed by progressive advocates but did not prevail in the end.

The public prerogatives to control and monitor CRAs are limited and dependent on quality and willingness to act of the regulator.

Critics contend that the presence of a public rating agency could counter some of the excesses and offer an alternative to a purely private-led model for providing ratings. But this possibility was off limits in the legislative discussion.
4. Derivatives

THE ISSUES:

The size of over-the-counter (OTC) derivatives market has increased from $91 trillion in 1998 to $592 or 605 trillion in 2008. During the crisis, derivatives markets were responsible for the collapse of American Insurance Group that led to the US government’s decision to bail out the company.

As alluded in Section 1, due to the large portion of cross – exposures among financial entities – the opacity and complexity of derivatives markets is also an obstacle to the orderly resolution, without resort to taxpayer funds, of large financial companies. At the same time, this same opacity amplifies the impacts when a financial firm fails, such as it happened with investment firms Lehman Brothers and Bear Sterns. Over 80% of derivatives are controlled by only five financial firms: JPM Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley.

One type of derivatives, credit default swaps, were blamed for the worsening of the Greek debt crisis earlier this year. It is believed they are the source of still undetermined risks in the debts of a number of US municipalities and other governments with large sovereign debt burdens, such as Italy.

Several independent analyses consider the deregulation of US commodity futures markets after year 2000, with the Commodity Futures Modernization Act, a critical juncture in the process of enabling speculators to drive up prices of food items. This legislation, as described by the Indian economist, Jayati Gosh, “effectively deregulated commodity trading in the United States, by exempting over-the-counter (OTC) commodity trading (outside of regulated exchanges) from CFTC oversight. Soon after this, several unregulated commodity exchanges opened. These allowed any and all investors, including hedge funds, pension funds and investment banks, to trade commodity futures contracts without any position limits, disclosure requirements, or regulatory oversight.”

DODD-FRANK APPROACH AND CRITICAL ASSESSMENT:

The legislation:

- Contains measures to improve transparency of derivatives trading, especially OTC derivatives. The bill will require a large portion of derivatives transactions – those that are standardized – to be traded in public and electronic exchanges to increase transparency and to go through central clearing houses to ensure risks being built are also transparent and cash collateral has to be posted.
- The OTC derivatives that are not cleared still have to be reported in “real time.” They will be subject to higher margins and capital requirements for the dealers will also have to be higher than if the transactions had been submitted to a clearinghouse. By forcing OTC derivatives onto public exchanges, the measures also facilitate competition in price and make the trading less profitable for bank dealers. They will also better enable regulators to oversee risks building up in the system and players to prevent fraud.
- The submission to a clearinghouse ensures that traders have to post collateral to back the transactions and collateral changes have to be monitored on a frequent basis – daily, in some cases. This is not necessarily done when the transactions are carried outside of a clearinghouse.
However, there are exceptions to the clearing for end users ("nonfinancial companies") using the contracts to hedge their underlying commercial risk. Clearing institutions can refuse to clear certain derivatives that regulators have decided must clear, if it would undermine the financial integrity of the clearinghouse or create systemic risk.

- Mandates regulators to establish position limits for traders (by commodity and by value of contract) and margin requirements.
  
  The purpose of such measures is to make speculation more difficult and to increase its costs. Position limits curb the ability of speculators to post contracts for the pure purpose of betting or getting exposure to the underlying commodity. Margin requirements is a percentage that traders have to post as collateral in their account for the derivative transactions they are conducting. The higher the margin requirements, the harder that it is to maintain a position in a contract open.

- Contains measures to limit the participation of government – insured institutions in derivatives trading, to avoid that banks can rely on government-insured funds to speculate in markets or exchange-traded funds.
  
  The bill will also forces banks to spin off derivatives operations into separately capitalized units. It does so by prohibiting any federal assistance, including federal deposit insurance and access to the Fed discount window, to financial firms in connection with their trading in derivatives. As a result, this section would effectively require most derivatives activities to be conducted outside of banks and bank-holding companies. But these rules have been narrowed with several exceptions. One is for derivatives "involving rates or reference assets that are permissible for investment by a national bank" under the relevant legislation. This allows derivatives based on: interest and exchange rates, gold and silver. In a separate provision the law also allows trading in cleared, investment grade credit default swaps. Finally, trading is allowed if it happens in hedging directly related to the firms’ own activities.

**CRITICAL ASSESSMENT:**

The provisions on exchange trading and clearing derivatives are definite improvements. It is worth mentioning, though, that the measures will only affected contracts entered into after the law is enacted.

It is important that the bill also mandates the establishment of speculative aggregate position limits across different markets for all contracts, and capital and margin requirements for dealers. Earlier in the process it was feared the legislation would authorize, rather than mandate, regulators to impose such limits (this was the language used in the House version). In this regard the bill out of conference was an improvement. Obviously, the legislation could not state what those requirements will actually be in practice, and this is not minor detail that will be essential that regulators get right, if the requirements are not to become meaningless. For instance, going to an extreme, position limits could be established above any current position in the market. In that case, it is unlikely they affect anybody. The lower they go, the more impact they will have. Similarly, margin requirements could be set at levels that are meaningless to curb speculative activity. The higher they are, the more difficult and costly that it will be for traders to speculate using derivatives.

The obligation to clear derivatives trades builds some safeguards against risks that were, otherwise, born by dealers and hard to isolate in a crisis situation. But it is worth noting that it also means transferring such risks to the clearinghouses. According to the legislation, clearinghouses are among the "financial market utilities" that the FSOC could declare of systemic importance. This declaration, in turn, would
enable the clearing institutions in question to access extraordinary discount and borrower facilities, as well as reserve requirements exceptions. As a result, the possibility that publicly-funded bailouts may be needed to support derivatives bets gone awry is not totally excluded.

The provisions to curb bank derivatives dealing have been so weakened by exceptions that their effect on banks’ ways of doing business will be quite limited. For instance, interest rate swaps alone, one of the categories that is exempted from the requirement, constituted, to go by figures the BIS provided in late 2009, 70 percent of OTC derivatives trading. One aspect that is not clear in the law but some analysts consider a risk is that by enabling banks to keep derivatives operations in a separately capitalized subsidiary, the bank is still liable for the risk and may have to end up bailing out that unit. If that is the case, the problem emerges, again, that no matter the prohibition of bailouts in the law, it is unlikely to be respected as a bank that had to bailout a derivatives unit risks failure.

Regulators will play an important role in clarifying myriad details that the legislation leaves open, and doubts remain the Commodity Futures and Trade Commission, with its 600-person staff, is adequately resourced to carry such burden.
5. Private equity and hedge funds

THE ISSUES:

Hedge funds can be defined as “private pools of funds that invest in traded instruments (both cash securities and derivatives.) In a simpler definition, hedge funds are funds established for the purpose of investing the money of their participating partners. Because hedge funds specialize in pursuing highly sophisticated, high-risk investment strategies with the purpose of achieving returns above average, they are usually engaged in highly leveraged bets that could carry risks for the entire system. They employ leverage through various means, including the use of short positions, and are generally not regulated.

Although hedge funds were only supposed to be accessible to high net worth individuals – which also ensured that average consumers were not exposed to the risk – the access to retail investors has increased in the period before 2008. Governments have also increasingly investing their pension programs money in hedge funds. In the United States for example, the Securities and Exchanges Commission reported in 2004 that about 20 per cent of corporate and public pension plans were using hedge funds in 2002, up from 15 per cent in 2001, and the trend was rising. Public pension funds are among the number of entities that, in the last few years have sharply increased the amount of money they put into hedge funds in an effort to boost their returns and diversify their holdings.

While the lines between hedge funds and private equity funds are blurred, and the lack of exact definitions does not help distinguish them, one could say that private equity funds are also pools of funds that had, generally, a strategy of investing in private — that is, closely held — companies. Oftentimes, the private equity funds achieve higher than average returns by investing in companies, restructuring them and selling them out.

Another reason why hedge funds and private equity funds have come under greater scrutiny is because many banks have proprietary trading strategies that involve hedge and private equity funds or even have established their own, in-house. Thus, they have become exposed (and expose retail investors and insured deposits) to the high risk that average consumers were not supposed to face.

Finally, hedge funds and private equity funds have been criticized because, oftentimes, the high rates of return they achieve are at the expense of operations that jeopardize the long-term interest of target companies and the provision of decent employment conditions and employee security for their workers. Indeed, making profits via the undermining of working or safety conditions has been a driving consideration for some of the operations how such above — average returns are achieved.

Some argue that the 2008-09 crisis had nothing to do with hedge funds, demonstrating that fears about these instruments are ill-placed. In fact, many hedge funds closed in the onset of the crisis, without needing to be bailed out by governments. However, this might have been believed for some time but it was disproved by a recent data release by the Fed that shows hedge funds were among the beneficiaries of Fed emergency bailout programs, effectively meaning taxpayers supported profits in these supposedly high risk-high return vehicles for wealthy investors. Setting such factual inaccuracy aside, hedge funds contributed to the crisis in other ways. They had significant linkages to banks and other financial firms’ whose excessive risk-taking they made possible by taking the counterparty positions in risky transactions — hedge funds were also in many cases housed or owned by banks and

8. This support was provided to some hedge funds through the Term Asset-Backed Securities Loan Facility (Talf).
other companies. Even if one were to conclude they were not at the center of the crisis this time does not mean they might not pose risks in the future and they might be an important source of counterparty risk for the banking system. The crash of Long Term Capital Management hedge fund in the 1990s is a cautionary tale in this regard, and not one whose repetition can be ruled out for the future. The level of cross — exposure that large financial institutions could have developed to the fund was a significant factor when regulators had to decide whether to rescue it.

Moreover, to the extent that some of the Dodd Frank regulations are effective in pushing the excessive risk-taking activities outside of banks, it is hedge funds and similar institutions that will likely step up to fill the gap. So it is crucial to implement strong regulations for them, too.

**DODD-FRANK APPROACH:**

**The legislation:**

- Requires managers of hedge funds and private equity funds to register with the SEC.

- The SEC is empowered to request that funds keep records and make filings with the SEC of any information they deem appropriate. The SEC is also able to conduct on-site inspections of such records.

**CRITICAL ASSESSMENT:**

The law strengthens registration and transparency requirements for hedge funds and their advisers, including reporting requirements of aspects that could be required by the FSOC to assess threats to systemic risk. But a lot will depend on the quality of information funds are requested to provide and, it follows, the capacity of regulators to analyze it and willingness to take action. The required information is provided under proviso that the public will not have access — this is especially protected in the law for “proprietary information” which concerns, for instance, trading strategies, analytical methodologies, software containing intellectual property, etc. This will represent a barrier to additional scrutiny — by external stakeholders — of this material.

To the extent that some private funds may be designated as systemically important, the FSOC would have jurisdiction on them and can increase the intensity of regulation, but not absent such designation — and, realistically, it is difficult to expect many private funds to be designated as systemically important, if any at all.

Unfortunately, the question of who can invest in these funds is still open to different interpretations. There is only a study ordered in the legislation to analyze “the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.”

It is worth noting SEC registration will also mean that managers of hedge funds and private equity funds will have a fiduciary duty to act in the best interest of their investors, which often include pension funds. (See Section 12).
6. Taxation of financial sector (bank levy, etc)

**THE ISSUES:**

As a consequence of the crisis, new attention has been paid to proposals to tax the financial sector. Proposals advocate taxation on a number of grounds: 1) Ensuring the banking sector contributes to sharing the burden of bailouts that were necessary during the crisis — in other words, compensating the public sector/taxpayers, 2) discouraging or reducing excessive risk-taking, 3) raising revenue for national (and global) public goods, 4) reducing the size of the financial sector to reduce tendencies to concentration and, thus, systemic risk.

**DODD-FRANK APPROACH:**

The legislation did not call for any special taxation measures of the banking sector.

**CRITICAL ASSESSMENT:**

In the chapter on the Resolution authority, the House bill contained a measure to ensure the financial sector pre-funds potential future bailouts, which would be done through a fund of USD 150 bn to be levied on banks with over USD 50 bn in assets and hedge funds with over USD 10 bn in assets. The Senate contained a similar measure but envisioning a fund of USD 50 bn, to be paid by entities with over USD 50 bn in assets, and in proportion to the potential benefit they could derive from the fund.

These measures were dropped, as was a measure to have the banks pay fees to finance USD 19 billion that the implementation of the law could cost. The law retained the call for taxpayer funds not to be used in resolution and, if any expense is incurred, to be restored after the fact by ex post levies on the financial sector. Paradoxically, the argument against the taxes was that a “prefunded” resolution fund would amount to a bailout.

It should be noted that the taxes were not intended to be a mechanism for reducing the size of the sector, compensate taxpayers for the losses in previous bailouts or prevent speculative activity. Only the President-proposed bank levy had some anti-speculative elements insofar as the basis for collecting the tax would be the non-insured debt liabilities of the companies.

A number of proposals targeting financial transactions for special taxes were introduced throughout the year, but not attached to the Dodd-Frank bill.  

7. Consumer Financial Protection Bureau
/ Investor Protection

THE ISSUES:

The financial crisis exposed an across-the-board failure to protect consumers in the financial system. Financial firms marketed innovative and complex financial products that the public was ill-positioned to understand. Abusive practices by mortgage lenders, insurance and credit card issuers played an important role in the hardship that the common public had to suffer during the crisis, but also is part of a broader pattern of behavior that condoned the financial sector practices in the name of deregulation and freedom of contract.

Since no office or government agency had consumer protections as its top priority, consumer protections did not get the attention it needed. The result was that unfair and deceptive practices were allowed to spread unchallenged, nearly bringing down the entire financial system.

DODD-FRANK APPROACH:

The legislation created a Consumer Financial Protection Bureau (CFPB or “the Bureau”) with a mandate to “regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws.” The agency is to function within the Fed, with the main mission of enforcing financial consumer protection laws so that “markets for consumer financial products and services are fair, transparent, and competitive.”

Among the functions listed for the CFPB are: 1) conducting financial education programs; (2) collecting, investigating, and responding to consumer complaints; (3) collecting, researching, monitoring, and publishing information relevant to the functioning of markets for consumer financial products and services; (4), supervising covered persons for compliance with Federal consumer financial law, and taking appropriate enforcement action to address violations of Federal consumer financial law; (5) issuing rules, orders, and guidance implementing Federal consumer financial law; and (6) performing such support activities as may be necessary or useful to facilitate the other functions of the Bureau.

The bureau’s authority extends to all large banks, all payday lenders, all mortgage companies and other players in the mortgage market, and all other large non-bank lenders. Supervision and enforcement for banks with under $10 billion in assets will be by their prudential supervisors, and other small non-bank lenders will be subject to Federal Trade Commission and state enforcement authorities.

The Bureau is housed at the Fed but is not dependent from the Fed. The President appoints the Director with confirmation from the Senate. The mechanism for funding is also not dependent from the Fed (neither from Congress, actually). The Bureau’s Director has authority to designate periodically how much of the Federal Reserve System’s earnings are to be transferred to the Bureau, up to a 12 percent of the Fed’s total 2009 operating expenses (adjusted for inflation) and the Fed has no authority over financial operations of the CFPB.
CRITICAL ASSESSMENT:

The CFPB ends the fragmentation of the consumer protection that was in place before (through, for instance, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Federal Reserve, the National Credit Union Administration, and the Federal Trade Commission). By being an agency with the specific mandate to look after the interests of the consumer, the agency also fills a gap – no agency had that as its only mandate before.

The authority it enjoys also is good for ending fragmented and often inconsistent rule-making. The states can only issue regulations that improve, but not lower, protection standards for the consumer. This was not an easy win in the debate, where financial firms lobbied to limit authority of the CFPB to the federal level. Car loan dealers are, however, exempted from its authority – but subject to authority of the Federal Trade Commission.

On the other hand, this rule-making authority is subject to a “small business impact” preview requirement that requires convening a review panel to consider impact on small businesses and take into account their concerns. It thereby offers the very firms whose abuses the regulations target, the chance to object to such regulations. The FSOC also can overrule CFPB rules if it decides, by a vote of 2/3 of members, that the rule would put at risk the safety and soundness of the US banking system or the stability of the US financial system.

The CFPB’s supervision powers are more limited, as small banks are exempt from it – but states have to enforce the same rules that CFPB issues.

It is quite an advantage that the agency’s independence and budget are protected from interference, as ensuing events are quickly proving. One of the instruments by which the new majority in Congress threatens to undermine the Dodd Frank achievements is the defunding of regulatory agencies, so the decision on the CFPB funding proves to be a wise one.

Another important factor is the leadership the regulator is willing to exercise and the backing that the Administration shows. After the Administration hinted that it would nominate Prof. Elizabeth Warren, a person widely supported by consumer and progressive advocates for the job because of her clear discourse and demonstrated action against abuses by the financial firms, it became clear the Senate would make it difficult – if not impossible – to approve her. The President, then, chose to name her in the double position of Assistant to the President and Special Adviser to the Treasury. While this prompted criticisms that the President was bypassing a Senate confirmation process this step has enabled her to begin the task of shaping and setting up the CFPB.

Ms. Elizabeth Warren was appointed in September 2010 as Assistant to the President and Special Advisor to the Secretary of the Treasury on the Consumer Financial Protection Bureau. Before that she served as the Leo Gottlieb Professor of Law at Harvard University. Warren was the Chief Adviser to the National Bankruptcy Review Commission, and she was appointed by Chief Justice Rehnquist as the first academic member of the Federal Judicial Education Committee. She has served as a member of the Commission on Economic Inclusion established by the FDIC and as Vice-President of the American Law Institute, and she has been elected to membership in the American Academic of Arts and Sciences. Ms. Warren has written nine books, and more than a hundred scholarly articles dealing with credit and economic stress.
8. Financial transparency/integrity (including Country-By-country reporting on extractives)

THE ISSUES:

Transnational companies, by reporting their income, profits, etc. on a global consolidated basis, can avoid and evade taxes in jurisdictions where such taxes should duly be paid. Reportedly, billions of USD are lost to developing countries in trade revenue each year because of the transfer mispricing that companies engage in\textsuperscript{10}.

DODD-FRANK APPROACH:

The legislation requires oil, gas and mineral companies, listed on the SEC to disclose a) Payments to each government annually, broken down, b) Country-by-country and project-by-project c) Electronically, tagged, and mandates the SEC to publish this information on its website.

CRITICAL ASSESSMENT:

The coverage of the requirement extends to limited industries and, thus, falls short from a cross-sectoral country-by-country reporting as civil society has been calling for.

Neither are the items covered under the reporting requirements as many as those listed in the country-by-country reporting proposals that CSOs have made (for instance, labor costs, profits, etc.).

However, civil society in both the US and Europe is delighted with this first major stage in the achievement of country-by-country reporting (cf. Tribune by CCFD-Terre Solidaire in Le Monde)

\textsuperscript{10} In a recent study, Global Financial Integrity puts trade revenue losses for developing countries in the range of between USD 98 billion and USD 106 billion annually during the years 2002 through 2006. These are only losses related to a narrow category of transfer mispricing, not all losses from transfer mispricing. See Hollingshead, Ann 2010. The Implied Tax Revenue Loss from Trade Mispricing. Global Financial Integrity. February.
9. Institutions for supervisory infrastructure (what regulators, how do they operate)

**THE ISSUES:**

The evolution of the US financial system had led to fragmented authority for supervision of different actors in the system, and a convoluted set of supervisors and regulators, including at state and federal levels, that enabled firms to engage in forum-shopping.

**DODD-FRANK APPROACH:**

The legislation:

- Only eliminated one regulator: the Office of Thrift Supervision.
- Creates the FSOC – referred in (1).

**CRITICAL ASSESSMENT:**

The web of regulators that enabled forum-shopping in the past remains largely intact, and some bodies have been even added to the list.
10. Resecuritization

**THE ISSUES**

In traditional banking, banks make a loan and hold it in their portfolio. However, banks and other lenders have increasingly relied on a process of issuing mortgages that are then transferred to other entities. The adoption of this so-called “originate-to-distribute” model by issuers of mortgages has been considered an important factor behind the financial crisis. The banks still earn a fee for the issuance but the loan and its risks are transferred alongside. With the delinking of banks from the risk of the loans, mechanisms for scrutinizing lenders, the quality of the loan and the risk of non-repayment became more relaxed and were given lower priority.

**DODD-FRANK APPROACH**

The legislation calls for mortgage and other asset-backed security issuers required to keep, on a non-transferable basis, 5% of the risk of assets they issue (“skin in the game”), a percentage that regulators may raise.

**CRITICAL ASSESSMENT**

It is expected that, by forcing originators of loans to keep a percentage, they have a stake and preserve the incentive to carry out due diligence. But a five percent minimum might not be enough to discourage reckless behavior by issuers. It is unlikely, though, that the regulators will go for a percentage that is much (or at all) higher than that.

Since 95 percent of originated loans are still susceptible of transfer, the role of unregulated entities such as Special Purpose Vehicles and conduits that were absorbing such risks remains crucial. However, the Dodd-Frank does little to strengthen the regulation of such other entities.
11. Accountability of the Central Bank (the Fed)

**THE ISSUES:**

Many attribute to Fed mistakes in the management of monetary policy that allowed the housing bubble and the limited supervision that allowed the excessive risk-taking triggering the crisis.

Fed enjoys, under this framework, limited checks that could balance its policy decisions.

While the monetarist school’s belief in the need for independent Central Banks has become conventional wisdom, the Fed is, at least in the US context, subject to significant influence from the actors it is supposed to regulate.

But Central Banks’ authority and legal framework for action is actually given by Congress and, in fact, is subject to change. During the US financial reform discussion there were proposals to restrict the authority of the Fed and/or place it under closer scrutiny from the public and Congress.

**DODD-FRANK APPROACH:**

The legislation:

- Eliminates the ability of the bank representative directors to vote for the regional bank Presidents.

- Calls for an audit of the Fed, to be carried out by the Government Accountability Office, on the emergency lending provided in 2007-08 crisis and grants ongoing authority for the Congressional Accounting Office to carry more audits on emergency lending in the future.

**CRITICAL ASSESSMENT:**

More radical proposals that would have placed the Fed under greater scrutiny from Congress and the public, and subject it to greater transparency obligations, were dismissed in the process.

Critics contend that, in fact, the Fed was rewarded for its bad performance in the lead up to the crisis by receiving not only a slot in the FSOC, but a preferential place in it.

Some of the proposals that did not make it at the end would have removed from the Fed the power for financial supervision and subjected it to a more comprehensive audit by Congress.
12. Investor Protection / Corporate governance

THE ISSUES

The crisis exposed failures in the inadequacy of the system to protect investors – in many cases retirement savings, union pensions or education funds. A culture that incentivized short-term gain at the expense of long term growth and stability emerged and was enabled by limited transparency and accountability. Executive compensation practices and limited control of company executives by shareholders were part of this problem.

DODD-FRANK APPROACH:

The legislation:

- Requires (1) a non-binding shareholder vote, at least once every three years, to approve the compensation of named executive officers at annual or other shareholder meetings for which the SEC requires compensation disclosure, and (2) a non-binding vote, at least once every six years, to determine the frequency of say-on-pay votes. Earlier versions of the bill required an annual say-on-pay vote.

- Calls on companies to adopt a clawback policy applicable in the event of an accounting restatement due to material noncompliance with financial reporting requirements and providing for the recovery of amounts in excess of what would have been paid under the restated financial statements from any current or former executive who received incentive compensation (including stock options) during the 3-year period preceding the date of the restatement.

- Authorizes the Securities and Exchange Commission (SEC) to adopt rules under which shareholders would be able to nominate directors.

- Calls on companies to disclose the ratio of CEO to average worker compensation.

- Authorizes the SEC to impose the same fiduciary obligation on brokers to act in the best interests of their customers that all other investment advisers now face. (this is, however, after the agency completes a six-month study and report on its findings to Congress).

CRITICAL ASSESSMENT:

Some of the reforms had been struggles of many years in the US system. At the same time, they could have been stronger. For instance, the “advisory” resolution on executive compensation could have been made binding. The threshold for shareholders to nominate directors is subject to a still high threshold.
PART 2

THE INTERNATIONAL DEVELOPMENT DIMENSION OF US FINANCIAL REFORM

At an analytical level, it is not difficult to establish the relevance of how US financial reforms turn out for international development.

Even though the financial crisis of 2008-09 had started in a major industrialized country and financial center, the effects of the global financial crisis on development finance have been widely reported. The crisis negatively affected the ability of developing countries to mobilize domestic resources leading to budget cuts or the reduction of budget surpluses where these existed, a fall in foreign investment flows and remittances, increased debt as a result of needs to borrow for plugging budget gaps or, in some cases, boosting stimulus spending. Trade played a critical role, as the reduction in demand in markets that developing countries had typically relied upon for their exports triggered a cascade of effects. Trade was, ultimately, the most significant transmission channel for the effects of the crisis in developing countries.

Numerous reports also speak of negative impacts of the crisis on jobs, social services, food security, human rights, throughout the developing world.

The story in 2010 was that developing countries recovered from the crisis faster than developed countries – whose recovery is, in fact, not to be taken for granted – but this story admits important qualifications. First, the average masks very uneven trends. On the one hand there are dynamic emerging markets that have seen their economies reach high speed levels again. On the other, poor countries continue to struggle with serious budget shortfalls. Second, it overlooks the important structural impacts of the crisis on the economies of developing countries, how it affected developing economies productive capacity and productive sectors. Third, many countries simply were able to weather the crisis better because they had been able to keep high fiscal balances and reserves. Both come at the expense of reduced consumption, a luxury that poor countries really cannot afford. The “strong and safe banking sectors” that some developing countries exhibited during the crisis were nothing else than the flipside of scarce credit conditions where only the most profitable and least risky projects typically receive credit. In this sense, they are more a virtue made out of necessity, rather than a positive economic condition.

Therefore, it is not hard to see that making the global economy less prone to crisis warrants being an important concern for development advocates.
At least for several of the reform items that have been examined here, one can single them out and establish, again, analytically, the international development impacts that different paths of reform might have.

Take, for instance, the reforms addressing the “too big, too complex and too interconnected to fail” problem. There is a substantial overlap between the institutions that are deemed “systemically important” and those that have global operations. The behavior of these global firms that had become important credit providers in many developing countries was a key reason for the crunch in credit, especially trade credit. In turn, as the credit crunch deepened these firms had to prioritize – in some cases as a condition of bailout packages – financing in home countries. So, from a development perspective, it is crucial to ensure that mechanisms for the orderly resolution of systemically important institutions in home countries take into account the potential impact that failure or resolution will have on other economies where such firms operate.

The reforms of the derivatives are of great importance to deter the speculation that has worsened poverty indicators in the developing world due to food price inflation and energy prices. The FAO has recently predicted that the international development goal of halving the percentage of people who go hungry or undernourished by 2015 will be, at current trends, missed. These are projections that do not account for the most recent resumption in the rise in food prices and experts predict the upward pressure on prices will not subside soon.

The reforms on taxation of the financial sector either through increased taxes on bank profits or financial transaction, have an important development dimension. Increased revenue from taxing the financial sector is seen as a way to generate revenue needed for financing international health, development or climate agreements.

The reforms on financial transparency could be helpful to curb the flight of capital that undermines the capacity of developing countries to put in place their own stable sources of finance via taxation.

Regardless of the connections that can be analytically drawn between financial reforms in the US and international development issues, to argue that such international development dimensions played a substantial role in the public debate that led to the reform, would be a stretch. Whether this reflection may be of general application to financial regulation efforts in developed countries or whether that is an idiosyncratic feature of how the reform was carried out in the US context escapes to the scope of this paper. What is clear from the examination of the outcomes on financial regulation reform so far is that its politics have been distinctly national (and very local in some cases). An assessment, advocacy and mobilization based on its development implications has been largely absent.

Indeed, the experience showed that even when some of the achieved reforms had clearly established development implications, the momentum to drive such reforms through did not come from the said implications, but from local politics.

For instance, the BP disaster whose substantial damage on the Gulf Coast took the front media headlines for weeks was a critical game-changer in the advocacy pressing the oil industry for more transparency. This paper also describes the decisive role that local politics played in the derivatives reform.

Even for an issue with clear and explicit links to development, such as the proposals for a financial transaction tax, the advocacy and the several bills that were introduced were generally the product of a
compromise where the international development implications were placed, in the best cases, together with matters of national concern such as jobs or the budget deficit. In fact, the concrete taxation proposals that made it to the Dodd-Frank bill before being stripped out were not at all concerned with development issues, but with the concept of ensuring taxpayers — that is, national taxpayers — would be adequately reimbursed for the bailout costs, or in the future protected from having to make such disbursements altogether.
GENERAL EVALUATION
POLITICAL FORCES AT PLAY
AND CSO IMPACT

Against this backdrop, the experience of civil society in trying to influence regulatory efforts in the Dodd-Frank Act offers important insights.

While the legislation is a far cry from the structural and far-reaching reform that progressive advocates in the US would have liked to see passed, it makes some important strides and could have certainly been worse and done more harm. Further, it could be argued that looking at the emerging letter of the legislation to judge success is, perhaps, a myopic approach to judge progress. Financial regulation is a field that has been traditionally removed from public scrutiny and dominated by a few experts, because it is technically challenging and where transparency and accountability are, thus, lacking. So the emergence of coalitions of CSOs and grassroots and the building of their capacity to understand, offer counterproposals and mobilize around aspects of financial reform and, in some cases, leave an appreciable imprint in the final legislation, is the most important progress that has been made.

This is the most important asset to build upon with a longer term perspective, particularly as financial crises are hardly going to stop happening, and because of the significant scope for the legislation to be undermined through its implementation, if the intensity of campaigning and scrutiny diminishes. Similarly, it would be advisable that efforts in other countries are undertaken with a long term view to build grassroots/CSO capacity to engage and provide a valid alternative in the debate around financial regulation issues.

From this perspective, assessing those achievements and the story of how they happened offer important insights about how the organization and mobilization of civil society and grassroots to provide a counterlobby to that of the financial industry. Moreover, assessing where, in spite of hard work to create that counterlobby, issues did not go the way of progressive advocates, offers also important insights for that same purpose.

The accomplishments and losses

In looking at the most important accomplishments, from a civil society perspective, one should bear in mind that, usually, the best bill is the one that is introduced. From there on, initial ideas tend to be watered down. But this was a legislation that became quite stronger in a number of ways after it was introduced.
THE ACCOMPLISHMENTS

A top achievement was the Consumer Financial Protection Bureau as an independent agency to protect consumers against abuse by lenders. If there is one story in the legislative reform that stands for what organized civil society and grassroots can achieve, against great odds, it is this one. The agency had been targeted by the financial industry and big banks executives are on record saying they would never let it happen. The US Chamber of Commerce had set up a website “stoptheCFPA.com” that could be used for online activism against the agency. Huge amounts of money went into creating myths about the agency that would spread fear. A symbol of this “mythology” was the “butcher” story – opponents argued that the agency would be so intrusive that even the town butcher that provided credit to a customer would be subject to regulation.

It made an important difference that this was an issue not only originally included in the President’s financial reform proposal of mid-2009, but also one where the President and Treasury constantly showed strong support and political commitment.

Another aspect that contributed to this success was that consumer protection on mortgages, credit card and car loans was an issue where civil society organizations had been working for a long time, a body of knowledge and experience had been already built.

The adoption of the “Volcker rule”, a small victory

The Volcker rule, as adopted (see Section I.1) is regarded, with all its imperfections, an accomplishment worth highlighting and whose trajectory is worth studying.

To properly evaluate what this means, it is worth noting that nobody would have considered feasible the introduction of this measure around 2009. It was off the political debate. Although Paul Volcker had suggested this measure early on, it was nowhere to be found in the House legislation proposal of December 2009. It took a sort of recalibration of the political mood by the Administration in January 2010 when it realized that the course of the financial reform was not going far enough, and Mr. Volcker’s proposal was called for by the Administration. Even then, the Senate draft bill launched in March 2010 had it as a mandate for regulators to issue rules that would prohibit proprietary trading by banks but only after a study to be carried by the FSOC. Senators Merkley and Levin proposed an amendment to strengthen the language, and AFR worked with bloggers and supporters setting “net routes” to the point that nearly half a million emails were sent to Congress in support of the measure. In the Senate, this amendment never got voted. To stop it from coming for a vote, Republicans tied it to an amendment opposed by progressives – to exempt car dealers from the jurisdiction of the CFPB. So both amendments were withdrawn. It was in the Conference reconciliation process where the rule was re-added.

The provisions on derivatives also represent an important accomplishment where the bill went farther than the initial proposals, both in the House and the Senate, had gone.

The critical game changer here was that the bill had to be examined in the Committee on Agriculture, which was chaired by Senator Blanche Lincoln. As she was having a tough primary election in her state, needed to attract support from more liberal constituencies and decided that this was an issue where she could be more liberal. So, while nobody expected the legislation from the Committee on Agriculture to be anything good, Americans for Financial Reform were called to provide advice on how to shape this legislation. Also, had it not been for the significant field work that CSOs had done to transform the arcane issue of derivatives on something relevant to and visible in the political debate, Sen Lincoln would have likely looked for another issue to place her mark.

It would be a mistaken assessment to put all the credit on a sudden turn by a senator. It is not by chance that AFR was called to provide advice on how to shape this legislation. Also, had it not been for the significant field work that CSOs had done to transform the arcane issue of derivatives on something relevant to and visible in the political debate, Sen Lincoln would have likely looked for another issue to place her mark.
In the end, the exemptions that had to be given for the up to 3% ownership of hedge funds and private equity funds was a concession to win the vote of Senator Scott Brown, who had become the swing vote necessary to pass the full bill. The financial firms lobbied, successfully, him to get that measure and it happened to be one that would favor companies in his home state – even though ultimately all Wall Street would benefit from them.

It is an interesting insight that, to the extent that more debate and engagement from the public could be achieved, the political costs of not passing this measure kept growing.

The measures on credit rating agencies also do not go as far as expected, but represent an important achievement. Though a definite mechanism to change the issuer-pays model that is at the heart of the CRA’s failure in the lead up to the crisis eluded the legislation, the principle that this business model is a problem has been accepted in the law. The study commissioned to look into this issue also demands that action be taken. The study comes with the proviso that, unless it comes up with a different way to implement the principle, an independent board will have to assign ratings to agencies.

There are several other pieces of the legislation that are worth mentioning. The possibility of applying the liquidation authority to nonbank financial institutions – with all its limitations – let us remember was a missing piece when Lehman Brothers and AIG came to the fore for a rescue.

A number of disclosure requirements that could easily be taken for granted by a cursory observer are actually the product of ongoing struggles for social justice with great potential for transformation and will become important levers in the continuation of those.

One of them is the requirement for financial firms to gather and disclose data on the size, race, sex, etc of their consumers. Community groups have been fighting for years to have mandates to ensure financial firms serve disadvantaged communities and minorities but regulators would refuse to even request this information from the companies they regulated. Now that information will be available and will allow advocates to make a better case about what companies are lending to which groups.

Another is the requirement that companies disclose in their filings with the SEC the ratio of CEO’s compensation to the average workers’ compensation. For transnational companies, this could become particularly problematic. Because salaries paid overseas are, oftentimes, much lower – that being the reason why those jobs were located abroad in the first place – the more that jobs are located overseas, the more that the average salary of workers would be pulled down, and the greater that the gap with CEO’s compensation would become.

**Senators that made things change radically:**

- **Senator Ms. Blanche Lincoln** was elected to the U.S. Senate (Dem.) for the State of Arkansas on 1998 and then again in 2004. In 2009 she became Chairman of the Senate Agriculture, Nutrition, and Forestry Committee. Before her terms at the Senate, she had been first elected to public office in 1992 as U.S. Representative for Arkansas’s First Congressional District.

- **Senator Mr. Jeff Merkley** was elected to the U.S. Senate (Dem.) for the State of Oregon in 2008. Before that he was House Representative for the State of Oregon since 1998, becoming minority leader in 2003 and speaker of the House in 2007.

- **Senator Mr. Carl Levin** was elected to the U.S. Senate (Dem.) for the State of Michigan in 1978. He was reelected in 1984, 1990, 1996, 2002 and 2008.

- **Senator Mr. Scott Brown** was elected to the U.S. Senate (Republican) for the State of Massachusetts on January 19, 2010 to fill the term of the late Senator Ted Kennedy. Prior to his election to the U.S. Senate, Brown served in the Massachusetts State Senate where he had been elected three times.
Also, the partial acceptance of “country-by-country reporting” – for certain industries – is good in itself and also as an important precedent for future extensions of the principle.

A few key actors of the civil society:

**Americans for Financial Reform** is a coalition that currently brings together over 250 US-based national, state and local consumer, labor, retiree, investor, community, business, and civil rights organizations that have joined together to fix the US financial sector and make sure it is working for all Americans. AFR started in June of 2009 with the goals of, first, passing a financial reform bill and, second, contributing to building a movement that could galvanize expanding action as well as advance the immediate legislative campaign. ([www.ourfinancialsecurity.org](http://www.ourfinancialsecurity.org))

**Public Citizen** is a nonprofit organization that does not participate in partisan political activities or endorse any candidates for elected office, and accepts no government or corporate money. Public Citizen serves as the people’s voice in the nation’s capital. Since its founding in 1971, it has delved into an array of areas, but with an overarching goal: To ensure that all citizens are represented in the halls of power. (see more at [www.citizen.org](http://www.citizen.org))

**DEMOS** is a non-partisan public policy research and advocacy organization founded in 2000. Headquartered in New York City, Demos works with advocates and policymakers around the country in pursuit of four overarching goals: a more equitable economy with widely shared prosperity and opportunity; a vibrant and inclusive democracy with high levels of voting and civic engagement; an empowered public sector that works for the common good and responsible U.S. engagement in an interdependent world. (for more visit [www.demos.org](http://www.demos.org))

**The Federation of state Public Interest Research Groups (PIRGs)** is an advocate for the public interest. PIRGs stands up to powerful special interests on behalf of the American public, working to win concrete results for health and well-being. With a strong network of researchers, advocates, organizers and students in state capitols across the country, PIRGs take on the special interests on issues, such as product safety, political corruption, prescription drugs and voting rights, where these interests stand in the way of reform and progress (for more visit [www.uspirg.org](http://www.uspirg.org))

**The Center for Economic and Policy Research (CEPR)** was established in 1999 to promote democratic debate on the most important economic and social issues that affect people’s lives. In order for citizens to effectively exercise their voices in a democracy, they should be informed about the problems and choices that they face. CEPR is committed to presenting issues in an accurate and understandable manner, so that the public is better prepared to choose among the various policy options. Toward this end, CEPR conducts both professional research and public education. (for more visit [www.cepr.net](http://www.cepr.net))

**The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)** is a voluntary federation of 57 national and international labor unions. The AFL-CIO was created in 1955 by the merger of the AFL and the CIO and represents 12.2 million members, including 3.2 million members in Working America, its community affiliate. (for more visit [www.aflcio.org](http://www.aflcio.org)).

**The National Community Reinvestment Coalition (NCRC)** serves advocates around the country by providing training and technical assistance, research and policy analyses and other resources to more than 600 community-based member organizations, assisting them as they expand access to basic banking services including credit and savings, to create and sustain affordable housing, job development and vibrant communities for America’s working families. Its mission is to increase fair & equal access to credit, capital, and banking services/products because discrimination is illegal, unjust and detrimental to the economic growth of underserved communities in the United States and around the world. (for more visit [www.ncrc.org](http://www.ncrc.org))
THE FAILURES

Studying the issues where civil society and mobilization ultimately failed also yields important insights.

Top among these was the difficulty to achieve a legislative requirement to break up big banks. The Brown-Kaufman amendment that would have done this was voted too soon, so it did not give time for a public argument which likely would have had a more favorable result.

The exemption of car dealers from the jurisdiction of the CFPB, largely opposed by consumer groups, owes a lot to the broad membership of car dealers all over the country and their capacity to organize themselves. Car dealers are, in addition, usually wealthy and/or influential individuals in towns and cities. This played much to their favor when mobilizing support for their positions from the grassroots. It is notable that this defeat happened even though the President had issued a statement opposing the exemption of car dealers.

The removal from the bill of the proposal to have a fund with contributions from the financial industry to be used in case of liquidation was partly due to the need to garner swing Republican votes. But an important factor was how the commitment to such fund was portrayed in the media as a “bailout fund” and, thus, opponents rode on the public’s aversion to bailouts. Paradoxically, it is dropping the fund what makes the use of taxpayer funding in the future more likely, but this was lost in the debate once it had been framed by its opponents.

The fact that a debate was held on the proper accountability that the public should exert over the Central Bank was quite an achievement. But ultimately little was achieved on improving the governance of the Fed, in spite of public aversion. The President and Treasury’s support for the Fed proved to be ultimately insurmountable obstacles.

The failure to address the foreclosure crisis in the legislation reform was decried by activists, and it shows how difficult it is to bring an issue onto the agenda unless it is there, in some way, initially – this issue was not in the initial Presidential proposal for legislation.

How it was done

Over the history of the efforts to counter the lobby of the financial industry, a number of features emerge.

Though several of the groups that ended up initiating AFR had been working on segments of financial reform in a “silo-ized” way, they realized it was important to come together and join forces in a formal coalition with a negotiated platform that could garner everybody’s interests. The main groups were consumer groups, investor rights groups, responsible lending groups, antipoverty groups, trade unions (AFL-CIO and Services Employees International Union, for instance), senior citizens groups interested in defending pension funds, community groups — fighting for access to credit for communities and minorities such as the National Community Reinvestment Coalition — and civil and human rights groups.
The networking and organizing connecting with memberships across all states was crucial to the effort, as lawmakers have to pay attention to what their constituents say.

Some of the experts were not only knowledgeable on the issues, but brought the memory of previous struggles and became also a resource in that regard.

The other bridge was between the lobbyists who could find out critical intelligence and the grassroots organizing efforts. The coalition provided a platform for the quick sharing of such information. For instance, some members of the coalition would be invited to weekly meetings with the National Economic Council, or would be invited to briefings by the Chairman of the respective committees discussing the bill in the House and Senate. Such information would not have had the same impact without the ready platform for turning it into action on the crucial and often, time-sensitive, pressure points.

A leading tool: the web

Internet was widely used as a tool. It was used to establish online petitions. In one instance, one organization set up a webpage with the positions of legislators on a certain issue. So activists were encouraged to call their legislator, ask what their position was on that issue and, once they found out, call the NGO so that legislator’s position would be advertised. This was not just a way to map out where legislators stood, but actually to encourage activists to get engaged. The “net routes” effort around the Merkley-Levin amendment reported before, is another example of the use of the internet.

An important challenge was to turn the complex issues of financial regulation into something capable of mobilizing grassroots and the public. Some practices can be identified that allowed this to happen. The ability to build trust and linkages between the few available sympathetic experts and grassroots groups was quite important. So, for instance, on a cumbersome issue like derivatives, it became possible to actually have two or three experts have their message reach thousands. But, obviously, this would not have been possible if every person had to understand every little detail in the experts’ proposals. This was not necessary once there was established trust and common purpose.

The effort sought synergies between experts, people who were quite good in lobbying and people who were good in messaging and communication. For every issue in debate the coalition would develop one-pagers. When proposals were out, members would divide up the task of summarizing them with a quick turnaround.

Bringing in the same platform some issues that had built campaigns and grassroots support for long time, such as the community reinvestment or the consumer struggles, with the novel and more complex ones, such as systemic risk or proprietary trading, was another way to build cross-sectoral support.

The work with messaging experts helped also frame some of the issues in simple terms. Not surprisingly, the ability to offer clear targets (Wall Street or “greedy bankers”) and clear solutions, were superior for action and mobilization purposes than complex, nuanced and highly technical presentations. Examples of slogans or messages were “stop the casino economy,” “Wall Street vs. Main Street,” “bankers should pay for their mess.” The call for taxes on financial transactions was termed “a financial speculation tax.” The coalition and members also relied on polling exercises to determine what messages would work best. Then, more complex or technical issues would be lumped together under the same message. For
the complex issue of proprietary trading in derivatives, the metaphor was “bankers are gambling with your money.” Some issues were easier to convey, such as that, in a time of crises, everybody was worse off, except bankers. Giving a human face to the victims was as important as giving a human face to the victimizer. So the efforts to identify people affected by mortgage and credit card abuses to shape media stories were also important.

The communications work also relied on national and local press conferences, letters to the editor, conferences and meetings with editorial boards. Sometimes AFR would have some of its experts do teleconferences with large numbers of union members.

Creative stunts and techniques combining activism and humor were not absent in the effort. Perhaps the best example of this was when Senator Brown, placed in the situation of being the swing vote, was being courted by the banking sector to oppose the bill. Coalition members presented Senator Brown with a BMW, arguing that driving this car was more in accordance with somebody who votes for Wall Street. Through a supporter with connections to comic stars, an ad was put together where all actors that had ever played a president in “Saturday Night Life” argued for the Consumer Protection Agency.

The leadership of the coalition, by Heather Booth, was another important factor. She carried a background as a community organizer and was able to frame issues in terms of specific and strategic sequential targets. As described by some members, she combined the understanding of the larger picture with the capacity to break it down into smaller pieces. The philosophy was one of giving organizers smaller battles that could be won and that would ultimately pave the way for larger wins.

It was important, in these one-pagers and in every common position, to seek unanimity. This was identified as a tremendous asset for the coalition by denying opponents the ability to split it up. Even though the need to get to common denominators generated sometimes positions that were less detailed than one would have hoped, the attempt to keep a unified platform can be characterized as worth the effort.

Some key people

Ms. Heather Booth is currently the Executive Director of Americans for Financial Reform. She was the founding Director and is now President of the Midwest Academy, training social change leaders and organizers. She has been involved in and managed many political campaigns and was the Training Director of the Democratic National Committee. She was the lead consultant for the 2006 Campaign for Comprehensive Immigration Reform. In 2008 she was the director of the Health Care Campaign for the AFL-CIO and just recently she directed the campaign to pass President Obama’s transformational budget. She is on the board of USAction, NAACP NVF, and the Center for Community Change.

Gary Dymski is professor of economics at the University of California, Riverside. He received his B.A. in urban studies from the University of Pennsylvania in 1975, and an MPA from Syracuse University in 1977, and his Ph.D. in economics from the University of Massachusetts, Amherst in 1987. He was a research fellow in economic studies at the Brookings Institution in 1985-86, and then taught economics at the University of Southern California from 1986 to 1991 before joining the UCR faculty in 1991. From 2003 to 2009. Gary was the founding Executive Director of the University of California Center Sacramento. His most recent books are Capture and Exclude: Developing Nations and the Poor in Global Finance (Tulika Books, New Delhi, 2007), co-edited with Amiya Bagchi, and Reimagining Growth: Toward a Renewal of the Idea of Development, co-edited with Silvana DePaula (Zed, London, 2005). He has also published articles, chapters, and studies on banking, financial fragility, urban development, credit-market discrimination, the Latin American and Asian subprime financial crises, exploitation, housing finance, the subprime lending crisis, and economic policy.
External factors that aided the effort to pass financial reform

Some external factors helped or offered a catalyst for the effort of civil society and grassroots in countering the financial industry.

From the outset, this was a crisis that had made the public angry at the financial industry, epitomized in Wall Street. There was pressure on politicians to explain why it was that while people were losing jobs, savings and homes, the sector whose risk-taking behavior had triggered the crisis received generous support at the expense of the taxpayers. Both Administration and Congress had an incentive to be seen as passing legislation that ensured politicians would never have to go back to their constituencies to request such a sacrifice again and that they would be reining in the excesses of Wall Street practices.

In fact, polling shows that, although American public tends to be against more regulation, if asked the question about only regulation of the financial industry, the majority is in support.

The initiation of the debate was also while there was some carryover of the excitement around President Obama’s message of change and idealism. The commitment of the Administration and its leadership in sending the initial reform proposals to Congress was quite helpful, as was, though later in the process, the launching of proposals for the “Volcker rule” and the continued support on different pieces of the legislation such as the Consumer Agency.

The uncovering during the legislative process of scandals (see Box) such as that involving Mr. Bernard Madoff’s Ponzi scheme, the use by Goldman Sachs and other financial firms of “repo” transactions to embellish quarterly reports, and the negligence or outright disregard by credit rating agencies of flaws in rating models or practices concerning the deals being rated, even when internal staff was bringing them to the attention of the leadership1, helped cement the public’s feeling that something had gone wrong in the way Wall Street did business. Events such as the scare around the so-called “flash-crash” apparently due to a failure of high frequency trading (see Box) and the continued troubles in the US economy that failed to recover from high levels of unemployment in spite of the recovery of the banking sector, also contributed.

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External factors against

On the other hand, the efforts to have a strong financial system reform also had important external factors against that should be acknowledged.

To begin with, the financial industry had almost unlimited amounts of money. It could and did deploy large amounts of funding to spread its message. Since the start of the reform debate, it is estimated that the financial sector has spent USD 1.4 million per day to influence Congress. The “revolving door” nature of lobbying also appears in the hiring of some 70 members of Congress and 940 former Federal employees.

This does not count the funding that is devoted just to staff who works on technical analysis and assessment of proposals. In contrast to the few experts who were available to perform advisory role with a pro-reform perspective, most advisors with technical knowledge and experience on the financial sector have been working with the financial industry for its purposes. Given the importance of justifying proposals on technical grounds and the high complexity of the issues at stake, this is no small disadvantage.

The influence of large banks was not only visible directly, but also indirectly, in their capacity to influence other groups. In the debate around derivatives, for instance, Wall Street became quite aware that they were not the best face for defending the status quo in the derivatives markets. So they mobilized the so-called “Coalition of Derivatives End-Users.” These were companies and businesses that feared that the reform effort would damage their costs for hedging commercial risk. The goal was to obtain a loophole that would permit not only end-users, but also big banks, continue with their activities. More recently it has been documented that banks are lobbying to have the regulator define “commercial risk” in such a broad way that provisions to also large derivatives dealers can avail themselves of such exemptions. (Similar efforts to misportray the CFPB as harmful to small business are reported above). In hindsight, some advocates go as far as saying that in some issues it was possible to win only because the financial industry may have calculated that it was not worth spending more to counter them.

The funding influence is also quite visible in a political culture where there is acceptable to donate large amounts of money to candidates and where candidates can hardly be taken seriously without money to back up their campaigns. This is especially so after a Supreme Court decision last year that rolled back some of the limited campaign finance reform that was passed a few years ago. Many candidates whose seats are up for re-election feared strongly the possibility that the banking sector might back an opponent if they did not “cave in” to demands.
There was also a quasi-monolithic front offered by the financial industry. Although an observer would think that the financial sector comprises a diversity of interests that would conflict, this was barely apparent in the legislative debate. Now and then small banks would pick up a fight with large ones. This happened when they demanded that big banks pay more for deposit insurance fees and in some instances where they demanded that big banks have more regulation — in fact, as reported, the CFPB does not carry enforcement powers for firms below USD 10 bn in assets. But these were the exception rather than the rule.

In spite of the Administration support for the reform, especially as embodied in the figure of the President, the Fed and the Treasury were consistently a roadblock in efforts to promote more significant reforms. Mr. Bernanke and Mr. Geithner would more often than not side with the industry on a myriad of issues. Observers report that a sense of fear (that pressing the banks too much would be ultimately bad for the economy and for everybody) was actively promoted as a way to emasculate the more far-reaching proposals. Not only did this rest credibility to proposals not supported by them. Sheer opposition by the Treasury and the Fed were enough oftentimes to make a proposal politically not viable in a Congress where the reformers were of the same party of the Administration.

The choice of priorities of the Administration was also not helpful. By making healthcare its first priority, it determined that financial reform efforts were not the subject of attention — among politicians, the media and the public — until healthcare reform was passed. By then — end of March — the bill had already passed the House and was being debated in the Senate. The moment with most potential for shaping the reforms — earlier in the legislative debate — was, thus, wasted.

**The impeding persons within the Fed and the Treasury:**

**Mr. Ben S. Bernanke** has been Chairman of the Board of Governors of the Federal Reserve System since February 1, 2006 (he is now in his second term as chairman). Before that Mr. Bernanke was Chairman of the President’s Council of Economic Advisers (2005 to 2006) and served the Federal Reserve as member of the Board of Governors (from 2002 to 2005), a visiting scholar at the Federal Reserve Banks of Philadelphia (1987-89), Boston (1989-90), and New York (1990-91, 1994-96); and a member of the Academic Advisory Panel at the Federal Reserve Bank of New York (1990-2002).

**Mr. Timothy Geithner** was appointed Secretary of the US Department of Treasury by President Barack Obama. Before that he served as the ninth president and chief executive officer of the Federal Reserve Bank of New York (2003-2009). Mr. Geithner had previously served in the Department of Treasury starting 1988 and worked in three administrations for five Secretaries of the Treasury in a variety of positions. He was also director of the Policy Development and Review Department at the International Monetary Fund from 2001 until 2003.
PART 4

GENERAL EVALUATION
RISKS TO IMPLEMENTATION

The legislation calls for more than 60 studies and approximately 430 regulations that will have to be issued. As the law got passed, the debate moves away from the spotlight of Congress, where legislators were — shortcomings notwithstanding — subject to accountability for their votes and initiatives regarding the legislation.

The expected change of forces in one of the Chambers, the House, after the recent mid-term elections will clearly tend towards weakening the law. Many Republicans have campaigned on proposals to overturn financial reform. While a repeal of the law looks unlikely — and impractical, as it would face Presidential veto — there are other means at the disposal of the new majority to achieve these goals. First, with implementation of the law dependent on so many regulatory rule-making, will be through pressing regulators to be lenient in the interpretation. The second is by defunding the regulatory agencies, or subjecting funding to specific conditions. Finally, by frequent questioning — “grilling” — of regulators in Congressional hearings.

In an example of how these tactics could work, even with an agency that was designed to be independent from Congress, the Republican lawmaker Spencer Bachus of Alabama, the leading contender to take the reins of the House Financial Services Committee, sent letters to the inspectors general of both the Treasury Department and the Federal Reserve, directing them to conduct an investigation into the work being done to establish the new CFPB.

With the end of the legislative process in Congress, there is a danger that a feeling, among a good part of the public, that “the job is done” limits the attention, energy and resources that could be devoted to follow up and ensuring the adequate monitoring of implementation.

Regulators are ultimately nominated and appointed through a process that enables accountability but certainly a more tenuous one. In addition, the type of rules that will need to be set up by these agencies are of a more detailed and technical nature, thereby skewing the opportunity for influence towards experts from the financial industry. Civil society and grassroots interests will have a harder time trying to influence such processes. In spite of its successful job, Americans for Financial Reform has seen already a downsizing in its staff at a time when, arguably, an increase would be in order to enable it to provide a counterbalancing point of view to that of the financial industry in these more highly technical processes.

Mr. Spencer Bachus was elected to the U.S. Congress (Republican) for the Sixth District of Alabama in 1992, and been reelected consecutively since then. Since 2007 he has served as Ranking Member on the House Committee on Financial Services and after the recent 2010 elections became its Chair. Before becoming a member of the House of Representatives he served as a Senator in the State Senate of Alabama.
Due diligence

The SEC (Securities and Exchange Commission) has already published its proposals for the implementation of this section of the Act, and a consultation process will run until January 31. All companies that use or transform minerals from the DRC or neighbouring states must present a “conflict minerals report” to the SEC, which will be independently audited at their own expense. The results of the audit and the report must be published on the company's website. The SEC reserves the right to comment on the quality of the report; however, until now there has been no mention of a system of penalties to ensure the enforcement of this obligation.

In addition, the definition of “armed groups” provided by the SEC is out of step with reality on the ground. It does not take into account the fact that elements of the national army are also involved in the control, exploitation and sale of minerals, a situation that was further clarified in the latest report on the UN group of experts on the DRC. The trade on minerals whose revenues benefit exclusively certain elements of the Congolese army can therefore freely spread to the US.

Therefore, the SEC has made advances in terms of transparency that will enable citizens to monitor the activity of multinationals, but the plan remains insufficient in terms of regulation. The SEC recognises that it has received messages from several groups expressing their scepticism of the Act. On December 2 last year, The Wall Street Journal cited action initiated by the main US electronic appliance companies with the SEC in order not to be forced to produce the conflict minerals report.

All in all, the US example has created a precedent that would benefit from being emulated in other countries, particularly in Europe and Asia, by expanding the field of companies targeted to include those that do not trade on the stock exchange. The international community must also create the conditions for an ongoing, global and systematic audit of due diligence practices; demanding only companies to do this is not enough. The complexity of the situation on the ground requires the permanent presence of people dedicated to each task. Therefore, the UN Security Council and local governments must form a permanent team to observe and evaluate the due diligence practices of economic agents until the situation stabilises.

On the other hand, it is important to refer to the comments in Section III in the sense that the most promising development of the last year is probably not the legislation per se, as much as the awareness and capacity built among grassroots and civil society to engage and provide a valid alternative in the debate on financial regulation issues.

By the same token, the achievements around the reform of financial regulation represent a milestone in the building of a self-image of civil society groups as a broader community that can join hands and, when it does so, trigger unexpected achievements.

It is worth noting that, just as regulatory action represents an opportunity for the law to be undermined, it can also represent an opportunity to strengthen it. This paper has shed light on several issues whose smart regulatory implementation will be crucial to effective regulation.

In addition, while not a reason for celebration, the limited reform is already translating in continued stress in the system, as expected austerity measures in states and cities take a toll and housing and unemployment figures continue to disappoint. At least some pressure towards continued reform of the financial system will exist in the near term and political opportunities to exploit it, too. While the
leadership of the new Republican majority may be bent on undermining the recently passed reform, it is no secret that the majority as such does not have monolithic views. Among some newly-arrived members of Congress, the zealous defense of market mechanisms against what is considered government intrusion also finds expression in a rejection of state-supported subsidies that shield opaque and unaccountable financial sector companies from market discipline.

In spite of the challenges, continued strategizing goes on in order to take advantage of the new opportunities. Indeed, since the passage of the Dodd-Frank legislation, numerous rule proposals have been made public for comment and AFR and other allies have been actively taking advantage of such processes to ensure the implementation process leads to furthering, rather than eroding, the gains.

### Transparency in extractive industries on a country-by-country basis (the Cardin Lugar amendment)

Section 1504 of the Financial Reform Act introduces a new transparency obligation applicable to all extractive companies (oil, gas and mineral companies) listed on the US stock exchange. These companies must now declare to the Securities and Exchange Commission (SEC) any payments made to governments in all countries in which they have operations. This information will be published on a universally accessible website.

This obligation of transparency constitutes a major advance in the fight against corruption and efforts to promote development. This should allow citizens of countries that are poor but rich in natural resources to better monitor the activities of their governments and the use of public funds.

The outreach of this new transparency obligation in the extractive sector exceeds widely American companies in that it covers 90% of international oil and gas companies, including numerous European and Asian groups listed on Wall Street, as well as 80% of large companies operating in the mining sector. Moreover, it goes further than country-by-country reporting, since the wording of the Act introduces a project-by-project reporting requirement. However, the devil is often in the detail and many elements have not yet been specified. The Act stipulates that the order implementing article 1504 must be published no later than 15 April 2011 in order to enter into force in 2012. Civil society organisations, such as Revenue Watch and Publish What You Pay, made contributions in relation to the implementation of the Act in the autumn of 2010 to specify their proposals: the activities and subsidiaries concerned, the level of detail required on payments declared, the definition of the scope of the project, the format of data published, materiality, etc. Later, the SEC published a draft decree on 15 December, on which it opened a consultation process that will end on 31 January 2011.

Nevertheless, the main approach of this measure is to fight corruption. According to organisations mobilised against tax evasion, the information required does not include essential information such as the volume of reserves, the level of production and information on intra-group trade. Without this additional requirement, multinational corporations will be able to continue to artificially move the wealth they produce around their accounts in order to avoid taxes.

Thus, the challenge of emulating this section of the reform on a European level poses a challenge when it comes to expanding the sectors covered and information required.
TRIBUNE DE BERNARD PINAUD, CCFD-Terre Solidaire, LE MONDE.FR

Wall Street à l’heure de la solidarité internationale ?

Bernard Pinaud, nouveau délégué général du CCFD-Terre Solidaire

La coalition internationale depuis 2002 dans 55 pays par les 600 organisations de la solidarité internationale. Cette demande de transparence est portée pour eux de violence, de corruption, de pillage écologique à regretter l’abondance de leurs sous-sols, synonyme de l’Angola, du Guatemala ou encore du Congo en venir de la richesse, qui voit les citoyens du Nigeria, de Birmanie, dans le secteur extractif. Une première parade au paradoxe d’une nouvelle ère – celle de la transparence – qui s’esquisse dans le secteur extractif. Une première parade au paradoxe de la richesse, qui voit les citoyens du Nigeria, de Birmanie, de l’Angola, du Guatemala ou encore du Congo en venir à regretter l’abondance de leurs sous-sols, synonyme pour eux de violence, de corruption, de pillage écologique et de misère. Cette demande de transparence est portée depuis 2002 dans 55 pays par les 600 organisations de la coalition internationale « Publiez ce que vous payez ». Elle doit permettre aux trois milliards et demi d’habitants des pays riches en matières premières de mieux mesurer et contrôler la part de la rente qui revient à leur gouvernement. Les sociétés qui achètent des minerais provenant de République démocratique du Congo (RDC) devront se déclarer au gendarme de Wall Street et prendre des mesures dites de « diligence raisonnable » pour s’assurer que leur activité ne contribue pas à l’enrichissement des groupes armés. L’enjeu : cesser d’alimenter la guerre pour le contrôle de ces minerais qui, depuis quinze ans, fait chaque jour dans l’Est du pays autant de morts que les attentats du 11 septembre 2001. Concrètement, les enseignes qui commercialisent l’or du Kivu devront, tout comme les industriels qui fabriquent téléphones portables et ordinateurs avec du coltan et de la cassitérite de RDC, garantir la traçabilité de leurs approvisionnements. Là non plus, ce premier pas décisif pour la restauration de la paix dans les Grands Lacs n’aurait pas été franchi sans le plaidoyer conjoint des ONG internationales et des acteurs locaux. La réforme prévoit enfin d’encadrer le recours aux produits dérivés sur les marchés à terme agricoles. Cette mesure contribuera à limiter la spéculation sur les produits agricoles. La stabilisation des prix agricoles est un long combat des ONG. Pour les pays en développement, où la crise alimentaire de 2008 a plongé 200 millions de personnes supplémentaires dans la faim, il en va à la fois de la capacité des plus pauvres à se nourrir dans les villes, et des paysans à vivre de leur travail. Lorsque les traders et autres intermédiaires font tripler en quelques semaines le prix du blé ou du riz, c’est le consommateur égyptien ou sénégalais qui souffre. Lorsqu’ils font chuter le prix du café ou de l’huile de palme, c’est le producteur égyptien ou sénégalais qui souffre. Bien sûr, la mobilisation citoyenne serait restée lettre morte si elle n’avait trouvé l’oreille de responsables politiques prêts à mener personnellement ces batailles. Des sénateurs américains, démocrates et républicains, ont pris leurs responsabilités. Avec l’assentiment de Barak Obama. Il faudra, aussi, toute la vigilance de la société civile américaine pour que ces victoires législatives se traduisent dans les décrets d’application. Mais la leçon est claire : les propositions émises par la société civile, quand elles rencontrent des hommes politiques responsables, peuvent changer la vie de millions de personnes ! En 2011, le président de la République française, hôte du G8 et du G20, sera sous les feux de la rampe internationale. La société civile française non plus ne manque pas d’idées : constituer des réserves agricoles pour juguler la spéculation sur les prix, obliger les multinationales à publier leurs comptes pays par pays pour éviter qu’elles ne placent artificiellement leurs profits dans les paradis fiscaux, taxer les transactions financières internationales… Nicolas Sarkozy saura-t-il s’en inspirer ?
Clearing house
An agency or corporation that settles transactions for a fee. Clearinghouses match orders together, ensuring that delivery is made to the correct party, and collecting and monitoring margin money and processing what each party owes or is owed in a central location so that the fewest securities and the least amount of money actually change hands.

Countercyclical ratio
A countercyclical (capital) ratio is a capital requirement that seeks to counterbalance and smoothen out sharp variations in the financial cycle. Thus, the countercyclical ratio seeks to increase capital – so as to moderate credit growth during boom times – and, inversely, reduce capital – so as to moderate credit reduction during bust times.

Credit Default Swap : CDS
A derivative contract by which one of the parties, for a fee, provides insurance to the other in case of the default risk on a bond or debt instrument materializes.

Cross-exposures
The exposure that financial institutions have to other institutions in the same financial system.

Dissolution fund
A fund created to aid the process of winding down of failing financial companies. It could be designed to finance different costs within that process, e.g. from merely financing the administrative costs of resolution to financing costs involved in purchase or guarantee of «bad assets» the failing company has in its balance sheet.

Exchange-traded funds
A security whose value tracks an index, a commodity or a basket of assets, just like an index fund, but that trades like a stock on an exchange.

Forum shopping
Practice that tends to emerge in situations where several regulators have overlapping, unclear and/or shared jurisdictions, whereby the companies in the industry under regulation would seek the regulator that is more lenient.

Government Accountability Office (GAO)
Independent, nonpartisan agency that works for Congress. Often called the “congressional watchdog,” GAO investigates how the federal government spends taxpayer dollars.

Leverage ratio
Generally, any ratio used to calculate and measure financial leverage of a company. In the context of the Basel Agreement on Capital Requirements, the leverage ratio has a specific meaning. It was designed, in the words of the Committee, to constrain leverage in the banking sector, thus helping to mitigate the risk of the destabilising deleveraging processes which can damage the financial system and the economy.
and introduce additional safeguards against model risk and measurement error by supplementing the risk-based measure with a simple, transparent, independent measure of risk.

**Long term capital management Hedge Fund**

The Long Term Capital Management hedge fund was established in 1994 with equity of USD 1.3 billion and its equity had grown, by 1998, to USD 5 billion. For an investor who was at the beginning and stayed until 1997, the annual return would have been 15 percent a year. LTCM’s leverage, based on money it had borrowed, was of 1-20. In September 1998, the New York Fed convened a series of firms that had lent money to the company and warned them about the “systemic risk posed by LTCM going into default.” Greenspan asserted that rescuing LTCM was necessary to prevent markets from “seizing up” and “impairing the economies of many nations.” As a result, a consortium of financial institutions organized a rescue.

**Macroprudential regulator**

A macroprudential regulator introduces regulation with the objective of preventing risks for the financial system as a whole, as opposed to a microprudential regulator, which would pursue measures to prevent the build up of risk in individual financial institutions.

**Over-the-counter (OTC) derivatives market**

Over-the-Counter Derivatives are those that parties enter into bilaterally (outside of any formal exchange trading venue and with no third party intervention).

**Prudential standards**

Rules, norms and regulations issued with the purpose of preventing or minimizing financial sector problems such as failure or the generation of systemic risk or instability.

**Regulatory capture**

A process by which, over time, regulatory agencies come to be dominated by the industries they are supposed to regulate.

**Securities that were rated as Triple A**

AAA (Triple A) is, in the grade scale of firms that evaluate credit risk, the highest grade, representing the lowest degree of risk in the security in question.

**Subprime**

Subprime is the adjective characterizing a loan that is made to a borrower with a tarnished credit history, or that for other reasons carries higher credit risk. Usually, such loans carry also a higher interest rate to compensate for such risk.

**Systemic risk**

A situation where the full banking or financial system comes under acute stress, usually beginning with the collapse of or a major problem in one firm.
| AFR  | Americans for Financial Reform |
| AFR-CIO | American Federation of Labor and Congress of Industrial Organizations |
| AIG | American Insurance Group |
| CDO | Collateralized Debt Obligation |
| CDS | Credit Default Swap |
| CFTC | Commodity Futures Trading Commission |
| CFPB | Consumer Financial Protection Board |
| CSO | Civil Society Organisation |
| GAO | Government Accountability Office |
| FDIC | Federal Deposit Insurance Corporation |
| FED | Federal Reserve System |
| FSOC | Financial Stability Oversight Council |
| NCRC | National Community Reinvestment Coalition |
| NEC | National Economic Council |
| OTC | Over the Counter |
| SEC | Security and Exchange Commission |