

# DODD-FRANK AND BASEL III'S KNOWLEDGE PROBLEM

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## I. INTRODUCTION

In 2010, a pair of responses to the 2008 financial crisis were released—the Dodd-Frank Wall Street Reform and Consumer

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Protection Act<sup>1</sup> and the Third Basel Accord.<sup>2</sup> Much scholarly attention has been paid to the Dodd-Frank Act,<sup>3</sup> but little has addressed its subtle—but consequential—nuances where interplay with Basel III implicates considerable knowledge problems.<sup>4</sup> That Dodd-Frank's implementation, particularly in the area of bank capital requirements, is coincidental with that of Basel III, raises concerns in the areas of both domestic and international business transactions.<sup>5</sup> Because it is only a recommended framework, countries are free to implement or not implement Basel III, in whole or in part.<sup>6</sup> Given the myriad policy choices and incentives among its potential adopters, the potential for market and competitive advantages between countries is enormous.<sup>7</sup> Thus, U.S. regulators must create rules that ensure domestic firms engaged in international commerce

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] (codified in scattered sections of 7, 12, 15, 18, 22, 31, and 41 U.S.C. (2012)).

2. BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 1 (2010) [hereinafter BASEL III GLOBAL FRAMEWORK], *available at* <http://www.bis.org/publ/bcbs189.pdf>; BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING (2010) [hereinafter BASEL III LIQUIDITY RISK FRAMEWORK], *available at* <http://www.bis.org/publ/bcbs188.pdf>.

3. Books regarding Dodd-Frank include SUSAN BERSON & DAVE BERSON, *THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: FROM LEGISLATION TO IMPLEMENTATION TO LITIGATION* (2012); DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* (2011). Journal literature includes John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019 (2012); H. Rodgin Cohen, *Preventing the Fire Next Time: Too Big to Fail*, 90 TEX. L. REV. 1717 (2012); Jerome Walker et al., *Reconciling the Dodd-Frank and Basel Committee Capital Requirements*, 129 BANKING L.J. 627 (2012).

4. The knowledge problem is the proposition that centralized planning requires access to data and other information that any one person, committee, or regulator does not have, nor has the incentive to find. See F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 519–20 (1945). It argues that dispersed knowledge in the marketplace—guided by price signals—permits the greatest volume of efficient trades. *Id.* at 519–22.

5. Michael Wiseman & Andrew Gladin, *Dodd-Frank, Basel III and the Age of Uncertainty*, BANKDIRECTOR.COM (Sept. 5, 2012), [www.bankdirector.com/files/9013/4694/3218/Basel-Dodd-Frank.pdf](http://www.bankdirector.com/files/9013/4694/3218/Basel-Dodd-Frank.pdf).

6. Walker et al., *supra* note 3, at 642–43.

7. *Id.*

are not disadvantaged or hamstrung by the U.S. version of Basel III, and the Basel Committee has a strong interest in ensuring a level playing field.<sup>8</sup> In similar fashion, market uncertainty follows the implementation of Dodd-Frank. The regulatory scheme seeks to segregate systemically important financial institutions for enhanced treatment,<sup>9</sup> opening the door and creating incentives for policy makers and regulators to push policy initiatives through those regulated institutions.<sup>10</sup>

The purpose of this Comment is to analyze the potential unintended consequences of Dodd-Frank and Basel III's implementation. Particular attention will be paid to the uncertainty they create and the potential effects of the knowledge problem. Part I contains a historical overview and brief explanation of the relevant legislative path. In it, emphasis is given to U.S. regulators' response to the crisis, as the historical market conditions and consequent incentives play a significant role in later analysis. This background information concludes with a summary of the current state of the relevant agencies' Dodd-Frank and Basel III rulemaking efforts. Part II focuses on the knowledge problem and the uncertainty created by these reforms. It will look to the purportedly simplified regulatory structure of the U.S. capital markets brought on by Dodd-Frank, and the problems that a hodgepodge implementation of international reforms, through Basel III, could exacerbate among U.S. financial firms.

## I. BACKGROUND

### A. *Landscape*

American financial regulation traces its contemporary roots to President Roosevelt and the New Deal Congress.<sup>11</sup> The purpose of this Comment renders unnecessary a full recitation of the interim regulatory climate, but the tendency to flip-flop through periods of enhanced regulation and deregulation is

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8. *Id.*

9. Dodd-Frank Act §§ 112(a)(1)(A), 113(a)(1), 12 U.S.C. §§ 5322(a)(1)(A), 5323(a)(1); see also discussion *infra* Part I.B.

10. SKEEL, *supra* note 3, at 94.

11. *Id.* at 1.

relevant to its premise.<sup>12</sup> The housing market's collapse triggered the 2008 financial crisis.<sup>13</sup> Improper lending practices, government policy, and the distribution of risk through the use of financial engineering all led to the expansion of the housing boom.<sup>14</sup> In general, mortgage loans provide a relatively stable cash flow for lenders, an attribute that makes them particularly suitable for securitization.<sup>15</sup> Banks seeking to mitigate their exposure to mortgage default risk frequently sell their loans to investment banks, who in turn package the loans into complex mortgage-backed securities.<sup>16</sup> After securitization, these mortgage-backed securities can be further securitized into

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12. Compare Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (facilitating affiliation among banks, securities firms, and insurance companies), and Garn–St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (deregulating thrifts and savings and loan institutions), and Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (establishing committee to phase out deposit account interest rate ceilings), and *Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299, 318–19 (1978) (permitting National Banks to export the usury law of their home state to out-of-state credit card customers), with Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (improving the accuracy and reliability of public company disclosures made pursuant to securities laws), and Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (reforming and enhancing the enforcement powers of the relevant federal financial agencies in response to the Savings and Loan Crisis), and Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (creating the Commodity Futures Trading Commission).

13. Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivatives Clearinghouses*, 61 EMORY L.J. 1153, 1164–65 (2012).

14. *Id.*

15. *Id.* at 1165.

16. *Id.* at 1165–66. Professor Griffith succinctly summarizes the basic securitization transaction as follows:

In a basic securitization transaction, an originator first contributes a group of assets to a distinct legal entity—a so-called Special Purpose Vehicle (SPV)—which then sells debt securities to investors protected by a security interest on these assets. The income received from the pooled assets is used to pay the interest rate on the securities sold to investors, and the proceeds from the sale of these securities are paid to the originator to compensate for the contribution of assets into the SPV and to fund future activities. Investors in the assets, meanwhile, receive a stream of payments, which, because they are pooled and typically given credit enhancements, are less risky than they were in the hands of the originator.

*Id.* at 1165 n.49 (citations omitted).

collateralized debt obligations (CDOs).<sup>17</sup> Broadly speaking, a CDO is a pooling of asset-backed debt obligations, further securitized into tranches to be sold to investors with various risk preferences.<sup>18</sup> To complicate matters further, investment banks frequently engage a counterparty in credit-default swaps (CDS) to further diversify their risk.<sup>19</sup> Mortgage originators are not the only parties seeking mitigation of risk; oil companies, energy providers, airlines, buyers and sellers in international markets, and agricultural operators frequently use derivatives to engage in risk management.<sup>20</sup> It is perhaps most important to note these engineered products are encapsulated—they are derivatives *of* derivatives—and this Author's Futures and Options professor described the harm from their misuse quite aptly: “The cover graphic of your textbook—a tumbling line of dominoes—is a rather appropriate analogy.”

From these market conditions, two principal mechanisms by which derivatives accelerated<sup>21</sup> the housing crisis are apparent: (1) their ability to systematically infect the market with risk through almost infinite derivation; and (2) by their opaque nature, financial institutions were capable of taking enormous positions on that widespread risk, resulting in an inability to determine the true nature of any one firm's exposure.<sup>22</sup> In the four years leading to the crisis, the notional principal value<sup>23</sup> in the CDS market was estimated by the Bank for International Settlements to increase tenfold, from \$5 trillion to a peak of \$57

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17. *Id.* at 1166.

18. JOHN C. HULL, *OPTIONS, FUTURES, & OTHER DERIVATIVES* 795 (2012).

19. Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 *FORDHAM J. CORP. & FIN. L.* 705, 718–19 (2008).

20. See Laurin C. Ariail, *The Impact of Dodd-Frank on End-Users Hedging Commercial Risk in Over-the-Counter Derivatives Markets*, 15 *N.C. BANKING INST.* 175, 176 & n.9, 189–91 (2011) (discussing the use of derivatives by nonfinancial corporate entities).

21. Professor Griffith nuances the causation issue nicely: Derivatives alone cannot be the cause of the housing bust because the relative risk posed by the underlying asset can be hedged. Griffith, *supra* note 13, at 1167 n.57.

22. *Id.* at 1166–67.

23. Notional principal of a derivative contract is a hypothetical underlying quantity upon which interest or other payment obligations are computed. HULL, *supra* note 18, at 805.

trillion.<sup>24</sup>

A party to a derivatives contract faces not only the relative riskiness of the underlying reference entity,<sup>25</sup> but also the risk of his counterparty's default.<sup>26</sup> This potential for nonperformance under the contract is referred to as "counterparty credit risk" and has serious implications in the event of a crisis.<sup>27</sup> When the reference entity is in default at the same time as the CDS protection seller, the buyer of that protection faces a double default and loses his protection at precisely the time he needs it most.<sup>28</sup>

To understand the systemic<sup>29</sup> harm such a scenario may pose to the financial system, consider the implications of the failure of a large counterparty. Consider a bank's agreement to loan a certain sum to an electricity provider for use as working capital. The bank may rationally determine its inability to fully build a default premium into the interest it charges the borrower, and decide to "buy protection" through the use of a CDS. Later, when the electricity provider defaults on its loan, the bank faces exposure to a loss. However, the bank properly evaluated its risk and engaged a counterparty for the purpose of mitigating its exposure to such a credit event. In this scenario,

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24. Griffith, *supra* note 13, at 1168.

25. A reference entity is an underlying entity to a derivatives contract—it is the entity for which default protection is bought in a credit default swap. HULL, *supra* note 18, at 807.

26. Griffith, *supra* note 13, at 1161.

27. *Id.* at 1161–62.

28. *Id.* at 1162. Professor Griffith explains this double default event: "Losses from counterparty credit risk are especially likely in periods of financial distress, when financial institutions, rendered unstable either by wild swings in the value of the underlying reference asset or by losses elsewhere in their portfolio, fail." *Id.*

29. Systemic risk is the risk of a significant reduction in the effectiveness of the financial system caused by a chain reaction of failures of major financial institutions; there are two different kinds of systemic risk:

- (1) the risk of sudden, near-term systemic seizures or cascading failures[;]
- and (2) the longer-term risk that our system will unintentionally favor large systemically important institutions over smaller, more nimble competitors, reducing the system's ability to innovate and adapt to change.

*Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 70 (2009) (testimony of Mary Shapiro, Chairman, U.S. Securities and Exchange Comm'n).

however, instead of settling the contract upon the credit event whereupon the buyer has purchased protection, the counterparty (protection seller) defaults on the CDS. This causes the protection-buying bank to fully realize the loss created by the initial credit event, plus the payments it has remitted to the protection seller in the interim. When the defaulting counterparty is large and interconnected, such a failure spreads enormous losses throughout the system because other institutions become exposed to unhedged positions at the same time the protection is needed.<sup>30</sup> It is precisely this sort of scenario that cascaded through the financial markets beginning in early 2008, precipitating the Federal Reserve's provision of an emergency loan to Bear Stearns whereupon it assumed a portion of Bear Stearns' credit risk.<sup>31</sup>

JP Morgan Chase was incentivized to purchase Bear Stearns based on the Fed's intervention,<sup>32</sup> which signaled to the market the administration's willingness to prop up systemically important firms.<sup>33</sup> Despite being several times larger than Bear Stearns, federal regulators provided no assistance to Lehman Brothers and instead, in September of 2008, directed it into bankruptcy.<sup>34</sup> In the days and weeks that followed, the Fed bailed out American International Group (AIG),<sup>35</sup> and together with the Treasury, announced its request for the \$700 billion Troubled Asset Relief Program (TARP).<sup>36</sup> The administration furthered its bailout policy in 2009, by partly financing the sale of Chrysler in Chapter 11 bankruptcy,<sup>37</sup> and by providing

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30. Griffith, *supra* note 13, at 1162–63.

31. William Poole, *Causes and Consequences of the Financial Crisis of 2007-2009*, 33 HARV. J.L. & PUB. POL'Y 421, 422 (2010).

32. *Id.*

33. SKEEL, *supra* note 3, at 26–27.

34. Poole, *supra* note 31, at 423. In the context of market signaling, Skeel argues the Bear Stearns bailout disincentivized a properly prepared or organized Lehman Brothers bankruptcy. SKEEL, *supra* note 3, at 26–28. The Bear Stearns signal likely contributed to Lehman rebuffing several credible purchase offers over the summer of 2008; further, the expectation of a bailout also likely deprioritized the shoring up of assets or otherwise planning for bankruptcy. *Id.* at 27–28.

35. Poole, *supra* note 31, at 423.

36. SKEEL, *supra* note 3, at 24.

37. *Id.* at 35. While Fiat was styled the “buyer,” it put up no money, the U.S. and Canadian governments provided all of the sale's financing. *Id.* In return for a large block

funding for General Motors to buy itself out of Chapter 11.<sup>38</sup>

The financial crisis developed through the systemic breakdown of the financial system that precipitated damage to the real economy.<sup>39</sup> The failure of large and interconnected financial institutions, as a direct result of the housing bubble, triggered that systemic breakdown.<sup>40</sup> The financial system is largely composed of intermediaries, markets, and the infrastructure necessary to support payment, settlement, and trading mechanisms.<sup>41</sup> Systemic risk spread through this system as a contagion, whereby the failure of one financial intermediary led to the failure of others.<sup>42</sup>

### *B. The Dodd-Frank Act*

In response to the need for a new financial regulatory framework, the Dodd-Frank Act was signed by President Obama in July 2010.<sup>43</sup> The President touted the sweeping Dodd-Frank reforms as creating a framework where markets “can function freely and fairly, without . . . suddenly bring[ing] the risk of financial collapse.”<sup>44</sup> While recognizing the constructive nature of financial derivatives, he declared their destructive tendencies would be mitigated by Dodd-Frank’s “common-sense rules.”<sup>45</sup> The Act bills itself as a promoter of U.S. financial stability and a protector of the American taxpayer by ending bailouts.<sup>46</sup> Indeed, President Obama’s remarks at the signing make the intent

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of stock in New Chrysler, Fiat agreed to provide its know-how and facilities. *Id.*

38. *Id.* at 39.

39. CCH ATTORNEY-EDITOR STAFF, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: LAW, EXPLANATION AND ANALYSIS 45 (CCH 2010).

40. *Id.*

41. *Id.*

42. *Id.*

43. Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES, July 22, 2010, at B3.

44. President Barack Obama, Remarks on 21st Century Financial Regulatory Reform 2 (June 17, 2009) (transcript available at [http://www.whitehouse.gov/the\\_press\\_office/Remarks-of-the-President-on-Regulatory-Reform/](http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/)).

45. *See id.* at 3.

46. Dodd-Frank Act, 124 Stat. at 1376.

explicit: “[t]here will be no more tax-funded bailouts—period.”<sup>47</sup> More generally, it possesses two clear objectives.<sup>48</sup> The first is to mitigate the systemic risk imposed by complex contemporary finance; the second is to mitigate the harm caused by the collapse of a large financial entity.<sup>49</sup>

The Act purports to accomplish these goals by enhancing the regulation of certain firms that are most likely to cause systemic problems if they fail.<sup>50</sup> Specifically, the Act focuses on bank holding companies<sup>51</sup> with at least \$50 billion in assets and other nonbank financial institutions deemed systemically important.<sup>52</sup>

Title I, titled the Financial Stability Act of 2010, establishes the Financial Stability Oversight Council (FSOC)<sup>53</sup> and the Office of Financial Research (OFR).<sup>54</sup> The title is designed “to prevent systemic risk to the entire financial system through . . . oversight, transparency and macro-prudential regulation in coordination with the primary federal financial regulators.”<sup>55</sup> The FSOC’s purpose is to identify risks to the financial stability of the United States from large financial institutions, to promote market discipline, and to respond to emerging threats to the system’s stability.<sup>56</sup> Dodd-Frank authorizes the FSOC to determine that a nonbank financial company will be supervised by the Fed and its heightened prudential standards where the FSOC determines material financial distress at the company

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47. President Barack Obama, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (June 21, 2010) (transcript available at <http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act>).

48. SKEEL, *supra* note 3, at 4.

49. *Id.*

50. *Id.* at 5.

51. Dodd-Frank adopts the Bank Holding Company Act of 1956’s definition of a bank holding company. Dodd-Frank Act § 102(a)(1), 12 U.S.C. § 5301(18)(B)(i) (2012). There, the term means “any company which has control over any bank or over any company that is or becomes a bank holding company . . . .” Bank Holding Company Act of 1956 § 2, 12 U.S.C. § 1841(a)(1) (2012).

52. SKEEL, *supra* note 3, at 5.

53. Dodd-Frank Act §§ 101, 111, 12 U.S.C. § 5321 (2012).

54. Dodd-Frank Act § 152, 12 U.S.C. § 5342 (2012).

55. CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 44.

56. Dodd-Frank Act § 112, 12 U.S.C. § 5322(a)(1) (2012).

would pose a systemic threat to U.S. financial stability.<sup>57</sup> In a supporting role, the OFR is authorized to standardize and collect data on the FSOC's behalf.<sup>58</sup> Section 171 of the Act requires regulators establish minimum leverage and risk-based capital requirements for banks, bank holding companies, and nonbank financial firms identified by the FSOC for enhanced Fed supervision.<sup>59</sup>

Title II establishes a new mechanism for the orderly liquidation of large, failing financial institutions that may threaten U.S. financial stability—it purports to end “Too Big to Fail.”<sup>60</sup> Under this title, the Secretary of the Treasury may appoint the FDIC receiver of a failing financial institution for the purpose of liquidating its holdings before any contagion effects reach the rest of the market.<sup>61</sup> It is believed this FDIC receivership provides a “viable alternative to the undesirable choice . . . between bankruptcy . . . and bailout.”<sup>62</sup> In the process of liquidation, “[t]he financial company’s business operations and assets will be sold off or liquidated, the culpable management of the company will be discharged, shareholders will have their investments wiped out, and unsecured creditors and counterparties will bear losses.”<sup>63</sup>

Title III includes a provision that permanently increases the Federal Deposit Insurance Act’s deposit insurance cap from \$100,000 to \$250,000.<sup>64</sup> Title VI, named The Bank and Savings Association Holding Company and Depository Institution

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57. Dodd-Frank Act §§ 112(a)(2)(H), 113(a)(1), 12 U.S.C. §§ 5322(a)(2)(H), 5323(a)(1) (2012).

58. Dodd-Frank Act § 153(a), (c), 12 U.S.C. § 5343(a), (c) (2012).

59. Dodd-Frank Act § 171(b), 12 U.S.C. § 5371(b) (2012). These leverage and risk-based capital adequacy requirements will be met through implementation of the relevant Basel III standards. *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,791 (proposed Aug. 30, 2012) (to be codified in scattered parts of 12 C.F.R.).

60. S. REP. NO. 111-176, at 1 (2010); *See* Dodd-Frank Act § 203(a)(2), 12 U.S.C. § 5383(a)(2) (2012) (establishing orderly liquidation authority and procedures).

61. S. REP. NO. 111-176, at 4 (2010).

62. *Id.*

63. *Id.*

64. Dodd-Frank Act § 335(a) (codified as amended at 12 U.S.C. § 1821(a)(1)(E) (2012)).

Regulatory Improvements Act of 2010, seeks to improve the regulation of bank and savings association holding companies and other depository institutions to ensure they do not pose a threat to the U.S. financial system.<sup>65</sup> With the abolishment of the Office of Thrift Supervision,<sup>66</sup> section 604 requires the Fed to regulate and examine bank holding companies with an eye toward potential risks to the stability of the U.S. banking or financial system.<sup>67</sup> Section 616 establishes the Fed's duty to promulgate capital adequacy requirements, notably mandating the countercyclicality of those requirements.<sup>68</sup> The so-called Volcker Rule, established in section 619, prohibits or restricts certain financial activity conducted by banking entities and nonbank financial companies supervised by the Fed.<sup>69</sup> These restrictions are put in place where the Fed characterizes the conduct as "high-risk or which create[s] significant conflicts of interest between these institutions and their customers."<sup>70</sup> Activities prohibited include proprietary trading, hedge fund activity, and private equity exposure.<sup>71</sup>

Title VII, named the Wall Street Transparency and Accountability Act of 2010, provides for the first time a comprehensive framework for the regulation of over-the-counter (OTC) derivatives.<sup>72</sup> In three parts,<sup>73</sup> the title amends both the Commodity Exchange Act and the Securities Exchange Act to create separate, parallel frameworks for both the CFTC and

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65. S. REP. NO. 111-176, at 82, 84 (2010).

66. Dodd-Frank Act § 313.

67. Dodd-Frank Act § 604(a)–(c), 12 U.S.C. § 1844(c)(1)–(2), (5) (2012); S. REP. NO. 111-176, at 84 (2010).

68. Dodd-Frank Act § 616(a)–(c) (codified in scattered sections of 12 U.S.C.).

69. S. REP. NO. 111-176, at 8 (2010).

70. *Id.*

71. *Id.* Proprietary trading means:

[E]ngaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the [Federal Reserve] Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, [or] any option on any such security, derivative, or contract[.]

Dodd-Frank Act § 619(h)(4), 12 U.S.C. § 1851(h)(4) (2012).

72. CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 248.

73. The three parts include (1) regulatory authority, (2) regulation of swap markets, and (3) regulation of security-based swap markets. *Id.* at 253.

SEC to regulate swaps.<sup>74</sup> It further requires rule-making coordination between the CFTC and SEC by mandating a joint process “assuring regulatory consistency and comparability.”<sup>75</sup> Additionally, section 716 prohibits certain forms of federal assistance to swap entities “with respect to any swap, security-based swap, or other activity of the swaps entity.”<sup>76</sup> This prohibition from federal assistance includes access to the Fed’s discount window and federal deposit insurance, but does not apply to a major swap participant or major security-based swap participant if it is also an insured depository institution.<sup>77</sup>

Finally, the Dodd-Frank Act contains numerous other provisions, such as Titles designed to shore up consumer financial protection, insurance, and mortgage reform, that are beyond the scope of this Comment.

### *C. The Basel Committee on Banking Supervision*

The Basel Committee on Banking Supervision was created in 1974 on the initiative of the Group of Ten (G10) countries’ central bank governors, and today is represented by twenty-seven member countries.<sup>78</sup> While the Committee’s decisions and recommendations lack binding effect, they are reached by consensus and returned to the members’ home countries with strong recommendation.<sup>79</sup> Indeed, both Basel I and Basel II enjoyed wide adoption by both member and non-member countries.<sup>80</sup>

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74. BERSON & BERSON, *supra* note 3, at 93.

75. Dodd-Frank Act § 712(a)(1)–(2), 15 U.S.C. § 8302(a)(1)–(2) (2012).

76. Dodd-Frank Act § 716(a), 15 U.S.C. § 8305(a) (2012).

77. Dodd-Frank Act § 716(b)(1)–(2), 15 U.S.C. § 8305(b)(1)–(2) (2012).

78. BASEL COMMITTEE ON BANKING SUPERVISION, A BRIEF HISTORY OF THE BASEL COMMITTEE (2013) [hereinafter BASEL COMMITTEE HISTORY], available at <http://www.bis.org/bcbs/history.pdf>. The Committee provides a “forum for regular cooperation between its member countries on banking supervisory matters.” *Id.* Its objective is to “improve supervisory knowhow and the quality of banking supervision worldwide.” *Id.* This is accomplished in three principal ways: “by exchanging information on national supervisory arrangements; by improving the effectiveness of techniques for supervising international banking business; and by setting minimum supervisory standards” in areas where they are considered desirable. *Id.*

79. *Id.*; Narissa Lyngen, *Recent Development, Basel III: Dynamics of State Implementation*, 53 HARV. INT’L L.J. 519, 519 (2012).

80. Lyngen, *supra* note 79, at 519–20.

Basel I was approved by the G10 governors and released to banks in 1988.<sup>81</sup> Its primary purpose was to encourage a firm and stable international banking system while minimizing the effect of competitive advantage between countries.<sup>82</sup> Its major contribution to that end was the establishment of a minimum capital adequacy requirement of eight percent, as measured by the ratio of capital to risk-weighted assets.<sup>83</sup> Implementation of this standard was complete among the G10 and several non-member nations by September 1993.<sup>84</sup> Various amendments to Basel I arose in 1995 and 1996 to address concerns with the manner and method with which banks, on both a bilateral and multilateral basis, netted their credit exposures in derivatives transactions.<sup>85</sup> Additionally, the interim amendments sought to separate market risk and credit risk and allocated a separate capital charge to market risk in the calculation of capital requirements.<sup>86</sup> Despite the initial success of Basel I, shifts in the global economy and local financial practices of the adopting countries greatly reduced its efficacy.<sup>87</sup>

In June of 2004, the Committee released its redesigned framework, Basel II, with significantly more risk-sensitive capital requirements.<sup>88</sup> In addition to retaining the core elements of Basel I and its subsequent amendments, Basel II mandated the consideration of operational risk, which included legal risk but not reputational or strategic risk.<sup>89</sup> Additionally, the framework provided regulators with choices, based on their

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81. BASEL COMMITTEE HISTORY, *supra* note 78, at 2.

82. Lyngen, *supra* note 79, at 524.

83. BASEL COMMITTEE HISTORY, *supra* note 78, at 2.

84. *Id.* at 3.

85. *Id.* at 2–3.

86. Eric Y. Wu, *Basel II: A Revised Framework*, 24 ANN. REV. BANKING & FIN. L. 150, 152 (2005).

87. Lyngen, *supra* note 79, at 525. Lyngen provides a vibrant recitation of the various causes, including analysis of several adopting countries, of this reduced efficacy. *Id.* While these causes have significant potential to replay themselves under Basel III, the narrower scope of this Comment precludes their discussion.

88. *Id.*; BASEL COMMITTEE ON BANKING SUPERVISION, BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004) [hereinafter BASEL II], available at <http://www.bis.org/publ/bcbs107.pdf>.

89. Wu, *supra* note 86, at 152–53.

jurisdictions' market infrastructure, for the calculation of credit and operational risk.<sup>90</sup> Basel II implemented two additional framework components, supervisory review and market discipline, to further improve upon the Basel I risk sensitivity analysis.<sup>91</sup>

In addition to bringing credit rating agencies to the risk analysis process,<sup>92</sup> the framework implemented an advanced Internal Ratings-Based approach for determination of the risk weight associated with a particular asset.<sup>93</sup> Under that approach, banks themselves provided estimates of the probability of default, exposure at default, loss given default, and maturity horizons.<sup>94</sup> To address conflict of interest concerns with this approach to ratings, U.S. bank regulators, prior to full implementation of Basel II, announced that only the largest banks would be required to use the Internal Ratings-Based approach, while smaller banks would continue to use the standardized approach.<sup>95</sup> These two approaches improved, as compared with Basel I, regulators' supervisory ability, but largely failed to prevent the systemic contagion effects of the 2008 crisis.<sup>96</sup>

At the 2009 Pittsburgh summit, the G20 countries mandated global financial reform in the wake of the liquidity and credit crisis.<sup>97</sup> The Basel Committee responded by promulgating Basel III in late 2010,<sup>98</sup> in many ways significantly altering the method and means with which

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90. *Id.* at 153.

91. *Id.* at 154.

92. Joshua N. Rudin, Note, *Basel III: The Banking Band-Aid?*, 6 BROOK. J. CORP. FIN. & COM. L. 621, 622 (2012).

93. L. Jacobo Rodriguez, *Banking Stability and the Basel Capital Standards*, 23 CATO J. 115, 121 (2003).

94. *Id.*

95. *Id.* Rodriguez explains the relevant conflict of interest concerns and the regulators' approach that subjects only the largest banks to the Internal Ratings-Based approach, details that are beyond the scope of this Comment.

96. See Rudin, *supra* note 92, at 622 (noting that Basel II's framework did not go far enough to avert the future financial crisis).

97. BASEL COMMITTEE ON BANKING SUPERVISION, THE BASEL COMMITTEE'S RESPONSE TO THE FINANCIAL CRISIS: REPORT TO THE G20 1 (2010), available at <http://www.bis.org/publ/bcbs179.pdf>.

98. *Id.*

regulators and banks manage liquidity risk through capital adequacy requirements.<sup>99</sup> Basel III seeks to accomplish this goal through a strengthening of Basel II's three pillars framework to enhance the quality and quantity of the relevant capital base and risk coverage.<sup>100</sup>

Basel III's three enhanced pillars include (1) Capital, Risk Coverage, and Containing Leverage, (2) Risk Management and Supervision, and (3) Market Discipline and Liquidity.<sup>101</sup> Because the banking sector's excessive exposure to on- and off-balance-sheet leverage precipitated the financial crisis, these enhanced capital adequacy requirements place heavy emphasis on the inclusion of common equity among a bank's regulatory Tier 1 capital.<sup>102</sup> This common equity is considered qualitatively superior to other forms of capital, and is best suited to the absorption of losses should a bank be subjected to a liquidity shock.<sup>103</sup> Basel III's capital adequacy requirements became effective (where adopted) on January 1, 2013, and are to be phased in by January 1, 2015.<sup>104</sup> The relevant capital requirements at the time of full implementation, as a percent of

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99. See PWC, THE NEW BASEL III FRAMEWORK: NAVIGATING CHANGES IN BANK CAPITAL MANAGEMENT, 5–6 (PwC Financial Services Institute 2010), available at <http://www.pwc.com/us/en/financial-services/publications/viewpoints/viewpoint-basel-iii.jhtml> (theorizing that Basel III will significantly alter the banking landscape through an evolution of capital management practices, including an evaluation of capital adequacy that is grounded in integrated stress testing). Basel III defines a bank, for purposes of capital adequacy requirements, as a “bank, banking group or other entity (e.g. holding company) whose capital is being measured.” BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 12.

100. BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 2–3; see also BASEL II, *supra* note 88, at 12, 204, 226 (delineating Basel II's three pillar framework).

101. Walker et al., *supra* note 3, at 629.

102. BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 1, 12. Both Basel II and Basel III mandate Total Capital be a minimum of eight percent of risk-weighted assets. *Id.* at 11–12. Basel III defines the components of capital as the sum of Tier 1 and Tier 2 Capital. *Id.* Tier 1 Capital is split into Common Equity Tier 1 and Additional Tier 1. *Id.* Tier 1 Capital is going-concern capital, and its Common Equity Tier 1 component is the sum of the common shares issued by the bank, stock surplus, retained earnings, accumulated other comprehensive income and other disclosed reserves, common shares issued by consolidated subsidiaries held by third parties, and any relevant regulatory adjustments. *Id.* at 12–13.

103. Walker et al., *supra* note 3, at 642.

104. BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 27–28.

risk-weighted assets, are displayed below:

<b>Capital Requirements (% of RWA)<sup>105</sup></b>	<b>Basel II</b>	<b>Basel III</b>
Minimum common equity capital ratio	2.0%	4.5%
Capital conservation buffer	-	2.5%
Common equity + capital conservation	2.0%	7.0%
Minimum Tier 1 capital ratio	4.0%	6.0%
Minimum total capital ratio	8.0%	8.0%
Total capital + capital conservation	8.0%	10.5%
Leverage ratio (non-risk-based)	-	3.0%
Countercyclical capital buffer (nat. discretion)	-	0 - 2.5%
SIFI capital buffer	-	Unknown

The Total Capital requirement remains at eight percent, with the view that enhancing its components with higher quality capital will mitigate a liquidity shock, and the remaining balance between Tier 1 and the Total Capital requirement may be met with Tier 2 and higher forms of capital.<sup>106</sup>

105. Mayra Rodriguez Valladares, *The Anti-Basel III Chorus: Throwing Out the Baby With the Bathwater?*, CME GROUP (Nov. 14, 2012) at 2 tbl.1, <http://www.cmegroup.com/education/files/mrv-throwing-basel-iii-baby-out-with-bathwater.pdf>.

106. BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 9, 28.

In addition to capital adequacy requirements, Basel III requires the use of monitoring tools—the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR)—for both banks and their regulators.<sup>107</sup> The LCR is developed “to promote short-term resilience of a bank’s liquidity risk profile by ensuring that it has sufficient high quality liquid resources to survive an acute stress scenario lasting for one month.”<sup>108</sup> The NSFR is designed to meet a second objective, that of “promot[ing] resilience over a longer time horizon by creating additional incentives for a bank to fund its activities with more stable sources of funding on an ongoing structural basis.”<sup>109</sup> While the LCR seeks to monitor high quality liquid asset proportions over a thirty day period, the NSFR attempts to provide a “sustainable maturity structure of assets and liabilities” over a one year time horizon.<sup>110</sup> Further monitoring tools include metrics assessing contractual maturity mismatch, concentration of funding, available unencumbered assets, LCR by currency, and various market-related monitoring tools.<sup>111</sup>

#### D. Current State of Implementation and Possible Conflicts

The regulatory implementation of the Dodd-Frank Act has met with fierce public comment and timeline failures.<sup>112</sup> The

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107. *Id.* at 8–9. The LCR measures the proportion of a bank’s stock in high quality liquid assets to an estimate of total net cash outflows over the next thirty calendar days. BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: THE LIQUIDITY COVERAGE RATIO AND LIQUIDITY RISK MONITORING TOOLS 7 (2013) [hereinafter BASEL III LCR], available at <http://www.bis.org/publ/bcbs238.pdf>. A high quality liquid asset “should be liquid in markets during a time of stress and, ideally, be central bank eligible.” *Id.* These assets fundamentally possess the following characteristics: (1) low risk; (2) ease and certainty of valuation; (3) low correlation with risky assets; (4) listed on a developed and recognized exchange; (5) have an active and sizable market; (6) low volatility; and (7) have historically been sought during a flight to quality. *Id.* at 7–8.

108. BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 8.

109. *Id.* at 8–9.

110. *Id.*

111. *Id.* at 10.

112. See, e.g., Editorial, *Dodd-Frank’s Financial Outsourcing*, WALL ST. J., Nov. 6, 2012, at A16 (lamenting two international banks’ decision to abstain from U.S. swaps markets due to the investment necessary to comply with new U.S. rules); Victoria McGrane & Jean Eaglesham, *Battle Plan Shifts on Dodd-Frank*, WALL ST. J., Nov. 9, 2012, at C1 (describing successful legal challenges to SEC and CFTC rules); Jamila

Fed,<sup>113</sup> SEC,<sup>114</sup> CFTC,<sup>115</sup> and FSOC<sup>116</sup> have begun substantial rulemaking. Of important note, the Fed has proposed rules implementing Basel III's capital adequacy requirements, modified to conform to Dodd-Frank.<sup>117</sup> In it, the Fed adopts Basel III's minimum capital requirements, discussed *supra* Part I.C., which gradually increase beginning in January 2013 to January 2015.<sup>118</sup> The proposed rules also incorporate the capital conservation and countercyclical buffers, with the intent to "encourage better capital conservation by banking organizations and to improve the resiliency of the banking system."<sup>119</sup> Institutions failing to meet the capital conservation buffer would be subject to restrictions on the distributions or other discretionary bonus payments to executive officers.<sup>120</sup>

Notably, and in response to overwhelming industry

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Trindle, *New Rules of Swaps Delayed*, WALL ST. J., Sept. 19, 2012, at C1; Ben Protess, *Wall Street Is Bracing for the Dodd-Frank Rules to Kick In*, N.Y. TIMES, Dec. 11, 2012, at F10, available at <http://dealbook.nytimes.com/2012/12/11/wall-street-is-bracing-for-the-dodd-frank-rules-to-kick-in/> (discussing the mass of regulatory implementation scheduled for 2013); Peter J. Wallison, *The Election and Dodd-Frank*, NAT'L R., Oct. 8, 2012, <http://www.nationalreview.com/blogs/print/329626> (describing the regulatory cost burdens imposed on financial institutions by the various Dodd-Frank regulators).

113. See generally *Regulatory Reform Milestones*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., [http://www.federalreserve.gov/newsevents/reform\\_milestones.htm](http://www.federalreserve.gov/newsevents/reform_milestones.htm) (last visited Oct. 21, 2013) (indicating progress on Basel III adoption and various aspects of Dodd-Frank requirements).

114. See generally *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Accomplishments*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml> (last visited Oct. 21, 2013) (listing, categorically, the relevant SEC actions pertaining to Dodd-Frank implementation).

115. See generally *Dodd-Frank Act*, U.S. COMMODITIES FUTURES TRADING COMM'N, <http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm> (last visited Oct. 21, 2013) (listing proposed and final rules, and a schedule of proposed rule releases).

116. See generally *Dodd-Frank Implementation*, FIN. STABILITY OVERSIGHT COUNCIL, <http://www.treasury.gov/initiatives/fsoc/Pages/dodd-frank.aspx> (last visited Oct. 21, 2013) (providing implementation roadmap and status of rules information).

117. Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; Proposed Rule, 77 Fed. Reg. 52,791 (proposed Aug. 30, 2012) (to be codified in scattered parts of 12 C.F.R.).

118. *Id.* at 52,800–24.

119. *Id.* at 52,800.

120. *Id.* at 52,803.

comment, the Fed, FDIC, and the Comptroller of the Currency issued a joint press release in the fall of 2012 indicating they would not impose these Basel III rules by January 1, 2013.<sup>121</sup> Further, the Basel Committee released a revised LCR framework in early January 2013 that expands the range of assets eligible for inclusion as a high-quality liquid asset and revises the formulation of in- and outflow rates.<sup>122</sup> Additionally, the revised LCR expanded the timeline for phase-in of its requirements.<sup>123</sup>

In several significant ways, Dodd-Frank conflicts with Basel III and will require U.S. capital adequacy standards deviate from those implemented by other Basel adopters.<sup>124</sup> Basel III incorporates the use of credit ratings in its formulation of risk weights, where Dodd-Frank explicitly prohibits such use.<sup>125</sup> Further, Basel III will not be uniformly adopted across the globe, even in markets most similar to the United States.<sup>126</sup> This uncertainty and idiosyncratic adoption may pose significant risks to U.S. financial institutions engaged in transnational business where foreign counterparties are not subject to the same regulatory standards.<sup>127</sup>

### III. UNCERTAINTY AND THE KNOWLEDGE PROBLEM

#### A. *Defining the Problem*

The question of the efficiency of an economic system's planning, along a spectrum of options containing central planning, monopoly, and delegation among many individuals, is

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121. Press Release, Bd. of Governors of the Fed. Reserve Sys., Agencies Provide Guidance on Regulatory Capital Rulemakings (Nov. 9, 2012), <http://www.federalreserve.gov/newsevents/press/bcreg/20121109a.htm>.

122. Press Release, Basel Committee on Banking Supervision, Basel Committee Releases Revised Version of Basel III's Liquidity Coverage Ratio (Jan. 7, 2013), *available at* <http://www.bis.org/press/p130107.htm>.

123. *Id.*

124. Walker et al., *supra* note 3, at 628.

125. *Id.* at 629–30, 643.

126. *See id.* at 628 (pointing to the Eurozone as an example of a region where even strict Basel adoption deviates substantially from the enhanced prudential standards mandated under Dodd-Frank).

127. *See id.* at 642.

answered by the determination of which option more fully uses all available knowledge.<sup>128</sup> Hayek questions whether we are more likely to succeed by placing in a single central authority “all the knowledge which ought to be used but which is initially dispersed among many different individuals, or in conveying to the individuals such additional knowledge as they need in order to enable them to fit their plans in with those of others.”<sup>129</sup>

In describing the problem, Hayek highlights the beneficial, market-based price-seeking function of individual knowledge—be it from an understanding of local conditions, better alternative supply sources, or even individual arbitrageurs trading on discovered price differences.<sup>130</sup> He laments the economic fallacy that a central planner can, in any way, command all relevant knowledge, and rejects a theory that takes all knowledge as given.<sup>131</sup> Hayek’s description of the knowledge problem confronts these fallacies as circular—if the wide distribution of knowledge is the goal, presuming that knowledge to be centrally warehoused sidesteps the original (efficient planning) question entirely.<sup>132</sup>

Of concern is a central planner’s inability to gain visibility on the sheer magnitude of minute detail necessarily incorporated into modern transactional practice.<sup>133</sup> Hayek speaks of the inclination of central planners to seek aggregate statistical models that fail to clearly conceptualize dispersed knowledge—small constant changes that inform local conduct.<sup>134</sup> In contemporary terms, imagine a regional electricity provider attempting to negotiate a contract with its wholesaler. The provider has performed an analysis of its projected needs over several various time horizons, and it commands *good* data on production upstream and *good* data on

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128. Hayek, *supra* note 4, at 520–21.

129. *Id.* at 521.

130. *Id.* at 522.

131. *Id.*

132. *See id.* (examining the circular nature of knowledge fallacies).

133. *See id.* at 524 (stating that all knowledge cannot be conveyed to a central authority through statistics; rather, decisions should be made by the people who are familiar with the circumstances surrounding the specific knowledge).

134. *Id.* at 523–24.

the demand of its customers. The provider is in a unique position to observe its demand and costs fluctuate both with prevailing market conditions and unforeseen circumstances, such as a weather disaster or supply shortage.

The use of derivatives, despite the provider's wealth of local market knowledge, is important because the provider is exposed to risks such as energy price fluctuations and currency exchange rate volatility. A central regulator, such as the SEC or the CFTC, may constrain the provider's ability to freely hedge its exposure to such uncertainties through the imposition of swaps regulation increasing the provider's cost structure.<sup>135</sup>

In another example, it would be perfectly rational for a large bank to discover more productive uses of its capital, or the need to diversify its holdings in response to market indicators. Bank regulation constraining the ability to quickly move into areas designed to accomplish those goals not only removes from private holders of such banks the incentive to monitor the bank, but also tends to restrict liquidity and increase its cost of capital.<sup>136</sup> Given the incentive to retain capital and investment in domestic sources, to stimulate growth in the domestic economy, will the uncertainty generated by broad, reactionary prudential regulation drive balance sheet transfers off-shore? If so, is that the sort of incentive U.S. financial regulators should be providing to institutions? The answer to these questions is important, but more important is the mere fact of their uncertainty. No actor's best interest is served by over-reaching regulation, and the coincidental implementation of Dodd-Frank and Basel III present a problem. Albeit well-intentioned, it is a

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135. See Hester Peirce, *10 Ways Dodd-Frank Will Hurt the Economy in 2013*, U.S. NEWS & WORLD REPORT (Jan. 7, 2013), [http://www.usanews.com/opinion/blogs/economic-intelligence/2013/01/07/10-ways-dodd-frank-will-hurt-the-economy-in-2013\\_print.html](http://www.usanews.com/opinion/blogs/economic-intelligence/2013/01/07/10-ways-dodd-frank-will-hurt-the-economy-in-2013_print.html) (stating that some of the many ways Dodd-Frank will hurt the economy is by raising costs, interfering with the functioning of the market, and giving the SEC and the Fed broad new regulatory powers despite their past failures).

136. See Hester Peirce & Robert Greene, *Rethinking the Volcker Rule*, MERCATUS CTR. GEORGE MASON UNIV., 1–2 (Jan. 15, 2013), [http://mercatus.org/sites/default/files/Rethinking\\_Volker-Rule\\_MOP\\_v1-0.pdf](http://mercatus.org/sites/default/files/Rethinking_Volker-Rule_MOP_v1-0.pdf). The so-called Volcker Rule, section 619 of the Dodd-Frank Act (codified at 12 U.S.C. § 1851 (Supp. 2012)), prohibits or restricts certain financial activity conducted by banking entities, namely proprietary trading, hedge fund, and private equity exposure. CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 227.

problem rife with a deficit of local knowledge because it removes from the hands of parties best suited to monitor and model their respective situations and react nimbly to satisfy their needs.

*B. Economic Policy Uncertainty*

Policy uncertainty may properly be blamed, at least in part, for the United States' anemic economic recovery from the 2008 crisis.<sup>137</sup> Baker et al.'s research, with the University of Chicago Booth School of Business' Initiative of Global Markets, entails the development of a model designed to track and apply domestic uncertainty conditions over time.<sup>138</sup> The research supports claims that (1) recent years have produced unusually high levels of economic policy uncertainty and (2) these high levels cause households and businesses to restrain spending, investment, and hiring.<sup>139</sup> Despite the difficulty in causal analysis regarding the second claim, the evidence shows declines in output, employment, and investment are all preceded by spikes in the model's determination of uncertainty.<sup>140</sup> While not as pronounced as other factors,<sup>141</sup> uncertainty regarding financial regulation tracks the overall uncertainty measures in recent years.<sup>142</sup>

Uncertain implementation of Dodd-Frank and Basel III impacts lenders, borrowers, and firms engaged in derivatives trading. With the recently-announced delay of Basel III's LCR applicability, large banks have received a reprieve from its prudential measures for a time, but its full implementation remains not only imminent, but inevitable.<sup>143</sup> This continued uncertainty negatively affects banks' decisions to lend and

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137. Baker et al., *Has Economic Policy Uncertainty Hampered the Recovery?* 1 (Univ. of Chi. Booth Sch. of Bus., Working Paper No. 70, 2012), available at <http://ssrn.com/abstract=2000734>.

138. *Id.*

139. *Id.* at 1, 8.

140. *Id.* at 1.

141. *Id.* at 6–7. Other factors more prominently figuring into overall economic uncertainty include monetary policy, taxes, and government spending. *Id.* at 6.

142. *Id.* at 7.

143. Brunsten et al., *Banks Win 4-Year Delay as Basel Liquidity Rule Loosened*, BLOOMBERG (Jan. 7, 2013), <http://www.bloomberg.com/news/print/2013-01-06/banks-win-watered-down-liquidity-rule-after-basel-group-deal.html>.

restricts the volume of loans they are willing to make while they wait to see what the Fed will require in terms of asset classes necessary to meet both capital adequacy and liquidity rules.<sup>144</sup>

Uncertain implementation of Basel III and Dodd-Frank similarly impacts borrowers. Increases in uncertainty necessarily increases any relevant cost of capital.<sup>145</sup> Further, the macroeconomic nature of economic uncertainty makes its diversification difficult, leading managers to engage in fortress-like behavior that shies away from risk and investment.<sup>146</sup>

Thomas Hoenig, now the Vice Chairman of the FDIC, addressed his concerns with Basel III to The American Banker Regulatory Symposium in Washington, D.C. in the fall of 2012.<sup>147</sup> There, after speaking of the poor record the Basel Accords have sustained, he opined Basel III is a mere continuation of those efforts.<sup>148</sup> While Basel III purports to address the lessons of the financial crisis,<sup>149</sup> Hoenig sees danger in Basel III's prolific adoption of increasingly complex modeling tools that "rely on a set of subjective, simplifying assumptions to align a firm's capital and risk profiles."<sup>150</sup> Hoenig feels, as does this Author, that market forces more properly align the banks' and public's incentives.<sup>151</sup>

Prior to the founding of the FDIC in 1933, bank capital reserves were dictated by the market.<sup>152</sup> Without the presence of the FDIC and the socialized safety net it provides, bank owners and creditors were incentivized to diligently monitor bank activities lest their claim be wiped out during a crisis.<sup>153</sup> During the Great Depression, evidence indicates a high correlation between the location of the majority of bank failures (largely

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144. Baker et al., *supra* note 137, at 8.

145. *See id.*

146. *Id.*

147. Thomas M. Hoenig, Dir., Fed. Deposit Ins. Corp., Address at The American Banker Regulatory Symposium (Sept. 14, 2012) (transcript available at [http://www.fdic.gov/news/news/speeches/chairman/spsep1412\\_2.html](http://www.fdic.gov/news/news/speeches/chairman/spsep1412_2.html)).

148. *Id.*

149. BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 1.

150. Hoenig, *supra* note 147.

151. *Id.*

152. *Id.*

153. *Id.*; *see also* Peirce & Greene, *supra* note 136, at 2–3.

those small, independently-operated banks) and state-level regulation preventing those failed banks from operating more than a single branch.<sup>154</sup> In other words, a single branch might operate in a region dependent solely on—and exposed solely to—the fluctuating prices of wheat, steel production, or textile manufacturing. The inability to diversify branch holdings among locales serving a variety of industries virtually guaranteed insolvency upon a shock afflicting the markets those banks served.<sup>155</sup> The political irony of central regulators, in one form or another, “fixing” problems arguably caused by inept intervention to begin with, should not be lost on the reader—for history repeats itself.

In a further example of the pre-FDIC period, the U.S. banking industry maintained a ratio of tangible equity to assets in the thirteen to sixteen percent range, vastly outstripping the levels now known to exist in the nation’s ten largest banks prior to the crisis—a paltry 2.8%.<sup>156</sup> What could possibly create such a disparity? It must be so, at least in part, that mandated deposit insurance, in conjunction with strictly regulated capital adequacy requirements, raises the specter of moral hazard—depositors are increasingly less likely to monitor their banks as the level of deposit insurance increases.<sup>157</sup>

The interplay between deposit insurance’s tendency to distort incentives and minimum capital adequacy requirements creates an interesting paradox. In an attempt to mitigate the effects of a capital crunch, regulators have imposed a top-down, centrally-planned alternative to market forces, while at the same time imposing an insurance scheme socializing the costs of failure that reduces any incentive to qualitatively analyze uncertainty and risk through owner and depositor monitoring.<sup>158</sup> Hoenig’s key indictment of Basel’s relevancy during the 2008 crisis is succinct:

It turns out that the Basel capital rules protected no one: not the banks, not the public, and certainly not the

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154. THOMAS SOWELL, *THE HOUSING BOOM AND BUST* 124–25 (2009).

155. *Id.*

156. Hoenig, *supra* note 147.

157. Peirce & Greene, *supra* note 136, at 2.

158. Hoenig, *supra* note 147.

FDIC that bore the cost of the failures or the taxpayers who funded the bailouts. The complex Basel rules *hurt*, rather than helped the process of measurement and clarity of information.<sup>159</sup>

In his proposal of an alternative to Basel III, Hoenig suggests a market-based regulatory approach—an effective capital rule will impose upon a bank an approximation of what the market would impose absent the insurance safety net.<sup>160</sup> There is much merit to this approach, as a market-driven capital adequacy requirement would more efficiently seek the “right” cost of capital, would increase transparency and liquidity, and would provide great incentive to both owners and large depositors to monitor the bank’s activities.<sup>161</sup>

Hester Peirce and Robert Greene, of the Mercatus Center at George Mason University, propose an insurance cap of \$50,000, in lieu of Dodd-Frank’s imposition of a permanent maximum of \$250,000 per qualifying account per bank.<sup>162</sup> This amount is optimal, as it continues to protect retail customers (who likely do not maintain demand deposit accounts of that magnitude) but provides just the right amount of incentive to large depositors to encourage market discipline.<sup>163</sup> This market discipline is crucial, and while the market is not infallible, places the critical decisions in the hands of the parties most invested and with the greatest access to knowledge.

Peirce and Greene further call for a return to the double liability era in place before the Glass-Steagall Act, whereby bank shareholders would be required, in times of crisis, to pay in additional capital up to the par value of their holdings.<sup>164</sup> Such a system was “remarkably effective at protecting bank creditors, including depositors[,]” and directly contributed to average annual losses from national bank failures of a mere seventy-

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159. *Id.*

160. *Id.*

161. *Id.*; see also Peirce & Greene, *supra* note 136, at 2 (stating that greater transparency for banks allows the public to assist in holding banks accountable and fosters increased stability).

162. Peirce & Greene, *supra* note 136, at 2.

163. *Id.*

164. *Id.*

seven cents for every one thousand dollars in deposits.<sup>165</sup> Much like a market-driven approach to capital adequacy requirements, such a double liability scheme would greatly incentivize appropriate risk-monitoring by a bank's shareholders and managers, while simultaneously protecting the public insurance fund from unnecessarily socialized losses.<sup>166</sup> More importantly, it places investment, monitoring, and management decisions where relevant knowledge exists—in the hands of those directly accountable and incentivized by their own investment motivations.

Dodd-Frank and Basel III's macroprudential regulations are generally geared to protecting the domestic and global economies from the threat of defaults and credit crunches.<sup>167</sup> During the 2008 crisis, however, evidence exists that the resulting fire sales of assets, in response to critically needed liquidity, further enhanced market instability and uncertainty.<sup>168</sup> Kashyap et al. argue that capital adequacy and liquidity regulation fails to address the effects of fire sales on the economy at large.<sup>169</sup> In their treatment of fire sales, they analyze incentives prudential regulation provides to hypothetical banks, nonbank financial companies, and housing consumers.<sup>170</sup> The incentive analysis is instructive, and speaks directly to the uncertainty and knowledge problems inherent in both Dodd-Frank and Basel III.

In Kashyap et al.'s model, macroprudential regulation necessarily entails trade-offs to all relevant market participants.<sup>171</sup> Regulations attempting to mitigate the devastating effects of a housing market crash will also make

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165. *Id.* (citing Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History & Implications*, 27 WAKE FOREST L. REV. 31, 59 (1992)).

166. *See id.* (emphasizing the incentive benefit of the double liability scheme).

167. *See* Dodd-Frank Act, 124 Stat. at 1376 (2010); BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 2–3.

168. *See, e.g.*, Anil Kashyap et al., *The Macroprudential Toolkit* 3 (The Univ. of Chi. Booth Sch. of Bus., Working Paper No. 60, 2011), available at <http://ssrn.com/abstract=1735445>. The working paper adopts the following definition of a fire sale: “[E]ssentially a forced sale of an asset at a dislocated price.” *Id.* at 4.

169. *See id.* at 1–2.

170. *See id.* at 9–11.

171. *Id.* at 14.

households worse off in non-crash scenarios.<sup>172</sup> Banks forced, not by the market but by regulatory fiat, to structure their capital in particular ways will provide a buffer against losses, but could also increase the cost of capital through the inability to freely exchange its assets, thereby removing from the knowledgeable entity strategic (and perhaps even tactical) capital allocation decisions.

In this trade-off scenario, overlain with the Basel III framework, banks will make fewer loans when those loans implicitly cost more. The loans cost more because of the uncertainty surrounding transaction costs. Will Dodd-Frank rules require banks shift these loans off the balance sheet? Will banks be incentivized to engage in this sort of practice to retain their federally insured status?

### C. *Dodd-Frank Derivatives*

Financial risk management is iterative and dynamic. Any competent risk management program must necessarily engage in processes that seek to identify, measure, control, and monitor risk.<sup>173</sup> For treatment of Dodd-Frank's swaps and derivatives mandates, consider implications to a large national bank. A large national bank, federally insured by the FDIC, obtains its charter from the Office of the Comptroller of the Currency.<sup>174</sup> A full recitation of Dodd-Frank's implications for this bank's derivatives trading is beyond the scope of this Comment, therefore several examples will suffice. First, as relevant to this discussion, section 721 of the Dodd-Frank Act defines a "swap" as an agreement that is:

a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies,

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172. *Id.*

173. See, e.g., Mayra Rodriguez Valladares, *Dodd-Frank as a Catalyst to Improve Energy Firms' Risk Management*, CME GROUP (Dec. 18, 2012), <http://www.cmegroup.com/education/files/mrv-associates-dodd-frank-risk-management-2012-12-18.pdf>.

174. See *About the OCC*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, <http://www.occ.gov/about/what-we-do/mission/index-about.html> (emphasizing that the OCC's primary mission is to charter, regulate, and supervise all national banks).

commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind.<sup>175</sup>

It includes “any purchase [or] sale . . . that is dependent on the occurrence [or] nonoccurrence . . . of an event or contingency associated with a potential financial, economic, or commercial consequence.”<sup>176</sup> Further, any agreement that “provides on an executory basis for the exchange . . . of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, [or] commodities” is deemed a “swap”.<sup>177</sup>

These definitions sweep into the CFTC or SEC’s jurisdiction any futures, options, CDSs, and interest rate or currency swaps engaged by any party. Dodd-Frank requires swaps not entered into for hedging purposes move into derivatives clearing organizations, with an exception where a non-“financial entity” opts to forego clearing.<sup>178</sup> Because our hypothetical federally chartered and insured bank likely meets the definition of a “financial entity,”<sup>179</sup> it cannot unilaterally opt-in to the clearing exception, though if it engages in bona fide hedges to mitigate its own exposure, it may be excepted under section 723.<sup>180</sup>

Moving these derivatives into clearinghouses has immense potential to *increase* counterparty credit risk for our hypothetical bank and similar banks, depending on the manner and method with which the CFTC decides to regulate the clearinghouses.<sup>181</sup> By substituting the dispersed and diverse counterparty credit risk present prior to Dodd-Frank with only a handful of authorized clearing organizations, counterparty credit risk is consolidated in a relatively small number of

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175. Dodd-Frank Act § 721(a)(21), 7 U.S.C. § 1a (2012).

176. *Id.*

177. *Id.*

178. Dodd-Frank Act § 723(a)(3), 7 U.S.C. §§ 2(h)(1)(A), 2(h)(3), 2(h)(7)(A)–(C) (2012).

179. *See* Dodd-Frank Act § 723(a)(3), 7 U.S.C. § 2(h)(7)(C) (2012).

180. *See* Dodd-Frank Act § 723(a)(3), 7 U.S.C. § 2(h)(7)(A) (2012).

181. *See* Hester Peirce, *10 Ways Dodd-Frank Will Hurt the Economy in 2013*, U.S. NEWS (Jan. 7, 2013), [http://www.usnews.com/opinion/blogs/economic-intelligence/2013/01/07/10-ways-dodd-frank-will-hurt-the-economy-in-2013\\_print.html](http://www.usnews.com/opinion/blogs/economic-intelligence/2013/01/07/10-ways-dodd-frank-will-hurt-the-economy-in-2013_print.html) (“[I]f one of these clearinghouses runs into trouble, the economic ramifications could be massive.”).

organizations designed to clear *all* trades.<sup>182</sup> This is in contrast with the purported design of Dodd-Frank, to eliminate Too Big to Fail and mitigate systemic risk.<sup>183</sup>

What happens when one of the clearinghouses—with deep, systemic connections to the financial markets—runs into trouble? Will the government be tempted to bail it out?<sup>184</sup> What does this mean for our nationally chartered bank, the convenient subject of our hypothetical analysis? The clearing requirement, while well-intentioned, means Dodd-Frank has substituted one uncertainty for at least its equal. Where previously the bank had the ability to perform due diligence on a counterparty and build counterparty credit risk into its decision-making models, it now is limited to pushing all non-hedging activity onto a clearinghouse counterparty. The bank will have little or no visibility on that counterparty's exposure to other trades, pending or future deals, or exposure to government policy pressure. This mandated activity precludes flexibility and the ability to engage in idiosyncratic swaps custom tailored to a particular financial need or situation.

To be sure, Dodd-Frank section 723 permits a clearing exception for bona fide hedges.<sup>185</sup> To a certain degree, this exception is notable in its exclusion of arbitrageurs and speculators, those the market traditionally leaves to their own devices, particularly where losses rear their head. After all, speculators would defy their definition without exposure to downside risk. What the following will show, however, is the uncertainty raised even in a common hedging transaction attendant to project financing.

To fully illustrate the increased costs regulatory uncertainty

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182. All trades not eligible for an exception to the clearing requirement, discussed above.

183. See Cohen, *supra* note 3, at 1726.

184. Indeed, if the FSOC determines a clearinghouse “could pose a threat to the financial stability of the United States” and votes to subject it to the Fed, SEC, and CFTC's enhanced prudential standards, then Dodd-Frank has effectively codified that clearinghouse's Too Big to Fail status. See Dodd-Frank Act § 113(a)(1), 12 U.S.C. § 5323(a)(1) (2012). That trigger permits application of the Treasury Secretary's orderly liquidation authority, under section 202, to appoint the FDIC as receiver and liquidate the clearinghouse. See *id.* §§ 202–04, 12 U.S.C. §§ 5382–84 (2012).

185. Dodd-Frank Act § 723(a)(3), 7 U.S.C. § 2(h)(7)(A) (2012).

imposes upon a transaction, consider a common transaction between the above-mentioned national bank and a regional natural gas developer. At a certain point, the developer will seek project financing to engage in its E&P activities. It will seek term or revolving credit facilities with our federally-insured, chartered national bank. To fund such a credit facility, the lender will insist upon, in either the credit agreement or a separate swap agreement, a condition of closing that the developer (1) provide security, (2) enter a swap agreement for  $x\%$  of the credit facility, or (3) both security and a swap agreement.<sup>186</sup>

Through this exercise, we must remember that the nationally-chartered bank is also a federally insured financial institution, subject to the prudential regulation mandated by Dodd-Frank and imminently through Basel III. Present regulatory uncertainty has many banks fearful that the prudential regulators will require federally-insured depository institutions to move these sorts of transactions off their balance sheets through transfers to affiliates. This sort of uncertainty, combined with affirmative signaling from regulators, incentivizes the bank to negotiate forcefully for contractual provisions providing for the unfettered assignment of its swap agreements to a third party. Enter the knowledge problem.

The oil and gas developer dealt with our hypothetical national bank and its syndicate directly when it engaged its counterparty in a swaps contract, a bona fide hedge. It did not purposely deal with an (as yet) unknown entity whereby it could engage in due diligence and risk analysis. Where the national bank possesses sufficient bargaining power to dictate terms to the regional developer, the developer will be faced with a Hobson's choice of receiving financing whereby its credit facility agent possesses the unilateral ability to assign its benefits and duties to an unknown third party.<sup>187</sup>

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186. For example, the swap agreement with Syndicate Bank (operating as a swap provider, not a member of the syndicate) will agree that if the spot price of natural gas is below  $\$y$ , Syndicate Bank will pay the developer the spot minus  $\$y$ . However, if the spot is above  $\$z$ , developer will pay the bank  $\$z$  minus spot.

187. It should be noted that a large integrated oil and gas company would likely wield sufficient bargaining power to demand inclusion of a provision requiring that any

In this process, the developer completely lacks the ability to vet the third party. By what measure should it ascertain its exposure to credit or counterparty credit risk? If it does none of these things, it must at a minimum build into its own cost structure the mere possibility of such an event, thereby increasing its cost of capital. In the aggregate, as a result of its bank's regulatory uncertainty, the developer's increased cost of capital will result in a reduced quantity of borrowed funds for any given price, and a smaller number of wells in the ground.

In this same vein, the knowledge problem and uncertainty adversely impacts the bank itself. Even assuming the developer's credit facility represents a small portion of the bank's loan portfolio, its degree of interconnectedness with other loans in the portfolio is difficult to determine. If the loan enters default, its ripple effects are questionable as the parties may not be certain which suppliers, partners, or customers are also represented in the bank's portfolio. If the swap agreement was assigned to an affiliate, can we know where the systemic risk is located? Is there any way to determine whether a crunch will be contained in the affiliated subsidiary? Moving these agreements off the balance sheet does not *eliminate* the risk, it just shifts it to a related party where transparency is lacking and further knowledge effects are amplified. Where Dodd-Frank purports to mitigate the harm caused by systemic shock, scenarios such as this are easy to imagine and run in direct contravention to its premise.

Finally, Basel III's enhanced prudential standards for capital adequacy dictates rigid requirements regarding the quality of Tier 1 Capital.<sup>188</sup> When the bank is constrained in its capital allocation decisions—as it is under Basel III—its ability to nimbly create, enter, or exit markets is hampered. The bank's

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potential assignee possess the same or greater credit rating as the swap-provider bank. If such a condition were found deficient, upon assignment, the large integrated firm would likely demand the ability to unwind its position. Even in this case, uncertainty impedes market processes—how does the hedging entity ascertain ahead of time (1) *when* such an event will occur and (2) who will be in- or out-of-the-money at the moment of unwinding?

188. See BASEL III GLOBAL FRAMEWORK, *supra* note 2, at 12 (explaining the elements of the Tier 1 capital and outlining the criteria for inclusion in Additional Tier 1 capital).

shareholders and interested directors and officers must be given the ability to monitor their investment because they know the market will punish poor decisions, not because of perverse disincentives to shift assets from the balance sheet for the sole purpose of satisfying a financial ratio determined by an international committee of bank regulators with little visibility on the relevant transactional details.

*D. Liquidation and Acquiescence*

Agency capture is the term frequently used to describe a situation where a regulatory agency advances the special interests of the industry it deigns to regulate, as opposed to the public interest for which it was created.<sup>189</sup> There is a risk, in the implementation of Dodd-Frank and Basel III, of what this Author will term “inverse agency capture.” Inverse agency capture may exist where the regulatory agency possesses such power over the industry to be regulated that it serves as a conduit through which policy flows from the executive branch to the regulated industry without the proper rule-making or adjudicatory process.<sup>190</sup> Like vanilla agency capture, power and influence is king.

Title II of Dodd-Frank permits the placement of a systemically important financial institution into FDIC receivership upon the initiative of the Treasury Secretary, FDIC, or the Fed if the company’s default would have serious effects on U.S. financial stability and there is no viable private sector alternative.<sup>191</sup> While the statute defines conditions whereby a financial institution *shall* be considered in default or danger of default,<sup>192</sup> the subjective element is left open to the

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189. See Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 15 (2010) (suggesting that administrative agencies are not isolated but rather experience political pressures and may serve political preferences).

190. Ian Aryes & John Braithwaite, *Tripartism: Regulatory Capture and Empowerment*, 16 LAW & SOC. INQUIRY 435, 457 n.53 (1991) (indicating the possibility of reverse capture, which is described as “agency capturing the firm to increase agency payoffs”).

191. Dodd-Frank Act § 203(b)(1)–(3), 12 U.S.C. § 5383(b)(1)–(3) (2012).

192. See Dodd-Frank Act § 203(c)(4), 12 U.S.C. § 5383(c)(4) (2012) (listing four potential default scenarios).

discretion of a two-thirds vote of both the Fed's Board of Governors and the FDIC board.<sup>193</sup>

Two potential inverse agency capture scenarios emerge. First, the mere specter of enhanced prudential regulation under the auspices of the Fed and Treasury may be sufficient to ensure a financial institution toes the administration's policy line. Inclusion in the enhanced prudential regulatory scheme is not only one step closer to Title II's orderly liquidation authority, but also inclusion in a regulatory climate rife with uncertainty and knowledge effects, described above.

Next, institutions already subject to the enhanced prudential standards mandated by Dodd-Frank (and forthcoming through Basel III) have a strong disincentive to question the policy decisions—come they may through rule-making or adjudication—of their prudential regulators. For example, if the administration determines it should establish the goal, again, of broadening the base of private home ownership in the U.S. (irrespective of loan qualification ability), what accounts for the conflict of interest this liquidation authority places upon the large banks subject to the Fed and Treasury's enhanced oversight? As another example, how will such a large financial institution rationally react to a rule proposal capping interest rates on consumer loans at, say, twenty percent? A rational institution will object, pointing to the reflection in interest rates of not only inflation and market risk but also default risk. Should it fail in that endeavor, the bank would rationally, and in the aggregate, reduce the amount of consumer loans it is willing to write, for it must be true that at least some individuals are worthy of loans but only at a rate above twenty percent.

When the administration begins to concern itself with perceived inequities amongst loan recipients, how should these institutions respond? Dare they contest their adjudicatory hearing or exercise their right to judicial review? At what point does the institution become less concerned with winning the battle lest it lose the war? To borrow from Director Hoenig's explicit indictment of Basel III: "the [orderly liquidation

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193. Dodd-Frank Act § 203(a)(1)(A), 12 U.S.C. § 5383(a)(1)(A) (2012).

authority] protect[s] no one: not the banks, not the public, and certainly not the FDIC.”<sup>194</sup>

Bankruptcy serves as the crucial mechanism by which capital is transferred from non-productive to productive uses. The bankruptcy process already exists. If improvements to the efficient transfer of non-productive capital to productive uses are necessary, the gains are properly made in reconsideration of the bankruptcy code—not through the addition of a separate layer of regulation that merely codifies, in an *ex-post* fashion, Too Big to Fail.

#### IV. CONCLUSION

Uncertainty and the lack of knowledge reduces efficiency, increases costs, and possesses the potential to return the economy to the stagnant place it has resided for the past five years. While Dodd-Frank’s breadth and depth may be workable, the question remains as to its cost. It seems increasingly likely the costs will outstrip any relevant benefit. Implementation of Basel III interposes the knowledge and experience of a global committee in the place of bank managers and shareholders with all of the relevant knowledge and incentive to succeed. The combined unintended consequences of Dodd-Frank and Basel III are but a preview of what has gone before—regulators attempting to establish a standard as a reaction to perceived failures of the past. One is left wondering what future catastrophe will spur the resolution of today’s “past.”

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194. See Hoenig, *supra* note 147, at 2.