Evaluating the State of Financial Reform Five Years After Dodd-Frank

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July 21, 2015, marked the fifth anniversary of the signing of the landmark Dodd-Frank Act and provided a natural opportunity to evaluate the progress regulators have made in establishing the new regulatory regime as well as consider what else remains on the agenda to remedy the shortcomings of the financial system exposed by the financial crisis. A significant part of the regulators' ongoing efforts centers around decreasing the probability of a financial institution's default as a result of a credit or liquidity event and establishing a regime that can preserve financial stability in the event of the default of a large financial institution.

As regulatory reform matures, this evaluation more systematically should focus on (i) reviewing whether the regulations cohere overall and determining whether, in light of evolving circumstances, they continue to support the purposes of financial reform, which was to better manage risk and to make financial firms (and, therefore, the financial system) more resilient to shocks, and (ii) identifying the emerging risks and establishing whether the current regulatory regime provides adequate tools to address them.

The first question simply concerns the business of smart regulation. Products, activities and actors in financial services change rapidly, and regulation must properly keep up — whether it is to enable innovation and growth or to manage and control potentially harmful practices and products. As Treasury Secretary Jacob Lew has stated, regulations are not "holy writ," but are shaped by the circumstances and time in which they are devised.

The second issue reminds us that the regulatory agenda must include more than fighting the last war. The Financial Stability Oversight Council (FSOC) was created in part to bring an interagency approach to the ongoing monitoring of financial stability and to the continuous identification of new risks.

In the past few years, regulators have identified certain technology-related risks as emerging issues. The risk that is cited most frequently, for good reason, is cybersecurity. Certain practices associated with the phenomenon of "high frequency trading" has been another. However, technology risks could take other forms. They could result, for example, from innocent mistakes by well-meaning traders, information technology personnel or other back-office employees, or from the malfunction of an information technology application under the weight of complex architecture and aging systems that may not be equipped to handle the volume and pace of financial transactions and markets today. Even more so than with credit and liquidity risk, operational risk from technology mishaps has the potential to produce immediate systemic consequences.

Although financial institutions and markets have long been technology-driven, a combination of factors is causing traditional financial services firms to reconfigure their platforms and to adopt a new generation of information technology. These factors include: (i) the need to respond to regulation, (ii) shareholder demands for efficiency, (iii) spectacular innovation in information and wireless technology, which has enabled back offices to become more seamless (thus, potentially helping to reduce risk) and has prompted rethinking front-end service to retail customers, (iv) customer demand, particularly on the retail side, for a different experience with financial services firms, and (v) the rise of financial technology firms that seek to use this improved technology to "disrupt" traditional financial services.

The pervasiveness of technology from the consumer touch point to the back office, and everything in between, means that technology will affect the way financial firms and their regulators think about consumer protection and safety and soundness. Future regulatory challenges involving financial stability and consumer protection will require

an understanding of the implications of technology firms' role in the financial system. Technology has the potential to affect not only the behavior of individual firms but also their behavior in the aggregate.

The impact of these themes coming together can be seen in the structure of the over-the-counter markets, as exemplified particularly by the Treasury markets. Almost a year ago, these markets — which have been among the most liquid and stable markets in the world — experienced significant and unprecedented price movements within a short period of time on one trading day (October 15, 2014). The migration to electronic trading may have, in part, been one of the reasons for the dramatic shift that day. Until relatively recently, the principal participants in this market were dealer banks and inter-dealer brokers, with the dealers assuming the role of market makers. Electronic trading, which is a result of improvements in information technology, has allowed new types of firms to enter the Treasury market, and these firms now account for more than about half of the trading volume in the markets. According to Federal Reserve Board Governor Jerome Powell, "Perhaps the most fundamental change in these markets is the move to electronic trading, which began in earnest about 15 years ago. It is hard to overstate the transformation in these markets."

Of course, it is likely that a number of other factors also have contributed to the current configuration of the Treasury market. Financial institutions cite both changed risk appetite and the impact of capital and liquidity regulations. Governor Powell noted that "[r]equiring that banks hold much higher capital and liquidity and rely less on wholesale short-term debt has raised funding costs. Regulation has also raised the cost of funding inventories through repurchase agreement (repo markets). Thus, regulation may have made market making less attractive to banks." Just as capital and liquidity rules have made the financial system safer by making financial institutions more resilient, it is possible that they have created less of an incentive for dealers to make markets.

While it is impossible to determine what contribution various causes have made to the behavior of the Treasury market, it is reasonably likely that change in technology has contributed significantly to the evolution of its structure, bringing with it a new mode of participation and new actors. Although, as SEC Commissioner Luis Aguilar recently noted, electronic trading has brought benefits "such as more efficient price discovery and lower trading costs," it also has introduced new risks such as the risk of algorithm malfunction or facilitating manipulative trading practices. Moreover, as Governor Powell has noted, electronic trading may persuade some traders to "withdraw from markets or seek other venues, thus fracturing liquidity."

The Treasury markets present an important example of how technology is transforming financial institutions and financial markets, and how the question of operational risk and resilience is not just limited to cybersecurity or equities trading. As that transformation continues to occur across the entire spectrum of retail and wholesale financial services, regulators and market participants will need to focus both on keeping that technology and the data it generates resilient, functional and secure, and on whether our regulatory regime and supervisory/financial stability tools are appropriate for this new world.