Some thoughts on regulatory changes and their impact on financial markets

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The Dodd Frank Financial Stability Act

- Caveats:
  - The Dodd-Frank bill only attributes authority to various governmental agencies (some newly created ones) to design and apply new regulation.
  - The PUBLIC LAW 111203JULY 21, 2010 is 849 pages long.
  - Good surveys of its main points are $\sim$ 200 pages long!
- It covers many issues:
  - Systemic Risk Measurement and management
    - **Orderly liquidation process** for failing institutions (involving Treasury, FDIC and FED).
    - **Financial Stability Oversight Council** run by 9 members from 7 agencies (makes Capital, leverage, liquidity, risk management rules recommendation to the FED.)
    - **Office of financial research** staffed with experts can request any data from any financial institution (bank or non-bank) deemed systemically important.
    - Limits emergency lending abilities of the FED (subject to Treasury approval) and debt guarantees by the FDIC.
    - bail-out fund paid for by industry.
  - OTC and Security-based Swaps Markets:
    - Generally all derivatives should be **centrally cleared and exchange traded**.
    - Un-cleared trades subject to greater margin requirements.
    - Swap dealers subject to capital requirements.
    - OTC markets regulated by SEC and CFTC
  - **Volker rule** aims to prohibit proprietary trading as well as investment in hedge funds and private equity funds for banks and other financial institutions supervised by the FED.

The Dodd Frank Financial Stability Act

- And more:
  - Securitization:
    - **retention requirement** $\approx$ 5% ‘skin in the game’
    - better disclosure.
  - **Office of credit rating agency** within the SEC imposes:
    - Transparency of NRSRO (nationally recognized statistical research organizations) rating methodology.
    - Increased liability of rating agencies
    - Generally remove unnecessary references to ratings in regulations.
    - Right to deregister NRSROs.
  - Consumer protection:
    - **Consumer Financial Protection Bureau** (CFPB housed within the FED).
  - Investor protection
  - Hedge fund industry with asset in excess of $100 million required to register with SEC.
- So much more:
  - Mortgage Resolution
  - Office of Minority and women inclusion
  - Exploitation and trade of conflict minerals originating in the Democratic Republic of Congo
  - ...

Questions

- Would all these rules (were they implemented) have prevented the current crisis?
- Will they prevent future (different) crisis?

⇒ Can we identify core mechanisms that led to market failure/instability?

- Review of Academic literature: consensus about the crisis?
  - Global imbalances (excess savings by Asia and Oil producing countries) (Bernanke)
  - Loose monetary policy and Greenspan put (Taylor)
  - Moral hazard in originate to distribute model of financial intermediation combined with ratings illusion (Coval et al.)
  - Regulatory arbitrage (ratings and capital requirement) in the financial industry (Acharya, Cooley, Richardson)
  - Run on the (otherwise sound) shadow banking industry (Gorton)
  - Behavioral "Animal spirits" cycle and mispriced risks (Akerlof-Shiller)
  - Increased cross-sectional dispersion in wealth due to greater human capital inequality... (Rajan).
- Which it is should affect regulatory design!

What were the main drivers of the crisis?

- There were two sources of systemic risk:
  - Excess leverage of US households which fueled (and fed on) the housing bubble.
  - Excess leverage within the global financial system.
- We (sort of) understand the first: Housing is the ideal candidate for a bubble. (Unmovable collateral, difficult to short, Low 'turnover' rate., large transaction costs, Heterogeneity- private values)
- What explains the second?
  - Lenders wanted to lend 'risk-free' (not to subprime borrowers).
  - They lent to the financial sector, which used securitization and shadow banking (off-balance sheet entities) to create 'risk-free' debt, effectively backed by the mortgages.
  - In the process financial sector held on to (a) super-senior tranche (tail) risk, (b) implicit (or explicit) 'liquidity' put guarantees to off-balance sheet entities. Why?

⇒ Combination of
  - Super-senior risk difficult to sell to 'absolute return yield chasing investors'.
  - Regulatory arbitrage (ratings based risk-capital requirements, insurance regulators).
  - Marking to (wrong) model made these trade appear like pure arbitrage.
  - Moral hazard of the industry as a whole creates incentive to ignore catastrophe state ('too big to fail').

- Creditors who lent 'safely' to financial industry ignored risk because of implicit government 'too big to fail' guarantee (Fannie/Freddie bonds, money markets, commercial bank debt), and perhaps a negative externality.

Does Dodd-Frank solve these issues?

- In part. But,
- Regulate the housing market
  - Get rid of Fannie and Freddie or at least prevent their hedge-fund activity
  - Impose larger hair cuts (loan to value ratios) on prime (subsidized) lending
  - Curb systematic political support to home ownership
  - Encourage a housing futures market
- Regulate the Shadow banking system.
  - Focus on short-term, 'risk-free' funding vehicles (Money-Markets, repo Markets, ABCP) and the lack of monitoring by creditors.
- Tackle too-big-to fail
  - Not clear OFR and FSC will limit too big to fail ex ante (data overload and cooperation of 7 agencies).
  - Instead, explicit limit on fraction of principal that can be 'bailed-out' by intervention (Calomiris).
  - Or, tax on safe money markets (Perotti).

Conjectures and questions about consequences of Dodd-Frank

- How do we implement the Volker rule (distinguish hedging from prop trading)?
  - Limit trading to client initiated positions: no hedging?
  - All traders have to be associated with a flow-desk, effectively becoming mono-instrument traders.
- This will impose large costs on end-clients. It will reduce trading or move these structured trades that require cross-hedging out of banks (into hedge funds?) or to different locations.
- Large established hedge-funds will strive.
  - regulation impose higher entry costs on new (smaller) funds.
  - banks prop desks loose their informational advantage (flow and inside bid/ask).
- Banks will have lower size and lower equity returns due to tighter leverage constraints (and lost prop trading revenue).
- There will be more regulatory arbitrage both across industries (hedge funds vs. insurance vs. banks) and geographically as governments and regulatory agencies compete.
- Financial innovation largely driven by regulation, so expect more of it. (example: derivative leverage $\neq$ 'outside' leverage)
- Lobbyists and Lawyers will strive.

Some of the open questions

- Lots of open questions:
  - What will be the consequences of reduced Bank leverage for informational efficiency and liquidity of prices? (costs and benefits of high financial intermediation sector not well understood).
  - What will be the consequences of central clearing for aggregate collateral efficiency and counterparty risk.
  - How long before regulation is established (and regulatory uncertainty is resolved).
  - Rating Agencies? What will replace them? how will it affect asset management industry?