Banking Regulation and Financing : A Post-Crisis New Deal?

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Reforming the US Financial System: Dodd-Frank Wall Street Reform and Consumer Protection Act

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Presentation Outline

Overview of Policy Issues

- ❑ Anatomy of Crisis and Limitation in Financial Regulation
- ❑ Regulatory Reform Issues: Macro and Micro Prudential Techniques
- ❑ Systemic Risk Oversight and Regulation
- ❑ Resolution Authority
- ❑ Volker Rule: Proprietary Trading and Investment in Hedge Funds
- ❑ Hedge Funds
- ❑ Clearing and Settlement of Swaps
- ❑ Corporate Governance

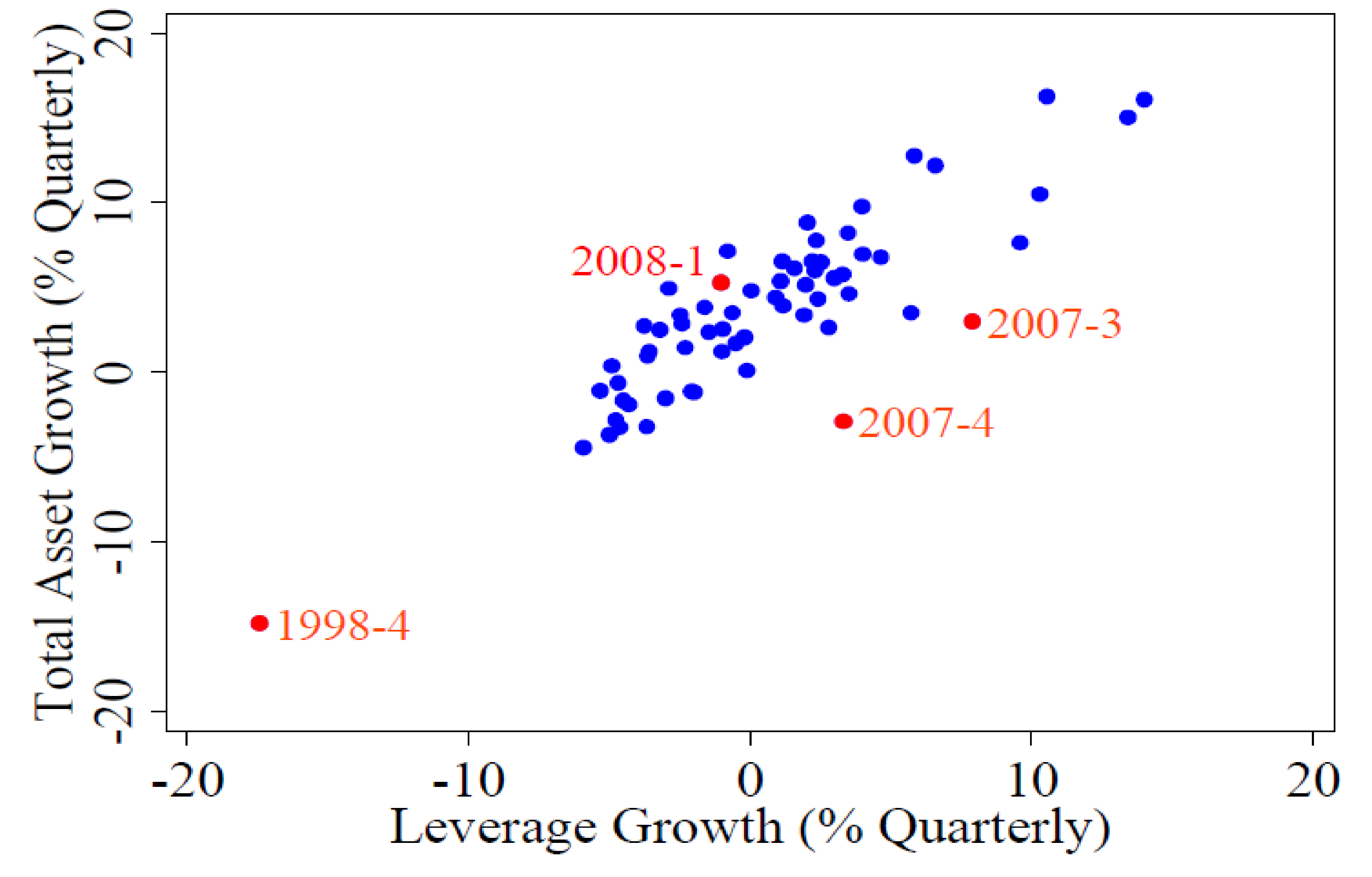
Anatomy of Crisis and Limitations of Financial Regulation

- Origins of Financial Crisis
  - Inadequate global demand
  - Loose monetary policy
  - Financial innovation (increasing leverage and regulatory arbitrage)
  - Light touch financial regulation
  - Weak consumer protection legislation
  - Excessive focus on shareholder value and executive pay
- Limitations of Financial Regulation
  - Build up of systemic risk
  - Increased complexity, interdependence and vulnerability
  - Turbulent growth of financial sector

Lessons Learned from the Crisis

- Banks adjusting capital ratios is problematic if:
  - Distress is not idiosyncratic
  - Having one bank adjust will cause externalities on others
  - Systematic costs may be large even if FDIC is protected
- Importance of Macro-prudential approach
  - Capital requirements should reflect large negative externalities associated with rapid deleveraging which leads to:
    - fire sales
    - credit crunch effects

The Deleveraging Phenomenon



Post-Crisis Regulatory Reform Issues

- Macro-Prudential Techniques:
  - Time-varying capital requirements
  - Dynamic provisions
  - Capital insurance schemes
  - Lending criteria
  - Warnings of risk buildup by supervisors
  - Interest rate policy
- Micro-Prudential Techniques
  - Liquidity standards
  - Contingent capital schemes
  - Intervention and resolution of large banks
  - Special resolution authority

Systemic Risk

- **Many examples of systemic risk during recent crisis, such runs on financial institutions and asset classes**
- ***What are the forms of systemic risk?***
  - Contagion
  - Endogenous build-up and unwinding of imbalances
  - Aggregate shocks
- ***How can systemic risk be regulated?***
  - Enhanced capital, liquidity buffers;
  - Improved risk management and leverage rules;
  - Stress testing;
  - Narrow banking; and
  - Forced asset divestitures

Addressing Systemic Risk

1. Financial Stability Oversight Council	Duties include: collecting information on financial firms, monitoring financial system to identify systemic risk; proposing regulatory changes; facilitating information sharing and coordination among regulators; identifying gaps in regulation; reviewing new or existing accounting standards; forum for dispute resolution	Council has no authority to eliminate emerging threats or close regulatory gaps
2. Systemic Oversight of Bank Holding Companies	✓ BHC with $50B or more will be considered SIFIs before prudential regulations in place ✓ Basle 2.5 (2011) heightened requirements on trading book exposure; Basle III (2012) heightened capital requirements and new leverage and liquidity measures	✓ Federal Reserve can enact own prudential standards ✓ Within 18 months, Federal Reserve must impose risk-based capital measures, leverage limits etc.
3. Systemic Oversight of Non-Bank Financial Companies	Designation as SIFIs before prudential standards are in place; transfer date (12 months after enactment); Fed must issue risk rules for systemically important non-banks	Within 18 months, Federal Reserve must impose risk-based capital measures, leverage limits etc.; Contingent Capital requirement (within 2yrs)

Resolution Authority

- Problem: bankruptcy resolution is too slow for financial institutions
  - Shareholder approval needed for forced merger
  - Prompt resolution framework introduced only for commercial banks after S&L crisis
- Good Resolution Procedure entails:
  - Ex post efficient outcomes that maximizes value of the bankrupt firm
  - Ex ante efficient outcomes by penalizing managers and shareholders in bankruptcy states so bonding role of debt maintained
  - Maintain absolute priority of claims to protect incentives for creditors
  - Resolution procedures should take into account costs of systemic risk

Resolution Authority

Liquidation Process	Description	Key Points
1. Liquidation Authority	FDIC, in consultation with Council, prescribes rules and regulations that would apply by authority, including rules on use of funds, termination of receiverships, assessments, sales of assets, recoupment of compensation and bans on managers and directors	No pre-funded resolution fund; FDIC's resolution expenses funded from borrowings from Treasury (repaid within 5 years)
2. Rules and Regulations	✓ Within 6 months, USDC must establish rules and procedures that govern the conduct of Authority's procedures	✓ Rules to make clear whether the petitioning company is a financial company and whether its in danger of default or not
3. Required Studies	Council must have completed studies on creditor haircuts; international coordination; implementation of prompt correct action; bankruptcy and liquidation proceedings and code	Must be done no later than 12 months after enactment of legislation

What about “Living Wills?”

- ***Potential benefits***
  - Reduces moral hazard;
  - Will cause SIFs to simply corporate structure and prepare; plan to preserve estate;
  - May cause SIFs to reduce risk exposures;
  - Clear plan to follow to minimize spillovers and maximize bankruptcy estate
  - Create level playing field between SIFs and smaller banks;
- ***Potential Costs***
  - Increased compliance costs, including IT upgrades;
  - May reduce efficiencies in which SIFs employ capital and liquidity;
  - Increases tax and regulatory costs to extent banks create subsidiaries to avoid taxes and engage in regulatory arbitrage;

TOO BIG TO FAIL REFORM: Criticism

- Reform and Basle III: “helpful” (Robert Shiller, Buttonwood Gathering, NYC)
  - Not enough to solve problems they address
  - Systemic risk inherent in modern financial system
- Limits of Reform?
  - Complexity of problem
  - Minimize trade-off between external costs of bank failure and moral hazard risk
  - Incentives and institutional design matter
  - Next crisis will come

VOLKER RULE

- Proprietary trading
  - Ban on bank's proprietary trading
  - Additional capital and other requirements places on SI nonbank financial entities (exemptions for permitted activities)
- Implementation
  - Council study on implementation of Volker Rule and regulators must adopt rules
  - Capital and quantitative limits on permitted activities may be placed on banking entities and important nonbank companies
  - Limits on permitted activities—rules imposed where permitted activities pose a threat

Volker Rule: Sponsoring and Investing in Hedge Funds

Requirement	Description	Key Points
1. Ban on Sponsoring and Investing	Banks proscribed from sponsoring or investing in hedge funds	Subject to transition periods and exemptions for permitted entities; regulators may issue rules on otherwise permitted activities
2. 23A/23B Limits	✓ Banking entity that serves as investment manager /sponsor of fund is prohibited in engaging in Section 23A covered transaction with any such fund	✓ Subject to exemptions (eg, prime broker transactions)
3. Additional capital and other requirements	Fed is required, subject to exemptions for permitted activities to impose additional capital requirements and other limits on their sponsoring and investment activities	Covers SI nonbank financing companies

HEDGE FUNDS

- Registration and reporting requirements covering all hedge funds
  - Aim: facilitate data collection that would permit regulatory assessment of hedge funds over time
  - As we've seen, Volker Rule: bans banks from acquiring ownership interest in or sponsoring hedge funds
  - Hedge fund would emerge as the locus of sophisticated, unregulated deployment of capital, perhaps also emerging as main liquidity providers across a variety of markets
  - For now, new reporting requirements are the one thing that Dodd-Frank's holds out for hedge funds

Hedge Funds

Regulation	Description	Key Points
1. Advisers must comply with Advisers Act	Advisers are required to adopt and implement written policies and procedures reasonably designed to prevent violation of AA. Advisers must also designate chief compliance officer to administrate policies	Registration exemptions: managers of venture capital funds and smaller funds (less than $150M); foreign private advisers
2. Record keeping requirements	✓ Extensive record keeping requirements covering advisers and funds to be monitored by SEC through routine and "for cause" inspections.	✓ Reporting requirements designed to allow SEC to collect information concerning leverage, counterparty credit exposures, trading and investment positions, valuation policies and practices and side letters
3. Disclosure of identities of advisers' clients	SEC permitted to require disclosure of an adviser's clients, related information for purpose of systemic risk assessment.	Information shared with FSOC for purpose of assessing risk and other Federal regulators and self regulatory entities

Hedge Funds (2)

Requirement	Description	Key Points
1. Regulation of sales materials	Regulation of sales materials, relationships with solicitors and custody clients as well.	Advisers must adopt: (1) ethics code; and (2) proxy voting policy; and (3) business continuity plan
2. Pay to Play	✓ SEC initiative arising from scandals involving fund managers ✓ Placement agent issues-new FINRA rule	✓ Coordination with state policies ✓ Compliance verification and monitoring to ensure robust information on fund managers and agents
3. Enforcement	SEC enforcement efforts fund focused; focus on insider trading, conflicts of interest, sales to seniors etc	

HEDGE FUNDS

- Preliminary Assessment
  - Question whether new regulation implies a threat to the business model of hedge funds
    - Required disclosure of proprietary information most invasive of new rules
    - Questions about the effectiveness of Act's confidentiality assurances
    - Could lead to added costs but model unimpaired
- SEC rulemaking authority
  - Exam process, hedge fund manager reports, etc.

ACCREDITED INVESTORS

- Regulation D
  - Minimum financial test for an individual as AI is not $1 million excluding value of personal residence, subject to increase and review by SEC
  - Rule change reflects concern with adequacy of this standard applied in particular Section 3(c)(1) hedge fund investors
- Study and Review
  - Initial review of definition (1yr post enactment) and periodic review (4yrs post enactment)
  - GAO study on financial thresholds to qualify as accredited investor and to invest in private fund

CLEARING & SETTLEMENT SWAPS

- Mandatory Clearing Requirement
  - Aim: transfer large segment of $615,000 BN privately traded OTC market onto clearing houses
  - Purpose: reduce risks for investors and financial system
- Potential Issues:
  - New rules may increase costs for investors and may result in some banks stop backing clearing houses
  - Main issue: how customer assets (eg, margins to cover potential losses) will be held

CLEARING & SETTLEMENT SWAPS

- Risk issue
  - Current approach: futures clearing merchants hold customer assets in pooled accounts
  - Protects against customer defaults—if one party defaults then FCM can rely on omnibus account to cover losses
  - US wants to shift to clearing house to avoid defaults by counterparties triggering fears of systemic risk
  - Problem with Lehmann was that many collateral payments made against positions were not held in separate accounts (investor/bank agreements deal with these problems now)
  - If regulators adopt client account, then costs will be higher since they will be unable to cover losses from omnibus accounts
  - Higher costs (to cover 60-100% rise in default fund) may lead banks to perhaps abandon clearing house business

Clearing and Settlement: Swaps

Regulation	Description	Key Points
1. Mandatory Clearing Requirement	All swaps that SEC and CFTC deem should be cleared must be submitted to a clearing house; swap not required to be cleared if one party is not a financial entity, is using swaps to hedge or mitigate risk	CFTC will review swaps to see if they should be cleared; Clearing houses must submit swap or group that they plan to accept for clearing; CFTC/SEC may stay requirement after decision made
2. Clearing Rules	✓ SEC/CFTC will establish rules governing clearing house's request for review of swap, review of clearing of swap that has been accepted for clearing; and prevention of evasion of rule by exempted parties (ie, commercial end users)	✓ CFTC/SEC will establish rules on real-time public reporting of certain swaps while preserving confidentiality
3. Post-enactment swaps	Swaps entered into after enactment of bill must be reported within 90 days	

CORPORATE GOVERNANCE

- New rules to limit agency problems
- Disclosure regarding Chair/CEO positions
  - Rules require issuer to disclose in proxy why Chair/CEO is combined or separated
- Proxy access – proxy solicitation
  - New SEC rules
- Board Approval for Some Swaps
  - Any issuer of registered company that elects exemption to use swap clearing must have board committee approval