

Dodd-Frank and Changing Financial Markets

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Background

- ✓ Reactive approach to financial regulation
- ✓ Traditional categories based on historical business models

“A lot of the rules and regulations [we have] are closer to the Civil War [1861-1865] than they are to today.”

Jamie Dimon
Chairman and CEO, J.P. Morgan Chase
N.Y. Post, July 9, 2008, at 31



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Background

- ✓ Reactive approach to financial regulation
- ✓ Traditional categories based on historical business models
- ✓ Goal – Begin to assess the new Dodd-Frank legislation against shifts in the financial markets
- ✓ Caveat – Difficult, even at this stage, to provide a detailed analysis of how the new regulatory structure will look



Background

Outline of Today's Presentation

- ✓ What do we mean by systemic risk?
- ✓ Is “too big” or “too interconnected” to fail the right (or complete) analysis?
- ✓ The case of traditional risk management and risk-outsourcing
- ✓ The Volcker Rule



What is Systemic Risk?

- ✓ Major challenge – how to create a definition of “systemic risk” that is clear and operational
- ✓ At what point does a financial problem become a systemic problem?



What is Systemic Risk?

- ✓ Basic definition – Systemic risk is the probability of :
 - an economic shock that affects one or more financial institutions or markets,
 - interrupting the efficient transmission of capital, often increasing the cost of capital-raising or decreasing its availability, and
 - in turn, affecting the broader, real economy



What is Systemic Risk?

✓ Transmission –

- Direct causation: chain reaction across interconnected financial entities and/or markets (“domino effect”), e.g.,
 - institutions that are “too big” or “too interconnected” to fail
- Indirect causation: information asymmetries result in losses by one or more firms creating uncertainty about the financial stability of others (“common shock”), e.g.,
 - bank runs
 - downward pressure on asset prices



What is Systemic Risk?

- ✓ Negative externalities –
 - Losses, resulting from risks borne by a financial intermediary, may extend well beyond those who make the decision to incur risk
 - Unlikely to be fully considered (or priced) by a firm's managers, shareholders, or customers when deciding what risk levels are optimal
- ✓ Financial regulation helps restrict the amounts and types of risk-bearing that an intermediary can assume by circumscribing the asset and liability sides of its balance sheet
 - Insurance minimizes customer incentives to withdraw funds, but lowers monitoring incentives and raises moral hazard concerns



What is Systemic Risk?

- ✓ Financial Stability Oversight Council, chaired by the Treasury Secretary, and comprised of the heads of the financial regulatory agencies
 - Charged with identifying risks to financial stability, responding to any emerging threats in the system and promoting market discipline, including
 - risks to U.S. financial stability arising from activities in or outside the financial services marketplace
 - gaps in regulation that could pose risks to U.S. financial stability
 - financial activities or practices that could create or increase risks among financial firms and markets



What is Systemic Risk?

- ✓ Financial Stability Oversight Council, chaired by the Treasury Secretary, and comprised of the heads of the financial regulatory agencies
 - Responsibility to decide which nonbank financial institutions and financial market utilities will be designated as systemically important and to recommend heightened prudential standards



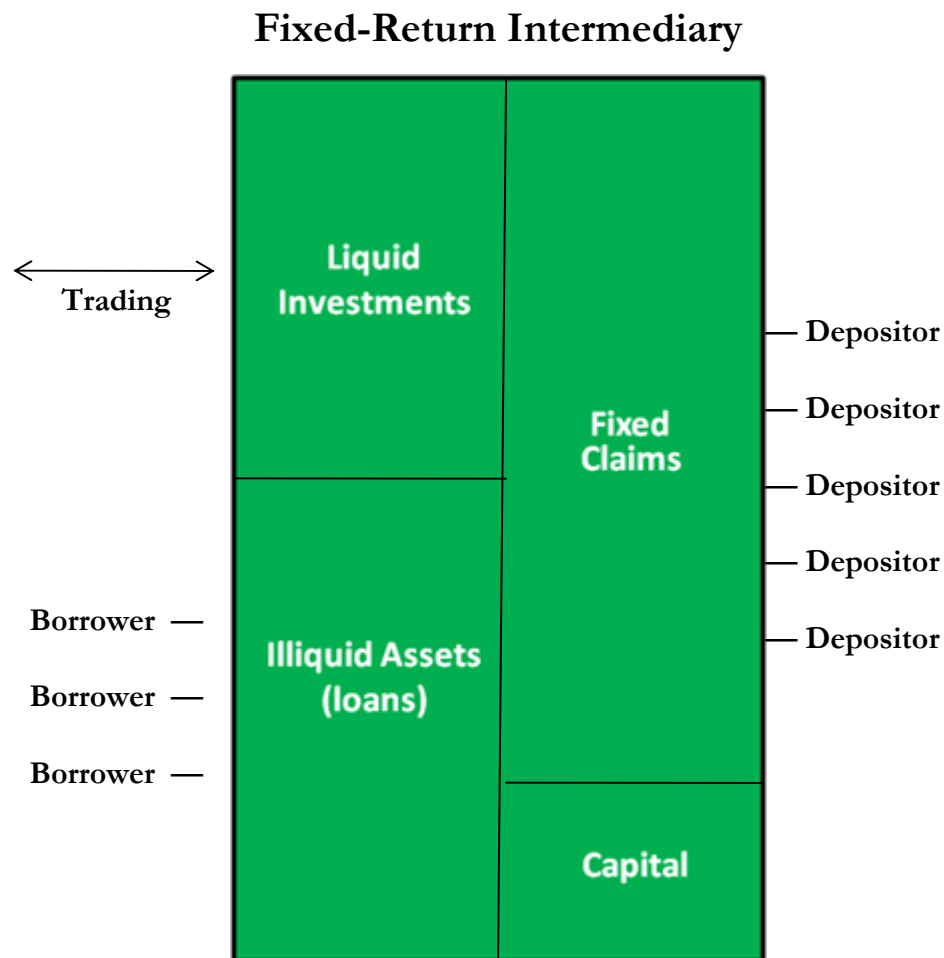
What is Systemic Risk?

- ✓ Certain provisions in Dodd-Frank permit a “systemic risk determination” to be made and set out the process to do so
 - Permits a determination based on the circumstances at the time
 - But also creates ambiguity –
 - What is it exactly that new regulation, under Dodd-Frank, is meant to minimize?
 - What metrics should be used to identify firms that are “too big” and “too interconnected” to fail? What (if any) other parameters should be used to determine what is systemically important?
 - How will the market react, during the period leading up to a systemic risk determination, absent certainty over whether and when a systemic event has occurred?



Traditional Intermediaries – Asset Transformation

- ✓ Short-term creditors vs. long-term borrowers
- ✓ Agency cost problems
- ✓ Risk of bank runs
- ✓ Regulation and insurance
- ✓ Regulatory costs offset by the value of the banks' franchise



Bank Runs and Non-Banks

New Market Participants

- ✓ Transfer of loan and related assets off balance sheet

Short-term Investors

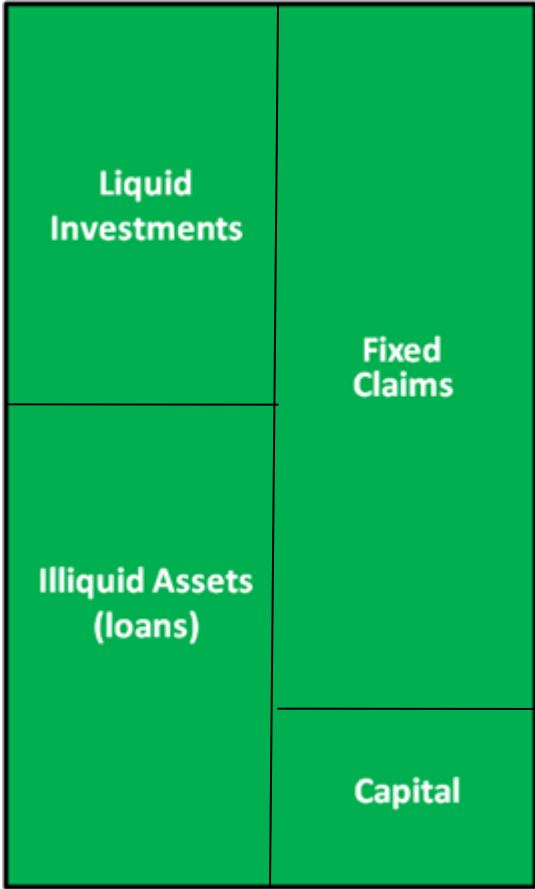


Trading

Long-term Assets



Fixed-Return Intermediary



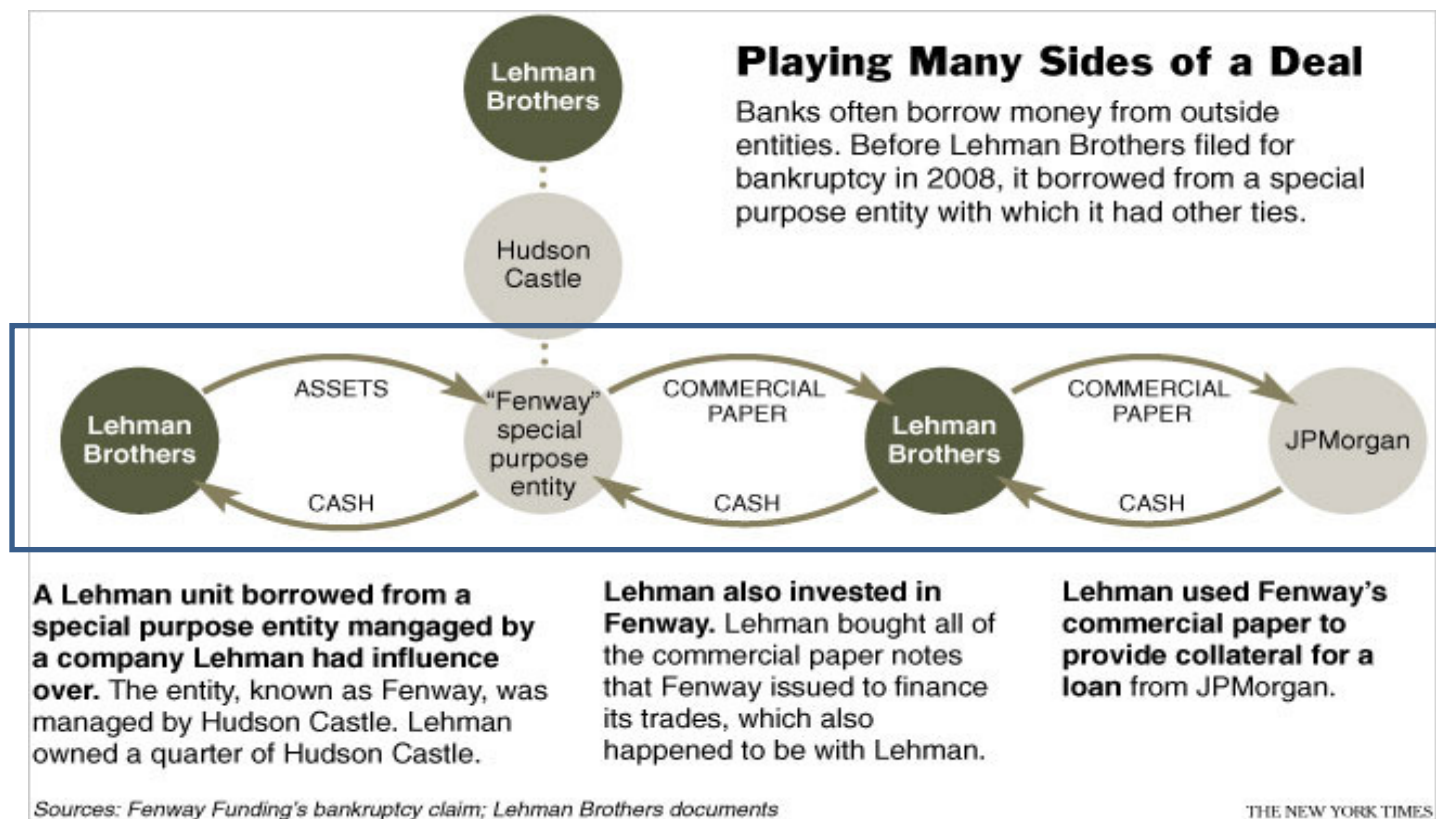
Depositor
 Depositor
 Depositor
 Depositor
 Depositor

Borrower —
 Borrower —
 Borrower —



Bank Runs and Non-Banks

Not just commercial banks . . .



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Lehman Channeled Risks Through "Alter Ego" Firm
The New York Times, April 13, 2010

Bank Runs and Non-Banks

New Market Participants

- ✓ Transfer of loan and related assets off balance sheet

Short-term Investors

Special Purpose Vehicle or Investor

- ✓ Investments funded with short-term credit

Long-term Assets

Fixed-Return Intermediary

Liquid Investments

Fixed Claims

Illiquid Assets (loans)

Capital

Depositor

Depositor

Depositor

Depositor

Depositor

Trading

Borrower

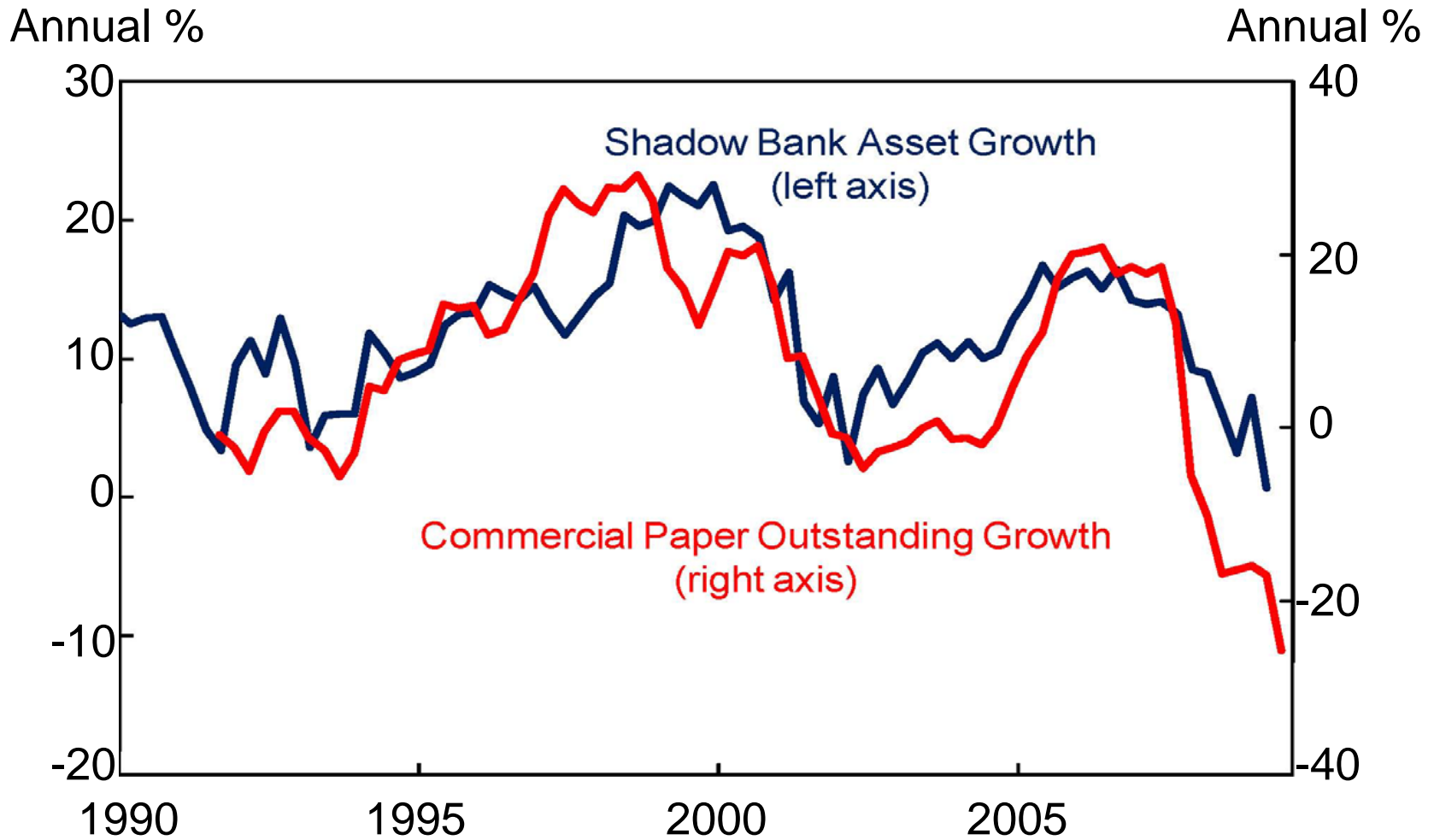
Borrower

Borrower



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Bank Runs and Non-Banks



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Source: Board of Governors of the Federal Reserve; Hyun S. Shin, Princeton University

Bank Runs and Non-Banks

New Market Participants

- ✓ Transfer of loan and related assets off balance sheet

Short-term Investors



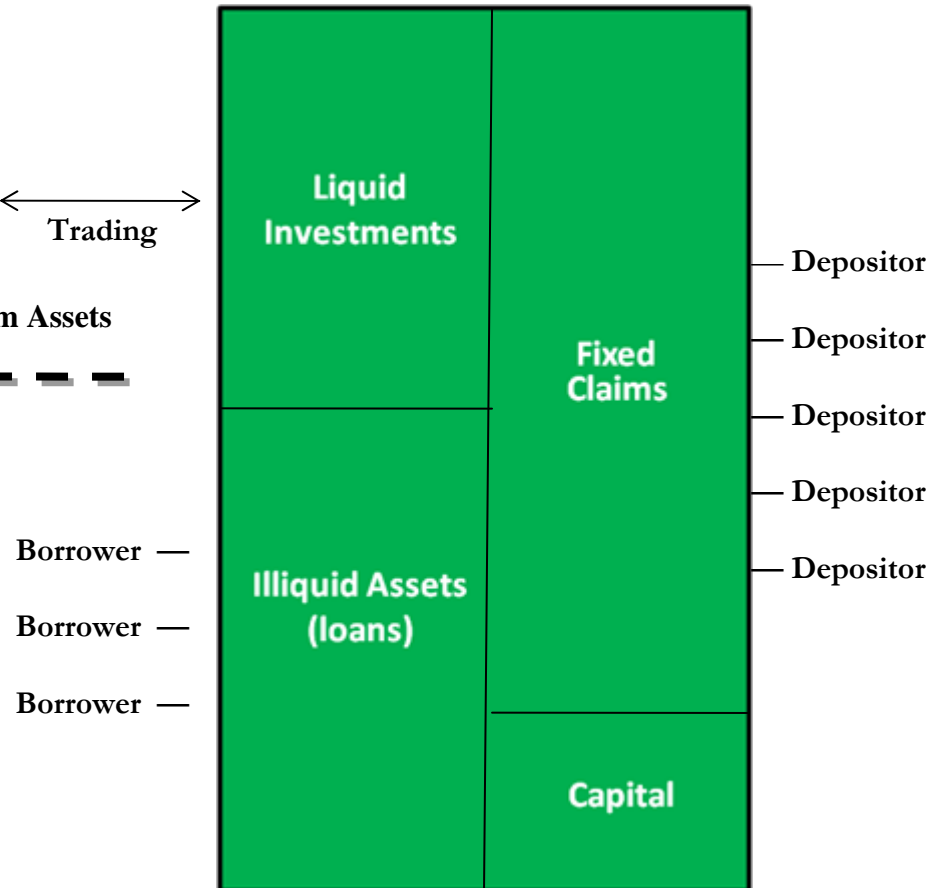
- ✓ Investments funded with short-term credit
- ✓ Risk of non-bank runs

↔ Trading

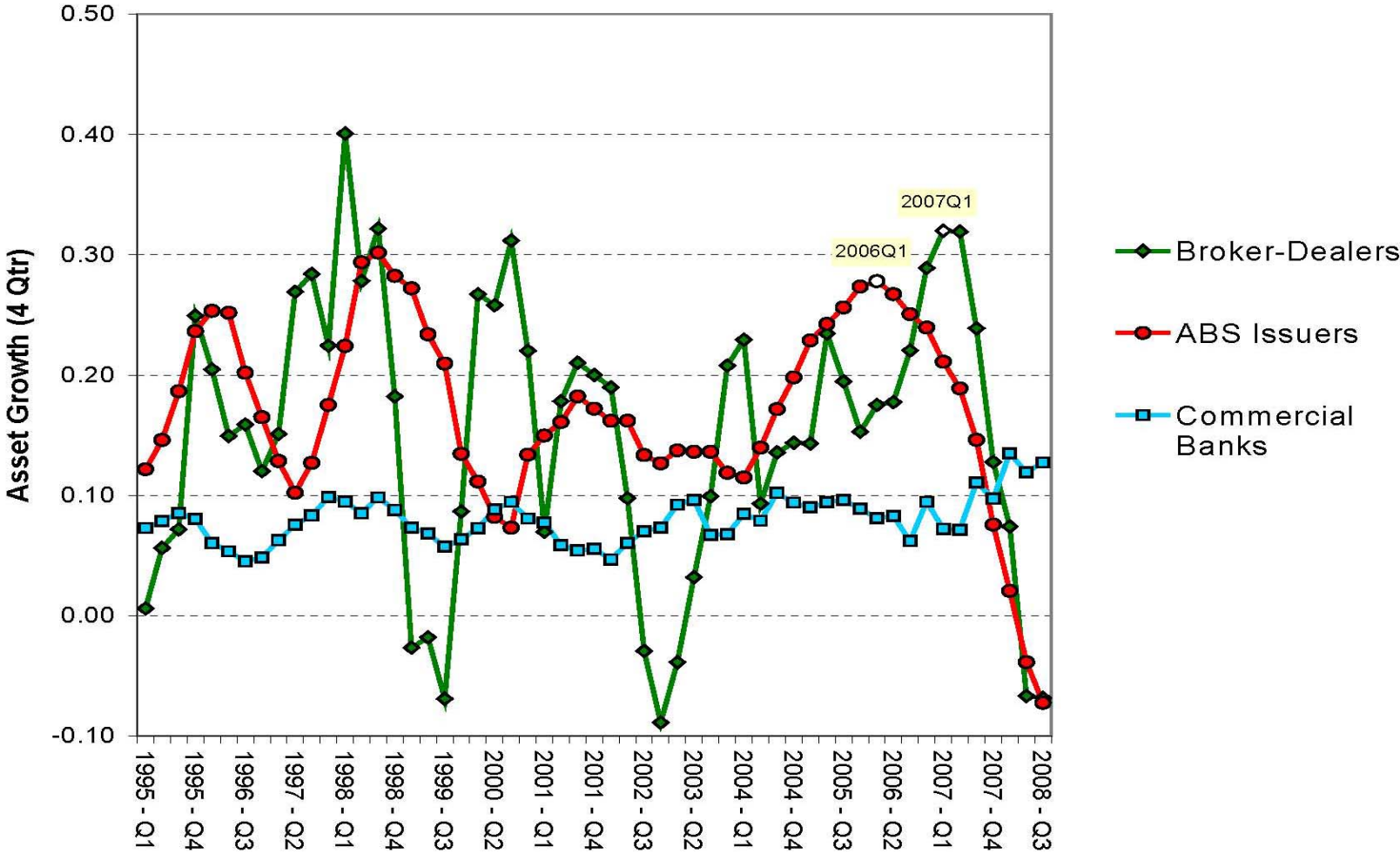
← Long-term Assets



Fixed-Return Intermediary



Bank Runs and Non-Banks



Bank Runs and Non-Banks

- ✓ Dodd-Frank addresses some of the disparities in regulatory costs
 - Bank leverage and risk-based capital requirements applicable to systemically important nonbank financial firms (designated by the Council)
- ✓ Key question – Will leveling the playing field between banks and the largest or most interconnected firms offset bank incentives to modify their business models?
 - Note that Dodd-Frank may also raise bank costs:
 - Prohibiting banks from proprietary trading in securities, derivatives, or certain other financial instruments, and from investing in, sponsoring, or having certain relationships with hedge funds or private equity funds (the Volcker Rule)



Bank Runs and Non-Banks

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- ✓ Or is the result simply to change how financial firms arbitrage different capital and other requirements?



Bank Runs and Non-Banks

Investment bankers have begun to develop ways in which banks might be able to circumvent the most punitive of the new capital rules being drawn up by international regulators.

According to investment bankers and senior bank executives, *new products are being developed that would allow banks to mitigate the shrinking of their capital bases under the new rules* by using a new generation of financing structures. . . .

The initiatives are focused in particular on ways in which deferred tax assets – to be outlawed as capital under current Basel thinking – can be turned into cash or an equivalent that would be valid for capital purposes. . . .

Investment Banks Bid to Cushion New Rules
Financial Times, April 12, 2010



Bank Runs and Non-Banks

- ✓ Dodd-Frank addresses some of the disparities in regulatory costs
 - Bank leverage and risk-based capital requirements applicable to systemically important nonbank financial firms (designated by the Council)
- ✓ Key question – Will leveling the playing field between banks and the largest or most interconnected firms offset bank incentives to modify their business models?
- ✓ Or is the result simply to change how financial firms arbitrage different capital and other requirements?
- ✓ More fundamentally, are we seeing a shift away from traditional financial intermediaries towards a greater reliance on the capital markets?



Entities and Markets

Traditional Intermediation



Capital Markets

*Prob: Depositors/Policyholders
vs. Shareholders*

*Mirror: Short-term Lenders (Repo)
vs. Shareholders*

- ✓ Regulatory arbitrage
- ✓ New participants are more efficient than traditional intermediaries
- ✓ Broad risk dispersion



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Entities and Markets

Traditional Intermediation



Capital Markets

*Prob: Depositors/Policyholders
vs. Shareholders*

*Mirror: Short-term Lenders (Repo)
vs. Shareholders*

- ✓ In a market-based system, do new risks extend beyond entities that are “too big” or “too interconnected” to fail?
- ✓ To what extent can/should the Council focus on market-wide activities, by less significant firms, that potentially raise their own systemic problems?



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Entities and Markets

Traditional Intermediation



Capital Markets

*Prob: Depositors/Policyholders
vs. Shareholders*

*Mirror: Short-term Lenders (Repo)
vs. Shareholders*

- ✓ To date, regulation has largely focused on individual firms, each considered separately
 - Bank capital requirements, for example, help minimize the systemic effects of a banking collapse by reinforcing the financial stability of *each bank*



Entities and Markets

Traditional Intermediation



Capital Markets

*Prob: Depositors/Policyholders
vs. Shareholders*

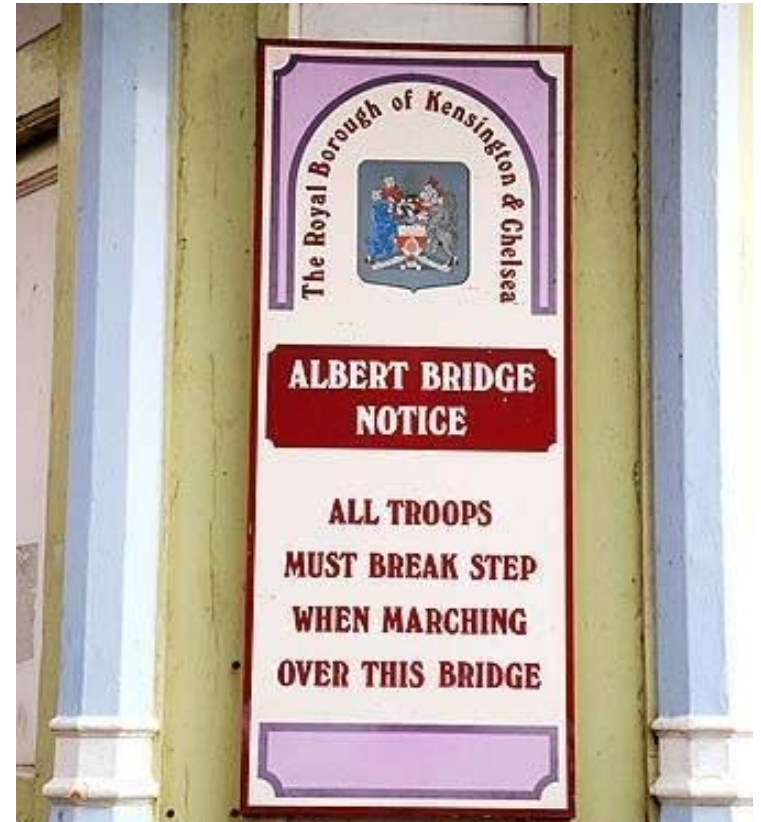
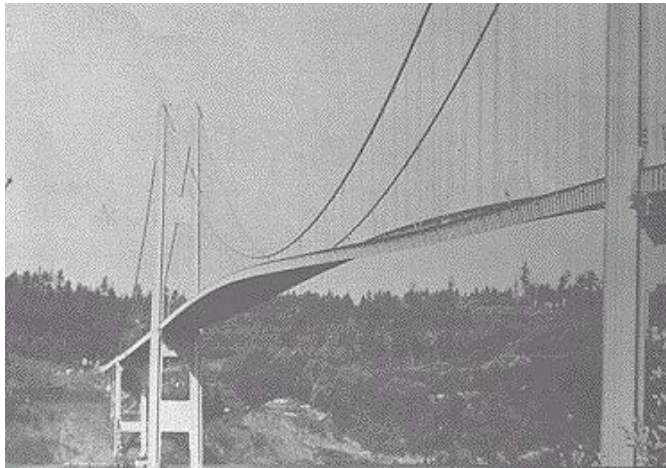
*Mirror: Short-term Lenders (Repo)
vs. Shareholders*

- ✓ To date, regulation has largely focused on individual firms, each considered separately
- ✓ Have market changes introduced new risks that extend beyond *individual* firms?

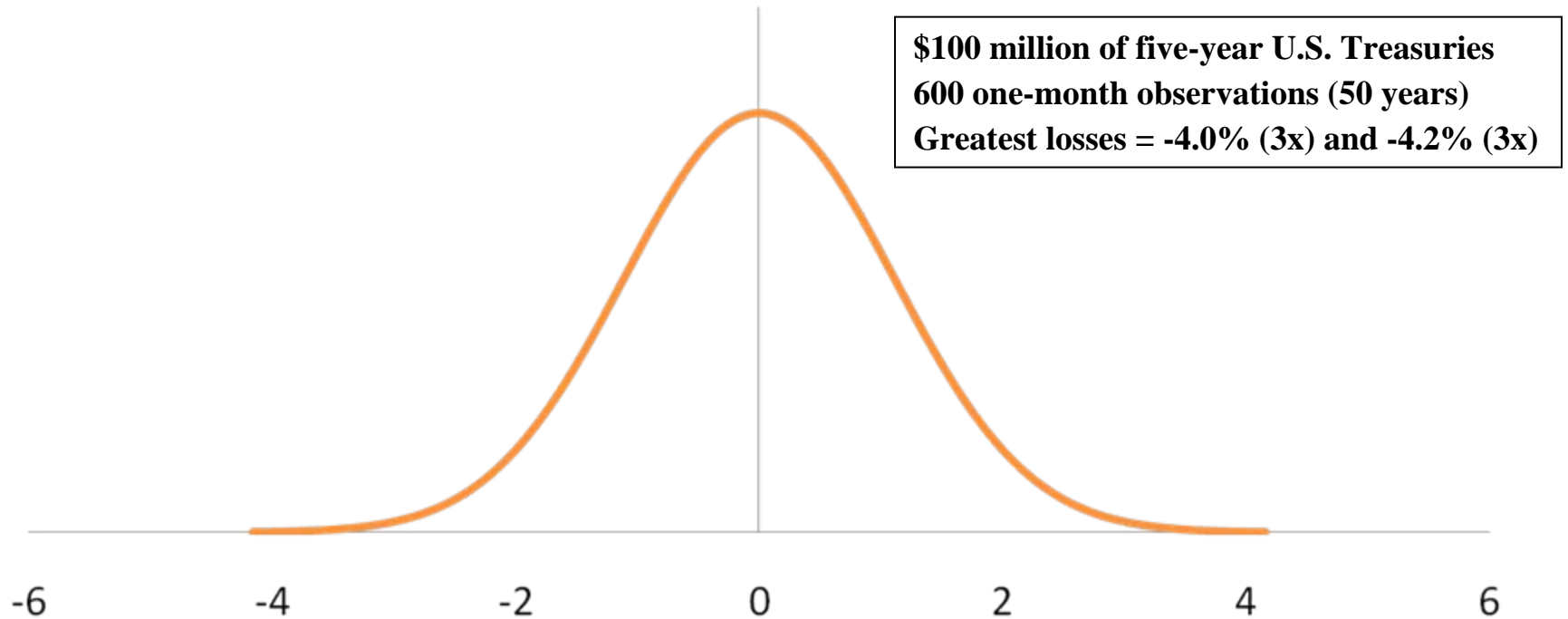


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Regulation and Standardization



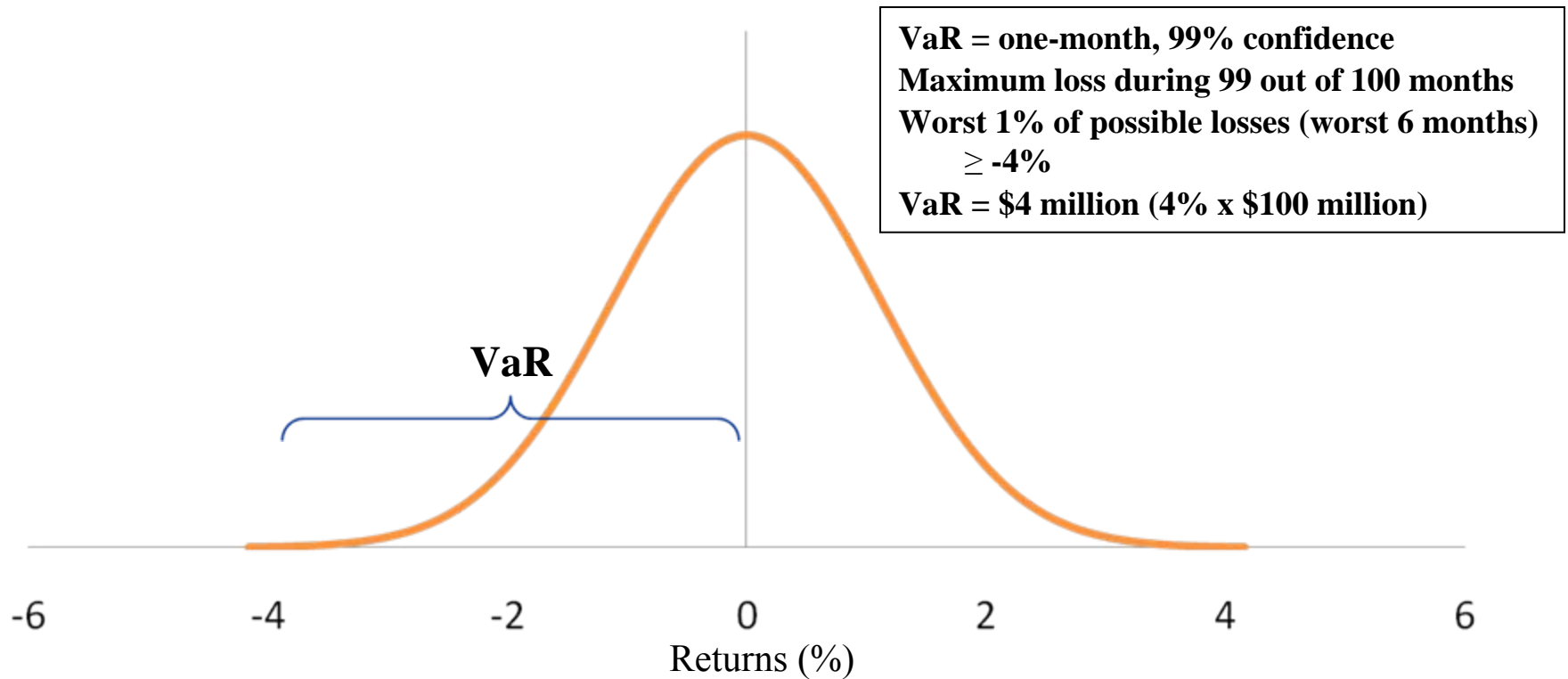
Regulation and Standardization



- ✓ Much of modern financial economic theory is premised on a world of rational individuals, each separately seeking to maximize her own wealth



Regulation and Standardization



- ✓ Likewise, the basic tools used to manage financial risk presume a world of independent actors and random changes in asset prices



Regulation and Standardization

- ✓ Promoting coordination is an important function of the law, creating greater uniformity in conduct and minimizing the risk of costly conflict
- ✓ Financial regulation also promotes coordination, largely focused on individual firms, each considered separately
- ✓ Example of global bank capital regulation –
 - Reinforces the financial stability of individual banks
 - Stronger bank capital levels in over 100 countries around the world



Regulation and Standardization

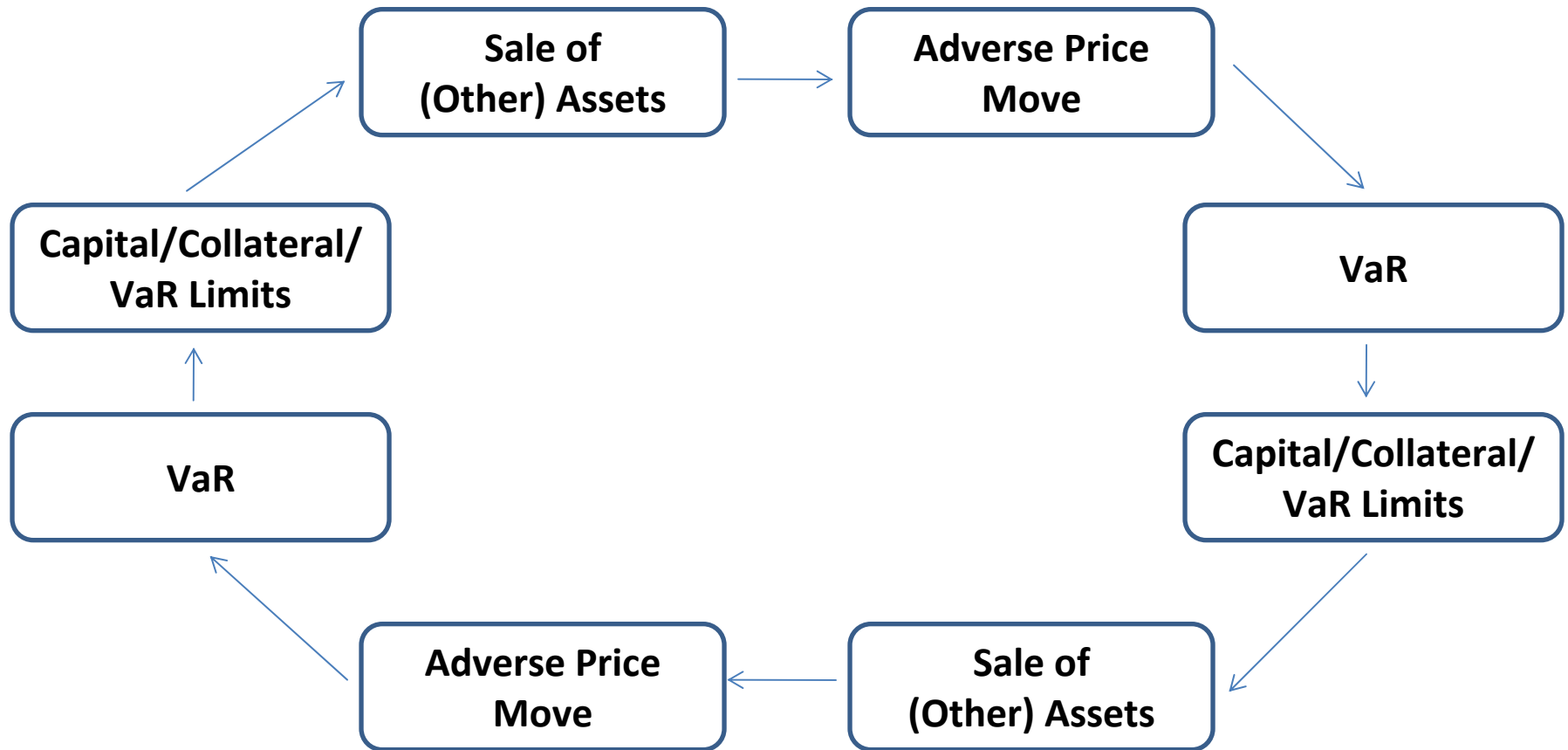
A paradox:

Regulation is necessary to balance the negative externalities of financial risk-taking

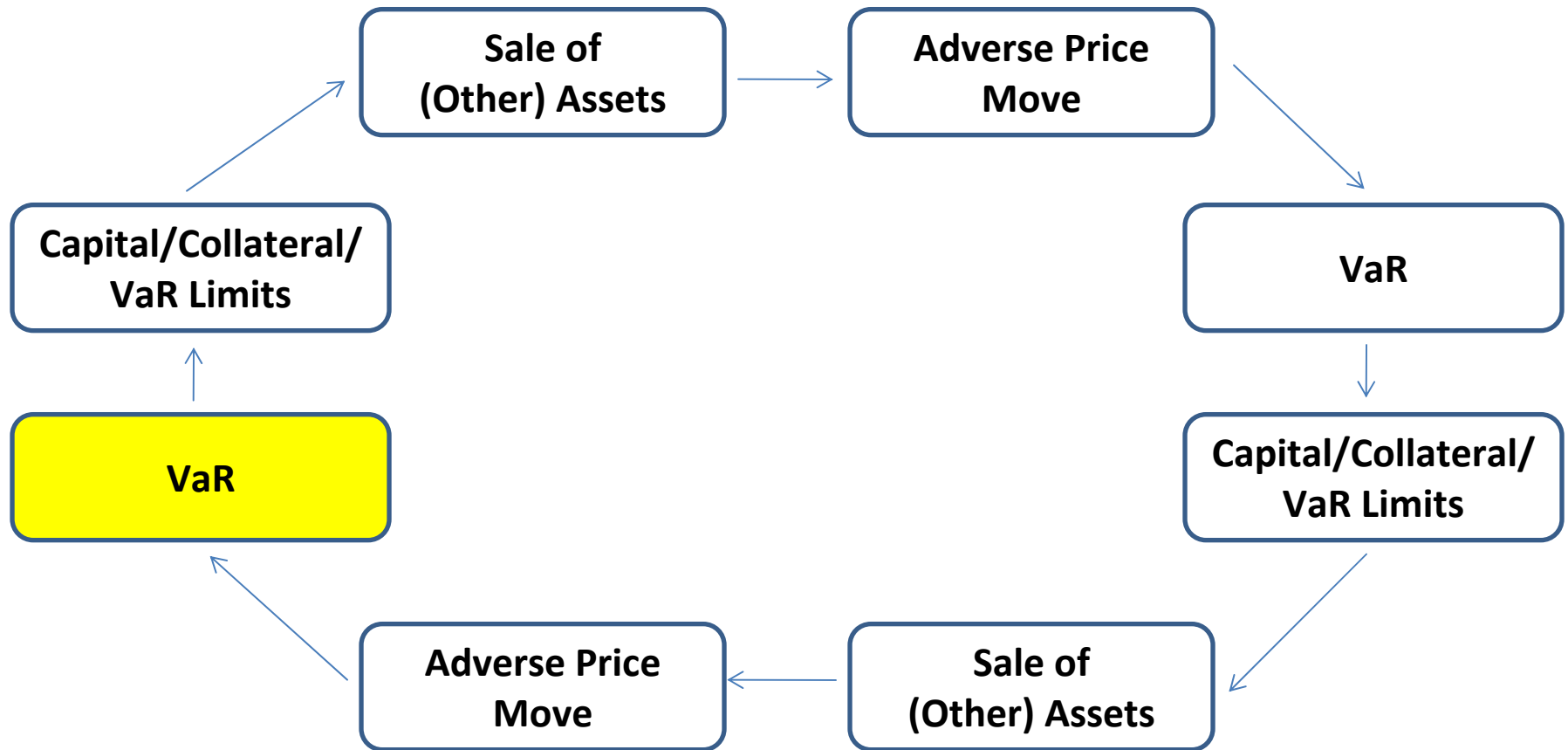
Greater coordination, however, can erode the presumptions that underlie much of financial risk management; portfolio managers can begin to act in unison – each independently responding to the same legal requirements, but together, influencing asset prices and trading by others



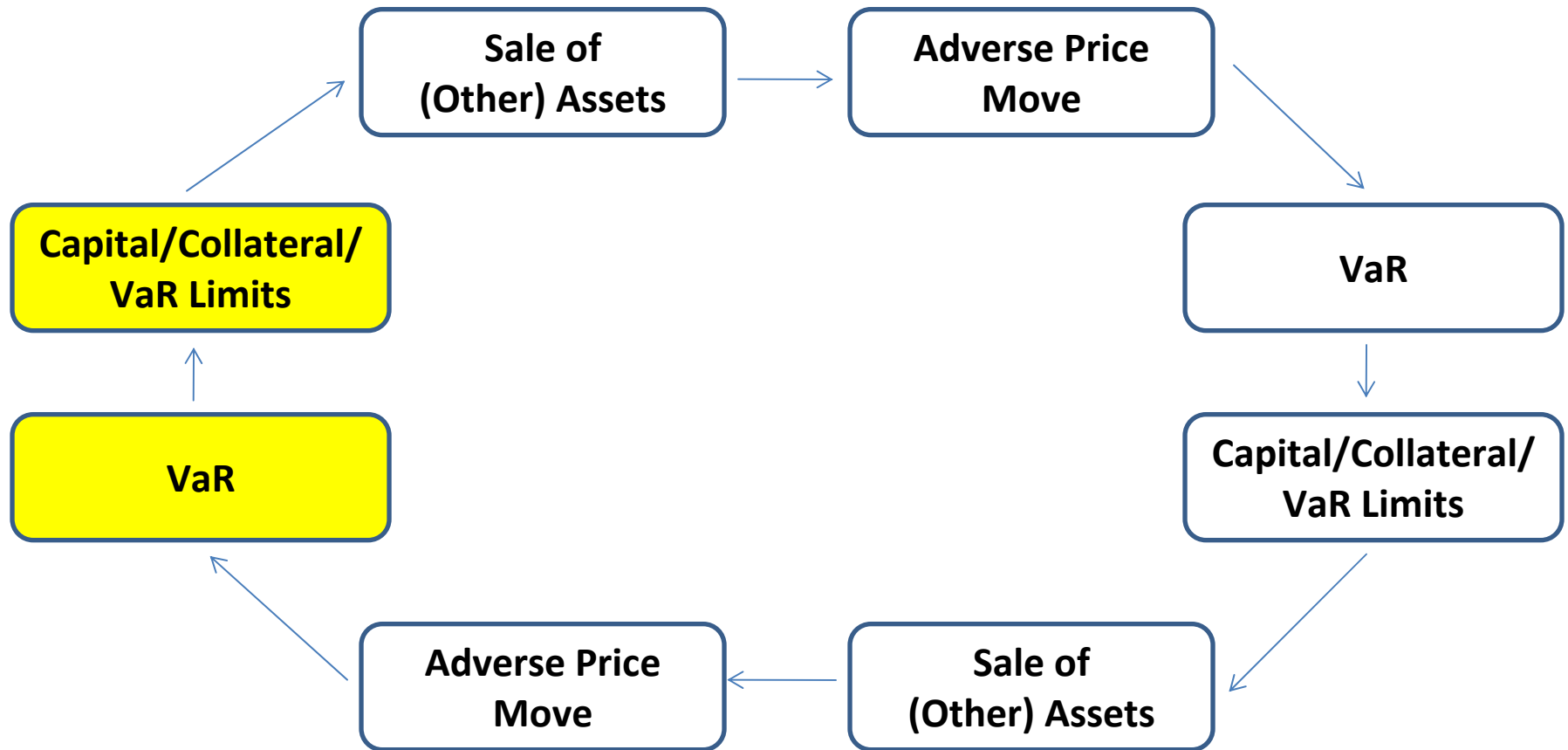
Regulation and Standardization



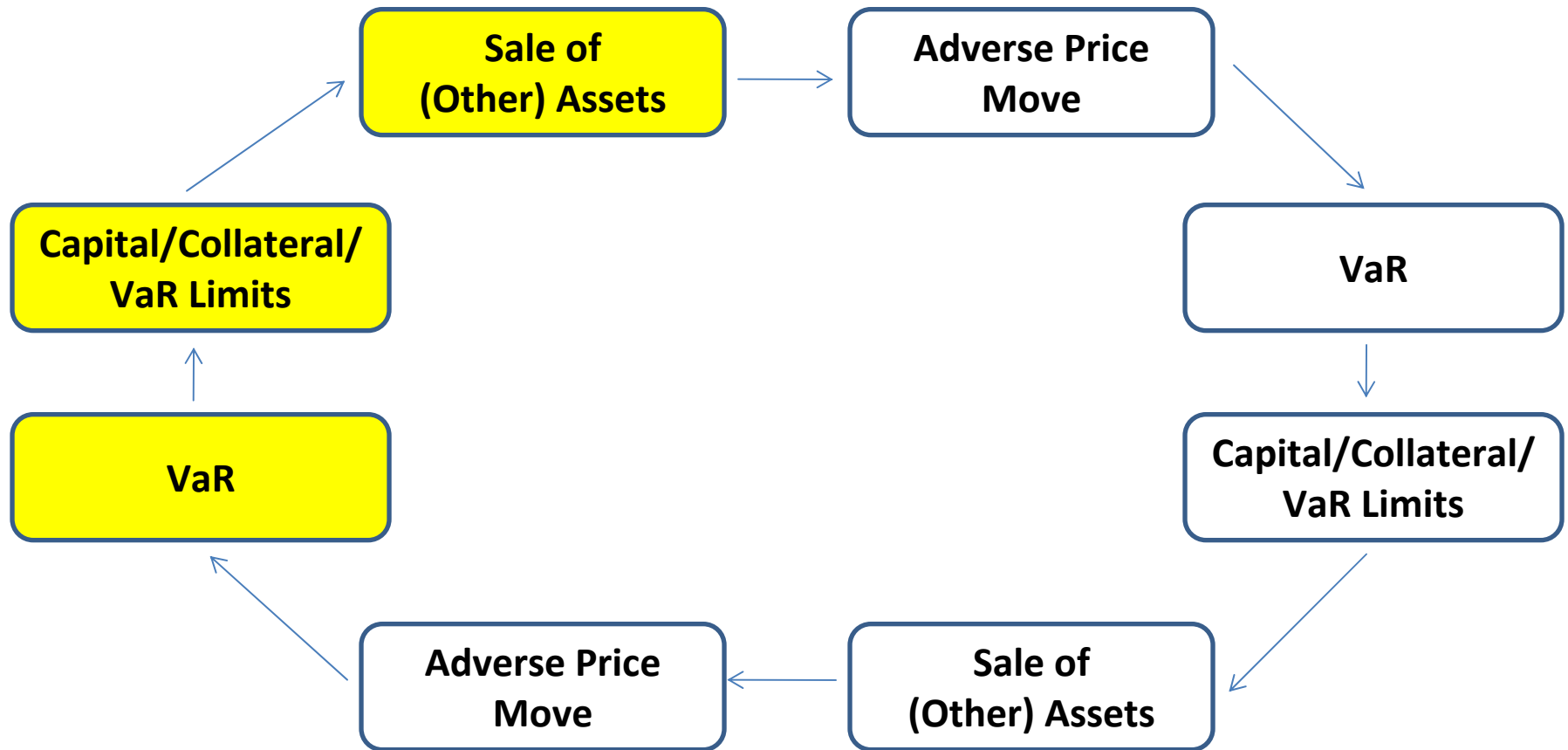
Regulation and Standardization



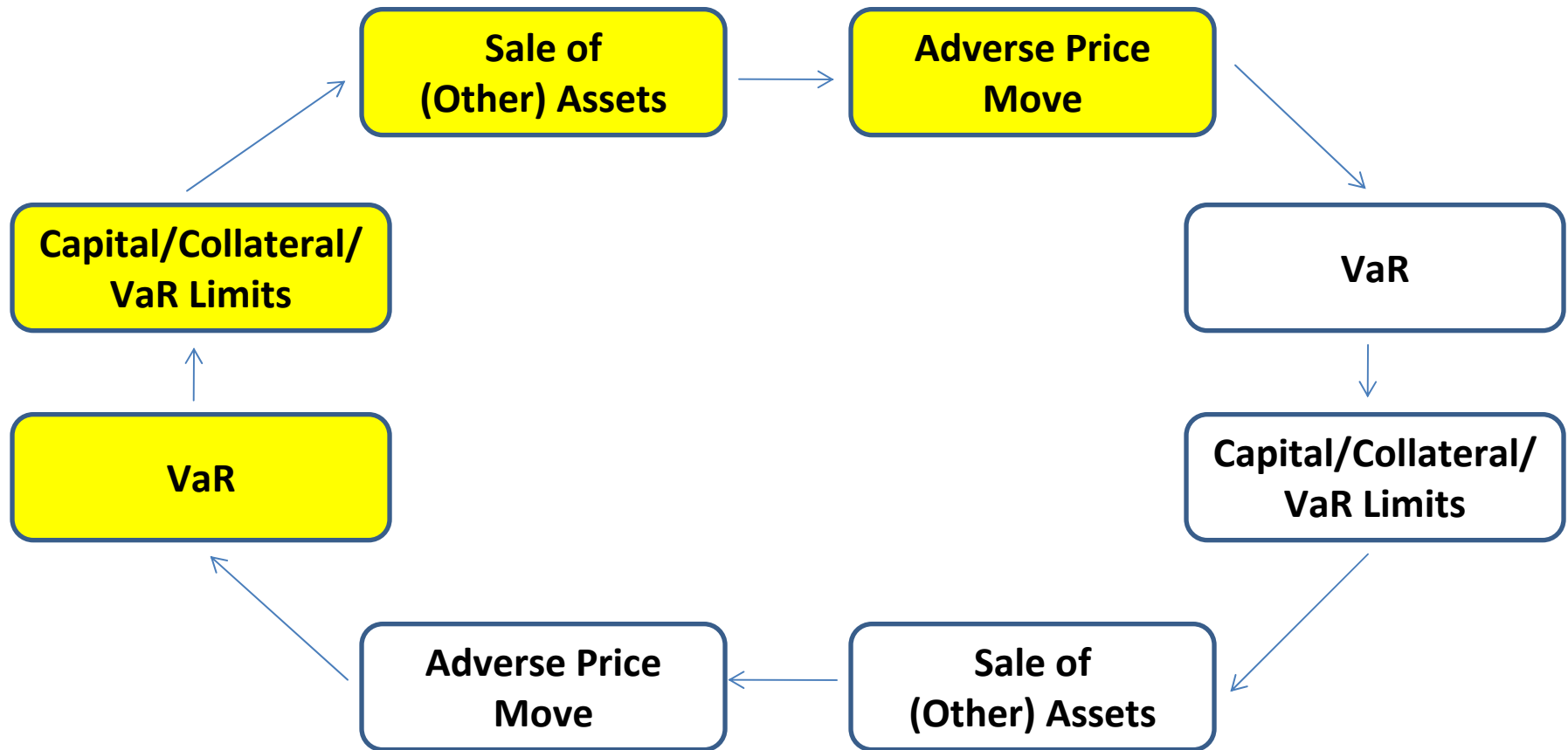
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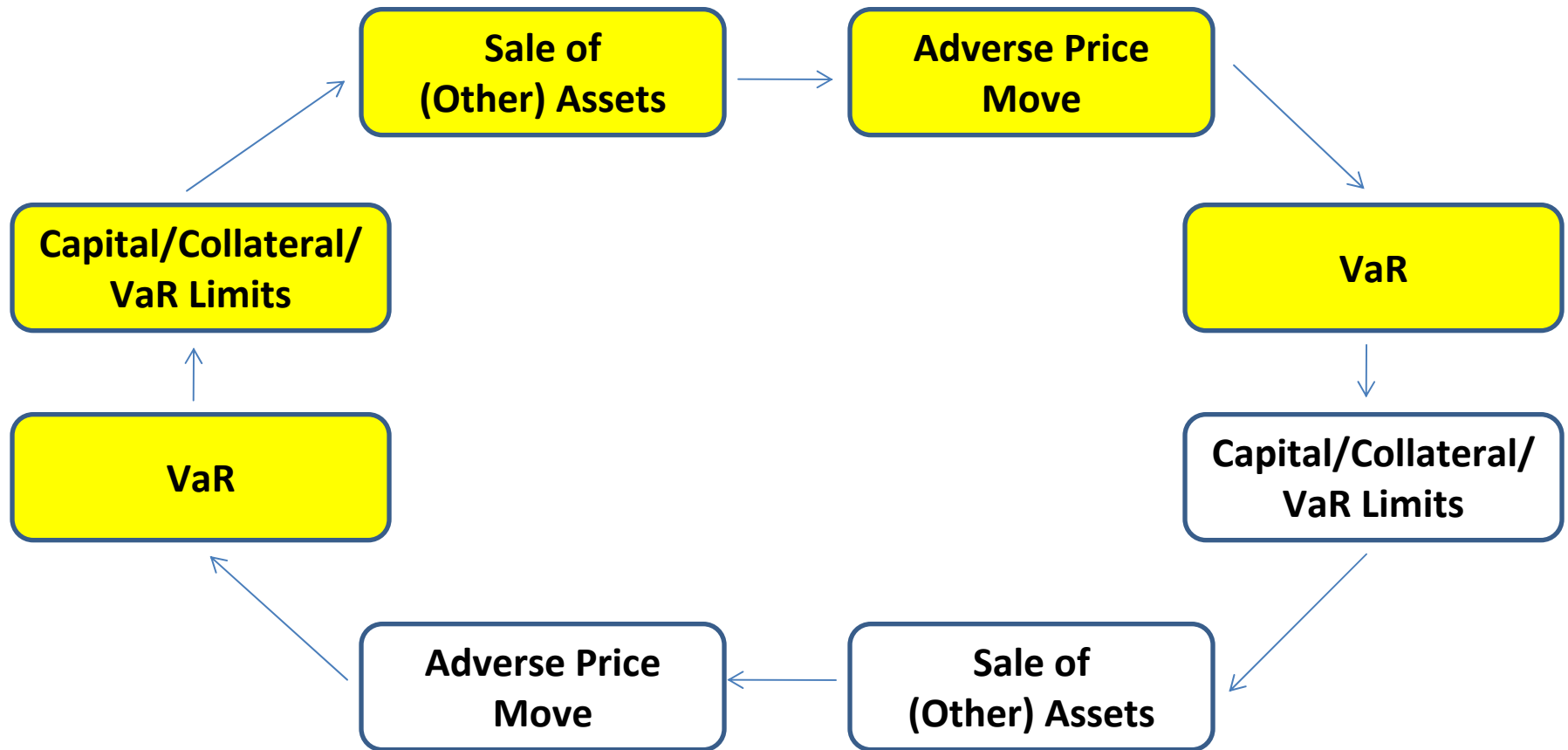
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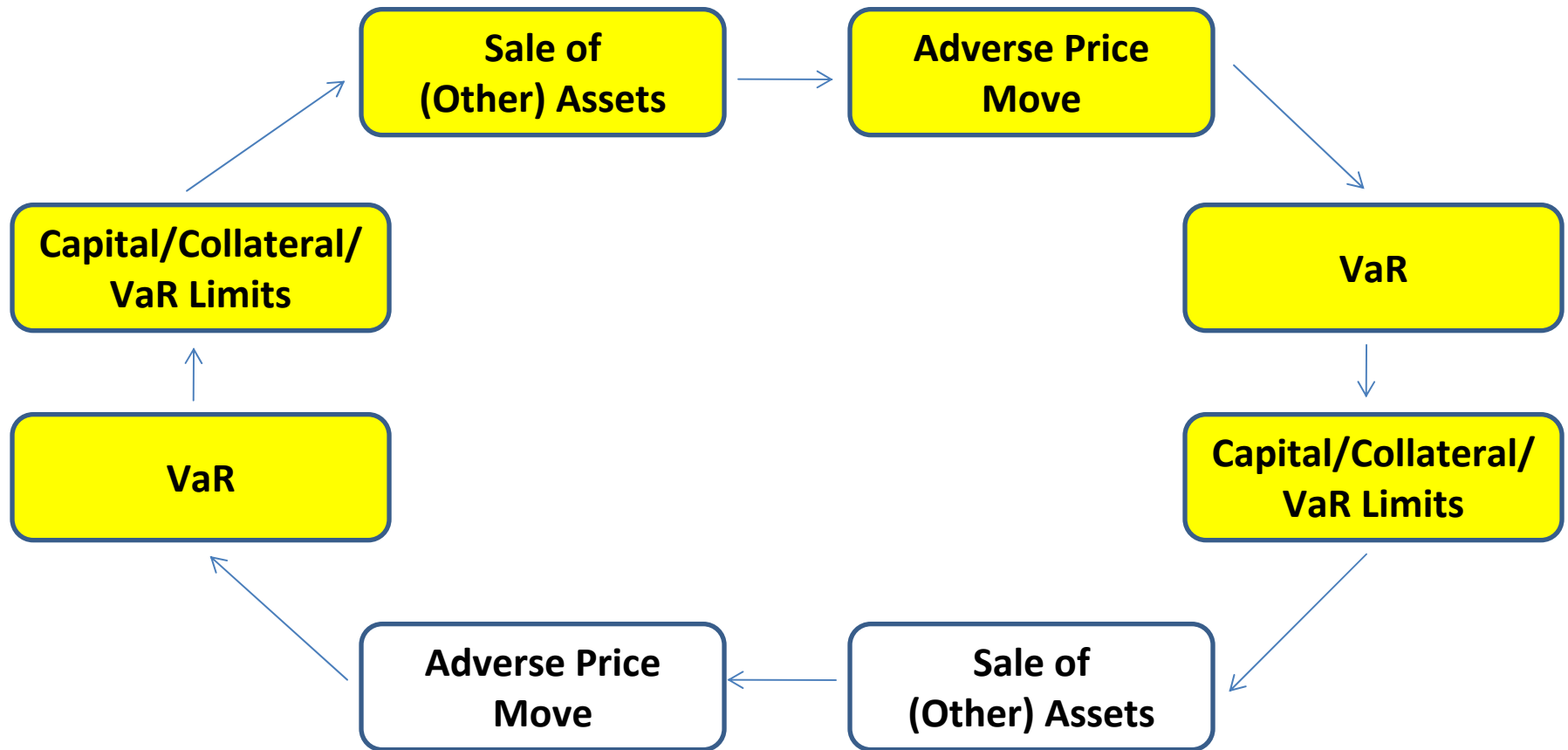
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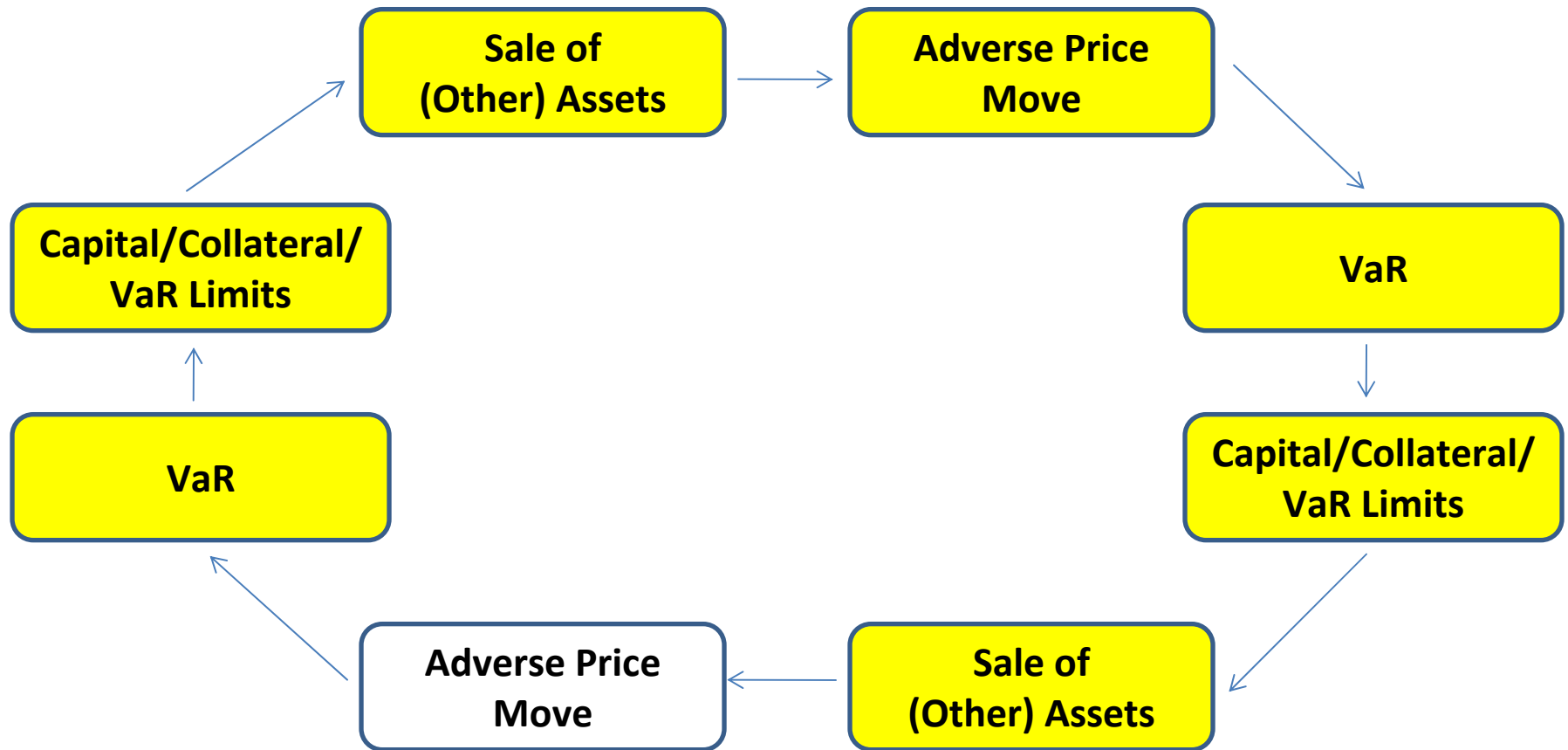
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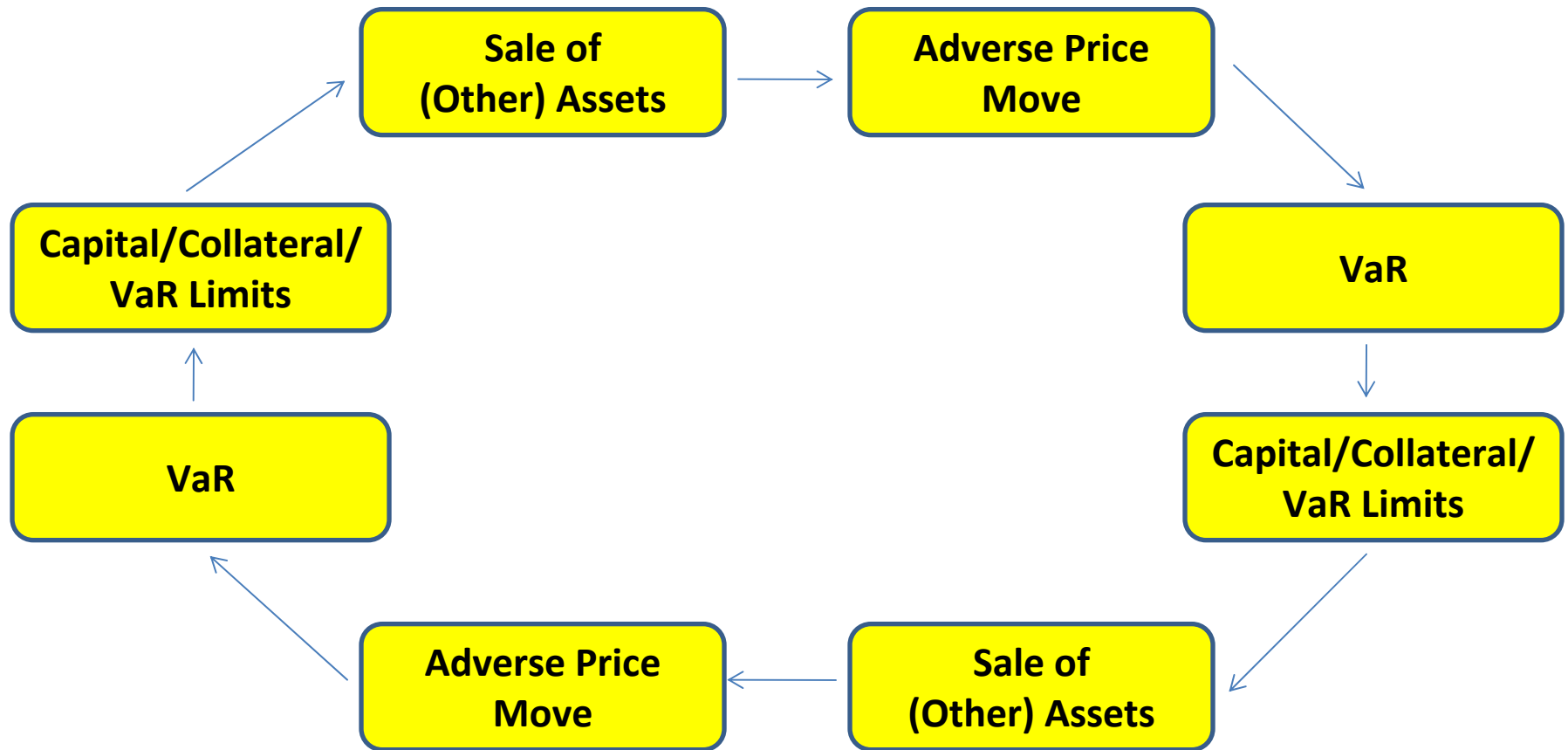
Regulation and Standardization



Regulation and Standardization



Regulation and Standardization



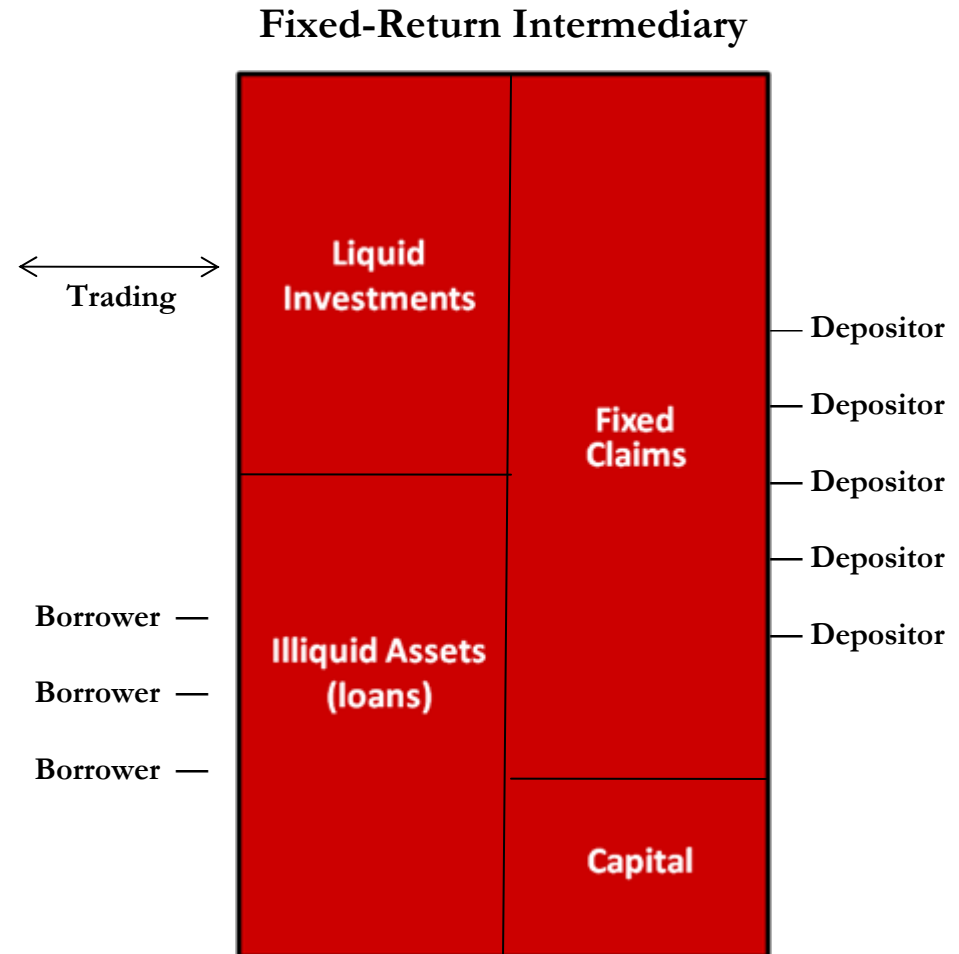
Regulation and Standardization

- ✓ Can regulation create its own negative externalities?
 - Through coordination, increasing the systemic impact of a downturn in the financial markets
- ✓ Will a focus on entities that are “too big” or “too interconnected” address the systemic problems that arise from market-wide decisions that stem, in this example, from a common VaR-based response to a drop in price?
- ✓ And, if not, do we care?



Traditional Intermediaries – Managing Risk

- ✓ Managing risk is a core function of intermediation
- ✓ Agency cost problems
- ✓ Negative externalities and systemic risk
- ✓ Regulation and insurance

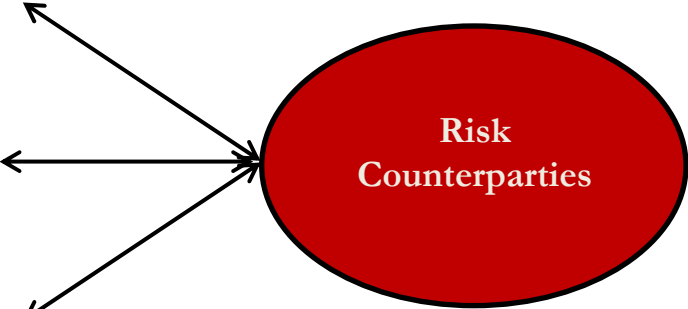


Outsourcing Risk Management

New Market Participants

- ✓ Changes in risk management; greater private credit liquidity

Other Risk Counterparties

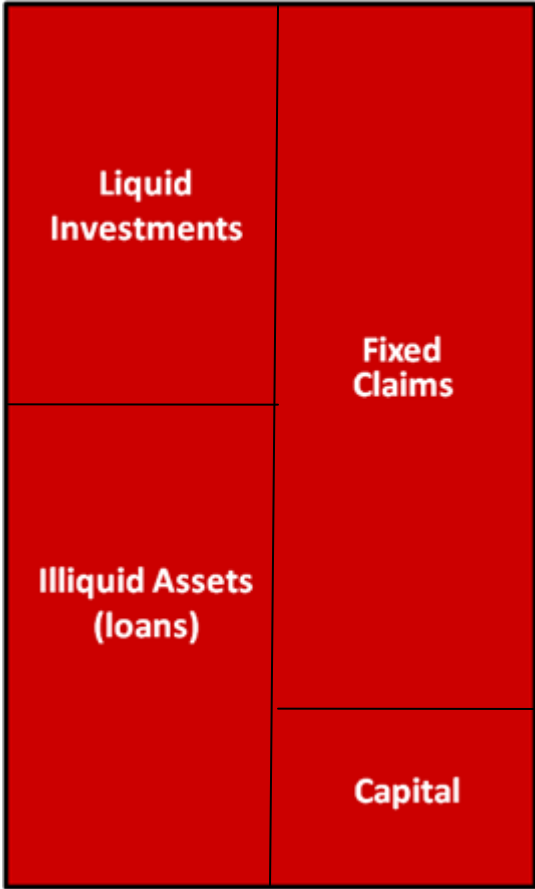


- ✓ Separating working and risk capital

Risk Outsourcing

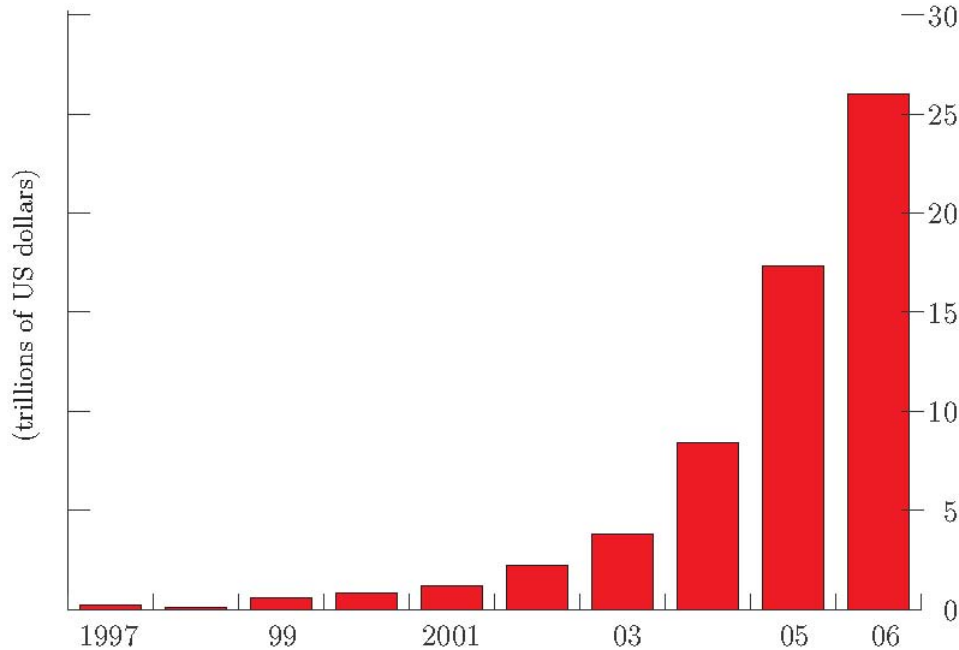


Fixed-Return Intermediary



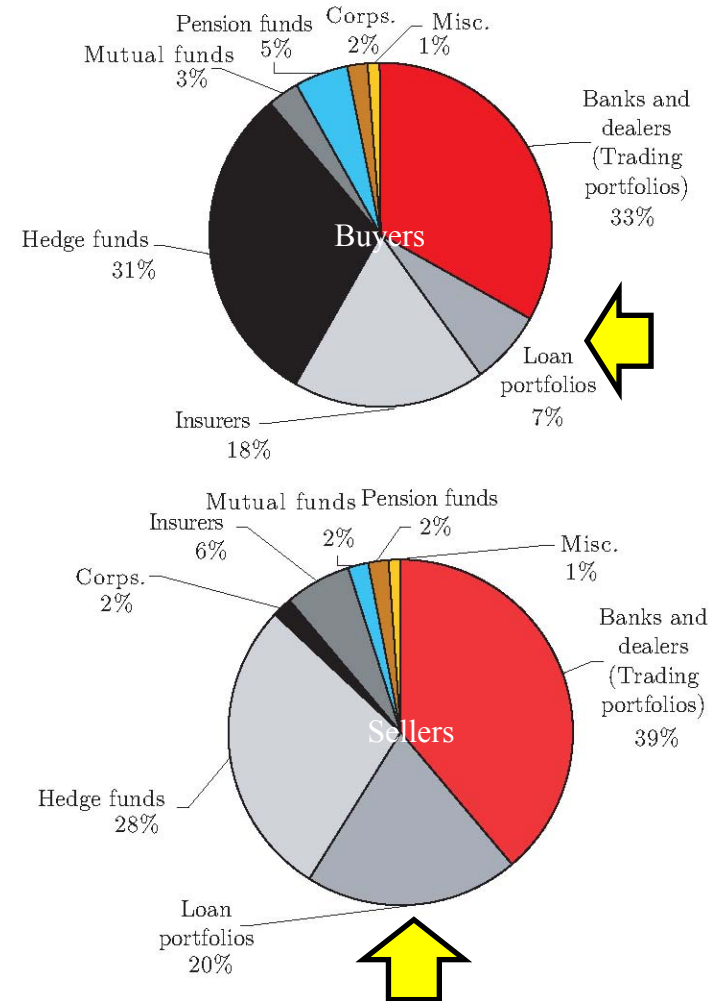
Outsourcing Risk Management

Outstanding Notional Amount of CDSs



Source: British Bankers Association;
Darrell Duffie, BIS Working Paper No. 255

Buyers and Sellers of CDSs (2006)



Source: Bank of America;
Darrell Duffie, BIS Working Paper No. 255



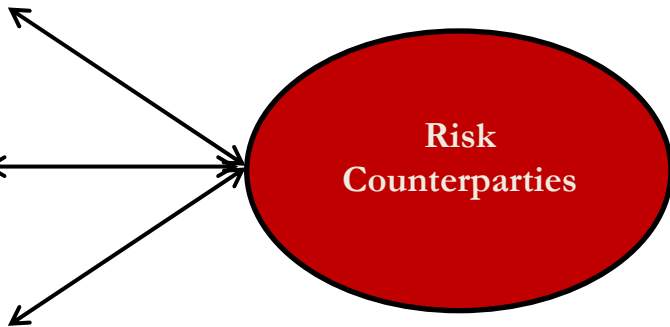
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Outsourcing Risk Management

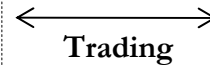
New Market Participants

- ✓ Changes in risk management; greater private credit liquidity

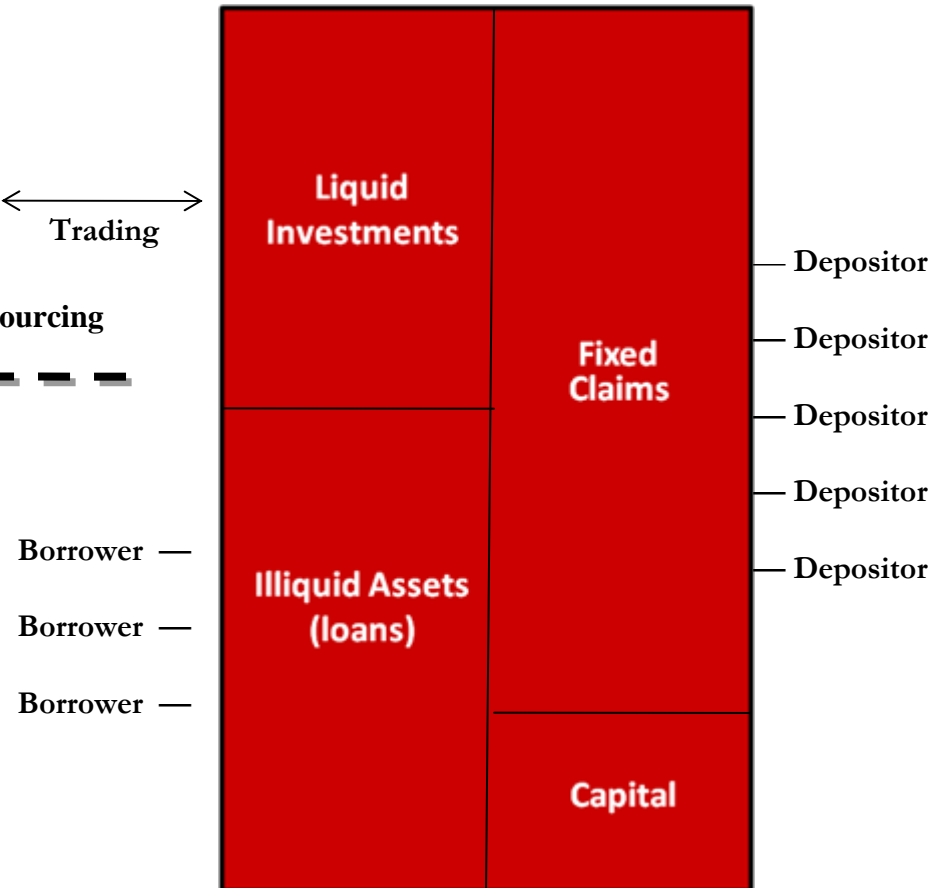
Other Risk Counterparties



Risk Outsourcing



Fixed-Return Intermediary



- ✓ Separating working and risk capital
- ✓ Dispersion of risk across the capital markets



Outsourcing Risk Management

- ✓ Dodd-Frank increases regulation of the hedge fund industry somewhat
 - Eliminates the private adviser exemption from the Advisers Act
 - With some exceptions, requires private fund advisers to register with the SEC
 - Swap dealers or major swap participants (MSPs)?
- ✓ Treats hedge fund trading as part of the capital markets – doing little to directly address (in this example) the outsourcing of traditional bank functions
- ✓ Inability to ring-fence the hedge fund industry

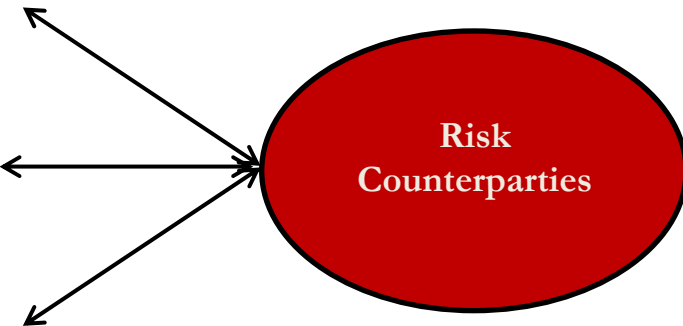


The Volcker Rule

New Market Participants

Fixed-Return Intermediary

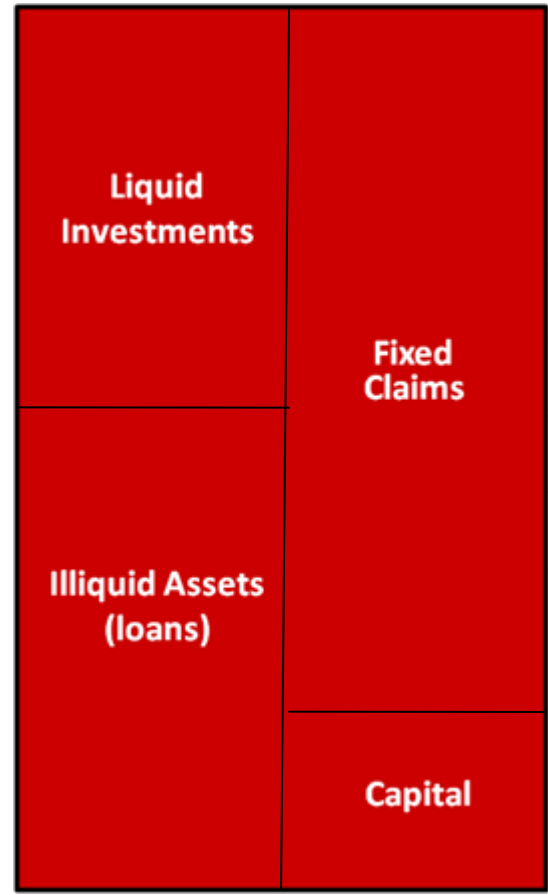
Other Risk Counterparties



Trading

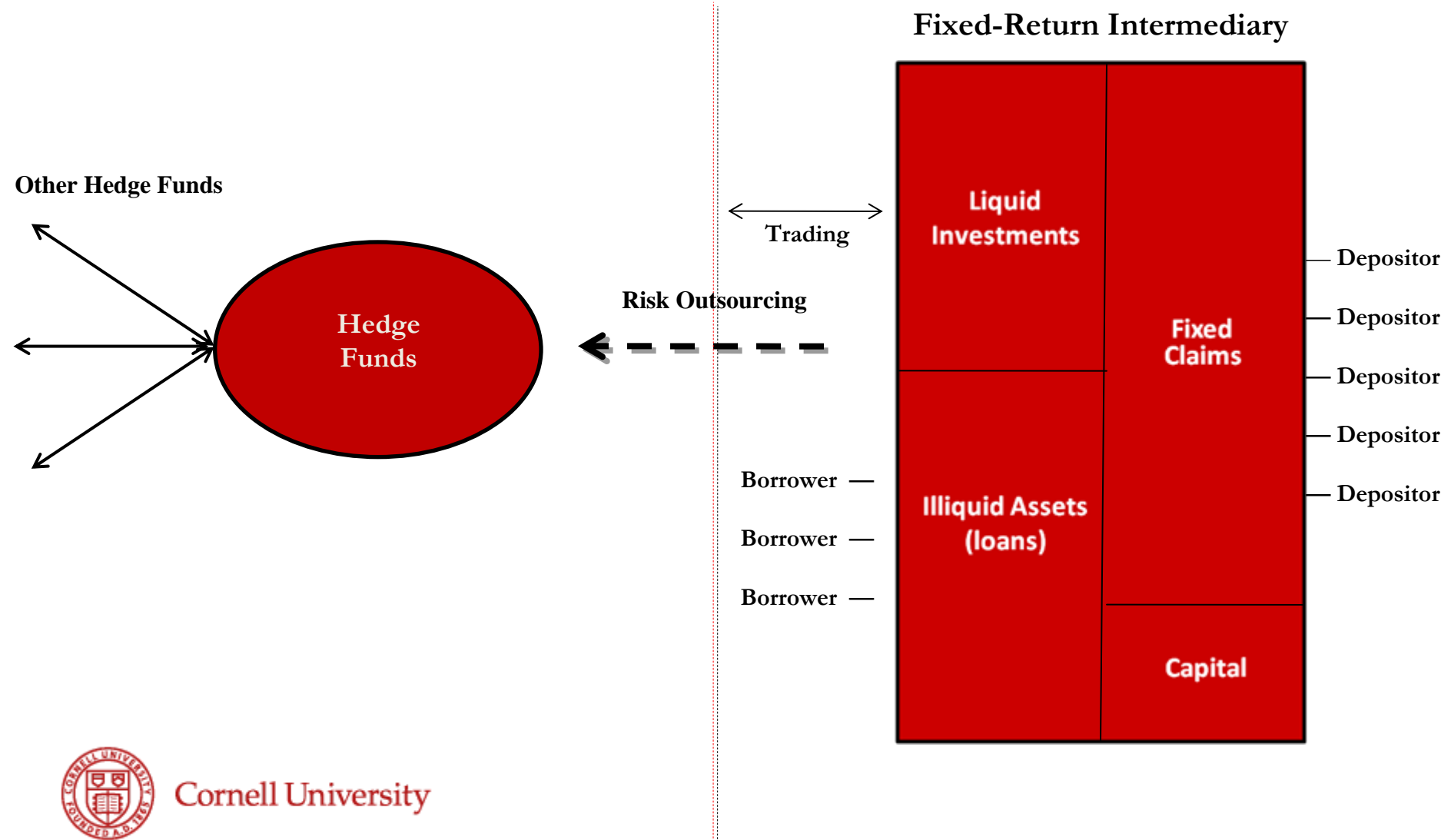
Risk Outsourcing

Borrower —
Borrower —
Borrower —

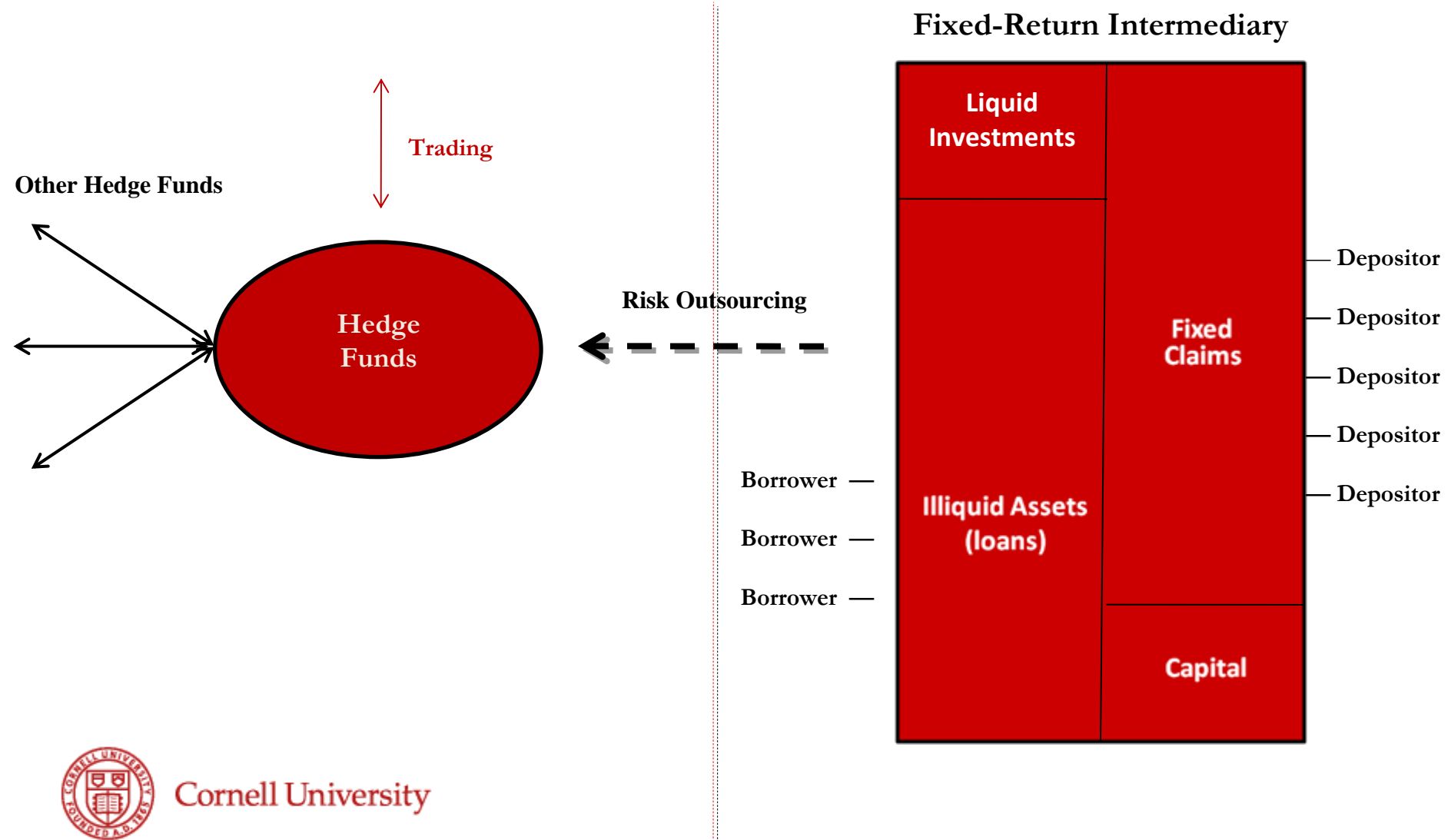


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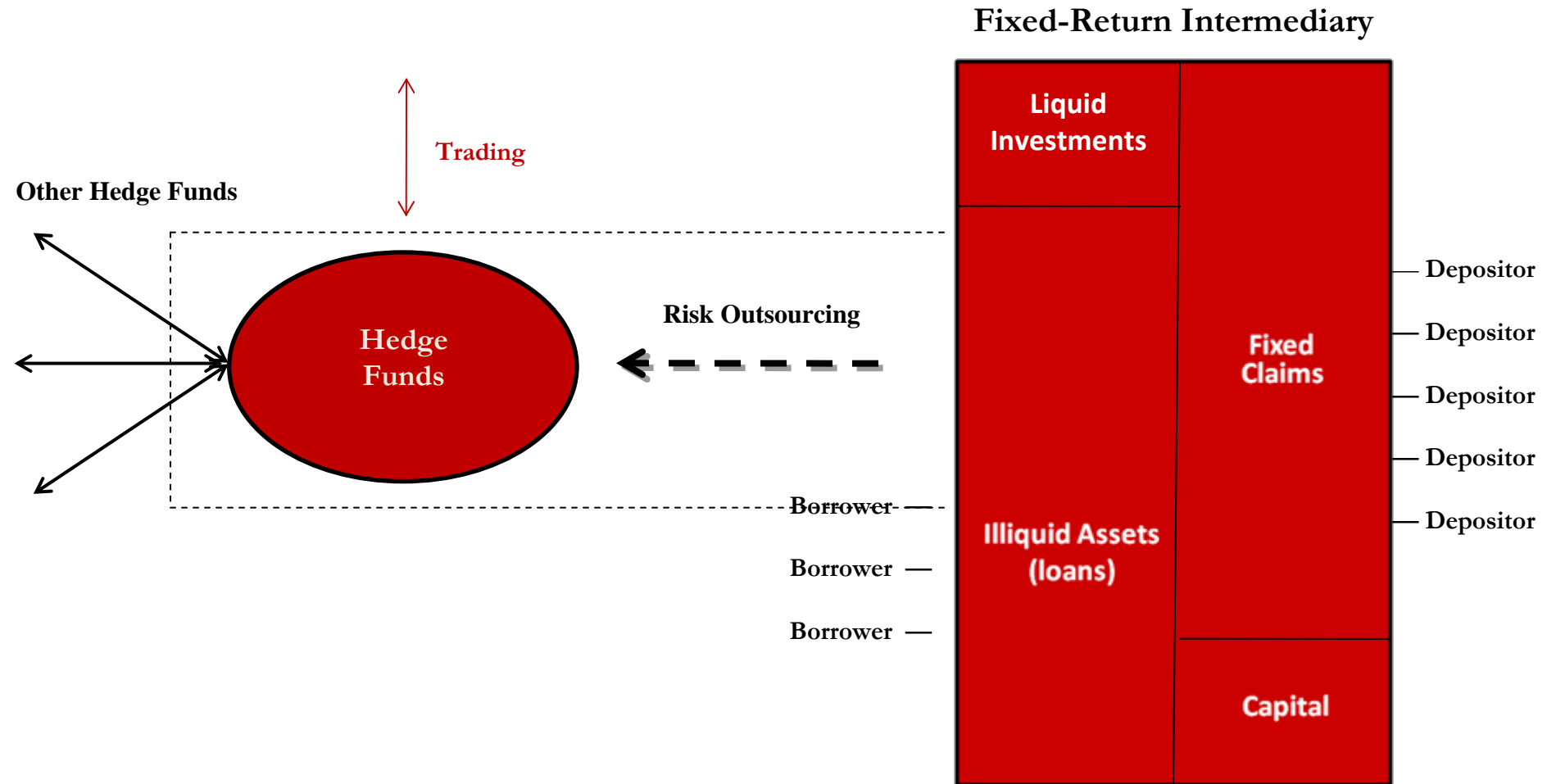
The Volcker Rule



The Volcker Rule



The Volcker Rule



Summary

- ✓ No agreed, operational definition of systemic risk
- ✓ Dodd-Frank may help level the regulatory playing field
 - But also raise costs and prompt new arbitrage instruments



Summary

- ✓ Shift from entities to markets –
 - Resulting in old risks appearing in new places
 - And new risks that extend beyond firms that are “too big” or “too interconnected” to fail
- ✓ Market risks can affect traditional intermediaries – like banks – and so have systemic consequences
 - Requiring a similar shift in financial regulation that takes account of changes in the markets
- ✓ Static regulation (e.g., the Volcker Rule) may not capture new relationships in the marketplace
- ✓ But Dodd-Frank leaves open the ability of the Council and financial regulators to address new risks

