Systemic Risk Implications of Dodd-Frank

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Overview

- How did we get here?
- Why did we end up with Dodd-Frank? ("The Dodd-Frank Wall Street Reform and Consumer Protection Act")
- What is Dodd-Frank and how does it address systemic risk?
    - What is really new?
    - Will change really take place?
    - Will it prevent bailouts?

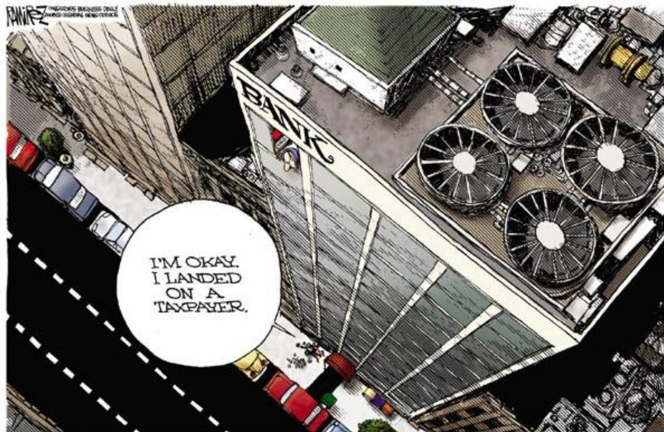
How did we get here?

- Through the 1920s
  - "Bucket shops" and off exchange stock and commodity speculation (forerunner of "over-the-counter" = OTC)
  - Bank depositor funded stock speculation
- Government responses
  - Grain Futures Act (1922) OTC derivatives illegal - only exchange traded permissible
  - Glass-Steagall (Banking Act of 1933) (only 37 pages, believe it or not!)
    - Separation of commercial and investment banking (a US innovation - Universal banking model continued in Europe)
    - Federal Deposit Insurance Corporation (FDIC) established deposit insurance for small savers
  - Commodity Exchange Act (1936) established Commodity Exchange Commission, forerunner of Commodity Futures Trading Commission (CFTC) created in 1974

The Volatile 1980s

- In a series of “no action” letters in response to industry efforts to create OTC swaps and derivatives, the CFTC blesses the product
- Regulation Q (Federal Regulation derived from Section 11 of Banking Act) phased out (1978-1986) for non-demand deposit accounts enable bank deposit alternatives (Savings/NOW) to money market funds
- Brokered deposits (“hot money”) proliferate as insolvent Savings and Loans (S&Ls) use insured deposits to double down on property bets.
- Banking institutions remain open as FDIC resolution only permitted when FDIC is **asked** to resolve a troubled institution by primary regulator
- Continental Bank fails (1984) and even equity holders receive support (first banking use of term “Too Big To Fail”)

Reaping the Benefits of the S&L Crisis



Curry and Shibut (2000) estimate taxpayer cost at \$125 billion vs. \$25 billion in bank assessments.

The Government Responds, Again

- FDIC Improvement Act or FDICIA (1991)
  - Prompt Corrective Action (PCA) - FDIC is to close institutions **prior** to insolvency using a capital monitoring process (no longer wait on primary regulator for invitation!)
  - Least Cost Resolution (LCR) - Prevention of tax-payer losses is the primary driver of FDIC decision-making. Chosen resolution avenue ("insured deposit transfer" and "purchase and assumption" most popular) must be driven by limiting tax payer losses.
  - Systemic risk exception - can override tax-payer loss prevention if not doing so would "have serious adverse effects on economic conditions or financial stability" and such protection would "avoid or mitigate such adverse effects"
- CFTC Chair Brooksley Born introduces concept release to oversee and regulate OTC derivatives (1998) prior to Long Term Capital Management crisis. Legislation is ultimately passed **to prevent** any regulation of OTC derivatives by CFTC or SEC (Commodity Exchange Act in 2000)

Erosion of Glass-Steagall

- 1987: Federal Reserve Board **reinterprets** Section 20 to mean that commercial banks can derive 5% of bank holding company affiliate ("Section 20 Sub") revenue from underwriting of residential MBS, Municipals, Commercial Paper and consumer ABS
- 1989: With congressional prodding by William Proxmire, Federal Reserve Board expands definition to include corporate bond and equity underwriting and increases revenue cap to 10% for "bank ineligible securities"
- 1996: With congressional prodding by Jim Leach, Federal Reserve Board increases revenue cap to 25%
- 1998: Citicorp merges with Travelers and Federal Reserve approves Salomon Smith Barney becoming a Citibank affiliate via the 25% revenue rule
- 1999: Gramm-Leach-Bliley Act (repeal of sections 20 and 32 of Banking Act). Glass-Steagall is dead.

'Too Big To Fail' Debates pre-Credit Crisis of 2007-2008

- 'Too Big To Fail' not an issue - PCA and LCR of FDICIA
- 'Too Big To Fail' not an issue - rational policy response to preventing systemic events (hard to differentiate between solvency and liquidity issues)
- Stern and Feldman write book "Too Big To Fail" in response (2004) not to be confused with Andrew Ross Sorkin book/HBO movie by same title (2009). They argue that 'Too Big To Fail' support would come into play to prevent spillovers for any U.S. financial firm of great enough complexity or relative size in critical markets:
    - payments processing
    - securities settlement
    - OTC derivatives
- The explicit government support of Bear Stearns, Fannie Mae, Freddie Mac, and AIG and perhaps the encouragement of Bank of America's purchases of Countrywide Financial and Merrill Lynch made these arguments prescient.

Getting from the Credit Crisis to Dodd-Frank

- September, 2008: Goldman Sachs and Morgan Stanley given Bank Holding Company status by Federal Reserve to enable stronger support if needed.
- October, 2008: Troubled Asset Relief Program makes capital investments in troubled banks
- February, 2009: Treasury Secretary Geithner initial speech about reform criticized as vague
- March, 2009: Treasury Blueprint for Financial Reform released (DavisPolk snafu)
- December, 2009: House passes bill under guidance of Financial Services Committee chair Barney Frank
- January, 2010: Scott Brown elected to Ted Kennedy's seat in MA. President Obama resurrects Paul Volcker speaking in support of what became known as "Volcker Rule"
- April, 2010: Goldman Sachs sued by SEC over Abacus Transaction
- May, 2010: Senate passes bill under guidance of Banking Committee chair Christopher Dodd
- July, 2010: Reconciled versions passed along party lines and President Obama signs bill

Why did we end up with Dodd-Frank?

- Per Skeel (2011) Treasury Secretary Geithner, a principal player in the bailouts as New York Federal Reserve Bank President, wanted all of the powers that he and then Treasury Secretary Paulson were lacking to better manage the crisis
- Skeel describes two historic approaches to large US firm regulation:
  - Corporatism or Government-Private partnerships ala France
  - Breaking up large firms to increase competition ala Louis Brandeis
- Current US preference appears to be moving towards the European model, taking the opposite tact from the New Deal reformers of the Great Depression, not surprising given the prominent role of Secretary Geithner who has not supported the Volcker Rule

Why did we end up with Dodd-Frank? (cont.)

- Skeel references congressional testimony of Moss (2009) regarding three avenues of response to a systemic institution in distress:
  - Bankruptcy
  - Bailout
  - Administrative Resolution
- Bankruptcy avoided due to jurisdictional issues in congress
- Bailouts untenable
- Administrative Resolution modified to copy as much of bankruptcy as possible with adjustments for derivatives due to the “safe harbor” rule
- Fears of populist resistance and “institutionalization of the 2008 bailouts” have led to form over function changes:
  - The Volcker Rule (no proprietary trading, private equity or hedge funds in commercial banks)
  - The Lincoln Amendment (no derivatives in commercial banks)
  - The Boxer Amendment (no taxpayer funded bailouts just liquidations of distressed financial institutions)

Dodd-Frank and Systemic Risk

- Regulation of OTC Derivatives
  - Derivative clearing and exchange trading requirement
  - Does not address repurchase agreements!
- Regulation of Systemic Institutions
  - Financial Stability Oversight Council (FSOC)
  - Systemically Important Financial Institutions (SIFIs)
  - Does not address Fannie Mae or Freddie Mac!
- Resolution of Systemic Institutions
  - FDIC back to pre-FDICIA role of waiting on primary regulator (FSOC)
  - FDIC must liquidate large institutions just like in FDICIA (1991) LCR or Least Cost Resolution preventing taxpayer costs
  - FDIC has unfettered discretion, however, and broad powers similar to systemic risk exemption of FDICIA to choose stability and prevent systemic risk spillover as opposed to minimizing taxpayer costs

Dodd-Frank and Derivatives

- SEC and CFTC divide derivatives universe, **ignoring repo**
- Designations of "Swap Dealers" and "Major Swap Participants"(=AIG!) unrelated to hedging activity by large non-financial firms
- SEC and CFTC rule making to determine what derivatives are to be cleared. If a contract must be cleared, it must be exchange traded with price transparency
- Clearinghouse model has two potential outcomes (extremes)
  - Many clearing bodies (central counterparties or CCPs) with potential "race to bottom" standards to attract business and potential to increase system wide collateral requirements over existing private bilateral approach with netting
  - A couple of undoubtedly 'Too Big To Fail' CCPs requiring tax-payer funded Federal Reserve support in times of crisis. Recall the Options Clearing Corporation (OCC) required Federal Reserve support in 1987 during the stock market crash.
- Failure to clear most derivatives leaves us in the same place as prior to the crisis bailouts of Bear Stearns and AIG

Dodd-Frank and Derivatives (cont.)

- Trading location - move activity off shore to avoid Dodd-Frank left to regulatory discretion
- Same bank international competitiveness arguments used in forty years of resistance to Glass-Steagall dusted off for derivatives treatment
- JPMorgan **London based** Chief Investment Office (CIO) derivative "hedging" losses in May, 2012 had dramatic affect on regulatory public statements:
  - The Financial Times reported, "US regulators are exploring ways to give large foreign banks and overseas subsidiaries of US lenders a reprieve from stringent new derivatives rules..." on April 22, 2012.
  - The Financial Times next reports, "US banks were dealt a blow on Monday after the main US swaps regulator said new rules will probably apply to overseas branches of America's lenders and the affiliates they guarantee." on May 21, 2012.
  - On June 29th, the CFTC approved for public comment "Proposed Interpretive Guidance on Cross-Border Application of the Swaps Provisions of the Dodd-Frank Act."

Dodd-Frank and SIFI Regulation

- Federal Reserve and FSOC are primary regulators
- Act avoids calling SIFI institutions "systemic" - defined as bank holding companies of $50 billion or more in assets and non-bank financial holding companies supervised by the Federal Reserve
- FSOC composed of Treasury Secretary (Chair), Chairs of Fed, FDIC, SEC, FOI, CFTC, etc.
- SIFI designation for non-bank requires 2/3 vote of FSOC leading to higher capital levels as overseen by Federal Reserve (see Basel III for levels). Higher capital levels expected to curtail risk-taking
- Basel II regulations took effect in 2007 prior to the crisis
- Recent regulatory failures disturbing. Federal Reserve and OCC (Office of Comptroller of the Currency) had over 100 full time regulators assigned to JPMorgan. Nothing amiss discovered in Chief Investment Office (CIO with $360 billion portfolio) until public dissemination of synthetic credit position sizes in early April.
  - Regulators unaware of Value-at-Risk(VaR) model change for CIO in first quarter 2012. After restatement to old model daily VaR nearly doubled from $67 million to $129 million.

Dodd-Frank, the Volcker Rule and the Lincoln Amendment

- Volcker Rule prohibits proprietary trading but permits market making, hedging, customer trading and trading of Treasury and Agency Securities
- Widespread reports of proprietary traders moved into market making areas. Many of senior officers in JPMorgan CIO display significant proprietary trading experience on LinkedIn!
- Regulatory enforcement in overseas affiliates without application to foreign institutions with US presence open the door to competitive objections
- Lincoln amendment (no derivatives in commercial banks) watered down to a non-bank affiliate ("Swaps Pushout")
- During crisis, Federal Reserve waived regulations forbidding banks from funding broker dealer operations from banking operations. Why different next time?
- Recent Morgan Stanley efforts to move derivatives operations into bank to limit effect of rating agency downgrades will be instructive. Ongoing as of Jun 22, 2012 as wait on Fed ruling per Bloomberg.

Dodd-Frank and SIFI Resolution: FSOC and FDIC

- FSOC votes on putting SIFI into administrative resolution ("three keys turning")
- SIFI need not be designated in advance as long as 85% of revenue from financial activity! Any institution whose failure would be destabilizing may be designated with 2/3 of FSOC voting members
  - Court has 24 hours to hold a **secret** hearing and only justification for overturning designation is "arbitrariness" or "capriciousness"
  - Very likely violates the due process clause of the constitution
  - While regulatory designation and resolution will probably be delayed like pre-FDICIA troubled banks, opens door to the activist Treasury secretary like Paulson or Geithner as portrayed in Sorkin's (2009) "Too Big To Fail"
- FDIC then responsible for liquidation (note just like pre-FDICIA) of entire holding company, not just the subsidiary bank

FDIC Resolution Track Record

- Historical FDIC success frequently pointed to in justifying Dodd-Frank role
- However, FDIC will need to wait for political process as in pre-FDICIA
- Historical FDIC success is post-FDICIA and small institutions
- FDIC approach rarely liquidation but usually "insured deposit transfer" or "purchase and assumption" to protect franchise value
- FDIC track record for large institutions mixed. Consider IndyMac (2008). FDIC failed to close early in spite of PCA and resolution cost $9 billion
- Who will buy assets of very large firms? Other large firms leading to significant growth in already 'Too Big To Fail' institutions
  - JPMorgan bought Bear Stearns and Washington Mutual
  - Bank of America bought Countrywide and Merrill Lynch
  - First Citigroup but then Wells Fargo bought Wachovia
  - Who could buy one of the big four?

FDIC as Bankruptcy Judge Under Dodd-Frank

- FDIC can borrow (issue Treasuries) up to 10% of resolution firm asset value in first 30 days and 90% thereafer
- FDIC can delay cancellation of qualified financial contracts (derivatives) until 5PM of next business day (remember "safe harbor" rule)
- FDIC can repudiate or pay any contracts in full but must respect ISDA master agreements
- FDIC can purchase or guarantee firm assets, assume or guarantee debts
- FDIC can enforce preference and prevent fraudulent conveyance
- While Dodd-Frank expects FDIC to follow absolute priority, FDIC has discretion to cherry pick creditors (think of WAMU or Chrysler/GM bailouts)
- FDIC can take up to 3 years to set up a bridge institution (final end run of liquidation requirement)

Recent FDIC Resolution Proposal (May 10)

- FDIC plans to take-over parent holding company and use borrowing capacity to fund operating units around the world
- Will transfer assets and some liabilities to bridge company
- Equity holders wiped out, debt holders swap for equity
- Recapitalized firm reappears as a private firm
- FDIC cooperating closely with Bank of England and Financial Services Authority given the heavy concentration of US Bank international assets in London
- Efforts were to build off "Living Wills" required of all SIFIs, but initial nine submitted July 2nd, assume, as directed by regulators, that failure is an isolated event, not part of a global meltdown. Citi's living will notes that it will not be needed given its recapitalization (per Wall Street Journal, July 5th).

Federal Reserve Powers Under Dodd-Frank

- Section 13(3) of Federal Reserve Act (lending to non-banks in "unusual and exigent" circumstances and source of Bear Stearns support) modified to permit only broad market based as opposed to institution specific support actions.
- For example, the Fed can guarantee all bank debt
- Specific institution support will require creativity (structuring something broad that is only useable by the target institution) or putting together a private consortium like that used to rescue Long Term Capital Management in 1998

Conclusions

- Results will be very dependent upon regulatory rules and implementation
- Where would we be now if JPMorgan had either not lost money or it had not become broadly known?
    - CFTC would already be delaying application of Dodd-Frank rules for foreign subsidiaries of US banks, perhaps forever
    - Jamie Dimon would still be dressing down regulators in public and talking about international competitiveness and profitability needs of US banks
- What is more important, growing bank profitability or preventing taxpayer funded support of institutions already provided with deposit insurance?
    - If foreign banks remain supported and protected by their nations our regulators will never protect taxpayers due to "unfair competition" arguments
    - Regulators have repeatedly shown their preference for supporting those they regulate
    - OCC (Office of Comptroller of Currency) is particularly well known for cozying up to and protecting banks with national charters

Conclusions (cont.)

- Unlikely all derivatives will move to a clearing and exchange traded model
- Given a critical mass of private OTC derivatives and still existing private repo, basic systemic fears will remain
- Historical experience with political process for declaring a large financial institution in distress not promising for early intervention
- FDIC resolution process also more consistent with continuing large institutions (best case is large firm reappears - worst case it is added to another large firm)
- International competitiveness arguments have no historical push back from either elected representatives or regulators
- With entrenched "Too Big To Fail" institutions and broad powers for regulators, bailouts will continue

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