DODD-FRANK APPROACH TO SYSTEMIC RISK

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Too Big To Fail

- Chairman Bernanke defined the problem as follows:
  
  “A too-big-to-fail firm is one whose size, complexity, interconnectedness, and critical functions are such that, should the firm go unexpectedly into liquidation, the rest of the financial system and the economy would face severe adverse consequences.”
  
  - We said: “When in order to stave off unacceptable political or economic risks, governments would put taxpayer money at risk to avert failure of an institution.”
  
  - Swiss Commission of Experts: “A firm that provides services that are essential to the economy and other market participants cannot replace these services within a reasonable period of time.”

- Fannie Mae, Freddie Mac, AIG, Citi among others were examples before Dodd-Frank. Following Lehman, assumption was that all major financial institutions, bank and non-bank, would be saved until legislation enacted.

- Lord Turner has further refined the issue:
  
  - Institutions can be (a) too big to fail, (b) too interconnected to fail, or (c) too big to save (i.e., size relative to the economy of the national domicile deprives national regulator of resources for an orderly liquidation, much less rescue).
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- Goal of Regulatory Reform as articulated by the G-20
  - Every financial institution should be able to die quietly without disrupting the market and without taxpayer support.

- Alternatives that have been proposed and debated
  - Limitation on size
  - Improving existing regulation and supervision to reduce risk
  - New regulatory mechanisms to monitor and reduce systemic risk in individual institutions, financial system as a whole
  - Insolvency regime capable of unwinding largest financial companies in a manner that protects domestic and international financial markets.
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- Limitation on size
  - Simon Johnson’s proposal in 13 Bankers.
  - Number of banks affected.
  - Stiglitz in Freefall has a variation of this approach. He would combine breaking up too big to fail institutions, restricting their activities and calibrating deposit insurance, capital requirements to “level the playing field.”
  - Particularly relevant in light of concentration in the industry.

- Criticisms of size limitation
  - Size constitutes neither a necessary or sufficient condition – Bear Stearns, savings and loan crisis.
  - Raghuram Rajan in Fault Lines argues size restrictions would lead banks to conceal activity from regulators, only to have it come back to light and balance sheets at the worst of times.
  - Other ways to control risk posed by size.
  - Could affect competitive position of institutions restricted.
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- Size limitation generally rejected in Dodd-Frank, with exception of merger, acquisitions.

- Rejected by Swiss Committee of Experts. Open issue in the U.K.

- Improving existing Regulation and Supervision To Reduce Risk
  - Stricter separation of the commercial bank with its insured deposits from affiliated investment and other non-banking subsidiaries.
  - Roubini’s approach – no loans or extensions of credit; restrict investment bank’s use of short term funding.
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- New Regulatory Mechanisms

  - Revival of Glass-Steagall. Variant: mandatory activity restrictions ab initio; discretionary restrictions imposed as institutions weaken. Shortcomings. Citi.

  - Limited Purpose Banking System
    - Laurence Kotlikoff’s proposal in Jimmy Stewart is Dead.
    - Banks create, intermediate but take no risk

  - Regime of systemic oversight and structural reform – Robert Pozen in Too Big to Save
    - Consolidated regulator for diversified financial conglomerates with oversight of all affiliates to prevent build-up of risk in unsupervised entities, i.e., curtail “shadow banking.” Eliminate U.S. fragmented regulatory structure.
    - Capital requirements and incentives designed with crisis scenarios in mind; e.g., capital requirements should account for liquidity risk, not just interest rate and credit default risk
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- New Regulatory Mechanisms (continued)
  - Capital enhancements, including buffers. Basel III
  - Leverage constraints
  - Contingent capital
  - Stress test
  - Enhanced and flexible resolution authority
  - Elimination of shadow banking system. Group of 30 Report and recommendation concerning money market mutual funds.

- Role of the G-20
  - Declaration on Further Steps to Strengthen the Financial System
  - Heightened Prudential Standards; Firm specific contingency plans; establishment of crisis management groups; strengthen legal framework for crisis intervention, winding down firms.
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- **Role of the FSB**
  - Roles of Colleges of Supervisors.
  - Approaches to coordinated cross-border resolution authority.

- **Progress to date in achieving a common approach to oversight and management of systemic risk:**
  - Dodd-Frank
  - E.U. and revision of regulatory structure.
  - U.K.’s Independent Commission on Banking: Issues raised for comment.
    - Separation of retail and investment banking
    - Narrow banking and limited purpose banking
    - Limits on proprietary trading and investing by deposit taking institutions
    - Contingent capital
    - Structural separability, including living wills and resolution schemes
    - Recommendations due by September 2011
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- Progress to date in achieving a common approach to oversight and management of systemic risk: (continued)

  - Switzerland – the Committee of Experts approach
    - Capital
      - Minimum for normal business activities
      - Buffer
      - Progressive component rising with increasing systemic impotence of affected bank.
    - Organization
      - SIFI must organize itself so that continuation of systemically important functions guaranteed if crisis.
      - Falling capital ratio leads to spin off; contingent capital converted.
      - Liquidity
      - Risk diversification
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- Dodd-Frank approach

- Rejected size limitation per se or repeal of GLB. Rather determined that combination of the following would limit or eliminate moral hazard:
  - Enhanced oversight of wider range of significant financial institutions;
  - More rigorous capital, liquidity and leverage requirements, coupled with restrictions on certain activities and power to restrict activities of weakened financial institutions;
  - Enhanced and flexible resolution authority; and
  - Limitation on growth by acquisition.

- Took very few decisions, deferring to regulators to oversee, act and report in a new complex regulatory structure. Powers granted quite wide.
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- Financial Stability Oversight Council

- 10 voting members, 5 non-voting members

- Task is to identify risks that could arise from the material financial distress or failure, or ongoing activities of large, interconnected bank holding companies or non-bank financial companies

- Mandate – collect information, assess gaps in regulation or identify activities that should be subject to more stringent regulation

- Compare to ESRB

- Council must identify all systemically important non-bank financial companies doing business in U.S. FRB will oversee these entities as well as all bank holding companies with more than $50 billion in assets (SIFIs). First meeting on October 1. Advance Notice of Proposed Rulemaking concerning designation of SIFIs, implementation of Volker Rule.
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- Financial Stability Oversight Council (continued)

- SIFIs will be subject to heightened capital, liquidity and other prudential standards; risk management requirements; concentration limits for credit exposure to customers; living wills; periodic stress tests; 15:1 leverage ratio for any SIFI which poses a grave threat to financial stability.

- Additional tools to restrict size, growth and activities of SIFIs, including power to block acquisitions, require divestiture.

- With exception of Volker rule, all these mandates are not self-implementing, depending on regulatory action in a fragmented system where consensus may be difficult to achieve.

- How responsive, effective and efficient can the Council be?

- Moreover once market is aware of SIFIs, is it likely there will be a different market perception with respect to moral hazard?
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■ Volker Rule
  ➢ Prohibits banking entities from engaging in some types of proprietary trading. Extremely contentious.
  ➢ Imposes limits on sponsoring or investing in hedge funds or private equity funds.
  ➢ Non-bank SIFIs not subject to rule, but will be subject to additional capital and quantitative limits.
  ➢ JPMC and GS.
  ➢ Foreign bank holding companies can engage in these activities solely outside the United States.

■ Derivatives
  ➢ Mandatory clearing and trading on designated exchanges or other trading platforms.
  ➢ Push-out provision.
  ➢ Central clearing parties may be systemically significant and designated as such by the Council. As a result, the FRB will have oversight and can review capital, other requirements.

■ Hedge Funds
  ➢ U.S. approach.
  ➢ E.U. approach.
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- Resolution Authority
  - Congress weighed two options:
    - Modifying existing bankruptcy regime to provide more flexibility.
    - Create new regime based on the administrative bank receiverships of the FDIA.
  - Congress opted for a new regime and created an orderly liquidation authority ("OLA"). Applicable if regulators determine at time of failure a SIFI should be liquidated under OLA because of effects on market stability. Otherwise subject to existing resolution authority, typically bankruptcy.
  - Effective resolution authority is the essential component in dealing with Too Big To Fail.
  - But unlike the existing FDIA approach for insured depositary institutions, there are significant limitations with OLA, because of domestic politics.
  - Liquidation is the only option. Thus, all losses imposed on unsecured creditors, shareholders.
  - Management, Boards must be axed.
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Resolution Authority (continued)

- FDIC receivership under OLA not only displaces bankruptcy but other forms of governmental assistance. FRB can no longer lend to a particular firm.

- Flaws
  - Only applicable to U.S. entities. Would it have made a difference if in place when Lehman collapsed? FSB will in November issue its views about global coordination.
  - FDIC does not have recourse to a dedicated fund to avoid disruptive liquidation process. FDIC must borrow from the Treasury.
  - FDIC emergency loan guarantee authority restricted to firms in receivership. Under Dodd-Frank, FDIC can issue guarantees to financial firms not in receivership only with prior Congressional approval, which is likely to be seen as a bailout.
  - Receivership path of least resistance, resulting in likely nationalization of many firms if there is a significant failure.
  - FRB’s emergency lending authority constrained, limiting capacity to provide sectorial relief in a financial emergency.
  - Dodd-Frank reliance on receivership may successfully resolve an individual failing firm, but likely to exacerbate a financial crisis.
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- Resolution Authority (continued)
  - Need for funding from sector to provide more flexibility – Gordon proposal.
  - Bank tax generally.

- IMF Approach
  - “Well-designed resolution frameworks that allow authorities to address the insolvency of financial institutions – not just banks and not just within national brokers – are . . . necessary ingredients of a strategy to maintain global financial stability.” (IMF Staff Position Note Oct 3, 2010)
    - Financial Stability Contribution.
    - Four prong approach in IMF Staff Position Note.
      - Recovery and resolution plans (so-called “living wills”).
      - Effective resolution regimes.
      - Cross-border resolution frameworks, burden-sharing arrangements (e.g., with respect to insured deposits).
      - Absent effective cross-border resolution authority, “stand alone subsidiaries” or ring fencing.
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- International Coordination
  - FSB mandate
    - Colleges of Supervisors
    - Guidelines for cross-border resolution coordination
  - IMF
    - Peer review
    - Name and shame

- Impact on Competitiveness