Understanding the Post-Crisis Financial Reform Agenda in the US

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Outline

• I. The Rise of Post-Crisis Reform Agenda

• II. Basel III Rules

• III. Dodd-Frank overview

• IV. Implementing the Tailored Approach
1. The Rise of the Post-Crisis Reform Agenda
Post-Crisis Regulatory Framework

• Macro-prudential techniques
  – Time-varying capital requirements
  – Dynamic provisions
  – Capital insurance schemes
  – Lending criteria
  – Warnings of risk buildup by supervisors
  – Interest rate policy
Post-Crisis Regulatory Reform Framework

Because of the financial crisis regulators have focused on a range of Micro-prudential techniques:

– Liquidity standards
– Contingent capital schemes
– Intervention and resolution of large banks
– Special resolution authority
Post-Crisis Regulatory Architecture

• Core objectives:
  – Higher and better quality capital
  – Stronger liquidity
  – Increased resolvability

• New regulation has improved resilience of the financial sector but involved significant costs:
  – Heightened capital regulation
  – Stress Testing
  – Liquidity Regulation
  – Resolution Authority
Post-Crisis Regulatory Reform Agenda

• Regulation that may require changes or repeal:
  – Stress-testing for smaller banks
  – Heightened capital liquidity for small banks
  – Volker rule

• Central question is how to allow for greater regulatory and supervisory differentiation across
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• I. Post-Crisis Reform Agenda
• II. Basel III Rules
• III. Dodd-Frank overview
• IV. Treasury Reform of Dodd-Frank
Basel III Rules
Heightened Capital Requirements

• High capital burden under Basel III CET1 position of the bank (4.5%) (with buffers 7%)
• Additional Capital Buffers:
• Capital Conservation buffer of 2.5% CET1 buffer to ensure banks build up capital outside periods of stress
• Global Systematically Important Bank Surcharge with potential top-up requirements of 1 to 3.5% CET1
• Counter-cyclical Buffer applies some of the time and may be set at 2.5% CET1.
Are the Changed Capital Requirements Enough?

Major changes to Capital Regulations:
• CET1 capital has been substantially increased.
• Efforts have been made to reduce procyclicality of capital rules through two buffers (CCB and CCCB).
• Systemic importance has been recognized through introduction of further buffer for systemically important banks.
• Higher levels of CET1 increase chances that a bank will survive an external shock.
Criticism of Changed Capital Requirements

Criticism:

• It may be that only very high levels of equity (25% or more) will provide some guarantee of survival (Admati and Hellwig 2013).

• On the other hand, substantially higher levels may induce short term investors to withdraw their investments in the case of uncertainty in the value of their assets.
Heightened Liquidity Requirements

Net Stable Funding Ratio and Liquidity Coverage Ratio (LCR) designed to provide more stable funding reducing immediate requirements

- Net Stable Funding Ratio (NFSR)
- Limiting the extent to which banks can finance long-term liquid assets using short term debt.
- Ratio involves: (1) weighting banks’ assets according to the likelihood of the bank being able to liquidate them at face value in a stressed market; (2) weighting the banks’ liabilities according to the likelihood of funding being withdrawn at the same institution.
Heightened Liquidity Requirements (2)

- Stability by type of funder matters. Retail and business customers are preferred over short term wholesale funding.
- Liquidity characteristics are important, but also tenor of the asset.
- Long-term commercial loans require stable funding of 65-85% of the face value of the loan, no requirements for shorter funding of 6 mos.
Heightened Liquidity Requirements: Liquidity Coverage Ratio

Liquidity Coverage Ratio (LCR) designed to ensure that banks have sufficient cash and other high quality liquid assets on hand to meet withdrawals during a severe 30-day run scenario.

- Liquidity Coverage Ratio (LCR)
- To model likely outflows: rules require minimum run-off rates for different classes of bank liabilities (percentage of liability class that would be withdrawn during the 30-day stress period).
- High Quality Liquid Assets (HQLA) requirement of on availability of funds includes: cash, treasures, any investment grade bond and some securitization issues.
Liquidity Coverage Ratio: Concerns

• Concerns:
• LCR may consume large quantities of high-quality liquid assets that could create a costly and unnecessary shortage of such assets.
• Cost of holding at all times liquid assets will likely have significant impact on banks’ businesses (eg transformation function of bank impeded).
• New form of regulation—not a simple requirement that a certain amount amount of bank’s assets be in liquid form. Rather, liability and asset side of bank’s balance sheets are linked up. HQLA requirement is a function of predicted stability of short-term funding in stressed scenario.
Liquidity Coverage Ratio: Concerns (2)

• Concerns:
• Maybe unclear whether banks will be willing to draw down liquidity buffers in a stressed liquidity scenario.
• LCR is a buffer not minimum and thus can fall below a 100% ratio of liquid assets to expected cash flow in a stressed scenario.
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Dodd-Frank
Dodd Frank: Coverage

- Systemic Risk
- Banking Industry
- Derivatives
- Hedge Funds and PE
- Securitization
- Consumer and Investor Protection
- Corporate Governance and Executive Compensation
Dodd-Frank Rulemaking Progress on Passed Deadlines
As of April 2, 2012

Total (222)
- Missed Deadline: Proposed, 134, 60.36%
- Finalized: Deadline Passed, 67, 30.18%
- Missed Deadline: Not Proposed, 21, 9.46%

Bank Regulators (73)
- 51, 70%
- 6, 8%
- 16, 22%

CFTC (53)
- 19, 36%
- 33, 62%
- 1, 2%

SEC (73)
- 53, 73%
- 6, 8%
- 14, 19%

Other (23)
- 11, 48%
- 8, 35%
- 4, 17%

Rulemaking counts are based on estimates and require judgment.

Values Refer to Number of Rulemaking Requirements
Dodd-Frank Rulemaking Progress in Select Categories
As of April 2, 2012

- Asset-Backed Securities Offerings: 14
- Banking Regulations: 44
- Collins Amendment: 6
- Consumer Protection: 63
- Credit Rating Agencies: 22
- Derivatives: 90
- Executive Comp. / Corp. Governance: 15
- Mortgage Reforms: 43
- Orderly Liquidation Authority: 21
- Investment Advisers / Private Funds: 7
- Investor Protection / Securities Laws: 11
- Systemic Risk: 28

Rulemaking counts are based on estimates and require judgment.
Number of Required Rulemakings (Joint Rules are Counted for Each Applicable Agency)
Systemic Risk

• Financial Stability Oversight Council
• Stress Testing
• Orderly Liquidation Authority
Financial Stability Oversight Council

- Financial Stability Oversight Council
- FSOC is responsible for monitoring systemic risk posed by SIFIs and respond to threats to stability of financial system.
- Systemically important is a category that includes all large banking groups (BHCs with more than $50B in assets), but FSOC can also designate other firms that it considers appropriate.
- Criteria for SIFI designation: whether material financial distress of firm could pose a threat to US financial stability; and whether the nature, scope, size, scale, concentration, interconnectedness of or mix of activities at firm (even absent financial distress) could pose a threat (Dodd-Frank Act, sec 113(a)(1)).
Financial Stability Oversight Council

• Non-bank SIFIs are subject to enhanced prudential oversight, along with systemically important banks.

• FSOC designated all three insurers, Met Life, Prudential financial, and AIG, on the basis that financial distress could pose a threat of financial stability to the economy of US.

• Concerns: structure of FSOC is cumbersome and hence it make limit the speed and predictable intervention of regulators.
Stress Testing

• Federal Reserve implemented requirements of stress tests for setting time-varying capital requirements in relation to banks.
• Comprehensive Capital Analysis and Review (CCAR) assesses if banks have robust forward looking capital plans of projected losses and revenues based on each bank’s portfolio and circumstances.
Stress Testing (2)

- Loss estimates are used to determine post-stress capital ratios and ratios under adverse circumstances.
- Banks are required to restrain share buybacks and dividends if stress test shows that the bank would fall short of regulatory benchmarks in stressed environment.
- Transparency Concerns: Fed can change parameters each year without letting banks know full details (more costs for banks).
- Benefits: changes in microprudential measures (eg., require banks to have more capital to cover higher than expected write-offs)
Orderly Liquidation Authority

Orderly Liquidation Regime (OLR) was created to facilitate orderly failure of large, complex financial firms (see Resolution slides for details).

- Title II of Dodd-Frank created FDIC’s Single Point of Entry (SPOE) resolution strategy.
- Procedure: FDIC will impose receivership on SIFIs and then transfer its assets to a bridge bank (Holdco). Holdco disappears into the FDIC receivership while the bridge bank continues. Holdco’s debt will be partially written off and partly converted into equity of fully capitalized bridge bank.
- Scope: foreign subsidiaries will be protected in same manner.
Total Loss Absorbing Capacity

Federal Reserve’s Total Loss Absorbing Capacity (TLCA) requirements for the very largest financial firms (applies to all G-SIBs)

• Aim: to ensure that stockholders and long-term debt-holders of large financial firms—and not taxpayers—bear the losses associated with any future financial failures.

• Requirements: TLAC of equity plus subordinated term debt that is greater than twice the amount of equity capital on both risk-weighted and leverage measures.
Total Loss Absorbing Capacity (2)

- TLAC equal to the greater of 18% of risk-weighted assets (plus additional regulatory capital buffers when appropriate), and when fully phased in, a Basel III leverage ratio of 6.75%.
- Six of the eight US G-SIBs fall short of the 18% risk weighted assets or 9.5% of total leverage and will need to raise $120B in TLAC, including long-term debt, which should be held outside banking system.
Special Resolution Regime

Summary

• SPOE creates a credible mechanism for implementation of bail-in strategy

• Reforms have addressed the too-big-to-fail problem by reducing the implicit guarantees which benefited larger financial firms before the crisis.

• Since long-term debt holders may suffer losses in an orderly failure, they will be more selective to whom they are willing to lend to.

• Evidence already reveals that the ratings on long-term debt of largest US financial firms have declined.
Banking Industry

• Regulatory consolidation (with greater powers for the Fed)
• Volker Rule (Title VI, Sec 619 of Dodd Frank): rationale to mitigate systemic risk.
  – Prohibition on proprietary trading (acquisition or disposal of securities principally for the purpose of benefiting from short-term price movements.
  – Ban extends to doing this through investment in a fund, and taking an equity interest or sponsoring a private equity or hedge fund.
Volker Rule

• Criticisms of Volker Rule
• 1. No evidence that proprietary trading had any destabilizing effect during or after the financial crisis.
• 2. Rule limits ability of banks to diversify.
• 3. Discouraging speculation at broker-dealer banks will dissuade dealers from providing liquidity during a market correction.
• 4. Hard to distinguish between market-making and proprietary trading in practice and hence some difficulty involved in enforcement.
• 5. Moving proprietary trading groups from banks to hedge funds is likely to result in same risks within the financial system, with little regulatory oversight.
Consumer Protection

• Bureau of Consumer Financial Protection
• Preemption provisions (state-federal law dichotomy)
Enforcement & Litigation Provisions

- Dodd-Frank provides regulators and private litigants with enhanced incentives and expanded rights in key areas:
  
  **Securities**
  
  i. Whistleblower Incentives and Protections
  
  ii. Restoration of Extraterritorial Jurisdiction for Antifraud Provisions
  
  iii. Nationwide Service of Subpoenas
  
  iv. Civil Penalties in Administrative Proceedings
  
  v. Executive Compensation Clawback
  
  vi. Control Person Liability Clarified
  
  vii. Aiding and Abetting Violations
Enforcement & Litigation Provisions

Consumer finance litigation
  i. State Consumer Protection Laws
  ii. Whistleblowers in the Consumer Finance Context
Corporate Governance: Say on Pay

• Executive Compensation:
  – § 951: Added §14A to ‘34 Act to require corporation to:
    • Provide shareholders with advisory vote on executive compensation
    • Provide shareholders with advisory vote on frequency of say-on-pay vote
    • Provide shareholders with advisory vote on golden parachute arrangements
Impact of “Say-on-Pay”

- 45 companies failed to win the support of a majority of SHs in 2012
- Those companies are working to avoid an embarrassing repeat in 2012
  - meeting with investors, hiring new compensation consultants, reducing use of stock options, etc.
- Executive turnover at companies that failed say-on-pay votes in 2011 is 2x higher than at companies overall
  - 25% of those that failed say-on-pay in 2011 got a new CEO
  - 20% got a new CFO
  - In comparison: overall annual CEO turnover rate of 9% and CFO turnover rate of 12%
- Citigroup CEO Vikram Pandit’s $15 million package failed say-on-pay vote in April 2012
- Shareholders derivative suits related to say-on-pay votes: most have failed, but some have led to settlements, and a few have survived motion to dismiss
2012 Say-on-Pay Vote Results for Companies Under 70% in 2011

<table>
<thead>
<tr>
<th>Company</th>
<th>Meeting Date</th>
<th>GICS Industry</th>
<th>S&amp;P 500</th>
<th>Trailing 4Q Revenue</th>
<th>Say on Pay Vote Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rofin Sinar Technologies Inc</td>
<td>03/15/12</td>
<td>Electronic Equipment, Instruments &amp; Components</td>
<td>$592</td>
<td>76%</td>
<td>70%</td>
</tr>
<tr>
<td>Monsanto Co</td>
<td>01/24/12</td>
<td>Chemicals</td>
<td>X</td>
<td>$12,425</td>
<td>87%</td>
</tr>
<tr>
<td>Johnson Controls Inc.</td>
<td>01/25/12</td>
<td>Auto Components</td>
<td>X</td>
<td>$41,713</td>
<td>58%</td>
</tr>
<tr>
<td>AECOM Technology Corp</td>
<td>03/08/12</td>
<td>Construction &amp; Engineering</td>
<td>$8,130</td>
<td>58%</td>
<td>61%</td>
</tr>
<tr>
<td>SurModics Inc</td>
<td>02/06/12</td>
<td>Health Care Equipment &amp; Supplies</td>
<td>$65</td>
<td>96%</td>
<td>59%</td>
</tr>
<tr>
<td>Headwaters Inc</td>
<td>02/23/12</td>
<td>Construction Materials</td>
<td>$596</td>
<td>78%</td>
<td>53%</td>
</tr>
<tr>
<td>Hewlett-Packard Co</td>
<td>03/21/12</td>
<td>Computers &amp; Peripherals</td>
<td>X</td>
<td>$124,979</td>
<td>77%</td>
</tr>
<tr>
<td>Beazer Homes USA Inc.</td>
<td>02/07/12</td>
<td>Household Durables</td>
<td>$822</td>
<td>95%</td>
<td>46%</td>
</tr>
<tr>
<td>Jacobs Engineering Group Inc.</td>
<td>01/26/12</td>
<td>Construction &amp; Engineering</td>
<td>X</td>
<td>$10,657</td>
<td>96%</td>
</tr>
<tr>
<td>Shuffle Master Inc</td>
<td>03/15/12</td>
<td>Hotels, Restaurants &amp; Leisure</td>
<td>$240</td>
<td>86%</td>
<td>45%</td>
</tr>
</tbody>
</table>

1 As of April 4, 2012.
Economic Growth, Regulatory Relief and Consumer Protection Act (2018)
Key Reforms

Legislation introduces some major changes including:

- **SIFI Threshold**—raising the threshold from $50B to $250B and allowing some banks with $100B in assets to be exempt and those between $100B to $250B is assets subject to Fed discretion.

- **Volker Rule**—Repeal of Volker rule for banks with assets less than $10B.

- **Stress-tests**: Repeal of Dodd-Frank rule requiring BHCs with assets less than $250B to run company-run stress tests.

- **Amended LCR rules**—exempting municipal banks with less than $10B exempt from generally applicable and capital and leverage requirements.
EGRRCPA Approach

- Seeks to improve efficiency in achieving core post-crisis objectives
- Tailoring of regulation according to asset size is but one factor
  - Banks have different business models
  - Also, a variety of risk profiles
  - Need to consider other factors
Phasing in targeted measures for some group of banks

- Most suited for Community Banking Organizations and small BHCs
- But cannot be introduced overnight
- Tailoring can apply to banks of any size
  - Tailoring can be applied to an individual bank or class of banks, based on certain statutory factors.
- Also a staggered approach for larger BHCs
  - New regime for BHCs with more than $100B-$250B in assets to tailor or flexibly eliminate some rules.
Regulatory Relief for Smaller Institutions

• Dodd-Frank modifications focused on reducing regulatory burden:

• Volker Rule
  – Exemption for banks with less than $10B in consolidated assets
  – Funds permitted to share name of banking entity that is investment advisor to fund

• Capital Requirements for Small Institutions
  – New Community Bank Leverage Ratio of 8-10% for depository institution, bank or BHC

• Small Bank Regulatory Relief
  – Ability to repay safe harbor for depository institutions
  – Short –form call reports for institutions with less than $5B in consolidated assets
Wrap Up
Key Points

• Dodd-Frank is only the latest in a series of federal interventions in corporate governance/financial market activity
• Legal complexity expands exponentially with each intervention
• Only time will tell if Dodd-Frank remedies weaknesses in financial regulation of banks and the architecture for bank governance
• Evidence seems to point to several financial regulatory reforms that are well-conceived and may provide greater financial stability:
  • Heightened capital regulation
  • Stress testing and capital planning
  • Liquidity regulation
  • Resolution authority
• Post-crisis reforms some reforms have been subject to modification in order to introduce tailoring:
  • Volker Rule
  • Dodd-Frank thresholds