GARP Webcast

The Risk Management Implications of the Dodd-Frank Act

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January 11, 2011

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The Risk Management Implications of the Dodd-Frank Act

The financial crisis has reshaped banking and the regulation of banks and financial services

- National and international efforts
  - CRD IV
  - Dodd-Frank Act
  - Basel III Accord

- The objective is to reduce the likelihood of a new financial crisis
  - Raise capital levels
  - Improve risk management practices
  - Focus on allowable activities
  - Address shortcomings in the system

- Dodd-Frank Wall Street Reform and Consumer Protection Act
  - Significant regulatory realignment in the US
  - Global jurisdictional impact
Dodd-Frank and Its Impact on Risk Management During 2011

From regulatory efficacy and suitability to day-to-day risk management challenges

- Regulatory efficacy and suitability:
  - Regulating the financial sector effectively from an economic perspective
  - Comparing the impact of Dodd-Frank with the New Deal
  - Learning from experience

- Day-to-day risk management challenges:
  - The impact on risk management
  - The impact on risk managers
  - Ongoing challenges
  - Future challenges
A View of the Dodd-Frank Act*

* Based on "Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance," John Wiley & Sons, Nov. 2010. "Regulating Wall Street" was a joint effort of 40 faculty members and students at NYU Stern and was edited by Viral V Acharya, Thomas Cooley, Matthew Richardson and Ingo Walter.
A View of Dodd-Frank

A four-part evaluation:

- Encore: Causes of the financial crisis of 2007-09
- Assessment of the Dodd-Frank Act from the first principles
- Comparative evaluation relative to financial reforms of the 1930s
- What-if analysis for the Dodd-Frank Act during 2003-08
(Lack of) Pricing Guarantees

Guarantees, if uncharged, distort capital budgeting of economy

- Walter and Weinberg (1999): 45% of all ($8.4 trillion) financial liabilities in the U.S. received some form of guarantee.
- Malysheva and Walter (2009): 58% of all ($25 trillion) are under safety net.
- Government guarantees lower cost of debt, raise financial sector leverage, distort capital budgeting to riskier assets, increase financial fragility.

1. GSEs, the largest — government sponsored — “hedge fund,” ignored in the Act.
2. No proposal to reform FDIC insurance premium so that banks pay premiums in good times too.
4. Orderly Liquidation Authority (OLA) does not cover all systemic institutions nor rule out future guarantees with certainty.
Systemic risk of failures implies costs beyond firm’s stakeholders

- Simply wiping out management, shareholders, creditors *ex post* may not suffice to internalize the full costs of failure.
- No attempt in the Act to change an upfront tax for those firms whose systemic risk contributions are greater.
  - See “Measuring Systemic Risk” — Acharya, Pedersen, Philippon and Richardson (2010)
- What is worse, the Act proposes a scheme that aggravates systemic risk.

1. Charging the surviving SIFIs when other large banks fail is poor design.
   - Can exacerbate recession and credit crunch by weakening remaining banks.
   - Hence, SIFIs unlikely to pay for systemic risk *ex post* or *ex ante*.
   - Banks may even find it better to herd and all fail together.
2. The Act limits Fed LOLR to individual non-depositories but creates no *ex ante* funds for resolving their failures.
The Act remains preoccupied with depository institutions

- Several bank-like non-banks in the financial system: investment banks, money-market funds, swap dealers, some insurance companies, etc.
  - Giving access to federal assistance to banks but not to others creates the lack of level playing field.
    - Can create “race to the bottom” in risk between banks and non-banks.
    - Also as non-banks approach distress, they will merge with banks.
  - The Act will lead to creation of central clearinghouse for derivatives.
    - Mark Twain: “Put all eggs in a basket” but then “watch that basket!”
    - Ruling out Fed’s LOLR to clearinghouses while they get recapitalized can create disorderly liquidation and uncertainty.
While the Act deals with OTC derivatives reasonably well, it remains agnostic about systemic risk in other markets.

- Collection of small institutions and economic agents and transactions can be systematic if it is central to plumbing of the financial sector.
- Examples: Payment and settlement systems, wholesale financing markets (repos, money market funds), reserve currency market (currently, mainly USD).

1. Sale and repurchase agreements (“repos”): Estimated $5 - $10 trillion.
   - Contain a “fire sale” externality, akin to runs on banks by demandable deposits.
   - No resolution proposed: Cannot simply pass losses to end financiers all at once.
   - Emergency repo bank (LOLR) or repo resolution authority (like FDIC) needed.

   - Uninsured deposits, subject to same risk of runs in the pre-FDIC era.
   - Again, no resolution proposed under the Dodd-Frank Act.
“The difficulty lies, not in the new ideas, but in escaping from the old ones…”

Sizing Up Dodd-Frank: A Risk Manager’s Perspective
Key Focus Areas

Many provisions cut across risk management processes and activities. Here are a few with game-changing potential for risk managers:

• Governance
  o Provisions for board risk committees
  o Risk experts on boards
  o Executive compensation and incentive alignment with risk-taking

• Risk identification
  o Financial Stability Oversight Council and Office of Financial Research
    ▪ Development of data standards

• Risk management
  o Derivatives transparency
  o Securitization
    ▪ Risk retention rules
    ▪ Qualified Residential Mortgage (QRM) definition

• Risk measurement
  o Credit ratings
Risk Committees — Policy and Impact

Policy:

• Applies to all public bank holding companies and non-bank financial companies with over $10B in assets
• Oversight by the Fed
• Responsible for enterprise-wide risk management oversight
• At least 1 risk management expert

Impact:

• Strengthens governance for risk managers by providing greater “air cover” for risk management teams
• Enhances the stature of risk management as a key focus area within the company
• Firms should consider taking these measures further by having the Chief Risk Officer report at least indirectly if not directly into the head of the risk committee
• Does not satisfactorily address smaller firms board level risk governance
Office of Financial Research — Policy and Impact

Policy:

• OFR becomes the analytical arm of the Financial Stability Oversight Council
• Among its duties will be to establish standards for reporting of financial data across institutions including exposures and transactions

Impact:

• Greater scrutiny on data at the enterprise level than ever before by regulators
• Should facilitate enterprise data warehousing activities that in many firms received limited support
• Creates huge opportunity for risk managers to take the lead in their firms for designing the data processes for the enterprise
• Will facilitate greater integration of risk information vertically and horizontally
• Some potential concerns over regulatory reporting burdens above existing data requests
• Some potential concern over release of sensitive or proprietary information, particularly for customer data
Securitization: Risk Retention and Qualified Residential Mortgages — Policy and impact

Policy:

• <100% QRM securitizations
  o Requires securitizers to retain an economic interest in a portion of the credit risk of a securitized asset
  o Minimum of 5% of credit risk to be retained for securitizations not 100% QRMs
  o Could be <5% if the originator meets certain underwriting standards
  o CMBS risk retention could be satisfied with a 1st loss position by a qualified 3rd party purchaser
  o No ability for risk transference of risk retention requirement

• 100% QRMs
  o No risk retention for securitizing firm

• QRM definition
  o TBD by regulatory interagency group
  o Product and risk attribute-focused
Impact:

- Still an unknown until regulators define what a QRM is
  - Product risk could be substantially altered
  - Reps and warrant issues currently plaguing the mortgage industry not fully addressed

- Could be significant depending on how wide or narrow the QRM “box” winds up defined
  - Broad QRM definition
    - Reduces risk retention impacts on firms
    - Reduces capital needs
    - Less effective at controlling mass marketed products with excessive risk layering
  - Narrow QRM rule
    - Could increase significance of FHA mortgages
    - Potentially increases the accuracy of loss prediction models by limiting inclusion of loans with risk layering and limited historical performance
    - Could raise borrower costs and limit credit availability
Dodd-Frank and Risk Management Takeaways

- New risk committee provisions are the vehicle to elevate stature for risk management at the largest firms
  - Expect some trickle down effect for smaller firm regulators to apply/recommend some variation of this provision
  - Enhances the possibility for risk managers to have a more independent voice without putting careers at jeopardy
  - Provisions do not go far enough in supporting risk managers

- Office of Financial Research will raise the importance of data warehousing to a new level at the financial firm
  - Risk managers need to take strategic control of the process and assert themselves in ways perhaps not possible before
  - Will not be easy to navigate against new data and information requests from a new regulator

- Risk retention and QRMs create “skin-in-the-game” consequences for securitizations
  - A narrower definition could improve loss prediction
  - Enhances ability to understand and price risk better
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