Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance, A Review

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Abstract

This article is a review of a 531 page book that in turn is a review and evaluation of the 2,319 page Dodd-Frank Wall Street Reform and Consumer Protection Act passed by Congress on July 16, 2010. The overriding theme of the book is to pose two approaches to attaining financial stability in the future. One approach is to establish a council of wise men and women supported by an army of highly skilled professional financial economists to formulate and implement regulations designed to prevent future financial crises that wreak havoc on the real economy and require financial support from taxpayers. This is the approach of the Dodd-Frank Act. The second approach proposed by the authors of this book is to design a taxing system that taxes systemically important financial institutions on the basis of their contribution to systemic risk. Borrowing ideas from the literature on the taxation of negative externalities their view is that financial institutions that create crises should pay for the clean-up. They also argue that requiring the financial polluters to pay for the creation of systemic risk will reduce the supply of systemic risk. The reader is invited to decide which approach is best.

JEL Classification: E32, E44, E52, G18, G1
I. Introduction

This book by Acharya, Cooley, Richardson, and Walter is the sequel to an earlier book entitled *Restoring Financial Stability: How to Repair a Failed System* published by John Wiley & Sons in 2009. Both books are remarkable. They are remarkable in that they were both done roughly in one year, and both represent a remarkable feat in academic organization. It would be the equivalent of trying to herd 40 odd cats for some useful purpose. The first book consists of 18 chapters written by 47 different scholars (most of whom were from NYU) and is 377 pages long; while the sequel also consists of 18 chapters, a prologue, and an epilogue all written by 39 different NYU or visiting NYU scholars (many of whom participated in writing the first book) and is 531 pages. The first book *Restoring Financial Stability* was written in response to the financial crisis of 2007-2009 as the Dodd-Frank Wall Street Reform and Consumer Protection Act was in the process of being drafted by the U.S. Congress. It described the reasons why the financial system became seriously impaired in 2007-2008 and proposed reforms for both the prevention and financing of future meltdowns. *Regulating Wall Street* in turn describes and evaluates the Dodd-Frank Act as the official U.S. regulatory response to the crisis. It also compares Dodd-Frank to the proposals advanced in *Restoring Financial Stability*. To the extent Dodd-Frank proposals conformed to the proposals suggested in *Restoring Financial Stability*, the authors are generous in their praise. When Dodd-Frank strays from their proposals they are less generous. Based on these comparisons, *Regulating Wall Street* gives the Dodd-Frank Act the tentative grade of a “gentlemen’s B.” Our grade on their book is higher. For scholars and policymakers in the areas of money, financial institutions, and markets who have not read the 2,300 plus pages that describe the Dodd-Frank Act, *Regulating Wall Street* is a must read. For macroeconomists the Prologue and the first five chapters might suffice as a must read. For all others the Prologue and one or two of the special subject chapters might do. All concerned citizens should at least read chapter 17 on executive compensation in the financial services industry.

In beginning this review the main question is to decide what to report and what not to report in this wide-ranging book. To compare and contrast the Dodd-Frank Act and *Restoring Financial Stability* for all the issues covered in the 18 chapters would make this a very long review. Our strategy will be to focus on the author’s description of the main issues in the Dodd-Frank Act since that is probably the main reason this book will be read. However at times we
will discuss both the author’s views and our own on certain important issues taken up in the Act. Finally, many of the ideas described in the Act, this book, and our own view have appeared elsewhere in the voluminous literature that sprang up as the great financial and economic crisis unfolded in 2007-2009. We apologize in advance to these scholars that contributed to this literature but who will go unnamed in this review. The book itself is organized around five parts: i) Financial Architecture (3 chapters); ii) Systemic Risk (6 chapters); iii) Shadow Banking (4 chapters); iv) Credit Markets (3 chapters); and v) Corporate Control (2 chapters). Each part will be discussed in turn.

II. Financial Architecture

Chapter 1 sets the overall agenda for the book. The authors identify four regulatory paths to improve the financial architecture of an economy that satisfy their conditions for a good financial system. These conditions include: i) encourage innovation and efficiency; ii) provide transparency; iii) ensure safety and soundness; and iv) promote competitiveness in global markets. Obviously these conditions cannot be satisfied simultaneously and the choices that will be made will depend on the weight given to each of the four by regulators at a given point in time. For example, at present (spring 2011) regulators put a heavy weight on safety and soundness and this could compromise the criteria of innovation and global competitiveness.

The first regulatory path they call Modified Laissez-Faire. This is the path favored by the financial industry. It is also the path favored by the authors. In this path Gramm-Leach-Bliley rules permitting financial conglomerates would be maintained. To prevent future financial crises the authors would create a systemic risk regulator, design a tax on the systemic risk created by individual financial companies, improve the transparency throughout the financial system, and create a bankruptcy code more suitable to financial companies. Could modified laissez-faire succeed? According to the authors it would depend on how well the systemic risk regulator (eg., the Federal Reserve) would do its job. It would also depend on how well the regulatory authority is able to avoid regulatory capture. The authors admit that history provides little comfort here.

The second regulatory path is Glass-Steagall which separated commercial banking of deposit-taking and lending from the underwriting and trading business of investment banking. The main argument in favor of restoring Glass-Steagall is that it worked very well for almost a half century, although the authors also think that the economic position of the U.S. in the post-WW II period had something to do with that. It did not seem to impede innovation and global competitiveness, and it certainly fostered safety and soundness. Where it broke down was in
the regulatory capture following the oil shocks of the 1970’s and early 1980’s which in turn resulted in high inflation and interest rates and facilitated the growth of shadow banks in the form of money market mutual funds. The author’s view is that failure of the Modified Laissez-Faire approach in the future with a repeat of 2007-2009 would in all probability bring on some variant of Glass-Steagall.

The third path the authors call Functional Carve-Outs, Size Constraints, and the Volcker Rule. The main idea of the Volcker Rule part is to separate the financial intermediation function between savers and investors from the trading function which is becoming more casino like. The financial intermediation function would include traditional bank lending and traditional investment banking in the form of underwriting securities issues by firms so in this respect it is not a return to Glass-Steagall. Lumped in with the Volcker Rule is a constraint on size. Size is a determining factor of the government safety net underlying the policy of “to big to fail.” The authors feel there is little empirical evidence that size is a key determinant of efficiency, stability, and competitiveness, and for that reason they are inclined to believe that restrictions on size would be beneficial. However, recent evidence reported in Wheelock and Wilson (2009) and Mester (2010) would challenge their belief on scale economies.

The fourth and final path is that of Global Alignment. Regulation across countries should not be such that it impedes capital flows or gives rise to regulatory shopping by global financial institutions. Anything that impedes the flow of capital the authors argue would impede economic growth and for that reason is to be avoided. The so-called “race to the bottom” where financial institutions seek the most permissive regulatory environment in the authors view is overrated in that other factors such as good legal systems and supporting infrastructure are more important than regulation.

How does Dodd-Frank measure up to the four regulatory paths? According to the authors Dodd-Frank contains elements of all four but mostly from the Modified Laissez Faire and the Functional Carve-Outs, Size Constraints, and the Volcker Rule. Just how much it measures up or falls short of these regulatory paths will be the subject of the rest of this review. However, before beginning it is important to remember that Dodd-Frank is a political Act subject to all the political infighting fuelled and greased by an intense and well financed lobbying effort on behalf of the financial services industry. In a way it is surprising to us that the Congress took so much (but certainly not all) of the advice that was coming from the financial economics profession.

Chapter 2 discusses the role of the Federal Reserve in the new regulatory framework and chapter 3 the new consumer finance protection agency housed and financed within the Federal Reserve. The Dodd-Frank Act proposes major changes for the Federal Reserve. The Central bank has a new mandate to preserve the stability of the U.S. financial system along with its traditional mandates on full employment and price level stability. It is clear that all three
mandates are not internally compatible. The Federal Reserve orchestrated liquefaction of the financial system in the 2007-2009 crisis carries with it a massive increase in bank reserves and the dangers of future inflation. Whether the Federal Reserve will be able to extinguish these reserves without causing a recession and prevent inflation in the goods and/or asset markets in the future remains to be seen. This new mandate of preserving financial stability is to be implemented with a new vice chairman for supervision who will be appointed by the President subject to Senate confirmation. This vice chairman will formulate and recommend policy to the Board pertaining to financial stability and regulation, and report to Congress at least twice a year. While the Federal Reserve is given a new mandate on financial stability it is losing some flexibility in achieving that objective. What it is losing is the flexibility to lend to whatever company it thinks necessary to preserve financial stability. First and foremost the Federal Reserve can no longer lend to individual nonbank companies nor banks that pose a substantial risk of going bankrupt. Instead the Federal Reserve must make liquidity available to a general class of borrowers providing they can supply acceptable collateral. Secondly, to supply liquidity to a general class of financial companies using an extraordinary way (eg., the commercial paper funding facility) now requires permission from the Secretary of the Treasury. The purported reason for the first restriction is to preclude taxpayer subsidization of restructuring or liquidating financial companies. It is not clear what purpose Congress had in mind for the second restriction. The authors criticize both restrictions because there will be times when the Central bank must provide liquidity to various types of financial firms in a timely way to avert a crisis. Waiting to get the Secretary of the Treasury on board may be costly and result in a missed opportunity. Finally, the Federal Reserve will be subject to more stringent reporting requirements. To begin with, all lending transactions (both ordinary and extraordinary) are subject to full public disclosure. This involves disclosure of amounts, terms of loans, and names of counterparties. The authors worry that this detailed disclosure will discourage some weaker banks from participating in borrowing through ordinary discounts and advances, and the special borrowing through the term auction facility of the Federal Reserve because of potential negative signaling effects from this disclosure.

Another major change resulting from the Dodd-Frank Act (and the subject of chapter 3) was the creation of the Bureau of Consumer Financial Protection and its location as an independent entity within the Federal Reserve. Typically financial crises reveal a number of sharp if not outright fraudulent practices and 2007-2009 was no exception. Many of these practices centered on the contractual terms of subprime home mortgages such as 2/28 adjustable rate mortgages, prepayment fees, and others. Other perceived abuses were in so-called payday loans and interchange and other hidden fees in credit card debt. While these questionable practices were not a major cause of the crisis, they were a flashpoint for the human suffering that accompanies a crisis. For that reason they elicited a political outcry that required a regulatory response. To control these abuses the Dodd-Frank Act created the Bureau. The
Director of the Bureau is appointed by the President subject to confirmation by the Senate. The Bureau is given the authority to regulate a number of consumer financial products (but not all) that formerly were under the control of the Federal Reserve, FDIC, and the Office of the Comptroller of the Currency. It prohibits and establishes penalties for unfair lending practices. The authors of this book offer a sound recommendation to the Bureau that would require financial service providers to include plain vanilla and understandable products in their menu of products. Finally it is ironic that the Bureau is located in the Federal Reserve. The Federal Reserve is now mandated to maintain a healthy banking system. Healthy banks must be profitable banks and profits come from sound and fair practices as well as questionable if not fraudulent practices. To the extent the Bureau is successful in reducing these sharp practices they will in all probability reduce the profitability of the banking system. However, most people would agree that profitability can never be the sole measure of a successful banking system.

III. Systemic Risk

Chapters 4-8 are on identifying and addressing systemic risk and constitute the essence of the Dodd-Frank Act and this book. Systemic risk is the risk of a partial or complete breakdown of a financial system in terms of markets and institutions. Typically the breakdown is initiated by the failure of a significant financial institution. There are exogenous and endogenous causes for such an event. One exogenous cause could be the destruction of the infrastructure underlying the financial system due to an act of cyber terrorism or natural disasters. The Dodd-Frank Act is only concerned with endogenous causes such as the failure of one or more large institutions or markets that would spread to other institutions and markets until it engulfed the entire financial system. The real economy depends on a functioning financial system to facilitate the transfer of savings from what Gurley-Shaw called surplus units (those who spend less than they earn) to deficit units (those who spend more than they earn). When a financial system breaks down, firms are more or less constrained to finance their real investments from internal sources and savers have fewer choices in which to invest their savings. This lack of coordination between saving and investment always results in a non-optimal allocation of scarce financial resources. For this reason governments are under a strong obligation to prevent a breakdown in the financial system.

How does the Dodd-Frank Act deal with systemic risk and the breakdown of the financial system? In principle the Act would like to identify systemic risk before the realization of that risk in the form of a breakdown in the financial system. The stress test conducted on 19 large banks in 2009 was an attempt to do just that. The 2009 stress test wanted to determine how much individual banks would lose if the recession in 2009 grew worse with the unemployment rate rising to 10.3 percent, a fall of 3.3 percent in GDP, and a further reduction in house prices.
of 22 percent. As a result of the tests 10 of the 19 banks were told to raise in aggregate $75 billion in equity capital. The authors propose an alternative way to measure a financial company’s contribution to systemic risk which we will discuss in the next paragraph. The Dodd-Frank solution to the problem of systemic risk relies on the judgment of wise men and women. This wise judgment takes the form of creating a Financial Stability Oversight Council (hereinafter the Council) chaired by the Secretary of the Treasury and whose membership consist of the heads of the various financial regulatory bodies such as the Federal Reserve, FDIC, Office of the Comptroller of the Currency, the newly created Bureau of Consumer Financial Protection, the SEC, the Commodity Futures Trading Commission, the Federal Housing Finance Agency, the National Credit Union Administration, an independent member with insurance expertise, and several at large non-voting members. This Council has three main goals: i) identifying financial companies capable of creating systemic risk; ii) shield taxpayers from absorbing the losses of debt and equity investors in systemically important financial companies; and iii) to respond to emerging threats to the stability of the U.S. financial system. The Dodd-Frank Act even suggests how the Council should go about doing this. To identify financial companies capable of generating systemic risk the Act advises the Council to take into account: the company’s size in terms of assets and liabilities; the degree of concentration in its particular market; importance of the company as a source of credit to households, firms, low income, and other disadvantaged groups; the extent of the company’s interconnectedness with other large financial intermediaries; the extent of its off balance sheet exposure; the amount of leverage of the company; and the amount of risk-based capital of the company. Once identifying a systemically important financial company, the Council is to refer it to the appropriate regulator (for the most part, the Federal Reserve) for remedial action. This action can take the form of: requiring more risk-based capital (as in the 2009 stress test) and liquidity, less leverage and limits on short-term debt, requiring a living will or resolution plan, implement a resolution plan before actual bankruptcy, limitations on concentration, and contingent capital.

To help the Council in addressing systemic risk the Act establishes the Office of Financial Research whose purpose is to generate data, develop tools for risk measurement and monitoring, carry out applied research helpful to the Council, and make the results of these activities available to the regulatory agencies represented on the Council. This research center is to be financed by fees assessed on systemically important financial companies. In conclusion the Dodd-Frank Act relies on the Council with the assistance of the Office of Financial Research to both identify future changes in systemic risk and then through the appropriate regulatory agency take steps to prevent a breakdown in the financial system.

One of the most remarkable powers of this Council is to dissolve a financial company prior to an actual bankruptcy if in the opinion of a 2/3rd majority the Council feels such dissolution
will preserve financial stability. An interesting counterfactual question is whether the Council would have dissolved Lehmann before it actually went bankrupt and whether this way of dissolving Lehmann would have been better from the perspective of systemic risk than the actual bankruptcy that occurred on September 15, 2008.

Besides describing the Dodd-Frank solution to identifying systemic risk, the authors propose in chapter 4 a stock market-based measure of a financial institution’s contribution to systemic risk which they call Marginal Expected Shortfall (of the financial institution’s equity capital) or MES. Unfortunately the clarity the authors bring to other chapters in this book is absent in this part of chapter 4 and parts of chapter 5 where they discuss taxing firms on the basis of the systemic risk they create. In any event MES is the expected loss in the value of the stock of a particular financial institution on a given day when the general stock market declines 2 percent or more. The greater the decline in its market valuation relative to the general stock market, the greater that institution’s contribution to systemic risk. The general idea is that investors know (or think they know) which financial institutions will do badly in a crisis and price those firms accordingly. (For details on the exact techniques used in calculating MES see Brownlee and Engle, 2010). Do the statistical rankings of the expected MES have the same rankings as the actual losses these firms experienced during the 2007-2009 crisis? The authors find that the average rank correlation over all the 2 percent down days is .30 for the sample period 1977-2009, and for the crisis period of 2007-2009 it was .44. While the correlations are positive, they are not perfect. The next step is to accumulate these daily losses for each individual financial company and the market for 6 months. The criteria for MES for an individual financial firm is to compare the expected loss in stock market value for the individual financial firm and the entire market over 6 months when the market falls by more than 40 percent. The individual financial company’s decline in stock market value relative to the general market decline is defined to be the firm’s crisis MES for the 6 month period. An individual financial company’s contribution to systemic risk is then measured by ranking the firm’s crisis MES. The authors find that this market-based way of measuring systemic risk creation identified the financial firms that turned out to be most vulnerable during the crisis and required taxpayer bailouts and arranged mergers. These rankings are made available at http://vlab.stern.nyu.edu/welcome/risk.

In our opinion the authors are to be commended for developing this metric for identifying systemically vulnerable financial intermediaries. Market-based measures for identifying systemically vulnerable financial companies should prove to be a useful and relatively cheap supplement to any future stress testing mandated by the Federal Reserve. It should also prove useful in guiding the Council in their mandate of identifying systemic risk in advance of it occurring.
Once identifying the buildup of systemic risk with market and/or non-market-based methods, the big question is how to deal with it. This is the subject matter of chapters 5-9. Two approaches are offered. The first is the author’s preferred solution of taxing financial institutions on the basis of their contribution to creating systemic risk. This approach is described in chapter 5. The other is the Dodd-Frank Act approach which relies on the ability of the Council to contain systemic risk in various ways once it arises. Various elements of this approach are taken up in chapters 5-9. We take up the Dodd-Frank approach first.

The strategy underlying Dodd-Frank is to rely on the Council--aided by the research Office--to identify systemically important financial institutions and then to subject them to greater regulatory scrutiny. This scrutiny takes the form of: i) enhanced risk-based capital, leverage, and liquidity requirements; ii) contingent capital requirements; iii) resolution plans through living wills; iv) enhanced public disclosure including credit exposure reporting; v) short-term debt limits; vi) concentration limits; and vii) overall risk management requirements. Dodd-Frank also bans bank holding companies from proprietary trading (except in connection with underwriting and market-making) and limits bank ownership in hedge funds and private equity funds to no more than 3 percent of the bank’s equity capital. The general idea is that greater regulatory control will for the most part prevent systemically important financial institutions from going bankrupt. In the event a systemically important financial institution gets into financial difficulties, the Council has the authority to liquidate the firm in an orderly way before actual bankruptcy occurs. If losses remain the surviving financial institutions will be charged a clean-up fee to cover these losses.

The authors raise a number of objections to the Dodd-Frank approach of addressing systemic risk. One objection is: Why impose clean-up fees on prudently managed financial institutions that do not fail in order to pay for the losses incurred by imprudently managed companies that do fail? That kind of policy sends the wrong signal to the financial industry and exacerbates the moral hazard problem. A second and more basic criticism is that Dodd-Frank focuses on individual firms and ignores problems that arise due to the co-movements of asset returns (initiated by fire sales) among interconnected and systemically important financial institutions. Correlated returns via fire sales exacerbated the 2007-2009 crisis. A third criticism is that the Act does not adequately deal with the moral hazard problem of “too big to fail” in spite of the Council’s ability to break-up large financial firms. For these and other reasons the authors reject the premise upon which Dodd-Frank is based, namely, relying on the Council’s ability to contain systemic risk by timely identifying and regulating systemically important financial institutions.

Instead the authors take the view that periodic systemic crises will always be a feature of a U.S. style financial system. The best way to minimize the number and magnitude of these
crises is to tax the decisions that create them. Even so some firms will be willing to pay the cost of a tax in order to make the risky investments that could lead to high profits but at the cost of increased systemic risk that might require a bailout. The question is then: Who will pay for the bailout, taxpayers or the private investors of financial institutions? The authors want the financial institutions that create the systemic risk to pay a tax based on their relative contribution to this risk. Each financial institution would be charged a fee/tax based on its contribution to total systemic risk. How would this relative contribution be determined? They suggest it be based on relative stock market valuations of the financial institutions on the grounds that the market knows best who is relatively more vulnerable in a financial crisis. Those firms whose stock valuations fall most in a down market end up paying a larger proportion of the bailout costs while those whose stocks fall least pay a smaller proportion of the bailout costs. An important question is whether the market can assess the vulnerability of a financial company subject to systemic risk better than a rigorous but more expensive bank examination where the bank examiner has access to inside and presumably confidential information. Dodd-Frank relies on the bank examiner and the authors on the stock market. With strong form market efficiency the market may do as well as the bank examiner. With semi-strong market efficiency the edge might go to the more costly bank examiner. Even if the market is able to correctly sort out the relative contribution of individual financial institutions to total systemic risk and provide the basis for a set of relative fees, there remains the problem of trying to estimate the overall expected dollar costs of a future financial crisis. The actual dollar tax/fee for a particular company will depend on its relative proportionate share of the tax/fee but also the total dollar cost of a financial crisis. In the end neither the authors nor Dodd-Frank have an answer to this problem and they end up suggesting that the risk-based tax/fee be supplemented with Glass-Steagall and Basle like restrictions on capital requirements and portfolio restrictions.

A second market-based approach recommended by the authors is an insurance scheme patterned on the Terrorism Risk Insurance Act of 2002. In their own words (Acharya et al., 2010, p. 138):

“A market solution would require each financial firm to buy insurance against its own losses in a financial crisis. In the event of an insurance payout, payment would not go to the firm itself, but to the government. This contingent capital insurance fee is not equal to the tax, but instead would be used to determine the proportionate share of each financial firm’s contribution to the total systemic risk tax. The level of the systemic risk tax would be determined by the expected systemic cost of a financial crisis times the proportionate share of each firm. The important point is that each firm’s share would be determined by the private market for insurance.”

In this proposal the tax proceeds are not to be used to bail out failed institutions but instead to support the affected real sector and the financial institutions that did not fail.
The mechanism by which the tax proceeds are to support the affected real sector is unfortunately not spelled out.

Chapter 6 continues the discussion on financial stability by considering Capital, Contingent Capital, and Liquidity Requirements as partial solutions to the systemic risk problem. The regulatory capital solution was not originally developed by the Dodd-Frank Act, but instead by various versions of the so-called Basle Accord (and before Basle the Camel ratings in the U.S.) starting in 1988. The common sense idea underlying the Basle Accord is that when financial institutions undertake speculative portfolio investments, they should be required to undertake conservative financing decisions that take the form of issuing equity or retaining earnings. It is a kind of balance sheet matching idea; the more risky the assets, the thicker the equity cushion should be to absorb possible losses.

As a general proposition balance sheet matching would seem to be incontrovertible. So why did it not work and prevent the 2007-2009 crisis? There are a number of possible reasons. One possible reason is that the tier 1 equity requirement of 4% and tier 1 plus tier 2 (mostly subordinated debt and loan loss reserve) requirement of 8% of risk-based assets and a 4% equity leverage ratio were simply too low. Had they been 15%, 25%, and 10% respectively the outcome might well have been different. A second reason is that many banks were allowed to move their risky assets off their balance sheet into special purpose investment vehicles that were not subject to Basle requirements. Had those off balance sheet special vehicles been subject to the same Basle capital requirements the outcome might have been different. A third reason is that the asset buckets upon which risk-based capital was calculated were somewhat course providing an incentive for banks to take the riskiest assets with the highest expected return within a given bucket. Several new balance sheet ratios have been added to Basle 3. One is a countercyclical buffer that ranges anywhere from 0.0-2.5% of risk-based assets at the peak of the country’s credit cycle and it will consist entirely of tier 1 equity. This countercyclical buffer is intended to rise during periods of excessive credit growth (measured relative to GDP) during cyclical expansions in order to strengthen the capital cushion during the following downturn. A second new balance sheet requirement is that a required liquidity ratio proposed to be equal to 30 days of a bank’s average cash outflow will be added to Basle 3. The Dodd-Frank Act for the most part sets capital and liquidity standards that conform to the Basle regulations. The authors on the other hand fault all versions of the Basle Accord on the grounds that it doesn’t target systemic risk nor does it get financial institutions to internalize the systemic risk they produce thereby providing the basis of a tax on the systemic risk they produce.

Our own view is that a perfectly working Basle Accord does get financial institutions to internalize the systemic risk they produce, at least the risk they produce on the asset side of their balance sheet. The more portfolio risk they generate on the asset side of their balance
sheet, the less financial risk they are allowed to produce on the other side of their balance sheet. In effect Basle requires banks to offset portfolio risk with financial risk. To make the Basle Accord work it will be necessary to close the existing loopholes and most important of all raise the capital requirements further. Switzerland now requires equity capital to be at least 10% of risk-weighted assets. Mervyn King, Governor of the Bank of England, and a number of research papers from the Bank of England, have argued throughout the crisis for higher capital ratios. Still another way to make Basle 3 more effective would be to remove or limit the tax deductibility of interest paid by financial institutions. One reason financial companies have so much leverage is because interest payments on debt are tax-favored at the corporate level over equity payments.

Finally chapter 6 considers the innovation of a contingent convertible bond, or CoCo bonds. CoCo bonds are bonds that automatically convert to equity when the tier 1 equity ratio (on total assets or risk-based assets) falls below a pre-specified level. The conversion feature on these bonds is not particularly attractive from the perspective of bondholders. When tier 1 capital falls (due to charges against equity resulting from losses on the bank’s portfolio), that is just the time when the bank’s stock prices will be falling. For that reason bondholders will demand a high rate of interest on CoCo bonds in order to compensate them for the risk of the bond converting into equity on a falling market. Dodd-Frank mandates that the Council look into the feasibility of banks using CoCo bonds as a financing instrument. The authors are not opposed to financial institutions using CoCo bonds although they don’t think it will solve the moral hazard problem. For this reason they do not think that it is a substitute for their plan to impose special taxes/fees on the systemic risk produced by an individual financial institution.

We agree with the authors that CoCo bonds will not necessarily overcome the moral hazard problem and in fact might increase it. Financial institutions that issue CoCo bonds might have an increased incentive to speculate knowing that if the strategy fails the debt issued to finance it will not force the firm into bankruptcy but instead automatically convert to equity when the tier 1 equity capital falls below some pre-specified level. It is, however, possible to think of alternative types of bonds that would tend to affect the portfolio decisions of financial firms. In this connection consider a subordinated debenture bond with a covenant that contains a so-called “poison put” with a pre-specified trigger based on some tier 1 equity capital ratio just like the CoCo bonds. The poison put feature would then allow the bondholders the option to put the bonds to the firm at some pre-specified price (eg., 105) when the tier 1 capital fell below the pre-specified ratio. The original objective of the poison put in the 1980’s and 1990’s was to control the risk-taking behavior of managers in non-financial enterprises triggered by an event (e.g., a merger or spin-off, hostile takeover, debt financed takeovers and recapitalizations, entry into new businesses) that would have a major effect on the firm’s balance sheet. To see how this might work in the context of bank regulation suppose the event that would trigger the
poison put is when the tier 1 equity capital to risk-based assets ratio fell to the Basle minimum. At that point bondholders at their option could “put” the bonds back to the company and demand full payment in cash at the pre-specified price of 105. The consequences for managers and equity-holders of allowing the equity to fall to the trigger point would be more severe than an equivalent CoCo bond. For that reason the banking firm with poison put bonds outstanding would have an incentive to implement a more conservative portfolio strategy. This more conservative portfolio strategy would be reinforced by the fact that a bond with a poison put covenant would sell at a lower required rate of interest than an equivalent CoCo bond with the same trigger thereby allowing the bank to invest in safer assets. This would be one example of a covenant that would align the interests of the bondholders and regulators. It could also be used by the Council as the reason to close down a bank before it actually goes bankrupt. Our view would be that CoCo bonds are a useful way to resolve bankruptcy issues; poison put covenants would be a way to prevent them. We would expect CoCo bonds to emerge in low interest rate environments like the present and poison put bonds in high interest rate environments.6

Chapter 7 is on Large Banks and the Volcker Rule. Both the authors and the Dodd-Frank Act think that large complex financial institutions pose a threat to the financial stability of an economy. Both are unimpressed by the arguments often made by bankers that synergies associated with economies of scale and scope rationalizes large financial institutions. This is because there is a lack of objective empirical evidence indicating the existence of these synergies. While it is true that older empirical studies failed to find evidence of scale economies, some new studies using non-parametric and semi-parametric methods that avoid the problem of pre-specifying a particular functional cost relationship are beginning to find evidence of scale economies (Wheelock and Wilson, 2010). The Dodd-Frank Act addresses the benefits and costs of large complex financial institutions through the Council. To begin with the Act states that no financial company can merge with another if their combined liabilities exceed 10 percent of the industry total. Furthermore if in the opinion of the Council (more specifically, a 2/3rds majority) parts of a large complex financial company are deemed to pose a potential threat to financial stability, the Council has the authority to break-up the company subject to any judicial review initiated by the stockholders of the company. One defense the Dodd-Frank makes available to stockholders in a judicial review is to argue that global competitiveness requires the financial firm to be large and complex. One curious and interesting fact the authors point out (p. 197) is that the Council’s authority for break-ups extends to non-financial enterprises.

The original intent of the Volcker Rule was to separate financial intermediation in both its commercial and investment banking functions from the more speculative business of proprietary trading, and ownership in both hedge funds and private equity funds. This
complete separation of financial intermediation and trading did not pass the Congress. What finally passed in the Dodd-Frank Act was instead a limitation placed on banks engaging in these trading activities and that limitation was spread out up to 7 years into the future. The limitations were to not allow proprietary trading and restrict bank ownership in hedge funds and private equity funds to no more than 3% of the bank’s tier 1 capital, and no more than a 3% share in the total ownership of hedge funds and private equity funds. A fuzzy area in the Act was the treatment of market-making in connection with the underwriting of securities. The Act allows banks to engage in market-making activity in connection with their underwriting, and that activity is not subject to any limitations. In practice it might be very difficult to differentiate trades in connection with market-making from proprietary trading. Also there is no limitation when the securities traded are the direct or indirect obligations of the U.S. government and state and local government securities. By and large the authors favor the original intent of the Volcker Rule of separating the financial intermediation function from the trading function. They also feel that even the watered down version of the Volcker Rule passed in the Dodd-Frank Act will make a modest contribution to financial stability.

So far the Dodd-Frank Act and the authors have described regulations designed to keep systemically important financial institutions from failing. Once they have failed, what is the most efficient way to terminate these large complex financial institutions? This is the subject matter of chapter 8. The Dodd-Frank Act provides an alternative treatment to the bankruptcy court for systemically important financial institutions. This alternative is called the Orderly Liquidation Authority or OLA. The objective of this Authority is to first liquidate the firm in an orderly way, and then see that creditors, shareholders, directors, and managers bear the losses associated with the liquidation. To implement this alternative treatment the Federal Reserve, or FDIC, or SEC, or Federal Insurance Office can declare a financial institution a Covered Financial Company but only when they have a 2/3rd majority vote favoring the designation from their respective boards. If such a designation survives a judicial review the FDIC becomes the company’s receiver and with the permission of the Secretary of Treasury has all the necessary powers to sell or transfer assets to settle claims. In effect the OLA gives the FDIC the power to liquidate non-bank financial institutions in the same way they now liquidate banks. The main drawback is the elaborate process a regulatory agency must go through to attain OLA and this could be time-consuming resulting in a run on the financial company. Moreover since the Dodd-Frank Act has severely restricted the Federal Reserve’s emergency powers to provide liquidity, especially to non-bank financial companies, there is a danger of financial contagion. While in this state of Orderly Liquidation, the FDIC would have access to the Treasury’s Orderly Liquidation Fund to satisfy the cash needs of an affected firm. In addition to the Orderly Liquidation Authority, the Dodd-Frank Act enables the Council to require certain systemically important financial companies to periodically draw-up so-called Living Wills that describe how a distressed company could unwind its portfolio and capital structure. Potentially a living will
could facilitate a speedy and orderly resolution of a financial company in financial difficulties. One way this can be done in the event of a default is to prioritize the outstanding debt and equity securities of a company into well-defined tranches with the lowest converted into equity until liquidity is restored. In fact this is precisely what CoCo bonds attempt to do.

Chapter 9 is the last chapter in the section on systemic risk and deals with Systemic Risk and the Regulation of Life Insurance Companies. The authors do an excellent job in describing the evolution of the insurance industry, and their appendices on AIG and an example of Systemic Risk Measurement are particularly helpful. Ordinarily the life and casualty insurance business should not be a source of systemic risk since they pool and diversify idiosyncratic risks that when realized have devastating consequences for an individual or a firm. All that changed when some companies, most notably AIG, started to insure what turned out to be systemic or macro risks. This insurance took the form of guarantees on structured financial products the most popular of which were pools of commercial and residential mortgages, credit card debt, and student loans. Falling real estate prices across the country along with the 2008-09 recession resulted in massive defaults on these structured products and severe losses for the insurers in this business which were covered in part by the Federal Reserve and Treasury. The Dodd-Frank Act reacted to this government bailout of the industry by creating the Federal Insurance Office within the Treasury Department to monitor events that could lead to financial instability. At the same time one of the voting members of the Council was to have expertise in insurance, but curiously this member would not be the head of the aforementioned Federal Insurance Office. Thus the head of the Federal Insurance Office could advise the Council on developments in the insurance industry that could lead to financial instability, but they would have no regulatory authority over the insurance industry. Regulatory authority would reside in the Council and regulatory action would be implemented by the Federal Reserve.

Given the importance of AIG and other monoline insurers in the 2007-2009 crisis the authors feel that the Dodd-Frank response is somewhat tepid. Essentially Dodd-Frank leaves the specifics of regulation up to the Council. The authors think this is inadequate and make a number of suggestions. To begin with, they are opposed in principle to regular insurers writing macro risk insurance products. To the extent they do they should be subject to Basle like capital and liquidity requirements that are appropriate for the products they sell. They also would like to move insurance regulation and policy guarantees from the states where they now reside to a new federal agency they call the National Insurance Regulator and the National Insurance Guarantee Fund. In effect this would be taking insurance regulation out of the Financial Stability Oversight Council. This suggestion is controversial. No doubt one of Dodd-Frank’s objectives was to tie together regulatory authority over the entire financial system into one body partly for ease when negotiating with other countries. In addition all of the interconnections with counterparties would be within the purview of the Council. It is not clear
why separating insurance from the rest of financial intermediation would be a good idea. However we would agree that there should be a national regulator of insurance and the head of that agency have a seat on the Council.

IV. Shadow Banking

Shadow banks are financial intermediaries that for the most part are not financed with checkable deposits, but like banks they facilitate the transfer of funds from surplus units to deficit units. It is curious that the authors did not choose to describe all of these financial intermediaries and their role in the crisis in this part of their book. Instead they chose to describe only two types of shadow banks (money market mutual funds and hedge funds) along with two financial instruments they invest in (repurchase agreements and derivatives).

Chapter 10 begins this section with an analysis of money market mutual funds. These funds are financial intermediaries that are financed with claims denominated in units of $1 that have limited checking account rights. Typically the limitations apply to the dollar amount the check can be written for and the frequency of use per period of time. Because their claims are for all practical purposes demand claims (even though for tax purposes they are treated as equity mutual funds), existing regulation before the crisis required them to invest in short-term high quality securities like short-term government securities and highly rated commercial paper. Money market mutual funds played a key role in the crisis. They were an important source of wholesale financing for commercial and investment banks. When the banks fell into financial difficulties (particularly after the Lehmann bankruptcy) there was a run by their customers and the $1 price per unit was threatened. In addition there was a substantial flight to quality and liquidity by the money market mutual funds which saw them move out of commercial paper and into government securities. At that point the Federal Reserve and Treasury intervened with the Treasury offering temporary insurance on their shares and the Federal Reserve initiating a loan program called the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility. The purpose of this facility was to provide loans to banks to buy the commercial paper held by the money market mutual funds. If the commercial paper defaulted the Federal Reserve would take possession of the defaulted commercial paper and extinguish the loan. Moreover to fill the void of money market mutual funds withdrawal from the commercial paper market the Federal Reserve in October 2008 initiated its Commercial Paper Funding Facility and lent directly to financial and non-financial enterprises.

The Dodd-Frank Act referred the regulation of money market mutual funds to future research by the Council aided by the Office of Financial Research. Nevertheless the SEC has tightened
up existing investment quality standards for the industry including certain liquidity requirements and more frequent reporting of their balance sheet. There also is a new rule that allows money market mutual funds to delay redemptions when there is a financial crisis. Going forward there seems to be two ways to deal with money market mutual funds. One way is to make them less like banks and more like other mutual funds with their net asset value based on the market prices of the securities in their portfolio rather than some arbitrary unit value like $1. For the same reason we would advocate that the limited checking account service should be removed. The fact that they do have limited checking account features is perhaps one reason why they were not allowed to “break the buck.” In a market-based economy it is hard to argue against market valuations for savings and investment instruments. Our preference would be for this solution. At the other end of the spectrum there is the solution of making them more bank-like subject to greater regulation such as portfolio restrictions, Basle-like capital buffers provided by fund sponsors, share insurance financed with industry insurance premiums, and access to central bank liquidity. Ultimately this would involve more subsidies and would appear to be a first step towards a slow creep towards the socialization of savings.

Chapter 11 is on the Repurchase Agreement Market. The Dodd-Frank Act does not have much to say about the repo market and for that reason our review will be somewhat terse. The authors do a good job of explaining repurchase agreements and the historical evolution of this market. The inability of some shadow banks to refinance themselves as shadow banks in the repo market played a role in amplifying the financial crisis of 2007-2009 although how important a role is still open to question. Why were some of these banks unable to continue borrowing with essentially the same margin or so-called haircut in the repo market? The standard answer was that much of the collateral put up by the borrowing bank was in the form of risky securities like corporate bonds and various securitized assets many of which were tied to the subprime market. When real estate prices declined the value of the collateral tied to residential and commercial mortgages declined and lenders would then require additional amounts of collateral. Eventually borrowers could no longer provide acceptable collateral and would be forced to sell assets to repay the loan, and where they couldn’t, lenders would seize the collateral and sell it in the marketplace for whatever they could get. These fire sales would further depress the market value of the risky securities that were being used as collateral along with their close substitutes. This in turn had a depressing affect on the balance sheets of relatively sound banks thereby spreading the problems of distressed banks to banks that were previously healthy. Chapter 11 offers two suggestions for reducing this negative externality and improving the repo market. The first (Gorton, 2009) is to tax the use of repos. This tax or fee would (i) build up a fund and offer insurance for the repo contract much like deposit insurance and (ii) get repo financiers to internalize the externality the repo contract creates. The second policy suggestion (Roe, 2009) was to change the bankruptcy laws so that there would be an automatic stay on the risky securities comprising the collateral. Automatic stays would
eliminate the fire sales of the risky securities comprising the collateral thereby reducing the transmission of financial difficulties from one financial firm to others. Another argument in its favor is that it would expose repo financiers to the credit risk of the counterparty. This in turn would subject borrowers to market discipline and nudge repo financiers to choose safer counterparties.

Hedge Funds, Mutual Funds, and Exchange Traded Funds are the subject of chapter 12. Neither of these funds had much to do with originating the crisis of 2007-2009. Nevertheless the largely unregulated hedge fund industry has been subject to regulatory and public suspicion ever since Long-Term Capital Management’s orderly bankruptcy was brokered by the New York Federal Reserve in 1998, the Madoff affair, and the series of insider trading scandals involving hedge funds in 2009-2011. The public response was predictable, more regulation. The Dodd-Frank Act now requires hedge funds with assets in excess of $150 million to register with the SEC with an exemption granted to family hedge funds. Moreover the SEC may require these hedge funds to file reports indicating the amount of assets under management, the use of leverage, counterparty risk exposure, trading positions, valuation methodologies used, side arrangement with preferred customers, and any other information deemed necessary by the SEC. If these large hedge funds are thought to pose a threat to the financial stability of the U.S. by the SEC and the Financial Stability Oversight Council, they can require them to reduce their leverage and in the extreme liquidate. One unfortunate omission from Dodd-Frank is the failure to require investment advisors including hedge funds to use independent custodians for client assets to prevent Madoff-type frauds.

Europeans have had for some time a deep suspicion of Anglo-American type hedge funds and private equity funds since they have on occasions broken the implied social compact in some European countries. For that reason the European Union’s regulation of hedge funds and private equity funds goes much further than Dodd-Frank even though these funds had little or nothing to do with causing the great crisis. Europe’s regulatory framework is contained in their Directive on Alternative Investment Fund Managers. This Directive covers hedge funds and private equity funds selling their products to institutional investors in the EU. To begin with these funds will require a passport to operate throughout the EU. For those funds domiciled outside the EU, their country will have to abide by the EU’s regulatory framework in order for the fund to actively market their products within the EU. On the other hand if their home regulatory framework does not conform to the EU’s, they will be allowed to passively market their products. There is no definition offered on the distinction between active and passive marketing. As of March 2011 all of this occurs sometime in the undisclosed future. More transparency will be required of the funds and all information will be available to the European Systemic Risk Board for possible action. Limitations on leverage can be imposed on both types of funds if they become a threat to financial stability. As a result of the Madoff affair fund
assets must be kept by an independent depository and not lent out, and the depository is to be subject to a high liability. Pay limitations to fund managers will parallel those proposed for banks with no more than 20-30 percent in cash up-front with the remainder payable in the shares of the fund spread over a 3 year period. Finally there will be limitations imposed on private equity funds concerning the amount of “asset stripping” allowed. These funds will also be required to announce in advance what their intentions are concerning the continued operation of firms they acquire. Like the Dodd-Frank Act much of the specific details of the Directive will be gradually worked out in the next 2-3 years.

Chapter 13 deals with Regulating OTC Derivatives. This is a very difficult area for implementing regulation. The regulatory authorities involved will be the SEC and the Commodity Futures Trading Commission. The authors start by pointing out two problems encountered in the 2007-2009 crisis with the over the counter derivative market. The first problem was that the regulatory capital requirements for banks did not reflect the risk exposure of operating in the OTC market where illiquidity, counterparty risk, and systemic risks on collateralized debt obligations and credit default swaps turned out to be substantial. This was because banks carried out this business off-balance sheet in “structured investment vehicles” where minimum Basle capital ratios were not required. The second and related problem was the opacity of exposure in OTC derivatives. According to the authors the Dodd-Frank Act addressed these issues in a 450 page section entitled the Wall Street Transparency and Accountability Act of 2010. One proposal was to move as much derivative trading to centralized trading platforms as possible where margin and transparency requirements would be imposed by the platforms. End users such as non-financial enterprises using derivatives for hedging purposes were excluded. In addition the Secretary of the Treasury can decide whether foreign exchange derivatives must be centrally cleared. Major participants in derivative markets will be required to register with the SEC or Commodity Futures Trading Commission (CFTC). They will be required to keep records and provide financial reports to their regulatory authority. They will also be subject to capital and margin requirements to be set sometime in the future by the SEC and CFTC. The appropriate federal banking agency will set the capital and margin requirements for the spun-off affiliates of banks that are required to register as major participants in the swap market. The Act also enables the regulatory authority to set limits on the size of positions. Finally the Dodd-Frank Act prohibits the central bank or deposit insuring agency from providing financial assistance to any major participant in the derivative market unless overridden by a 2/3rds majority of the Financial Stability Oversight Council.

Will the Act succeed in ameliorating the risks experienced in the 2007-2009 crisis emanating from the OTC market for derivatives? The answer must be: “Who knows?” The authors point out that most of the details about clearing requirements have not yet been specified and the Act as discussed earlier puts its trust in the Council in identifying and addressing systemic risk
before it is transformed into financial instability. What effects will running all or most derivative transactions through an organized centralized exchange have on financial stability? What happens if that exchange fails? Will loopholes regarding capital requirements still exist? There also seems to be no good resolution for the failure of a major participant in the market for derivatives in that failed clearing houses are not allowed to be merged into healthy ones, and to be rescued by the central bank requires a 2/3rds majority vote by the Council. Also there is no automatic stay on collateral to prevent fire sales of assets. Even with all of the weaknesses the authors point out they believe the Act has the potential to stabilize the derivative market.

V. Credit Markets

This section consists of three chapters dealing with i) Government Sponsored Enterprises (GSE’s); ii) Regulation of Rating Agencies; and iii) Securitization Reform. Chapter 14 begins with the role of government sponsored enterprises in the crisis. According to the authors the Dodd-Frank Act has very little to say about government sponsored enterprises even though they played a key role in causing the 2007-2009 crisis. The reason is that GSE’s, particularly in the area of housing, were the creation of various Congresses and Administrations going back to the depression era of the 1930’s. They are the reflection of a bi-partisan social policy that encouraged home ownership for low and middle income families. The two GSE’s discussed in this chapter are the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). The objective of FNMA was to insure home mortgages provided by private lenders to middle and low income families. That objective expanded to one of providing stability and liquidity to the secondary market for residential mortgages of all income classes. In this role FNMA was more like a hedge fund in that it engaged in buying, holding, and selling Federal Housing Administration or FHA-insured mortgages. FHLMC was created by Congress in 1970 to provide competition to FNMA. The authors do a good job in summarizing the history of the two GSE’s including their role in the 2007-2009 crisis. Since Dodd-Frank had little to say on how to fix the GSE problem the authors provide their own solution. They begin by arguing that both GSE’s should discontinue their trading activities to stabilize and liquify the secondary market for home mortgages since the private sector is better able to provide those functions. It is then suggested that assets in the portfolios of the GSE’s be turned over to a type of Resolution Trust Corporation that could keep them to maturity or dispose of them in the private market in an orderly fashion over time. They also advocate that the function of insuring home mortgages should be discontinued or at least significantly revised. One possible revision here is to nationalize the mortgage insurance business for conforming loans and charge a fee that more accurately reflects the risks of
mortgage lending. The problem with this suggestion is that judgment will be required in setting the fee, and judgments in the past have proven to be fallible. A second option is to completely privatize the insurance business and do away with the subsidy to residential investment. Whether there is enough private capital for this insurance business is an open question. Finally they like many scholars in finance favor market solutions to the allocation of scarce financial capital. Government should not be in the business of favoring one type of investment (say housing) over another (say investment in plant and equipment). What started out to be a subsidy for low and medium income families has become a subsidy for the rich and poor alike. If the goal is to encourage investment in housing for the low and middle income families the insurance guarantee is better carried out by the FHA presumably with some means-test criteria for qualifying for a subsidized mortgage loan.

Chapter 15 describes the Regulation of Rating Agencies. The three main credit rating agencies of Moody’s, Standard & Poor, and Fitch were grouped together in 1975 and given the designation of Nationally Recognized Statistical Rating Organization or NRSRO’s. These three credit rating agencies or CRA’s were thought to play an important role in the financial and economic crisis of 2007-2009 in that a number of complex securities originally given the very highest Aaa rating fell to junk bond status in a short period of time. The collapse in the valuation and ratings of these securities created a crisis in the confidence of suppliers of finance and a freeze on lending in certain markets due to the uncertainties associated with the financial strength of the counterparties. What is the problem here? Many have argued that two parts of the market for credit ratings have contributed to this problem. The first is that many types of regulated investors such as banks, insurance companies, pension funds, endowment funds, money market mutual funds and others require an investment grade rating in order to make an investment in a particular financial instrument. That requirement drives the demand for credit ratings. The other factor is credit ratings are paid for by the security issuing entity. This provides an incentive for the issuing entity to shop around for a favorable rating. Together these two factors help account for the fact that there is a bias towards high credit ratings. What is the solution to this problem? The Dodd-Frank Act solution to regulation in general and this area in particular is to establish a body of expertise to study and promulgate regulatory change. Towards this end they mandate the creation of an Office of Credit Ratings within the SEC to study the CRA’s and administer the rules of the SEC. The ultimate purpose is to get more accurate ratings on financial instruments particularly the more complicated asset-backed securities. Dodd-Frank also requires there be greater transparency in ratings made by a CRA in that the ratings and perhaps more importantly subsequent changes in ratings are publicly disclosed in order that users might evaluate the relative accuracy of each individual CRA. In addition Dodd-Frank requires that each CRA supply data and the methodology upon which the rating is based. To regulate the demand side for credit ratings Dodd-Frank calls for the removal of federal and state requirements that certain investors are required to invest in financial
instruments of a certain minimum rating. More to the point the Act mandates replacing the language of “non-investment grade” to “does not meet the standards of creditworthiness” and also requests that federal agencies look to other measures of creditworthiness. On the supply side of the ratings market the Act prohibits marketing considerations from influencing the actual rating assigned to a financial instrument. How this can be enforced is not made clear. Perhaps the most important reform in principle is that Dodd-Frank defines liability standards so that investors can now more easily sue the CRA’s for knowingly or recklessly failing to carry out a reasonable investigation in rating a security. While the standard for a successful suit is fairly high, it is lower than it was before the financial crisis, and in that sense represents a beginning.

The authors feel the most important reform is that the Act calls for a two year study of the way credit ratings are established for complex structured products and the conflict of interest and free rider problems arising from the “issuer pays” and “investor pays.” One promising solution proposed by Dodd-Frank that might help reduce the conflict of interest problem is that for complex instruments, issuers would be required to first submit the security to the Office of Credit Ratings who would then choose the rater based on their past record. The selected rater would then perform the rating for a fee. The issuer could shop around and obtain other (and presumably higher) ratings, but they would be required to publicly disclose the first rating. This solution could help mitigate the moral hazard problem associated with the existing practice of “issuer chooses.”

The last chapter in this section is on Securitization Reform. Securitization is an arrangement where a lender (sometime called a securitizer such as a bank) or group of lenders packages some of their loans into a portfolio. One (of many possible) arrangement is where the bank then transfers the portfolio to a special purpose vehicle and then sells securities against that portfolio to individual or institutional investors. If a single security is issued against the portfolio now in the special purpose vehicle, it is known as a pass through and is not much different than an ordinary mutual fund. A more complex arrangement is when several types of securities all with different priorities relative to one another are issued against the portfolio. The underlying loans are the assets that back-up these different securities (called tranches) issued against the portfolio. For a bank there are several advantages of securitization. One advantage was to get the risky loan off the asset side of its balance sheet which may have had a high tier 1 equity capital requirement compared to the equity capital requirement of the special purpose vehicle. Now the rules apply the same tier 1 equity capital requirements to both balance sheet assets and liabilities and those that are off-balance sheet. A second advantage is that the bank gets additional funds to make new loans. A third advantage is that the bank gets fee income for originating the individual loans and putting them in the portfolio and subsequent fees from servicing the underlying loans. The advantage to the individual or firm that borrows from a securitizing bank is a lower cost of financing. For evidence on the interest
cost savings (on average 15 basis points) to corporate borrowers see Nadauld and Weisbach (2010).

Securitization has been partly blamed for the severity of the 2007-2009 crisis. In the run-up to the crisis the lending standards for mortgages that comprised the underlying assets in the securitized pools deteriorated quite sharply. Many economists thought this was the flaw in the “originate to distribute” model of bank lending in that banks had little incentive to carefully screen borrowers or to monitor the loans while they were outstanding. The Dodd-Frank Act addressed this problem by requiring the securitizing bank to hold at a minimum an unhedged 5 percent interest in the credit risk for all assets in the securitized pool of assets except for qualified residential mortgages which were guaranteed by the government. In addition regulators can set the retention investment at less than the 5 percent if deemed appropriate. The idea was that banks would do a better job screening loan customers if they were required to hold a portion of the individual loans in the pool. The Act also requires the Chair of the Financial Services Oversight Council to conduct a study of the macroeconomic effects of the 5 percent retention of bank investments in individual pooled assets. Securitizers are also required to disclose for each tranche information on the individual assets within the pool including: i) trades associated with market making made in the asset-backed security to provide liquidity; ii) the amount of risk retention by the securitizer; and iii) the nature and amount of compensation for the originator of the assets within the pool.

The authors question the 5 percent rule since there is no allowance for differences in the risk structure and opacity of the pool. They also point out that Dodd-Frank is silent on how the 5 percent retention is to be spread across the various tranches. During and before the crisis banks tended to invest in the Aaa tranche because the tier 1 equity capital requirement was the lowest. The authors feel that some of the 5 percent retained by the securitizing bank should be in the equity tranche. Finally, they point out one unintended consequence in this area that should in some way be overcome, namely, inflicting too great a tier 1 equity requirement on banks will retard credit creation and that in turn will retard economic growth.

VI. Corporate Control

Chapter 17 on compensation in the financial services industry is one that every informed citizen should read. There were few issues in the everyday news surrounding the crisis that aroused such passions as the amount of pay going to executives and other (mainly traders) individuals in the financial services sector. The end result was a call to place limits on the level and form of pay in the banking sector. The first legislation in this direction occurred in the U.K. where a “super tax” of 50 percent was imposed on bank bonuses over £25,000. The tax was in
effect from December 9, 2009 until April 5, 2010 when it expired and only raised £550 million. Europe was the next to respond to the popular mood. The restrictions took two forms. For those financial institutions that received government aid there was an outright prohibition on payment of bonuses until the aid had been repaid. For banks and other asset managing firms not in debt to the government there were no restrictions on the level of bonuses but there was on the form and time period over which the bonus could be paid. Under present (March 2011) EU law the current upfront cash component of an annual bonus will be limited to 20-30 percent of the award depending on the size of the bonus. Furthermore at least 40-50 percent must be deferred for 3-5 years and at least one half the award must be made in stock or other performance related securities.

In the U.S. under the old FDIC Improvement Act of 1991 the FDIC could limit compensation (as well as dividends) of officers in banks if the bank’s equity capital ratio fell below a certain minimum. Here the objective was to induce firms to keep their equity leverage above a certain level. After the crisis compensation plans would be regulated to the extent they induced risk-taking decisions on the part of managers. Accordingly in June of 2010 the Federal Reserve implemented new regulatory authority giving them some control over bank compensation policy in that they can reject a compensation plan if it is deemed to result in risky decisions on the part of bank managers and traders. Curiously some parts of Dodd-Frank do not single out the banking sector for special treatment on compensation. Instead it promulgates rules for executive compensation that apply to all public companies. The most important of these are the following: i) it requires all public firms to submit to their stockholders through the annual report and proxy statement a nonbinding vote on their company’s proposed executive compensation plan; ii) it requires firms to provide data on the relationship between shareholder return and executive compensation; iii) it requires firms to try and recover previously awarded bonuses up to 3 years in the past if the accounting measures on which the bonuses were based are subsequently revised; and iv) it mandates that companies report to stockholders whether executives are allowed to hedge any decrease in the market value of securities awarded as part of the bonus plan. As recent as March 2011 the SEC announced pay rules similar to those of the Federal Reserve including the deferring of 50 percent of a bonus for 3 years for very large ($50 billion or larger) financial institutions.

The authors oppose regulation that limits the amount and form of executive bonuses on the grounds it would compromise the ability of financial firms to attract the best talent. They are indifferent to requesting a non-binding shareholder vote of approval for informational purposes, but only because it is non-binding. Their view is that directors are in a better position to judge compensation and other issues within the firm than outside shareholders. We would add one twist to the non-binding proxy vote on executive compensation. It would be that in the following year’s proxy statement the firm be required to report: i) the previous year’s
suggested executive compensation; ii) the stockholders vote on the suggested compensation; and iii) the actual compensation awarded. In that way the shareholders could see to what extent managers respond, if at all, to shareholder preferences as expressed in the proxy statement. Finally, the authors argue that the conflict of interest problem in banking is not one between shareholders and management or managers and society, but instead between shareholders and society. However, the distinction between shareholders and managers is not all that clear in the financial services industry. To begin with the authors state that one-half of the earnings of many financial companies go into a bonus pool that is distributed to certain employees. This suggests that there are two equity claimants to the earnings of the firm. One group is the many outside shareholders that are represented by their duly elected directors. These shareholders are entitled to dividends when directors see fit to declare them and they can vote on matters brought to them by the directors. There are also inside shareholders represented by a relatively few managers. They receive dividends in the form of bonuses also declared by the company’s directors. The question is who proposes the slate of directors to represent the shareholders? In most U.S. companies the managers do. If in effect managers or these inside shareholders appoint the directors it should come as no surprise that the dividends/bonuses of these inside shareholders will be upward biased. In this sense there would be a conflict of interest between these inside stockholders or managers and the outside shareholders.

I would like to make one last observation on executive compensation. Recently it was reported in the Financial Times that Barclays Bank developed a novel form of compensation that in effect linked bonuses to the bank’s capital ratio. As originally proposed the bonuses would be paid in the form of a type of CoCo bond that would convert into equity if the bank’s core tier 1 capital ratio fell below 7 percent. Subsequently the plan was changed to where the bonus is in the form of cash, but the company can take the cash back if the core tier 1 capital ratio falls below 7 percent. This is an interesting approach to compensation in the banking sector in that it links pay to the bank having sufficient capital. This would be one way to resolve the conflict of interest problem between managers as inside shareholders and society.

Chapter 18, the last chapter in this long and informative book, is on Accounting and Financial Reform. I was unable to find any reference to the Dodd-Frank Act in the chapter and that is because there isn’t any. Further research indicates that the Financial Stability Oversight Council is empowered by the Act to review and comment to the SEC on any existing or proposed accounting principle, standard, or procedure. Evidently it will be up to the Financial Accounting Standards Board (FASB) to implement any suggestions from the Council and SEC. The important issue in accounting is whether banks should be required to value all assets and liabilities at “fair market value” (sometime known as mark to market value) or amortized historical cost values. In principle the authors and the FASB favor fair market valuation even for
illiquid assets and independent of any effects this method of valuation might have on systemic risk. Their main reason is that amortized historical cost hides relevant information on assets that dynamically evolves over time and thereby delays into the future the necessary price and resource adjustments. Market illiquidity is a practical problem. One solution to this practical problem for illiquid instruments proposed by the FASB is to value them at “exit value,” that is, the value that could be obtained in an orderly sale of an asset or what the firm would pay to extinguish a liability in an orderly transaction. An alternative is a discounted cash flow approach where the discount rate reflects the risk of the financial instrument and the illiquidity of the relevant market. For reporting purposes the authors favor presenting and reconciling all three approaches to valuing bank assets and liabilities in the financial statements.

Banks through the American Banker Association (ABA) are bitterly opposed to fair market value accounting. Their reasons are mainly centered on costs. It would be very costly to implement this type of accounting system especially for small banks. Continually changing valuation of assets could also confuse various stakeholders in the firm such as workers, debt holders, and shareholders. Another and more important criticism of fair value accounting is that it would impart a procyclical bias into the valuation of bank assets and then through changing risk aversion subsequent bank lending. There is much evidence that bank lending is already procyclical. With fair market value accounting bank lending could be even more procyclical. In good times when asset valuations are high, bank risk aversion would fall and they would expand risky lending thereby prolonging the expansion phase of the business cycle. In bad times when asset values fall bank risk aversion would rise and there would be a flight to safety and lending would decrease thereby prolonging the recession. If the goal of the regulator is to get the best static allocation of financial capital, then fair market value accounting is preferred to amortized historical cost in valuing the illiquid financial instruments of a bank. On the other hand if the goal of regulation is to reduce the financial amplification of business cycles, then it might be better to use amortized historical cost methods.

VII. A Summing Up

For the past three years financial stability and regulation have been among the most researched topics in all of economics. This is appropriate given the human suffering the financial crisis of 2007-2008 has unleashed in the ensuing recession of 2008-2009 and the high unemployment that still prevails in the subsequent recovery.\(^9\) Regulating Wall Street has made a substantial contribution to this research literature as much in the questions it raises as the solutions it offers. The many technical issues discussed in the book are too numerous to summarize at this point. However it is worth repeating that the deep underlying theme of the 18 chapters comprising this book is the comparison of two approaches to financial stability.
One is to establish a council of wise men and women supported by a host of highly skilled professional financial economists. Their brief is to formulate and implement a set of financial regulations that will prevent or at least moderate the effects of future financial crises. The problem is that wise men and women have failed in the past and are likely to do so in the future, notwithstanding the army of highly qualified financial economists that will stand behind them. The other approach is promulgated by the authors and other scholars in financial economics. Their view is to tax the externality of systemic risk created by individual financial institutions much like a tax on pollution. This approach internalizes the externality and would be a factor that managers in financial institutions would have to take into account when making the investment and financing decisions for their firm. The problem here is that the pollution of systemic risk created by the financial system is not as easily measured as the smokestack pollution created by nonfinancial enterprises. There are no easy answers for designing regulatory structures for complex financial systems.

Modern financial systems have become very complex over time. Similarly the regulation of the financial system has also become very complicated. What took Glass-Steagall 37 pages in 1933 to write an Act of Congress that provided financial stability for roughly a half century until it was gradually undone, now takes Dodd-Frank 2,319 pages to try and accomplish the same task. Will it succeed in the next 50 years as well as Glass-Steagall did when it was first enacted in 1933? Few have ventured an affirmative opinion that it will, at least in print. But what would it mean to succeed in redressing the instability in the financial system? The authors of Regulating Wall Street do not devote enough attention to that question perhaps because they think the answer is obvious. Phrasing the question somewhat differently, what social purpose does the financial system serve that necessitates preserving it? The standard answer (which the authors give) is that the financial system facilitates the efficient transfer of scarce financial capital from surplus units to deficit units where the financial capital can be used to finance productive investment and economic growth. That is the social justification for the financial system and that is why it is important to eliminate financial instability. For the most part that is what the financial system did when it was less complex.

There is however another side to the financial system and that is to facilitate trading much like a casino facilitates gambling. Intermediating between surplus units and deficit units creates wealth; trading redistributes wealth. However defenders of trading will argue that trading leads to price discovery, reduces bid/ask spreads, and creates liquidity, all three of which benefit all types of market participants and not just traders. The elderly who wish to cash out of the assets that comprise their life savings (in order to consume in their retirement) need a way to access the medium of exchange. Trading by speculators helps to enable the elderly (or anyone else for that matter) to obtain the liquidity to realize their intertemporal consumption plan. Much of the innovation that has increased the complexity of the financial system has
found its way into the business of trading. How much trading do we need to provide the liquidity for firms, the young, and elderly to achieve their intertemporal consumption/savings/investment plan that creates wealth? Does unlimited trading cause any harm by imposing a negative externality on non-speculators? Recent research by Dichev, Huang, and Zhou (2011) has shed some empirical light on this question. For common stocks they find there is a substantial and positive correlation between the volume of trading and stock volatility after controlling for fundamental information. Since volatility over and above that accounted for by changing fundamental information is a bad in all asset pricing models, this is an important finding particularly if it holds up in subsequent empirical research. For one it raises the question of the desirability of a “Tobin Tax” on security transactions. Neither Dodd-Frank nor the authors discuss whether a Tobin Tax should be part of the regulatory framework. While one empirical study on volatility and trading is not a strong foundation for setting regulation, it is to be hoped that more empirical work will be done in this important area and provide the basis for a policy discussion. In addition to the computer and software innovations that speed up trading, there are also innovations in derivatives that some claim help complete the market with time state preference securities. One such innovative security is called a credit default swap or CDS. This is a security that provides the buyer with a payment in the event of a default on a credit instrument. To get this security the buyer must pay a periodic premium to the seller. The premium is paid by the buyer until the credit instrument either matures or defaults whichever comes first. The benefit of CDS’s is that in principle they should: i) reduce the cost of borrowing in that they provide a relatively cheap way for investors to hedge their risk exposure to a default on the credit instrument, and ii) they provide investors with information when these credit instruments trade in the secondary market. However, recent empirical research by Ashcraft and Santos (2009) call this conclusion into question. They find that on average traded CDS’s have not reduced the credit spreads for nonfinancial companies in the corporate bond and syndicated loan markets. In fact surprisingly they find that for risky and informationally opaque firms credit spreads actually widened once trading in their CDS’s begin. Again one study does not establish an empirical fact but instead a further call to research.

On this note we conclude. The financial and economic tsunami of 2007-2009 and the strong aftermath shock of an employment crisis that so far has extended into 2011 are strong calls for further research by economists in general and financial economists in particular. The lives of many citizens working in the private and public sectors have been adversely affected for abnormally long periods of time. These citizens deserve more from the body of professional financial economists who are in part paid to foresee coming crises and then to implement policies that will moderate them and formulate the necessary regulatory changes that will prevent them in the future. This call for further research spans theoretical modeling and
empirical work. The authors of this book and the Dodd-Frank Act are doing their part. They and others will follow in the future.

End Notes

- I would like to thank Professors Werner DeBondt, James Johannes, and Tim Riddeough for their extensive comments and discussion over the past several years on the issues raised in this book. While they helped me avoid many mistakes they are not to be blamed for any errors that might remain. Lynne Krainer checked for grammatical errors and made stylistic suggestions. This paper is much better because of her efforts.

1. From 1934-2011 Table BF02 entitled Federal Deposit Insurance Corporation Failures and Assistance Transactions report that a total of 3,913 banks and thrifts failed or required assistance. For the 47 year period 1934-1981 there were only 624 reported failures or institutions requiring assistance. For the 29 year period from 1982-2011 the FDIC reports that 3,289 banks and thrifts failed or required assistance. Clearly the breakdown of Glass-Steagall beginning in the 1980’s resulted in a dramatic increase in the failure rate among banks and thrifts. Source: http://www2.fdic.gov/hsob/HSOBSummaryRpt.asp

2. More particularly (pp.131-132) the risk regulators should consider the following factors for systemically important financial companies: 1) the amount and nature of the firm’s assets and liabilities; 2) the extent of the company’s leverage and off-balance sheet exposure; 3) the interconnectedness of the company with other systemically important companies; 4) the importance of the company as a source of credit to households, firms and local governments; 5) the nature, scope, and mix of the company’s activities; 6) the extent to which the company is already regulated; and 7) the operation of a clearing, settlement, or payment business in the markets in which it operates.

3. The balance sheet matching idea underlying the Basle Accords was first used by Krainer (1985, 2003, and 2009) to describe the investment decisions and financing decisions of nonfinancial and financial enterprises. In that model there is a conflict of interest problem between stockholders and bondholders for nonfinancial enterprises, and stockholders and depositors/regulators for banks. The solution to this conflict of interest problem was a bond contract with covenants for nonfinancial firms, and Basle type regulation for banks. In both types of firms a sort of “assignment rule” governed the management of the enterprises. Under this assignment rule stockholders managed the asset/investment side of the balance sheet in a way that reflected their risk aversion, and bondholders/regulators managed the financing side of the balance sheet in a way that offset the changes in operating/portfolio risk initiated by the investment decisions of equity investors. In both types of enterprises financing decisions depended on the operating/portfolio risks generated by the investment decisions.

4. For an analysis of the costs and benefits of higher required tier 1 equity capital ratios see Miles, Yang, and Marcheggiano (2011).
5. For an analysis of poison put bonds see Cook and Easterwood (1994). They find that poison put bonds have a positive effect on bondholders and a negative effect on stockholders. The advantage of poison put bonds is that they lower the required rate of return of bondholder by protecting them against event risk. They also find evidence that poison put bonds protect managers from hostile takeovers. At one time subordinated debt was thought to be a solution to the moral hazard problem in banking since depositors were protected by FDIC insurance and had no incentive to monitor the manager’s portfolio and financing strategies whereas subordinated debt holders did. Subordinated debt with a poison put is one mechanism that to a certain extent aligns the interest of bondholders and managers. These kinds of bonds could prevent managers from buying into new lines of financial services business but at the same time make it more difficult for outsiders to take over the bank.

6. Even though CoCo bonds have some unattractive features from the perspective of bondholders, the recent issue by Credit Suisse for $2 billion reported in the Financial Times (February 18, 2011, p.13) was oversubscribed by $22 billion. The reason was the relatively high interest rate of 7.875 percent on the issue.

7. For an empirical assessment of how much the repo market contracted during the financial crisis see Krishnamurthy and Nagel (2011).

8. There is still in 2011 strong congressional support for the subsidization of housing for low and middle income Americans even though the Obama administration is budgeting $73 billion for the Fannie Mae and Freddy Mac bailouts. The administration drew strong criticism from Congress when the Secretary of the Treasury presented their plan to the House Financial Services Committee to withdraw from the mortgage finance business. See “Democrats Hit Out at Housing Finance Plans” in the Financial Times, March 2, 2011, p. 6.

References


