RESPONDING TO REGULATORY FAILURE: FINANCIAL REGULATION IN THE US (AND BEYOND) SINCE THE GLOBAL FINANCIAL CRISIS

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Roadmap:

1. Summarize background of the financial crisis in the US
2. Describe some of the most significant regulatory responses and reforms
3. Describe current efforts to revisit and reserve some of those reforms

Bubble

Residential Mortgages

Mortgage Brokers

Banks

Mortgage Backed Securities

Investors (Financial Institutions)

Bubble

Residential Mortgages

Mortgage Brokers

Banks

Mortgage Backed Securities

Investors

(Financial Institutions)

-- Upward spiral of housing values

-- Financial innovation, appetite of financial system

-- Mortgage brokers essentially unregulated

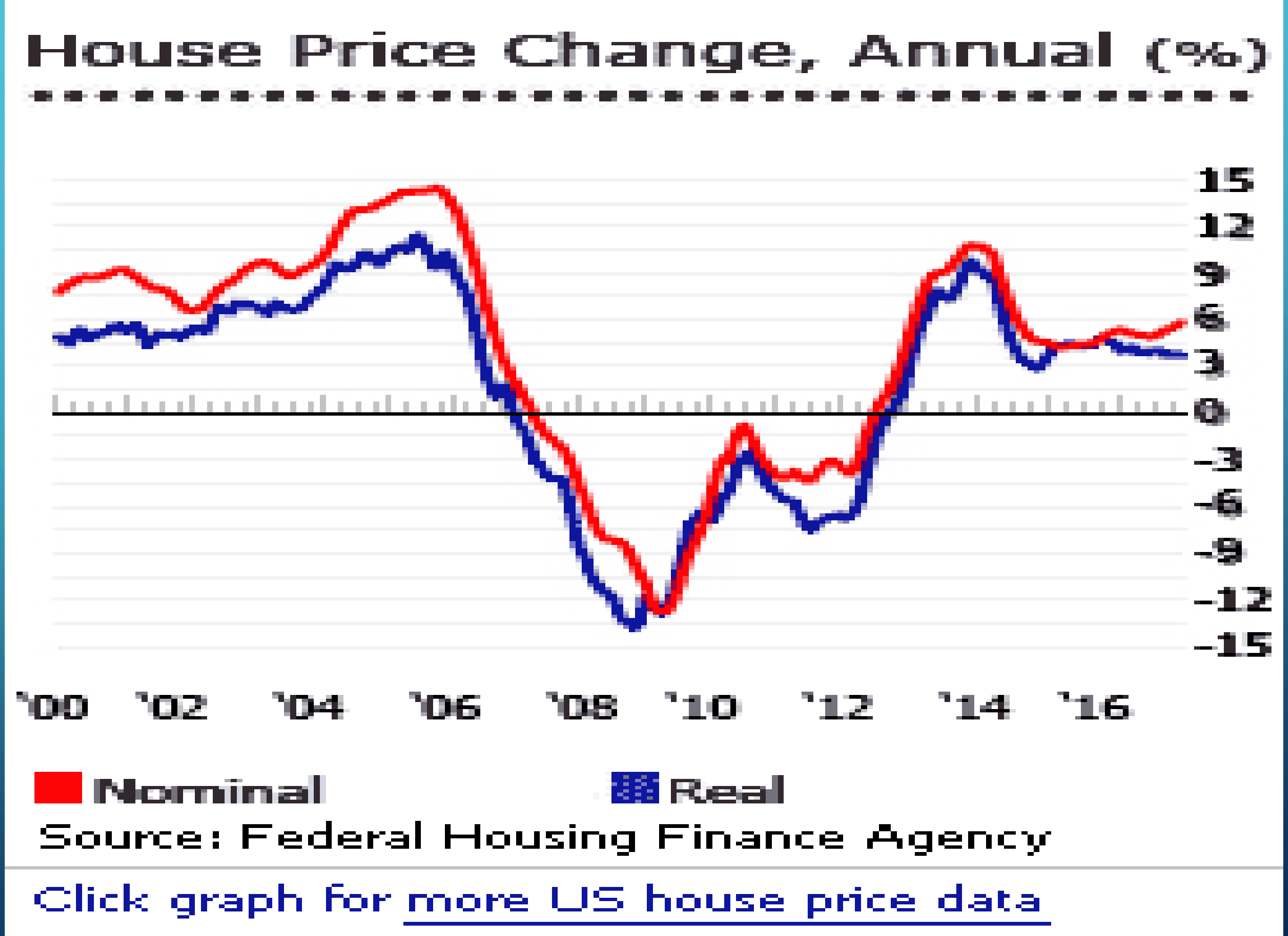
-- Banks and other FI’s heavily leveraged

-- With short term (often overnight) debt

Shadow banking

- Securitization (MBS)
- Money markets
- Unlisted derivatives (including credit default swaps)
- Repos

Crash



House Price Change, Annual (%)
15
12
9
6
3
0
-3
-6
-9
-12
-15
'00
'02
'04
'06
'08
'10
'12
'14
'16
Nominal
Real
Source: Federal Housing Finance Agency
Click graph for more US house price data

Crash

MBS market collapses → Banks and FI's holding MSBs fail → Financial system seizes up → Effects quickly in real economy

-- Funding for exposed firms stops, they fail
-- Financial ties opaque (derivatives not cleared)
-- No mechanism for adjusting mortgages
-- Non-bank FI's only subject to bankruptcy (Lehman)
-- Disrupts money market, which is uninsured

Collapse

Phase I:

Credit markets seize, globally

→

Phase II:

Economies stall;

Gov oblig'ns spike

→

Phase III:

Sov debt crises; (FI's, debt holders, require more support)

Initial responses

- Bailouts, including through forced acquisitions, until Lehman
- Bailout of AIG, to protect other FI's
- Emergency lending facilities from the Federal Reserve
- Federal Reserve currency swaps with other countries
- Ex post guarantee of money market
- TARP
- Bailout/bankruptcy of auto industry
- Some criminal cases against mortgage brokers; efforts to restructure mortgages

Legal reforms

- Basel, capital requirements
- Dodd Frank Act, 2010
- European union-level financial regulation

Big regulatory themes

- Counter-cyclical
- Macro-prudential
- More (and better) capital
- No bailouts
  - Protect taxpayers/govt viability
  - Reduce moral hazard

Basel bank capital reforms

- Basel I
  - Original accord, major international achievement
  - Relatively blunt approach, not very onerous requirement
- Basel II
  - Developed in years before crisis, especially to account for operational risks
  - Relied on internal risk-management models and, among other things, contemplated reduced requirements for strong risk management

Basel III

-- Improve the quality of capital

-- Additional “capital conservation” and “countercyclical” buffers

-- Improves risk weighting for securitzation, counter-party risks, trading portfolio

-- Adds a liquidity capital requirement

-- Heightened requirements for “SIFI’s”

-- Improves risk management through, among other things, required stress testing

Dodd Frank

- Regulatory structure:
  - Consumer Financial Protection Bureau
  - Financial Stability Oversight Council
  - Office of Financial Research
  - Eliminates Office of Thrift Supervision
- Orderly Liquidation Authority
  - Enables the FDIC to resolve bank holding companies and, especially, non-bank financial firms – liquidation required, taxpayer bailout prohibited

Dodd Frank, continued

- Volcker Rule
  - Provides that banks cannot engage in ”proprietary trading” or own or affiliate with various types of investment firms
  - Designed to reintroduce significant division between commercial and investment banking
- Living Wills
  - Large banks and SIFIs’ must create living wills to explain how they would be resolved without creating system instability if they experience financial distress
  - Must be approved by the Federal Reserve and FDIC

Dodd Frank, continued

- Additionally:
  - Ends preemption power over bank subsidiaries
  - Requires many derivative and complex financial products to be the traded and cleared through exchanges
  - Prohibit emergency lending by Fed to individual firms, only general programs, and that any lending is secured to avoid taxpayers losses
  - Disclosure of executive pay
  - FSOC can designate systemically important financial institutions – these and largest banks are SIFI's – and financial market utilities
  - FSOC can grant the Federal Reserve expanded regulatory powers of over bank and non-bank SIFI's, e.g.,
    - Enhanced supervisory powers and prudential standards
    - Power to take "mitigatory" actions if SIFI's pose "grave threat to … financial stability"

Dodd Frank, in operation

- SIFI's
  - Relatively few
  - MetLife designation overturned, GE and AIG designated then shed
  - "regulation by threat?" – Schwarcz & Zaring (U Chi L. Rev. 2017)
- Living wills
  - Close review by regulators
  - Plans of major banks initially rejected – Wells Fargo took three tries
- Volcker
  - Long regulatory rule-making process (5 years) to define exceptions (what is hedging and market-making)
  - Extensions allowed for exiting "illiquid" investments

Europe & Eurozone

- Pre-crisis:
  - Liberalization of cross-border financial services/product
  - National regulation
  - National deposit insurance schemes, with significant variation
  - No risk sharing, emergency financing mechanism ("no bailout" clause)
- Since:
  - European banking union, supervision and regulation
  - Still national deposit schemes, with more coordination and harmonization
  - Emergency stabilization mechanism

Other international developments

- Rise of the G-20, very attentive to financial system stability
- Creation of the Financial Stability Board, council of national regulators
- IMF more aggressively focused on financial regulation, managing capital flows

Counter-revolution in the U.S.?

- Choice Act, would , among other things:
  - Eliminate the FDIC's Orderly Liquidation Authority
  - Eliminate designation of SIFIs
  - Eliminate designation of financial market utilities
  - Eliminate the Office of Financial Research
  - Restructure and generally weaken the FSOC
  - Require cost-benefit analysis by financial regulators
  - Reduce the general deference courts give to regulatory decisions for financial regulators

Counter-revolution in the U.S.?, continued

- Treasury proposals
  - Relax some of Basel III, loosen new capital requirements
  - More permissive regs for smaller banks
  - Expand exceptions to the Volcker Rule
  - Consolidate regulators
  - Move OFR to Treasury
  - Stress test fewer firms, only the very largest (raise trigger to $50 billion from $10 billion)
  - Raise $50 billion trigger for living will enhanced regulation of SIFI's
  - Restructure function and leadership of CFPB
- Quiet reversal of administrative-level rules, policies?
- General withdrawal from international governance?

Implications for global regulatory project

- Increase risk of instability?
- Loss of American influence?
- Reordering of international regulatory landscape?