Issues on Dodd-Frank

Is Proprietary Trading Detrimental to Retail Investors?

Falko Fecht, Andreas Hackethal and Yigitcan Karabulut

Counterparty Risk Externality: Centralized Versus Over-the-Counter Markets

Viral Acharya and Alberto Bisin

Yesterday's Heroes: Compensation and Creative Risk-taking

Ing-Haw Cheng, Harrison Hong and Jose Scheinkman

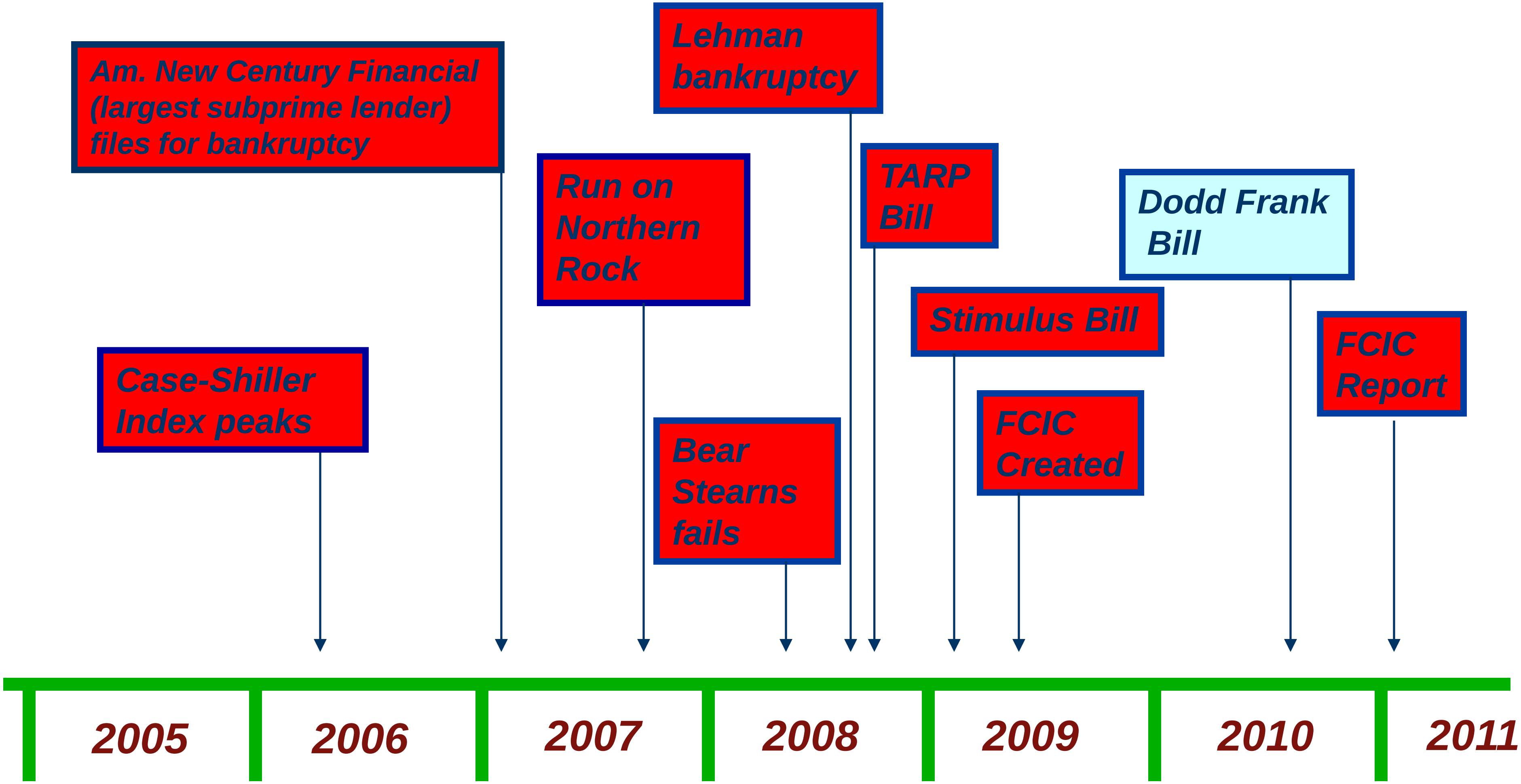
Do Depositors Discipline Banks? An International Perspective

Allen N. Berger and Rima Turk-Ariss

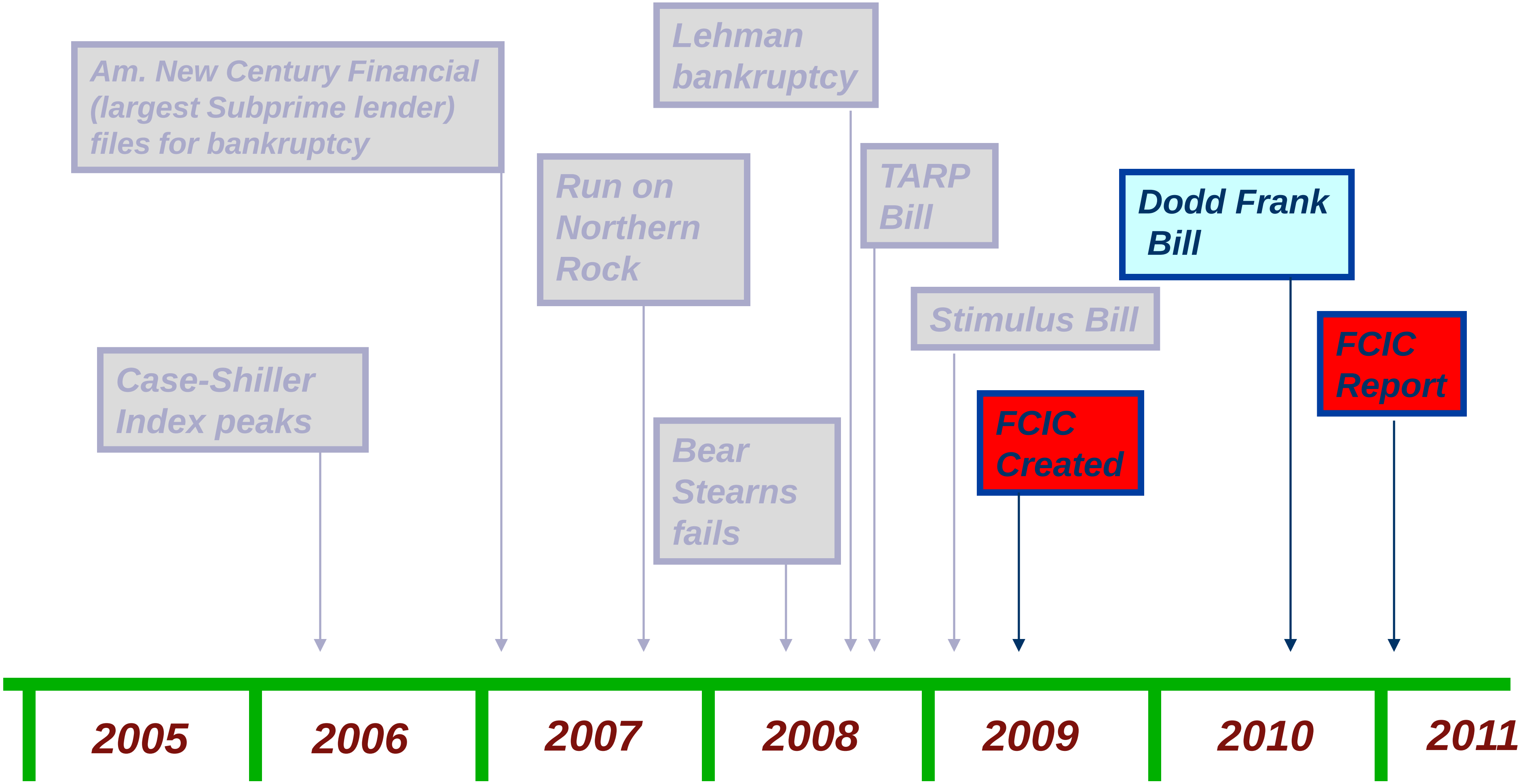
Discussion by

Greg Udell

CRISIS TIMELINE



CRISIS TIMELINE



THE TIMING OF DODD-FRANK

- **D-F preceded the FCIC report**
- **D-F is the outcome of a political process**
  - **Affected timing as well as content**
  - **Threats to dismantle**
- **Also, D-F is very much a *work-in-progress***
  - **<u>Astronomical</u> number of rulemakings, principal studies, and recommendations by 33 government entities including 11 regulators**
  - **Much of which is still ongoing**
- **The work of assessing D-F, including papers like these, is in some sense, just beginning**
  - **In a perfect world much of this work would have preceded D-F**
  - **But, D-F focuses our attention**

THE DODD-FRANK BILL

- Council on systemic risk
- “Ends” too big to fail bailouts
- Reforming the Federal Reserve
- Proprietary trading
- Transparency and accounting for derivatives
- Shareholder say on CEO comp
- New consumer protection watchdog
- New rules for credit rating agencies
- Other stuff

THE DODD-FRANK BILL

(THESE PAPERS)

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THE PAPERS AND DODD-FRANK

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Falko Fecht, Andreas Hackethal and Yigitcan Karabulut

- New consumer protection watchdog
- Proprietary trading

THE PAPERS AND DODD-FRANK

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THE PAPERS AND DODD-FRANK

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- Shareholder say on CEO comp
- Council on systemic risk
- Ending too big to fail bailouts

THE PAPERS AND DODD-FRANK

Do Depositors Discipline Banks? An International Perspective

Allen N. Berger and Rima Turk-Ariss

- Council on systemic risk
- “Ends” too big to fail bailouts

Is Proprietary Trading Detrimental to Retail Investors?

Falko Fecht, Andreas Hackethal and Yigitcan Karabulut

- **Key findings:**
  - Banks dump losers on their retail customers
- **Relevance to D-F:**
  - Compelling documentation of conflicts of interest in banking
  - Provides a potential additional motivation for the Volker Rule
- **Specific comments:**
  - The paper could be better nested in the empirical literature on conflicts of interest, e.g.,
    - Michaely and Womack (RFS 1999) – booster shots
    - Irvine, Lipson and Puckett (RFS 2007) – tipping
    - Berzins, Liu and Trzcinka (2011) – bank run mutual funds
  - Can you dig deeper down to the security level to examine whether this is driven by an informational advantage?
    - Is the effect bigger for more informationally opaque firms

Counterparty Risk Externality: Centralized Versus Over-the-Counter Markets

Viral Acharya and Alberto Bisin

- **Key findings:**
  - Opacity in the OTC markets leads to a “counterparty risk externality” in the form of excess leverage (e.g., AIG)
    - Nobody fooled in this world; the insured just can’t observe the short positions
  - Centralized clearing mechanisms allow risk of excessive short positions to be priced and avoid deadweight bankruptcy costs
- **Relevance to D-F:**
  - Directly addresses “Transparency and Accountability” part of D-F
- **Specific comments:**
  - Clearly identifies a major benefit to transparency
  - Not sure to what extent the model describes why the OTC market failed: Did we see the CDS pricing predicted by the model?
    - Were market participants anticipating excessive shorts?
    - Were market participants relying on a government bailout?
    - Were agency problems driving behavior of the “longs” as well as “shorts”?
  - The benefits of OTC trading not modeled – how significant?
  - The moral hazard problem inherent in clearing houses?
    - Will the clearing houses become the GSEs of the next crisis?
    - Explored in Acharya, Shachar and Subrahmanyam (2011) – *Regulating Wall St.*

Yesterday's Heroes: Compensation and Creative Risk-taking

Ing-Haw Cheng, Harrison Hong and Jose Scheinkman

- **Key findings**:
  - "Residual compensation" captures incentive for tail risk
  - Higher residual comp. => good realization in dot.com period; bad realization in crisis period
  - Residual compensation driven by heterogeneous investors
- **Relevance to D-F**:
  - Implications for both prudential supervision & systemic risk
  - Raises doubts about D-F emphasis on aligning the interests of management and stockholders
    - The problem here is the stockholders! (i.e., the "short-termists")
- **Specific comments**:
  - How does TBTF affect the paper's hypotheses?
    - Interesting firm variation: Countrywide vs. Citibank
  - What about risk management (e.g., Ellul and Yerramilli 2011)?
  - Natural tension between this paper and the Berger and Turk-Ariss paper
    - What role are depositors/creditors playing in this?
    - Controls for depositor discipline?

Do Depositors Discipline Banks? An International Perspective

Allen N. Berger and Rima Turk-Ariss

- **Key findings**:
  - Evidence of discipline in deposit growth and deposit rates, particularly with respect to the impact of the leverage ratio
  - Stronger effects for smaller institutions
- **Relevance to D-F**:
  - Financial Stability Oversight Council to promote market disc.
  - Study on creditor haircuts mandated
- **Specific comments**:
  - Pre-crisis discipline? Seems like an up-hill battle.
    - Wasn't this a world where the Reserve Fund broke the buck because of its Lehman investment?
  - What does "significant depositor discipline" mean?
    - What if we replace deposit growth with asset growth?
    - Were disciplined banks less likely to fail?
  - Consider using MBS & CRE allocation as key risk variables
  - Consider risk management (e.g., Ellul and Yerramilli 2011)
  - Might also consider controlling for "residual compensation"