The Dodd-Frank Act

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"Regulating Wall Street goes a long way toward clarifying the intent of the various provisions of the Dodd-Frank Act and evaluating both its effectiveness and limitations. The need for effective implementation by agencies is appropriately emphasized. Not a quick read, a useful reference work on an enormously complex piece of legislation, dealing with an even more complex financial reality."

— Paul Volcker, Chairman of the Economic Recovery Advisory Board and former Chairman of the Federal Reserve (1979-1987)
What’s Good

- Looks at the entire financial architecture
- Main regulatory focus is on the market failure – systemic risk
- Plugs loopholes
- Brings back some major, and systemically important, markets like OTC derivatives into the fold
Individual firms are not sufficiently discouraged from putting the system at risk

- One example - creates wrong incentives by charging *ex post* rather than *ex ante* for systemic risk: surviving SIFI’s pay for other large banks failure
Government guarantees remain mispriced, leading to moral hazard

According to Fed Reserve Bank of Richmond study, in 1999, 45% of all financial liabilities fell under U.S. safety net, now a decade later 58%.

- Only mild changes to FDIC insurance premiums
- GSEs, the largest – govt sponsored – financial firm, ignored in the Act
- Insurance sector: tiny state guarantee funds, so too big to fail problem
- Orderly Liquidation Authority (OLA) does not rule out future guarantees with certainty
The Act falls into the familiar trap of regulating by form, not function.

Reserve Primary Fund
Assets & Yield Spread

Reserve Primary Fund
Holdings

“Implicit Guarantees and Risk Taking” by Marcin Kacperczyk and Philipp Schnabl
(NYU Stern working paper)
Regulatory arbitrage is not adequately addressed

Fannie & Freddie Growth
$5.2 Trillion, 37% in US Banking Sector

AIG Quarterly Filings, February 2008

At December 31, 2007 the notional amounts and unrealized market valuation loss of the super senior credit default swap portfolio by asset classes were as follows:

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Notional Amount (in billions)</th>
<th>Unrealized Market Valuation Loss (in millions)</th>
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</thead>
<tbody>
<tr>
<td>Corporate loans</td>
<td>$230</td>
<td>$ —</td>
</tr>
<tr>
<td>Prime residential mortgages</td>
<td>149</td>
<td>—</td>
</tr>
<tr>
<td>Corporate Debt/CLOs</td>
<td>70</td>
<td>226</td>
</tr>
<tr>
<td>Multi-sector CDOs</td>
<td>78</td>
<td>11,246</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$527</strong></td>
<td><strong>$11,472</strong></td>
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</tbody>
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(a) Predominantly represent transactions written to facilitate regulatory capital relief.
(b) Approximately $61.4 billion in notional amount of the multi-sector CDO pools include some exposure to U.S. subprime mortgages.

Approximately $379 billion (consisting of the corporate loans and prime residential mortgages) of the $527 billion in notional exposure of AIGFP’s super senior credit default swap portfolio as of December 31, 2007 represents derivatives written for financial institutions, principally in Europe, for the purpose of providing them with regulatory capital relief rather than risk mitigation. In exchange for a minimum guaranteed fee, the counterparties receive credit protection in respect of diversified loan portfolios they own, thus improving their regulatory capital position. These derivatives are generally expected to terminate at no additional cost to the counterparty upon the counterparty’s adoption of models compliant with the Basel II Accord. AIG expects that the