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
2005 2008
Am. New Century Financial (largest subprime lender) files for bankruptcy

2007
Lehman bankruptcy

2006 2007
Run on Northern Rock

2008
Bear Stearns fails

2009
TARP Bill

2010
Stimulus Bill

2011
Dodd Frank Bill

Case-Shiller Index peaks

FCIC Created

TARP Bill

FCIC Report

2009
CRISIS TIMELINE

2005
Am. New Century Financial (largest Subprime lender) files for bankruptcy

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FCIC Report
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
  – Astronomical 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)

- Council on systemic risk
- “Ends” too big to fail bailouts
- **Reforming the Federal Reserve**
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- New consumer protection watchdog
- Proprietary trading
THE PAPERS AND DODD-FRANK

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

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- Transparency and accounting for derivatives
Yesterday's Heroes: Compensation and Creative Risk-taking

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- Shareholder say on CEO comp
- Council on systemic risk
- Ending too big to fail bailouts
Do Depositors Discipline Banks? An International Perspective

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Is Proprietary Trading Detrimental to Retail Investors?
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• **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”