Basel 2.5, Basel 3, and Dodd-Frank
This time is the same:
Regulation follows crises
This time

• Basel 2.5: Redefinition of market risk requirements
  – Substantial increase in capital for banks with large trading activities

• Basel 3: New capital standards, but fully implemented in 2019
  – Substantial increase in common equity requirement, especially for SIFIs; liquidity requirements

• Dodd-Frank: Addresses all aspects of the financial sector except for Fannie and Freddie.
Hold it! Didn't you guys already wreck this car once?

Dodd-Frank

U.S. Financial Health
Dodd-Frank

Oversight and Systemic Risk
- Financial Stability Oversight Council
- Orderly Liquidation Authority
- Federal Reserve Emergency Credit

Financial Institutions
- Regulation of banking organizations
- Volcker Rule
- Private fund investment advisers
- Insurance companies
- Supervision of payment, clearing and settlement

Capital Markets
- Derivatives and swaps clearinghouses
- Securitization
- Credit Rating Agencies
- Investor protection and securities enforcement

Business Conduct and Practices
- Governance and compensation
- Consumer protection

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Dodd-Frank Rulemaking Progress in Select Categories
As of April 2, 2012

Rulemaking counts are based on estimates and require judgment.

Number of Required Rulemakings
(Joint Rules are Counted for Each Applicable Agency)
But

• We have a long way to go with Dodd-Frank.
• Parts of it could get repealed.
• The most important rules may be the ones that are discussed little: Bailouts have become much harder to implement.
• Yet, there is no solution of resolution of multinational banks.
Do the changes matter?

• Banks will have to more than double their common equity capital compared to before the crisis.

• Banks look at the world through ROE. Hence, their ROE falls in half if they do nothing.

• Few banks have market-to-book greater than 1. So, they are more likely to work on their balance sheet than to issue equity.

• Not all activities are affected equally.
Product-specific RoEs show highest impact on structured products, especially credit and rates

RoE (effect), Percent (Percentage points)

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Pre regulation</th>
<th>B II.5</th>
<th>Basel III/Other</th>
<th>Post regulation</th>
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<td>EQD - Strctrd</td>
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<tr>
<td>Total</td>
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Borrowed from McKinsey/Toni Santomero
Consequences

• Banks will shrink.
• Tailored products will become more expensive.
• Non-bank financial activities will expand.
• Offshore financial activities will expand.
Do the changes address the causes of bank poor performance during the crisis?

- Did an international study of performance of large banks during the crisis with Andrea Beltratti.
- All public banks with more than $50 billion assets.
Where the banks that did better less risky in 2006?

• No, except for leverage.
• They had higher idiosyncratic volatility.
• They had lower distance to default.
• Same beta, same real estate beta.
• However, much higher tangible equity:
  – 6.35% versus 4.10%
Regression results: Key variables

<table>
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<th>Banks</th>
<th>Banks + Non-banks</th>
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<td>Tangible equity</td>
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<td>Funding fragility</td>
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<td>Board</td>
<td>-3.421***</td>
<td>-3.013**</td>
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</table>
Is Volcker right?

• Regulation is not related to performance except that banks from countries with more restrictions on bank activities did better.
• But, banks from countries with more restrictions were not less risky.
• Those banks could not invest in some activities that performed poorly, but these activities were not expected to perform poorly.
Regulation, governance, macro

- Banks that did better come from tougher regulation, weaker governance, current account surplus countries.
- All banks in the bottom quartile of performance come from countries with formal deposit insurance.
Are we on the right track?

• Ever more complicated and intrusive regulation can’t work.
• It would be much better to make the system safer by making sure that the collapse of a financial institution has no significant impact.
• We have gone the opposite way, though.
IF MOUSETRAPS WERE DESIGNED LIKE THE FINANCIAL REFORM BILL