

## Word from the Editor

As expected, much of the government, central bank and regulatory interventions since the subprime and financial crisis of 2008 have produced no lasting results in terms of sustainable growth and jobs. If anything, these have tended to dislocate markets, creating uneven effects against what is supposed to be market-driven reallocation of resources.

While politicians and central bankers claim credit for what their actions were supposed to avert, the outcome is far less positive than what had been hoped for. Unemployment continues to pull stubbornly in the downward direction. Growth is sputtering and economies are braking to stall-levels. And many are starting to slide into the negative zone. Personal and more importantly, sovereign debts are rising to unprecedented levels, with many sovereigns now clearly at risk of default. Capital flows and flights are becoming the order of the day. Capital markets are increasingly distorted to a level beyond recognition. Borrowing is made attractive with near-zero short-term nominal rates and a historically flat low yield even to the ultra long-end of the curve. However, this is not matched by interests on the lending side. Lenders are struggling to make sense of doing business at such ridiculously low margins and potential high risks. Business outlook is weak, and is not encouraged by concerns of slowing growth in major emerging economies. Heavy actions on the regulatory front are now coming on-stream at a fast and furious pace, at the worst possible time. These, which are intended to correct gaps from past failures, are making banks, financial institutions and corporations extremely nervous about the poor timing, implementation costs, being unfairly disadvantaged and impact on bottom-line.

I can go on, but the picture is clear. We are living in an era of unprecedented uncertainty. Uncertainty that is exacerbated by political infightings, unpredictable government and central bank policy actions. These include possible interventions and policy actions touted as remedies for fighting all sorts of existing and coming economic ills - unemployment, depression, inflation, excessive debt, potential defaults, bail-outs of banks, companies, states, countries. The list is frighteningly long. When mixed with nervous market reactions, you can imagine the flux and swing these could bring. The volatility is already unsettling with reactions from the heavy actions already taken. Much more unsettling is the fear of what other actions might be taken, especially with many countries all hitting different or even the same buttons in quick successions. Mind-reading and outright guess-work is the order of the day. Recent volatilities in the markets are a good indicator and barometer of the level of uncertainty and fear felt out there.

Having crafted some of the most comprehensive regulations, many are still concerned that we might be barking up the wrong

tree. In this issue, we present one such viewpoint that challenge the premise underlying the **Dodd-Frank Act**.

For those who feel we are on the right track, there is concern about implementation and the flood of rules that could smolder whatever is left of life in the economy and businesses. For businesses, risk management has become more unwieldy by the day. Boards and business management now have to grapple with not just traditional business risks, but also external actions that trigger macro-risks that could dramatically shift the ground in the blinking of an eye. We will have to cover this whole new area of **managing macro-risks** in another issue.

What we want to bring to you in this issue are some of the rumblings on the role of **ratings agencies**, and the troubles that are shaking the whole world - the **EU debt crisis**. We have also featured an article on the effectiveness of the **PCA (Prompt Corrective Actions) framework** on the prudential supervision of banks here in the US. Given the quickly shifting ground, we also asked the question in our **RiskCareers** column- what's the **future for the financial services industry and careers in risk management** for this industry?

To help us stay abreast of developments in the regulatory front, we continue to highlight some recent proposed and finalized rules in our **RiskRegulations**. In our **RiskResources** section, we highlight links interesting and useful materials on **Stress Testing**.

We are ever thankful to all our contributors for sharing their thoughts through this newsletter. We encourage all members to continue to engage actively through various PRMIA and DC Chapter events. As usual, do send us your suggestions on how we can further improve.



**Steven Lee, Global Client Consulting  
Editor, RiskJournal  
Deputy Regional Director, PRMIA DC**

## CONTENTS

1. Editor’s Message .....	1
2. The Error at the Heart of the Dodd-Frank Act .....	3
3. Europe in Wonderland .....	10
4. RiskCareers - Future of Banking and The Financial Services Industry .....	11
5. Prudential Banking Supervision - PCA Reforms Needed? .....	13
6. Mission Impossible for Ratings .....	14
7. RiskRegulations .....	16
8. RiskEducation - The PRM Certification .....	18
9. RiskResources - Stress Testing .....	19
10. RiskEvent .....	20
11. RiskEvent Highlight - Third Annual FDIC-PRMIA DC Policy & Risk Symposium .....	21

## RISKJOURNAL EDITORIAL POLICY

We endeavor to bring a different quarterly newsletter to our members; one that will hopefully interest you to engage and participate actively in our PRMIA Global and PRMIA DC events and activities. It is our belief that only through active participation can we all benefit from our collective learning and information sharing. We encourage interested members to join us in this endeavor. Do feel free to contact any of us with suggestions and comments

RiskJournal accepts paid or sponsored advertising, separate from editorial content. Contact us at [DC.PRMIA@gmail.com](mailto:DC.PRMIA@gmail.com) for more information on sponsorship and ad rate structure.

RiskJournal’s primary goal is to serve PRMIA’s Washington D.C. chapter and its industrywide constituency as a credible source of up-to-date risk management information and thought-provoking discussion. We welcome written contributions on topics relevant to risk management. RiskJournal does not accept compensation of any kind, including money, gifts or other favors, in exchange for editorial. We welcome diverse topics, discussions and points of view. Publication is merit-based, and submission does not guarantee publication. PRMIA D.C.’s Editorial Board makes all editorial decisions, and decisions are final. The Board reserves the right to edit all content for clarity, accuracy, length and/or other factors. The individual viewpoints represented in RiskJournal express the viewpoint of the writer and do not necessarily reflect the views of the Professional Risk Managers’ International Association organization (PRMIA), the DC Chapter or our sponsors and supporters.

RiskJournal encourages republication of content with the author’s consent. Any such republication should include the note, “This article originally appeared in the [DATE OF PUBLICATION] issue of RiskJournal, the publication the PRMIA’s Washington, DC chapter.” Please contact members of our Editorial Committee for more information.

## PRMIA DC STEERING COMMITTEE

### **Co-Regional Directors:**

Thomas Day & Christopher Laursen

### **Deputy Regional Director:**

Steven Lee

### **DC Steering Committee Members:**

Nick Kiritz

Weihua Ni

Cliff Rossi

Tim MacDonald

Ashish Gupta

Kennan Low

Paul Bond

Keith Ligon

Greg Coleman

Marlon Attiken

Lindsay Steedman

Chris Whalen

John Schwitz

David Green

Kevin Stemp

## RISKJOURNAL EDITORIAL COMMITTEE

### **Editorial Board:**

Steven Lee

### **Advisors:**

Thomas Day

Nick Kiritz

Christopher Laursen

Paul Kurgan

Weihua Ni

# The Error at the Heart of the Dodd-Frank Act

By Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute for Public Policy Research



The underlying assumption of the Dodd-Frank Act (DFA) is that the 2008 financial crisis was caused by the disorderly bankruptcy of Lehman Brothers. This is evident in the statements of officials and the principal elements of the act, which would tighten the regulation of large financial institutions to prevent their failing, and establish an "orderly resolution" system outside of bankruptcy if they do. The financial crisis, however, was caused by the mortgage meltdown, a sudden and sharp decline in housing and mortgage values as a massive housing bubble collapsed in 2007. This scenario is known to scholars as a "common shock"—a sudden decline in the value of a widely held asset—which causes instability or insolvency among many financial institutions. In this light, the principal elements of Dodd-Frank turn out to be useless as a defense against a future crisis. Lehman's bankruptcy shows that in the absence of a common shock that weakens all or most financial institutions, the bankruptcy of one or a few firms would not cause a crisis; on the other hand, given a similarly severe common shock in the future, subjecting a few financial institutions to the act's orderly resolution process will not prevent a crisis. Apart from its likely ineffectiveness, moreover, the orderly resolution process in the act impairs the current insolvency system and will raise the cost of credit for all financial institutions.

## **Key points in this Outlook:**

- Congress passed the Dodd-Frank Act under the mistaken assumption that the failure of Lehman Brothers caused the ensuing chaos—hence the Dodd-Frank provision for "orderly resolution" of firms in danger of failing.
- The financial crisis was not caused by one firm's failure, but by a common shock to all firms: the decline in mortgage values after the housing bubble collapsed, exacerbated by mark-to-market accounting.
- The orderly resolution process is unnecessary; in the absence of a common shock, the failure of a single firm would not cause a financial crisis; in the presence of a common shock, the orderly resolution of a single firm, or even a few, would not prevent a financial crisis.
- Orderly resolution, by allowing the Federal Deposit Insurance Corporation to do almost anything it wants with the assets and liabilities of any financial firm, creates uncertainty and raises the cost of credit for all financial institutions.

It is no exaggeration to say that the orderly resolution provisions are the heart of the DFA. Whenever someone in the administration or Congress is called upon to list the benefits of the act, the fact that a large financial institution can purportedly be resolved without triggering another financial crisis is always cited as one of its principal achievements. The orderly resolution process is also treated as a solution to the alleged problem that some institutions may be too big to fail—that is, they are so large that their failure will destabilize the financial system as a whole. With orderly resolution, we are told, all large financial institutions can be safely wound down and thus are not too big to fail.

However, the orderly resolution provisions of the DFA are another example of the misconceptions underlying this troubling legislation. These provisions, together with the special "stringent" regulation mandated for large, "systemically significant" financial institutions, are based on the assumption that the 2008 financial

crisis was caused by the failure of a large financial institution and that future financial crises will stem from the same cause. Presumably, what the administration and congressional framers had in mind was that the failure of a large financial institution has knock-on effects, which drag down other "interconnected" institutions, creating a systemic event. If this were true, then it would be sensible to impose stringent regulation on large financial institutions, and perhaps even to provide for a special form of resolution or wind-down if such an institution failed.

But there is something wrong with this picture. The 2008 financial crisis was not caused by the failure of a single institution, but by a "common shock"—a weakening of all financial institutions because of a general decline in the value of a widely held asset. In this case, the asset was almost \$2 trillion in mortgage-backed securities (MBS) held by financial institutions in the United States and around the world. When the unprecedented ten-year housing bubble collapsed in 2007, Bear Stearns, Wachovia, Washington Mutual, AIG, Lehman Brothers, and many other financial firms in the United States and around the world were all severely weakened, particularly because of mark-to-market accounting. Of these large financial firms in the United States, only Lehman was allowed to go into bankruptcy, but that event told us a great deal about what happens when a large financial institution fails. Contrary to the conclusions of the DFA's framers, it demonstrated that the failure of a large financial institution is very unlikely to cause a financial crisis. Even in a financial environment severely weakened by a common shock, Lehman's bankruptcy had virtually no knock-on effects. In other words, the collapse of Lehman showed that almost all financial institutions can survive the failure of a large firm even in the midst of a severe common shock.

This conclusion calls into question the need for both the stringent new regulations in the DFA's Title I and the orderly resolution provisions in Title II. If, as seems clear, the financial

crisis was caused by the severity of the common shock rather than the Lehman bankruptcy itself, the proper policy response was to take steps to mitigate the likelihood of future common shocks. Given a severe common shock to virtually all financial institutions, the orderly resolution of one or even a few large firms will not mitigate its effects; in the absence of a severe common shock, on the other hand, it is unlikely that the failure of one or a few large financial institutions will cause a systemic breakdown.

**Common Shock and the Financial Crisis**

Most observers now recognize that the precipitating cause of the financial crisis was a collapse of the huge US housing bubble in 2007. This was not just any bubble. It was almost ten times larger than any previous postwar housing bubble, and almost half of all mortgages in this bubble - 27 million loans - were subprime or otherwise weak and risky loans.

The reason for this was the US government's housing policy, which - in the early 1990s - began to require that government agencies and others regulated or controlled by government reduce their mortgage underwriting standards so borrowers who had not previously had access to mortgage credit would be able to buy homes. The government-sponsored enterprises Fannie Mae and Freddie Mac, the Federal Housing Administration, and banks and savings and loan associations (S&Ls) subject to the Community Reinvestment Act were all required to increase their acquisition of loans to homebuyers at or below the median income in their communities. Often, government policies required Fannie, Freddie, and the others to acquire loans to borrowers at or below 80 percent, and in some cases 60 percent, of median income.

Of course, it was possible to find qualified buyers that met prime lending standards in these areas, but when all these agencies and institutions were trying to meet increasing government quotas for lending to low-income borrowers, mortgage underwriting standards had to -deteriorate. Aggregate government demand, coupled with competition among the agencies trying to meet their quotas, not only built the housing bubble but loaded it up with subprime and other low-quality mortgages.

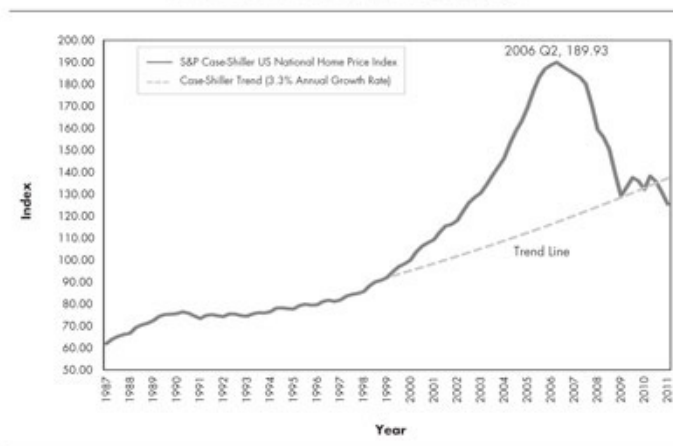
By 2008, before the financial crisis actually struck, two-thirds of the 27 million low-quality mortgages were on the books of Fannie and Freddie, other government agencies, and insured banks and S&Ls subject to the Community Reinvestment Act.

As bubbles grow, they tend to suppress delinquencies and defaults, since borrowers can easily refinance their homes or sell them for more than they initially paid. So, to banks and other financial institutions, MBS issued against pools of these weak loans looked like good investments. They were paying high rates because the loans were high risk, but they were not showing the high levels of default normally commensurate with these risks. As a result, starting in about 2004, financial institutions around the world began to buy these instruments in large numbers,

eventually acquiring MBS backed by pools of about 7.8 million mortgages - somewhat less than one-third of the 27 million low-quality loans outstanding.

But when the bubble began to deflate in 2007, the 27 million subprime and other weak mortgages started to default in unprecedented numbers, driving down housing values. Figure 1 shows the huge run-up and subsequent decline in real house prices during the bubble years 1997–2007.

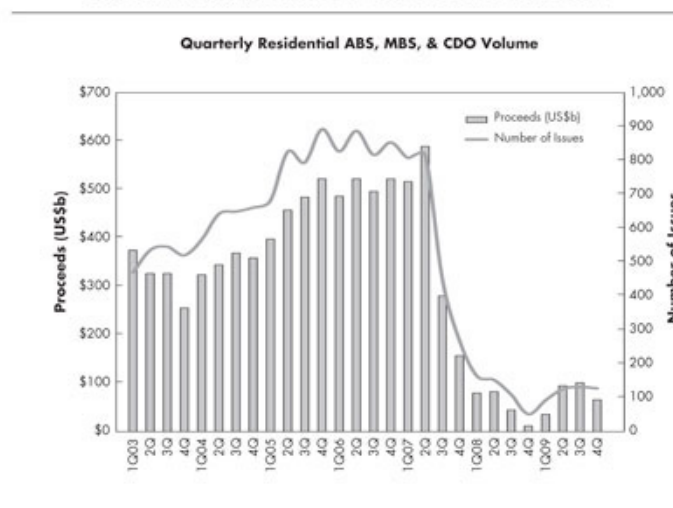
FIGURE 1  
THE US HOUSING BUBBLE: CASE-SHILLER NATIONAL HOME PRICE INDEX VALUES, 1987–2011 Q1



SOURCE: S&P Case-Shiller National Home Price Index.

With housing values falling precipitously, investors fled from MBS, making portfolios of these instruments unmarketable.

FIGURE 2  
THE MBS MARKET REACTS TO THE BUBBLE'S DEFLATION



SOURCE: Thomson Reuters, *Debt Capital Markets Review* (New York, NY, fourth quarter 2008). NOTE: ABS = asset-backed securities; and CDO = collateralized debt obligations.

Figure 2 shows the speed of the collapse in the MBS market. This had a devastating effect on the balance sheets of the large

financial institutions in the United States and around the world that were holding these assets - a problem seriously aggravated by mark-to-market accounting, which required the write-down to market value of assets on which losses had not yet been suffered. With the market collapsed and moribund, these values were far lower than the capitalized values of the cash flows the portfolios were generating. As a result, at least in an accounting sense, the institutions holding these securities looked unstable or insolvent, triggering significant declines in their stock prices and general investor and creditor anxiety around the world. Panicky investors, fearful of insolvencies, began to withdraw their funds from financial institutions and place them in safer hands.

The rescue of Bear Stearns in March 2008 temporarily quieted the markets but created substantial moral hazard. Most market participants believed that the US government's policy had been established: it would rescue all large financial institutions. On the evidence, it was not rational to believe otherwise. However, when Lehman was allowed to file for bankruptcy, market participants were shocked. Because of the decline in MBS asset values, it was unclear who was solvent and who was not—and now it really mattered. As a result, major financial institutions stopped lending to one another, creating the financial crisis.

Thus, the events of 2008 were the result of a sudden, generalized loss in value for a widely held asset - about \$2 trillion in privately issued MBS - coupled with the effects of mark-to-market accounting and the moral hazard that flowed from the rescue of Bear Stearns. What happened in 2008, as mortgage asset values began to fall and investors fled from the MBS market, was a classic case of a common shock, described as follows in a 2003 article about bank failures by banking scholars George G. Kaufman and Kenneth E. Scott:

*Except for fraud, clustered bank failures in the United States almost always are triggered by adverse conditions in the regional or national macroeconomies or by the bursting of asset-price bubbles, especially in real estate. . . . Banks fail because of exposure to common shock, such as a depression in agriculture, real estate, or oil prices, not because of direct spillover from other banks without themselves being exposed to the shock.*

In other words, bank failures—and by extension, financial institution failures—are generally caused by declines in the values of widely held assets, not by spillovers from the failure of other banks.

### **The Theory of the DFA's Framers**

However, the lesson of this history - that the financial crisis was caused by a common shock - was not absorbed by the framers of Dodd-Frank in the administration and Congress. From all indications, they diagnosed the crisis as the result of losses arising from the bankruptcy of Lehman Brothers, as though Lehman's failure had dragged down other financial institutions. This error is written boldly in their own statements, in their emphasis on the concept of "interconnections" among financial institutions, and in the DFA.

For example, in testimony before the House Financial Services Committee on October 1, 2009, Fed chair Ben Bernanke noted:

*In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after Lehman Brothers' and AIG's experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for such firms.*

This is a point repeated frequently by administration spokesmen—that the financial crisis came about because there was no choice but to allow Lehman to file for bankruptcy, and in effect that the bankruptcy itself caused the crisis.

Interconnections among financial institutions are also emphasized by the act's supporters, again to suggest that when one large financial firm fails it will drag down others. For example, Treasury Secretary Timothy Geithner, in a speech at New York University's Stern School of Business in August 2010, declared that "[t]he largest and most interconnected firms cause more damage when they fail." Although financial institutions are certainly interconnected to some extent, implicit in Geithner's use of the term is the argument that financial institutions are so critically interconnected that the knock-on effects of the failure of one could cause others to fail—in other words, a systemic collapse. A further illustration of this approach appears in a widely read speech in March 2011, by Federal Reserve governor Daniel K. Tarullo. Tarullo focused on the effects of a single firm's distress, outlining four ways in which that might cause general financial instability: a "domino effect" in which the failure of one large institution infects other firms; a "fire sale" effect in which a failing firm dumps assets and thus lowers asset values generally; a "contagion effect" in which market participants conclude from one firm's distress that others are in similar straits; and the discontinuation of a critical function for which there are no substitutes. None of these scenarios involves a common shock; it was an idea foreign to the framers of the DFA.

Thus, the DFA authorizes the Financial Stability Oversight Council to identify those financial firms which—if they fail—are likely to cause instability in the US financial system. If it is in fact true that these knock-on effects can result in systemic breakdowns, the 2008 financial crisis would be the acid test; we are unlikely ever to see a case in which a firm as large as Lehman Brothers is allowed to fail when the solvency or stability of other large financial institutions is subject to such doubt among market participants. Yet, as discussed below, there is very little evidence of knock-on effects associated with the Lehman bankruptcy.

Finally, and most importantly, the DFA creates a new orderly resolution system for large nonbank financial institutions of all kinds, administered by the Federal Deposit Insurance Corporation (FDIC). In effect, the DFA extends to all financial institutions the FDIC's authority to resolve insolvent insured

banks. Although there are some differences between the FDIC's authorities under the DFA and its authorities under the Federal Deposit Insurance Act, the authorities are essentially the same. It is important to note that these authorities can be extended to all financial institutions, and not just those designated by the Financial Stability Oversight Council as systemically important financial institutions (SIFIs). As discussed below, this will have an important effect in creating uncertainty about the enforceability of creditors' rights among firms that are not initially designated as SIFIs and thus will raise the cost of credit to these firms, as well as their consumer and business customers.

All of this raises the question of whether Lehman's bankruptcy—the kind of failure the orderly resolution provisions were designed to prevent—caused the financial crisis, either through the disorderliness of its bankruptcy or the knock-on effects of its failure to meet its financial obligations.

### **Did Lehman's Failure Cause the Financial Crisis?**

Contrary to the underlying assumptions of the DFA, the events that followed the failure of Lehman demonstrate the weakness of the interconnectedness and knock-on theories in explaining the financial crisis. With the single exception of the Reserve Fund, a money market mutual fund, there is no evidence whatever that any significant firm was caused to fail through the knock-on effects of Lehman's bankruptcy. Indeed, the case of the Reserve Fund is itself an example of the ill effects of the moral hazard created by the rescue of Bear. The fund could have rid itself of its Lehman holdings as Lehman was perceived to be weakening, but it likely held on to a large portfolio of the firm's commercial paper in the belief that Lehman, like Bear Stearns, would eventually be rescued and its creditors fully paid. AIG, one of the other high-profile failures around the time of Lehman, had virtually no exposure to Lehman. Nor is there any indication that the problems at Wachovia or Washington Mutual - the other institutions resolved in some way during the financial crisis - had any significant exposure to Lehman. In reality, all were victims of the same common shock that caused Lehman's failure. So in the absence of any evidence of knock-on effects from Lehman's failure, it is necessary to conclude that interconnectedness among financial institutions - as a theory for preventing a future financial crisis through tighter regulation - is invalid.

In the absence of any other examples, supporters of the interconnectedness theory have pointed to credit default swaps (CDSs) as a mechanism through which the failure of one financial institution could be transmitted to others. This is perhaps true in theory, but even in one of the greatest financial meltdowns ever, there is no evidence that the failure of Lehman or AIG - both of which were major players in the CDS market - caused any other financial institution to fail. Indeed, the CDS market continued to function effectively after Lehman and AIG (and through the entire financial crisis); losses on CDSs written on Lehman were resolved five weeks after its bankruptcy by the exchange of approximately \$6 billion among hundreds of

counter-parties. The CDSs on which Lehman was a counterparty were either terminated by its counterparties (who presumably bought replacement coverage) or continued in force by Lehman's trustee if they were favorable to the bankrupt estate. In other words, no great crisis developed in the CDS market as a result of Lehman's failure.

A particularly good summary of the outcome thus far with respect to Lehman's CDS portfolio is the following (by Kimberly Anne Summe in "An Examination of Lehman Brothers' Derivatives Portfolio Post-Bankruptcy and Whether Dodd-Frank Would Have Made Any Difference," April 24, 2011):

*While derivatives certainly lived up to their famous moniker as weapons of mass destruction in the view of the media and many policymakers, the fact remains that derivative transactions were terminated quickly and efficiently, although obviously settlement of claims and the ensuing fiduciary requirements of administration certainly slow the process, no major counterparties slid into bankruptcy, parties were eventually able to re-hedge their positions and quality collateral was fairly ubiquitous both before and after the meltdown in 2008.*

AIG, of course, was devastated by its participation in the CDS market, but this was because it had made the gross error of taking only one side of CDS transactions. It had sold protection against others' losses, but unlike other market participants it never hedged its bets by buying protection for itself. To use AIG's experience as a reason to condemn CDS activity as too risky to be carried on without regulation - the basis for the DFA's regulation of the CDS market - is like regulating all lending because one lender made imprudent loans.

Sometimes it is argued that the Troubled Asset Relief Program (TARP) prevented more failures. That seems highly unlikely. The first funds were made available under TARP on October 28, 2008, about six weeks after the panic following Lehman's failure. By that time, any firm that had been mortally wounded by Lehman's collapse would have collapsed itself. Moreover, most of the TARP funds were quickly repaid by the largest institutions, and many of the smaller ones, only eight months later, in mid-June 2009. This is strong evidence that the funds were not needed to cover losses coming from the Lehman bankruptcy. If there were such losses, they would still have been embedded in the balance sheets of those institutions. If the funds were needed at all - and many of the institutions took them reluctantly and under government pressure - it was to restore investor confidence that the recipients were not so badly affected by the common shock of the decline in housing and mortgage values that they could not fund orderly withdrawals, if necessary. However, even if we assume that TARP funds prevented the failure of some large financial institutions, it seems clear that the underlying cause of each firm's weakness was the decline in the value of its MBS holdings, and not any losses suffered as a result of Lehman's bankruptcy.

The same is true of many other extraordinary actions taken by the government after Lehman's bankruptcy, including

guaranteeing loans, purchasing commercial paper, and ring-fencing weak assets on the balance sheets of large financial institutions. These actions were made necessary by the effects of the common shock, not by the bankruptcy of Lehman. The fact is that even in their weakened condition, most financial institutions are so highly diversified that any losses suffered because of the failure of another firm are unlikely to leave mortal wounds, and that appears to be the lesson of Lehman.

This analysis leads to the following conclusion. Without a common shock, the failure of a single Lehman-like firm is highly unlikely to cause a financial crisis. This conclusion is buttressed by the fact that in 1990 the securities firm Drexel Burnham Lambert - then, like Lehman, the fourth largest securities firm in the United States - was allowed to declare bankruptcy without any adverse consequences for the market in general. At the time, other financial institutions were generally healthy, and Drexel was not brought down by the failure of a widely held class of assets. On the other hand, in the presence of a common shock, the orderly resolution of one or a few Lehman-like financial institutions will not prevent a financial crisis precipitated by a severe common shock. Resolving one institution, or even a few, will have little or no effect on the weakened condition of those still surviving. This question remains: even if the orderly resolution provisions of the DFA are not effectively designed to prevent a financial crisis, are they an improvement over the bankruptcy system? That issue is addressed in the rest of this Outlook.

### **Dodd-Frank and Insolvency Law**

As long as they remain part of the law applicable to financial institutions, the orderly resolution provisions of the DFA will have important adverse effects on insolvency law. In effect, by giving the government the power to resolve any financial firm it believes to be failing, the act has added a whole new policy objective for the resolution of failing firms. Before Dodd-Frank, insolvency law embodied two basic policies - retain the going concern value of the firm and provide a mechanism by which creditors could realize on the assets of an insolvent firm that cannot be saved. The DFA, based on the view that Lehman's bankruptcy was a cause of the ensuing chaos, added a third objective - preserving the stability of the financial system by giving the federal government a role in any insolvency.

As this Outlook will discuss, there is a real question whether the orderly resolution of the DFA is any better than bankruptcy as a resolution process. But there is little question that orderly resolution leaves creditors' rights in a state of serious uncertainty. This is because the FDIC, which is the statutorily designated receiver for any firm placed into orderly resolution, is given virtually unlimited discretion to determine who among a firm's creditors gets paid and to what extent.

In the interest of preventing instability in the financial system, the FDIC as receiver can do almost anything it wants with the assets and liabilities of a covered firm. As outlined in the DFA, the orderly resolution process is invoked by the Federal Reserve,

the FDIC, and the secretary of the treasury, acting separately. Each must decide that a financial firm is in default or "in danger of default" and that its failure might cause "instability" in the US financial system. If they so decide, but the firm itself does not agree, the secretary can go to a federal district court in a secret proceeding for approval to place the firm involuntarily into the orderly resolution process.

Incredibly - I should probably say absurdly - the court has only one day to render its judgment, after hearing both sides. If it cannot decide in a day, then the orderly resolution process is automatically invoked and the FDIC becomes the receiver for the institution. Obviously, a court would have to be considerably outraged by what the government was trying to do before it would intervene. It would be far easier just to let the day pass. The right to a hearing, therefore, is essentially a nullity, and the idea that the government can at any time take over a financial firm it believes to be "in danger of default" is of questionable constitutionality under the "takings" clause.

There are two additional aspects of this process that are noteworthy. First, the DFA seems to assume that the regulators' approach to the firm, the dispute with the board and management, and the court proceeding can all be kept secret. This is wildly naïve. In our financial system, with its 24/7 financial news cycle, nothing can be kept secret. It might even be a violation of securities law for these discussions to be held and not revealed to the markets. Still, the DFA provides for criminal penalties - a fine of \$250,000 or a prison term of up to five years - for anyone who "discloses a determination of the [Treasury] Secretary" to seek a takeover of a firm believed to be in danger of default. So here, as a demonstration of the mindset and naïveté of the DFA's framers, we have our first Official Secrets Act for a matter not involving national security. It's a good thing for its sponsors that the act has a severance clause. A clearer and more meritless restraint on free speech can hardly be imagined.

In a paper published in early 2011, the FDIC argued that its examination of a prospective target would not attract the attention of the markets. Such an examination, it said, would be regarded as "routine." That is a statement one would expect from an agency that has earned its stripes taking over small banks on Friday afternoon and reopening them under new ownership on Monday morning; it is a bit alarming that the FDIC thinks markets will not watch it closely as it goes about its business with firms that have billions of dollars in assets spread throughout the world. Once the rumors start, the markets and counterparties will react. There is a huge premium for those who can get out first. A firm that was stable one day will be unstable the next. Moreover, as its current creditors and counterparties desert it, no new creditors will be willing to come in - even as secured creditors - because the DFA leaves the ultimate discretion on payment of creditors with the FDIC. In the DFA's orderly resolution process, there is no stay and no debtor in possession financing. The assumption is that the government will provide the financing, recovering any losses from other large financial institutions - assuming they are not themselves in financial difficulty at the time - after the fact.

Second, to make the FDIC the statutorily designated receiver for any financial institution was - to put it plainly - a bizarre idea. During the few congressional hearings about the DFA, administration witnesses praised the FDIC as a highly successful agency in resolving insolvent banks. These statements were of questionable accuracy and clearly misleading. The FDIC is required by law to close down banks when their capital falls below 2 percent. If this process works, the agency should not suffer any losses because of bank failures, since the bank should have more assets than liabilities when it is closed. However, the FDIC has suffered losses averaging 25 percent on two-thirds of the banks it has closed in the last three years, and is itself currently underwater. With very few exceptions, the banks the FDIC closes are quite small, operating locally and not internationally, and the closure is done over a weekend, with accounts transferred to a healthy institution by the following Monday. The agency has no experience at all resolving non-banks, or even bank holding companies. How it would resolve a trillion-dollar insurance holding company like AIG or a \$600 billion securities firm like Lehman Brothers is anybody's guess. The only thing sure is that it would not happen over a weekend. It seems likely that the FDIC was selected and put forward as a qualified receiver because no one in the administration or Congress had any better idea.

Once the FDIC is appointed as receiver, it will have many of the extraordinary powers it already has under the Federal Deposit Insurance Act, but with very little of the judicial review available to creditors and others under bankruptcy laws. The agency's authorities as a receiver under the DFA include the power to:

Transfer all or any portion of the assets and liabilities of a firm in receivership to any person - or merge the institution with any person - without any approvals. Presumably, this would be for the agency's estimate of fair value, but even that would not be subject to judicial review.

Cherry-pick assets and liabilities without creditors' consent or court review, even if it differentiates between creditors in the same class or treats junior creditors more favorably than senior creditors.

Set up a bridge institution and transfer to that institution any portion of the assets and liabilities of the firm in resolution. If there is any doubt that the act allows the FDIC to protect creditors - which is really the meaning of a bailout - this provision should resolve it. Liabilities transferred to the bridge bank will be fully protected against loss. The DFA, despite the hoopla, has authorized bailouts instead of preventing them.

The net effect of these powers, and others, is to leave creditors' rights in a state of uncertainty. The FDIC has proposed a regulation that purports to limit its discretion in certain respects, but the statutory language can override that regulation in special circumstances the FDIC declares.

Uncertainty about the insolvency law applicable to a particular financial firm will continue to affect the US economy as long as the orderly resolution provisions of the DFA remain on the statute books. This is because all financial firms - not just the largest ones that have been designated for special regulation by the Fed - are potentially subject to this procedure. Section 202 of the act specifically confers authority on the secretary and the other officials noted above to cover any financial institution under the orderly resolution provisions. Accordingly, it will be difficult to tell in advance whether a financial firm in danger of failing will be resolved in bankruptcy - where one set of rules applies - or by the FDIC under the DFA's orderly resolution provisions.

The key will be whether the Federal Reserve, the FDIC, and the secretary of the treasury determine that the failure of a particular firm at a particular point in the future is likely to cause instability in the financial system.

That decision, however, will be strongly influenced by the conditions when it is made and is unknowable when credit is advanced. If the financial system is stable when such a firm is in danger of failing, it will likely be allowed to go into bankruptcy. On the other hand, the same firm might seem to be a candidate for the orderly resolution process if the financial system is weak and investors are nervous.

The uncertainty about a firm's status will increase the cost of credit for any financial institution that might reasonably be subject to the DFA's orderly resolution rules. Ironically, this might not be true of the very largest firms that are eventually designated as SIFIs. These firms will in effect have been declared too big to fail, and their creditors are likely to believe that they will be better protected in lending to such a firm in the event of the firm's failure. After all, if a firm is designated as systemically important, it is because its distress could - at least in the view of the government officials then in office - cause instability in the financial system. Thus, its creditors could be reasonably confident that regulators will not allow such a firm to fail. In effect, then, the systemically important firms designated by the Financial Stability Oversight Council will have additional advantages over smaller competitors because the uncertainty about their status is much lower.

Finally, one of the key policies of bankruptcy laws is the preservation of the going concern value of a bankrupt institution; for this reason, bankruptcy laws allow the management of a failed firm to reorganize it and maintain it as a going concern. Liquidation is an option in bankruptcy, of course, but usually only when the management cannot persuade creditors that the firm has prospects for a return to profitability. Preserving the going concern value of a firm is especially difficult for financial institutions, because they are uniquely dependent on client relationships and the trust and confidence of their counterparties. But this possibility is cut short by the DFA, which requires the liquidation of any financial firm put into the orderly

resolution process. Workout and reorganization are not an option.

The reason for this provision, which can only be described as punitive, seems to flow from the mistaken idea that unless a firm is liquidated its shareholders will be bailed out. Certainly this is not true of bankruptcy, where shareholders are generally wiped out and creditors work with the management to reorganize the firm. In contrast, under the DFA, the management of a firm taken over by the FDIC as receiver has to be immediately dismissed. So when the FDIC walks in, it does not know anything about how the firm really operates - who the key people are, where they are located, and how they carry out the successful and essential functions of the business.

To summarize, then, the orderly resolution provisions of the DFA will create uncertainty about which financial firms will actually be covered in the future, raise the financing costs of all financial firms that might be covered, destroy the value of going concerns by requiring liquidation and firing management, and turn over the resolution process for the largest nonbank financial firms to an agency - the FDIC - that has never resolved a nonbank and has not been particularly successful in resolving small banks.

### **Will It Work?**

From the discussion above, it should be clear that the orderly resolution provisions of the DFA will have an adverse effect on the financial system and the economy generally. It is possible that this effect is already being felt in credit restrictions and the unwillingness of businesses to expand and hire new employees. More-over, these provisions are not likely to help prevent a financial crisis: orderly resolution will not prevent or ameliorate the effects of a common shock, and is likely unnecessary in the absence of a common shock. Nevertheless, it is a legitimate question whether - simply by giving the FDIC the authority to replace the bankruptcy system under -certain circumstances - the DFA reduced the likelihood of a financial crisis. In other words, if Lehman had been placed into the orderly resolution process of the DFA, rather than into bankruptcy, would that have reduced the chaos that followed Lehman's bankruptcy?

The answer to this question is fairly obviously no. As noted earlier, Lehman's bankruptcy filing was not itself the cause of the financial crisis; it was the fact that its filing upset the market's expectations - after the rescue of Bear Stearns - about the US government's willingness to rescue all large financial institutions. The context is also important: at the time, because of the common shock associated with the mortgage meltdown and the collapse of the MBS market, virtually all large financial institutions were seen as unstable and possibly insolvent. The CDS market on Lehman's debt shows this confidence; it held steady for almost six months after Bear, blowing out only just before the last weekend when it became apparent that the government had run out of other options and was still refusing to support a Lehman rescue. When Lehman ultimately filed for

bankruptcy, all market participants had to reevaluate their counterparties and hoard their cash, bringing lending - even among the largest banks - to a halt. Placing Lehman into the DFA's orderly resolution process would not have changed the fact that the government was not willing to do for Lehman what it did for Bear. The financial crisis would have proceeded exactly the same way as it did in 2008, and been just as severe.

But let's go one step further. Let's assume that Bear had not happened and Lehman was the first large financial institution to be threatened with default. Is there anything about the orderly resolution process that would have made the aftermath of the Lehman failure less chaotic? No, again. In fact, it would have been much worse. As Lehman's time began to run out, the FDIC and others would closely monitor the company, leading market observers to believe that the firm would be placed into the orderly resolution process. The DFA specifies that as far as possible the losses in any resolution should be borne by unsecured creditors. Accordingly, the unsecured creditors would not be hanging about doing nothing; they would be withdrawing whatever funds they possibly could, and the firm would be bleeding liquidity. It would have to be put into the resolution process quickly, before it lost any ability to operate.

What would happen then? Under the DFA, the management would be dismissed and the FDIC would try to run the firm as receiver - without any experience in operating a firm of this type or of this global size. In its 2011 paper, the FDIC makes the claim that if it had had the authority conferred by the DFA before Lehman's failure, it would have been able to preserve Lehman's going concern value by transferring its assets and liabilities to a bridge bank. Let's consider this for a moment. What assets? What liabilities? Who makes this decision, and how fast could it possibly be made? A decision like this about a \$600 billion global enterprise could not be made in days or weeks, or even months. Meanwhile, with no stay, creditors would be declaring defaults and insisting on payment. Congressmen and senators would be calling to make sure their favored constituents were at the top of the list for immediate payment or at least transferred to the bridge bank. Chaos would reign.

Is this any better than a bankruptcy filing, in which there would be a creditor stay, politicians would have no influence, and the Lehman management would get protection from creditors while they worked out a reorganization plan? There is much reason for doubt.

So what has the DFA wrought in this area? It has seriously disrupted the universality of the bankruptcy system for nonbank financial institutions, ensured the same chaotic wind-down that occurred with Lehman, and put an inexperienced political agency in charge of the resolution, all without actually addressing the true causes of the financial crisis.

# Europe in Wonderland

By David M. Rowe, President, David M. Rowe Risk Advisory (reprint of article from from August 2011 issue of Risk Magazine)



**Only when governments realize that the power wielded by officially recognized rating agencies is largely created by the governments themselves will they make any real progress in reducing the impact of self-referencing feedback effects.**

European politicians are still blaming rating agencies for the continent's debt crisis – obscuring some of the real problems posed by ratings, argues David Rowe

It is a hard time to be a credit rating agency. After being rightly excoriated for the disastrous shortcomings of their analysis in rating structured sub-prime mortgage securities, they are now being pilloried for their understandable caution about falling behind the curve in the European sovereign debt crisis.

I have previously noted with approval Roger Bootle's comment that risk managers would do well to read less mathematics and more history and literature. I suspect, however, that he was not thinking of literature as far removed from our daily fare as Alice in Wonderland. Nevertheless, I was reminded of the below quotation while reading reports of José Manuel Barroso's (President of the European Commission) tirade against the rating agencies on July 6, following the latest downgrades for Portugal, Ireland and Greece.

"When I use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean – neither more nor less."

"The question is," said Alice, "whether you can make words mean so many different things."

"The question is," said Humpty Dumpty, "which is to be master – that's all."

A more ominous literary precedent is George Orwell's 1984, in which Big Brother proclaims that war is peace, freedom is slavery and ignorance is strength. Now, with equally brazen self-assurance, the powers-that-be would have us believe demanding private sector participation in resolving Greece's problems does not constitute a default on sovereign obligations.

Unless we are to corrupt language beyond recognition, such an interpretation cannot stand. Barroso issued a thinly veiled threat to make rating agencies civilly liable for their decisions. Presumably this means imposing fines and other penalties if ratings prove inaccurate after the fact. In an additional Orwellian twist, he combined this threat with the observation that agencies are "not infallible" and that they failed to anticipate the crisis of 2008 properly. Presumably, we are to conclude from this that infallibility is required to avoid breaking the law.

Barroso also fell into the trap which I addressed in the July article. He implied that measures to improve the methodology and transparency of sovereign ratings and reduce conflicts of interest could resolve the problem (Risk, July 2011, page 60, [www.risk.net/2080207](http://www.risk.net/2080207)).

Of course, many attacks on the agencies are really a smokescreen for the real political agenda, which is to suppress the ability of independent voices to speak truth to power. The view seems to be that if only these pesky agencies were subject to the benevolent oversight of European authorities, it would be possible to paper over the fundamental flaws of a system of monetary union without fiscal union.

But it is hard to be wrong on every single count. Barroso argued, for example, that financial institutions should be less reliant on agency ratings, and I certainly agree with this. Nevertheless, Barroso must realize that one of the biggest contributors to this reliance is the inclusion of ratings in the Basel II capital framework. Responsibility for this lies primarily with banking regulators. While the framework was being drafted, the agencies were critics, questioning whether it would complicate their job.

Leaving aside the question of blame, however, it is genuinely important to tackle the self-referencing dynamic created by the inclusion of ratings in the regulatory capital system. Even where methods and integrity are wholly sound, official agency ratings are not simply external insights into an objective reality. As we have seen repeatedly, such ratings are part of the market dynamics surrounding the securities they evaluate. It is this feedback that so complicates the entire situation and is at the heart of Barroso's outburst.

In a related argument, Barroso calls for the introduction of greater competition in ratings – again, a desirable goal. In the same breath, however, he calls for the creation of a European rating agency. If such an agency emerged spontaneously this would be fine. Unfortunately, it is likely to be bureaucrats and politicians that shepherd a European rating agency into existence. Few would take the assessments of such an organization seriously.

There is a more radical and more immediate way to foster competition in credit ratings. This is to abolish the entire concept of Nationally Recognized Statistical Rating Organizations – the registration system under which the big US agencies currently operate. Removing this certification role from the government would allow the emergence of specialized competitors, using a variety of techniques and covering differing securities and sectors. The market would be left to evaluate their effectiveness. Only when governments realize that the power wielded by officially recognized rating agencies is largely created by the governments themselves will they make any real progress in reducing the impact of self-referencing feedback effects.

# RiskCareers: Future of Banking and The Financial Services Industry

Steven Lee, Governance, Risk & Compliance, Global Client Consulting



*If you were asked to gaze into the future, what's your take on the future of banking? Of the financial services industry? Of careers in risk? How should aspirants position themselves for the future?*

Steven Lee

I had an interesting discussion with the RiskJournal Subcommittee recently on the future of the banking and financial services industry, in the wake of the global market crisis starting with the financial or subprime mortgage crisis in 2008, and spiraling to what we have today - sovereign debt weigh-down and likely a currency crisis in the not-too-distant future. What would become of the banking industry and the financial services industry-at-large? What would be the implications for those in risk management, and those aspiring careers in risk?

If you were asked to gaze into the future, what would be your take on the future of banking? Of the financial services industry? Of careers in risk? How should aspirants position themselves for the future?

The WSJ had a good article (<http://www.fins.com/Finance/Sectors/7/Investment-Banking>) which outlined some changes in the investment banking landscape. The industry here in the US is clearly shaken, with many players seeking for the moment at least to shed excess capacity. This is in part due to the fewer larger and lucrative deals in sight, and increasing competition from non-traditional players like Blackstone, Carlyle, as well as price pressures from the smaller boutique advisory firms with their significantly lower ask-fees. No doubt there will still be a place for the big players such as Morgan Stanley and Goldman Sachs. The global contraction is likely to lead to more near-term consolidations and mergers; but competition will be ultra-stiff and fees will continue to thin.

One may argue that with the poor market sentiments, corporates would be hard-pressed to seek the best advisors for their financing options and needs. That's true but with an increasingly thinning markets and hungrier competition, fee expectations will be suppressed. Markets are also likely to shift geographically; with increasing competition moving also into emerging markets more aggressively in search for the more lucrative deals.

There is also another article from InsideCareers (<http://www.insidecareers.co.uk/802574D8005177B3.nsf/id/82AEKSCWIS!opendocument>) on the changes to the banking industry following the crisis.

Clearly, market sentiments have shifted. Traditional lending business is being capitulated by the artificially suppressed interest rates and flat yield curve, especially with the recent announcement of "Operation Twist" by the US Fed. Ironically, such actions were enacted to spur credit growth through inciting borrowing demands. With crippling returns on most fronts and a very difficult lending business ahead, the industry's focus has moved to markets with more promising yields. This has caused banks to rationalize their business models, shedding presence where continued pain and contraction is likely to be persistent. The US and EU are two major markets suffering from an increasing pressure to cut-back to provide sustained return-on-capital. Cut-backs in hirings are therefore inevitable in face of fierce competition, difficult markets, increasing regulations, low yields, uncompetitive tax regimes and higher overall labor costs. The shift and potentially an exodus to the East and possibly also South should therefore not be a surprising phenomena. The question is whether this is just a temporary relocation or an actual dislocation of the global financial services marketplace.

Capital mobility is certainly not unusual in a globalized economy; but a major re-allocation of business investments which include setting up new operations, growing new divisions, shifting geographical focus are more "sticky" decisions that will "stick" around for longer. The search for better margins with prospects shifting outside the US and the EU, coupled with increasing trend of skilled financial expertise migrating East and South, attracted by the growth potential and build-up of the capital markets in these regions, we have to expect that such shifts will have a more lasting effect.

The time is short to prevent a tectonic shift that will start to gradually reduce the role of the US and EU in the global financial markets. Governments and regulators in the US and EU will need quick actions to stem this tide.

This shift has already started. More banks and financial institutions in the US and EU are moving or growing their footprint to more regulation friendly emerging economies to benefit from regulatory arbitrage. There is also continuing migration of private banking and wealth management businesses

to tap strong growth potential in the less mature markets especially with the vast build-up of wealth in those economies in recent years. In part, the growth in these newer markets is spurred by also by the more tax friendly regimes especially as compared with the US and to some degree also the EU. With the significant growth in the past few years, there has been further deepening and maturing of financial services industry and the capital markets in the East, and to some extent also some economies in the South. Governments in these economies continue to actively encourage development of capital markets including the growth of fund management and hedge fund businesses in these regions. The poor job prospects in the US and EU and the exciting growth potential in the East and South has encouraged migration of skilled labour, facilitating the transfer of experience, knowledge and skills to support the growth of the financial services sector in these regions. Large global financial institutions seeking to tap stronger growth in these regions to supplement declining revenue opportunities at home and elsewhere bring with them the technical know-how that would have been difficult to build organically. This pretty much completes the loop for a sustainable change in the global financial services landscape.

This shift that has taken place is unlikely to be reversed any time soon. If anything, it will likely be hastened if there are new and continued dysfunctional actions on the part of the regulators and governments that will actually drive more financial businesses away from their homeland in search of more sustainable businesses elsewhere.

Will this happen in the next 5 or 10 years? Even without the uneven pains of excessive and punitive regulations and tax burdens, there already exists a force to level the marked difference between the Emerging Economies (namely in the East and South) and the EU and the US. The rise of economic activity and growth in these emerging economies will necessitate an increasing demand for capital markets and financial services. Currently, the existing capital markets and financial services needs have mostly been serviced through offshore arrangements. However, these will be increasingly carried out within the fast growing regions as capital markets in these regions mature and deepen.

The continuing debt crisis, contracting economy and dismal job markets have driven governments, regulators and central banks to unprecedented interventions and policy actions. There is much to talk about regarding macro-risks which are not traditionally sustained and occurring at rapid successions that has created the need for corporates and institutions to manage these risks actively. I will try to cover this in our next issue in an article on "Managing Macro-Risks". For now, we will turn our attention to just central bank actions such as Quantitative Easing (QE) notably by the FRB and the BOJ and what is termed as "non-standard" measures by the ECB). These alone have created far too much uncertainty in the global marketplace,

especially of what, how and when further future actions might be taken.

The loose monetary policies and more importantly the perceived high level of uncertainty about possible central bank actions have undermined market confidence in longer-term Dollar and Euro denominated financing. While the Dollar, Yen and the Euro are hard to replace, the effects and uncertainty created by such intervention tendencies will drive the creation of alternative arrangements. How this will play out is subject of another discussion. But it creates incentives or even pushes emerging economies to work out multi-lateral arrangements that will help better shield their economies from increasing fall-outs from what is seen by some as arbitrary central bank market interventions. The recognition by these economies that this would only be more viable with more mature capital markets in their regions could certainly drive governments in these emerging economies to push to speed up growth, and offer greater incentives for large banks and financial institutions to drive that effort.

In conclusion, for the next few years, we can expect to see choppy developments. Some shifts have already started and will likely continue. This will primarily be driven by potential for better revenue streams, opportunities for "regulatory arbitrage" and a more forgiving tax environment in the near-term. But the bigger underlying reason for the shift will be the increasing recognition of the changing global marketplace and landscape. Economies in the East and the South will be increasingly more important players in the coming years, a shift back to historical global distribution of business and wealth, and a leveling of per capita GNP across the globe.

There will no doubt be effects arising from the global contraction caused by the debt weigh-down and economic slowdown in the US and the EU. Given the likely continued "hawkish" approach of the US and EU governments and regulators, there will likely be further stimulus and monetary easing in hope of dragging their economies out of a sinking hole. Such further actions will likely have less than sustained effects for their domestic economies, as structural reforms needed to supplement these actions are highly unlikely to materialize. These actions are in fact more likely to send businesses and capital flowing more into emerging countries in search of better yields. Apart from temporary effects of the flight of hot monies back into the Dollar and Yen from fear of a protracted global down-turn, these emerging economies are likely to be partly cushioned from the contraction by the mid-term tendency for flow of capital and businesses into their economies.

In all, we could expect to see a sustained shift of the financial markets and jobs, in the main to the East, and then the South. We are already seeing major banks and financial institutions making these big moves. Those who expect that these moves are likely to be temporary will be very disappointed.

# Prudential Banking Supervision PCA Reforms Needed?

Paul Kurgan, Global Client Consulting, PRMIA DC RiskJournal Editorial Subcommittee



*Prompt Corrective Action? The GAO says It Didn't Happen in Their Report Criticizing Bank Regulators. They made some sound recommendations but are more required?*

Paul Kurgan

The U.S. General Accounting Office's report ("Bank Regulation – Modified Prompt Corrective Action Framework Would Improve Effectiveness") to Congress in June 2011 confirmed what the markets had already concluded – that the bank regulatory agencies were slow to identify deteriorating conditions in the banking system and were ineffective in dealing with troubled bank problems during the period from 2007 to 2010.

The 3 federal banking regulatory agencies responded to the GAO's report and agreed with the major findings. They also stated the recommendation for additional tripwires, other than capital, within the PCA framework has merit.

PCA gave the regulators wide latitude in determining the required capital levels for banks. While the PCA framework defines 5 capital categories based on ratios of capital to both risk and non-risk weighted assets, the regulators are able to reclassify or downgrade a bank's capital category if they believe a bank is operating in an unsafe or unsound condition. The table below shows the PCA categories and thresholds.

Thus if a regulator found that a bank's loan portfolio was of

**Table 1: PCA Capital Categories**

Capital category	Total risk-based capital <sup>a</sup>	Tier 1 risk-based capital	Leverage capital <sup>b</sup>
Well capitalized <sup>c</sup>	10% or more and	6% or more and	5% or more
Adequately capitalized	8% or more and	4% or more and	4% or more <sup>d</sup>
Undercapitalized	Less than 8% or	Less than 4% or	Less than 4%
Significantly undercapitalized	Less than 6% or	Less than 3% or	Less than 3%
Critically undercapitalized	An institution is critically undercapitalized if its tangible equity is equal to or less than 2% of total assets regardless of its other capital ratios. <sup>e</sup>		

The GAO specifically studied the regulators track record in dealing with failed banks and those that were subject to Prompt Corrective Action ("PCA"). PCA was implemented as a result of the late 1980's/early 1990's bank and thrift crisis. It required the federal banking regulators to take prompt corrective action to identify and promptly address capital deficiencies at institutions to minimize losses to the FDIC's deposit insurance fund ("DIF"). The PCA requirements for minimum capital levels and the requirement to restore or increase bank capital have been a cornerstone of prudential bank supervision in the U.S. for over 20 years.

In their report, the GAO concluded that regulatory "actions to address early signs of deterioration were inconsistent and, in many cases, regulators either took no enforcement action or acted in the final days before an institution was subject to PCA or failed." An adequate level of capital was viewed by the regulators as essential and a legal requirement since 1991 but as a result of the regulatory lapses, the more than 300 banks that failed from 2007 to 2010 cost the DIF almost \$60 billion.

poor quality or heavily concentrated in one or more aspects, it could "downgrade" the capital rating to the next lower level and therefore require the bank to increase capital. Unfortunately, the GAO found that regulators made limited use of this authority.

The root causes for the regulators poor track record in using PCA as a principal supervision tool was not directly addressed by the GAO. The GAO did present a number of recommendations to improve its effectiveness in limiting losses to the DIF. Perhaps the most significant recommendation was to develop leading indicators of bank failure beyond just the capital ratios. The GAO stated that measures of asset quality, liquidity, and earnings could be used as tripwires to require higher capital levels. The GAO noted that the regulators currently use many indicators during their onsite and offsite supervisions to determine the financial condition of the banks. But they also noted that subsequent regulatory enforcement actions to address "riskier" aspects of a bank's financial condition were often inconsistent and did not always occur before banks were subject to the PCA process.

One of the indicators the GAO noted and recommended was that an accurate predictor of bank failure was loan sector concentration. Banks that failed had much greater concentrations (usually in real estate sectors) than their peers that continued in business. The Report offered the GAO's own concentration index based on sector exposure as well as the Herfindahl-Hirschman Index which was developed by two European central banks.

The other major recommendation was to raise all of the PCA capital categories. This is consistent with the new guidelines issued by the Basel Committee with recommends that increased capital levels be phased in by January 2015.

The GAO has offered a thoughtful approach and specific recommendations to improve the PCA process. Many of the recommendations will require further study and discussion before any revision to PCA is made. Clearly, the regulatory system will never be able to prevent all bank failures. The extent of the failures and the cost to the DIF would have been less if the regulators had done their job in spotting specific bank problems and then intervened earlier with a combination of stronger enforcement action and implementation of the existing PCA framework.

In their response to the GAO report, the 3 federal regulators acknowledge to some extent the shortcomings of their

application of PCA and state that they are working on implementing the lessons learned.

While there are some obvious lessons requiring a better regulatory process, regulations and supervision alone cannot assure the soundness of our financial system. As it is being played out now, the financial markets are both punishing and rewarding companies based on their performance and actions taken by management to meet the challenges faced. Thus the market imposes a discipline which no regulator can expect to provide.

Given that view, greater transparency is needed for financial institutions. Analyzing the financial health and soundness of these institutions is clearly difficult given existing disclosure and accounting standards. One method to improve transparency and apply pressure that only the markets can is to require disclosure of all enforcement action relating to unsafe and unsound practices unlike today where only the most serious enforcement actions are made public. If the regulators do revise PCA and develop tripwires as the GAO recommends, these should be made public. Bank Call Reports and SEC disclosures should note instances of non-compliance. In all, some quick measures can significantly improve effectiveness of prudential supervision. Supervising financial institutions is difficult. However, the stakes are too high for allowing history to repeat itself.

## Mission impossible for ratings

By David M. Rowe, President, David M. Rowe Risk Advisory (reprint of article from July 2011 issue of Risk Magazine)

### Transparency

The US Securities and Exchange Commission is soliciting views on how to reform the credit rating process to minimize conflicts of interest and assure higher-quality ratings. But this exercise is based on an erroneous view of the possible, argues David Rowe.

It is widely recognized that credit rating agencies failed miserably in their mission to provide credible evaluations of the quality of highly structured residential mortgage-backed securities. Many argue this failure was a direct result of conflicts of interest inherent in the 'issuer pays' structure of the rating market.



Significant elements of legislation spawned by the crisis have been intended to force greater disclosure and improve the quantity and quality of the information available to market participants and especially to regulators. In virtually all the discussion over transparency, though, it has been assumed that information will always be hoarded by private actors and that only legal compulsion can change that. It is worth asking whether there might be a better way.

While there is an element of truth in this view, it fails to capture the whole story. The only fully credible path the rating agencies could have taken was to refuse to wade into this swamp in the first place.

Having done so, they could have retained some of the credibility they have lost by refusing to rank the tranches of these securities on the same AAA to CCC scale traditionally used for corporate bonds and other traditional debt securities. Insisting on a new and distinctive rating scale, however, might well have been equivalent to refusing the business outright. For the arrangers of such securities, use of the traditional scale was a crucial advantage, as it allowed these securities to be eligible for purchase by many conservative long-term investors with mandates defined on this basis.

Currently, the US Securities and Exchange Commission (SEC) is soliciting comments on various proposals to reform the institutional framework of credit ratings.

The supervisor wants to ensure effective ratings, as if there is some objective truth that can be discovered as long as the right incentives are in place. In fact, when dealing with innovative, highly complex and historically untested structures, no such objective truth exists.

The perceived credit quality of such instruments can be as diverse as views on whether a given company's shares are a buy or a sell. Imposing a one-size-fits-all rating scheme risks unrealistically homogenizing market perceptions that should be highly diverse if adequate information for detailed analysis was widely available. Furthermore, it is just such homogenized perceptions that can lead to herd behavior and major market dislocations when broadly shared expectations prove to be unfounded.

Trying to reform market structure in search of a non-existent objective measure of credit quality and associated risk amounts to a mission impossible. It is bound to bureaucratize and homogenize ratings, thereby creating an inflexible structure that is vulnerable to a systemic crisis. In fairness, the SEC is only doing what was mandated by the US Congress. Nevertheless, what should be done is to seek a framework that will make all the relevant data underlying such securities readily available in a standard format to a broad community of analysts.

With access to the details underlying financial contracts and instruments (such as underwriting standards and statistics, pricing, terms and conditions, representations and warrants, as well as appropriate process and workflow calculations), new, complex and untested products could be analyzed in a wide variety of ways. This would probably lead to an equally wide variety of opinions on their likely performance. As programmers often say, 'that's not a bug, that's a feature'.

This is how markets are supposed to work. Over time, different views would prove more or less indicative of actual performance. Moreover, such heterogeneity of views is characteristic of a robust structure that tends to resist major systemic upheavals.

The question is how governments can promote such a structure. In particular, how can they ensure that detailed data will be maintained and updated as conditions change? I believe the essential lever for achieving this is a process that utilizes transaction credits. At one level, these can be a form of cash discounts for greater volumes of trading. These also can be used to provide discounted access to the detailed data needed for continuous risk assessments. An exchange for trading these products that was built on the foundation of such data would be able to charge for continuing access to the essential risk assessment information. Furthermore, discounts on the data fees would be linked to trading volume. In essence, the most valuable resource such a system would create – namely, access to currently updated underlying data – would be used as an incentive to drive trading volume and market liquidity, thereby addressing the biggest hurdle to the success of any new market venue.

A more detailed outline of such a system is described in a US patent granted to Marketcore, a small intellectual property company, under the title Efficient Market for Financial Products (see [http://www.marketcore.com/patents\\_efficientmarket.php](http://www.marketcore.com/patents_efficientmarket.php)). In the end, the SEC would do well to spend more time considering how to foster this type of institutional structure that encourages and rewards disclosure than in tilting at windmills in the belief that reshaping the credit rating market can produce uniquely reliable risk estimates of new, complex and historically untested financial instruments.

# RiskRegulations: Proposed Rules

Extracts from <http://www.stlouisfed.org/regreformrules>

Below are some selected **recent proposed rules**. For more complete and updated information, please refer to the website <http://www.stlouisfed.org/regreformrules>.

PUBLICATION DATE	COMMENTS PERIOD ENDED	RULE / DESCRIPTION	TOPIC
Jul 22, 2011	Aug 31, 2011	FRS - Notice of intent to continue enforcing certain OTS-issued regulations for savings and loan holding companies.	DFA Sections 312, 316; Thrifts
Jul 18, 2011	Aug 29, 2011	SEC - Proposed rules relating to external business conduct standards for security-based swap (SBS) dealers and major security-based swap (SBS) participants.	Derivatives Markets and Products; DFA Section 764; Investor Protection
Jul 6, 2011	Aug 30, 2011	IRS - Proposed rule-making modifying Treasury regulations to remove references to credit ratings and credit agencies.	DFA Section 393; Safety and Soundness
Jun 29, 2011	Aug 15, 2011	CFPB - Request for comment on implementation of a risk-based supervision program.	Consumer Protection; DFA Section 1001 et seq
Jun 27, 2011	Aug 26, 2011	SEC - Proposed rule amending the broker-dealer financial reporting rule.	Consumer Protection; DFA Section 982; Payments, Settlement & Clearing Activities
Jun 8, 2011	Aug 8, 2011	SEC - Proposed rule for nationally recognized statistical rating organizations.	Consumer Credit; DFA Section 901 et seq.
Jun 17, 2011	Aug 5, 2011	FRS - Proposed capital plan requirement for large bank holding companies.	DFA Section 165; Safety and Soundness
Jun 10, 2011	Aug 1, 2011	FDIC / FHFA / FRS / HUD / OCC / SEC - Joint proposal to implement credit risk retention requirements.	Consumer Credit; DFA Section 941
May 23, 2011	Jul 22, 2011	CFTC / SEC - Joint proposed rule and proposed interpretive guidance on the definitions of the terms "swap," "security-based swap," and "security-based swap agreement."	Derivatives Markets and Products; DFA Sections 712, 721, 761

# RiskRegulations: Final Rules and Notices

Extracts from <http://www.stlouisfed.org/regreformrules>

Below are some selected **recently finalized rules and notices**. For more complete and updated information, please refer to the website <http://www.stlouisfed.org/regreformrules>.

PUBLICATION DATE	EFFECTIVE DATE	RULE/ DESCRIPTION	TOPIC
Sep 1, 2011	Oct 31, 2011	<b>CFTC - Final rule establishing registration requirements, statutory duties, core principles and certain compliance obligations for registered swap data repositories (SDRs).</b>	<b>Derivatives Markets and Products; DFA Section 728</b>
Aug 25, 2011	Oct 24, 2011	<b>CFTC - Final rules implementing a whistleblower program that includes incentives and prohibits retaliation against whistleblowers.</b>	<b>DFA Section 748; Investor Protection</b>
Jul 26, 2011	Sep 26, 2011	<b>CFTC - Final rule on process for review of swaps for mandatory clearing.</b>	<b>Derivatives Markets and Products; DFA Sections 723, 745</b>
Sep 12, 2011	Sep 12, 2011	<b>CFTC - Final rules regarding retail foreign exchange transactions.</b>	<b>Derivatives Markets and Products; DFA Section 721; DFA Section 741; DFA Section 742</b>
Aug 3, 2011	Sep 2, 2011	<b>SEC - Removal of security ratings from rules and forms.</b>	<b>DFA Section 939A; Investor Protection; Securitization</b>
Jul 15, 2011	Aug 15, 2011	<b>FDIC - Final rule on certain orderly liquidation authority provisions.</b>	<b>DFA Section 209; Living Wills; Resolution Authority; Systemically Important Financial Institutions</b>
Jul 14, 2011	Aug 15, 2011	<b>CFTC - Final rules to implement new anti-manipulation authority in swap markets.</b>	<b>DFA Section 753; Investor Protection</b>
Jun 13, 2011	Aug 12, 2011	<b>SEC - Final rule to implement whistleblower incentives and protection provisions.</b>	<b>DFA Section 922; Investor Protection</b>
Jun 28, 2011	Jul 28, 2011	<b>FDIC / FRS / OCC - Final rule amending risk-based capital adequacy standards.</b>	<b>Bank Capital; DFA Section 171</b>
Jul 21, 2011	Jul 21, 2011	<b>SEC - Final rule on registration requirements for investment advisors and to the "pay-to-play" rule.</b>	<b>DFA Section 410; Investor Protection</b>

# RiskEducation: The PRM Certification

As many of you would testify, PRMIA aspires to a high standard for risk professionals, with more than 60 chapters around the world and over 72,000 members worldwide. As a non-profit and member-led association, PRMIA is dedicated to defining and implementing the best practices of risk management through education, events, networking, online resources, and certification including the Professional Risk Managers' (PRM) designation and the Associate PRM certificate. These two highly sought after certifications that PRMIA offers convincingly demonstrate members' knowledge and commitment to the field of Risk Management. Endorsed by leading businesses and universities, the PRM is the global standard for the world's top financial risk professionals - essential to practicing industry CROs. The Associate PRM Certificate is designed for those entering the risk management profession in addition to auditing, accounting, legal and systems development personnel who need to understand fundamental risk management methods and practices.

Our DC Chapter is proud that we have among us several new awardees of the PRM designation in the past months. Here we have two new PRM holders with our Chapter who are also proud to share with us why they pursue the PRM designation. We hope it will help others thinking about formal certification understand from them their reasons and the value of the PRM title.

## **Philip Lawton, CFA, CIPM, CMA, PRM**

Before joining Stone House Consulting, LLC as a partner in 2010, Philip Lawton was the founding head of Certificate in Investment Performance Measurement (CIPM®) program at CFA Institute. His earlier experience includes serving as vice president at State Street Investment Analytics and at Citibank. For eight years he was an officer in the Securities Department of The Travelers where, among other assignments, he managed a \$9 billion fixed-income portfolio. Mr. Lawton earned a doctorate in philosophy in the French-speaking section of the Catholic University of Louvain, Belgium, and an MBA degree with a concentration in finance at Northeastern University. In addition to holding the PRM designation, he is a Chartered Financial Analyst and a Certified Management Accountant. In 2007 he was awarded the CIPM designation in recognition of his central role in developing the CIPM program worldwide. A frequent speaker at industry conferences, Mr. Lawton is the co-author of a PRMIA Partner Publication, *The Top Ten Operational Risks: A Survival Guide for Investment Management Firms and Hedge Funds* (Stone House Consulting, 2010); the co-editor of *Investment Performance Measurement: Evaluating and Presenting Results* (Wiley, 2009); and the author of numerous articles in philosophy, professional ethics, and investment performance evaluation.

### ***Why did you pursue the PRM Designation?***

The PRM program is an outstanding practitioner-oriented course of study that equips financial professionals with the expertise they need to measure, monitor, and manage their firms' exposures to market, credit, and operational risks. The curriculum for the first three exams explains quantitative analytical techniques; the fourth part, based upon ethical principles and fascinating case studies, helps candidates develop the professional judgment expected of senior managers. The PRM credential assures regulators and employers of the professional's knowledge, skills, discipline, and commitment to excellence in the practice of risk management. I am proud to count myself among those who have earned the right to use the PRM designation

## **Tony Awoga, CPA, CMA, PRM**

Tony is an independent consultant whose job focus is on Accounting, Auditing, Business Intelligence & Analytics, Valuation and Risk Management

Tony holds a Masters of Accountancy degree from the Bowling Green State University, Ohio USA. Prior to venturing out to work as an independent consultant, he worked in the Internal Audit department of a secondary mortgage company where he evaluated the adequacy and effectiveness of business and accounting controls within the organization. Before joining Fannie Mae, he worked at both Deloitte and PriceWaterhouseCoopers and provided auditing and financial consulting services to companies in the manufacturing, financial services, government and not-for-profit industries. He is a Certified Public Accountant (CPA), a Certified Management Accountant (CMA) and a Professional Risk Manager (PRM).

### ***Why did you pursue the PRM Designation?***

I felt like there were gaping holes in my knowledge of risk management and financial instruments especially fixed income securities and after researching different programs in the risk management domain, I decided to pursue the PRM designation because of the comprehensiveness of the curriculum and the quality of the candidates' handbook. I also liked the fact that I could take the exam anywhere in the world and at anytime during the year."

I have been able to use the concepts I learned from studying the students' handbook in solving critical business problems, consequently adding value to my clients. I am also proud to be a member of an organization that is shaping the future of risk management and the regulatory landscape. I will not hesitate to recommend the PRM examination to anybody looking to distinguish him or herself in the risk management field.

# RiskResources - Stress Testing



## What's on the Web - Stress Testing after the crisis and the history

Inadequate capital and liquidity standards, deficient information models based on poor data, siloed risk management practices, and inadequate regulatory oversight – all of these factors contributed to the crisis but none are entirely new. The U.S. and Europe now require stress testing at both institutional and systemic levels to determine capital and liquidity requirements to withstand steady declines and sudden shocks. We hope you find the following websites valuable, whether you are establishing policy, managing implementation or conducting research.

**WeiHua Ni, PRMIA DC Steering Committee,  
PRMIA DC RiskJournal Editorial SubCommittee**

## What's on the Web - Stress Testing

### Bank for International Settlements (BIS)

<http://bit.ly/mX6d6B>

BIS is one of the best resources with stress testing international supervisory standards, best practices, and industry statistics, including the world widely accepted “[Principles for sound stress testing practices and supervision](http://bit.ly/nUdxXb)” (see: <http://bit.ly/nUdxXb>). The website has a “stress test” publication category, and more articles in other categories by searching “stress testing”.

### Financial Service Authority (FSA)

<http://bit.ly/pInBuK>

FSA, an independent non-governmental financial service industry regulator in U.K., is one of the best on-line libraries for stress testing. It collects materials on both institutional and system-wide level, including framework, methodologies, models, and practical Q&As.

### European Banking Authority (EBA)

<http://bit.ly/rv3kWL>

Having taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS), and cooperating with the European Systemic Risk Board, EBA initiates and conducts EU-

wide stress test, and published the outcome, scenarios, methodologies, and Q&As since 2009, including the “CEBS Guidelines on Stress Testing” by Aug 26, 2010 (see: <http://bit.ly/q2zAMg>), and the “Questions and Answers on the EBA 2011 EU-wide stress test” (see: <http://bit.ly/o3uDVd>).

### Board of Governors of the Federal Reserve System

<http://bit.ly/qMYrHu>

Federal Reserve Board in the U.S., along with the Federal Deposit Insurance Corporation, Department of the Treasury, and the Office of the Comptroller of the Currency, published the “proposed Guidance on Stress Testing for banking organizations with more than \$10 Billion in Total Consolidated Assets” by July 2011 (see: <http://1.usa.gov/qTdTdSz>). The web also has some commentary responses, and a “testimony and speech” sector including “Lessons from the Crisis Stress Tests” (see: <http://1.usa.gov/a2y1vX>).

### Committee to Establish the National Institute of Finance (CE-NIF)

<http://bit.ly/r54uT0>

CE-NIF is a group of volunteers that share the goal of positioning the NIF to be a key player in the coming financial regulation restructure in the U.S. The website has a good collection of the government reports, industrial publications, and academic research

papers including stress testing, capital planning, etc.

### DefaultRisk.com

<http://bit.ly/5Gj4O9>

This website collects publications and claims to be the biggest credit risk modeling online resource. It has a 'top twenty section' of the latest in-depth papers worth of reading, including a working paper, “The Role of Stress Testing in Credit Risk Management” from the Moody's Research Labs (see: <http://bit.ly/ll2jVS>).

### WOLTERS KLUWER LAW & BUSINESS, CCH Financial Reform News Center

<http://bit.ly/mWUOna>

The CCH Financial Reform News Center has a unique “stress testing” category collects discussions, expert's comments, and financial reform milestones from media and its own reporters.

### European Central Bank

<http://bit.ly/pg6gHF>

European Central Bank published “EU BANKS' LIQUIDITY STRESS TESTING AND CONTINGENCY FUNDING PLANS” by November 2008 (see: <http://bit.ly/pg6gHF>). The report provides an overview and insights based on literature review, workshop, survey, and the experience of regulatory agencies.

# RiskResources - Stress Testing History

The following websites provide a good history of the stress testing, a good resource to learn the evolving process of stress testing especially after the financial crisis.

## Czech National Bank (CNB)

<http://bit.ly/pF7nsz>

CNB, facing the increased financial instability in many countries in the 1990s, published paper “Stress Testing: A Review of key Concepts” in 2004 (see: <http://bit.ly/pF7nsz>). It provides a literature review on the quantitative methods used to assess the system-wide risks.

## International Monetary Fund (IMF)

<http://bit.ly/n41gNy>

Jointly with the World Bank, IMF prepared Financial Sector Assessment Program as a response of the 1999 Asia financial crisis. In addition to that, IMF has a series of publications on the system-wide stress testing, including “Stress Testing of Financial System: An Overview of Issues, Methodologies, and FSAP Experiences” (see: <http://bit.ly/qMEFja>), “Stress Testing Financial

Systems: What to Do When the Governor Calls” (see: <http://bit.ly/pjuMSJ>), and hold an “Expert Forum on Advanced Techniques on Stress Testing: Applications for Supervisors” in 2006 (see: <http://bit.ly/pXRjSG>).

---

## RiskEvents

### Upcoming PRMIA Events - N. Americas

Events below highlighted in ***bold italics*** are notable events which all **PRMIA DC Chapter** members should consider participating..

1. ***CRO Lecture Series - Featuring Capital One's Peter Schnall*** | Oct 11 2011 | Washington, DC
2. ***Credit Risk*** | Oct 19 2011 | Montreal
3. ***3-C Risk Forum*** | Oct 28 2011 to Oct 30 2011 | Toronto
4. ***Third Annual Policy and Risk Symposium*** | Nov 07 2011 | Arlington, VA
5. ***22nd Edition: SOX Compliance & Evolution to GRC*** | Nov 15 2011 to Nov 16 2011 | Chicago
6. ***The 13th Finance & Risk Management Career Conference*** | Nov 18 2011 | Montreal

# RiskEvent Highlight



## Nov 7, 2011 FDIC & PRMIA DC Third Annual Policy & Risk Symposium

Our next bi-annual FDIC-PRMIA DC Policy & Risk Symposium is coming up shortly - November 7, 2011. Do remember to save-the-date and register at our PRMIA website for the event before the seats run out. For more information, please [click here](#) or visit [http://www.prmia.org/events/view\\_events.php?eventID=4584](http://www.prmia.org/events/view_events.php?eventID=4584). For registration, please [click here](#).

Past sessions have always been very well attended and many participants have found the sessions to be informative and full of good insights. We are glad that many have been impressed with the quality of speakers and topics, as well as the strong networking opportunities with fellow risk professionals in the regulatory agencies, financial institutions, corporates and consulting firms. This is an important objective for all of us with the PRMIA DC Steering Committee, and we will continue to seek to do better each time.

For November 7, we will thread through some of the key developments arising from recent regulatory pronouncements and activities following the enactment of the Dodd-Frank Act and the agreement on the Basel III accord. There are indeed many issues that can be covered, and we have to limit ourselves to a few key ones that we view would be of strong interest to most. We have assembled an outstanding cast of distinguished speakers, among whom Nicholas Dunbar, Sean Egan, Simon Johnson, Allan Mendelowitz, Alex Pollock, and Chris Whalen are probably names that most of you recognize. They will help take us through a series of key topics which we have tried to outline below along with short abstracts of each to give you a sense of what we propose to cover.

We believe the speakers and the panels will have interesting perspectives and insights that they will discuss and share with us. To make the sessions more proactive and engaging, we will be allocating as much time as possible also for questions and answers with participants. We encourage you to think about these topics before the Symposium and come ready to engage the speakers and panels with your questions, and insights if time allows.

Below are highlights of the day's agenda. There are of course the usual niceties, including the networking session at the close of the event. It will be a day filled with a solid agenda, gaining strong insights from some of the best practitioners and thinkers in the field. Come join us and let's learn and engage each other!

### **HIGHLIGHTS OF THE DAY'S AGENDA**

#### **1. OPENING & INTRODUCTORY REMARKS**

#### **2. PANEL 1: The Qualified Residential Mortgage (QRM) Rule and Housing Finance: A Cure or More Trouble Ahead?**

**Abstract:** The QRM rule has been characterized by some as a strategy to restore faith in the originate-to-distribute mortgage model; an effort that will get the securitization markets in gear and ensure an on-going stream of available, cheap debt into our nationally subsidized housing complex. Critics of the rule are incensed by the exemptions granted to FHA and the Agencies which, they contend, were at the heart of the mortgage debacle. Why should GSE loans, perhaps the source of the bubble, get a break from risk retention? Others believe that the QRM effectively addresses the cause of the mortgage crisis by drawing a much more distinct line between good and bad credits, assuming the rules are written with enough teeth. They argue that the crisis was driven by the explosive growth of subprime, Alt-A, and pay-option arm mortgages produced without government subsidies, and that more radical changes will only exacerbate the current weakening of the housing market leading to continued economic misery. This panel will explore various alternatives to current policy direction with specific emphasis on risk retention, underwriting standards, and the capital allocation and industry distortions encouraged by broader national housing policy. Effort will be applied to answer whether the Dodd-Frank Act fails or succeeds to properly address these areas and what technical amendments may be needed to move us in the right direction.

#### **3. SPEAKER: Nick Dunbar - OTC Derivatives Clearing: Issues and Challenges**

**Abstract:** Former CFTC Chairman Brooksley Born has documented her efforts to enlist the financial regulators in efforts to contain the systemic risk posed by opaque over-the-counter (OTC) derivatives; however, the industry insists that OTC products played a minor role during throughout the on-going financial crisis. As a reminder, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") requires bilateral OTC derivatives with financial institution counterparties to be cleared on

exchanges. This move to Central Counterparties (CCPs) will increase transparency around potential systemic risk, will make the derivatives market more competitive, reduce risk, and improve price discovery. As a result, these actions will clearly dig into the bid/ask spreads of dealer banks and, therefore, dilute the profitability of the large banks. DFA has been opposed by both issuers and users of derivatives due to concerns including, on the one hand, reductions in margins to issuers and, on the other, increased cash capital requirements for users hedging economic risk and facing asymmetric cash-flows from their hedges and hedged core business positions. Users also fear that lack of liquidity in some derivatives may make the promise of price discovery illusive while making front-running of large hedging operations ubiquitous. We will provide an update on where things stand relative to the current move to CCPs and seek to address overlooked areas that will impose costs such as netting, lack of inclusion of variation and maintenance margins in the rule, and CCPs as emerging “Too Big To Fail” entities that should come under Title II and, potentially, be declared Systemically Important Financial Institutions (SIFIs), as the rules are currently described.

**4. KEYNOTE SPEAKER: Simon Johnson - Insights on The Crisis, Government & Regulatory Responses, Issues & Challenges**

**5. PANEL 2: The Volcker Rule and The Banking Business Model: Flawed or Fixed?**

**Abstract:** Is the classic model of the banking business unstable and fatally flawed? Recently some have argued in favor of alternatives, such as mutualization, Limited Purpose Banking, and money-market-like entities. Is this the right answer to our banking problems? Are the large banks still operating in a fundamentally insolvent condition and how should we begin to think about the “too big to fail” and “too complex to manage” problem that we seem to have ignored during the recent reform? Does the U.K. have the right approach given the ring-fencing proposal of “retail” banking or do we need more fundamental change, such as a move back to a Glass-Steagall world? Further, the panel will take on issues related to regulatory structure and oversight of the industry as well as challenges of supervision related to insurance, hedge funds, and exchanges given that banks operate within an across all of these domains.

**6. PANEL 3: Regulatory Interventions, Quantitative Easing and Future of Capital Markets**

**Abstract:** The Treasury and Federal Reserve have committed themselves to maintain policies of extraordinary monetary easing and other interventions for the indefinite future—policies that had been deemed necessary in order to bring the system back from the brink of collapse in 2008. However, the minority view is that a series of interventions and regulatory failures over the last several decades in fact caused the ongoing financial crisis and contribute to the flare-ups that have occurred every few years and that continued easing will only reproduce these crises. This crisis is unique in that we have claimed that we’ve learned our lessons from past errors and have applied greater wisdom this time around to the near meltdown of the financial system. However, what errors have we made during this crisis and what systematic mistakes have been made that will cause harm as we move forward? This panel seeks to address policy errors and solutions on a macro-prudential and broad cross-border macroeconomic basis, including the devaluation of the dollar, trade policy, and the role of our financial system in promoting and achieving global stability or, in this case, potential instability.

**7. CAPSTONE ADDRESS: The Capital Accord - Breaking with Basel: Consideration of Alternatives**

**Abstract:** In the wake of the financial crisis, measures were taken at the international level to adjust regulation of banks that led to the changes to the Basel Capital Accord, termed commonly as Basel III. These measures include among other things significant changes to capital requirements, liquidity requirements and bank leverage ratio. This has been viewed by some quarters as too much of a one-size fits all set of capital and liquidity rules, and may not be the right or effective approach to manage the largest, most complex banks on a cross-border basis. With regards to capital, it is unclear whether the Basel capital rules remain an appropriate framework for ensuring the safety and soundness of the broader financial system. There is also concern that the application and enforcement of the new standards will be uneven across borders. This would be inconsistent with one of the key principles of the Basel capital accord, which is to ensure a level playing field such that jurisdictional weaknesses in capital supervision and requirements don’t result in regulatory and capital arbitrage and a race to the bottom.

Will Basel III’s intent to shore up risk capital, enforcing strict liquidity and leverage requirements and address pro-cyclical concerns make for a stronger framework ahead? Some have expressed concern that the EU region might be taking on a lighter approach to Basel III than the U.S., in part due to Dodd-Frank Section 165 requirements that make U.S. rules more intense and of higher standard than any international arrangement. How should these concerns be reconciled? Is it time to abandon multilateralism in banking supervision and work instead to create the strongest financial system we can with focus on bilateral arrangements – a system that will promote capital security, safety and soundness? What impact might this have on capital flows? And, will this make for a safer global financial system?

# RiskEvent Highlight

## Nov 7, 2011 FDIC & PRMIA DC

### Third Annual Policy & Risk Symposium

COME LISTEN & ENGAGE WITH AN OUTSTANDING LIST OF SPEAKERS



**Thomas Day**  
**Managing Director, Risk and Policy**  
**SunGard Ambit**



**Kathryn E. Dick**  
**Managing Director, Promontory Financial Group**



**Nicholas Dunbar**  
**Author & Editor**  
**Bloomberg**



**Sean Egan**  
**Co-Founder & Managing Director**  
**Egan-Jones ratings agency**



**Jesse Eisinger**  
**Pulitzer Prize Winner**  
**Senior Reporter**  
**ProPublica**



**Paul Getman**  
**Executive Director**  
**Moody's Analytics**

# RiskEvent Highlight

**COME LISTEN & ENGAGE WITH AN OUTSTANDING LIST OF SPEAKERS**



**Simon Johnson**  
**Ronald A. Kurtz (1954) Professor of Entrepreneurship and  
Professor of Global Economics and Management**



**Christopher Laursen**  
**Vice President, Securities & Finance Practice  
NERA**



**Steve Lindo**  
**Director of Treasury Management and Mortgage Risk  
Fifth Third Bancorp**



**The Honorable Dr. Allan I. Mendelowitz**  
**Director, Federal Housing Finance Board and  
Former Chairman of Federal Housing Finance Board  
Founding Member, Committee to Establish the National Institute of Finance**



**Alex J. Pollock**  
**Resident Fellow  
American Enterprise Institute (AEI) for Public Policy Research**



**Richard Christopher Whalen**  
**Senior Vice President & Managing Director  
Institutional Risk Analytics (IRA)**