FTI JOURNAL

March 2015

Risky Business: Is Dodd-Frank on Target?

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Four years after Congress passed the most sweeping financial reform since the Great Depression, the regulatory framework shaped by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) remains a work-in-progress, with many rules still unwritten. But as regulators, rulemakers and finance industry lobbyists wrangle over how best to reduce systemic risk in the U.S. financial system, there’s a clear question hovering over the endeavor: Have the new rules actually accomplished what they were intended to do? In the inaugural FTI Consulting | Compass Lexecon Experts Forum, held in cooperation with the U.S. Securities and Exchange Commission (“SEC”) Historical Society, we asked specialists about Dodd-Frank, derivatives and structured finance, the assumptions that guided lawmakers, the impact of the assumptions on financial markets so far and the regulatory riddles yet to be solved.

What was the most frightening part of the 2008 financial meltdown? Was it the collapse of Lehman Brothers; the evaporation of the subprime mortgage market; the Fed bailout of insurance giant AIG; the global credit freeze? Ultimately, history will decide.

But in the wake of what for a long moment looked like the demise of American-style capitalism, Congress didn’t have the luxury of time. As a consensus built around the notion that treacherous risks, seen and unseen, had been haunting the financial markets for too long, legislators in 2010 crafted the legislation known as Dodd-Frank to exorcise as many demons as possible. The goal was to make sure such a financial crisis could not happen again.

So far, however, only about half of the rulemaking requirements have been met. And regulators have missed almost half of the rulemaking deadlines. But for the regulations that have been rolled out, how well are they serving their intended purpose? To find out, FTI Consulting and Compass Lexecon convened a group of experts to address Dodd-Frank Derivatives and Structured Finance.

Craig Lewis: Let us begin with a brief stage-setting discussion. Jim, as a former Chief Economist at both the SEC and the CFTC, you have a unique perspective on the events that precipitated the 2008 financial crisis, which led to the passage of Dodd-Frank. Could you describe the key market failures that Dodd-Frank addresses?

James Overdahl: Dodd-Frank was the response of Congress to the financial crisis of 2008, an event that included the collapse of Lehman Brothers, AIG and the near collapse of several other systemically important financial institutions. Members of Congress were acting to address what they felt were the key causes of the financial crisis. Lawmakers sought greater transparency across financial markets — transparency both to regulators and to end users of the market. Many of these transparency reforms were aimed at the market for over-the-counter [“OTC”] derivatives. For example, Congress required regulators to implement real-time reporting of OTC derivatives transactions to a swap data repository. In addition to this transparency objective, Congress directed that central counterparty clearing be required for most OTC derivatives transactions. Legislators felt central counterparty clearing would address counterparty credit risks that were a feature of the financial crisis.

MODERATOR

Craig Lewis is Madison S. Wigginton Professor of Finance at Vanderbilt University’s Owen Graduate School of Management and Professor of Law at Vanderbilt Law School. He previously was Chief Economist at the SEC, where he also served as Director of the Division of Economic and Risk Analysis.

PANELISTS

Christopher Culp, a Senior Advisor at Compass Lexecon, an FTI Consulting subsidiary, is an expert on structured finance, derivatives, structured insurance, credit risk and credit markets, and risk management.

Jason Kravitt is a Senior Partner at Mayer Brown LLP, where he founded the global firm’s Securitization Practice.

James Overdahl, is a Partner with Delta Strategy Group. He previously served as Chief Economist for both the SEC and the Commodity Futures Trading Commission (“CFTC”) and was a Vice President in the Securities and Finance Practice at NERA (National Economic Research Associates) Economic Consulting.

Lawmakers also addressed issues related to structured finance in the so-called originate-to-distribute model of banking [in which loans are made to be sold, not held], particularly when applied to subprime home loans where the cash flows of home loans were packaged into marketable securities with different risk-return characteristics.

Congress directed regulators to require that banks retain some risk in the process, sometimes called the "skin-in-the-game" requirement with respect to securitizations and also attempted to make credit rating agencies more accountable for the ratings they give to various tranches associated with these securitizations.

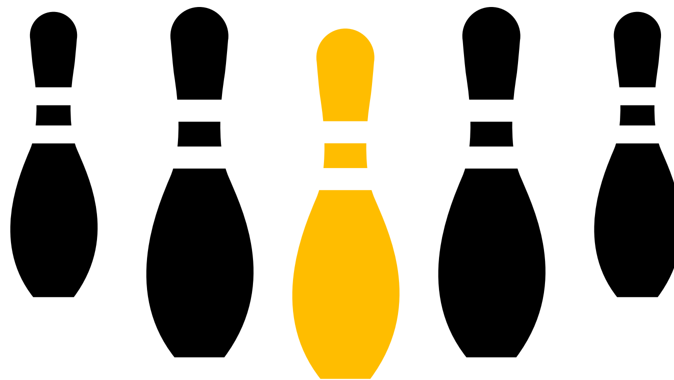
In the course of addressing market transparency, clearing and subprime mortgage securitizations, the legislative process that created Dodd-Frank has been likened to a bar room brawl, where the participants refrained from hitting the guy who started the fight in favor of attacking the guy they've been looking for an opportunity to punch. The legislation failed to address many key issues that were widely viewed as central causes of the crisis such as the unraveling of systemically important government-sponsored enterprises ["GSE"], including mortgage giants Freddie Mac and Fannie Mae.

However, Dodd-Frank addressed many issues that were not central or even remotely related to the crisis but had more to do with settling long-standing grievances.

Craig Lewis: Innovations in the market for OTC derivatives resulted in two key market failures. The first was the facilitation of the originate-to-distribute banking model that allowed big banks to create asset-backed securitizations and sell them to investors. Rather than performing their own due diligence, those investors relied on credit rating agencies to assess the risk.

The second market failure stems from the interconnected nature of the market for credit default swaps and the systemically important exposures financial institutions had to one another. The bankruptcy of Lehman Brothers made it clear that the inherent opacity of the pre-crisis OTC derivatives market prevented financial institutions from fully understanding the systemic nature of their exposures to other financial institutions, which, ultimately, led to the failure and subsequent bailout of AIG.

Jason, could you discuss the regulatory responses to the market failure surrounding the asset-backed securitization market?



Jason Kravitt: We have been putting emphasis on the originate-to-distribute model. I'd like to take a step back from that. The problem we're trying to solve is the creation of poor-quality asset-backed securities. The regulators, the legislators and a big part of the market quickly assumed the cause was the originate-to-distribute model. But originators didn't keep a piece of these asset-backed securities and, therefore, didn't bother to vet their credit quality in a way that owners would have done had they had their skin in the game.

To my knowledge, there is no definitive academic proof that the originate-to-distribute model was the cause of the poor underwriting. But as part of Dodd-Frank, Congress speedily came up with a requirement that six different agencies together adopt a risk-retention model.

What's interesting is that in the model legislators devised, subprime mortgage-backed securities — the very asset class that people feel started the problems — ended up, in large part, not having any rules that required securitization sponsors to retain any risk. What the regulators decided was that if the underlying mortgages were written in accordance with what the Consumer Financial Protection Bureau ["CFPB"] calls qualifying mortgage ["QM"] rules, and what in retention is called qualifying residential mortgage ["QRM"] rules, securitizers don't need to have *any* retention. QRM mortgages are expected to comprise the majority of the market.

Similarly, if it's a residential mortgage-backed security, guaranteed by a government-sponsored enterprise such as Freddie Mac, the security also is exempt from risk retention, assuming the GSE is in receivership, which seems to be a given for the foreseeable future. Returning to that bar room brawl analogy, it turns out that the people who threw the original punches received no punches in return and are not required to have risk retention.

The regulators also required restructuring of risk-based capital and the creation of two liquidity ratios for banks. It was easy to see that the banks didn't have enough capital and that securitizations probably should have required more capital. But securitization now actually has a cost of capital disadvantage compared with more traditional types of financing like lending.

Craig Lewis: I'd like to turn our attention to the OTC market for credit derivatives and the regulation contained in Title VII of Dodd-Frank. Chris, could you explain what is happening in this area?

Christopher Culp: Title VII, which deals with OTC derivatives, is an effort that's also going on in most of the big 20

industrialized countries. In September 2009, the heads of state of the G20 nations decided they wanted certain reforms. One was to establish central counterparty clearing for OTC derivatives. The leaders also set out to establish mandatory execution venue format requirements; that is, transactions that are subject to mandatory clearing should be executed on a transparent trading facility with mandated reporting requirements.

Not very long thereafter, the Bank for International Settlements — the international financial organization — and the International Organization of Securities Commissions decided that non-cleared OTC derivatives should be subject to higher margin requirements and that capital required to support non-cleared swap transactions also needed to be greater than it was before. So each country is implementing the regulations in a different way. Although some of the underlying principles are similar in spirit, there are a lot of cross-border issues that continue to plague implementation.

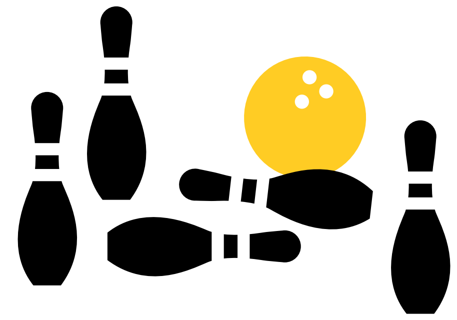
In the United States, we have new registration requirements that classify derivatives participants. By derivatives, I am referring to three categories of OTC derivatives. The two official categories are swap dealers and major swap participants. Under Dodd-Frank, we now have size-based definitions of swap dealers, which essentially reside on both sides of the market acting as market makers and classic intermediaries. The second category of major swap participants is an institution whose activities are big and diverse, but it doesn't operate on both sides of the market on a regular basis. Then there's an unofficial third category of end users, which is the customer. Examples of customers would be the airlines that use jet fuel derivatives to manage price risk or agricultural cooperatives that use wheat and corn derivatives to manage price and quantity risk.

The requirements that are aimed at non-cleared swaps and cleared swaps include a mandated clearing rule, requiring that most standardized OTC derivatives be cleared by a central counterparty. But the products involved, especially the interest rate derivatives, are not the products that caused the crisis. In fact, I'm not aware of any credible study that blames plain vanilla fixed or floating interest rate swaps for the global financial meltdown. Yet a lot of those products are exactly the ones that have been implicated by the mandatory clearing rule. Related to that is a mandatory venue execution rule for products that are subject to the clearing mandate or for other products that are specifically identified by the CFTC or the SEC. As part of Dodd-Frank's effort to bring greater transparency to the OTC swap market, those trades have to be made over a regulated facility, trading system or platform that's formally known as a swap execution facility. It's worth noting that these new rules do not necessarily cover some of the transactions that people cited that rationalized the basis for creating the rules.

Dodd-Frank also features a comprehensive reporting requirement, and most countries have gone all out on reporting and have required some kind of organized reporting to a swap data repository — or a trade repository as it's called in Europe — for, more or less, all OTC derivatives.

Craig Lewis: Jim, let me return to you. What have been some of the unintended consequences of Dodd-Frank and subsequent rulemakings?

James Overdahl: I can think of several, but one that stands out is with respect to swap data repositories. Part of Dodd-Frank requires that regulators, in this case the CFTC, implement a swap data repository rule known as the real-time reporting requirement. What we found is that some end users have had their information put into the public domain by the counterparty to the swap where it can be understood by the market, particularly in some illiquid markets. What this means for end users is that they face higher costs to get their swaps completed. The counterparty is going to require a higher spread because it's going to be more costly to hedge in a market where people know that a particular security is coming to the market. That



would be one example I can point to where a law that was designed to help protect users actually may have caused them harm.

Craig Lewis: Jason, I have questions about risk retention. It's understandable that purely on the grounds of providing credit protection for investors, GSE-guaranteed mortgage loans will require no retention. But does the architecture of the rule fit its purpose? And could you explain the lack of an investor down payment requirement?

Jason Kravitt: Sure. Remember that the purpose of the risk retention rule basically was to bring quality back into the securitization market. The question is, does it do that where it's necessary and does it not do that where it's not necessary? It looks as if we're going to have 100 percent retention in the asset-backed commercial paper market because the safe harbor that legislators came up with is not practical. Why do we need to have a bank finance any of the asset-backed commercial paper that a conduit issues when no one has ever lost a penny?

The down payment issue is fascinating. Everybody treats the 30-year fixed rate mortgage as God's gift to humanity and American civilization in particular. But it simply is a horrendous way for households to build wealth. I don't think it's a product that is worth distorting the system to preserve. As for the GSEs, investors don't need retention since the federal government is standing behind the institution. But the GSEs themselves need protection. Just recently, Melvin Watt, Director of the Federal Housing Finance Agency, said he intends to loosen guidelines on down payments for GSE mortgages. A lot of people worry that

we're again sliding down the slippery slope of poor underwriting. I'm not saying that's going to happen, but the concern has been raised.

Craig Lewis: Jim, under Dodd-Frank, the CFTC has authority over anti-disruptive trading. But how will legislators determine what disruptive trading actually is?

James Overdahl: In the past four years, the CFTC has been unable to come to a consensus on the definition of what constitutes disruptive trading. I think this indicates that disruptive trading is going to be determined by enforcement actions. There will be cases brought, and it will be determined whether any given party is found to be a violator. The issue is going to be how to separate out nefarious activity vs. legitimate behavior or even actions that should be encouraged.

Jason Kravitt: I think we've gone astray in the way we propose, adopt and apply rules. The more complicated they become, the more questions they raise, and nobody develops a moral sense of what the rules are supposed to be doing. The Ten Commandments contain less than 200 words. The Declaration of Independence has about 1,500 words. The U.S. Constitution numbers around 5,000 words. The proposing release for the CFPB rule on QM, which defines whether a customer can afford to repay a mortgage, is more than a quarter of a million words. So are we doing things the right way?

Craig Lewis: One of the reasons these rules become so long and complicated is that most regulators think they have only one bite at the apple so they try to anticipate every possible contingency. We would be much better off if we had simple rules where it is easy to see where the market failures actually have occurred.

Christopher Culp: When you're going to establish a regulatory framework based on what an asset-backed security is, you have to spend a lot of time defining an asset-backed security as a regulatory and legal matter. No matter how many pages, there is no way you can adopt a sort of ethics-and-principles-based approach to a product. A product is a product. It's a piece of paper with a staple in it. But perhaps this is too philosophical a question.

Craig Lewis: Gentleman, thank you. It's been a pleasure being with all of you. ■

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