Deregulating Wall Street

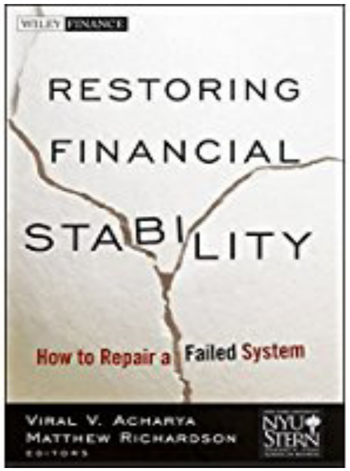
MATTHEW RICHARDSON, KIM SCHOENHOLTZ AND LARRY J. WHITE

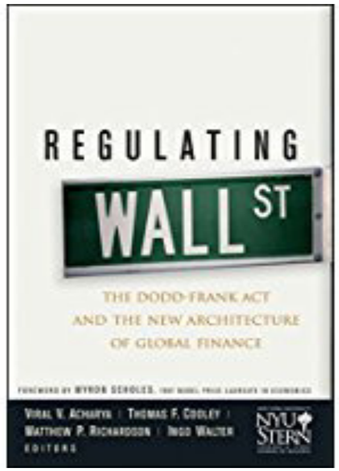
FOR PRESENTATION AT

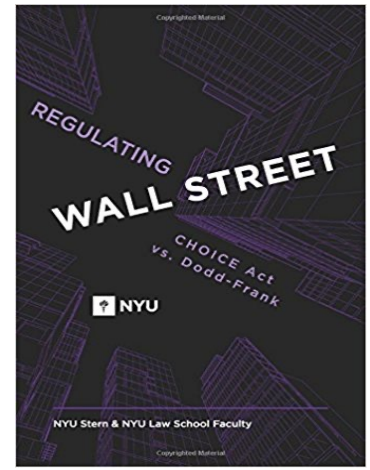
WHITHER REGULATORY REFORM, NOV 3RD

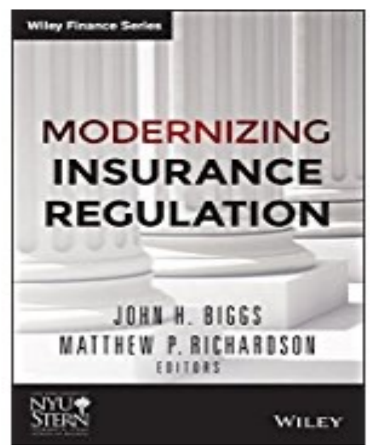
COLUMBIA/SIPA INITIATIVE ON CENTRAL BANKING AND FINANCIAL POLICY

NYU STERN BOOKS







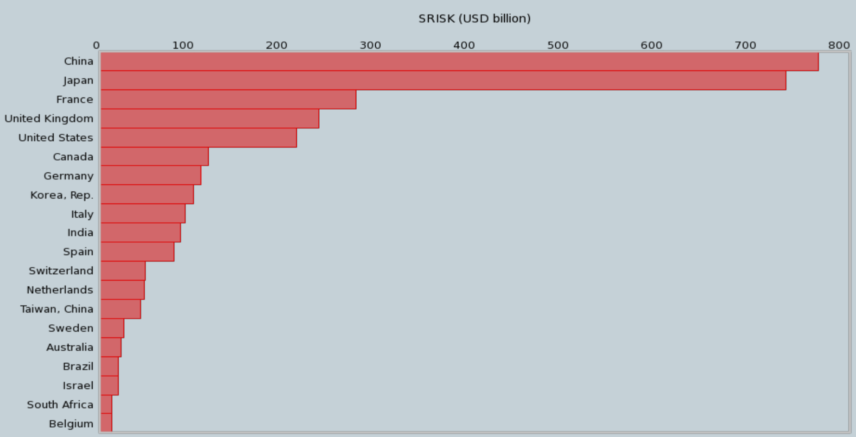


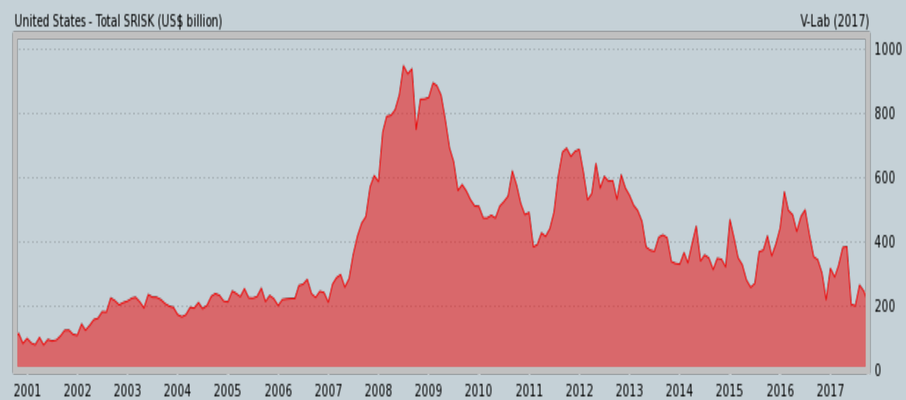
Systemic Risk

- Systemic Risk
  - The risk of widespread failure of financial institutions or freezing up of capital markets that can impair financial intermediation, including payments system and lending to corporations and households.
- Why Regulation Is Needed
  - Mispriced government guarantees of debt
  - Systemic risk costs do not get internalized by individual institutions.
- Two levers
  - Capital regulation
  - Regulation of scope

The Dodd-Frank Act

- 845 pages, 16 titles, and 225 new rules across 11 agencies - pulls on all the levers
- Assessment
  - All encompassing, but not particularly efficient, regulation
  - Aimed at reducing systemic risk
    - Some success https://vlab.stern.nyu.edu/en/welcome/risk/





The Dodd-Frank Act continued…

- Assessment
  - Systemic Risk
    - Management of systemic risk if it emerges
    - Individual, not system-wide, based
  - Threw the “kitchen sink” at the U.S. financial sector
    - A range of new and complex rules on the regulation of banks and financial products
    - Costs of regulation accumulate even though benefits overlap

Capital Regulation

- Systemic risk comes from (in aggregate) excess leverage or risk-taking Two levers to pull on.
  - More capital provides a buffer against losses, freduces risk of failing
  - Costs more controversial
- Dodd-Frank vs CHOICE Act
  - "Off-ramp" trades off higher capital requirements against exemption from Dodd-Frank regulation. Safer & sounder banks don't need to be regulated as much.

Capital Regulation continued…

- Caveats (in terms of CHOICE Act)
  - 99%, but not 100% of banks
    - Cannot accurately measure bank's risk and leverage
    - *Only* systemic risk assessment tool in Dodd-Frank is Stress Test – measures bank capital shortages across all SIFIs during a common shock.
    - Leverage ratio & risk-weights needed.
  - Consider impact of SIFI on financial system when it fails (OLA or new bankruptcy code)
    - Credible resolution plan ("living will")
    - Federal DIP financing

Capital regulation continued…

- With higher capital requirements, there will be regulatory circumvention towards *de facto* (shadow) banking activities
  - CHOICE Act eliminates non-bank SIFI designation
  - Consider last crisis & the investment banks
  - Does designating a non-bank as a SIFI make it TBTF?

Regulation of Scope

- Volcker Rule (section 619 of the Dodd-Frank Act); the creation of the Bureau of Consumer Finance Protection (CFPB) (Title 10) to deal with misleading products and more generally predatory lending practices; new underwriting standards especially in residential mortgages (Title 14); and rules for trading and the clearing of most derivatives transactions (Title 7), among others

Regulation of Scope continued…

- Most famous "regulation of scope" – Glass Steagall Act separating investment banking from commercial banking in 1933
  - Carter Glass vs Charles Mitchell
  - *"Banks are in the business of providing businesses with the capital they need to grow. Sometimes that means offering a loan and other times making an equity investment… We ensure our investments comply with all regulations, including the Volcker Rule."* (Goldman Sachs)

The Volcker Rule

- Restricts banks from particular holdings and activities – prohibits banks from prop trading in most securities and derivatives, and limits investments in hedge funds and private equity funds.
- Highly complex rule (75 pages plus a 800 page preamble) – prop trading vs market making, onus on banks (high compliance costs)

The Volcker Rule continued…

- Is Volcker Rule sensible?
  - Corporate loans vs corporate bonds vs private equity/ hedge funds making loans. Does it reduce risk?
  - Is "nonbanking" business more systemically risky?
  - What is core to banks?
  - Synergies
  - *De facto* banking activities
  - Market liquidity

Which lever to pull on?

RISK-WEIGHTED CAPITAL & LEVERAGE RATIO (W/ MEASUREMENT)

VS

REGULATION OF SCOPE (VOLCKER RULE, DERIVATIVES TRADING,UNDERWRITING STANDARDS,…)