Deregulating Wall Street

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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
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, reduces 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.
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
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
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)
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, ...)