Financial Regulation: Past, Present & Future

Deregulating Wall Street

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2008  Financial Crisis: A Ten-Year Review
November 8, 2018
Roadmap

• Dodd-Frank

• Key tradeoff: higher capital substitutes for other policy tools (such as restrictions on scope)

• Recent regulatory shifts: impact on resilience
  – Legislative changes
    • CHOICE Act (passed House, 2017)
    • EGRRCP Act (S.2155; enacted 2018)
  – Discretionary changes
    • Treasury reports and FSOC

• Inefficiencies (Volcker Rule)

• Conclusion

Note: Comments based on joint paper with Matthew Richardson and Lawrence J. White, and on joint work with Stephen Cecchetti. Errors are all mine.
Dodd-Frank

• Stern faculty books

• Dodd-Frank addresses systemic risk using:
  – capital requirements (buttressed by stress tests)
  – liquidity requirements
  – resolution mechanism
  – restrictions on scope of activities

• Regulation creates compliance costs
  – Broad consensus: reduce burden on small institutions
  – Disagreement about large intermediaries
Lower Systemic Risk

Legislation Relaxes Bank SIFI Oversight

• Eases burdens on small banks (EGRRCP Act)

• Relaxes scrutiny of larger ones
  – Bank asset threshold raised from $50bn to $250bn
  – Fed has to justify scrutiny of mid-sized banks
Threats to System: Size is Overrated

Source: Based on bank holding company data in Treasury Office of Financial Research update of Size Alone is Not Sufficient To Identify Systemically Important Banks.
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Treasury/FSOC: Amplifying Regulatory Arbitrage

- Principles and goals for designation
- Nov 2017: Treasury report — activities over entities
- FSOC Actions
  - 2013-14: AIG, GE Capital, MetLife, and Prudential
  - 2016-17: De-designation of GE Capital and AIG
  - Jan 2018: Treasury withdraws court appeal of MetLife
  - Oct 2018: Prudential de-designated
Discretionary Changes: Nonbank SIFIs

Notes: The numerator of each ratio is the market value of equity. The denominator is the sum of debt and the market value of equity. These leverage measures exclude “separate accounts” that are segregated from the firm’s “general account.” Final observation as of October 12, 2018. Source: NYU Stern Volatility Lab.
Volcker Rule Not Cost Effective

• Long and complex
• Not focused on risk management
• Market making vs. proprietary trading
• More effective tools available: higher capital
What is to be done?

• Streamline byzantine regulatory framework
  – U.K. has 3 regulators
  – U.S. has more than 100

• Transparency to promote market discipline

• Raise capital requirements further
  (remain alert to side effects)

• Address other forms of risk