

The Volcker Rule, Systemic Risk, and Financial System Efficiency

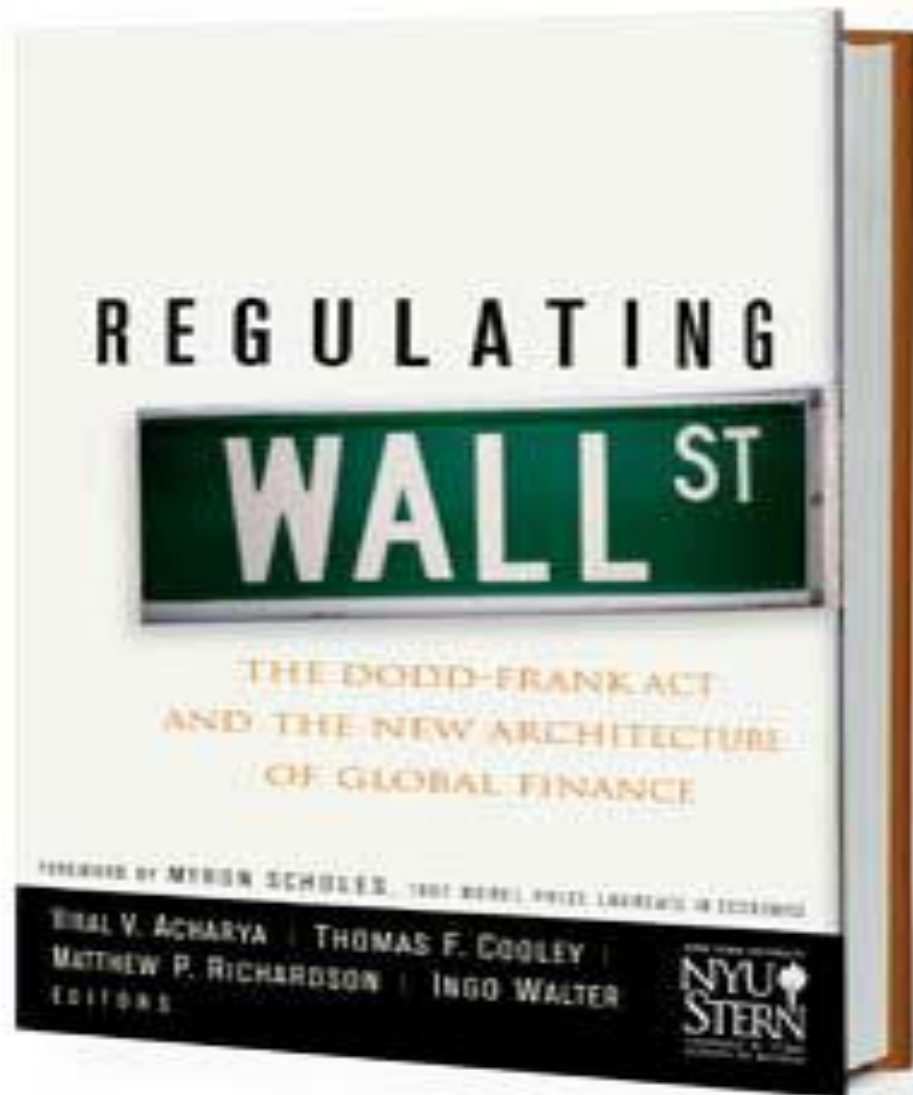
Professor Matthew Richardson

NYU Stern School of Business

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Economic Rationale for Financial Regulation

- Regulate the market failure: **systemic risk**
- First best: impose a **surcharge on financial institutions** proportional to their level of systemic risk
 - Firms organically choose lower leverage, less risky assets
- Second best: impose **hard constraints** on financial institution's **leverage** and **activities** (e.g., asset holdings)
 - In the last big financial crisis (30s), Glass-Steagall
 - In this one, Dodd-Frank – enhanced capital requirements and the Volcker rule

Volcker Rule Logic

1. Many activities are systemically risky, e.g., lending, fee-related financial businesses, principal trading, etc...
2. Some of these – like principal trading – are not core and can be done elsewhere.
3. Why do we care? Two reasons:
 1. Added systemic risk cost of having these activities in the banking sector.
 2. Higher leverage given access to the safety net - deposit insurance (banks), SIFIs (TBTF).

Principal Trading and Systemic Risk

Principal trading is at the center of our financial crisis and the one currently in Europe.

1. Near fatal investments in asset-backed securities as a way to avoid capital requirements. (AIG, Bear Stearns, Citigroup, Lehman Brothers, Merrill Lynch, RBS, UBS, ...)

3 Points About Implementing the Volcker Rule

1. We should not ignore:

- Carry trades and exposure to tail risk (rule is ambiguous):
 - E.G., Lehman Brothers report from April '08 shows holdings of RMBS of banks/thrifts as \$901 billion of agency and \$483 billion of non-prime AAA versus, for the GSEs respectively, \$741 billion and \$308 billion.
- Fee-based activities if non-core (e.g., asset management). (rule for most part ignores).

3 Points About Implementing the Volcker Rule continued

2. Hedging and market-making are key financial activities. Using these to exploit loopholes in the Volcker rule is an issue, but of second-order importance.
3. It is easier to write “first-best” rules that are complex than simple, but “second-best” simple rules may be more effective.