

Stability, market function in focus of debates over SIFI resolution, Volcker Rule

Jan 25 2012 Julie DiMauro and Stuart Gittleman

Another debate is looming over the Federal Deposit Insurance Corporation Systemic Resolution Advisory Committee meeting Wednesday on the resolution of systemically important financial institutions, or SIFIs. And this one is about implementing the Volcker rule.

Like the committee's mission, the Volcker rule was spurred by the Dodd-Frank Act. The idea is to have the regulators who oversee the banks that could affect global markets the most coordinate with their colleagues to avoid the riskiest of business lines, such as proprietary trading, and to protect creditors and investors if any such bank fails.



Anat Admati

The FDIC committee will discuss how a failed SIFI will be resolved under Dodd-Frank, how well SIFIs have developed "living wills" describing how they will be resolved under the Bankruptcy Code, and how to coordinate the wind-down of international SIFIs.

The meeting – please click here for the webcast – will feature FDIC officials discussing the issues with members of an advisory board that includes professors, corporate directors, executives and general counsel with significant experience in the banking arena.

The board includes Paul Volcker, the former Federal Reserve chairman who inspired the rule; Deven Sharma, president of Standard & Poor's; John Koskinen, non-executive chairman of Freddie Mac; and Professors Anat Admati of the Stanford University School of Business and Simon Johnson of the MIT School of Management.

Ahead of the meeting, Professor Admati discussed the agenda – and a controversial report by her Stanford colleague, Professor Darrell Duffie, on banks and the proprietary trading activities they and their affiliates engage in – with *Thomson Reuters*.

Professor Duffie is one of the many experts who are supplying information to the agencies responsible for implementing the Volcker Rule provisions of Dodd-Frank to advise them of the likely benefits and/or costs associated with the law.

In a report he wrote for SIFMA, the Securities Industry and Financial Markets Association, on the condition that his

fee go to a charity, Duffie concluded that the rule will reduce the quality and capacity of market-making services that banks provide to U.S. investors. Investors will find it more costly to borrow or raise capital, invest, hedge risk and gain liquidity for their positions under the Volcker rule, Duffie warned.

Comments on the proposed implementation of the Volcker rule are due February 13, 2012.

Duffie cited the "safety and soundness" of banks and the burdens the rule may impose on banks and their quarterly profits, but Admati countered that the rule is concerned about the long game -- the safety and soundness of banks, investors and the financial system in general.

"The reason we need to even think about stability is because banks, when they run into short-term trouble, the trouble affects all of us," Admati noted.

"It's not a question of market-making being a problem by itself; it's just a question of how much of it needs to be done by the banks. When banks do it and do not provide for their ability to fund oneself or invest adequately, the public bears the brunt," Admati added.

Duffie also referred to the importance of banks in the market-making process by providing immediacy to investors who rely on such services, but Admati, for her part, noted that broker-dealers are more than equipped to provide such services.

"The banks could spin off their trading activities and the trader, with valuable skills and experience, could raise outside capital and continue doing an equivalent version of his or her job, but bearing more of their own downside risks now," Admati said.

Referring to banks' capital requirements, Duffie implies in his writing that the mandates of Basel III will be adequate, while Admati would prefer they be significantly higher -- at least 10 percent of un-weighted assets. She also advocates that the weighting system that Basel uses to calibrate the risk of the assets be reconsidered, as it has not worked well and can create undesirable biases in banks' investment decisions.

"We should ban equity payouts for a while. There is absolutely no need or urgency for them until the banks reach a higher capital threshold," Admati said.

Many critics of the Volcker rule, Duffie included, focus on the mortgage losses incurred during the financial crisis, whereas those who support the rule often point to the risk-taking activities and high leverage of the banks as the main causes of the meltdown.