Reforming Financial Regulation and Supervision

Session 1: Why Did Regulation Fail?

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Three possible discussions

- Comment on paper by De la Torre and Ize

  "Regulatory Reform: Integrating Paradigms"

- Comment on issues in session program
  - What are market failures addressed by current regulation?
  - Is there a need for a radical rethinking of regulation?
  - If so, what should be the future regulatory architecture?
- Comment on other related issues

Part I

Comments on De la Torre and Ize

Overview

- Summary of paper: Three possible explanations
- Summary of paper: Five policy recommendations
- Comment 1: Approach of paper
- Comment 2: Radical change in regulatory architecture?
- Comment 3: On policy recommendations

Summary of paper

Three possible explanations

- Agency (risk-shifting) paradigm
- Externalities (social cost) paradigm
- Mood swings (behavioral) paradigm

Summary of paper

Five policy recommendations

- Distinguish between regulated & unregulated intermediaries

  → Unregulated not subject to capital requirements

  → Unregulated restricted to borrow from regulated

- Penalize short-term borrowing
- Improve safety next (deposit insurance, LOLR)
- Introduce authorization regime for <u>all</u> financial innovations
- Increase discretionary powers of supervisors

Comment 1

Two alternative approaches

- General overview of literature

  → Implications that are vaguely related to models

- Specific models

  → Implications that are tightly derived from models

Comment 1

- Paper follows first approach
  - Recommendations may (or may not) follow from models
  - Different models may lead to different recommendations
  - There is no “discipline”
- I would go for second approach
  - Not easy: There are many models and many puzzles
  - But it is the only way to design sound policies

Comment 2

A radical change in regulatory architecture?

- Proposal ignores
  - Self-correcting market mechanisms
  - Risk of creating new forms of moral hazard
  - Risk of creating new forms of regulatory arbitrage
  - Risk of supervisory failure

Comment 2

- I would favor a “minimal approach”
  - Keep basic regulatory structure (including Basel II)
  - Increase level of capital requirements
  - Introduce countercyclical adjustments in capital regulation
    - → Repullo, Saurina and Trucharte (2009)
- I would also favor increasing research on financial regulation
  - By academics → launch research program funded by IFIs
  - By policy-makers → increase research capabilities

Comment 3

On policy recommendations

- Introduce an analytical examination of <u>all</u> recommendations
  - → Panel of independent experts look at each proposal
  - → Policy-makers then decide on basis of this advice
- Radical changes should require significant expert support
  - → They may have negative “side-effects” (like drugs!)
- My initial reaction
  - → Against proposal on unregulated intermediaries
  - → Against proposal on financial innovations

Part II

Comments on issues in session program

Overview

- Market failures addressed by regulation
- What went wrong: market failures
- What also went wrong: regulatory failures
- What did not go wrong

Market failures addressed by regulation

- Common externality: Social cost of bank failure

  → Contagion to other banks

  → Destruction of lending relationships

  → Disruption to payment system

  → Distortions in monetary transmission

Market failures addressed by regulation

- Specific channels
  - Risk-shifting incentives of debt financing

    → Minimum capital requirements
  - Inefficient bank runs by small investors

    → Deposit insurance
  - Inefficient bank runs by large investors

    → Lender of last resort

What went wrong: market failures

- Underestimation of systemic risk

  → Partly due to the good experience of past decade

- Downside of financial innovation – Rajan (2005)

  → Greater scope for risk-shifting

- Increased competition → lower charter values

  → Higher risk-shifting

- Weak corporate governance → compensation-related distortions

  → Higher risk-shifting

What also went wrong: regulatory failures

- Underestimation of systemic risk

  → Focus on micro-prudential approach to financial regulation

- Regulatory capture

  → Low capital requirements (given higher risks)

  → Weak enforcement of regulation

  → Disregard for liquidity risk

What also went wrong: regulatory failures

- Poorly designed supervisory institutions
  → Little incentives to collect prudential information
  → Relevant information in the wrong place
- Poorly designed deposit insurance schemes
  → Widespread criticism by academics and practitioners
  → Illusion of monitoring by small depositors

What did not go wrong

- Hedge funds

  → Despite “obsession” with hedge funds prior to crisis

  → Too little

- Basel II

  → Despite widespread criticism by many commentators

  → Too late

Part III

Comments on other related issues

Overview

- Role of macroeconomic factors
- Search for yield?
- A simple model
- Another simple model
- Summing up

Role of macroeconomic factors

- Global imbalances → Blame the Chinese (and possibly others)
- Low interest rates → Blame Greenspan (and possibly others)
- Connection with risk-taking

  → "Search for yield"

Search for yield?

An uncontroversial statement

- In a market economy investors always search for yield
- This should be independent of the level of interest rates

Two puzzles

- Why the "search for yield" story has become so prominent?
- Why so little serious work has been done on this?

A simple model

- At date 0
  - Bank raises 1 unit of deposits at fixed rate c (no capital)
  - Bank invests in risky asset + chooses risk parameter p
- At date 1
  - Return from investment

$$R = \begin{cases} 1 + r + s(p) & \text{with probability } 1 - p \\ 0 & \text{with probability } p \end{cases}$$

→ r is policy rate set by central bank

→ $s(p)$ is risk-shifting function, increasing and concave

A simple model

- Bank's optimal choice of risk

$$\max_p (1-p)\left[r+s(p)-c\right]$$

- First-order condition

$$(1-p)s'(p)=r+s(p)-c$$

- Effect of changes in r → differentiating FOC

$$\frac{dp}{dr}=\frac{-1}{2s'(p)-(1-p)s''(p)}<0$$

→ Result: Lower asset returns (r) implies higher risk (p)

A simple model

- Key assumption

  → Cost of liabilities c does not move in line with policy rate r

- How could we justify this assumption?

  → Commercial banks: c may be zero (checking accounts)

  → Pension funds: c may have been set when rates were high

- Alternatively c may capture fixed operational costs (wages, etc.)

Another simple model

- At date 0
  - – Bank raises 1 unit of deposits at variable rate *r*
  - – Bank invests in risky asset + chooses risk parameter *p*
- At date 1
  - – Return from investment

$$R = \begin{cases} 1 + c + s(p) & \text{with probability } 1 - p \\ 0 & \text{with probability } p \end{cases}$$

→ *c* is fixed (e.g. mortgage) rate set when rates were low

→ *s*(*p*) is risk-shifting function, increasing and concave

Another simple model

- Bank's optimal choice of risk

$$\max_p (1-p)\left[c+s(p)-r\right]$$

- First-order condition

$$(1-p)s'(p)=c+s(p)-r$$

- Effect of changes in r → differentiating FOC

$$\frac{dp}{dr}=\frac{1}{2s'(p)-(1-p)s''(p)}>0$$

→ Result: Higher funding cost (r) implies higher risk (p)

Search for yield?

- Can any of these models contribute to explaining crisis?

  → Need much more theoretical work

  → Need much more empirical work

  → Need general equilibrium perspective

  → Until such work is done

  maybe we should not blame the Chinese (or Greenspan)

Summing up

- Be very careful with radical changes in regulation

  → They may do more harm than good

- Have proper analysis of regulatory trade-offs

  → Resist the urge of politicians to do something quickly

- Do not underestimate self-correcting market mechanisms
- Do not overestimate regulatory and supervisory capabilities
- Significantly increase research budgets

  → Policy mistakes are <u>very</u> expensive

  → It makes a lot of sense to invest in crisis prevention