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A ‘wish list’ for regulatory design

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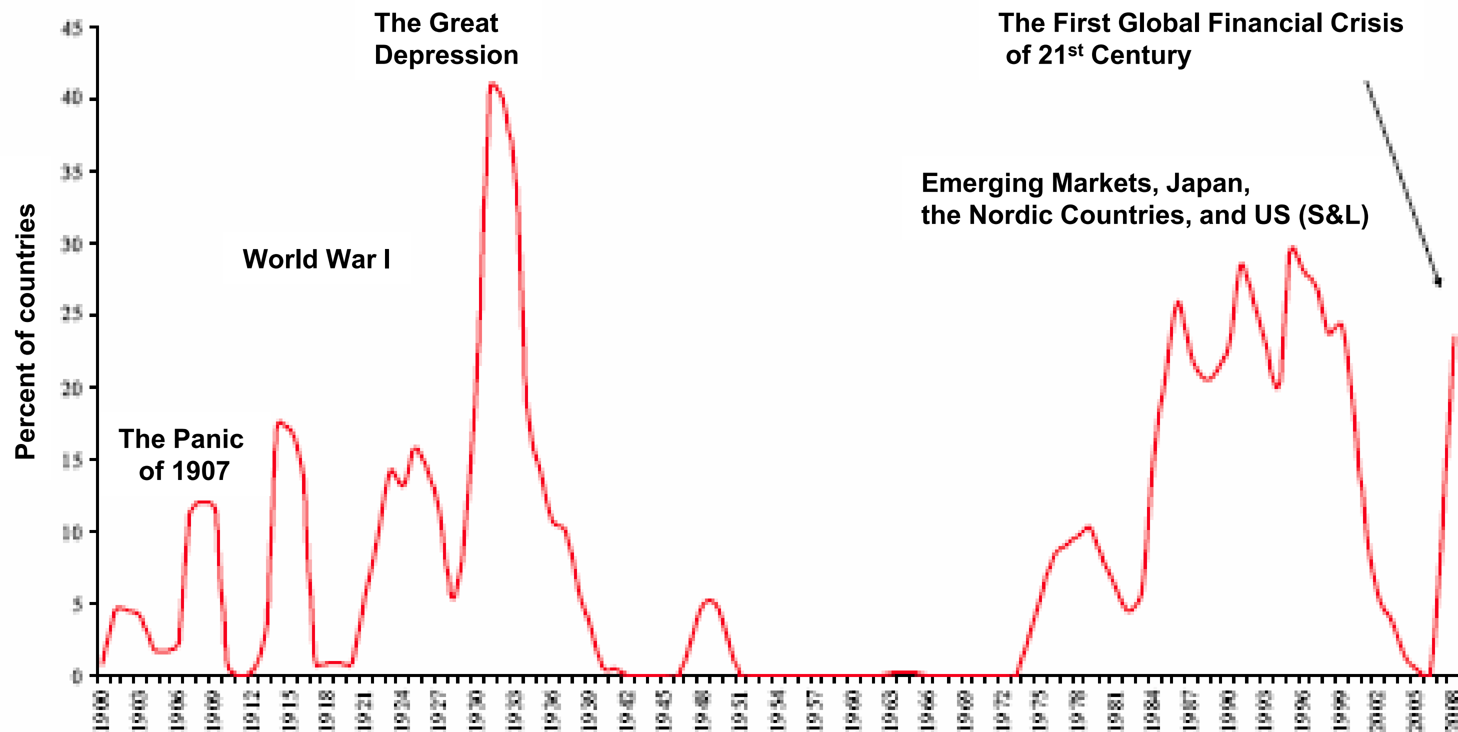
Whither regulatory reform?

2017 “Challenges for the Future of Banking” conference

SIPA-Columbia, November 3, 2017

Proportion of countries with banking crises: 1900-2008

Weighted by their share of world income



Source: Figure 1 in Reinhart & Rogoff (2008), "Banking Crises, An Equal Opportunity Menace", NBER WP 14587.

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Will we ever learn?

Regulatory failure and regulatory cycle

*“**Post-2008 financial regulatory changes largely have been a failure**.*

They have produced high compliance costs, while constructing regulatory mechanisms that are unlikely to achieve their intended objectives.

Furthermore, financial regulation increasingly has adopted processes that are inconsistent with adherence to the rule of law, which not only threaten the fundamental norms on which our democracy is founded but also undermine the effectiveness of regulation.

The combination of high costs, ineffective mechanisms, and inappropriate processes reflects a neglect of the core principles that underlie successful financial regulation.”

Preface, Calomiris (2017)

Post-2008 regulatory failure

- Risk-based capital requirements can be gamed, there are too many ratios and there is overreliance on book values.
- Fed has conflict of interest with intervention with MBS (QE and bank regulator) and repos (repo counterparty and repo regulator).
- Too much opacity and discretion in Fed stress tests, Volcker rule, living will enforcement, SIFIs designation by FSOC
- Basel liquidity requirements have no basis in economic theory.
- New resolution authority will promote bailouts.
- Volcker rule: “a solution in search of a problem”.
- Leverage/liquid ratios decrease liquidity in OTC markets.
- Regulating banks transfers problem to shadow banks.
- CARD reduces CC lending and increases share of (shadow bank) finance companies in consumer credit to high-risk consumers.
- CFPB Structure, Process and Policies: “a lighting rod for controversy”.

Why is it so difficult?

- Second best principle under simultaneous market failures
- Financial innovation
- Political economy of banking and regulation

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COMPETITION AND STABILITY IN BANKING

THE ROLE OF REGULATION AND COMPETITION POLICY

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Principle (Calomiris)

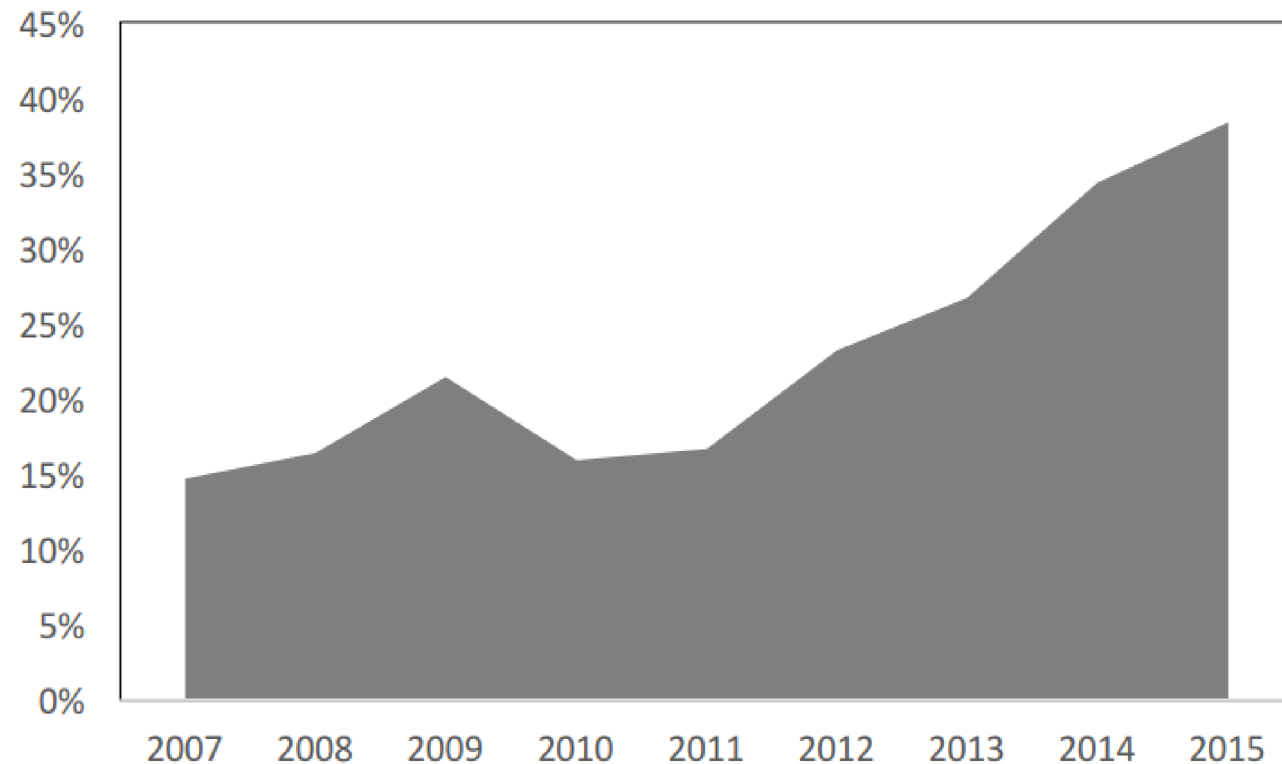
"Designing financial regulatory policy should not be viewed as striking a balance between economic growth and financial stability. The best ideas for regulatory reform can achieve the highest sustainable growth without increasing the risk of a financial crisis".

Prudential regulation: a piecemeal approach will not work

- Capital, liquidity, disclosure requirements, macro-prudential ratios have to be thought together (taking into account activity restrictions if present):
  - Vives (RFS, 2014): liquidity and default risk are related and capital and liquidity ratios have to be combined to manage default probabilities.
- Competition policy is not independent of prudential regulation.

Regulation and shadow bank growth US mortgage market post-crisis

Shadow bank origination as a fraction of total originations from all mortgages. Buchak et al. (2017)



(a) All loans

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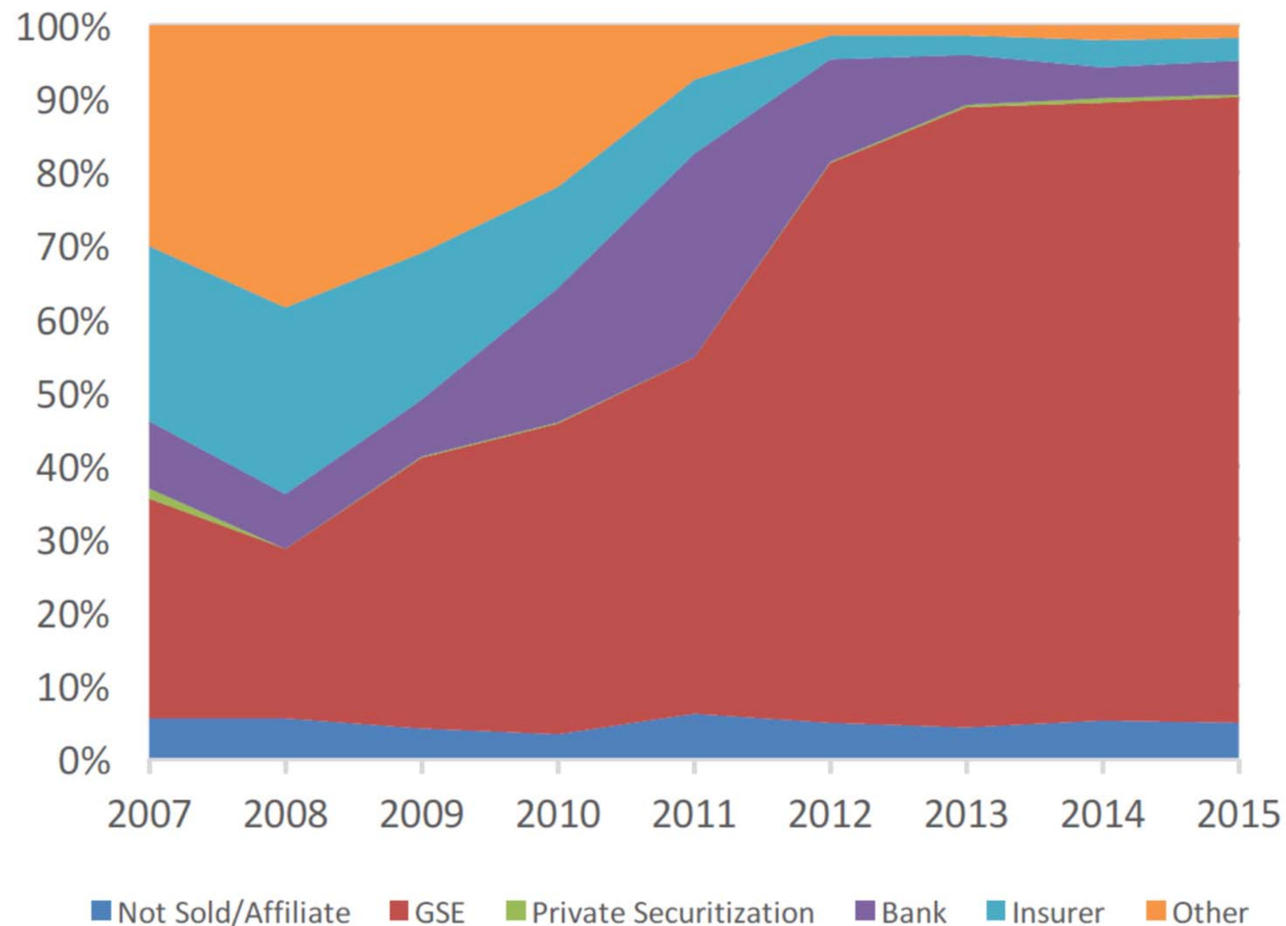
Disposition of mortgage loans of shadow banks



Source: Fig. 4 in Buchak et al. (2017)

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General comment

- Broad (not total) agreement on criticism of regulatory reform but not so negative.
  - Increase resiliency of financial institutions taking into account systemic risk:
    - Macroprudential regulation: capital and liquidity.
    - Improved supervision and stress testing.
  - Resolution
  - Corporate governance and executive compensation
  - Consumer protection
    - CARD/CFPB may help control exploitation of behavioral biases of consumers and investors that survive competition (”nudges”)
    - Aggarwal (2015) on CARD: savings of $11.9bn in fees per year for CC customers in the US and nudges to pay early effective.
    - Some potential exclusión but controls overborrowing.

Bank structural reform

Are capital requirements enough when risk is not priced properly?

(Matutes and Vives (EER, 2000))

Trade-offs of separation of activities

- Pros:
  - Limit subsidizing risk-taking with insured deposits.
  - Reduce conflicts of interest.
  - Reduce complexity and improve resolution and market discipline.
- Cons:
  - Increase supervisory burden and discretion: Distinguishing «proprietary trading» from market making.
  - Risk of migration of risky activities to unregulated areas (regulatory boundary).
  - Residual liquidation/contagion costs

Proposed reforms (Calomiris)

- Capital requirements need to be simple risk-based (15%) and leverage (10%) minimum equity ratios.
  - How to set the right levels?
  - Interaction between leverage and RWA ratios?
- SIFIs with 10% Co-Cos (convertible to equity on dilutive basis with MA market trigger).
  - Assessment of externalities?
- Replace the two complex Basel liquidity requirements with a 20% remunerative cash-reserve ratio.
  - Consistent with Vives (2014)

The way forward

- Resolution and no bail-outs
  - Account for systemic effects.
  - Time inconsistency: Make it credible (e.g. Fed's Dodd-Frank restriction on LOLR, EU bail-in rules)
- Design appropriate regulatory architecture: avoiding conflict of interest and fostering accountability
  - Separate agencies for competition policy and prudential oversight.
  - Case for integrating financial consumer protection agency with financial conduct/competition authority (UK FCA model).

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