Regulatory Reform
Where to From Here?

Xavier Vives
IESE Business School

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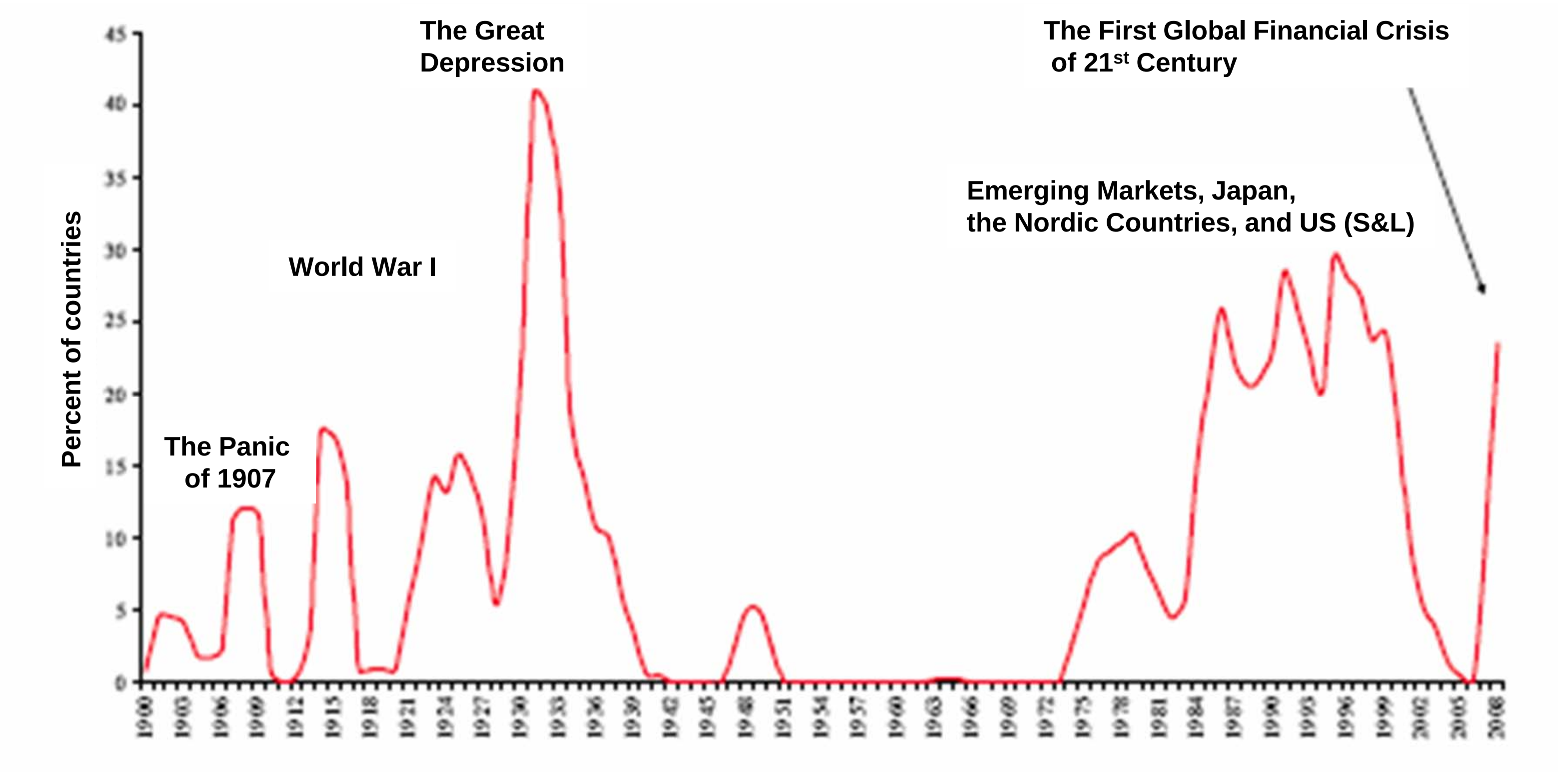
Outline

- The crisis and regulatory failure
- Regulatory reform
- Assessment of regulatory reform
- The way forward

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.

Will we ever learn?

Regulatory cycle

Core areas of Regulatory Reform (FSB)

- Building resilient financial institutions
- Ending too-big-to-fail
- Making derivatives markets safer
- Transforming shadow banking into resilient market-based finance

Assessment of regulatory reform

- Regulatory reform moving in right direction
- The question is whether
  - it goes far enough,
  - it will be effective, and
  - there is consistency in the instruments used.

Assessment of regulatory reform

- Level, quality of capital and liquidity requirements, and pace of implementation.
- Treatment of SIFIs.
- Interaction between capital, liquidity, and transparency requirements.
- Trade-offs in structural banking reform.
- Resolution, bail-in and systemic risk.
  - SPOE vs MPOE

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).
- Competition policy is not independent of prudential regulation.

Need to coordinate prudential regulation and competition policy

- Capping deposit rates to limit systemic risk when weak institutions exploit deposit insurance (Spain, Portugal).
- Resolution of failing entities by selling them to other institutions (preferred solution by supervisor, e.g. HBOS-Lloyds) may lead to the formation of anticompetitive and TBTF market structures.
- Competition policy as a credible tool to check TBTF:
  - Competitive distortion based on the advantage of being under the TBTF umbrella.
  - CP authority may impose structural and conduct measures on TBTF entities formed out of mergers or helped entities.
  - Divergence US-EU.

Financial architecture

- The need for coordination of competition policy and regulation does not mean that the policies should be enforced by the same agency.
- Separate agencies for competition policy and prudential oversight with well-defined missions avoid the potential conflict of interest of competition policy and supervision (e.g. mergers).
- Case for integrating financial consumer protection agency with financial conduct/competition authority (UK FCA model).

Price or quantity regulatory controls?

	Risk-taking incentives		
Banking regimes	**Liability (rates)**	**Asset (investment)**	**Regulatory instruments**
No insurance			
Observable risk/ high disclosure	Medium-low	Absent	Capital requirements
Unobservable risk/ low disclosure	Medium-high	Maximal	Capital requirements + asset restrictions
Insurance			
Risk-insensitive pricing	High	Maximal	Capital requirements + asset restrictions
Risk-based pricing	Low	Absent	Capital requirements

Basic frictions: limited liability, product differentiation (market power), social cost of failure Necessary regulatory instruments when charter values are low and the social cost of failure is high.

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: Distinguishing «proprietary trading» from market making.
  - Risk of migration of risky activities to unregulated areas (regulatory boundary).
  - Residual liquidation/contagion costs

The way forward

- Holistic approach to regulation:
  - Account for interaction between capital, liquidity and transparency requirements.
  - Coordinate prudential regulation and liberalization/ competition policy.
- Banking structural reform
  - Risk-based insurance mechanisms for traditional banking activities (e.g., inside the ring-fence in the UK) that have to be protected.
  - Market discipline with strong disclosure requirements and credible resolution for market-based segments (based on hard information as in investment banking).

The way forward

- Resolution:
  - Account for systemic effects.
  - Explore hybrid models (SPOE vs MPOE) and consider strategic effects.
- Design appropriate regulatory architecture
  - Separate agencies for competition policy and prudential oversight.
  - Case for integrating financial consumer protection agency with financial conduct/competition authority (UK FCA model).
  - Coordination of jurisdictions (important for cross-bored resolution).