Reform of Financial Regulation: How to Make the System More Robust

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Objective of Regulatory Reform

- The goal of financial regulatory reform should be to support and enhance sustainable economic growth
- Many studies show how a more deep and developed financial system is a driving force behind economic development and growth
  - But might there be a trade-off with volatility?

Interconnectedness and the Crisis

- Increasing layers of financial intermediation -- greater interconnectedness – so information about funders, counterparties, and customers needed to judge soundness of an institution
  - Is increased layers of intermediation due to
    - More efficient allocation/dispersion of risk?
    - Regulatory arbitrage?
- Thus, "Too Big to Fail" is really a subset of "Too Interconnected to Fail"

Funding and Counterparty Fragility

- Fragmented structured leading to excessive reliance on short-term external funding
  - Legacy of Glass-Steagall separation in the US
  - Rise of MMMFs
- Interconnectedness through counterparty and funding chains
  - Legal uncertainty about bankruptcy resolution and contract enforcement
  - In illiquid market, broken hedges can’t be repaired so exposure explodes

Implications for Reform

- Focus should be on combination of funding runs and freezing of markets
  - Inability to fund operations
    - Maturity mismatch plus leverage
  - Uncertainty about balance sheet when markets become illiquid and counterparties may fail
    - Inability to hedge/replace broken hedges
    - Thus net exposures can become gross exposures
      - → Never sufficient capital to withstand this shock

Unintended Consequences of Very High Capital Requirements

- Crucial to understand unintended consequences
  - Must have skin in the game to get the incentives right
  - Must have cushion against losses to maintain confidence and protect taxpayers
  - ***But*** must understand the incentives and ability to get around such regulations (difficulty of appropriate "pricing")

    →Either

    - move off balance sheet again or
    - "unregulated" institutions undertake risky activities

What Should be the Focus of Reform?

- Emphasize not only crisis prevention but also on robustness of market infrastructure
- Key is to give policymakers and market participants sufficient comfort that key institutions can fail without causing the system to collapse
  - Otherwise, cannot eliminate either
    - →Uncertainty that leads to implosion of market-wide confidence/liquidity, and
    - →Moral hazard problem and uncertainty associated with “too big/interconnected to fail”

Reforms going forward

- Reducing “pro-cyclical” regulation
  - Accounting
  - Liquidity
  - Capital and leverage
    - Contingent capital?

Reforms going forward

- More information for regulators and markets
- Role of Consumer Protection
  - Crucial to integrity and stability of the markets
  - Is a separate agency the most effective approach?
  - What is appropriate coverage?

Reforms going forward

- Systemic risk regulator?
  - Defining systemically important institutions
    - "Boundary Problem"
  - Authority and responsibility
  - Single or council of regulators
  - Higher capital?
  - International cooperation/coordination

    → Financial Stability Board, Basel Committee, G-20?

Making Markets More Robust

- Resolution and bankruptcy regimes
  - Perhaps most important issue for making institutions less likely to be systemically important
  - Crucial cross-border issues should be addressed by the G-20

- Improve secured lending markets
  - Clarify how counterparties will be treated
  - Not operating as truly secured today so external funding still fragile and subject to “runs”

Making Markets More Robust

- Over-the-counter derivatives vs central counterparty clearing
  - Long history of successes through turbulence
  - Clearinghouses have innovated and thrived through more than 150 years of depressions, crises, and wars
  - Improves information disclosure and reduces interconnectedness problem

Making Markets More Robust

- Destabilizing contracts
  - Credit enhancements/guarantees/etc. that might seem to protect against trouble at an individual institution can make the system more fragile (e.g., rating downgrades triggering the posting of more capital)
  - Exacerbates interconnectedness

Making Markets More Robust

- Role of Credit Rating Agencies
  - Is the model broken?
  - More “competition” and disclosure
- Simplify and Standardize contracts
  - Less reliance on Credit Ratings and reduces costs of doing “due diligence”

Housing Finance

- Settle Future Role of GSEs
  - Securitization will be slow to recover with continuing uncertainty
  - Make housing subsidies explicit on the Federal government’s budget so subject to debate and approval (not off balance sheet GSE)
    - Can guarantees reduce the demand for information and due diligence?
  - Increase capital to protect taxpayer and reduce portfolio holdings

Volcker Rule?

- Former Chairman Paul Volker has proposed that banks be restricted in their activities
  - Proprietary trading, hedge funds, private equity
- But this was not the cause of the problems at the banks
- And it could cause an increase dependence upon external finance, increasing interconnectedness and perhaps reducing stability

Conclusions

- Crucial to understand limits and unintended consequences of supervision and regulation
  – Regulatory and capital arbitrage can reduce stability
- Focus should be on providing sufficient comfort to policymakers and markets that consequences of failures can be contained
  – Otherwise “too big/interconnected to fail”
- Thus, priority for reforms should be on making markets more robust
  – G-20 cooperation crucial but must get priorities right