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

Randall S. Kroszner
Norman R. Bobins Professor of Economics
The University of Chicago
Booth School of Business
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