Using Economic Theory to Think of Bank Regulation: Remarks at Weberfest

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Basics

- Financial intermediaries often have deposits/short-term debt as liabilities and illiquid loans as assets

- System prone to runs/confidence issues

- Mechanism seems crazy

Stories for Mechanisms

- Insurance/maturity transformation
  - Diamond-Dybvig
- Efficient way of extracting information
  - Chari-Jagannathan
- Discipline managers
  - Calomiris-Kahn
  - Diamond-Rajan

Stories for Mechanism

- Diamond-Dybvig requires illiquid assets. No hidden trading
    - See Jacklin-Wallace
- Suggests prohibiting banks from holding widely-traded assets!
- Suggests suspension of convertibility
- Discipline story says do not suspend for idiosyncratic shocks, do suspend for aggregate shocks
- Debt convertible to equity?

Historical Evidence

- Sprague studies National Banking era
- Widespread banking crisis led to suspension
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    2%!

Policy

- We cannot return to glory years from 1935–1980
- System too competitive
- We cannot rely on regulators
- If majority of market participants think the world is fine, why should majority of regulators be different?

Moral

- When aggregate shock hits
- Make returns state-contingent
- Suspend convertibility
- Convert debt to equity
- What rules to use?
- What role for discretion?