Regulatory Reform
Where to From Here?

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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?
<table>
<thead>
<tr>
<th>Banking regimes</th>
<th>Risk-taking incentives</th>
<th>Liability (rates)</th>
<th>Asset (investment)</th>
<th>Regulatory instruments</th>
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<tbody>
<tr>
<td><strong>No insurance</strong></td>
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<tr>
<td>Observable risk/high high disclosure</td>
<td>Medium-low</td>
<td>Absent</td>
<td>Capital requirements</td>
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<td>Unobservable risk/low disclosure</td>
<td>Medium-high</td>
<td>Maximal</td>
<td>Capital requirements + asset restrictions</td>
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<tr>
<td><strong>Insurance</strong></td>
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<td>Risk-insensitive pricing</td>
<td>High</td>
<td>Maximal</td>
<td>Capital requirements + asset restrictions</td>
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<tr>
<td>Risk-based pricing</td>
<td>Low</td>
<td>Absent</td>
<td>Capital requirements</td>
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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.

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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

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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).