Regulatory Reform: Integrating Paradigms

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International Conference on “Reforming Financial Regulation and Supervision: Going Back to Basics”

Madrid, Spain

June 2009

BANCO DE ESPAÑA
Eurosistema

World Bank
Latin America and the Caribbean Region

Structure of presentation

- Explaining the crisis from alternative paradigms
  - Agency
  - Externalities
  - Mood swings
- Regulatory implications
  - What is the role of markets vis-à-vis that of supervisors?
  - What is the appropriate regulatory approach?
  - What to expect from the safety net?
- Towards a more harmonious equilibrium
  - Scope: regulatory perimeter
  - Focus: internalizing systemic risk
  - Dynamics: managing the cycle and uncertainty

1. Explaining the Crisis

It all depends on your lenses…

A simple (prudential) typology…

- **They understood but did not care**
  - ⇒ Intermediaries took the risks because
    - They captured the upside but not the downside (**agency paradigm**)
    - They did not internalize social costs (**externalities paradigm**)

- **They did not care because they did not understand**
  - ⇒ In a constantly evolving, uncertain world intermediaries were overly enthusiastic innovating and investing … and then they were gripped by the fear of the unknown (**mood swings paradigm)**

The agency view

- The current regulatory framework (Glass-Steagall's "line in the sand") reflects an agency view of the world
  - Restrict prudential regulation (and supervision) to the systemically important commercial banks that also benefit from the safety net
  - Let market discipline and transparency take care of agency problems in the unregulated world of informed investors

- The dynamics
  - Innovations/shocks got ball rolling, boosting upside/reducing downside
  - Once in motion, with little to loose, a crisis became unavoidable
  - Ex-post public intervention ultimately validated the paradigm

- But why did market discipline fail?
  - A control problem?
    - But why did investors and shareholders not vote with their feet?
  - Or an information problem?
    - But why did deep information asymmetries endure for so long?

The externalities view

- The drivers
  - Liquidity is the best-recognized source of externalities
    - Ex-ante: rely on others to provide it (creates fragility)
    - Ex-post: beat the others to retrieve it (makes downturns violent)
  - But many other un-internalized externalities fed the bubble and aggravated the collapse

- The dynamics
  - The unregulated grew at the expense of the regulated, leveraging on short-term funding
  - Glass-Steagall ended up being a double disaster
    - Its introduction boosted systemic risk outside commercial banking
    - Its repeal boosted risk inside commercial banking

- But what threw the system into the abyss?...
  - Rational players should maintain safety cushions
  - There was no apparent exogenous shock

The mood swings view

- The dynamics
  - Creativity was real but went wild
  - Seemingly predictable behavior inducing exuberance on the way up ("*this time things are really under control…*")
  - Then, unexpected icebergs were spotted in the fog, leading to acute uncertainty aversion and unpredictability on the way down

- What is missing?
  - Without externalities, would the swings be so violent?
  - Without agency problems, rational agents would have arbitraged?
  - Why can't systemic wizards make a living? (a public good?)
  - What determines moods? (is it Alice in Wonderland?...)

2. Regulatory Implications

Harmonizing the paradigms won’t be easy…

The oversight role of markets and supervisors varies radically across paradigms…

	Agency	**Externalities**	**Mood Swings**
Can risk be priced and systemic crises avoided?	*Yes*	*Not fully ("one hundred year floods")*	*Not really (unless supervisor is Moses…)*
How effective is market discipline?	*Potentially very effective*	*Ineffective (inability to internalize or withstand systemic risk)*	*Ineffective (inability to comprehend or withstand systemic risk)*
What is the role of the supervisor?	*Market discipline enhancer (crime police residually)*	*Crowd management - fireman*	*Scout-moderator-fireman*

… with very different implications for regulation…

	Agency	**Externalities**	**Mood Swings**
Does fair value accounting help?	*Yes, it is fundamental to keep principal-agent incentives aligned*	*No, it exacerbates the transmission and impact of externalities*	*No, it exacerbates the transmission and impact of mood swings*
Should the line in the sand be redefined?	*No*	*Yes*	*Not necessarily*
Are dynamic macro-prudential norms needed?	*No*	*Yes, rules-based*	*Yes, partly judgment based*
Should prudential and monetary authorities coordinate?	*Not really*	*Tightly*	*Joined at the hip*

… and contrasting views on the need for, and purpose of, the safety net

	Agency	**Externalities**	**Mood Swings**
Can players learn?	*Yes: got me once, won't get me twice…*	*No: there is nothing much to learn and even if there was, I am not interested!*	*No: it is an oxymoron!* *(optimism might lead me to think so, which is part of the problem…)*
Is a LOLR facility needed?	*No, it is counterproductive*	*Yes, to **provide liquidity** in systemic events*	*Yes, to **absorb risk** in systemic events*
Is a deposit insurance needed?	*No (setting aside consumer protection)*	*Yes, to limit risk of "wrong" runs*	*Yes, to calm the frayed nerves*

3. Towards a More Harmonious Equilibrium

Not easy but not impossible and, in any case, must try…

The key challenges

- Scope of regulation
  - Redefining the regulatory perimeter in a way that balances structural stability (no regulatory arbitrage) with financial deepening/innovation
- Focus of regulation
  - Internalizing systemic liquidity risk in a way that aligns ex-ante incentives with ex-post access to the safety net
- Dynamics of regulation
  - Managing uncertainty and the cycle (expected and unexpected elements therein) in a way that harmonizes rules and discretion

Redefining the perimeter: the two-tier approach

- Unregulated intermediaries are allowed
  - All the regulated have the same capital requirements for *all* credit exposures, including contingent ones and off-balance sheet related
  - Intermediaries choose whether to be regulated or not
  - The unregulated have lower entry and reporting requirements…
  - … *but they require license and can only borrow from the regulated*
  - Only the regulated have access to the LOLR

- Advantages of the two-tier approach
  - Minimizes regulatory arbitrage
  - Does not require definition of who is a “systemic” player
  - Promotes of entry, hence competition and innovation
  - Simplifies monitoring (“delegated supervision”)

Comparing the approaches

	Eliminates regulatory arbitrage	Limits supervisory costs	Promotes intermediation	Addresses TITF
Line in the sand	No	Yes	Yes	No
Inner dungeon without limits on outside activities	No	Yes	Yes	No
Inner dungeon with strict limits on outside activities	Yes	Yes	No	Yes
Outer wall	Yes	No	No	No
Variable geometry based on simple criterion	No	Yes	Yes	No
Variable geometry based on complex criterion	No	No	Yes	Yes
Two-tier system	Yes	Yes	Yes	Partially

Internalizing systemic liquidity risk

- Measuring it
  - *Asset side*: differentiate between systemically liquid assets and other short-duration assets that do not provide systemic protection
    - Maturity gaps are not appropriate (pushing the liquidity risk on debtors may be good for an intermediary but bad for the system)
  - *Liability side*: differentiate according to duration of funding; distinguish between (anchored) insured deposits and uninsured deposits

- Aligning incentives – Insurance fees? Capital charges? Limits?
  - Systemic liquidity requirements and/or access to LOLR exacerbate incentives for short funding by enhancing the value of the run option
  - The deposit insurance further enhances the value of the run option (it will hold the bag once everybody else has run)
  - ⇒ Ensure consistency between prudential regulation and LOLR access
  - ⇒ Expand the basis on which deposit insurance is paid and/or adjust the premium to reflect short-term wholesale funding

Managing the cycle and uncertainty

- Expected risks (micro-prudential)
  - *Objective*: protect intermediaries' soundness through the cycle
  - *Modalities*: set norms/premia "through the cycle" or allow for rule-based cyclical adjustments
  - *Mandate and capacity*: regulatory agency
    - Focus on individual institutions and their interconnectedness
    - Determine how the system is wired
    - Emphasis on stable rules of the game with some discretion at micro level

- Unexpected risks (macro-prudential)
  - *Objective*: dampen the cycle and enhance system resilience to tail events
  - *Modalities*: use judgment and discretion
  - *Mandate and capacity*: Central bank
    - Optimally combine different instruments (interest rate, reserve requirements, generic provisions) to satisfy multiple objectives
    - Explain and justify the use of discretion

END