Regulatory Reform: Integrating Paradigms

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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 lose, 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 arbitrated?
- 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...

<table>
<thead>
<tr>
<th></th>
<th>Agency</th>
<th>Externalities</th>
<th>Mood Swings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Can risk be priced and systemic crises avoided?</strong></td>
<td>Yes</td>
<td>Not fully (“one hundred year floods”)</td>
<td>Not really (unless supervisor is Moses…)</td>
</tr>
<tr>
<td><strong>How effective is market discipline?</strong></td>
<td>Potentially very effective</td>
<td>Ineffective (inability to internalize or withstand systemic risk)</td>
<td>Ineffective (inability to comprehend or withstand systemic risk)</td>
</tr>
<tr>
<td><strong>What is the role of the supervisor?</strong></td>
<td>Market discipline enhancer (crime police residually)</td>
<td>Crowd management - fireman</td>
<td>Scout-moderator-fireman</td>
</tr>
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</table>
... with very different implications for regulation...

<table>
<thead>
<tr>
<th>Does fair value accounting help?</th>
<th>Agency</th>
<th>Externalities</th>
<th>Mood Swings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, it is fundamental to keep principal-agent incentives aligned</td>
<td>No, it exacerbates the transmission and impact of externalities</td>
<td>No, it exacerbates the transmission and impact of mood swings</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Should the line in the sand be redefined?</th>
<th>Agency</th>
<th>Externalities</th>
<th>Mood Swings</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>Yes</td>
<td>Not necessarily</td>
<td></td>
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</table>

<table>
<thead>
<tr>
<th>Are dynamic macro-prudential norms needed?</th>
<th>Agency</th>
<th>Externalities</th>
<th>Mood Swings</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>Yes, rules-based</td>
<td>Yes, partly judgment based</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Should prudential and monetary authorities coordinate?</th>
<th>Agency</th>
<th>Externalities</th>
<th>Mood Swings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not really</td>
<td>Tightly</td>
<td>Joined at the hip</td>
<td></td>
</tr>
</tbody>
</table>
... and contrasting views on the need for, and purpose of, the safety net

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

<table>
<thead>
<tr>
<th>Approach</th>
<th>Eliminates regulatory arbitrage</th>
<th>Limits supervisory costs</th>
<th>Promotes intermediation</th>
<th>Addresses TITF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Line in the sand</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Inner dungeon without limits on outside activities</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Inner dungeon with strict limits on outside activities</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Outer wall</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Variable geometry based on simple criterion</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Variable geometry based on complex criterion</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Two-tier system</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Partially</td>
</tr>
</tbody>
</table>
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