

Containing Systemic Risk: Are Regulatory Reform Proposals on the Right Track?

The International Financial Crisis and the Future of Financial Regulation

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Outline

- I. Introduction – reform needs to rebalance paradigms
- II. Perimeter of regulation
- III. Systemic liquidity risk
- IV. Dynamic oversight

Introduction – Rebalancing Paradigms

Paradigms and regulatory reform proposals

- ✦ Regulatory reform prescriptions depend on preferred “paradigm”
- ✦ Three self-contained paradigms, depending on the market failure of focus (De la Torre & Ize, 2009), with first-order importance implications
 - ✦ Agency frictions
 - ✦ Externalities & coordination failures
 - ✦ Mood swings
- ✦ Paradigms lead to typically inconsistent regulatory prescriptions → challenge lies in balancing the trade-offs
- ✦ Agency paradigm
 - ✦ Has dominated recent (Basel II) regulatory policy
 - ✦ Provides the most popular explanation of the Subprime crisis
 - ✦ Is the most influential in current reform proposals
- ✦ Externalities: embraced by growing consensus to tackle systemic risk
- ✦ Mood swings: lots of talk, no proposals

Current regulatory architecture is paradigm-unbalanced

- ✦ Prudential norms mostly reflect an agency view while safety net reflects an externalities view, but there is no functional regulatory link
 - ✦ A “line in the sand” between the regulated *systemically important core* (banks) and the unregulated world of informed investors where market discipline should suffice
 - ✦ No need seen to link prudential requirements to institutions’ individual contribution to systemic risk
 - ✦ Safety net to prevent contagious runs and limit systemic implications (contagion) of bank failures, but option value to lend-short-and-run not priced into prudential norms
- ✦ Mood swings were simply overlooked
 - ✦ Keynesian thinking was overshadowed by rational expectations revolution and not included in mainstream finance theory of efficient markets
 - ✦ The implication of mood swings of greater power to the supervisor was too radical to be contemplated
 - ✦ As a result, the mantra was “institutions and markets know best”

Do proposals on the table achieve appropriate paradigm rebalancing?

- ✚ Developing regulatory agenda has a robust agency emphasis...
 - ✦ Transparency & consumer protection, limits to conflicts of interest, governance improvements, revision of compensation schemes, more skin-in-the game
- ✚ ...although the trade-offs with other paradigms are not well fleshed out
- ✚ We focus on the few (three) proposals that relate to externalities and mood swings, and find them faulty
- ✚ Proposal 1
 - ✦ Question: how far to extend prudential regulations and to what institutions?
 - ✦ Emerging consensus: apply stricter regulation to “systemically important institutions
- ✚ Proposal 2
 - ✦ Question: how to dissuade intermediaries from excessive reliance on short funding?
 - ✦ Emerging consensus: systemic liquidity “tax” on maturity mismatches.
- ✚ Proposal 3
 - ✦ Question: how to limit pro-cyclical?
 - ✦ Emerging consensus: rules-based countercyclical provisions?

Proposal 1: On the Perimeter of Regulation

The two-tier approach

What is being proposed?

- ✚ The popular proposal: differentiate regulation across intermediaries
 - ✦ Increase regulatory rigor as “systemic importance” rises
 - ✦ Use a measure of “systemic footprint” to define systemic importance

- ✚ The rationale for this proposal is understandable
 - ✦ Limit the unfair competitive advantages of being too big to fail (TBTF) or too interconnected to fail (TITF)
 - ✦ Limit the systemic impact (contagion risk) of the failure of a TBTF/TITF intermediary

What are the problems?

- ✚ The popular proposal underestimates
 - ✦ The scope for dynamic regulatory arbitrage between the more rigorously regulated “systemically important” institutions and the rest
 - History seems to be repeating itself
 - ✦ The difficulties of assessing systemic footprints
- ✚ A simple criterion like size
 - ✦ Can result in a swarm of intermediaries below the threshold
 - ✦ Would ignore systemic herding and systemically important activities
- ✚ A more elaborate criterion (e.g., quantification of interconnectedness)
 - ✦ Could be a wild goose chase—considering constant bouts of innovations and evolving markets structures and linkages
 - ✦ Could provide a false sense of security—just as Basel II did with internal risk models
- ✚ Reclassifying intermediaries in and out of the systemic list would be an operational nightmare, with dreadful signaling implications

What are the alternatives?

- ✚ Address TBTF/TITF with more appropriate instruments
 - ✦ Take the systemic steam off by focusing more on upstream risk (including macro-prudential conditions and liquidity risk—see below)
 - ✦ As regards the downstream failure risk, address TBTF/TITF through the right tool: improved resolution arrangements for large institutions
- ✚ Define the regulatory perimeter without fostering regulatory arbitrage
 - ✦ The European option—to regulate all financial intermediaries equally and uniformly under a universal banking format
 - If entry and prudential requirements are set too low → too costly
 - If they are set too high → too biased against entry (competition) and innovation
 - ✦ Our proposal: a two-tier approach
 - All intermediaries that take deposits or borrow in the market to be subject to the same prudential (mainly capital) requirements
 - Licensed but unregulated intermediaries can only borrow from the regulated and would have much lower entry requirements
 - Only the regulated have access to the LOLR

Advantages & trade-offs of the two-tier approach

✚ Advantages

- ✦ Avoids regulatory arbitrage (everybody ends up paying the same Pigovian tax) if all exposures (on and off-balance sheet) are captured
- ✦ Does not need a definition who or what is a “systemic” player
- ✦ Promotes entry, hence competition and innovation
- ✦ Simplifies monitoring (“delegated supervision”)

✚ Difficulties

- ✦ How to define “intermediary”? (Are GM or Cargill intermediaries?)

✚ Trade-offs

- ✦ Extending regulation has a cost, but better than the European option
- ✦ Extension of the safety net can have a moral hazard cost unless it only makes explicit a coverage that already exists implicitly

Proposal 2: On Dissuading Reliance on Short-Term Funding

What is being proposed and its problems

- ✦ The popular proposal is to penalize maturity mismatches
- ✦ The problem: it does not take externalities into account
 - ✦ Matching short assets to short liabilities protects an individual intermediary at the expense of exacerbating systemic vulnerability
 - As the Subprime crisis amply illustrated
 - ✦ Lending short is meaningless under systemic events (short loans become as illiquid as long loans)...

The alternative: penalize short borrowing *and* short lending

- ✚ Contain systemic liquidity risk upstream through a Pigovian tax that induces investors to retain more of the liquidity risk onto themselves...
- ✚ ...without allowing intermediaries to offset this tax and pass it on to someone else downstream via short lending
- ✚ For loans to unregulated intermediaries: apply a Pigovian tax that increases as loans' time to maturity decrease
- ✚ For loans other than to unregulated intermediaries: penalize only short maturity funding irrespective of the maturity of the loans

- ✚ The trade-offs
 - ✦ Pigovian tax increases the private costs of maturity transformation...
 - ✦ ... and limits the ability of investors to use the “short leash” as disciplining device
- ✚ But proposal is consistent with better aligning private with social costs and the proposition that a healthier system results in individually healthier institutions

Proposal 3: On Taming Pro-Cyclicality

What is being proposed and its problems

- ✚ The popular proposal: apply rules-based counter-cyclical prudential norms
- ✚ Rationale: limit pro-cyclicality while avoiding supervisory discretion
- ✚ Problem: assumes that cyclical swings are only of an “expected” nature
- ✚ However, aggregate cycle management will require judgment and real time calibration to deal with unexpected developments
 - ✚ Too loose a rules-based regulation would be ineffective
 - ✚ Too tight a rules-based regulation would be a straightjacket

The alternative: differentiate between expected and unexpected risk...

- ✦ Expected risks (micro-prudential)
 - ✦ **Objective:** protect intermediaries' soundness through the cycle
 - ✦ **Modalities:** rules-based counter-cyclical adjustment to provisioning requirements
 - ✦ **Mandate and capacity:** regulatory/supervisory authorities
 - Ensure systemic soundness focusing 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 banking authorities
 - Optimally adjust and combine different instruments (interest rate, reserve requirements, generic provisions or capital requirements) to satisfy multiple objectives
 - Explain and justify the use of discretion

- ✦ Use of discretionary prudential tools by central banking authorities would need coordination and agreement with regulatory authorities

...and build up scouting capacity

- ✚ Scouting (looking ahead, connecting the dots and assessing potential vulnerabilities) should become a key supervisory function
- ✚ How to scout?
 - ✦ “Systemic stress testing” is fine but good scouting is perhaps more qualitative than quantitative
 - ✦ On site or off site: how close do you need to hug the trees to understand the forest?
- ✚ How to build up scouting capacity?
 - ✦ Supervisory agencies and central banks need to truly connect
 - ✦ The supervisory skill mix needs to evolve
 - ✦ Multilaterals have an important role to play but the tools (e.g., FSAPs) needs also to evolve, towards more holistic assessments

END

