FINANCIAL REGULATION REFORM

by

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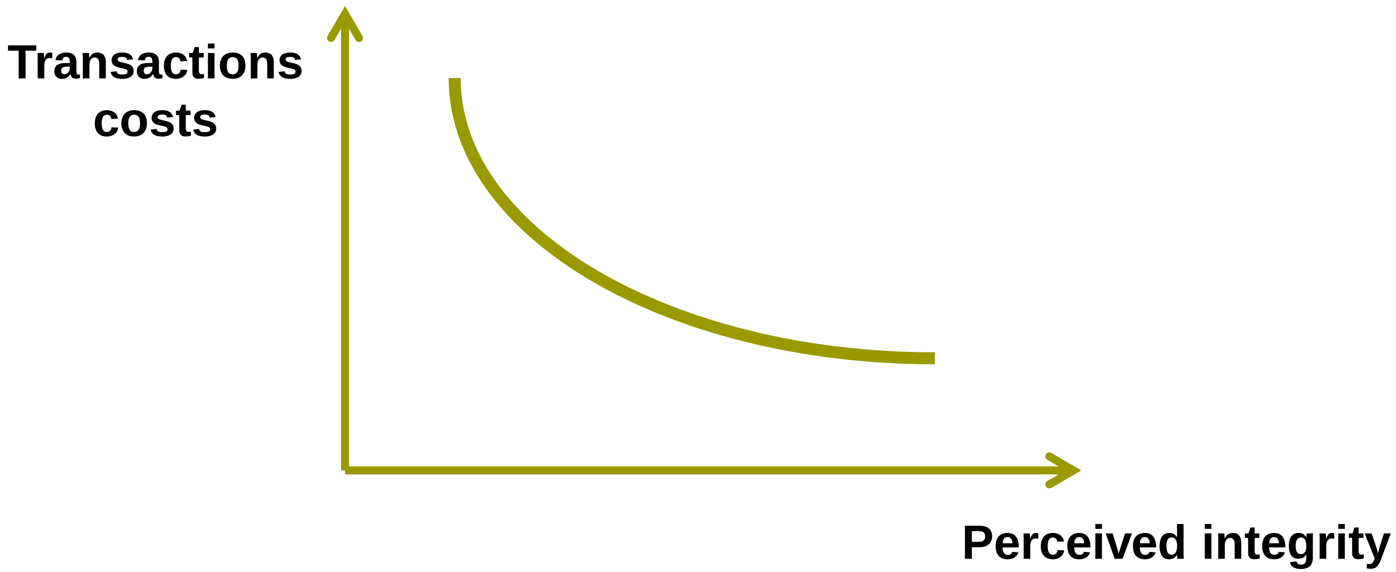
SINGLE MOST IMPORTANT EFFECT OF FINANCIAL REGULATORY REFORM

1. To restore confidence in the integrity of financial markets.



2. To address systemic risk issues.

UNANTICIPATED CONSEQUENCES: NOT UNDERSTANDING SECOND-ORDER EFFECTS

- Governments are good at observing and acting on first-order effects... *not* second-order effects.

- The NYC car-rental example.

- The new Financial Reform Bill attempts to address a host of issues: consumer protection, TBTF, Financial Stability Oversight Council, Credit Ratings Agencies, Hedge Funds, Insurance, etc.
  BUT...does not address Fannie and Freddie, and how to protect markets from politics and the *second-order effects* of politics.

- Second-order effects already seen in credit ratings.

FINANCIAL STABILITY OVERSIGHT COUNCIL

- Collecting data related to events that could create systemic risk is a critical function.

- E.g. repo market is estimated to be between $10 - $20 trillion and yet we have very little systematic data on it.

  AND...

  it was a big factor in systemic liquidity crisis in shadow banking system.

MICROPRUDENTIAL AND MACROPRUDENTIAL REGULATION: CONNECTION AND TENSIONS

- **Microprudential regulation:**
  To contain risk at the individual bank level.
  - Basel II Pillars: - Capital requirements
    - Supervisory Review (monitoring)
    - Market Discipline

- Acharya, Mehran, and Thakor, "Caught Between Scylla and Charybdis? Regulating Bank Leverage When There is Rent-Seeking and Risk-Shifting".

  ➔ Tension/conflict between:
  capital requirements (more capital) and market discipline (more sub debt)

MICROPRUDENTIAL AND MACROPRUDENTIAL REGULATION: CONNECTION AND TENSIONS

- **Macroprudential regulation**:
  To contain systemic risk.

- Acharya and Thakor, “The Dark Side of Liquidity Creation: Leverage and Systemic Risk”.

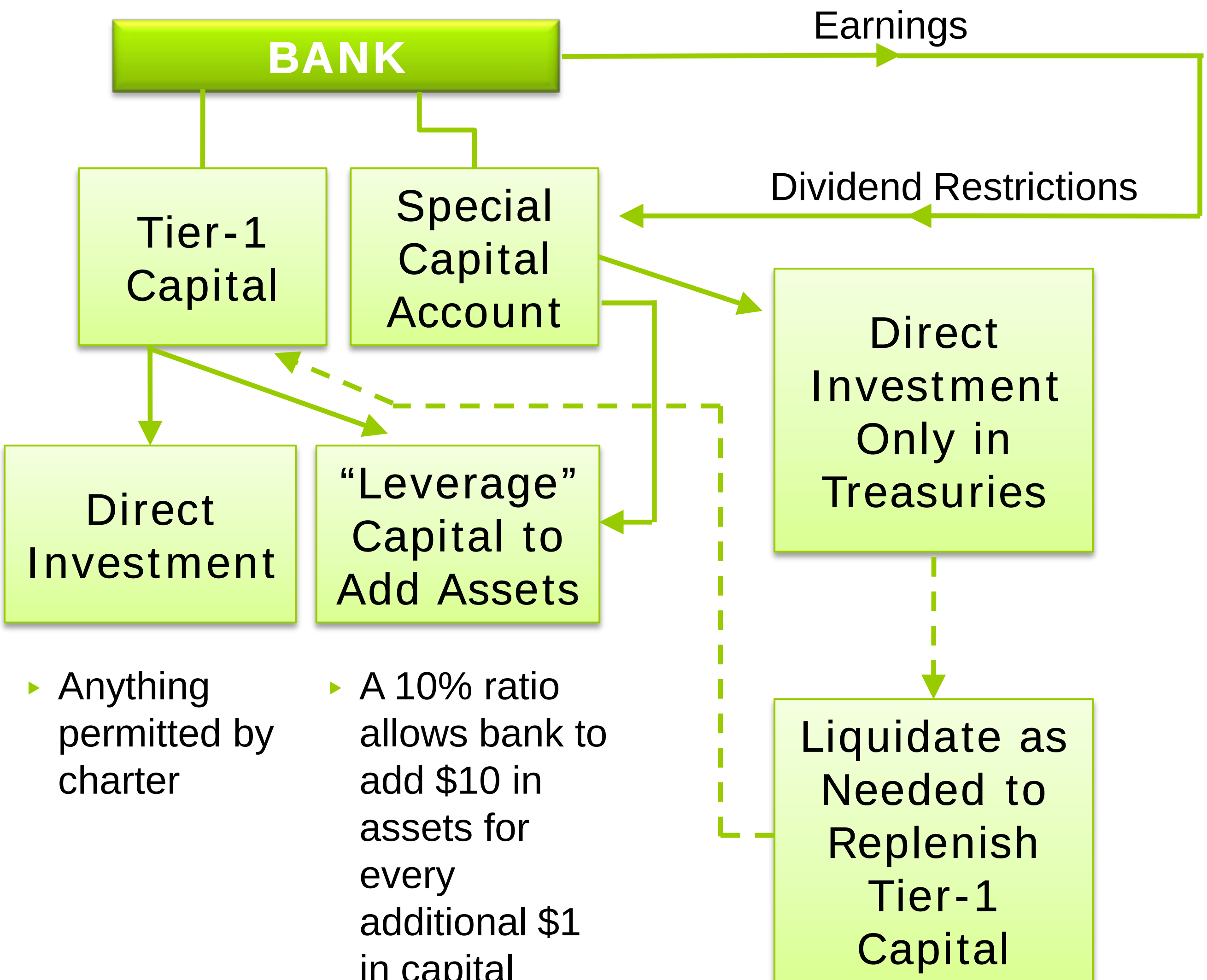
  ➔ High individual bank leverage creates more SYSTEMIC RISK by creating more market discipline.

  ➔ Tension between Pillar III of Basel II (Market Discipline) and macroprudential regulation.

MAIN LESSONS

- Microprudential and macroprudential are connected and potentially conflicting.
- Hard to “have your cake” (market discipline) and “eat it too” (low systemic risk)!
- Acharya – Mehran – Thakor propose a two-tiered capital requirements regime to address these issues.

IMPLEMENTATION DETAILS



- Anything permitted by charter

- A 10% ratio allows bank to add $10 in assets for every additional $1 in capital

- Shareholders own special capital account in good states
- Regulator owns it if bank goes bankrupt

- Could think about countercyclical policies like raising special capital ratio during good times

TO CONCLUDE

- Reform bill is a start but it is incomplete.
- Heavier reliance on litigation (e.g. credit rating agencies) to get more market discipline fails to anticipate second-order effects.
- Many provisions of the bill should have “sunset” clauses to permit adjustments based on learning.
- Effectiveness of bill will depend on details yet to be worked out (e.g. Financial Stability Oversight Council and capital requirements).