Navigating the Financial Regulator's Impossible Trinity

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Generals fight the last war, regulators prevent the last crisis.

- In order to prevent privatization of gains and socialization of losses, force banks to hold sufficient amount of high-quality capital, so that taxpayers' money need not be used.
  - *But it this the correct lesson?*

- "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity (myself especially) are in a state of shocked disbelief" Then FRB Chairman Alan Greenspan (Congressional testimony October 23, 2008)
- "…as long as the music is playing, you've got to get up and dance. We're still dancing" Citigroup then Chairman, Chuck Prince (FT July 9, 2007)

Interests of financial institutions managers, employees and shareholders are not necessarily aligned with broader interest of the society.

Pre-GFC
Economic Capital > Regulatory Capital

- Common regulatory capital rules designed as minimum capital standard to identify deteriorating banks that might resort to gambling for resurrection. (Prompt Corrective Action for deteriorating banks.)
- Tier 2 to absorb losses for failed institutions.
- Possible to set same standard globally despite differences in business models and economic/market conditions.
- Increasing use of internal models: trust that banks understand their own risks best. (Incentive compatibility.)
- Safety net for small savers and systemic events. (99% confidence interval)

However,

- Significant lag in reported capital adequacy numbers. Losses on assets don't emerge gradually.
- Tier 2 capital not able to absorb losses when bank liquidation is not a usable option. Liquidation value are also usually well below going concern value.
- Banks and shareholders have no incentive to set aside capital for tail risk. (Economic capital does not anticipate extreme events.)
- Massive costs for the safety net because tail is much fatter and longer than supposed.
- Globalization of financial activity means crisis spillovers and cross-border leakages of fiscal backstop.

⇒ Large demand on the safety net.

Post GFC: Never Again!

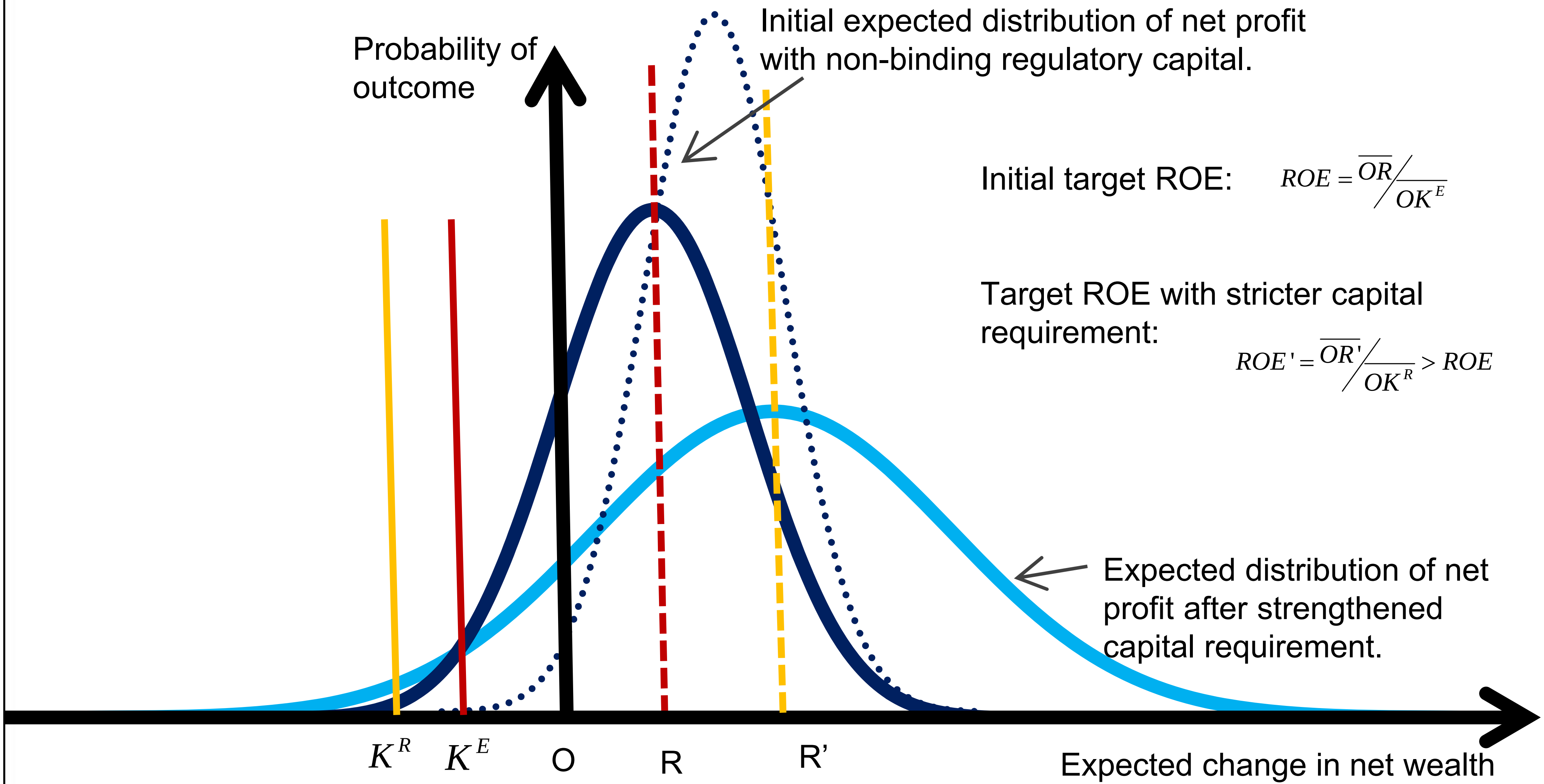
Strengthen capital requirements to minimize cost to safety net

1. Economic Capital > Regulatory Capital
   (Increase in RC small or regulatory arbitrage allows circumvention)
   → No improvement in stability.

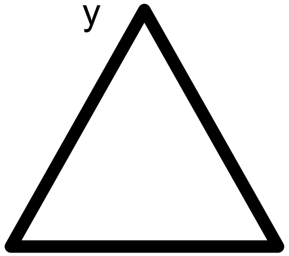
2. Economic Capital < Regulatory Capital
   → No reason to be in the business; business model will adjust until Economic Capital ≥ Regulatory Capital
   - Increase margin (negatively affects economic activity)
     - Product differentiation to increase margin difficult, so must come from reduced overall supply
     - Disintermediation and competition from non-regulated intermediaries (Helps mitigate effect on economic activity, but source of instability shifts to shadow banking sectors.)
   - Shift to high-risk, high-return business (if capital charge on them are low)
     - Greater and wider tail risk
   - Restriction on activity (Volker, etc.) to limit the size of tail events
     - Helps limit cross-subsidization of risk capital?

But common global standards could mean that RC that is (ex-ante) lower than EC for one country may be higher than EC in another. To ensure that common standard provides a level playing field requires extremely detailed regulation and a high degree of calibration.

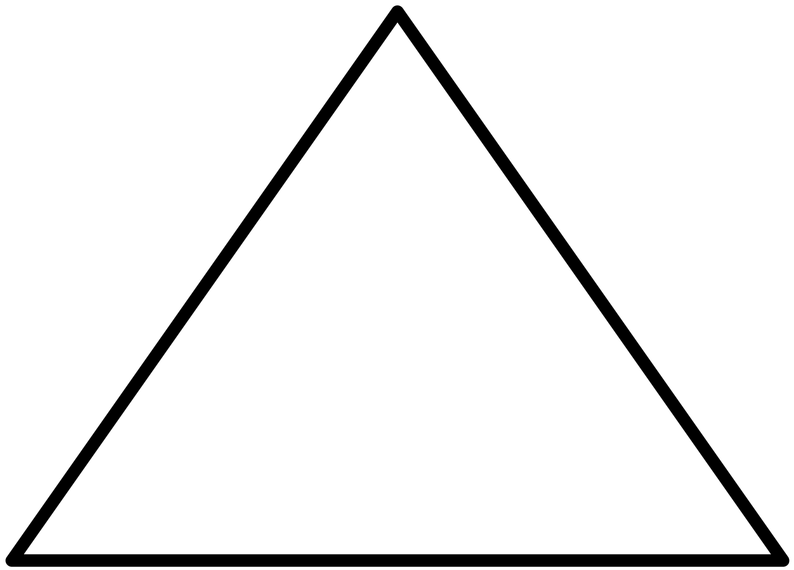
Illustrative response to stricter capital requirement



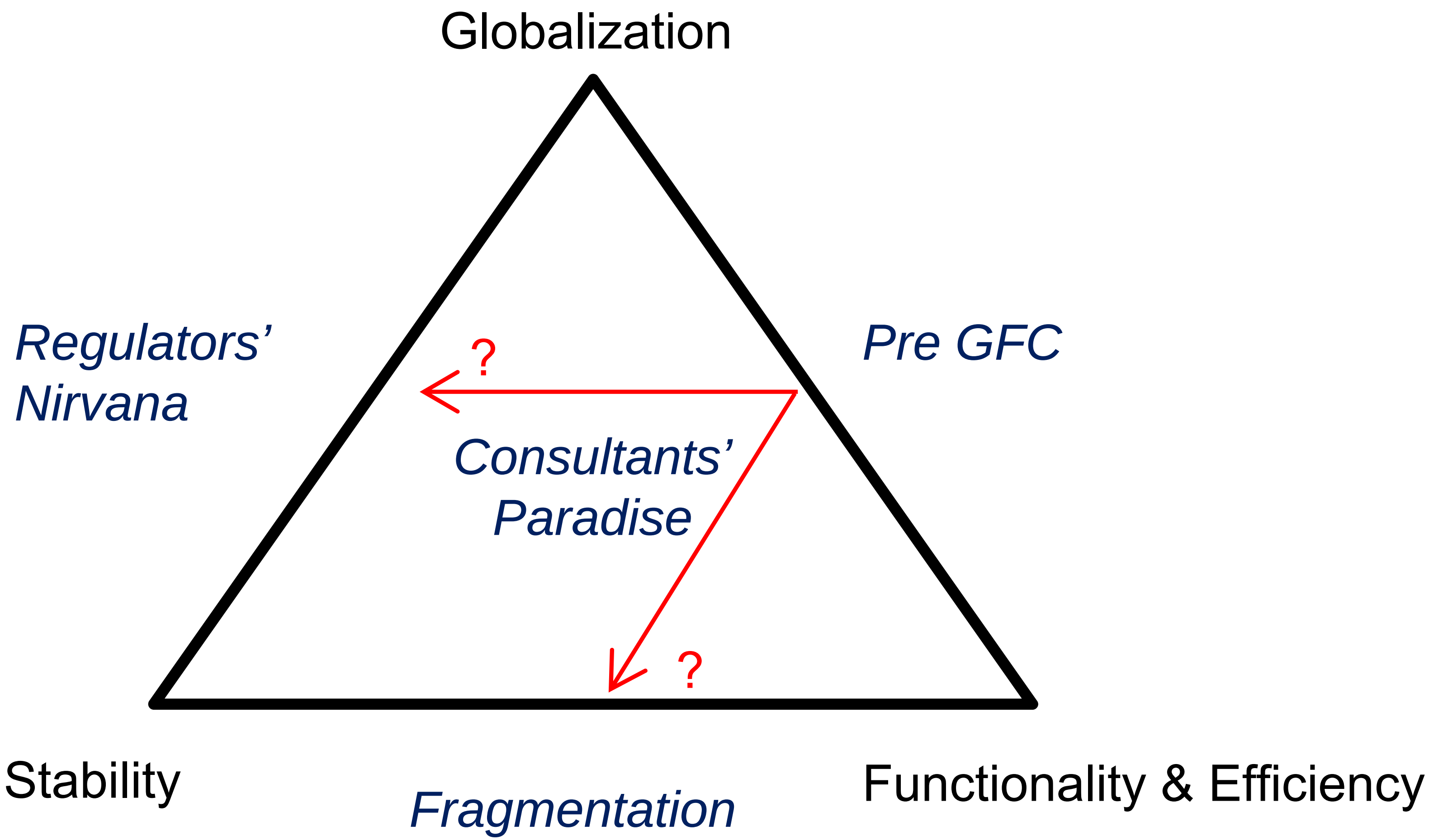
Have cake and eat it too? Impossible trinity of financial regulation.



(Impossible trinity in exchange rate regime.)



Striking an appropriate balance: No happy middle ground?



Thank you.

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