

Inefficient credit allocation: what are the regulatory challenges?

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On the buildup of financial imbalances

- Jordà, Schularik and Taylor (2011, 2013):
 - Credit booms increase the probability of a systemic crisis
 - If preceded by a credit boom, crises are aggravated
- Brunnermeier and Schnabel (2015) :
 - The emergence of bubbles is often preceded or accompanied by an expansionary monetary policy and lending booms
- Gourrinchas and Obsfeld (2012):
 - The likelihood of a crisis increases with leverage, credit expansion and real currency appreciation
- But Dell’Ariccia et al (2012):
 - One in three credit booms ends up in a crisis.

So, what drives credit booms?

1. Lower credit standards
2. Liability structure
3. Monetary expansion and low interest rates
4. Bubbles, herding and collateral prices
5. Capital inflows
6. Corporate governance
7. Competition
8. Political Economy

The New Regulatory Objectives

Before the crisis: banking regulation aimed at fostering financial stability

After the crisis:

Reduce the probability of a crisis

Reduce the inefficiency of credit allocation

By smoothing credit cycles both objectives can be reached simultaneously. Can current regulation control the build up of imbalances and reduce credit crunches?

Designing the regulatory the framework: Capture theory

- Political economy/lobbies
- Regulatory cycles as a reaction to immediate political pressure
- Resilient regulatory design should take the political economy constraint into account.

Designing the regulatory framework: what level of risk?

- Preliminary issue: is the market level of risk efficient or does it reflect market imperfections?
 - Higher risk taking implies higher growth
 - Example: is securitization efficient or a pure regulatory arbitrage? Should cross-currency residential mortgages be forbidden?

Cost-benefit of bank regulation

- Multiplicity of instruments imply that the cost-benefit is to be determined for every combination of instruments.
- The per dollar marginal net benefit should be equal across different instruments.
- Examples: what is the interaction between liquidity and capital requirements? Between LTV and LTI and the countercyclical buffer?

Ex ante prevention vs. Mopping up ex post

- As there is a cost in ex ante prevention, a balance should be found between ex ante prevention and ex post crisis management.
- Defining strong restructuring and resolution mechanisms (bail-ins, cocos, loss absorbing debt capacity) allows to reach the efficiency frontier.
- Jeanne and Korinek : ex-post policy are better targeted but distort incentives and create moral hazard . Ex-ante measures are blunter since they depend on crisis expectations.

Macroprudential vs. Microprudential

- Microprudential regulation is the first line of defense and the necessary condition for overall stability
- Yet macroprudential regulation considers, in addition,
 1. feedbacks and general equilibrium
 2. Systemic risk (Covar, SRISK, MES)

The role of a Systemic Risk Board

- Identify and prioritize systemic risks
 - Identify bubbles and imbalances (time dimension)
 - Identify potential contagion spillovers and real effects (cross section)
 - Identify risks to SIFIs (cross section)
- Issue early warnings for systemic risks
- Issue policy recommendations for mitigating those risks

The complexity of the macroprudential task

- Weighting financial stability vs. economic growth: erodes the board accountability
- Measuring systemic risk
 - Time dimension
 - Cross-sectional dimension
 - Conflicting measures from alternative models
- Choosing the right instrument
 - Aggregate: countercyclical buffer
 - Effectiveness and lags: may increase the political pressures

Limits to the conduct of macroprudential policy

1. Difficulties in having an independent systemic risk board, because of its limited accountability
2. Difficulties in establishing a system of early warnings
3. Different systemic risk measures are not necessarily correlated
4. Bad timing of the countercyclical buffer (Repullo and Saurina, 2013)

Limits to the conduct of macroprudential policy (2)

- Accountability
 - Difficulty in setting a transparent systemic board
 - Only type 1 errors (miss the buildup of a crisis) are visible
- The communication challenge: too little too late vs. cry wolf.
- So, how could the Systemic Risk Board reduce endogenous risk taking?

Beyond communication : using microprudential tools for macroprudential objectives?

- Measures of systemic risk should be used to improve banks' internal risk models
- The standard microprudential instruments should be viewed from a macroprudential perspective.
(Dell'Ariccia et al. 2012)

Effectiveness of Macroprudential Policies

- Dell’Ariccia et al. (2012): better at reducing the crisis impact than at preventing it.
- Instruments to build capital and liquidity buffers have reduced the ex post costs of a financial crisis.
- Increase in reserve requirement during boom years was successful when funding dried up.
- Poland, Croatia, Spain with its loan loss provisioning rules, Brazil on high-LTV car loans...

Liquidity crises and Credit crunch: Monetary policy vs. recapitalization

- Monetary bail-outs (LTRO) are common and perfectly agreed.
- The capital insurance mechanism. Drawback: it creates moral hazard.
- Once bail-in and claw back measures are in place the “moral hazard” argument is weak. In fact, both generate collective moral hazard (Farhi and Tirole); monetary bail-out may be equally damaging but will never alleviate a credit crunch.

To conclude

- A realistic approach to regulation should take into account the equilibrium level of regulation: regulatory arbitrage, regulatory capture.
- Thus efficient regulation should first be protected against political pressures, against the next round of deregulation and this implies building institutions that are focused and target oriented, which, in turn, allow them to be transparent: less is more!

Designing the regulatory framework : Improving banks' corporate governance

New restructuring and resolution procedures will improve corporate governance

Importance of expertise, independence and engagement

Is this enough to reduce the incentives to extract rents from debt holders and tax payers?

Maximize value of the bank rather than shareholders' value. Structure compensations accordingly (Bolton, Mehra and Shapiro).

The Two Macroprudential dimensions

1) The cross-sectional dimension:

- Contagion
- Amplification and feedback effects
- General Equilibrium (consolidate with shadow banking)

2) Time dimension

- Procyclicality
- Endogenous risk taking
- Notice: contagion effects are stronger when fundamentals are weaker (Iyer and Peydró).