

Discussion of

**Regulatory stringency
as a competitive tool for financial centers**

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Introduction

- What are the stability effects of competition btw financial centers?
 - Financial center = financial regulator (reg)
- Theoretical framework: Stability vs growth trade-off
 - 2 regulators compete for FI (financial intermediaries)
 - Regulators value stability and growth – tension -
 - FI like lax regulation (low stability)
 - How lax would regulation be if..?
- Main message
 - **Competing regs set lax regulation → lower than stand alone**
 - The laxity depends on parameters (e.g. difference of regs)

My personal view

- Thank you for doing applied theory
 - You might be able to do it better (or not) → at least you do it!
- Clean paper with relevant policy implications
 - We might be in a world with (too) lax regulation!
 - Some caring less for stability might make others care more!
- Well written and clear mechanism → I could understand (I think)
- Some ideas that came to my head – Could we learn more?
 - Should the BIS grow? Not only banks...
 - Why mixed strategies? Unobservability of reg?
 - Simplification without laxity? Why and how?

Competition among regulators

- Some financial intermediaries FI are mobile (others not)
 - Mobile FI can choose in which country to locate
 - FI like lax regulation – regulation is costly for them-
 - **Mobile FI would go to country with laxer regulation**

- Regulators want to attract FI

→ Reg value production (alpha) and stability (1-alpha)

$$W(t_i, \alpha_i) := \alpha_i \underbrace{(\Pi_E(t_i) + \Pi_B(t_i))}_{\text{Surplus from financial intermediation}} - (1 - \alpha_i) \underbrace{Lg(t_i)}_{\text{Bank failure externality}}$$

→ **Stability vs production trade-off**

→ Laxer regulation attracts more FI at the cost of stability

- **How lax a reg wants to be depends on how much it can win**

Some other relevant assumptions

- Mobile and non mobile FI
 - Some FI cannot move countries → limit to laxity
 - What would happen if all FI would be mobile?
- Laxity is not observed by the competing regulator
 - But it is observed by everyone else – even financiers-
 - Mixed strategies equilibria (sometimes)
- Regulators (exogenously) differ in their stability utility parameter
 - One prefers stability more than the other
 - They are (exogenously) heterogeneous in their preferences
 - Non symmetric competition Reg1 (stability) Reg2 (growth)

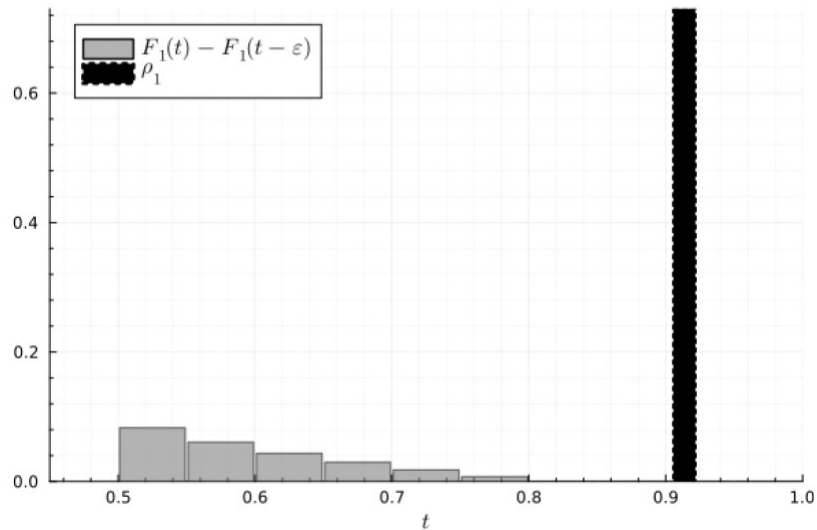
Two types equilibria: Stand alone vs competitive

- **Stand alone equilibria** (no competing regulators)
 - Regulators set high stringency regulation t^*
 - Interior stability vs production
- **Competitive equilibria** (regulators compete for mobile FI)
 - Extreme competition: very lax regulation $\underline{t} \ll t^*$
 - $\underline{t} > 0$ is fixed by assumption – race to bottom-
 - Intermediate competition: Intermediate regul. $t_{int} \rightarrow t^* > t_{int} > \underline{t}$
 - t_{int} is a mixed strategy (not pure equilibria like t^* or $\underline{t}$)
- What determines each equilibria?
- How does each of these t vary with parameters?

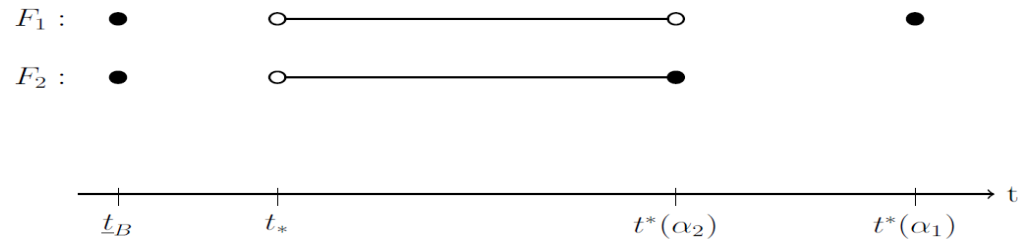
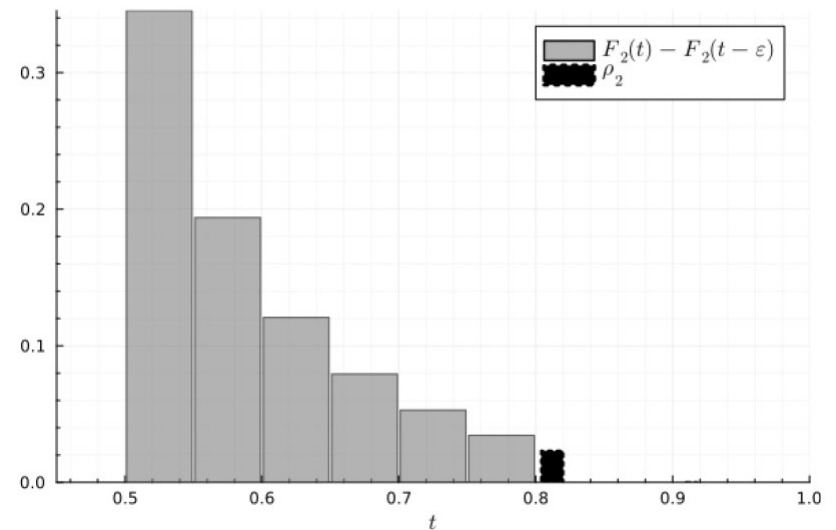
Mixed strategies equilibria

- t_{int} is a mixed strategy equilibria

(a) Histogram of regulator 1 (stability-focused) PDF including mass ρ_1



(b) Histogram of regulator 2 (growth-focused) PDF including mass ρ_2



What determines each region of equilibria?

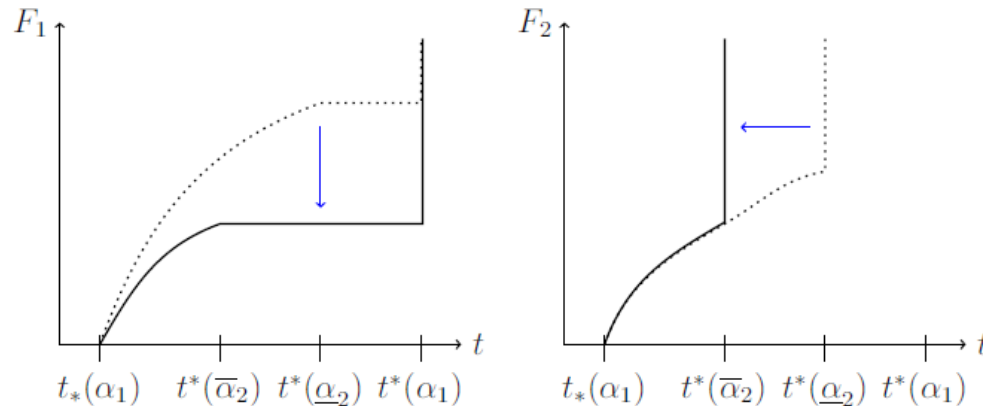
- More prone to be in t^* (non competing) – t (race to bottom)
 - When stability is very important (L high) – not important
 - Low amount of mobile FI – high amount of mobile FI
 - Equilibrium is independent of each others action
- For intermediate parameters we are in intermediate competition
 - Strategic game what Reg 1 does depends on Reg 2 incentives
 - and vice-versa

How does stability vary with growth focus

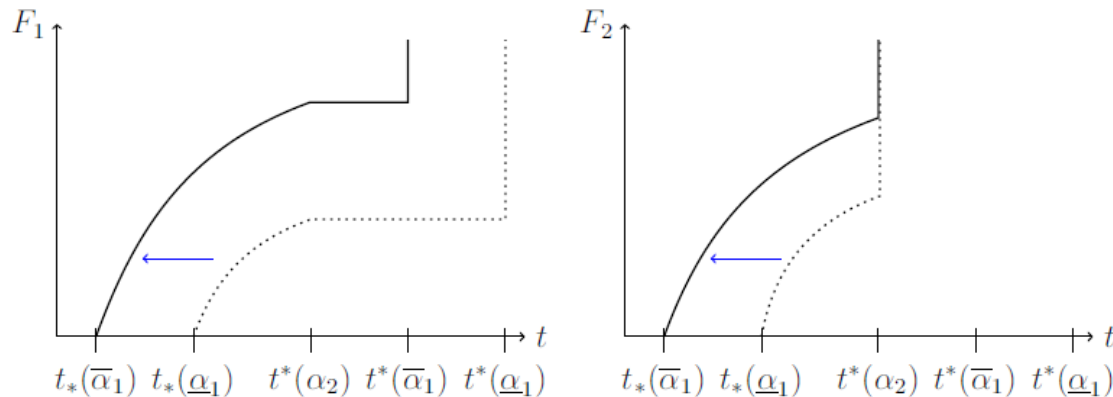
- With own growth focus stability is hampered → t goes down
- With competitor's growth focus it depends -use t to compete-
 - When the high growth (Reg2) becomes more growth oriented
 - Effectively competition is decreasing
 - It is “impossible” to win so why pay the cost of lower t
 - Reg 1 becomes more stringent
 - When the low growth (Reg 1) becomes more growth oriented
 - Effectively competition is increasing
 - It is more possible to lose so need to be more aggressive
 - Reg 2 becomes even more lax

How does stability vary with growth focus

- Growth focus becomes even more growth focus (less competition)



- Stability focus becomes more growth focus (more competition)



C.1 Observability of regulation

- The model assumes that t (regulatory stringency) is observed by everyone except for the competing regulator
- How realistic is this?
 - A financier of a financial institution can observe it
 - But those that are specialists (regulators) can not...
 - Note that it can not be a private deal - investors need to know

C.1 Observability of regulation

- Why is this needed?
 - Why not assume that t is an observable choice variable
 - And there is a heterogeneous cost of moving to each country
 - Each mobile FI has unique moving cost – Inverse demand
- Conjecture: This would lead to pure strategies
 - Possibly easier to characterize
 - I do not think it would change the main forces
 - “Simplify without sacrificing message?”

C.2 Symmetric competition

- Why only characterize asymmetric competition?
 - There is no microfoundation of Regs objective function
 - Both countries are basically symmetrical
- Wouldn't the symmetrical equilibrium be worthy of analysis?
 - Possible “obvious” higher growth by both lower t by both.
 - But you could also show asymmetries if only one becomes more growth oriented
 - Conjecture if Reg 2 becomes sufficiently growth oriented
Reg 1 becomes more strict.

C.3 Aggregate results

- The paper shows that some results might differ for Reg1 and Reg 2
 - But what about aggregate (average) results?
 - Is the world becoming more or less stable?
 - This might be of interest for certain institutions (BIS?)
 - BIS was not created to “level playfield”
 - But it is now one of its mandates

C.4 Other comments

- Effect of higher fraction of mobile FI
 - You state that effect on Reg 1 laxity is ambiguous
 - But is this the case when fraction $\rightarrow 1$
 - Conjecture: when all mobile $t = \underline{t}$ (nothing to protect)
- No welfare but
 - Would both regs have incentives to collude?
 - Level the playfield through BIS
- Bargaining between borrowers and FI
 - Looks like the cost of regulation is not part of the bargain
 - Infinite borrowers and finite FI but borrowers receive >0 ...

C.4 Other comments

- FI like positive regulation → why?
 - Without aggregate externalities they would monitor themselves, not clear why they need regulation.
- Not microfounded regulatory tastes
 - Wouldn't the tastes be related to fundamentals e.g. more productive entrepreneurs? This would affect first best allocations.
 - Maybe they are due to regulatory careers or incentives...

C.5 Simplifying without sacrifice

“**Simplifying** banking regulation and supervision **without sacrificing** safety”

→ Heard it quite a bit lately in regulatory cycles – **why now?**-

→ Is this even possible? I highly doubt it → I am concerned.

- “There is no such thing as a free lunch” / Pareto optimality

→ If possible to simplify w/out sacrifice → **how did we end here?**

→ Inefficiencies of (previous) designers of regulation?

→ Private incentives of (previous) designers of regulation?

- I think we need to understand **the causes** of current reg. landscape

→ Are we changing those causes? Need to **sacrifice something**

Conclusion

- Nice paper on the effect of regulatory competition on stability
 - Why not observable regulations (pure strategy)?
 - What about collusion – could it improve both + stability?

“Simple is (nearly) always better”