Discussion of “Financial System: Shock Absorber or Amplifier”

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Why are banks regulated?

- A&C follow MM approach – "perfect" world, then aberrations
  - Intuitive and academically effective approach
- What precisely are the aberrations? Will regulation help?
- Can we motivate the existence of banks under such a framework?
  - Theorems on double irrelevance

F&C's reasons for regulation

- Avoiding costs of banking crises
  - Market failure 1: Coordination problems
    - Depositors panic
    - But why have banks in a modern economy?
      - Immediacy? Protecting value?
      - Why not money market funds?
  - Market failure 2: Inadequate risk sharing
    - Liquidity is costliest when those in need can afford to pay the least
    - No ex ante contracts providing aggregate liquidity insurance
  - Are there other possibilities?
    - Holmstrom and Tirole, Caballero and Krishnamurthi, Diamond and Rajan

Are there other reasons for regulation?

- To ensure adequate economic competition
  - FAA, airline regulation, and entry
    - Reputations slow-acting
    - Industry self regulation mingles with self interest
    - But why not third party regulator?
  - JP Morgan, the Knickerbocker crisis, and the setting up of the Federal Reserve
- To ensure adequate political competition
  - Financial institutions as leverage points
    - Glass Steagall to cut down the House of Morgan (Roe)
    - Private Equity

Other reasons for regulation?

- Financial sector differs in degree
  - Nature of business more susceptible to fraud and mismanagement
    - Fungibility of assets
    - Ability to incur large losses in short order
    - Hard to assess performance
  - Agency and coordination problems exacerbated
    - Relative performance evaluation and
      - credit booms/herding
      - tail risk taking
  - Sector more central
  - Regulator has different incentives and can impose penalties (or be intrusive to an extent) private parties cannot

Other reasons for regulation? contd.

- Inability to commit to not intervene
  - Version 1: the Perverse Pottery Barn rule
    - Lenders do not internalize all the value the projects they lend to create
    - Excessive liquidation incentives (Holmstrom and Tirole)
    - Politicians will step in ex post to preserve societal value: You break it, we own it.
    - Should regulators therefore step in ex ante?

Other reasons for regulation?

- Version 2: Someone must be minding the store
  - NINJA mortgages
  - Who is watching – mortgage broker, lending bank, CDOs, rating agencies, CDO buyers?
  - Who is bearing the hit? How many are they? Where will it hit?
  - TMTF
  - Self-enforcing dereliction – multiple equilibria over responsibility?
- Version 3: The Greenspan put
  - If systemic enough and adverse enough, monetary policy will react.
  - Should the response be symmetric?

In sum

- As the paper argues, the precise rationale for regulation depends on the modeled aberration.
- Could there be more aberrations than the authors discuss?
- Yet as the authors correctly point out, the existence of an aberration does not imply regulators can help.

At the same time

- Direct costs of regulation
- Regulators are fallible
  - Can coordinate mistakes: CC or M to M and procyclicality
  - Improper rescues
  - Interference with private contracting: deposit insurance
- Excessive weakening of market discipline and caveat emptor

Bottom line: Trade-offs that we constantly attempt to revisit.