Regulatory Structure: Development and Financial Stability

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Government  Markets

Regulation: Principle-based rules
Change incentives of agents
Regional standardization, operational freedom

Basic market failures

- Broad justification for regulation
- PIT: System plus users: integrity of mkts, fairness
Market failure

- Monopoly or market power
- Asymmetric or imperfect information
- Externalities or public goods

Financial system: Oversight of operational framework

- Externality—excess volatility: one → others, financial → real
- Information—asymmetric; adverse selection, moral hazard
- Monopoly—network effects; TBTF → risk taking
Post Crisis Market and Regulatory Failure

Market efficiency implies (no failures):

- Market prices give economic value
- Market discipline constrains harmful risk taking
- Market competition weeds out unproductive innovations
  - Securitised credit: liquidity, diversification
  - Mathematical models: robust measures of trading risk
Market discipline did not work: Information available not used

But regulatory failure also:

- Information: Disclosures inadequate; warnings available ignored
- Volatility: incentives for procyclicality
  - Risk models based on market prices; Basel II
- Size: Regulatory capture: ideas; interests; wallets
  - Flexible US system → competitive innovation
- Safer to think the same even if it is wrong

Directions for regulatory reform: Pendulum

- Not self-regulation or regulatory forebearance
- But don’t damp energy and freedom of markets
Reform

- → market failures through better incentives: Principle-based rule
  - Micro-prudential regulation → securitization; PCA
  - Macro-prudential regulation → procyclical capital adequacy
    - Reduce under pricing of risk in booms
    - S-T Funding; Size (TBTF) → insurance premium
    - Imposed by host country (domestic cycles)

- Universal standards ⇒ ↓ regulatory arbitrage; ↓ Competitive risk-taking
# The Effect of Regulation on Risk

<table>
<thead>
<tr>
<th>Regulator/Country</th>
<th>No action</th>
<th>Bailout</th>
<th>Capital Charge</th>
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<tbody>
<tr>
<td>Bank Safe</td>
<td>(7,4)</td>
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<td>↑</td>
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<tr>
<td>Bank Risky</td>
<td>(9,0)</td>
<td>(8,3)</td>
<td>(5,2)</td>
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Regulatory structure: One or many; super regulator?

☆ Sectoral → splitting information
   - Specific information
   - Responsibility

☆ Apex → loss of information to CB, LOLR?
   - FSA (Northern Rock)
     - private corporation, industry fees
     - profits, UK competitive, ↓ costs, innovation
   - US multiple bank regulators (Bear Stearn, 106)

☆ CB → systemic risk, financial stability
   - LOLR → markets also
   - Market information ↔ monetary policy
Proposed European System (de Larosière Commission)

- Micro-prudential: Sectoral regulators

- Macro-prudential: Systemic risks; CBs, national level

- Regional coordination: Committee of CBs, sectoral regulators, Chair ECB
  - Harmonization of standards but operational flexibility

- Concerns: Standards yes but national priorities?
  - Dictation by others interests?
  - Saved stricter national regulations?
  - But national weaker if strong finance lobby
ECB chair → Stability over development?

☆ Financial sectors prefer FSA over CBs

☆ Single over multiple regulators

☆ Politicians want to attract finance, quick to pass blame to CBs, weaken them

Stable development → rules of the game

Lobbying more difficult if international judicial oversight (WTO?)

☆ But financial services kept out of WTO
Regulation → Development

- Development level → regulation versus legal recourse (Glaeser and Shleifer, 2003)
  - None → regulation (cost of damages high) → law
    (if lobby cost high—WTO!)
  - EMEs setting up strong regulatory agencies (as in US progressive era)
    - Convergence to international standards
    - Easier in regulation than in law
    - History, greater supervision; international position moving towards EMEs
    - Contextual features: banks led; volatile flows → NI FA
  - Technology: better monitoring → high powered incentives with better measurement
Creation of electronic markets: Exceeding international standards

- Disclosure: real time price sensitive info; norms; corporate governance

- Volatility: Var + SPAN+ margins +deposits+ circuit breakers +surveillance
  - **No stock exchange failed**

- Competition: liquidity → network → tipping
  - **BSE → NSE**
  - **Technology → insider groups → dispersed → governance**
  - **Anonymous trade → counterparty risk**
  - **Entry: MCX → platforms, lock-in, costs** ↓
**Principle Based Rules**

- Operational flexibility: Adjust to emerging trends
  - Contextual development requirements
  - Private placement; PNs, KYC; market hours

- Incentives for safe innovations
  - Central counterparties for OTC derivatives

- Create the correct incentives
  - Spirit not only letter of the law

- Both principle based flexible regulation and discretion
  - Response time too long
  - Respond to events after proving market failure

- Complex rules → principle based flexibility
- Easier regional convergence
Indian regulation

Crisis—financial sector healthy
- No road, or good regulation?
- Eye on market failures

Restrictions
- Market development; FX controls to rule based systems of self-certification
- But complex financial products, securitization
- Slow innovation

Supervision
- Post liberalization crises → strengthened
- Conglomerates → universal regulation

Counter cyclical incentives - prescient
- Provisioning
- Accounting standards—unrealized gains and losses asymmetric
- PCA
Financial stability

- Objective of monetary policy after the East Asian crisis

- 2006 Amendment to RBI Act
  - Expanded its powers to give directions to all market agencies
    - prevents narrow focus on small part of the financial sector

- Synergy between monetary policy and regulatory responsibilities
  - Protection during crisis: information

- LOLR required by many non-bank entities also
  - So monitor all risk sources and protect tax-payer who supports LOLR

Functional criteria for allocation of regulatory responsibility

- First systemic risk then task
Structure: HLCC of sectoral regulators

- Chair CB
- Coordination only effective during crisis
- Delays
  - Corporate Repo Market
  - Overlap: Clear allocation of responsibility
- Objectives include development, time lines
  - Stable development

Thank you