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

Regulator/Country

		No action	Bailout	Capital Charge
Bank	Safe	(7,4)	(7,4)	
	Risky	(9,0)	(8,3)	(5,2)

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 Larosiére 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 → NIFA**
  - 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