

# The future of financial regulation: an exchange of views <sup>1</sup>

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*A conference took place on 3 March 2009, on the issue of the future of financial regulation, between Anil Kashyap and several Banque de France staff members.*

*Six issues were discussed:*

- *the future of capital regulation;*
- *liquidity regulation;*
- *macroprudential regulation;*
- *moral hazard;*
- *the relationship between monetary policy and financial stability; and*
- *bank restructuring.*

*Here is the transcript of their discussion. Three main conclusions emerged from the discussion:*

- *regulators should design mechanisms aimed at avoiding asset fire sales in stress times, possibly through a mandatory mechanism for recapitalisation;*
- *strengthening central banks' responsibilities for financial stability should not blur their main task of maintaining price stability;*
- *the current situation is fundamentally different from the Japanese experience during the "lost decade" insofar as in Japan, banking losses came from lending to bad firms whereas today, problems come from bad collateral.*

<sup>1</sup> *Transcript of a discussion between Anil Kashyap, Professor of Economics and Finance at Booth School of Business, University of Chicago, Jean-Pierre Landau, Deputy Governor of the Banque de France, Sylvie Matherat, Financial Stability Director, Pierre-Francois Weber, Financial Stability Directorate, and Benoît Mojon, Monetary and Financial Analysis Directorate.*

## 1 | THE FUTURE OF BANKING CAPITAL REGULATION

**Jean-Pierre Landau:** *Has the crisis revealed a regulatory failure? Does Basel II need to be amended?*

**Anil Kashyap:** The current capital regime is characterised by its strong asymmetry over the credit cycle: in good times, the market does not require banks to hold much capital and exerts little monitoring. Banks using their own internal models of risk that mimic the market's assessment can easily expand credit and at best the regulatory rules slow this down a bit. When the slowdown comes, the market (and the banks' models) suggest the required capital buffer is far above the regulatory requirement. Put differently, everyone understands that if we cut regulatory capital requirements right now it would have no effect on bank behaviour because banks need very high levels of capital just to attract funding. This asymmetry means that financial system amplifies cycles, something that has also been evident since the middle of 2007.

Therefore, capital regulation needs to be amended to avoid excessive deleveraging during the slowdown. This requires constraining banks' ability to expand their balance sheets and leverage during good times. If this can be done then the banks might enter the slowdown with enough capital to not have to cut back their lending. This would reduce the extent of asset fire sales in times of stress that result from the bank system collectively selling assets to comply with capital ratios.

But achieving this will not be that easy. The pitfall in this solution lies in the need to avoid regulatory arbitrage. Constraining banks' leverage in good times will incite them to transfer their assets to a shadow banking system in order to escape regulation.

**Jean-Pierre Landau:** *In good times, no capital regulation is likely to bite. Hence there is a need to prevent risk taking per se. Do you think that requiring more capital is enough to achieve this? Would it be sufficient in order to avoid deleveraging in bad times?*

**Anil Kashyap:** An analogy can be made with monetary policy. In conducting monetary policy, central banks can fix quantities (through the level of reserve requirements) or prices (through the

level of the interest rate). Along the same lines, in my 2004 paper with Jeremy Stein, we put forward the idea of creating a market for regulatory capital relief. This market would be supplied by the regulator (central banks or supervisor) with a small amount of tradable capital certificates provided through periodical auctions. The market price of these certificates would be a direct and transparent measure of the shadow value of bank capital. In this way, a high price would indicate a relative shortage of bank capital to regulators. The regulator may then be allowed to increase the supply of certificates in response to rising prices, so as to tie the effective capital requirement to the shadow value.

**Jean-Pierre Landau:** *I interpret your proposal as a way to create an artificial scarcity of capital, as monetary authorities do with central bank liquidity through reserve requirements.*

**Anil Kashyap:** Exactly. Your remark leads me to ask you whether Banque de France has considered implementing such a mechanism of pricing capital.

**Jean-Pierre Landau:** *We are carrying out reflections at the Banque de France on the way of ensuring an appropriate pricing of risks in good times aimed at changing incentives and reducing the procyclicality of financial systems. To that end, financial reporting and accounting systems should force banks to retain and put aside profits in good times and allow them to use these buffers in bad times.*

**Anil Kashyap:** Changing the accounting framework to recognise that financial stability is something that merits consideration. The accountants tend to focus only on realised losses and worry that allowing provisioning against potential losses is a license to manipulate earnings. This may be true, but there are benefits to having banks build up a buffer when times are good.

In addition, banks should have to draw up business continuity plans for crisis management. Large banks and other systemically relevant institutions should have to tell their supervisors how they could be quickly wound down. These plans would force financial institutions to internalise extreme risks in their risk management system. Figuring out where to draw the line on which organisations are subject to this rule is going to be a challenge.

**Sylvie Matherat:** *Your proposal is converging with the works in progress within the Financial Stability Forum: a working group chaired by John Gieve, Deputy Governor of the Bank of England, recently issued a report on cross-border crisis management. This report advocates the elaboration by groups of authorities of firm-specific contingency planning exercises covering practicalities and strategic policy considerations.*

**Jean-Pierre Landau:** *Your point on tail risks is essential. It seems obvious that this kind of risks has not been internalised by the financial systems. It is likely that financial innovation has reduced average risks, but magnified tail risks. A crucial question related to this is whether it would be economically and socially efficient for financial intermediaries to insure against tail risks. In other words, should insurance be private or socialised?*

**Anil Kashyap:** The key point may not be whether insurance should be private or public, although if it is public we need to bear in mind that it may lead to some underpricing of risk. Rather, what we should keep in mind that the purpose of this to avoid rapid asset disposal and a credit crunch when tail risks materialise. Banks should continue to carry out their function of intermediation in any case. At the same time, the private sector should be forced to do the pricing of tail risks and to bear the costs. This might turn out to come at a very high price for banks but would allow avoiding the recurrence of situations such as the rescue of AIG in which taxpayers bear the costs in an unfair way.

**Pierre-François Weber:** *The question of the overcomplexity of capital regulation within the framework of Basel II is often raised. In your opinion, what kind of incentives does this alleged overcomplexity create?*

**Anil Kashyap:** Understanding the models that the banks have created under Basel II is a challenge. But the more important point is to amend Basel II to make sure that there is a mandatory mechanism for recapitalisation.

**Pierre-François Weber:** *As you know there is a debate about the scope of regulation. Do you think that the regulatory framework should be expanded*

*beyond banks, notably to hedge funds and the shadow banking system?*

**Anil Kashyap:** From a general point of view, public authorities should refrain from expanding regulation excessively. Hedge funds are not a root cause of the crisis. That being said, hedge funds may have contributed to fire sales and created externalities in the markets. Their role as stress amplifiers might justify an expansion of regulation to cover these actors. Perhaps this can be accomplished simply by having them disclose more to supervisors.

## 2 | LIQUIDITY REGULATION

**Jean-Pierre Landau:** *A major dimension of tail risk has to do with liquidity risk. Could you think of a device which could induce financial institutions to internalise systemic risk of liquidity and of their transformation activities?*

**Anil Kashyap:** This can be tied back to capital requirements. Clearly, larger institutions can cause more problems on that liquidity front and should be held to a higher standard, since they impose a bigger externality. They pose a bigger risk as a result of short-term debt refinancing. Hence, they should be charged differently.

The problem is that higher "tax" may lead big financial institutions to search for ways to overcome the regulation. Therefore, this should be accompanied by a new reporting regime, to follow more closely what large banks are doing.

**Sylvie Matherat:** *Do you have a tax in mind?*

**Anil Kashyap:** Any type of such measure is, effectively a "tax"; we should refer to it as such. We need to recognise that larger institutions create more risk. The capital ratio should depend both on the composition of assets, and the composition of liabilities.

Recall that we have an incentive problem: how to constrain large institutions in expansion times, without "strangling" them and driving them to try to shift their activities to avoid regulation.

**Jean-Pierre Landau:** Are there any other regulations to be considered, such as looking at the compensation structure?

**Anil Kashyap:** Surely, we could also look at the compensation structure. What we need to realise is that all of these proposals may reduce efficiency and the mobility of resources. Hence, all of these measures should be considered as a form of “tax”.

### 3| THE MACROPRUDENTIAL APPROACH

**Jean-Pierre Landau:** The economic costs of financial crises and the limited scope of microprudential supervision strengthen the case for implementing a macroprudential surveillance. How should macroprudential regulation and supervision proceed? Do you consider that it should be underpinned by automatic stabilisers into the capital regime or leave some room for discretion?

**Anil Kashyap:** These are critical questions that have received too little attention so far. Ultimately, central banks need to be involved in supervision for several reasons. First, they are the liquidity providers and need to have an informed judgement in order to take responsible decisions on whether to rescue or not banking institutions. Second, experience shows that supervisory agencies tend to be captured by the institutions they supervise. This risk questions the relevance of Basel II internal ratings-based approach.

As regards over-the-counter derivatives markets, central banks need to be involved in the process of creating central counterparties, with regard to the systemic risks embedded in such markets. The difficulty lies in the effective implementation and the need to find a way of keeping central banks informed without overburdening them. Another pitfall results from the lack of data, which has meant much of the existing work has been purely theoretical.

### 4| MORAL HAZARD

**Jean-Pierre Landau:** Historically, we built our regulation system around the idea that moral hazard

should be dealt with so as to ensure that market discipline functions. Would you agree on the finding that the way in which public authorities collectively managed the financial crisis has undermined this framework? If so, what would you suggest for the design of future financial regulation?

**Anil Kashyap:** To answer your question, we should look at history. During the Great Depression, the US Supreme Court modified private debt contracts and public authorities decided to close markets temporarily, in a move which was described as outrageous and heralding the end of capitalism. I agree that the argument of moral hazard will be significantly weakened for a while. It played a key role in Lehman Brothers' failure but its implementation has proved to be very difficult with the handling of Bear Stearns.

**Jean-Pierre Landau:** I agree with you on the lessons we can draw from these two examples. Market participants followed strategic behaviours on the occasions of these two institutions' distress, some actors were searching for opportunities.

**Anil Kashyap:** These events point to the urgent need for an internally and time-consistent resolution regime that allows to let financial institutions fail without crippling the entire financial system.

### 5| THE RELATIONSHIP BETWEEN FINANCIAL STABILITY AND MONETARY POLICY

**Jean-Pierre Landau:** Should Central Banks be given a mandate for financial stability, which is at the same level as the objective of price stability?

**Anil Kashyap:** The conduct of monetary policy and the supervision of the financial sector are not necessarily part of the same skill set. To give you an example, the US regulatory agency has been criticised by the Consumer protection agency as a result of the subprime mortgage lending situation. More generally the issues related to most elements of consumer protection have little to do with macro or monetary economics.

Even though financial stability has macroeconomic implications, I am not sure Central Banks have those skills. If at all, there should be a section of the Central Bank exclusively dedicated to this function, to avoid any conflict of interest. We also may run into the risk of making the Federal Reserve Bank Chairman the target of criticisms. It is always difficult for the Central Bank to lean against the wind.

That said, there should indeed be a separate voice that is tasked with monitoring changes in conditions of financial markets.

## 6 | BANK RESTRUCTURING

**Benoît Mojon:** *How do we avoid the problem of "zombie lending"? How can we organise a restructuring without deleveraging: Can we clean-up the balance sheets without causing a major recession?*

**Anil Kashyap:** The situation in the United States is different from the problem in Japan. In Japan, lending was made to "bad firms", while in the United States, lending was made to "bad collateral". If Congress were to (say) force Citibank to lend to GM, that would be a disaster for both Citibank and for taxpayers, if as I expect the loans wind up not being repaid.

If we can afford to move all the bad assets to a different part of the bank, the private sector would again recapitalise the "good" part of the bank. Running a stress test on the banks to figure out the size of the bad assets problem is the right first step.

**Jean-Pierre Landau:** *Would you advocate punishing investors holding bonds of distressed banks?*

**Anil Kashyap:** There has to be some imposition of losses to bond-holders. If this were not a financial firm, bankruptcy laws would make clear what bond-holders would share some of the losses as a result of the liquidation.

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