

Discussion of Optimal Capital Regulation with Two Banking Sectors

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Message

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1. Cost of too tight regulation
2. Procyclical regulation

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Regulatory arbitrage → Greater risk

2. Procyclical regulation

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Tames regulatory arbitrage best

Model

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Banks' incentive to gamble with depositors' money

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Private contracting "failure" → Regulation

Regulation = deposit insurance + capital requirements

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Private contracting "failure" → Regulation

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Banks' choice to submit to regulation

Tension: fewer gambling benefits vs. lower funding costs

Timeline



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- Regulation set

Timeline



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- Investors and banks observe fundamentals

Timeline



- Regulation set

- Investors and banks observe fundamentals

- Funding raised

Timeline



- Regulation set
- Investors and banks observe fundamentals
- Funding raised
- Banks choose risk
- Payoffs realize

Model

Optimal regulation

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- "socially" optimal risk
- optimal mix of regulated and shadow banking

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Procyclical regulation

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Procyclical regulation

- risk-taking incentives increase in good times
- increase incentives to become regulated
- loosen capital requirements in good times

Comments

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- ▶ Regulation mixes sources of risk-taking incentives
 - Procyclicality = times of higher average asset quality
Asset risk treated as fixed!
 - Empirically, (measured) risk appears countercyclical
 - How does risk-taking respond?

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- ▶ Regulation mixes sources of risk-taking incentives
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Asset risk treated as fixed!
 - Empirically, (measured) risk appears countercyclical
 - How does risk-taking respond?
- ▶ Feedback between bank behavior and regulation
 - Lucas critique
 - Measurement can change measured risk
 - Feedback in model not so clear

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 - No failure in market among banks
 - Why does the market fail to discipline risk-taking?
 - Regulator and market share same information
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- ▶ Rationale for "shadow banking"
 - Merely charade or economic purpose?
 - If such evil, why not regulate it all?
 - What is the true cost/limit of regulation?

Bank Regulation and Risk Taking

Does regulation increase/decrease risk taking?

- Capital requirements can increase risk

Kahane 1977; Santomero et al. 1980, 1988; Genotte and Pyle 1991; Rochet 1992

- Deposit insurance can increase risk

Merton 1977, 1978; Bhattacharya et al. 1993, 1998; Demircuc-Kunt et al. 2002

- Excessive tax counterproductive

Opp 2012

Conclusion

- ▶ Nice paper (simple and clear idea)!
- ▶ Contemplate cleaner channel for risk-taking
- ▶ Robustness of regulation to risk measurement