Strengthening Financial Markets

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June 24, 2011
An intellectual failure

“The failure to understand that a systemic crisis was possible in the U.S. is an intellectual failure. This failure should be understood and explained. It should be recognized [and] admitted. We don’t understand why we didn’t understand. The problem affects researchers and policymakers alike. It affects economic research; it affects regulatory actions; it affected the recent Dodd-Frank legislation, and it affects our current understanding of the future.”
Insolvency or illiquidity

- *The sub-prime crisis*

- *Repo and ABCP*: Acharya and Schnabl (2009), Gorton and Metrick (2011)

- *Interbank markets*: Heider, Holthausen and Hoerova (2008); Acharya and Merrouche (2009); Ashcraft, McAndrews and Skeie (2008); Afonso, Kovner and Schoar (2010).
Willem Buiter:

“Liquidity is a public good. It can be managed privately (by hoarding inherently liquid assets), but it would be socially inefficient for private banks and other financial institutions to hold liquid assets on their balance sheets in amounts sufficient to tide them over when markets become disorderly. They are meant to intermediate short maturity liabilities into long maturity assets and (normally) liquid liabilities into illiquid assets. Since central banks can create unquestioned liquidity at the drop of a hat, in any amount and at zero cost, they should be the liquidity providers of last resort, both as lender of last resort and as market maker of last resort. There is no moral hazard as long as central banks provide the liquidity against properly priced collateral, which is in addition subject to the usual ‘liquidity haircuts’ on this fair valuation.”
Two views on liquidity provision II

Mervyn King:

“[T]he moral hazard inherent in the provision of ex post insurance to institutions that have engaged in risky or reckless lending is no abstract concept. The risks of the potential maturity transformation undertaken by off-balance sheet vehicles were not fully priced. If central banks underwrite any maturity transformation that threatens to damage the economy as a whole, it encourages the view that as long as a bank takes the same sort of risks that other banks are taking then it is more likely that their liquidity problems will be insured ex post by the central bank. The provision of large liquidity facilities penalises those financial institutions that sat out the dance, encourages herd behaviour and increases the intensity of future crises.”
Market freezes

- Interbank markets (Goodfriend and King, 1988; Allen, Carletti and Gale, 2009, 2011)
- Market liquidity and funding liquidity (Brunnermeier and Pedersen, 2009)
- Rollover risk (Acharya, Gale and Yorulmazer, 2011)
- Leverage cycles (Geanakoplos, 1997, 2009; Fostel and Geanakoplos, 2009)
- Repo runs (Gorton, 2010; Martin, Skeie and von Thadden 2011)
- Liquidity component of insolvency (Morris and Shin, 2009)
Maturity transformation

- Dynamic bank runs (He and Xiong, 2009)
- Maturity rat race (Brunnermeier and Oehmke, 2010)
- Maturity and risk shifting (Kashyap, Rajan and Stein, 2008; Huberman and Repullo, 2011; Eisenbach, 2010)
- Maturity and the debt overhang (Diamond and He, 2010)
The Dodd Frank Act

- The goal of regulation: a competitive, efficient and innovative financial system

- The Volker rule

- Social engineering and the CFPA

- Resolution regime for *Systemically Important Financial Institutions* (SIFI)

- The need for structural reform: transparency, competition and manageability.
Basel III

- Capital requirements

- Capital levels and risk taking (Gale, 2004; Gale and Ozgur, 2005; Hakenes and Schnabel, 2011; Martinez-Miera, 2009; Perotti, Ratnovski and Vlahu, 2011)

- Liquidity requirements: liquidity coverage ratio; net stable funding ratio

- What role for maturity transformation?
A new model for the parallel banking system

- The target returns to capital providers will be low, but stable,
- The activities that the Narrow Bank can engage in (e.g., the type of securities held) must be fully defined by a charter that is transparent to capital and debt investors and to regulators.
- The capital structure must be responsive to
  - (i) the credit quality of the portfolio;
  - (ii) the maturity of the assets;
  - (iii) the diversification of the portfolio; and
  - (iv) the asset-liability maturity gap.

(For example, the capital requirements could be based on a Basel-type formula that incorporates measures of credit quality, maturity, diversification, and asset-liability gap).
No off-balance-sheet exposures or contingent risk exposures would be allowed.

There would be no proprietary trading and most assets would be held to maturity.

Interest rate and currency exposure would be fully hedged.

Risk management would be consistent with ‘best practice’; in particular, asset quality evaluation would be based on in-house research and would not rely on rating agencies.

Most importantly, the Narrow Bank would be regulated by the FRS and would have access to central bank liquidity facilities.
Conclusion

- We need a better understanding of the role of funding markets and the reasons why they failed.

- Proposed regulation is backward looking, lacks a theoretical foundation and ignores important lessons from the financial crisis.

- Leaving in place the large, complex, unmanageable SIFIs is asking for trouble.

- Structural reform, including the extension of regulation and liquidity provision to a new PBS consisting of limited purpose financial companies (narrow banks), is a better way to go.