Reframing Financial Regulation

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Background

- Reactive approach to financial regulation

- Traditional categories based on historical business models

“A lot of the rules and regulations [we have] are closer to the Civil War than they are to today.”

Jamie Dimon
Chairman and CEO, J.P. Morgan Chase

*N.Y. Post, July 9, 2008, at 31*
Background

- Reactive approach to financial regulation
- Traditional categories based on historical business models
- Goal – Begin, as a first step, to assess financial regulation against shifts in the financial markets, and formulate a tentative approach to regulation not limited by fixed categories
- Caveat – Difficult at this stage to detail how a new regulatory structure would look

Traditional Intermediaries – Asset Transformation

- Short-term creditors vs. long-term borrowers
- Agency cost problems
- Risk of bank runs
- Regulation and insurance
- Regulatory costs offset by the value of the banks’ franchise
Bank Runs and Non-Banks

- New Market Participants
  - Transfer of loan and related assets off balance sheet
  - Investments funded with short-term credit
  - Risk of non-bank runs

- Fixed-Return Intermediary
  - Liquid Investments
  - Illiquid Assets (loans)
  - Fixed Claims
  - Capital

Traditional Intermediaries – Managing Risk

- Managing risk is a core function of intermediation
- Agency cost problems
- Negative externalities and systemic risk
- Regulation and insurance
Outsourcing Risk Management

New Market Participants

✓ Changes in risk management; greater private credit liquidity
✓ Separating working and risk capital
✓ Dispersion of risk across the capital markets

Other Risk Counterparties

Fixed-Return Intermediary

Financial Markets – Evolution and Regulation

Regulated Intermediaries → Less Regulated Entities

Prob: Incomplete Risk Assessment

Mirror: Incomplete Risk Assessment

New: Dispersed/Outsourced Risk Management

Traditional Intermediation → Capital Markets

Prob: Depositors/Policyholders vs. Shareholders

Mirror: Short-term Lenders (Repo) vs. Shareholders

New: Trading in Concert

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Some Lessons for Financial Regulation

- Traditional categories are too narrow
- A function-only approach is insufficient – must continue to take into account differences in agency, transaction, and other costs
- Suprafunctional approach – Deconstruct intermediation – into functions and problems – and identify what functions have emerged or re-emerged; consider the associated problems within the context of new institutions and/or markets

Example

- Administration proposal to tax derivatives transactions (credit default swaps) by banks and regulate hedge funds that are “too big” or “too interconnected” to fail
- Categories approach – Reacting to recent experience, focus on trading activities by traditional intermediaries
- Functional approach – Apply banking/prudential regulation to (largest) hedge funds, without taking institutional/market differences into account
- Suprafunctional approach – Reflecting dispersed, market-wide trading by new entrants, regulate all capital markets and other entities that trade credit derivatives; portfolio restrictions vs. capital requirements?