Reframing Financial Regulation

Cornell University

Charles K. Whitehead
Cornell University Law School

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

Cornell University

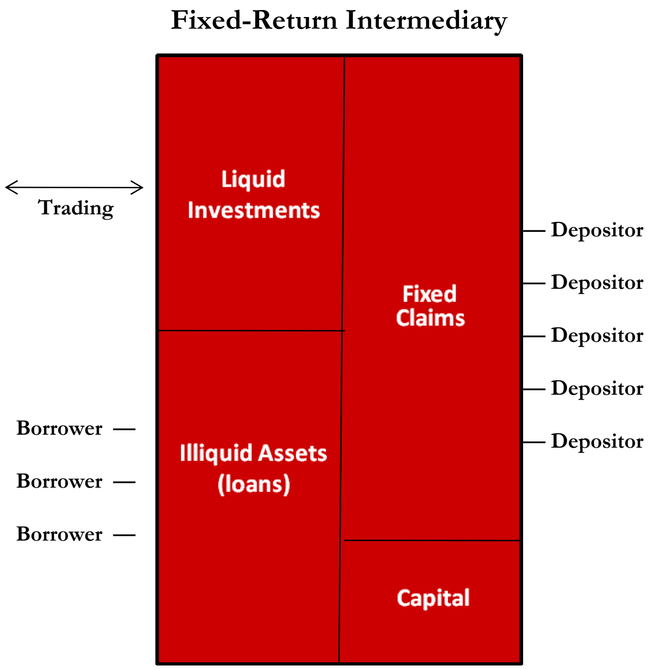
Background

- ✓ 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

Cornell University

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

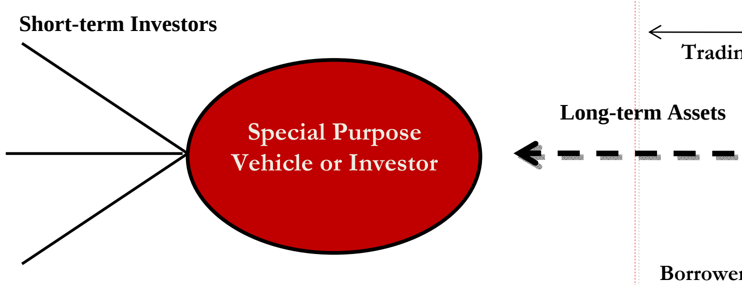


Cornell University

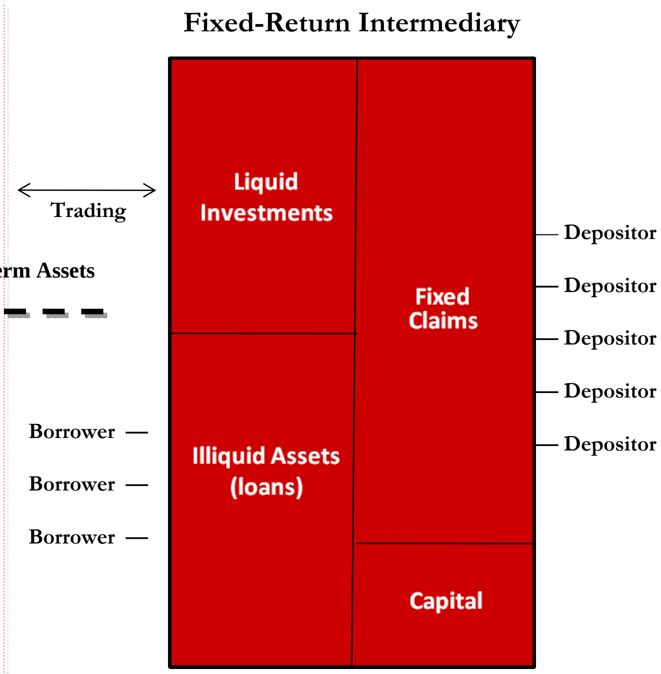
Bank Runs and Non-Banks

New Market Participants

- ✓ Transfer of loan and related assets off balance sheet



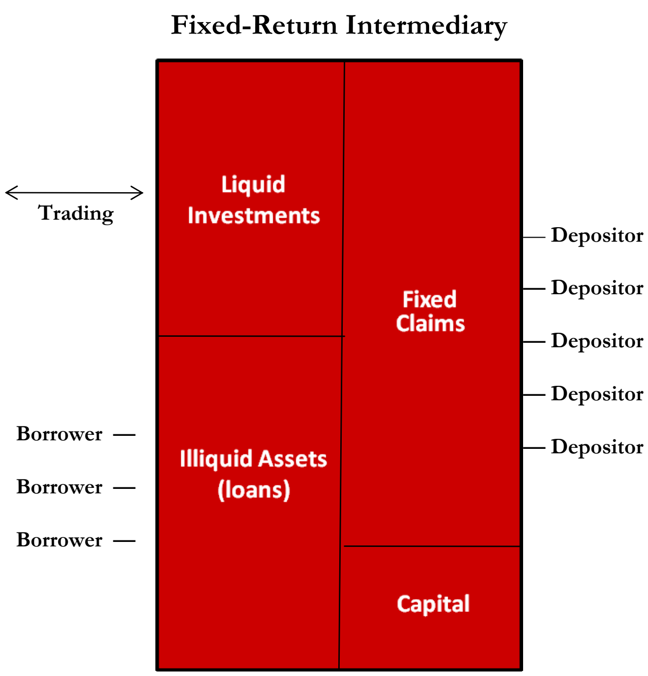
- ✓ Investments funded with short-term credit
- ✓ Risk of non-bank runs



Cornell University

Traditional Intermediaries – Managing Risk

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



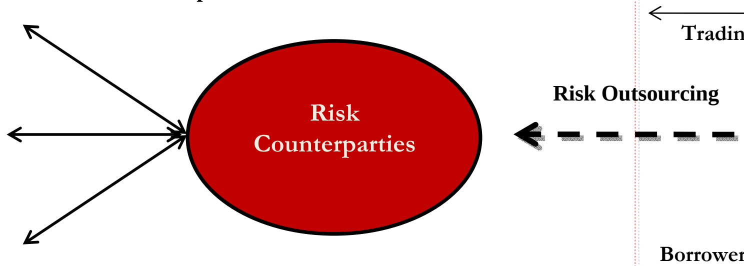
Cornell University

Outsourcing Risk Management

New Market Participants

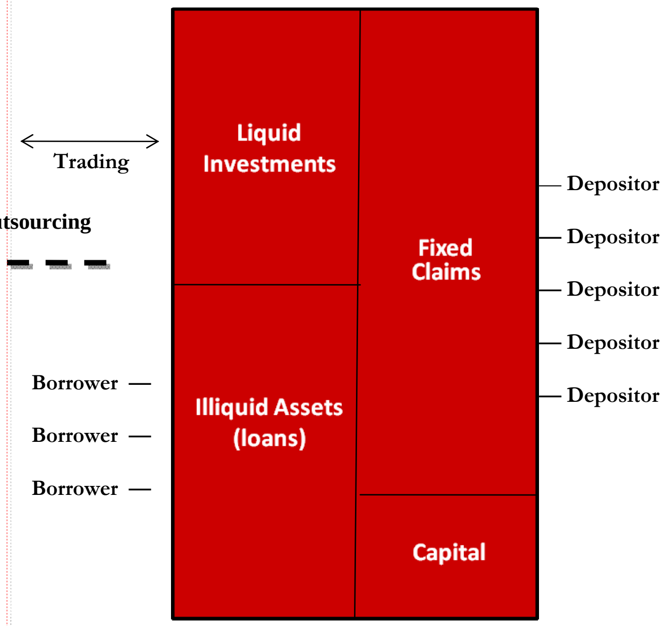
- ✓ Changes in risk management; greater private credit liquidity

Other Risk Counterparties



- ✓ Separating working and risk capital
- ✓ Dispersion of risk across the capital markets

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

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

Cornell University

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?

Cornell University

Reframing Financial Regulation

Cornell University

Charles K. Whitehead
Cornell University Law School