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OF FINANCE



NOBEL SYMPOSIA



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RIKSBANKENS  
JUBILEUMSFOND  
THE SWEDISH FOUNDATION FOR  
HUMANITIES AND SOCIAL SCIENCES

# Financial Regulation

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**Yale**

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**Chicago**

Discussion by

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**Stanford and Hoover**

Nobel Symposium on “Money and Banking”

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# Summary

## ❑ Tension: Information sensitivity of short term debt

- A feature (threat of run provides incentives): Raghu
- A bug (a side product of safe asset production): Gary

## ❑ Raghu:

- Systemic regulation is key but battling a moving and shape-shifting target
- Risk of fighting the last battle and strict regulation (talent/resources moving away?)
- *Broad, robust and timely regulation rather than micro management*

## ❑ Gary:

- Financial crisis are bank runs
- Solutions such as high quality collateral, insurance and others (charter value) had mixed success
- *Effective regulation a major challenge*

## ❑ Discussion: Learnt a lot from presenters and agree with theme on regulation

- Data: effective financial regulation (even more) challenging
- Conclusion: More quantitative cost-benefit of regulating banks (not just limited to short term debt)

# Aspects that Make Regulation (More) Challenging

- ❑ Several aspects make effective regulation even more challenging
  - Regulators
  - Bank Incentives
  - Design and Implementation
  - Political Economy
  - Beliefs and Culture

# Regulators

## ❑ Rules ≠ Effective Regulation

- “Will of the regulator”: Overlapping jurisdictions and conflicted incentives [Agarwal et al.]
- Funded (and governance) by constituents: Enforcement actions, Arbitration [Adams et al.]

FIGURE 1A: INCONSISTENT REGULATORS

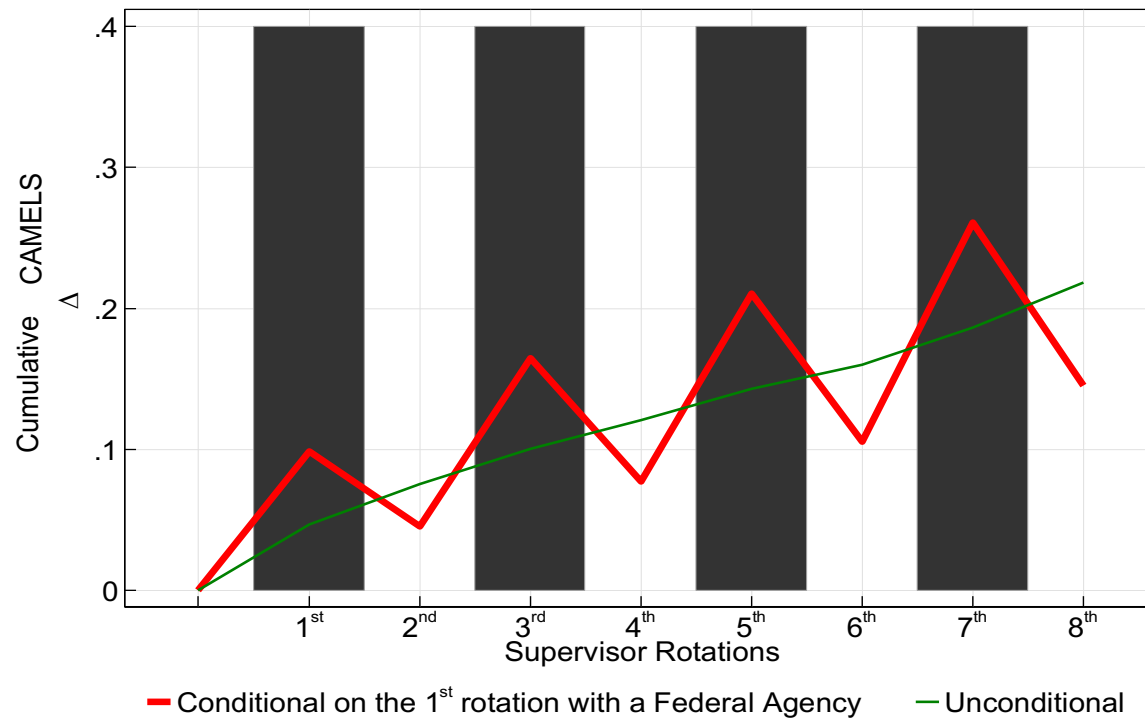
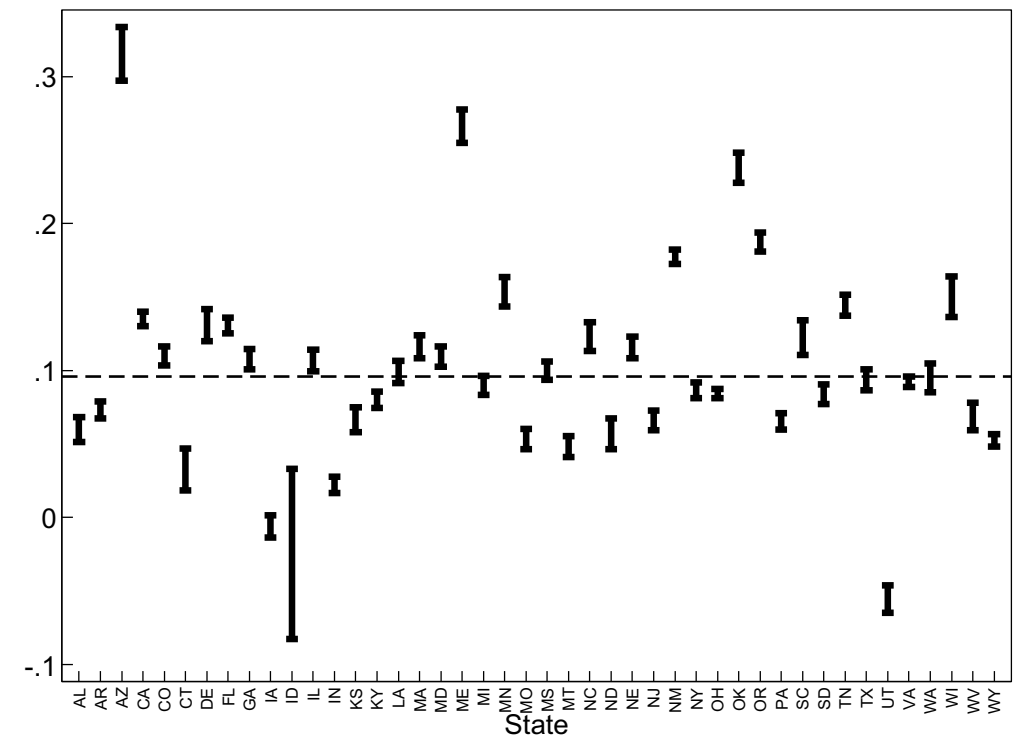


FIGURE 1B: VARIATION ACROSS STATES



# Regulators

## ❑ Rules ≠ Effective Regulation

- **Human biases in judgement and decision making**: directional biases and discretion that may not translate to better outcomes for banks and defaults [Chang/Schoar, Dobbie, Agarwal et al.]
- Can regulators agree if its solvency or illiquidity?

FIGURE 2A: LOW LENIENCY QUARTILE

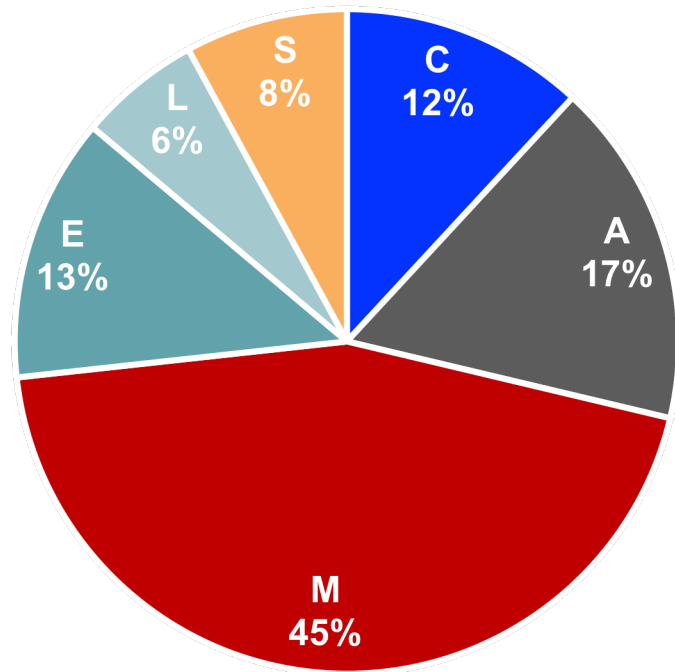
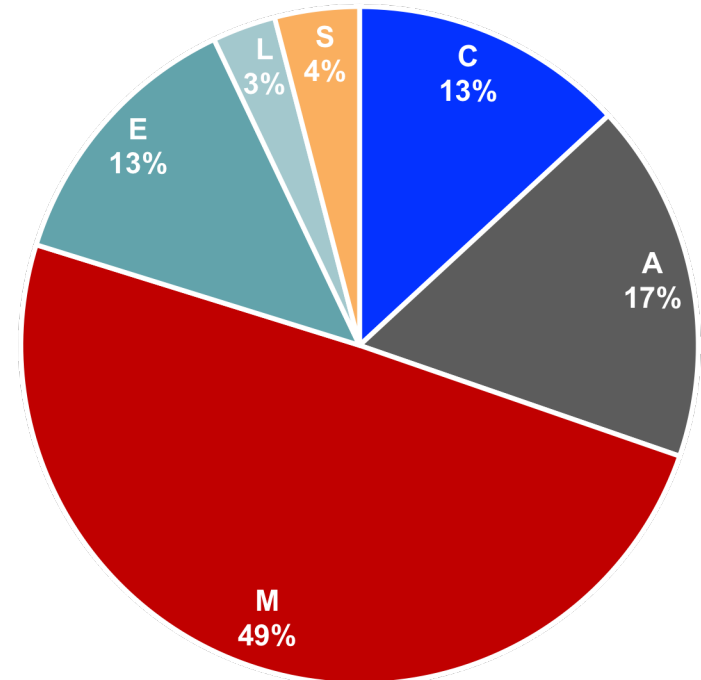


FIGURE 2B: HIGH DISCRETION QUARTILE



# Regulators

## □ Rules ≠ Effective Regulation

- Who comes up with with right models and tools?: **attracting and retaining human capital** a non trivial challenge [Shleifer, Lucca et al.]

FIGURE 3A: PERCENT WITH LONG SPELLS

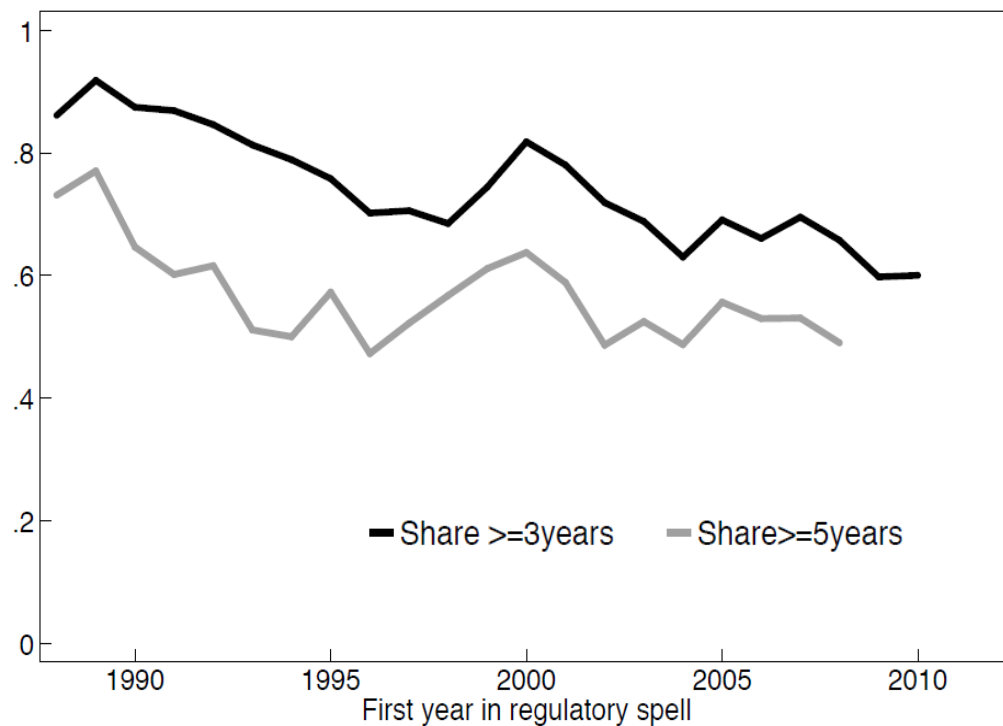
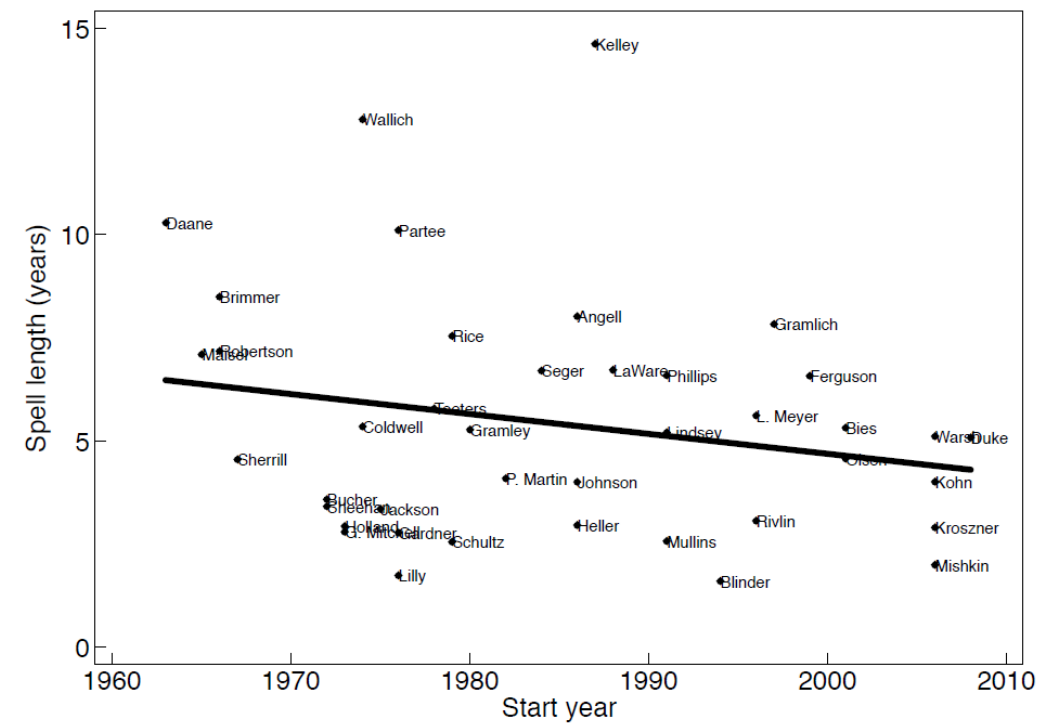


FIGURE 3B: FED GOVERNOR SPELLS



# Bank Incentives

- ❑ Opacity and limited liability → wealth transfer [Akerlof and Romer]
  - High degree of **misconduct** across institutions [Piskorski et al, Griffin et al., Mian/Sufi, Egan et al., Dimmock et al.]
  - Across functions and usual tools of governance may be too blunt [Zingales]

FIGURE 4A: RMBS MISREPRESENTATION ON TWO DIMENSIONS

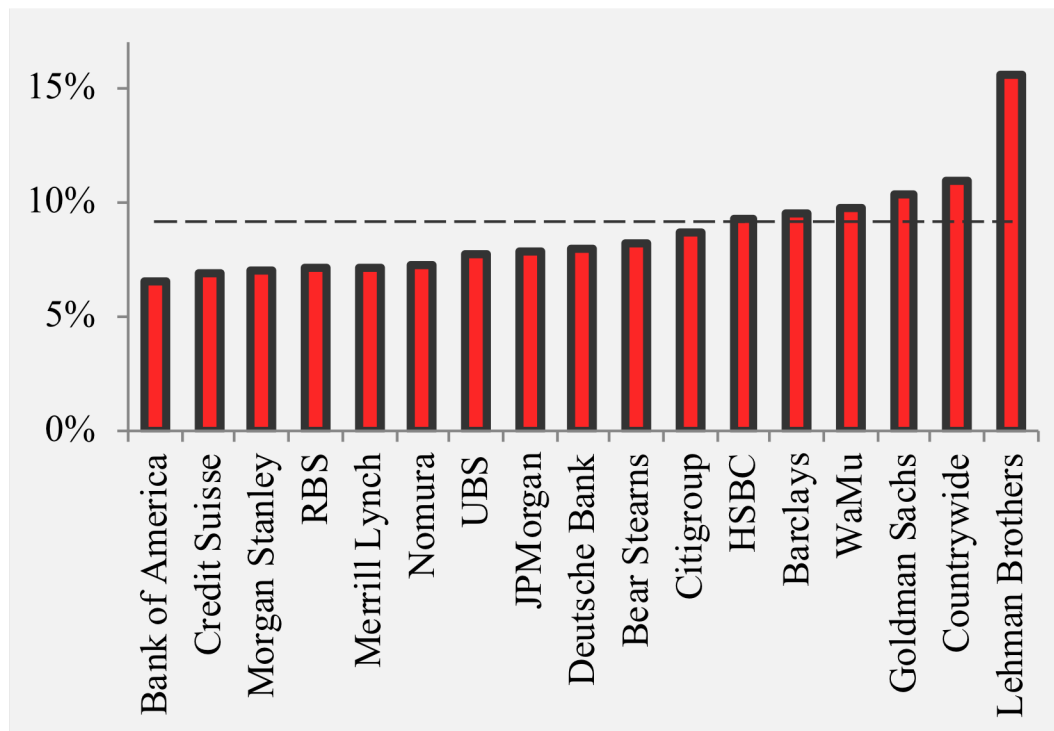


FIGURE 4B: % ADVISERS WITH MISCONDUCT

Rank	Firm	Misconduct Rate	# Advisers
1	OPPENHEIMER & CO. INC.	19.6%	2,275
2	FIRST ALLIED SECURITIES, INC.	17.7%	1,112
3	WELLS FARGO ADVISORS FN	15.3%	1,797
4	UBS FINANCIAL SERVICES INC.	15.1%	12,175
5	CETERA ADVISORS LLC	14.4%	1,432
6	SECURITIES AMERICA, INC.	14.3%	2,546
7	NATIONAL PLANNING CORPORATION	14.0%	1,760
8	RAYMOND JAMES & ASSOCIATES, INC.	13.7%	5,495
9	STIFEL, NICOLAUS & COMPANY, INC.	13.3%	4,008
10	JANNEY MONTGOMERY SCOTT LLC	13.3%	1,394



# Bank Incentives

## ❑ Why don't markets fix this?

- Labor and product markets may not react enough (ex post settling up)
- Unsophisticated consumers [Schoar et al., Hall and Woodward, Morse, Bertrand/Morse, Egan et al.]
- Everyone doing it: value consequences of good behavior? [Scharfstein and Stein, Rajan]

FIGURE 5A: LABOR MARKET ALLOCATION

	No Misconduct	Misconduct
Remain with the Firm	81%	52%
Leave the Firm	19%	48%
Leave the Industry	48%	56%
Join a Different Firm (within 1 year)	52%	44%

FIGURE 5B: SOME REGIONS EASIER TO HIDE IN

Rank	County	Rate	# Advisers
1	Madison, NY	32.1%	131
2	Indian River, FL	19.2%	282
3	Guaynabo Municipio, PR	19.0%	126
4	Monterey, CA	18.4%	397
5	Martin, FL	18.4%	357
6	Palm Beach, FL	18.1%	5,278
7	Richmond, NY	17.7%	436
8	Suffolk, NY	17.3%	4,136
9	Bay, FL	17.0%	106
10	Lee, FL	16.8%	853

# Design and Implementation

- ❑ Trying to fix by “capital” regulation/regulation → a **more complex and intertwined system**
  - **“Shadow Banks”**, reliant on GSEs and eating charter value: [Buchak et al., Pence/Wallace/Stanton.]
  - Similar before crisis [Brunnermeier, Acharya et al] and in Insurance [Koijen and Yogo]

FIGURE 6A: RISE OF SHADOW BANKS AND FINTECH

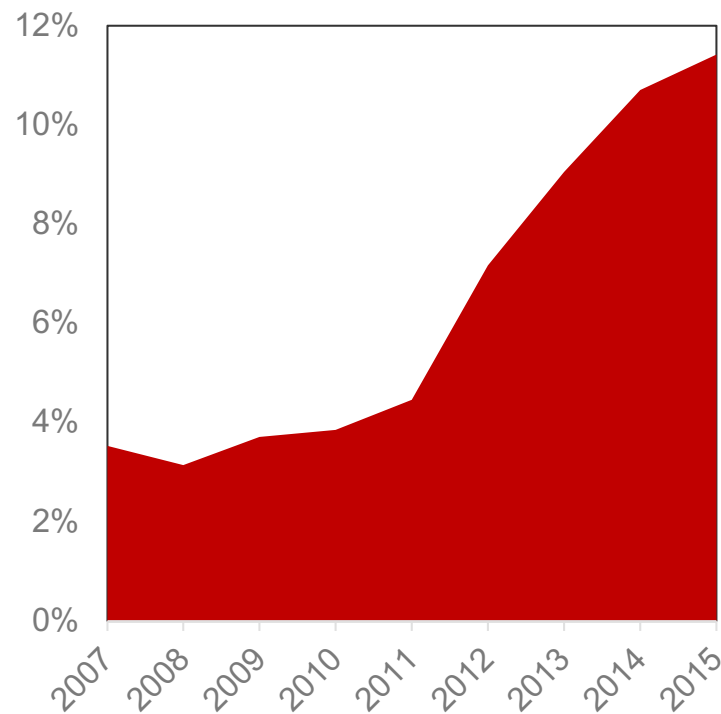
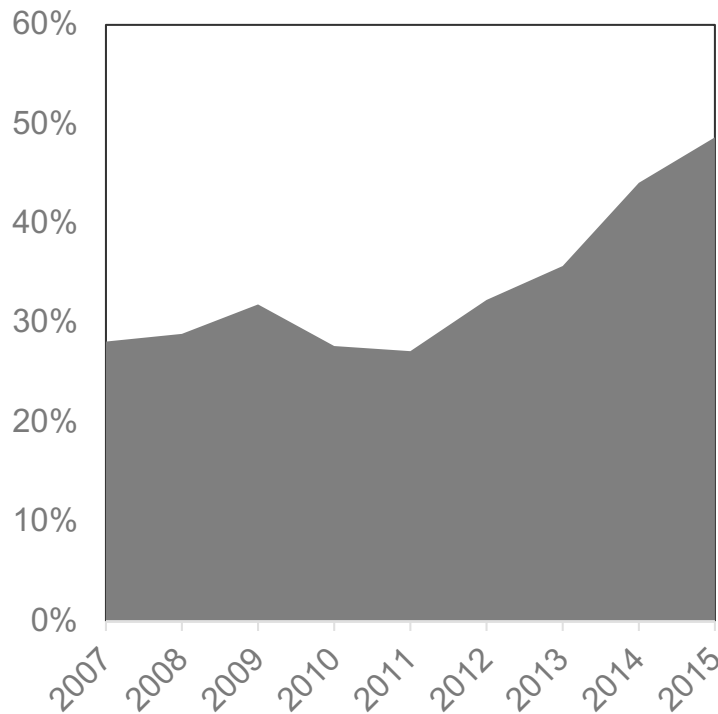
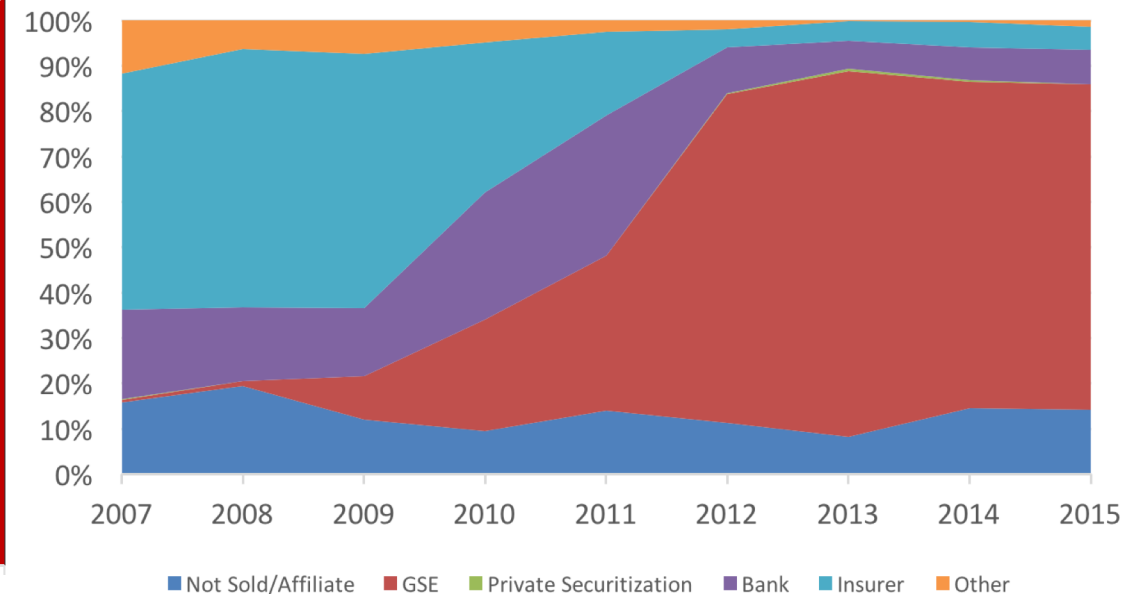


FIGURE 6B: RELIANCE ON GSEs



# Design and Implementation

## □ Design of ex ante regulations a challenge

- Circumvents many implementation frictions...but...

- **Hard to model relationships**...keeping human capital issue aside: Lucas, .... Beraja et al., Rajan et al., Behn et al., Guren et al., Piskorski et al., Becker and Opp

FIGURE 7A: SPATIAL DISPERSION IN HPI, CLTV & DEFAULTS

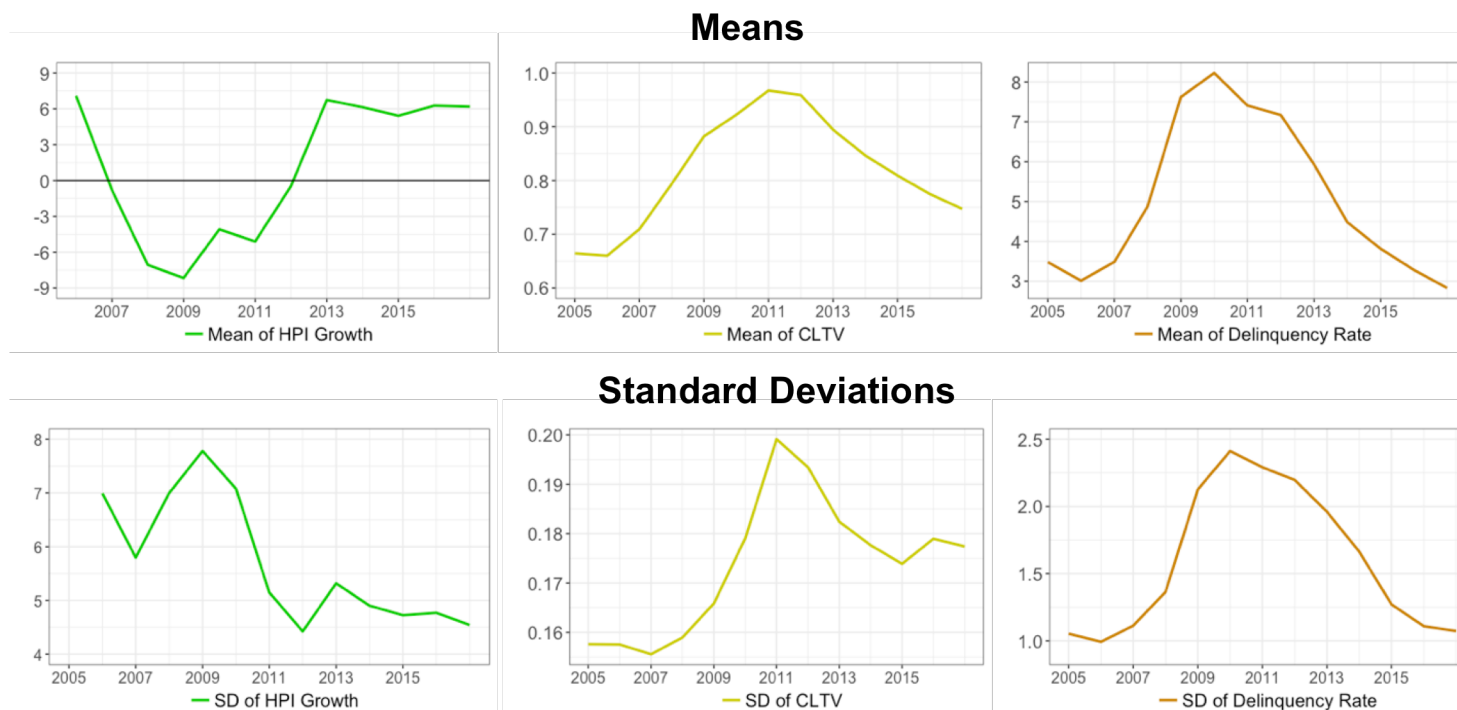
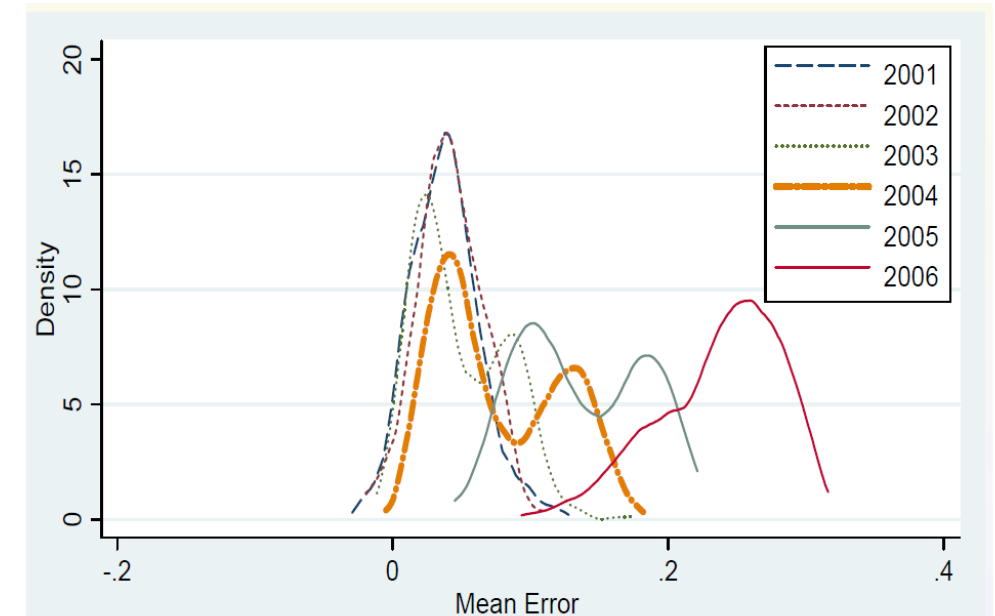


FIGURE 7B: CHANGING RELATIONSHIPS



# Design and Implementation

- ❑ Implementation of ex post (e.g., "living will" or "debt relief") regulations a challenge
  - Circumvents not knowing exact relationships...but...
  - **Face institutional and market frictions:** Agarwal et al., Beraja et al., DiMaggio, Palmer et al., Drechsler et al.

FIGURE 8A: ORGANIZATIONAL CAPACITY OF BANKS

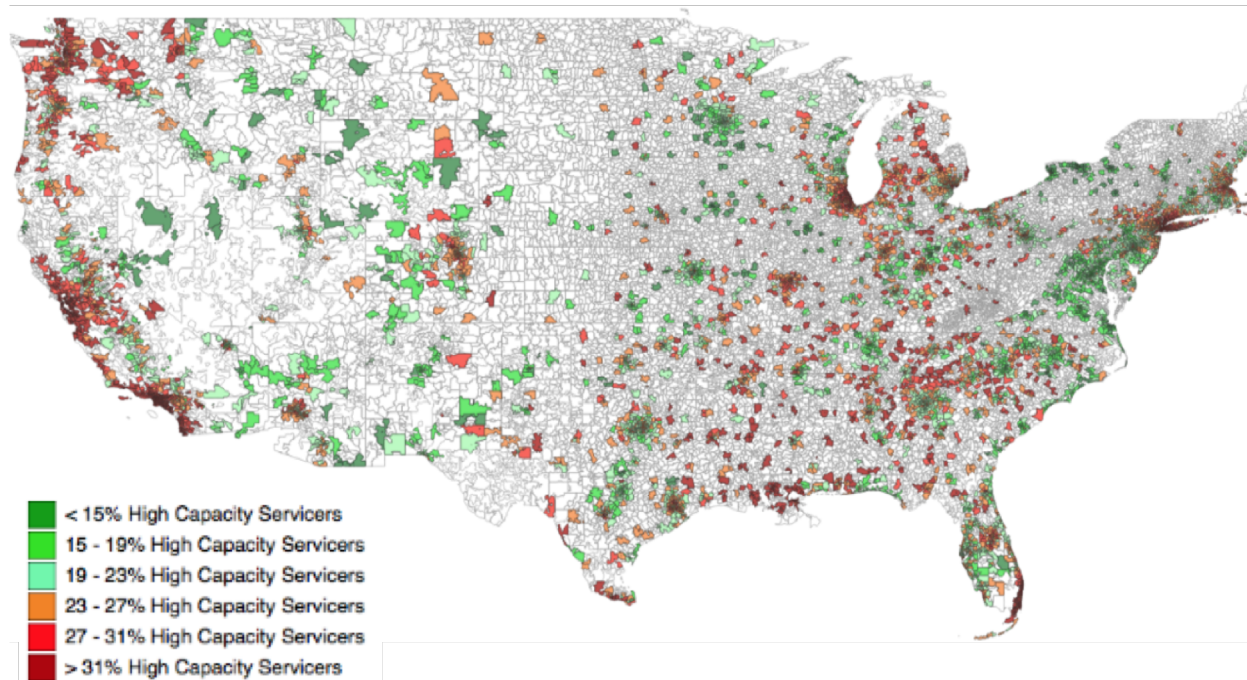
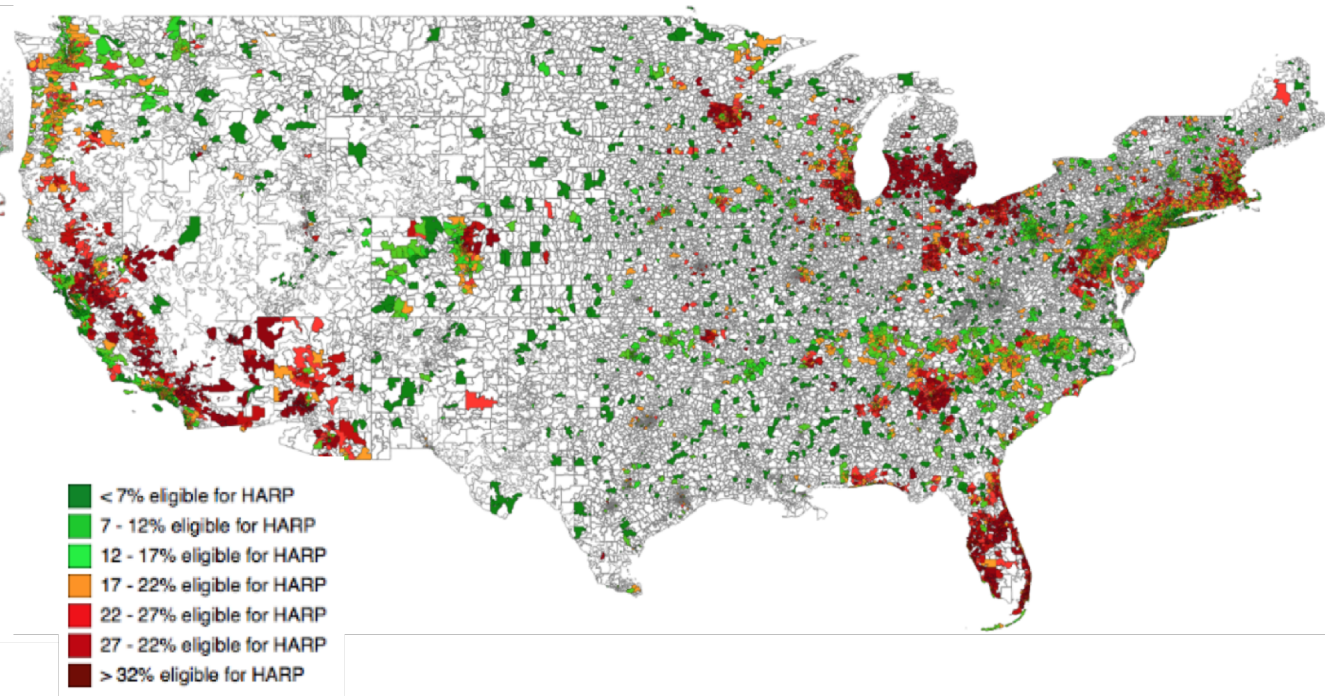


FIGURE 8B: ELIGIBLE FOR REFINANCING SHARE



*“The history of US banking regulation can be written largely as a history of government and private responses to banking panics” Calomiris and Gorton (1991)*

# Political Economy

- ❑ Regulation and deregulation a response to political pressure following crises (and elections)
  - **Shaping of rules and their implementation:** Kroszner and Strahan, Kroszner and Rajan, Rajan (several), Bertrand et al., Mian/Sufi/Trebbi (several), Benmelech et al., Hurst et al., Bartlett/Morse et al.

FIGURE 9A: US FINANCIAL DEREGULATION

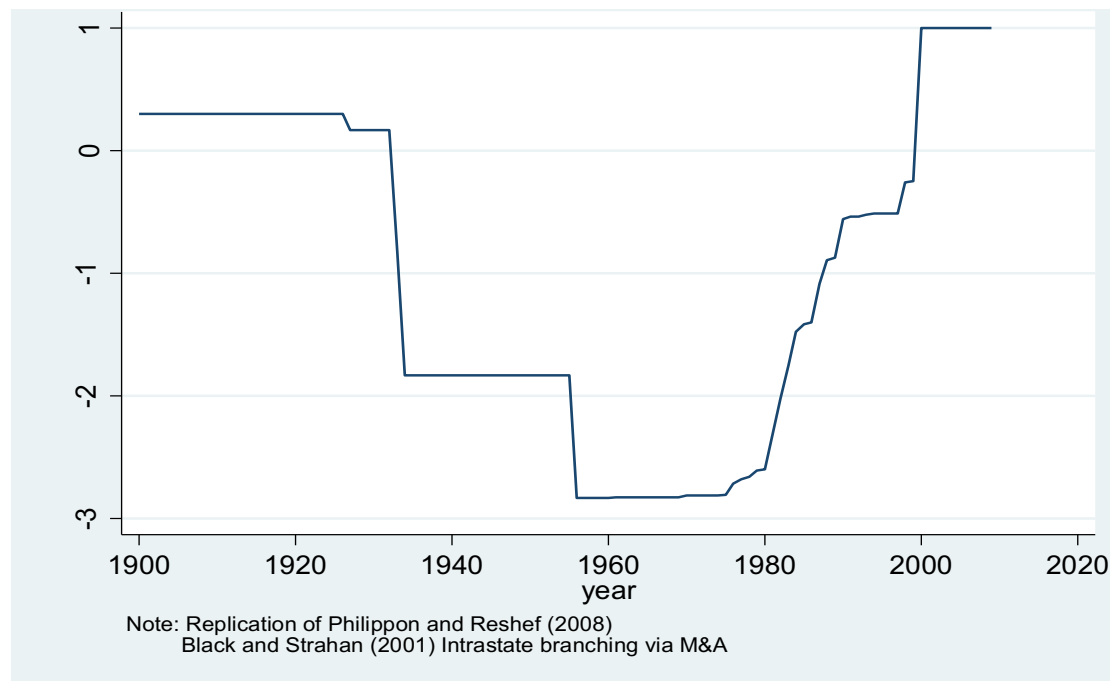
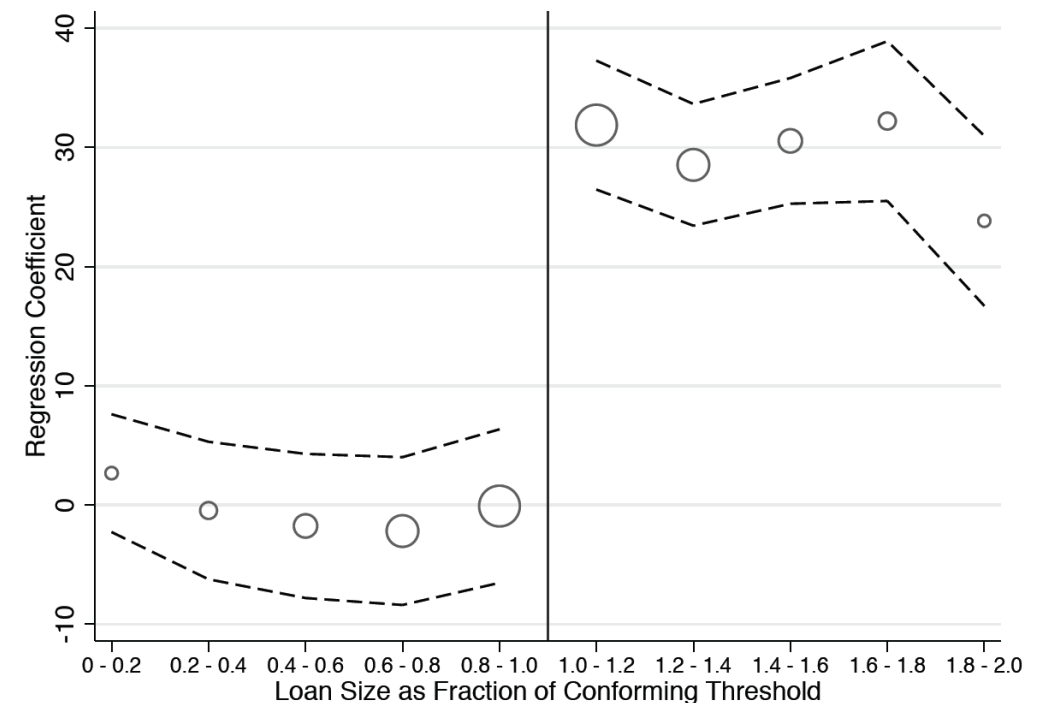


FIGURE 9B: POLITICAL ECONOMY AND RISK BASED PRICING



# Beliefs and Culture

- ❑ Regulating based on expected path of asset prices runs into “beliefs”: how are they shaped?
  - House prices: Adelino et al., Cheng et al., Foote et al., Bordalo/Gennaioli/Shleifer
  - Co-co triggers: Admati et al., Hart and Zingales
  - Stress testing scenarios: Hanson/Kashyap/Stein
  - Multiple constraints: Greenwood et al.
  
- ❑ Internal organization
  - What maintains culture and incentives from top to bottom and across divisions?
  - For banks?: Stein, Liberti, Liberti/Mian, Hertzberg et al., Vig
  - ...and for regulators?



# Conclusion

- ❑ Gary and Raghu's work has significantly shaped how we think about financial regulation and what may or may not work
- ❑ Several aspects make effective regulation challenging
  - Regulators
  - Bank Incentives
  - Design and Implementation
  - Political Economy
  - Beliefs and Culture
- ❑ There is an **active market for “whether and how to do effective regulation”**
  - What really are the net “quantitative” benefits of trying to regulate debt vs equity? other aspects?
  - **Good News:** “there is too much we do not know” → more analysis and quantitative assessments
  - **Bad News:** requires data that might disrupt/change those who provide data [Zingales]