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Enhancing Prudential Standards in Financial Regulations

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Editor's Note: The following post comes to us from Franklin Allen, Professor of Economics at the University of Pennsylvania and Imperial College London; Itay Goldstein, Professor of Finance at the University of Pennsylvania; and Julapa Jagtiani and William Lang, both of the Federal Reserve Bank of Philadelphia.

The recent financial crisis has generated fundamental reforms in the financial regulatory system in the U.S. and internationally. In our paper, Enhancing Prudential Standards in Financial Regulations, which was recently made publicly available on SSRN, we discuss academic research and expert opinions on this vital subject of financial stability and regulatory reforms.

Despite the extensive regulation and supervision of U.S. banking organizations, the U.S. and the world financial systems were shaken by the largest financial crisis since the Great Depression, largely precipitated by events within the U.S. financial system. The new "macroprudential" approach to financial regulations focuses on both the risks arising in financial markets broadly and those risks arising from financial distress at individual financial institutions.

Systemic risk has been a key factor in the financial crisis. However, our current understanding of systemic risk has remained rather limited. In addition, while the prevention of systemic risk and the maintenance of financial stability are the central goals of recent reforms of financial regulation, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) enacted in the U.S. in July 2010, it is less obvious how to design a regulatory framework that achieves this financial stability objective while also promoting an efficient and innovative financial sector.

The DFA has been a landmark piece of legislation—the most sweeping reform of U.S. financial regulations since the Great Depression. How effective will the DFA be in protecting the U.S. financial systems? This paper discusses fundamental questions related to financial reform and financial stability, such as whether the financial crisis was caused by TBTF, whether the DFA resolution regime would be effective in achieving financial stability and ending TBTF, the impact of increasing public disclosure of supervisory information, effectiveness of bank stress testing as a tool to enhance financial stability, and more. These are important discussion for public policy debate over the coming years.

Specifically, the paper discusses:

- Systemic Risk—Can we anticipate systemic risk events and can regulatory reform effectively combat systemic risk? Will the current changes in financial regulation be effective in enhancing financial stability? Are they sufficient or should monetary and fiscal policy tools be used as well? In response to the crisis, governments around the globe have attempted to reduce systemic risks posed by financial distress at systemically important institutions (SIFIs). While financial distress at SIFIs is sometimes the cause of systemic risk, there are many other causes—banking panics have occurred where there are no SIFIs. Government policies can be another causal factor. Moreover, there has been no total agreement on the correct measure of systemic risk. Our limited understanding of systemic risk has made it difficult for policy makers to effectively prevent systemic crises and mitigate the effects on the financial system.
- Level of Complexity in Financial Regulations—Is increasing the scope, intensity, and complexity of financial regulation the right approach or should we simplify regulation, increase transparency, and place greater reliance on market discipline? Complex financial regulations could become excessively distortionary—due to high costs associated with regulatory compliance and regulatory arbitrage, with ineffective regulations that cannot keep up with market innovations. Simple regulations are easy to understand and less costly to implement, thus they are likely to be more effective as long as they provide appropriate incentives for market discipline. Simple and unambiguous information released to the market could also help to enhance market discipline, which is also beneficial for banking supervision. Understanding the limits of layering on ever more complex financial regulations is an important principal in the design of the regulatory system.
- Greater Transparency—The new financial regulatory regime includes greater public disclosure by SIFIs as well as greater disclosure of supervisory assessments. Does increased public disclosure of supervisory information enhance financial stability or generate greater instability? Transparency could play a key role in enhancing financial stability. Disclosure (by regulators) of financial condition of regulated financial institutions (e.g. the disclosure of stress test results) contributed significantly in increasing market confidence in the U.S. financial system during the recent financial crisis. However, the potential impact of such disclosure could be much different in a different economic environment.

- Bank Stress Testing—Stress testing has become a central component of the supervision of SIFIs. Are stress tests an effective method for enhancing financial stability? Would a stress-testing regime have prevented the mortgage and financial crises? While stress testing is an important and valuable new supervisory tool, by itself it is unlikely to prevent future crises. The dynamics of risk-taking imply that new risks will arise that evade detection by standard risk measurement tools. This implies that other supervisory tools are needed to complement supervisory stress tests.
- TBTF Policies—Was TBTF a causal factor of the crisis? Are the new resolution authorities contained in DFA sufficient to end TBTF and contain the systemic impact of the failure of one or more SIFIs? While moral hazard behavior generated by TBTF subsidies is often cited as a causal factor for the crisis, there is no strong empirical evidence for this hypothesis. Many of the companies that were at the center of the financial crisis (e.g., AIG, Bear-Stearns) had little reason to believe *ex ante* that they were protected by the government safety net. Nevertheless, the extensive bailouts of financial firms during the crisis have undoubtedly broadened the public perception that large financial institutions will be protected. To counter this perception, DFA imposes a new resolution regime for SIFIs that is designed to prevent future bailouts. However, it is unlikely that the new resolution regime will be credible until there has been a successful resolution of a SIFI. Further, financial stability may not be obtained even if the new resolution regime turns out to be effective in ending TBTF.
- Mortgage Crisis and Reform—Housing and housing finance play a central role in the economy, and many financial crises have been associated with downturns in housing. What reforms in housing and housing finance are necessary to promote economic growth and financial stability? What should be the future of Freddie Mac and Fannie Mae? Although the GSEs, such as Fannie Mae and Freddie Mac, played an important role in the mortgage crisis and the global financial crisis, reform of the housing finance system was not a part of the DFA. It remains unclear how home ownership could be promoted without imposing a burden on third parties and whether the subsidy should be implicit or explicit.

The full paper is available for download here.