
The Fundamental Principles of Financial Regulation

Brunnermeier et al. (2009)

Who should be regulated (by whom)?

Part 3

Who should be regulated (by whom)?

- Commercial banks setting up Special Investment Vehicles and hedge funds in the last credit bubble is a vivid reminder of the “boundary problem”
- Banks have an incentive to move their business outside the boundary of regulation

Classification of Financial Institutions based on Objective Risk-Spillover Measures

- The classification of financial institutions should be based on objective risk measures that capture the risk-spillovers from one institution to the next
- Any financial institution that is subject to systemic risk should be covered by regulation

Classification of Financial Institutions based on Objective Risk-Spillover Measures (cont.)

- Bank X's CoVaR is the conditional VaR of bank X's counterparty or the whole financial sector after conditioning that bank X is in difficulty
- CoVaR seems to be a suitable measure for the classification of financial institutions under regulation

Classification of Financial Institutions based on Objective Risk-Spillover Measures (cont.)

- Financial institutions can be grouped as:
 - Individually systemic
 - So large and so interconnected
 - Macro + Micro prudential regulations
 - Systemic as part of a herd
 - Highly levered, small, but move together
 - Macro + some micro prudential regulations
 - Non-systemic large
 - Not highly levered
 - Micro prudential regulation
 - Tinies
 - Small and not interconnected
 - No regulation

Classification of Financial Institutions based on Objective Risk-Spillover Measures (cont.)

- AIG that sells CDSs on a large scale should belong to group 1 instead of 3
- Information about which institution is systemic should be shared with other supervisors
- However, need to be careful about the adverse effect

Rules for “Individually Systemic” Institutions

- There should be serious concern about allowing any of them individually to get into trouble
 - Micro prudential regulation is still important
 - Macro prudential is also relevant
 - Rules should be designed in such a way that banks have no incentive to move assets into off-balance-sheets vehicles
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Rules for Institutions that are “Systemic in a Herd”

- N different banks, each has a portfolio consisting of an identical fraction of the aggregate portfolio
- If one bank fails, the likelihood is that all will
- The current regulation does not take sufficient account of macro-prudential risk
- Micro prudential regulation is among a debate

International Considerations for International Entities

- The principle is that the country that bears the burden in case of a bailout should also be in charge of regulating that financial institution
 - If a bank choose to open branches in a foreign country that are large enough to be defined by that host country as “systemic”, then it will have to hold a separate pot of capital in that country, according to the host country’s regulation
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Counter-cyclical Regulation

Part 4

Counter-cyclical regulation

- The current regulation is pro-cyclical:
 - VaR
 - Mark-to-market valuation
- Three main principles
 - The main objective of counter-cyclical regulation should be to reduce the systemic risk from one institution on the rest
 - Tough during a credit boom, relaxed during a crisis
 - Should be independent of political pressures

Counter-cyclical regulation (cont.)

- Institutions that cause more negative externalities (risk spillovers) should face higher charges and using predictive analysis ensures a countercyclical regulation
- Countercyclical regulation should be most constraining during the height of a bubble (or lean against the wind)
- The regulation should base on variables that predict future circumstances

Counter-cyclical regulation (cont.)

- When there is increasing systemic risk, with increasing leverage, maturity mismatch, credit expansion and asset price increases, the charges should be higher, while they are smaller during periods of deleveraging
- A prompt and laddered response when a financial institution violates much more stringent capital and liquidity requirements starting at an earlier stage

Counter-cyclical regulation (cont.)

- Forced debt-equity conversion
- Objective and pre-specified rules should be put forward to guarantee that financial regulation is strictly enforced
- Regulators must face the right incentive structure and enjoy a degree of independence that allows them to impose potentially unpopular steps

Counter-cyclical regulation (cont.)

- Countercyclical measures should be applied on a country-by-country basis, since cycles are not identical and matching across all parts of the world
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