Proportionate regulation – some thoughts

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The problem

The basic policy dilemma: growth vs. stability

- Financial development can result in higher growth
- Higher credit growth can result in systemic crisis
- Caveat metrum – finance vs. financial development
- Type I vs. Type II error
- See recent paper by Dell'Arriccia et al. on lending booms (forthcoming: Economic Policy)

Competition and contestability – can there be too much (for stability's sake) or too little (for efficiency's sake)

Financial innovation (bright and dark sides)

Looking beyond regulatory (super)cycles

Four areas to focus on

Complexity vs. simplicity of regulatory rules
- Complex measures: better capture and price risk – but: Goodhart's critique
- Simple measures: might lead to aggressive risk-taking – but harder to escape
- Risk-weighted capital-asset ratios vs. leverage ratios
- Ringfencing vs. prohibition
- Need both!

Macro-prudential regulation
- Fallacy of composition
- Cross-sectional and time-series
- Protecting financial institutions or smoothing credit cycle!

Dynamic regulatory perimeter
- Regulatory reforms aimed at preventing the last crisis – but how to prevent the next one?
- Regulatory arbitrage and financial innovation result in risk-shifting, often towards outside the regulatory perimeter
- Regulatory perimeter as moving target – dynamic approach needed

Stronger focus on resolution
- Do not avoid failure at any price
- Not only for ex-post dealing with failure, but also to set ex-ante incentive structure

Thank you

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