



Discussion

**FDIC-JFSR Conference
Tradeoffs in Bank
Regulation**

by Itay Goldstein, Wharton

Bank Regulation: New Landscape

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- **Revised Old Tools**
 - Deposit Insurance (Van den Heuvel, Pancost-Robatto)
 - Bailout (Berger-Himmelberg-Roman-Tsyplakov)
 - Capital Requirement (Van den Heuvel, Pancost-Robatto)
- **New Tools**
 - Bail-in (Berger-Himmelberg-Roman-Tsyplakov)
 - Liquidity Requirement (Van den Heuvel)
- **And More...**
 - One can only wonder how we ended up in this “regulatory zoo” and what we do next...
- **The three papers in this session analyze different tradeoffs associated with different tools**

Outline

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- What I will do in the next twenty minutes or so...
 - Brief summary of the insight of each paper
 - ✦ Highlighting strength and a major challenge
 - Discussion of a few general challenges
 - ✦ Common to these papers and others
 - Some of the points I make are influenced by several recent related papers I have
 - ✦ Allen, Carletti, Goldstein, and Leonello: “Government Guarantees and Financial Stability”
 - ✦ Carletti, Goldstein, Leonello: “The Interdependence of Bank Capital and Liquidity”
 - ✦ Davila and Goldstein: “Optimal Deposit Insurance”

Van den Heuvel

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- **Sufficient statistic approach to measure cost of liquidity requirements and capital requirements**
 - Cost of liquidity requirement related to difference between return on deposits and return on treasuries
 - Cost of capital requirement related to difference between risk-adjusted return on bank equity and return on deposits
- **Strength:**
 - Sufficient statistic approach is very appealing in this case
 - ✦ Related attempt in Davila and Goldstein (2018)
 - Results that cost of liquidity requirements are much smaller than those of capital requirements are very intuitive
- **Challenge:**
 - How informative is the measurement of cost without knowing the benefit?
 - When comparing the two, shouldn't we think about the cost required to achieve a certain benefit?

Pancost-Robatto

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- Highlight a benefit of deposit insurance and cost of capital requirements
 - Liquidity creation by banks pushes firms to take on socially-beneficial risk; hence, limiting this liquidity creation discourages risk taking
- Strength:
 - This is an important insight, and I think generally we need to acknowledge that, counter to popular belief, a benefit of intervention in banking is to encourage some risk taking
 - ✦ Related point made in Allen, Carletti, Goldstein, and Leonello (2018)
- Challenge:
 - How important is the ability to hold money in banks for firms' risk taking? Is this first order? Any empirical evidence?
 - What about other forms of safe assets that firms can have?

Berger-Himmelberg-Roman-Tsyplakov

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- **Advantages of bail-in vs. bailout**
 - Creates incentive to increase equity in the bank ex ante
 - Saves on inefficiencies related to use of taxpayer money in bailout ex post
- **Strength**
 - Complex dynamic model captures incentives of banks given the regulatory regime
- **Challenge**
 - Downsides of bail-in might not be captured, e.g., run by creditors before bail-in is triggered
 - Why can't we achieve better outcomes with sufficiently high capital requirement?

General Challenge I: Runs and Source of Financial Fragility

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- Government intervention in financial sector is originally driven by the attempt to prevent runs
 - And/or prevent contagion
- Yet, none of these papers explicitly models runs (or contagion) and how they interact with different policy tools
 - Usually, these are mentioned as background justification
- There could be potentially important effects to explore:
 - How do liquidity and capital requirements directly affect the run incentives?
 - ✦ Carletti, Goldstein, and Leonello (2018)
 - Might bail-in policy aggravate runs when bank's fundamentals deteriorate?

General Challenge II: Interaction between Different Regulations

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- As regulators use more policy tools, the challenge of understanding how they interact with each other grows
 - To what extent does liquidity requirement do the job of a capital requirement? How do they interact?
 - ✦ Carletti, Goldstein, and Leonello (2018)
 - Do liquidity or capital requirements change the tradeoff with regard to optimal deposit insurance?
 - ✦ Deposit insurance enables the creation of liquidity, which is partly lost when these requirements are introduced
 - Banks' choices are driven to some extent by tax policy; should it also be adjusted in light of search for optimal bank regulation?

General Challenge III: Measurement of capital and liquidity

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- One of the key realizations following the crisis is that the measurement of bank's financial health based on book values failed to provide the required signals
- Shall we move to market-based measures?
 - How reliable are they? What is the optimal way to use them?
- How will this affect the analysis in the current papers?
 - Costs and benefits of liquidity and capital requirements are altered when uncertainty about valuations creates uncertainty about stringency of requirements
 - Implications for bail-in or bailout triggers might be complicated

Conclusion

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- Banking regulation after the crisis has gotten more involved following changes in existing tools and introduction of new tools
- Each one of the three papers highlights important forces and provides interesting conclusions related to these regulations
- But major challenges remain in interpreting these results and using them for the design of the regulatory landscape going forward