A Transition to What?

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2000-2008: Radical Changes in Finance

- Huge growth in short-term funding: repo and commercial paper.
- Short term funding, rising asset markets used to fuel pro-cyclical leverage.
- Gross international banking positions over 3.5 times greater in 2008 than 2000.
- Notional OTC derivatives grow from 3 times global GDP to 10 times global GDP.
- Substantial growth in trading volumes.

Real Economy Impacts

- Poor performance in GDP, family income growth.
- Phillipon (2012) finds that even the efficiency of credit intermediation has declined.
- Cechetti and Kharroubi (2012) find that rapid growth in financial intermediation is correlated with slower productivity growth.
- Manifestly huge costs of financial crisis.
- Distortionary effects of manipulated asset price bubbles even prior to crisis.

The Response To These Extraordinary Events

- Dodd-Frank is radical only in its length.
  - Enough incremental changes = major shift?
- Enormous regulatory discretion.
- Systemic reform: ‘Chinese menu’ approach.
  - Many broad mandates, few details.
- Market signals – significant, but will not solve the problem of regulatory direction.

Retail Consumer Space

- Combination of:
  - Interchange fee controls
  - New credit card protections (CARD Act)
  - Significant new mortgage origination rules
  - Consumer Financial Protection Bureau enforcement
- Hit to old income models.
- But still no direct control of interest rates.
- CFPB regulation of non-banks could assist bank competition with non-bank financial services.
- Will contribute to systemic reform.

Systemic Reform: Dodd-Frank's 'Yes, but' Approach

- Yes to tightening leverage.
  - But Basel III calls for marginal, not radical change.
- Yes to activity limitations.
  - But Volcker Rule exemptions are significant.
- Yes to removing implicit guarantees.
  - But size of large banks leads to doubts on effectiveness; discretion on specific types of liabilities.

‘Yes, But’ continued

- A clearer ‘Yes’ to derivatives reform.
  – But entire market maintained, major scope for rule weakness.
- Yes to oversight of shadow banking.
  – But through a slow and cumbersome discretionary process, potentially institution-by-institution.
- Yes to compensation restrictions, improved risk management.
  – But lacks clarity, follow through unclear.

Regulatory Fragmentation

- U.S. alone: at least five major agencies.
  - Split between market and institutional regulators.
- Complex politics of rulemaking.
- New coordination bodies in Treasury have important limits to power, authority.
- Serious problems in international coordination – U.S., Europe, London.

Regulatory Ambivalence

- Seductive allure of ‘complete credit markets’.
- Reviving securitization? Caution around regulating key liquidity sources e.g. repo.
- Regulation in the shadow of crisis.
  - Relationships with mega-banks; economic fragility.
- Combination of regulatory fragmentation, ambivalence = central role for ‘stress tests’.

Different Directions

- Regulators have broad statutory authority.
  - but can they harness it to create a coherent and effective vision?
- ‘Back to the future’: an updated version of traditional control of the financial markets.
- ‘Lighter touch’: incremental limitations on new financial model of last decade.
- Questions on both: can ‘lighter touch’ possibly be sufficient? Can deeper reform be achieved?

Significant Market Pressures

- Drive for return on equity is a constant.
- The economics of size – market power vs. efficiency.
- How deep is market shift in risk attitudes?
- Scope for expansion of securitization markets both within and outside U.S.
- ‘Financial depth’ in BRICs much less than U.S.