Congruent Financial Regulation

Andrew Metrick (Yale SOM and NBER)
Daniel K. Tarullo (Harvard Law School and Brookings)

Presentation at the BPEA conference, March 25, 2021

- A General Problem: Shadow Banking and Regulatory Arbitrage
- Case Study #1: Nonprime Mortgages
- Case Study #2: Treasuries
- A General Solution: The Congruence Principle
- Implementation: Ideas and Challenges

A General Problem

- We made banks safer. This is a good thing.
- But bank safety is not free, and the regulatory-arbitrage problem will not go away by itself.
- Since the GFC, non-bank financial institutions (NBFIs) have increased their market share across a wide variety of markets.
- These NBFIs are far less regulated than are banks, but they still get the benefit of the safety and contribute to systemic risk.
- Is this system efficient? Is this system what we want?
- We think not.

Case Study #1: Nonprime Mortgages

- The rise of nonprime mortgages through private-label securitization was a major contributor to the GFC. This is well known.
- Since the GFC, that pathway has closed. It has been largely replaced by mortgages guaranteed by the FHA and VA, securitized by GNMA, and then purchased by highly leveraged mREITS using repo finance. A new alphabet soup, illustrated in the paper by Figure 4. Regulatory arbitrage is once again a motivating force.
- This new pathway came under intense liquidity pressure in March 2020. Even agency mREITS (zero asset risk!) saw their value fall by 80 percent (Figure 8) before the Fed's intervention.

Case Study #2: Treasury Securities

- In the old days, primary dealers would buy Treasuries at auction, and then hold in inventory until sold to customers.
- Under post-GFC regulations, this takes up valuable balance sheet space. Over the past ten years, much of the intermediation has moved to a chain involving relative-value hedge funds, selling short Treasury futures and holding the physical treasuries until delivery, financed by repo. (Figure 10)
- Since 2017, a twist on this pathway moved the repo to a central counterparty (FICC), further reducing the regulatory-capital cost. (Figure 11). This pathway grew from almost nothing pre-2017 to about $500 billion by early 2020.
- This market, and its various NBFI players, was also rescued by the massive Fed intervention in March 2020.

A General Solution: The Congruence Principle

The regulation of economically similar activities should be coordinated across agencies, with the goals of minimizing regulatory arbitrage and ensuring that the social costs of systemic risk are internalized by private actors, regardless of their institutional form.

- “Congruent” does not mean “identical”.
  - For example, we would combine capital regulation with minimum haircuts for repo and initial margins for futures. These are economically similar concepts, but not identical.
- “Congruent” need not mean “activities-based”.
  - We rely on current institutional regulation. Implementation would not require an entirely new paradigm for regulation.

Implementation

- Analytic Exercise to Determine Congruent Macroprudential Charges

- Legal Authority and Agency Incentives

    - Treasury Authority Under Government Securities Act
    - Fed Authority Under Securities Exchange Act/Reg T

- Complicated Process…. But What's the Alternative?