Congruent Financial Regulation – Andrew Metrick and Daniel K Tarullo

Discussion

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Congruence Principle of Metrick-Tarullo

• “Waterfall Theorem of Arbitrage” (by Larry White):

Risk travels within the financial sector until it reaches the balance-sheet that has the lowest regulatory capital requirement to warehouse it!

• Regulate by function rather than form
  - Institutions (banks versus shadow banks)
  - Instruments (deposits versus money market fund accounts, portfolio mortgages versus mortgage-backed securities, etc.)
Banking and Shadow-Banking linkages

“Shadow always touches the feet”

• Explicit guarantees (Credit lines to support commercial paper)
• Implicit guarantees (SIVs)
• Flow of fund linkages (Bond market freeze -> Credit line drawdowns)
• Information contagion
• Interconnectedness

• Getting into the cracks is important to ensure safety of payments and settlements systems
Shifting sands of central banking remit

• From Lender of Last Resort to Buyer / Market-maker of Last Resort

• Massive expansion of the safety net

• Focus must be on ensuring “private insurance” in all contracts?

• Necessitates a system-wide approach...

• Is Congruence Principle the answer?
Political economy considerations

- Regulating by function rather than form --- not a new idea...

- Why hasn’t it been broadly accepted and implemented?

- Political economy considerations:
  - Short-term tradeoff in Growth/Employment vs Financial Stability
  - Not clear there is a long-term tradeoff

- Do regulators keep a part regulated better by avoiding other parts to avoid a complete race to the bottom?
Ways to implement the Congruence Principle

• Case by case approach may be difficult and politically vulnerable

1. Get FSOC / FSB to embrace/adopt the principle

2. “Hotel California” approach
   • Access the safety net once, then must be regulated as SIFI

3. System-wide stress tests
   • State-contingent remit to expand SIFIs based on stress tests
CONGRUENCE PRINCIPLE: IMPORTANT IDEA!

Thank you