

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
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- 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