Some thoughts on/around:

Financial Institutions, Markets and Regulation: A Survey

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Did we lack theory to understand the crisis?

- Publication years for papers in the survey:

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Frontiers of finance and the crisis

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- Two possible conclusions (both true):
  - We already knew a lot in 2008! Old problems in a new garb (e.g. runs on shadow banks).
  - A lot of updating to do on the theory side.
What was/is missing then?

- **Consistent body of knowledge** based on separate papers illustrating different mechanisms.
- Conceptual apparatus for market participants and regulators.
- Concepts need to be **operationalized**.
- Up-to-date applications of the theory, **in particular for regulation**.
- Some problems need deeper breakthroughs in economic theory.

Some gaps or frontiers to open up, from currently being done to long-term challenges.
A consistent body of knowledge?

From Benoit, Colliard, Hurlin, and Perignon (2015), citation network on systemic risk:
Theory of regulation

- Simple question: **are capital requirements good** for banking stability?
  - Theory cited in the survey suggests it’s unclear.
  - Few empirical studies (e.g. Aiyar, Calomiris, and Wieladek (2014)), weakly linked with theory.

- Need for calibrated models of bank regulation **that can be used by policy-makers**, current research front (e.g. Clerc, Derviz, Mendicino, Moyen, Nikolov, Stracca, Suarez, and Vardoulakis (2014)).

- Analysis of **new tools** and how to optimally design them, e.g.:
  - Stress-tests (Bouvard, Chaigneau, and De Motta (2015), Goldstein and Leitner (2015)).
  - Market triggers (Bond, Goldstein, and Prescott (2010), Sundaresan and Wang (2015)).
  - Financial benchmarks (Duffie and Dworczak (2014), Shapiro and Coulter (2014)).
Maturity transformation

- Recognized as key function of a bank, at least since Diamond and Dybvig (1983).
- Many more models since, e.g. Allen, Babus, and Carletti (2012), Brunnermeier and Oehmke (2013).
- Need for richer models amenable to calibration, rationalizing simple measures of maturity mismatch (Brunnermeier, Gorton, and Krishnamurthy (2014)).
- Equilibrium models where demand and supply of credit at different maturities endogenously determine the yield curve, with the short rate pinned down by the central bank?
- And with market failures generating an optimal liquidity ratio to impose?
Away from “partial” equilibrium

Good models have to leave a great deal aside, but richer models are necessary to study:

- Interaction between different regulations (Goodhart, Kashyap, Tsomocos, and Vardoulakis (2012)).
- Interaction of the real and financial sectors (e.g., macro-finance literature).
- Links between the labor markets for bankers, regulators, perhaps even academics (Bond and Glode (2014)).
- Political economy of regulation (Kahn and Santos (2005)).
Complexity and simplicity

Important regulatory debate, with calls for “simple” regulations (Haldane (2012)).

- Few measures of complexity (Haldane (2012), Cetorelli and Goldberg (2014), Vallee and Celerier (2014)).
- No theory-based measures.
- Optimal regulation in such contexts?
  ⇒ requires mechanism design/contract theory with bounded rationality.
Regulatory dialectics

- The economist’s traditional approach to regulation: design a game such that banks’ optimal behavior yields an optimal outcome (mechanism design or reverse game theory).
- In practice, banks find new strategies not foreseen by the regulator, and bypass the regulation.
- This makes a new, more complex regulatory framework necessary. 
  ⇒ process of regulatory dialectics (Kane (1977)).
- Close to evolutionary game theory: players discover new, better strategies over time.
- Little theoretical guidance on optimal regulations in such environments. 
  Towards “evolutionary mechanism design”? 
Debates around ethics in banking, some evidence (Cohn, Fehr, and Marechal (2014)) and regulatory concerns (Angeloni (2014)).

**Crowding out effect**: monetary incentives weaken intrinsic incentives and can be inefficient (Frey and Jegen (2001)).

Risk: may be an excuse for keeping weak regulations in place.

Still, we know little about optimal regulations in such contexts.

⇒ Need for behavioral mechanism design.
Beliefs and expectations

- Key problem in economic theory since long ago.
- Going beyond rational expectations?
  - Basel regulation ⇒ incentives to meddle with internal risk models (Behn, Haselmann, and Vig (2014), Colliard (2014)).
  - Agency issues, e.g. the “London whale”.
  - How to preserve a diversity of market views if all banks are subject to the same stress-test? (Bernanke (2013))
- Economics and regulation of model choices still unclear.
- New field of inquiry as data about models and forecasts become available.
Data

- We clearly need more/new/better data on everything.
- Maybe even more, we need a new approach to data collecting.
- Multiplication of studies with a clever experiment, hand-collected/private dataset used only in a couple of papers ⇒ lack of *systematicity* and replicability.
- First-order, if not exciting: develop *systematic databases*, e.g. EUROFIDAI, ambition to build the European equivalent of CRSP.
- Interacts with publication bias. Idea: can we separately publish experimental design and experimental results, as in e.g. biology?
Conclusion

- Easy to come up with long wish lists!
- A lot is being done already.
- Some important applied questions require new breakthroughs in economic theory.
- Keeping strong links between financial research and economic theory important, but increasingly difficult as both fields specialize.
Thank you!


References


