

Optimal Design: Some Thoughts on Process

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Optimal Bank Liquidity Regulation Conference

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Challenge

Given the important role of financial regulators in making law, what are the best mechanisms for introducing rigor and accountability into the rulemaking procedures?

The Distractor

Cost-Benefit Analysis

- Legal academics:
 - Revesz (2017)
 - Coates (2014); Coates (2015)
 - Gordon (2013)
 - Sunstein (2015)
 - Posner & Weyl (2015); Posner & Weyl (2013)
 - Bubb (2015)
 - Bartlett (2014)
- Government
 - MetLife Inc. v. Financial Stability Oversight Council, 177 F. Supp. 3d 219, 242 (D.D.C. 2016).
 - Financial Choice Act of 2017
 - Treasury Reports
- Think Tanks
 - U.S. Chamber of Commerce
 - American Enterprise Institute

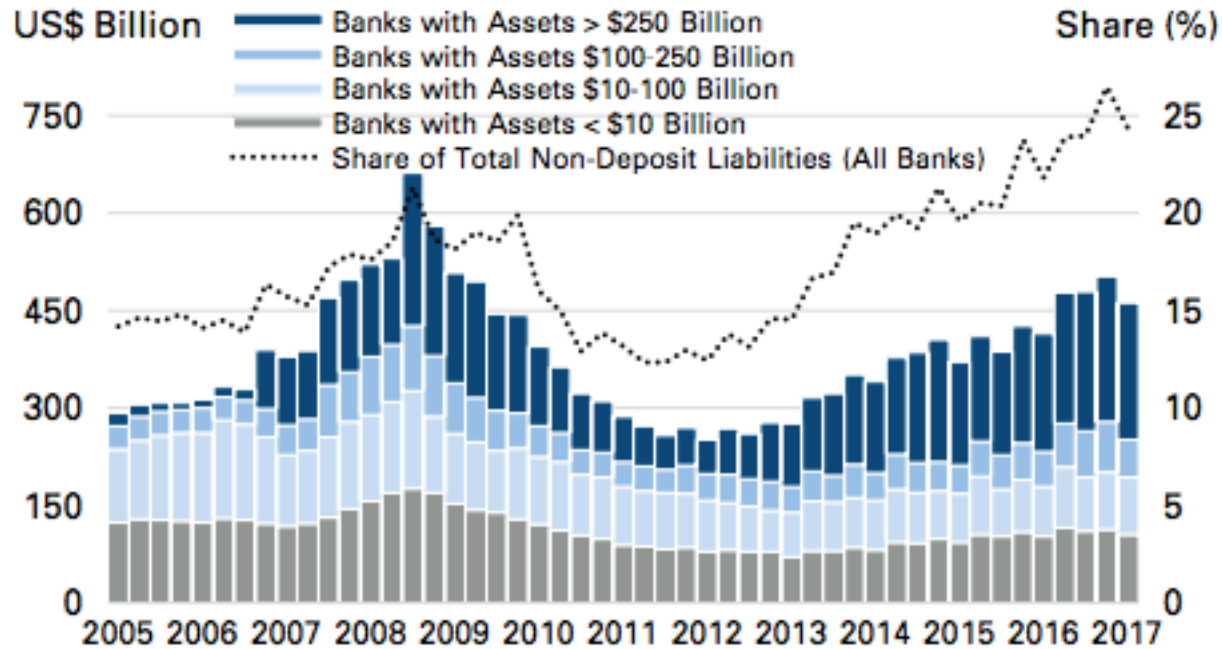
LCR as Case Study

Highlights limits of almost exclusive focus on cost-benefit analysis:

- Elusive baseline.
- Timing.
- Diverts attention from structural changes and other dynamics that cannot be easily wedged into CBA.

LCR as Case Study

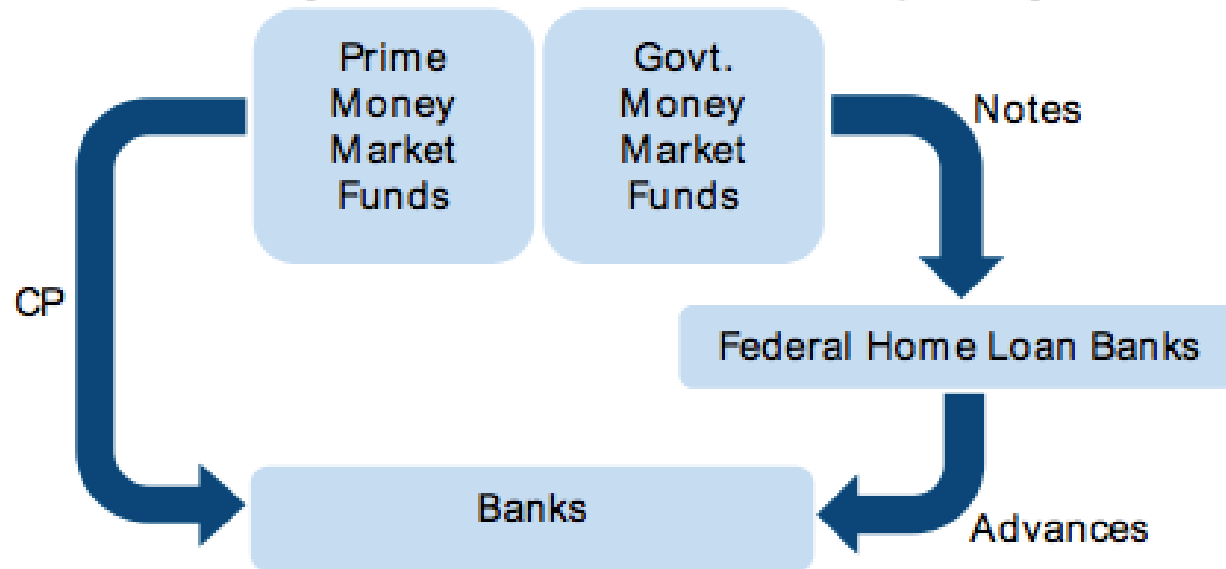
Figure 3. Large Banks Led a Resurgence of FHLB Advances



Source: Jonathon Adams-Kane and Jakob Wilhelmus, Milken Institute: The Real Story Behind the Surge in FHLB Advances: Macroprudential Policy Changed How Banks Borrow (2017)

LCR as Case Study

Figure 1. Banks Access Funding from Government MMFs Indirectly Through FHLBs



Source: Jonathon Adams-Kane and Jakob Wilhelmus, Milken Institute: The Real Story Behind the Surge in FHLB Advances: Macroprudential Policy Changed How Banks Borrow (2017)

LCR as Case Study

FHLBank advances to the four largest System members – the holding company subsidiaries of JPMorgan Chase, Wells Fargo, Citibank and Bank of America – collectively increased by 158% to \$135 billion between March 30, 2012, and December 31, 2013....

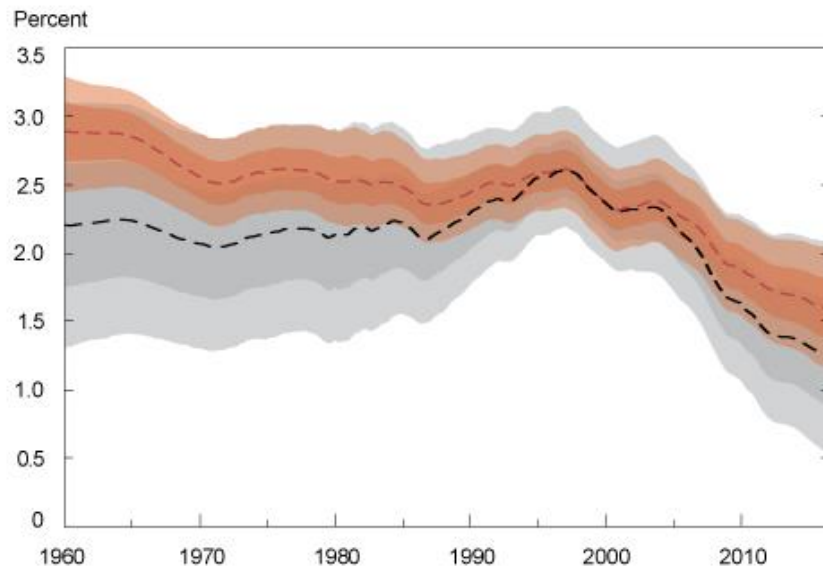
Officials from two [of these banks] ...confirmed ... that Basel III's liquidity requirements contributed to their increased use of FHLBank advances [and] one ... said that the Basel III requirements were the “primary driver” for its increased use of advances.

FHFA OIG, Recent Trends in Federal Home Loan Bank Advances to JPMorgan Chase and Other Large Banks (2014)

LCR as Case Study

Further structural changes seem likely:

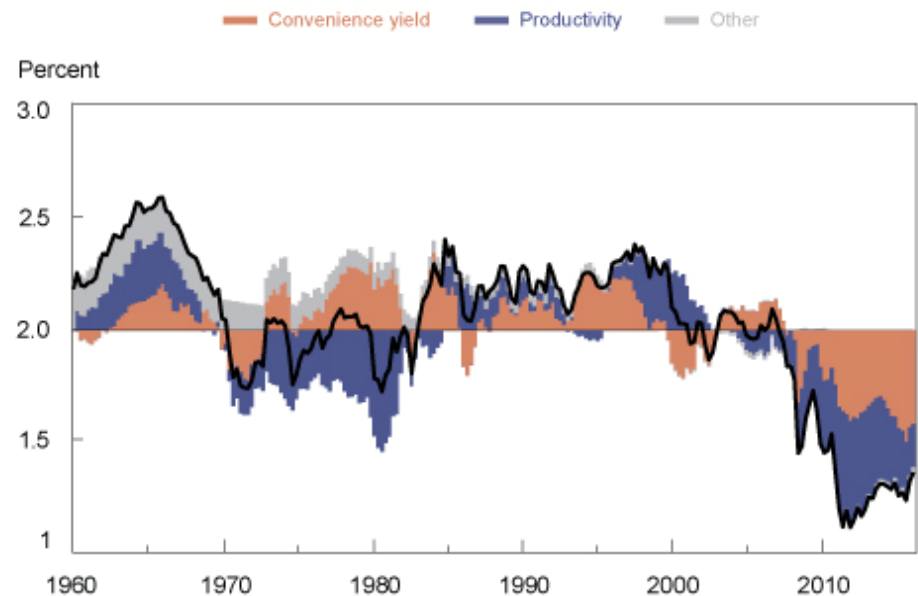
Trends in the Real Rate and in the (Negative of) Convenience Yield



Source: Authors' calculations.

Note: The chart summarizes the distribution of the vector autoregression (VAR) model estimates of the trends in the real rate of interest (in gray) and the negative of the convenience yield (in orange). The dashed lines are the medians and the shading marks uncertainty (97.5th, 84th, 16th, and 2.5th percentiles).

Trend Component of the Natural Rate of Interest and Its Drivers, 1960-2016



Source: Authors' calculations.

Note: The solid black line is the median of the trend in the real natural rate computed using the DSGE model. The colored areas are the contributions of the various shocks.

Sources: Brandyn Bok, et al, A Time-Series Perspective on Safety, Liquidity, and Low Interest Rates, Liberty Street Economics, Feb. 6, 2018 ; Del Negro, et al, A DSGE Perspective on Safety, Liquidity, and Low Interest Rates, Liberty Street Economics, Feb. 7, 2018.

The beginnings of a better approach

Revisit CBA limits

- Elusive baseline → tradeoffs
- Timing → revisit
- Diverts attention from structural changes and other dynamics that cannot be easily wedged into CBA
 - Multiple focal points
 - Focus on structural changes

The beginnings of a better approach

When?

- Interventions that explicitly require or incentivize firms to hold particular types of assets
- Interventions that could have a significant impact on the demand or supply of “safe assets”
- Others?