

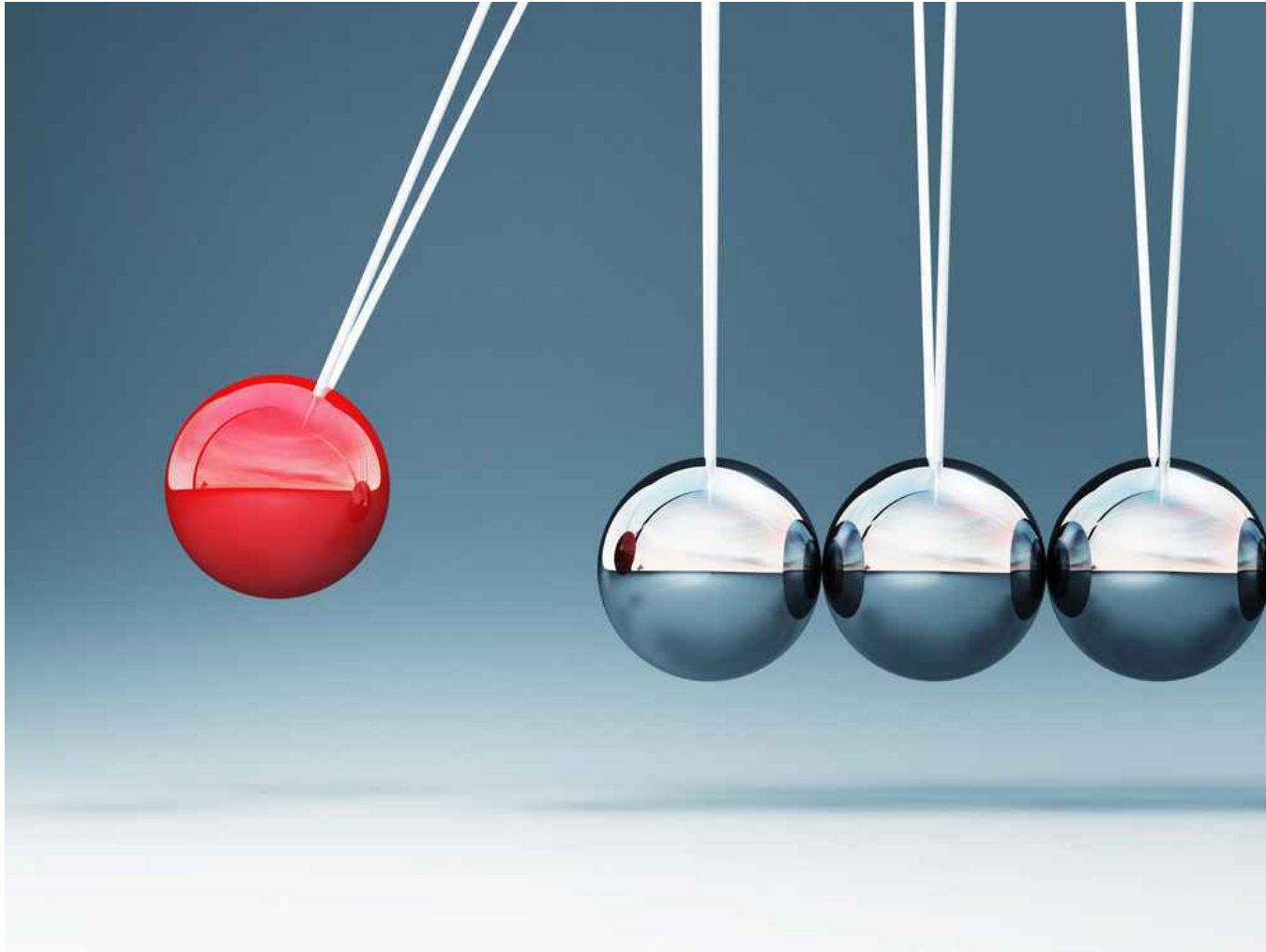
# **Banking Business vs Regulation: Where Does The Pendulum Stand?**

Donato **Masciandaro**

Bocconi University

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# Motivation: Where Does The Pendulum Stand?



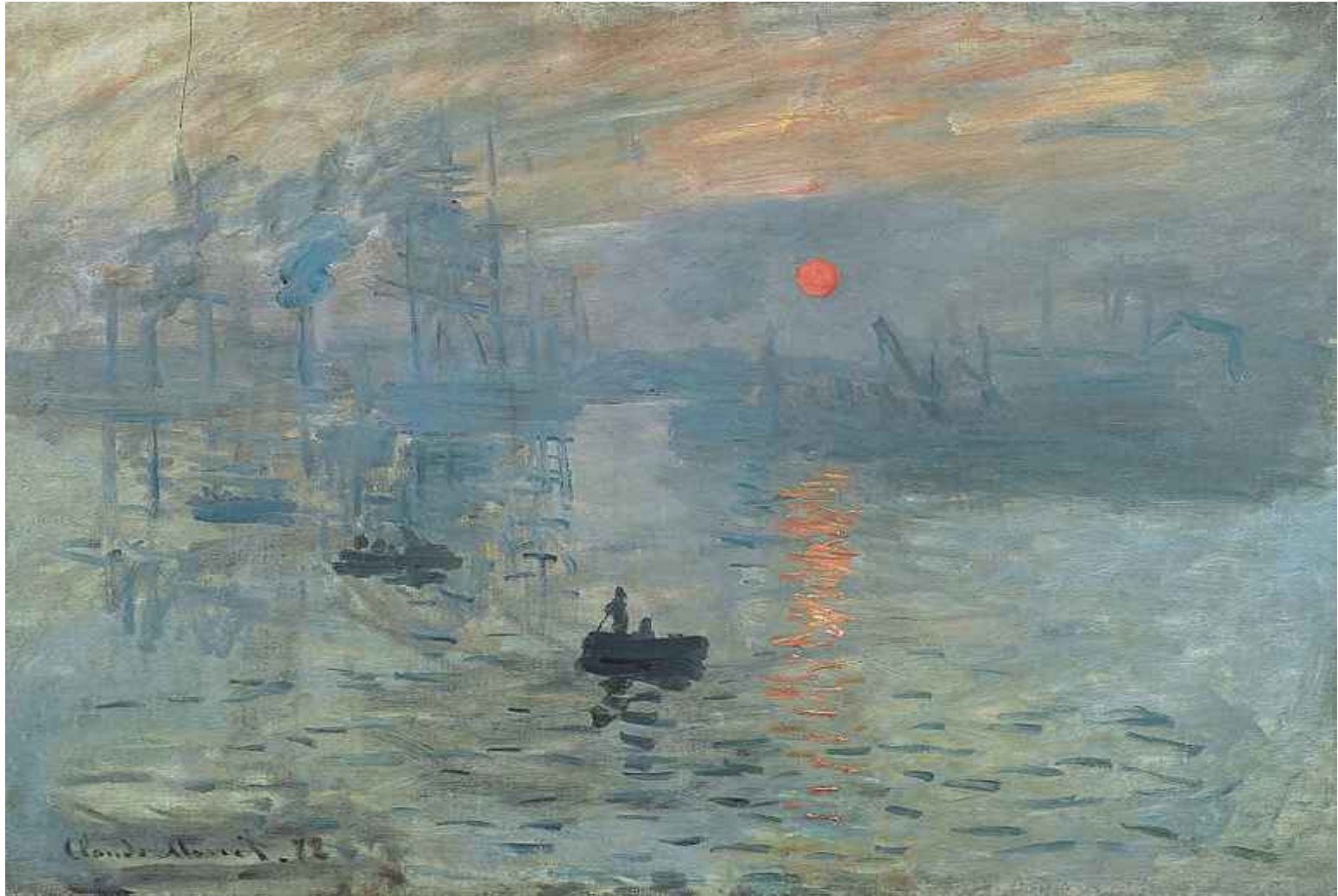
# What is Banking & Finance?

## The Drivers

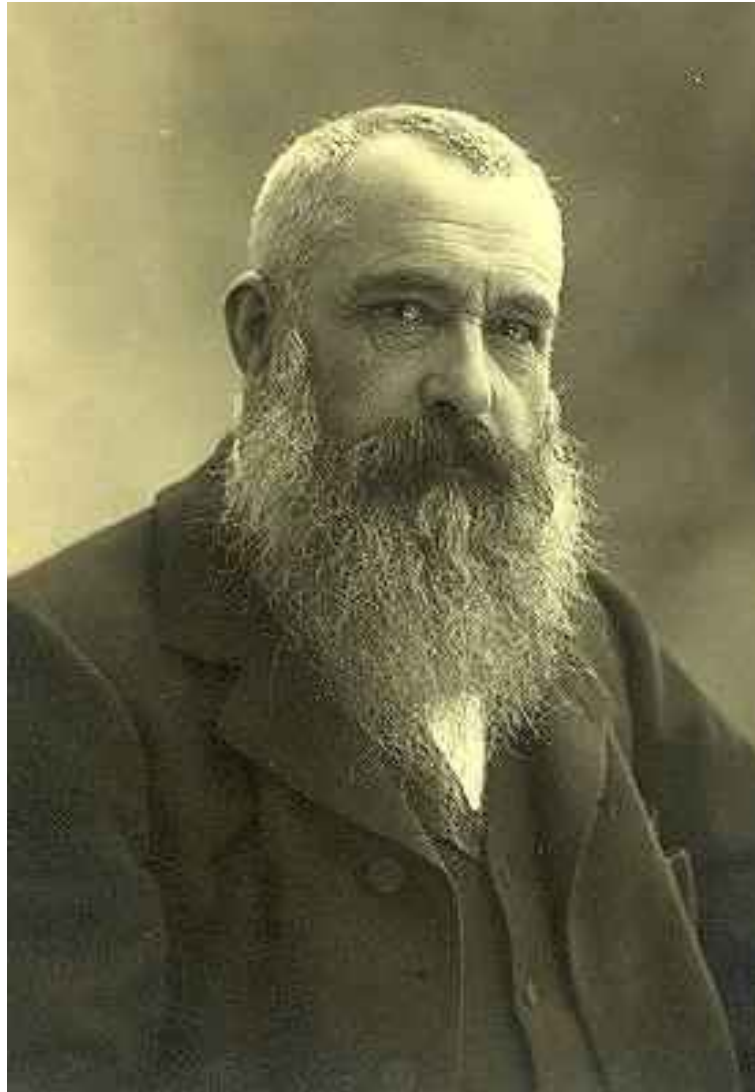
- **Banking & Finance** = Production and Distribution of **Leverage Contracts**
- **Finance Drivers**: Technology + **Rules**
- **Creativity** +  $\Delta$  **Technology** and/or  $\Delta$  **Rules** = Financial **Innovation**
  
- It's a general tale...

# Innovation

Bocconi



# Creativity



# Technology: before Monet = round brushes



# Technological innovation = new brushes (hog hair brushes)





# Rules before Monet = French Academicism





# Rules after Monet = Impressionism

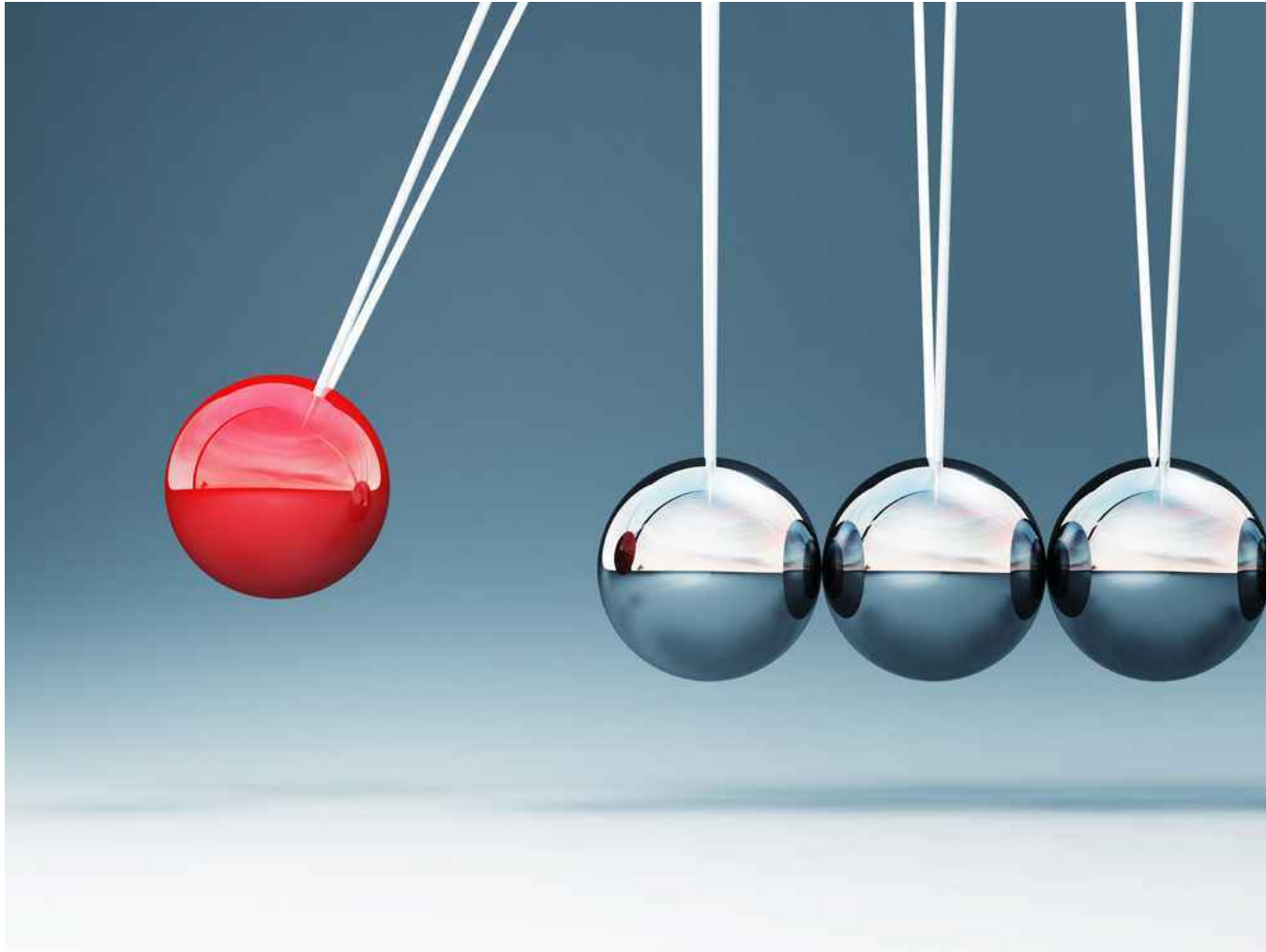
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# Financial Regulation

- What is **Regulation**?
- i.e. Which is your approach in addressing banking and financial **risks**?
- Two **approaches** ...

# The Pendulum After the Great Depression



# After the Great Depression ...



# Structural Regulation

- Key Assumption: Bank and Financial Risks **can be unpredictable**
- Therefore it is necessary to use **bans**:
- In defining banking and financial **businesses**
- In limiting the bank degree of freedom in setting their **business prices** (interest rates) and/or their **business products**



# Structural Banking Regulation and Bank Balance Sheet

- **Examples:**

- 1) Compulsory Reserve Requirement
- 2) Ceilings on Loan
- 3) Ceilings on Interest Rates
- 4) Business Banning

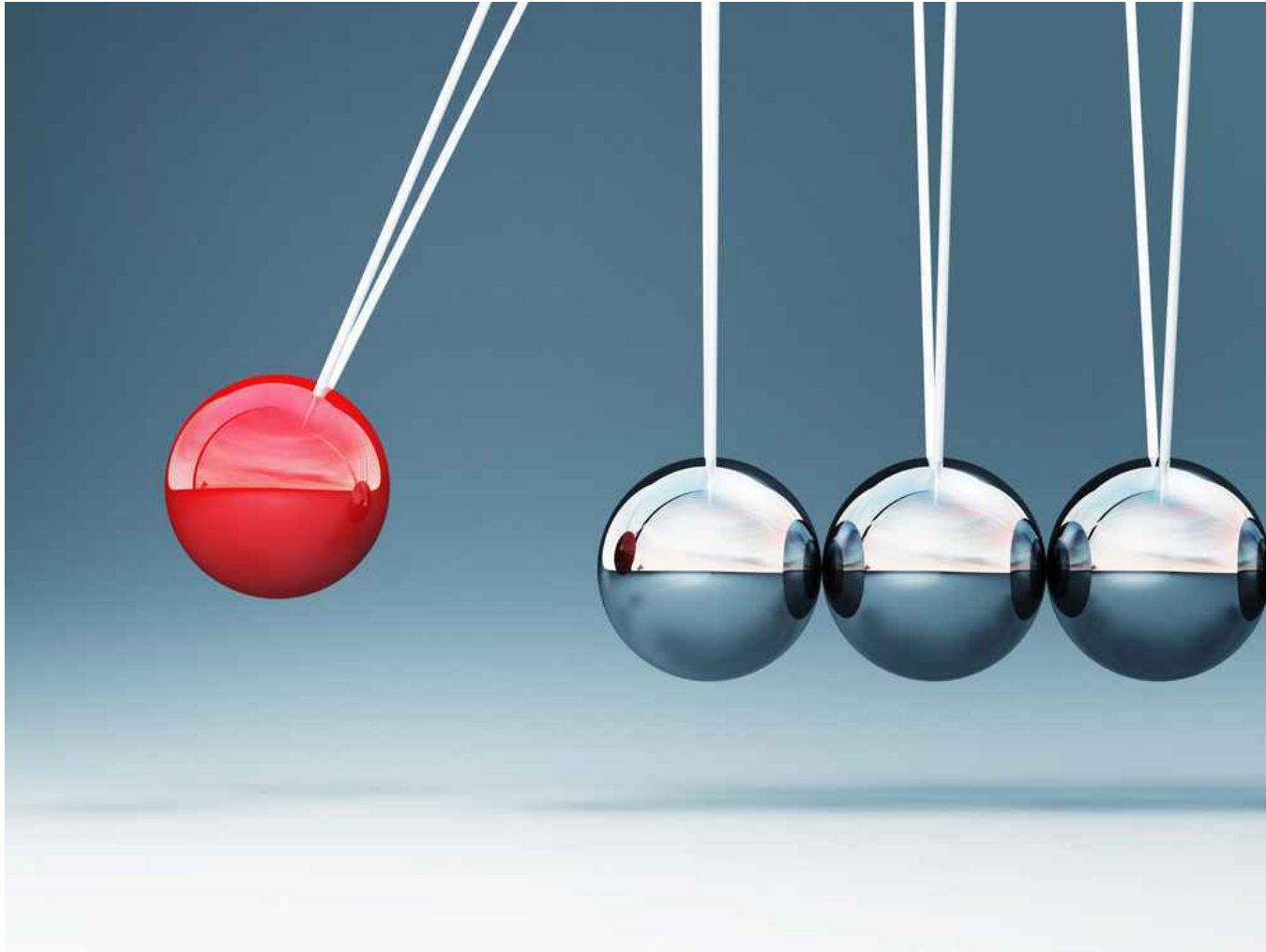
- Other Names:

- **Structural and Conduct Regulation**

- **Financial Repression:**  
Constraints on Competition

ASSETS	LIABILITIES AND NET WORTH
<p><b>CEILINGS &amp; BANNING on business and prices</b></p>	
<ul style="list-style-type: none"> <li>• LOANS (SUPPLY)</li> <li>• (FREE) RESERVES</li> <li>• <b>COMPULSORY RESERVES</b></li> </ul>	<ul style="list-style-type: none"> <li>* DEPOSITS</li> <li>* CAPITAL:</li> </ul>

# The Pendulum during the Great Moderation



# The Great Moderation: Prudential Regulation

- Key Assumption: Bank and Financial Risks **are** ever **predictable** and measurable
- Therefore it is sufficient to use **rules on the banking capital:**
- In order to exploit the relationships between risks and capital requirements

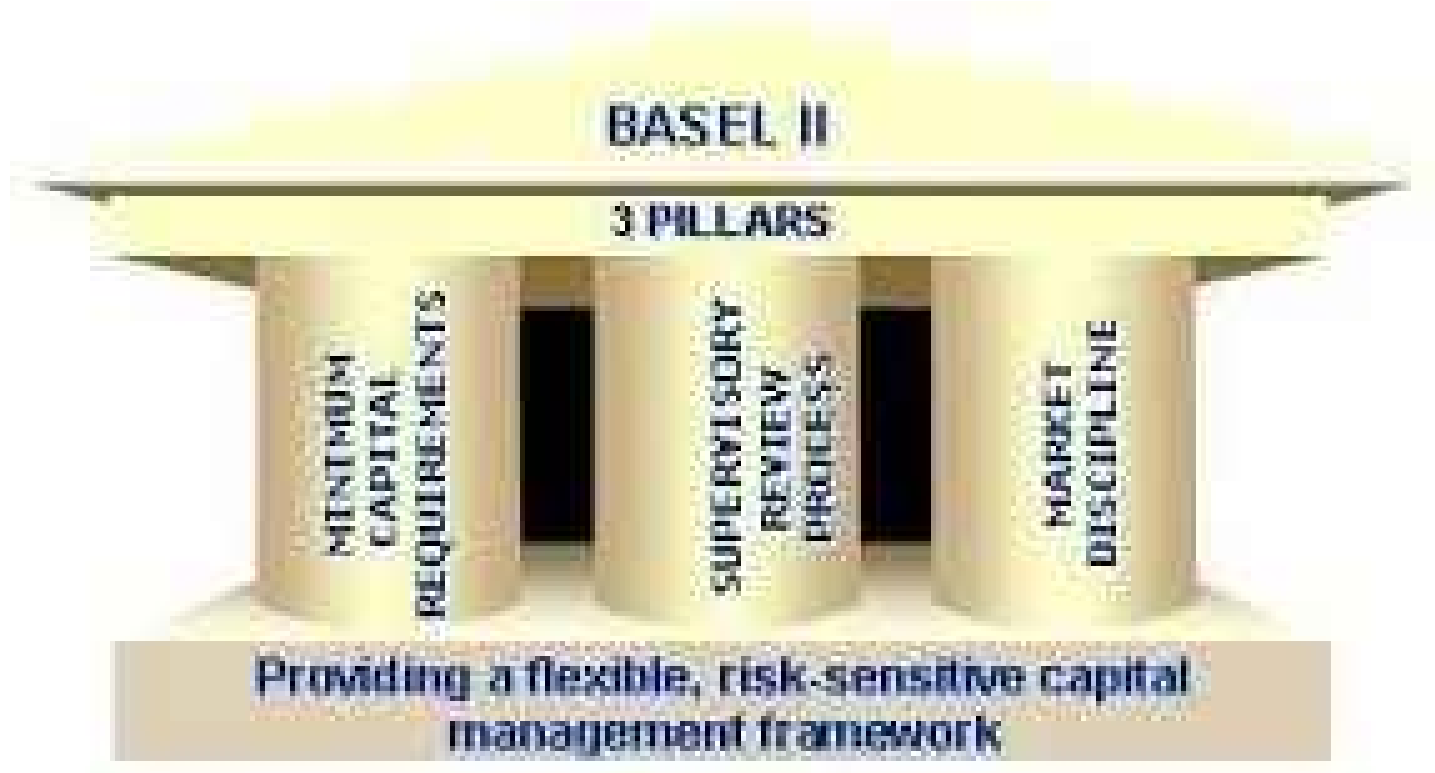
# Prudential Banking Regulation and Bank Balance Sheet

- **Examples:**

- 1) Capital requirements
- 2) Liquidity requirements

ASSETS	LIABILITIES AND NET WORTH
<ul style="list-style-type: none"><li>• LOANS (SUPPLY)</li><li>• (FREE) RESERVES</li><li>•</li></ul>	<ul style="list-style-type: none"><li>* DEPOSITS</li> <li>* <b>CAPITAL REQUIREMENTS</b></li></ul>

# Examples of Prudential Banking Regulation: The Basle Standards





# During the GM: From Structural (and Conduct) Regulation to Prudential

Table 2: Trends in Financial Regulation

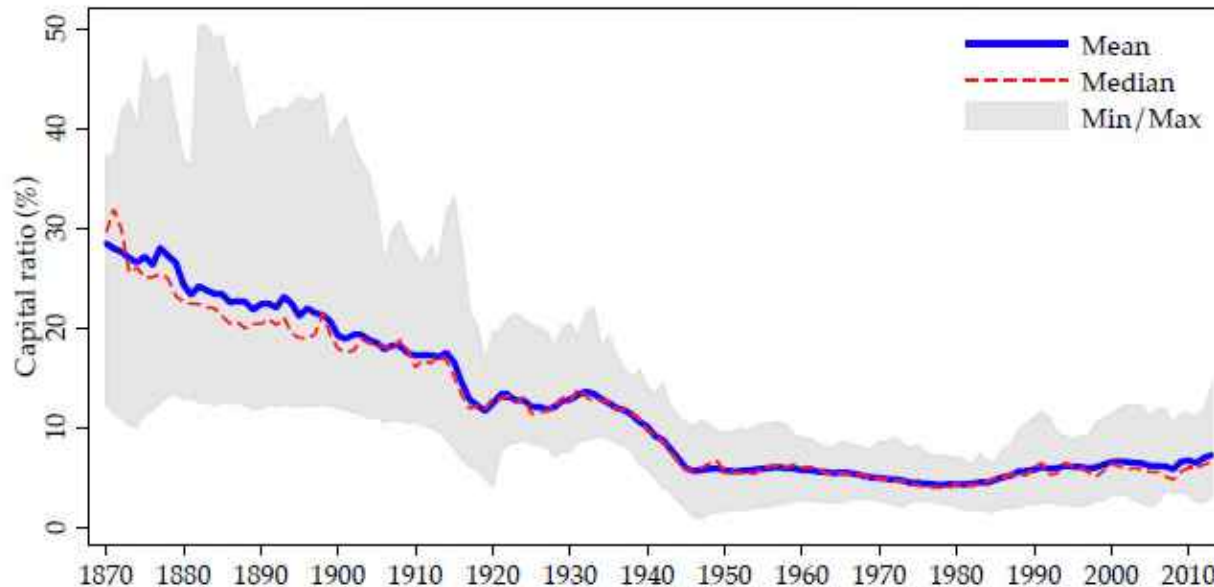
Structural Regulations		Conduct Regulations		Prudential Regulations	
Functional separation of institutions	↓	Regulations of bank's deposit and lending rates	↓	Deposit insurance	=↑
Entry restrictions	↓	Regulations of fees and commissions	↓	Discount window	=↑
Ownership restrictions	↓	Credit quotas	↓	Restriction on asset concentrations	↓=
Discriminatory rules against foreign investors	↓	Branching limitations	↓	Information disclosure	↑
				Solvency ratios	↑

Noted: Table is based on Vesala (1993), who in turn derived it from Diamond and Dybvig (1986), and Gual and Neven (1992).

Source: Classens 2016

# During the GM: Prudential Regulation: (Decreasing) Bank Capital

Figure 1: Capital ratio, averages by year for 17 countries, full sample.



Notes: The blue line plots the mean of capital ratios in the sample countries between 1870 and 2013. The red line refers to the median of the sample countries. The grey area is the min-max range for the 17 countries in our sample.

Source: Jorda, Richter, schularick, Taylor, NBER, 2017

# Prudential Regulation = Financial Deregulation

- Prudential Regulation =
- Bankers enjoy more degrees of freedom in setting their **business prices** (interest rates or fees) and/or their **business designs**
- Creativity +  $\Delta$  **Technology** and/or  $\Delta$  **Rules** = Financial Innovation
- Financial Innovation during the GM ...

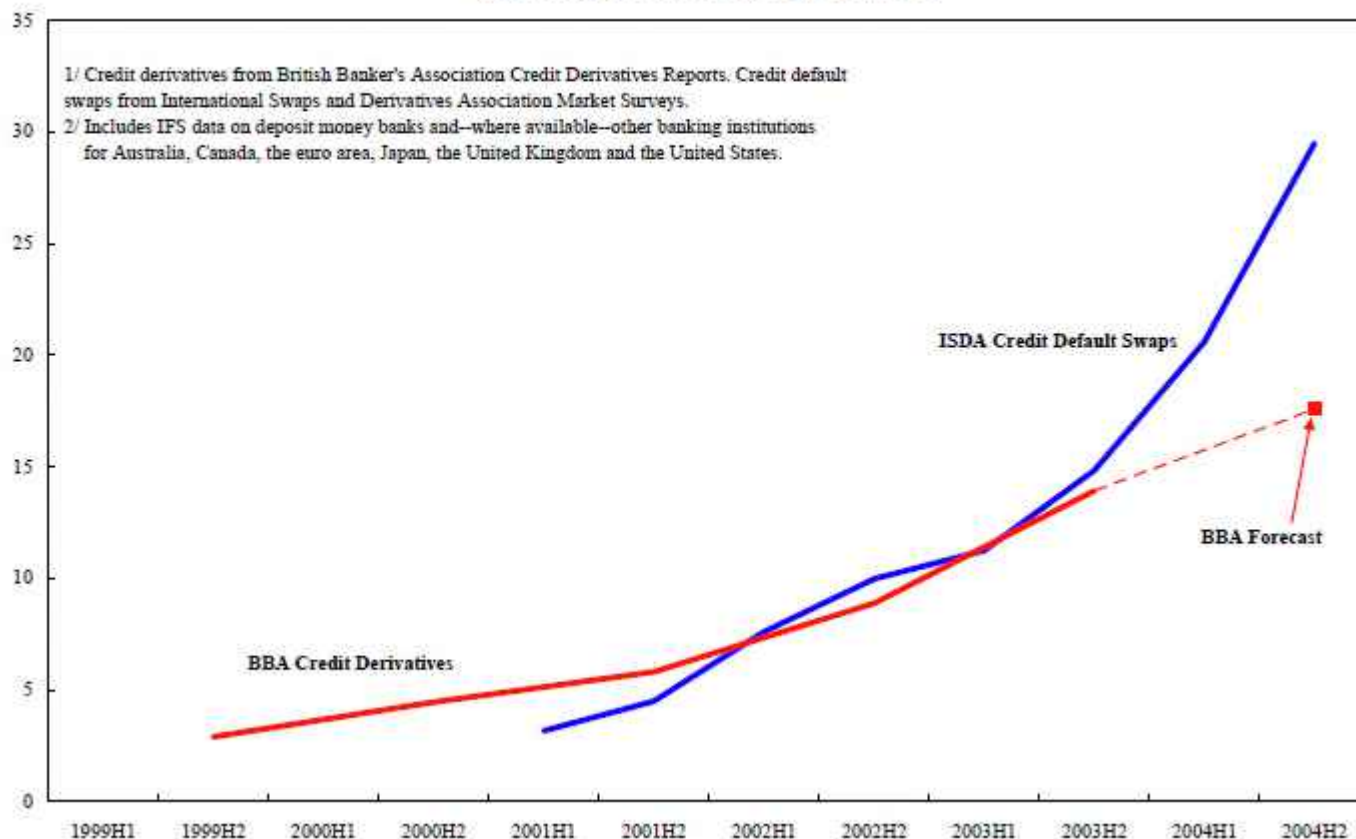
# Creativity



Fama, Hansen e Schiller, NP  
2013

# Financial Innovation

Figure 1: Credit Derivatives and Credit Default Swaps 1/  
(In Percent of Private Sector Bank Credit 2/)



Source: Rajan 2005



# Technology & Financial Innovation

Figure 4: IT Capital and Financial Patents

