Economics 435
The Financial System
(5/1/2013)

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Reforms

- Basel III

  http://www.moodysanalytics.com/~/media/Insight/Regulatory/Basel-III/Presentations/2012-13-06-Basel-III-Regulatory-Update.ashx

- Dodd-Frank

Four Questions

- Will the new regulatory structure make the financial system more robust to shocks by providing institutions the tools to heal themselves?
- Does the Dodd-Frank Act adequately deal with monitoring and measuring systemic risk?
- Do the provisions of the Act deal adequately with the problem of too-big-to fail institutions?
- To what extent will the Dodd-Frank Act involve the right mix of automatic "stabilizers" (e.g. higher capital requirements), fixed rules (e.g. the Volcker Rule) and discretion (e.g. Federal Reserve's ability to lend to illiquid, potentially insolvent, institutions at flexible haircuts), to be an effective framework for financial stability?

Robust to Shocks?

- The key issue is whether a financial firm or market participants will have adequate capital and liquidity to withstand adverse events whether they be due to idiosyncratic shocks or aggregate shocks.
- … regulatory capital requirements, both under Dodd-Frank and under Basel III rules.

Dodd-Frank and Systemic Risk

- Orderly Liquidation Authority (OLA) (FDIC)
- Liquidation versus resolution
- SIFI's versus markets (e.g., repo) or
- "herds of firms" (e.g., money market funds)

Stabilizers vs. Rules vs. Discretion

- Stabilizers (capital requirements)
- Rules - Volcker rule specifically prohibits a bank or institution that owns a bank from engaging in proprietary trading, and from owning or investing in a hedge fund or private equity fund, and also limits the liabilities that the largest banks can hold.
- Discretion: Is liquidation necessarily the right way to go, or resolution.