



The Functional Regulation of Finance

Posted by *Steven L. Schwarcz, Duke University*, on Monday, June 16, 2014

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How should we think about regulating our dynamically changing financial system? Existing regulatory approaches have two temporal flaws. The obvious flaw, driven by politics and human nature, is that financial regulation is overly reactive to past crises. The Dodd-Frank Act, for example, puts much weight on reforming mortgage financing.

There is, however, a less obvious flaw: that financial regulation is normally tethered to the financial architecture, including the distinctive design and structure of financial firms and markets, in place when the regulation is promulgated. This type of grounded regulation can have value as long as it is monitored and updated as needed to adapt to changes in the financial architecture. Yet without that monitoring and updating, it can quickly become outmoded—such as occurred in 2008 when the pre-crisis financial regulatory framework, based on the dominance of bank-intermediated funding, failed to address a collapsing financial system in which the majority of funding had become non-bank intermediated.

[The Functional Regulation of Finance](#) argues that financial regulation should transcend a time-bound architecture. This could be done by regulating the underlying, and thus less time-dependent, economic functions of the financial system—the provision, allocation, and deployment of financial capital—as well as the financial system's capacity to serve as a network within which those functions can be conducted. (This functional approach should not be confused with what is sometimes called a functional approach to financial supervision, in which the supervisory agency's jurisdiction is based not on entities but on the business being transacted; my article addresses how rules should be substantively designed, not how they should be bureaucratically supervised.)

My article first examines how “microprudential” financial regulation could improve the functioning of the components of the financial system—firms and markets—by identifying their functions and then considering how regulation could correct market failures that impede those functions (especially market failures that undermine the reliability of pricing, since funding depends on reliable pricing). Among other things, the article shows that microprudential regulation cannot perfectly correct those market failures. Furthermore, it shows that some of the inevitable market failures can have systemic consequences. That leads to a discussion of macroprudential regulation—regulation to protect the financial system's capacity to serve as a network within which its underlying functions can be conducted

Policymakers and regulators recognize the need for macroprudential regulation, but they tend to view it as a loose assortment of “tools” in their “toolkit.” It is unclear, though, which tools should be used in which circumstances, or how the tools should be calibrated. That itself creates risk because a misapplication—such as imposing excessively restrictive leverage or credit and credit-growth ceilings—may be as likely to cause financial problems as to solve them.

Macroprudential regulation should be less ad hoc. Ideally, it should work ex ante, eliminating the triggers of systemic shocks. The article demonstrates, however, that may not be feasible. As already mentioned, some market failures will inevitably have systemic consequences. Furthermore, other vulnerabilities of the financial system can trigger systemic shocks, and some of them—such as maturity transformation, the asset-liability mismatch that results from the short-term funding of long-term projects; and limited corporate liability, which allows firms to externalize harm and thus potentially motivates risky corporate conduct—are not merely vulnerabilities but also potential benefits of the financial system. Additionally, the financial system effectively comprises a high-risk system that is susceptible to “normal accidents,” so regulators cannot even predict all the triggers of systemic shocks.

Regardless of regulation, therefore, the financial system is likely to retain vulnerabilities that can trigger systemic shocks. Accordingly, macroprudential regulation should also work ex post, to help mitigate the harm from systemic shocks that inevitably will occur. This approach accords with chaos theory, which addresses the problem of inevitable systemic shocks in complex engineering systems; the most successful systems are those in which the consequences of failures are limited.

To accomplish that, the regulation should seek to break the transmission and limit the impact of those shocks. The design of that regulation should be partly informed by the risk factors that influence the transmission and impact of systemic shocks—which include interconnectedness, size, and substitutability. Regulation cannot completely break the transmission of systemic shocks because (among other reasons) the transmission mechanisms cannot all be identified. The article therefore also explores how regulation could limit the impact of systemic shocks by stabilizing systemically important financial firms and markets impacted by the shocks. That could be done by requiring those firms and markets to be more internally robust, or by providing appropriate liquidity to those firms and markets.

Financial regulation has long focused on requiring traditional deposit-taking banks to be robust, usually through capital and solvency requirements. Since the financial crisis, the United States and other countries are beginning to also subject “systemically important” non-bank financial firms to these requirements. A functional regulatory approach to limiting the impact of systemic shocks could likewise impose capital and solvency requirements. Significantly, though, a functional regulatory approach could also be more flexible, avoiding the need to impose those requirements.

Traditional regulation is inflexible because it implicitly (and confusingly) mixes microprudential and macroprudential regulatory goals. The only goal of functional macroprudential regulation should be to protect the financial system’s capacity to function as a network. It need not, therefore, impose capital or solvency requirements on individual firms—even those that are systemically important—so long as it otherwise protects the financial system’s capacity to function as a network. This regulatory flexibility is important because capital and solvency requirements do not always efficiently reduce systemic risk.

In closing, I observe that my article’s functional approach is primarily normative. Nonetheless, it provides regulatory ordering principles that should have practical utility, at least as a set of standards to inform actual regulatory design.

The full paper is available for download [here](#).

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