Is a less pro-cyclical financial system an achievable goal?
Lessons for domestic and global financial regulation

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Sources of Procyclicality

• Regulatory
  – Mark to Market plus Value at Risk

• Inevitable Market Discipline
Leverage and Asset Growth for Large US Commercial Banks

Source: updated from Greenlaw, Hatzius, Kashyap, Shin (2008)
Combating Procyclicality

• Regulation concerns \( \frac{\text{Capital}}{\text{Assets}} \)

• Preventing deleveraging means either:
  • Stopping asset sales
  • Forcing institutions to raise capital from the market
  • Hard-wiring capital infusions
Policy options

• Time-varying capital requirements
  – But, capital is a tax to the banks (agency costs)
  – Forbearing during a crisis is unlikely to help

• Mandatory Convertible Debt
  – Better response to fundamental reluctance to hold capital
  – Various potential triggers
    • Flannery
    • Kashyap, Rajan, Stein
    • Squam Lake Working Group
(New/Old Idea) Capital Permits
(Kashyap-Stein 2004)

• Auction permits that count as “capital during booms” (i.e. when the market capital constraint is NOT binding).

• Macro prudential regulator could target the price of these permits or the quantity of permits
  – Adds a tool that is separate from monetary policy
  – Generates some useful information for the regulator
Four lessons for regulatory reform

1. De-leveraging is very disruptive

2. We need to pay more attention to leverage and think about how to manage it

3. The short term interest rate matters for repo and hence leverage

4. Regulation should be tied to fundamental frictions that lead financial firms to have little equity financing