
The Fundamental Principles of Financial Regulation

Geneva Reports on the World Economy 11

Markus Brunnermeier

Princeton University and CEPR

Andrew Crockett

JPMorgan Chase

Charles Goodhart

London School of Economics

Avinash D. Persaud

Intelligence Capital Limited

Hyun Song Shin

Princeton University and CEPR

Each author has contributed on a personal basis, and no responsibility should be attached to any institution to which that author either is or has been attached.

ICMB INTERNATIONAL CENTER
FOR MONETARY
AND BANKING STUDIES

CIMB CENTRE INTERNATIONAL
D'ETUDES MONETAIRES
ET BANCAIRES



Contents

<i>About the Authors</i>	v
<i>List of Conference Participants</i>	x
<i>Acknowledgements</i>	vx
<i>Foreword</i>	xvi
<i>Executive Summary</i>	xvii
<i>Introduction</i>	xxi
1 Analytical Background	1
2 Nature of Systemic Risk	13
2.1 Solvency, liquidity and maturity mismatch	13
2.2 Funding liquidity and the domino model	15
2.2 Loss spiral – asset price effect	16
2.3 Margin/haicut spiral	18
2.4 Procyclicality and margin spirals	22
2.5 Externalities – rationale for regulation	23
2.6 Aggregate liquidity expansions and contractions	23
3 Who Should be Regulated (by Whom)	25
3.1 Classification of financial institutions based on objective risk spillover measures	25
3.2 Rules for individually systemic institutions	27
3.3 Rules for institutions that are ‘systemic in a herd’	28
3.4 International considerations for international entities	28
4 Counter-Cyclical Regulation	31
4.1 Focus on systemic risk spillover	31
4.2 When to look out for systemic risk?	32
4.3 Predicting institutions’ future systemic risk contributions	32
4.4 How to impose charges	33
4.5 More on bank capital: two notions	35
4.6 Ladder of responses	36
4.7 Forced debt-equity conversion	36
4.8 Clear incentives for regulators: rules versus discretion	37
4.9 Cross-country considerations	37
4.10 Contrast to Spanish dynamic provision mechanism	37
5 Regulation of Liquidity and Maturity Mismatches	39
5.1 Focusing solely on Assets	40
5.2 Funding liquidity and maturity mismatch	40
5.3 Mark to funding – a new accounting rule	41
5.4 Capital charges against illiquidity	46
6 Other Regulatory Issues	49
6.1 Introduction	49
6.2 Remuneration	49
6.3 Loan to value ratios in mortgages	53

6.4	Credit rating agencies	54
6.5	Centralized clearing house arrangements vs. OTC markets	55
6.6	Year-end spikes	55
6.7	Crisis management	56
7	The Structure of Regulation	57
8	Conclusions	63
8.1	General conclusions and recommendations	63
8.2	Capital requirements	64
8.3	Liquidity	65
8.4	Other considerations	66
	Appendix : The Boundary Problem in Financial Regulation	67
	Discussion and Roundtables	75
	Session 1 Presentation of the Report (Chapters 1-3)	75
	Session 2: General Discussion	86
	Session 3: Presentation of the Report (Chapters 4-7)	93
	Session 4: General Discussion	101
	<i>References</i>	<i>108</i>