The Political Economy of Prudential Regulation

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Political Economy Matters

Democratic senators call for tougher capital requirements for US banks

Sherrod Brown and Elizabeth Warren warn Fed it would be 'grave error' to extend pandemic relief

FT.com, 03.03.2021

Politics

Biden Fed Pick Pits Powell Against Liberal Push for Regulation

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- Evidence: politicians respond to interest groups when
  - designing (Igan & Mishra, 2014; Mian et al. 2010)
  - and enforcing financial regulation (Lambert, 2018)

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- Gap: How is it affected by political economy factors?

  → **this paper**

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Questions: Policy preferences? Strictness & efficiency of regulation?

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- Income inequality: prudential regulation is re-distributive

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- Regulatory capture: **policy preferences reversed**

  Intuition: capture → heterogeneous costs & lower benefit of policy

Model: Borrowing Externality

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- 3 dates; consumption good and capital

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  $\Rightarrow$ have zero capital demand, pin down $r_t = 1$

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(Collateral Channel)

$\Rightarrow$ capital buyers gain, capital sellers lose

(Capital Trade Channel)

Choice of Debt at t=0

- Each borrower chooses debt taking **price as given**:

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Inefficiency and Planner's Policy

If inequality is not too high: the initial debt is **inefficiently high**.

A debt limit $\bar{d}^{SP}$ can restore constrained efficiency.

The Model: Political Equilibrium

Majoritarian Elections

At the beginning of $t = 0$ politicians A and Z compete for an office

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- Policy of the winner is implemented
- Winner receives benefits R for holding office

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- Concentration $\psi^J \rightarrow$ responsiveness to policy of group J

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- Each politician maximizes Prob(win), the FOC is:

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    - Capital trade channel

      $\rightarrow$ high-income borrowers (capital buyers) prefer a lax limit

      $\rightarrow$ low-income borrowers (capital sellers) prefer a strict limit

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The limit **increases** in the **electoral power of high income borrowers**:

$$\frac{\partial \bar{d}^*}{\partial \psi^r} > 0$$

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- if $\psi^r > \psi^p$ policy caters to high-income types $\Rightarrow \bar{d}^* \uparrow$

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Political Friction: Regulatory Capture

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Politicians **cannot commit to universally enforce** the policy

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  - subject to $\bar{d}$ set in elections

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- Connected borrowers choose d_0^c so that:

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Regulatory capture $\Rightarrow$ effectiveness of policy $\downarrow$

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Regulatory capture $\Rightarrow$ cost of regulation shifted to the non-connected

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Equilibrium Debt Limit

The equilibrium debt limit set in elections is **too strict** if the electoral power of the **connected** is high:

$$\bar{d} < \bar{d}^{SP} \iff \psi^c > \psi^n$$

It may be **too lax** if the electoral power of **non-connected** is high.

▸ Numerical Example

Implications of Capture

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- Connected borrowers shift regulation on non-connected $\sim$ evidence:

  lobbying firms impose **externality** on non-lobbyists (Neretina, 2018)

Conclusions

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$\rightarrow$ policy is **inefficient** & preferences may be **reversed**

Thank You

Appendix

Planner's Policy

Planner's FOC:

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Efficiency

Proposition

Equilibrium debt limit corresponds to policy of a constrained social planner with $\frac{\psi^r}{\psi^p} = \frac{\chi^r}{\chi^p}$.

With universal enforcement $\rightarrow$ internalize externality when voting
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- if $\psi^r > \psi^p$ policy caters to high-income types $\Rightarrow \bar{d} \downarrow$

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