

Charges to FRAC for delivery at February 27, 2020 Winter Meeting

TOPIC: Encouraging Market Discipline to Enhance Financial System Resilience

SUMMARY

The Office of Financial Research (OFR) charges its Financial Research Advisory Committee (FRAC) with identifying promising strategies to increase financial resiliency through greater transparency, more effective incentives, and ultimately more reliable market discipline.

BACKGROUND

The 2007-09 financial crisis was at least partly a product of opaque counterparties and insufficient skin-in-the-game, which fueled systemic risks. Many of these risks were rooted in the housing and derivatives markets, where they were poorly understood or communicated by parties to over-the-counter transactions. Short-term, profit seeking incentives exacerbated the situation, as the financial system levered up on mispriced securities.

Lawmakers and regulators have worked to improve many dimensions of market transparency. For example, the Dodd-Frank Act required that standardized derivatives (largely swaps) be cleared and traded through central counterparties (CCPs). More transparent derivatives data allow for better price discovery, easier acquisition of information on underlying risks, and more effective monitoring by regulators. In addition, securitized financial products now also require greater disclosure throughout the intermediation chain, which increases their price efficiency. However, as with much regulation, there is a flip side to the benefits from CCPs: they concentrate risk in the CCP, another potentially worrying source of systemic risk.

After the crisis, steps also were taken to better incentivize financial markets and institutions to behave in ways that support a resilient financial system. One step was the introduction of margin requirements to incentivize the netting of risk and the use of central clearing. Another was the establishment of singlecounterparty credit limits for bank holding companies and foreign banking organizations. These limits were designed to incentivize greater diversification of counterparty risk, yet some researchers still question whether our financial system is sufficiently well capitalized.

QUESTIONS

1. Identify up to three features of the financial system (whether a feature of financial institutions, markets, or activities) where increased transparency can further financial stability, and how that transparency might be achieved.
2. Propose up to three strategies that can (1) better align private-sector incentives with (2) the societal goal of a more resilient financial system through (3) improved market discipline.