The Political Economy of Prudential Regulation

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Motivation

- Vast literature on optimal prudential regulation
- Can we expect policy-makers to implement it?
  - Evidence: lobbies and voters impact regulation
  - Theory? **This paper**

Key Results:

- If *political process is frictionless*:
  - Low income borrowers prefer a tight debt limit
  - High income borrowers prefer a lax debt limit
- With *regulatory capture* preference may be reversed
- Equilibrium policy determined by electoral power

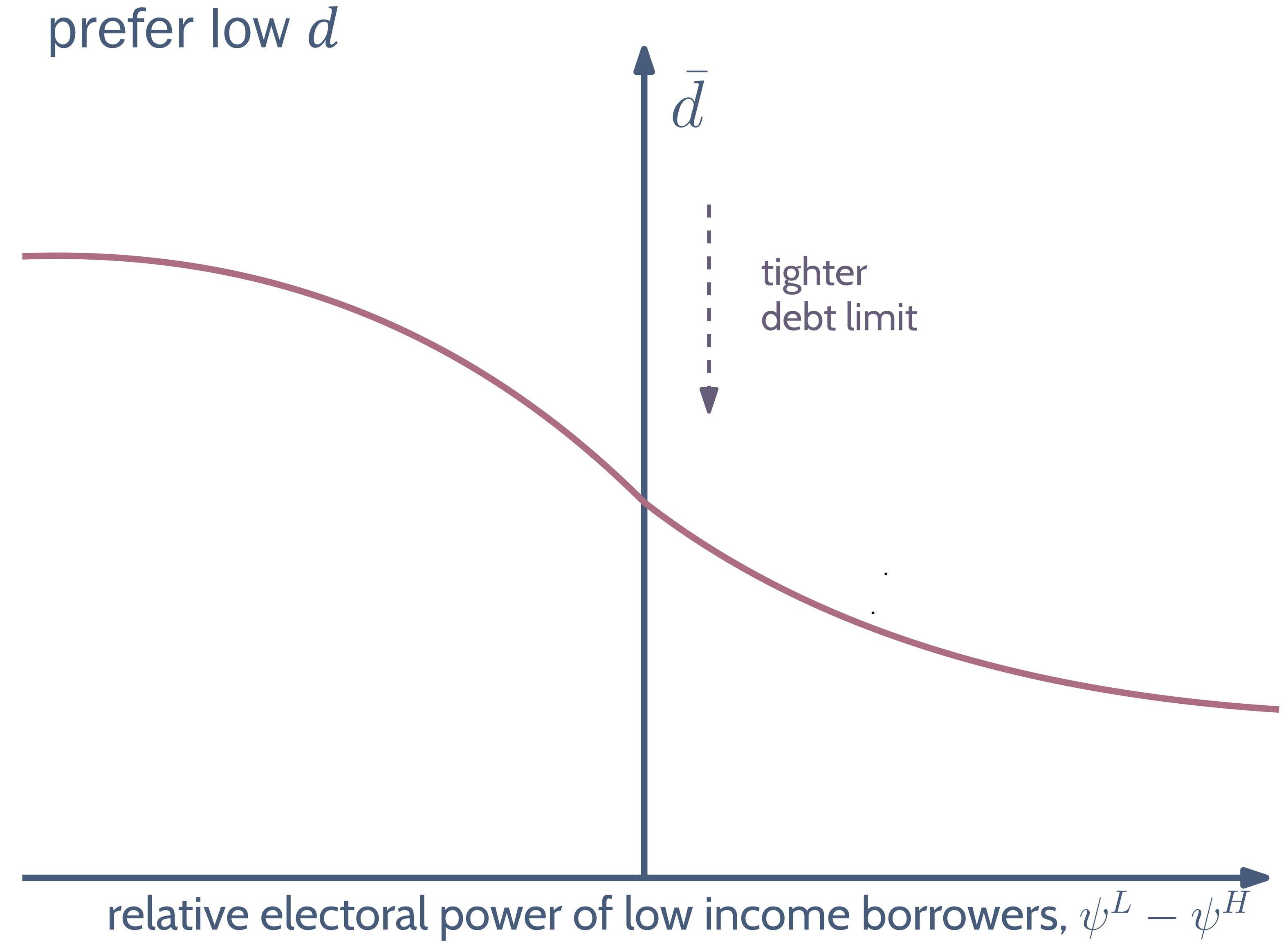
Model

- Lenders: deep-pocketed, risk neutral
- Borrowers:
  - 2 types: high and low income
  - Issue debt to smooth consumption
  - Hold productive capital → collateral
- Collateral constraint binds at $t = 1$ → fire sale → pecuniary externality → **excessive debt at $t = 0$**
- Elections: politicians compete, propose debt limit $\bar{d}$
- Group J's responsiveness to policy when voting= ψ^J → determines **electoral power**
- Two cases:
  - Frictionless political process
  - Regulatory capture

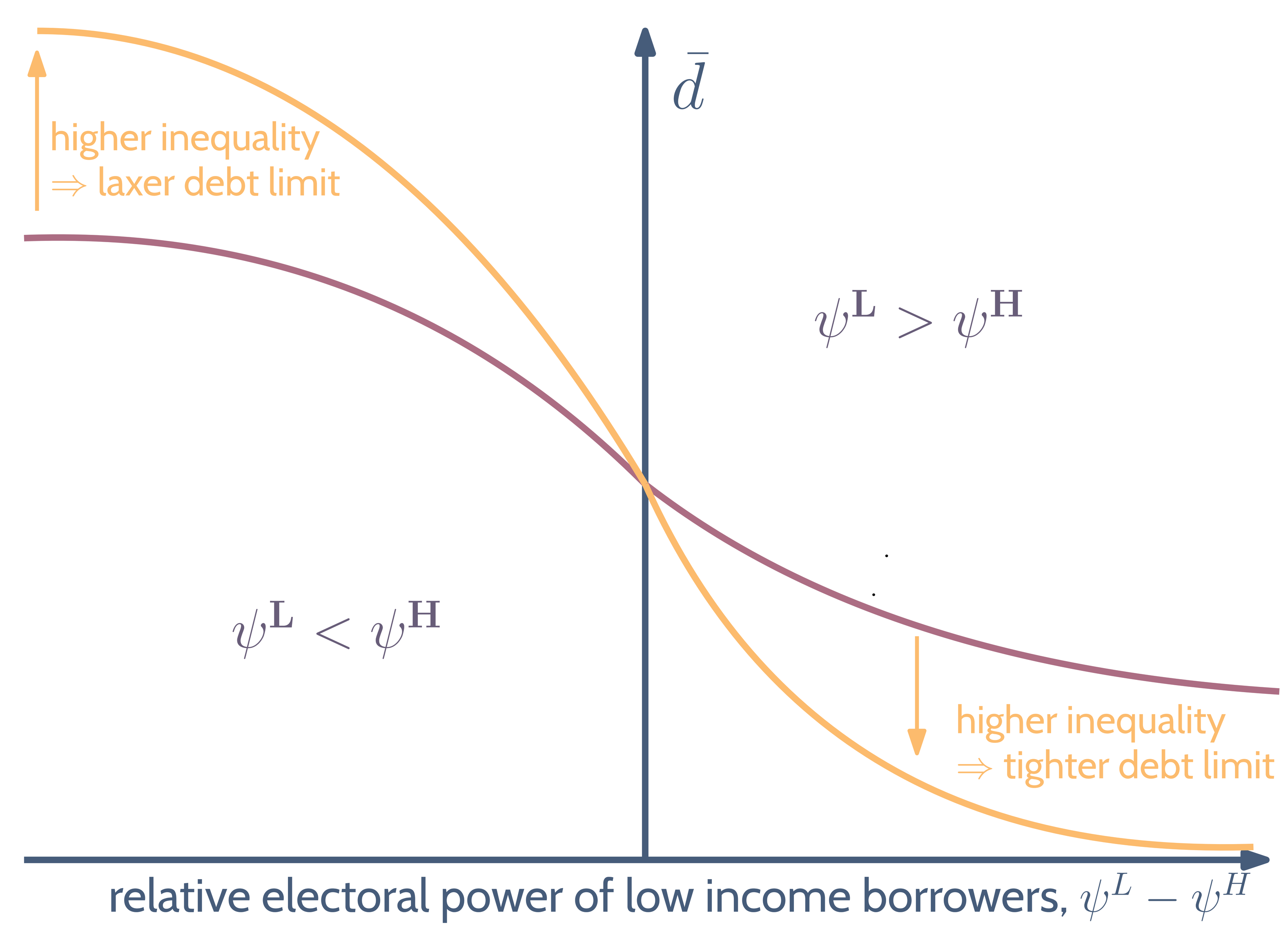
Frictionless political process

= debt limit enforced among all borrowers

- When voting, borrowers internalize impact of $\bar{d}$ on extent of fire sale
- Low income borrowers **hurt more by fire sale** → prefer low $\bar{d}$



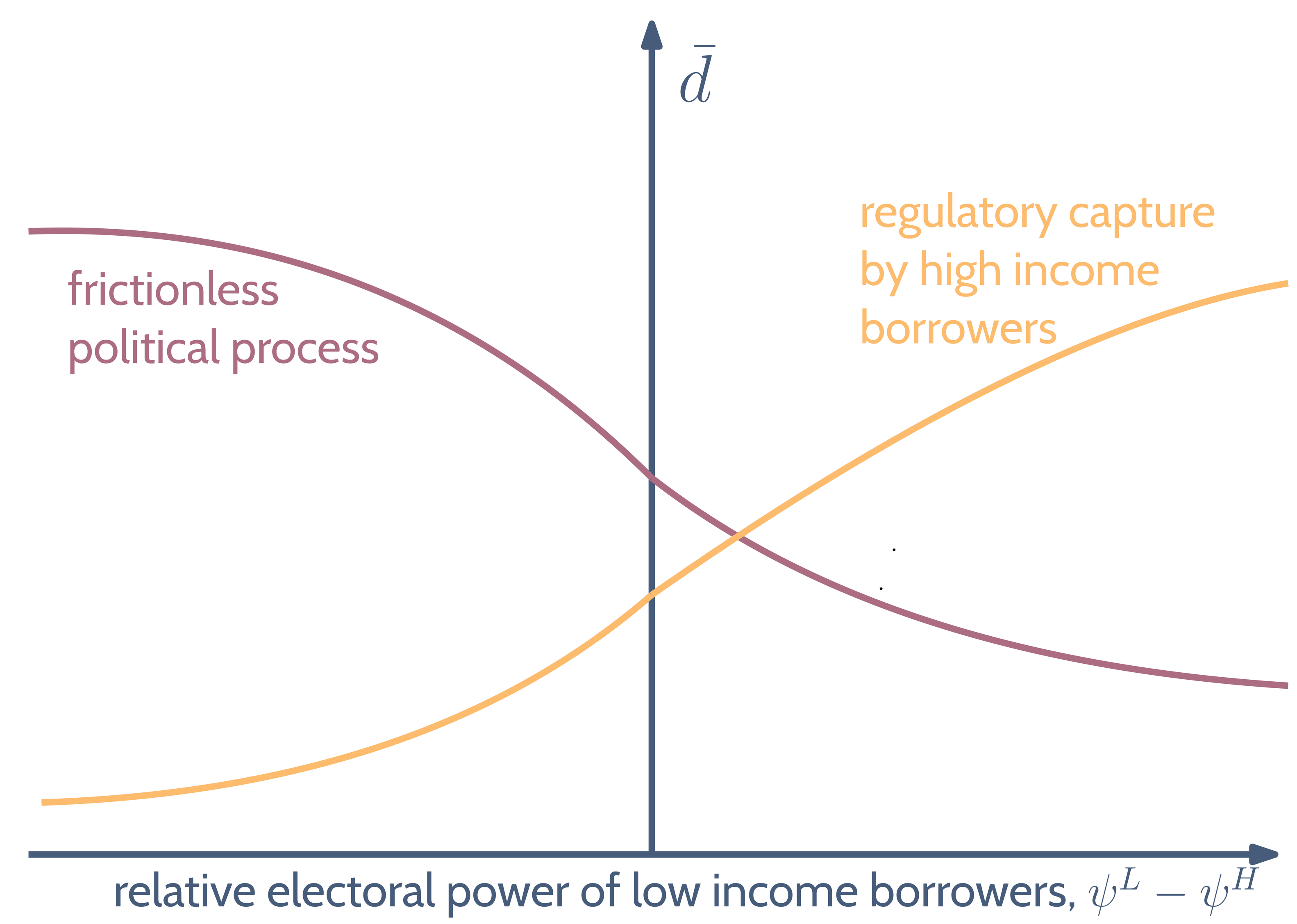
- Higher inequality → policy conflict ↑



Regulatory capture

= politically connected borrowers exempt from policy

- For politically **connected** only benefits of debt limit → **prefer low $\bar{d}$**
- Exemption → policy effectiveness ↓ → **non-connected prefer high $\bar{d}$**
- If politically connected = high income borrowers:



- **Imperfections in political process may reverse voter preferences**

Welfare:

- If *political process is frictionless* policy is constrained efficient
- With *regulatory capture* policy is:
  - Too lax if non-connected have high electoral power
  - Too tight if connected have high electoral power