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Regulatory Uncertainty Amid the Banking Crisis

By: Zhoudan Xie | April 6, 2023

In brief…

Recent bank failures drove regulatory uncertainty around finance and banking regulation to its highest point in over a year. However, the increase is not as prominent as many historical times and certainly not as large as it was during the 2007-08 financial crisis.

The recent bank failures once again cast doubt on financial regulation in the U.S. On the top of all the criticism of regulators' ineffective oversight, regulatory uncertainty adds extra panic and fear of another global financial crisis. In this commentary, I show that finance and banking regulatory uncertainty increased amid the banking crisis, possibly due to lack of clarity on what went wrong, but the change is not as large as it was during the 2007-08 financial crisis.

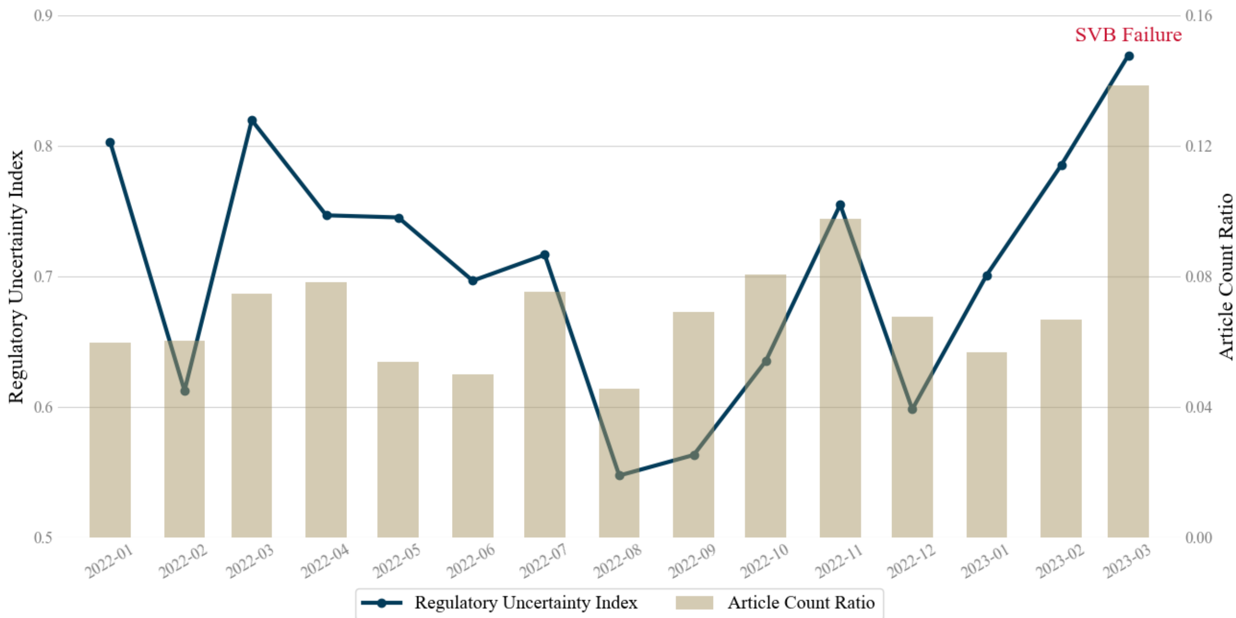
My recent research with Tara Sinclair[1] attempts to quantify regulatory uncertainty in the U.S. using natural language processing of newspaper articles to construct time-series measures going back to 1985. Specifically, we identified a news corpus related to regulation and different regulatory policy areas from major U.S. newspapers and measured the degree of uncertainty expressed in the corpus. Following the same method and using the latest news data, I have updated the measures through March 2023 to examine how finance and banking regulatory uncertainty changed with the collapse of Silicon Valley Bank (SVB) and Signature Bank.

Figure 1 plots two measures of regulatory uncertainty specifically around finance and banking regulation from January 2022 to March 2023. The first is the monthly regulatory uncertainty index (the navy line), which extends the same index in the previous research. While the measure reflects fluctuations over time, the change in March 2023 brings regulatory uncertainty to its highest point in the time period evaluated. As an alternative measure, the ratio of the number of news articles that express uncertainty around finance and banking regulation to the number of all regulation-related articles (the tan bars) also had a substantial increase in March. The ratio in March was 0.14, meaning that 14% of the news articles that discussed any

[1] Tara Sinclair is currently Deputy Assistant Secretary for Macroeconomics at the Department of Treasury. The views expressed in the research cited here are her own and do not necessarily reflect those of the Treasury or the U.S. government. The updated data and interpretation of the results in this commentary are my own work.

regulatory issues expressed uncertainty toward finance and banking regulation, compared to an average of 7% from January 2022 to February 2023.

Figure 1: Finance and Banking Regulatory Uncertainty (January 2022 – March 2023)

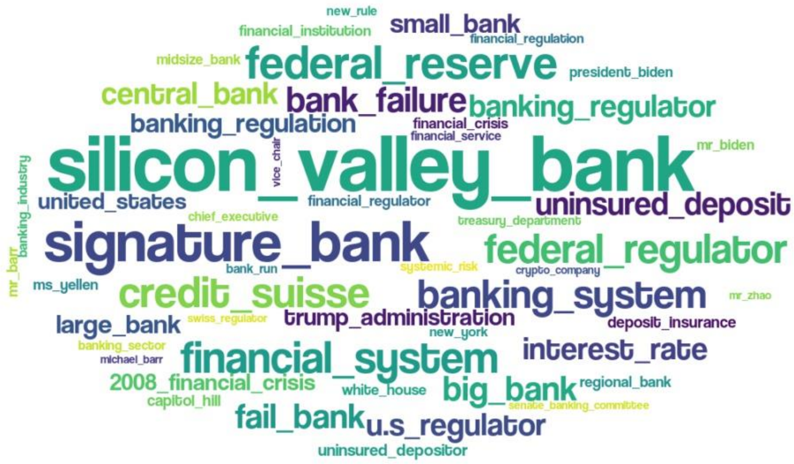


Notes: The regulatory uncertainty index is the monthly index of uncertainty around finance and banking regulation constructed using the method of Sinclair and Xie (2022). The article count ratio is the ratio of the number of articles that express uncertainty around finance and banking regulation to the number of all regulation-related articles in the month.

The word cloud shown in Figure 2 gives a glimpse of what was discussed in the news articles expressing finance and banking regulatory uncertainty in March. Unsurprisingly, SVB and Signature Bank were the central topics in the news. Terms like the Federal Reserve, Credit Suisse, banking regulators, and deposit insurance were also frequently mentioned. One who paid attention to relevant news could tell that the media discussion was mostly focused on blame for regulators' lack of supervision and neglect of risks in those financial institutions.

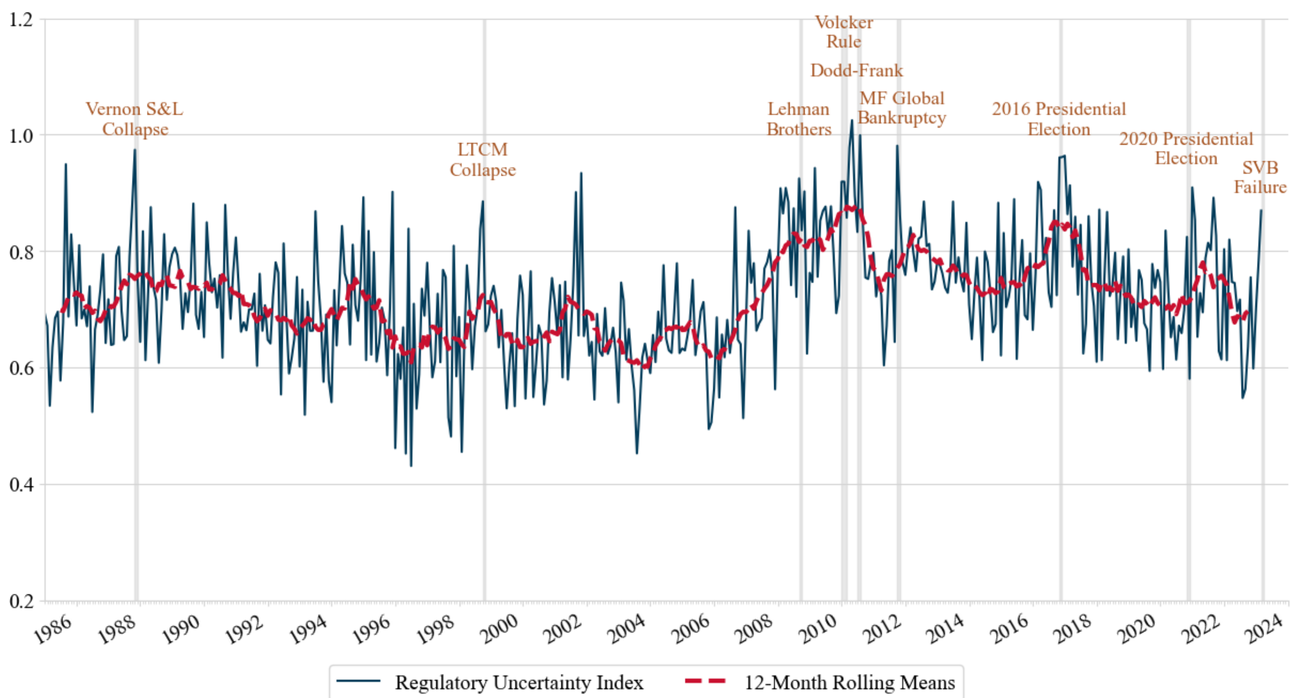
While policy uncertainty is generally perceived as forward-looking, often involving an unclear picture of what policy actions are coming in the future, the current regulatory uncertainty may stem from something else. With federal regulators' prompt promise to fully insure and protect all depositors and their balances at the two failed institutions, there is little uncertainty in terms of what regulatory interventions would be taken. Rather, a large degree of uncertainty comes from what happened instead of what's coming. While some claim that the bank failures are due to fundamental flaws in the regulatory system after the Dodd-Frank, government officials argue that it is the post-crisis reforms that prevented the worst-case scenario. It's not always easy to figure out what went wrong in the near past. As an article from the Wall Street Journal noted, "[b]anking regulators will spend months, if not years, getting to the bottom of what happened."

Figure 2: Word Cloud of News Articles Expressing Finance and Banking Regulatory Uncertainty in March 2023



From a historical point of view, is the current level of finance and banking regulatory uncertainty considered high? The answer is No. Figure 3 shows the monthly regulatory uncertainty index from January 1985 to March 2023. Despite a clear spike last month, the increase is not as prominent as many historical times and certainly not as large as it was during the 2007-08 financial crisis. Although some argue that regulatory uncertainty was a central cause of the financial crisis and that subsequent financial regulation was an attempt to reintroduce regulatory certainty, our systematically constructed measure suggests it did not succeed. Regulatory uncertainty related to finance and banking reached the highest point in 2010, when the Dodd-Frank Act was enacted.

Figure 3: Finance and Banking Regulatory Uncertainty (January 1985 – March 2023)



Notes: The figure plots the monthly regulatory uncertainty index around finance and banking regulation constructed using the method of Sinclair and Xie (2022).

At least in the case of the 2007-08 crisis, the most significant increase in regulatory uncertainty did not occur at the time of the market collapse but when new regulations in response to the crisis were issued. As such, uncertainty about how the policy regulators issued would be implemented and affect the market may be perceived more importantly by market participants than uncertainty about what policy decisions regulators would make in face of a crisis. This banking crisis is different from the 2007-08 financial crisis in many ways, but in terms of regulatory uncertainty, we may also see a larger increase if regulators respond to the recent bank failures with major changes to existing finance and banking regulations.