Financial Crisis and Regulatory Reform: Unfinished Business

Asli Demirguc-Kunt
The World Bank
March 27, 2012; Columbia Univ.

Causes of the Crisis…

- Macro policy and global imbalances made the crisis more likely…
- … but microeconomic policies that **distorted the incentives** were the real cause; subsidization of mortgage risk, regulatory failures, corporate governance problems..

…and Lessons

- Perhaps the most important lesson that good regulatory reform **must address incentives**.

  Reforms must address incentives of banks to avoid effective regulation and of supervisors, regulators and politicians to forebear.

  The problems of risk measurement, capital budgeting ex ante that is commensurate with risk, as well as the maintenance of capital in the face of losses are not just technical problems, but rather are mainly incentive problems.

- But how? The difficult question is how to implement such a framework

How to address incentives?

- Three thoughts:
  - Transparency and simplicity: Regulation should be simple rather than complicated
  - Claw back subsidies for the large and the interconnected: Fix the exit mechanism (TBTF)
  - Monitor incentives not regulations: Do not "audit" core principles, conduct "incentive audits."

Simple vs. Complicated?

- Crisis challenged the Basel framework in important ways (flaws with external ratings, accuracy of internal risk models, lack of disclosure and transparency..)
- Can we learn something about the usefulness/ possible redesign of bank capital regulation by looking at what happened during the crisis? (Demirguc-Kunt, Detragiache, Merrouche, 2011)
- For 381 banks in 12 countries we study quarterly stock returns over 2006-2009 period
- Using the crisis that started in August 2007 as an unexpected negative shock, we explore whether market participants perceived different capital definitions to be effective measures of banks' ability to withstand stress.
- All banks did poorly in terms of their stock market value, but some did better than others. Were better performing banks also better capitalized? Which "measure" of capital was most informative?

Simple vs. Complicated?

- During the crisis stock market investors placed higher value on better capitalized banks.
- The simple capital/total assets ratio (leverage ratio) more relevant than the Basel ratio, especially for large banks (crudest measure of risk exposure more informative than measure used by regulators)
- There is also evidence that "higher quality" Tier I capital and tangible common equity were more relevant for stock market investors
- What does this mean for capital regulation?

Simple vs. Complicated

- Required capital for a bank is complicated to calculate; but regulation need not be.
- Basel regulations still emphasize “risk-adjusted” capital which leads to manipulation, regulatory arbitrage.
- Much better to use simple easy to enforce and monitor ratios such as leverage ratio, complemented with signals from the market itself – transparency and increased disclosure
- Transparency and simplicity needs to be emphasized again, because complexity itself distorts incentives and makes banks invest in regulatory arbitrage which the markets readily dismiss..

Fixing the exit mechanism

- Need to credibly address the TBTF problem – without it the task of effective regulation becomes impossibly difficult.
- Not by introducing size or activity limits that have negative consequences…but by clawing back the incentives to become large and interconnected
  - Higher capital requirements
  - Living wills, shelf bankruptcies, greater crisis preparedness
  - Phase out explicit deposit insurance for large banks

Monitor Incentives

- Need an approach that identifies incentive problems on an on-going basis
- the current approach that emphasizes assessment of compliance with Basel Core Principles of Bank Supervision
- Huge resources are spent in an effort to emulate these principles and assess whether countries are compliant with various rules and regulations through Fund and Bank FSAPs
- But studies looking at the impact of compliance with BCPs and bank financial strength find no robust correlation, or at best with the principle that captures the quality of transparency and information provision (Demirguc-Kunt, Detragiache, Tressel, 2008; Demirguc-Kunt and Detragiache, 2011).

Incentive Audits?

- Propose "incentive audits" to identify perverse incentives giving rise to systemic risk become a core part of the financial architecture (Cihak, Demirguc-Kunt, Johnston, 2011)
- The need for a macroprudential authority is already acknowledged by the international community, but the approaches that are envisaged are prudential add-ons.
- But we propose that the focus of the macroprudential regulator should be incentive audits as a means of identifying and correcting systemic risk.
- Similarly FSAPs can move away from compliance with principles to an assessment of incentive problems through use of incentive audits in individual countries