Comments on "The global roots of the current financial crisis and its implications for regulation"

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0. Introduction

This is a very useful paper with three main themes:

♦ Analysis of the reasons for the over-exposure of banks.

♦ Discussion of alternative principles for capital regulation.

♦ A specific proposal for capital regulation.
1. Over-exposure of banks

♦ Crisis due to a combination of two factors:
  – Substantial amounts of MBS’s remained in the commercial and investment banks.
    ⇒ Why did MBSs become popular? Some reasons are:
      - Low interest rates and savings glut shifted the focus of investors on housing markets.
      – These risky assets were financed by short-term borrowing.
♦ The deep explanation comes from agency problems in banks:
  – In incentive schemes it is difficult to separate genuine excess return from increased risk-taking (outcomes realized after a lag).
  – Short-term debt finance of banks is a natural response to agency problems in equity and to high liquidity of assets held by banks.
♦ The downturn in housing prices exposed the implicit risks and led to asset price decline.
♦ Banks forced to ”fire sales”, which created further price declines and thus a negative externality on other banks.
♦ The previous externality is associated with adjustments that use a lot of capital
  => cuts in lending to businesses. (A credit crunch externality)
♦ I think that there is a further externality and market failure:
  – The losses led to liquidity problems for and solvency concerns about individual banks.
  – This created a ”lack of trust externality” between banks, which in dried up interbank-funding markets.
2. Principles for regulatory reform

♦ Improvements to bank governance:
  – Employee compensation should be tied to longer-term performance.
  – Profit measures should be risk-adjusted.
  ⇒ Authors suggest that these are not regulation issues, but belong to internal governance. Comments:
    • Employee compensation is a major public concern, but not a regulation issue.
    • Risk-adjusted performance measures might be subjected to regulatory inspection.
Higher capital requirements (traditional view):
- These are costly because of high costs of equity.
- Higher capital requirements do not avoid the fire-sale externality.
- Traditional regulation forms do not deal with the viral nature of financial innovation.
- Cyclically-adjusted requirements would offer some help.

Government (and private) recapitalization of banks is a response to fixe-sale and credit crunch externalities.

Recapitalization and public guarantees of bank debt are a response to interbank market failures.
3. Capital Insurance

♦ Banks to buy insurance that pays off in states of the world in which the overall banking system is in trouble.
  – Insurer buys treasury bills and puts them in a ”lock box”.
  – Insurance money returned to insurer with premia by banks and interest on treasuries if no systemic event occurs.
  – If the event occurs, then agreed sums of funds transferred to bank’s balance sheet.
  – A trigger mechanism invoked to decide on insurance payments.
  – Thresholds and caps to payments and also staggering of contracts to ensure smooth functioning.
Comments and questions on the KRS proposal:

- The proposal would largely be a "private solution" to recapitalization.
  - In some earlier crises private solutions were emphasized, but in big crises (e.g. Nordic countries) they were usually insufficient.

- The supply side of capital insurance is not discussed.
  - Pension funds usually have requirements or restrictions on forms of asset holdings.
    => They cannot provide the insurance. Which institutions can?

- "High water marks" based on the aggregate of banks mean that insurance paid out only in a sufficiently big crisis.
  - Such crises are systemic with most banks in trouble.
  - High aggregate losses arise from correlated portfolios and realized systemic risks.
  => Is supply of capital insurance available in such situations?
♦ Capital insurance can have its own moral hazard concerns:
  – Reduced incentives to hedge against crisis.
  – Possible incentives for excessive risk-taking.

♦ Global aspects of the KRS proposal:
  – It is suggested that banks obtain insurance separately in the different countries in which they operate.
  – This can be cumbersome for international banks (e.g. HSBC in 88 countries).
  – A lot of coordination and probably public regulation would be required.

♦ A very thoughtful and inspiring paper. However, the KRS proposals require quite a bit of further analysis.