Post Crisis Regulatory challenges

Xavier Freixas

Universitat Pompeu Fabra and CEPR

Outline

- The crisis
- Regulatory failure
- Regulatory reform
- Why the current regulatory trend is dangerous

The crisis

- Capital shortage crisis? (Calomiris)
- Complexity of financial instruments crisis (Gorton)?
- Asset bubble crisis?

A classical systemic crisis

- Macroeconomic fragility
- Contagion
- A trigger

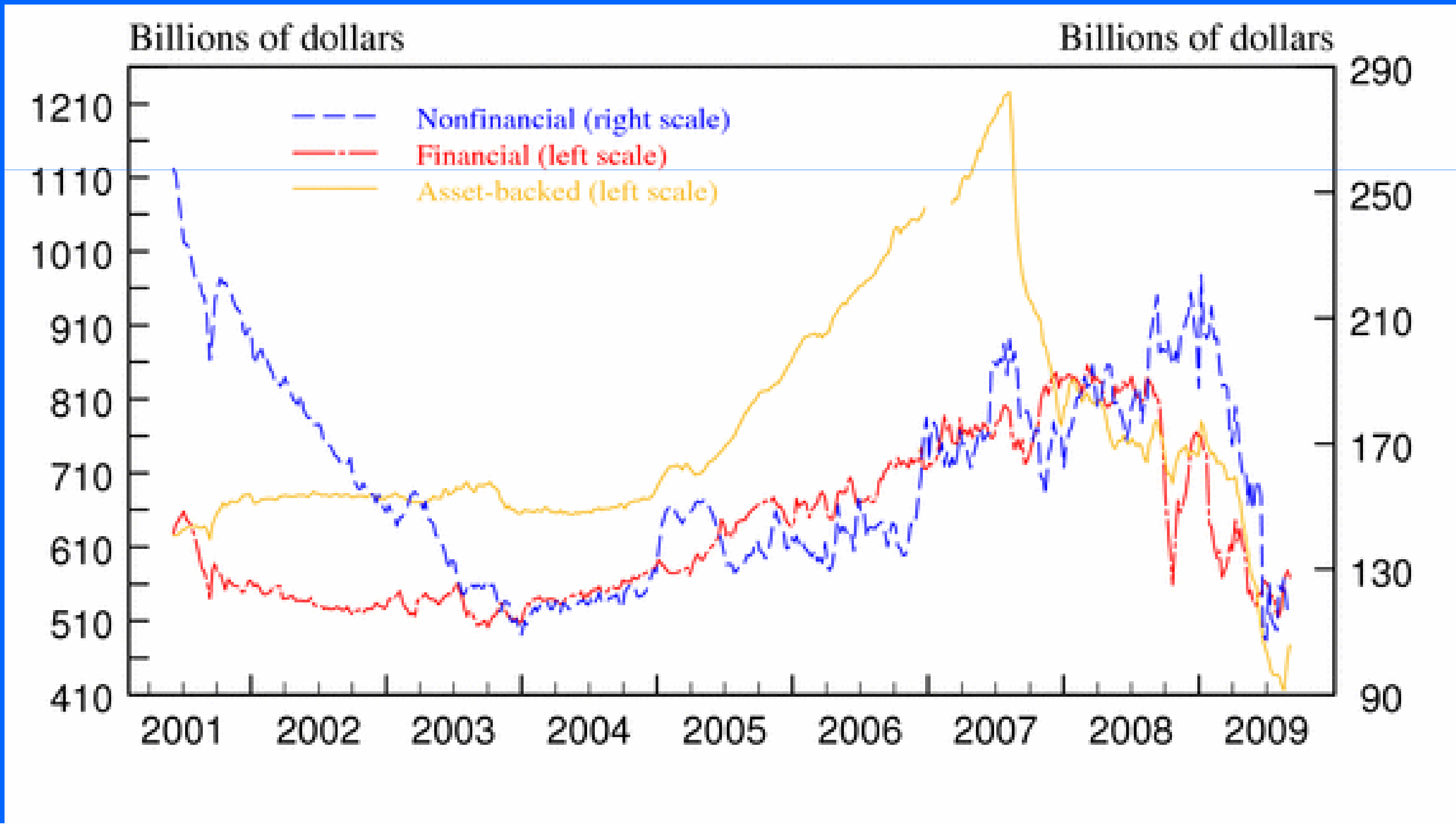
- But a new contagion channel

Macro Fragility: financial imbalances and bubbles

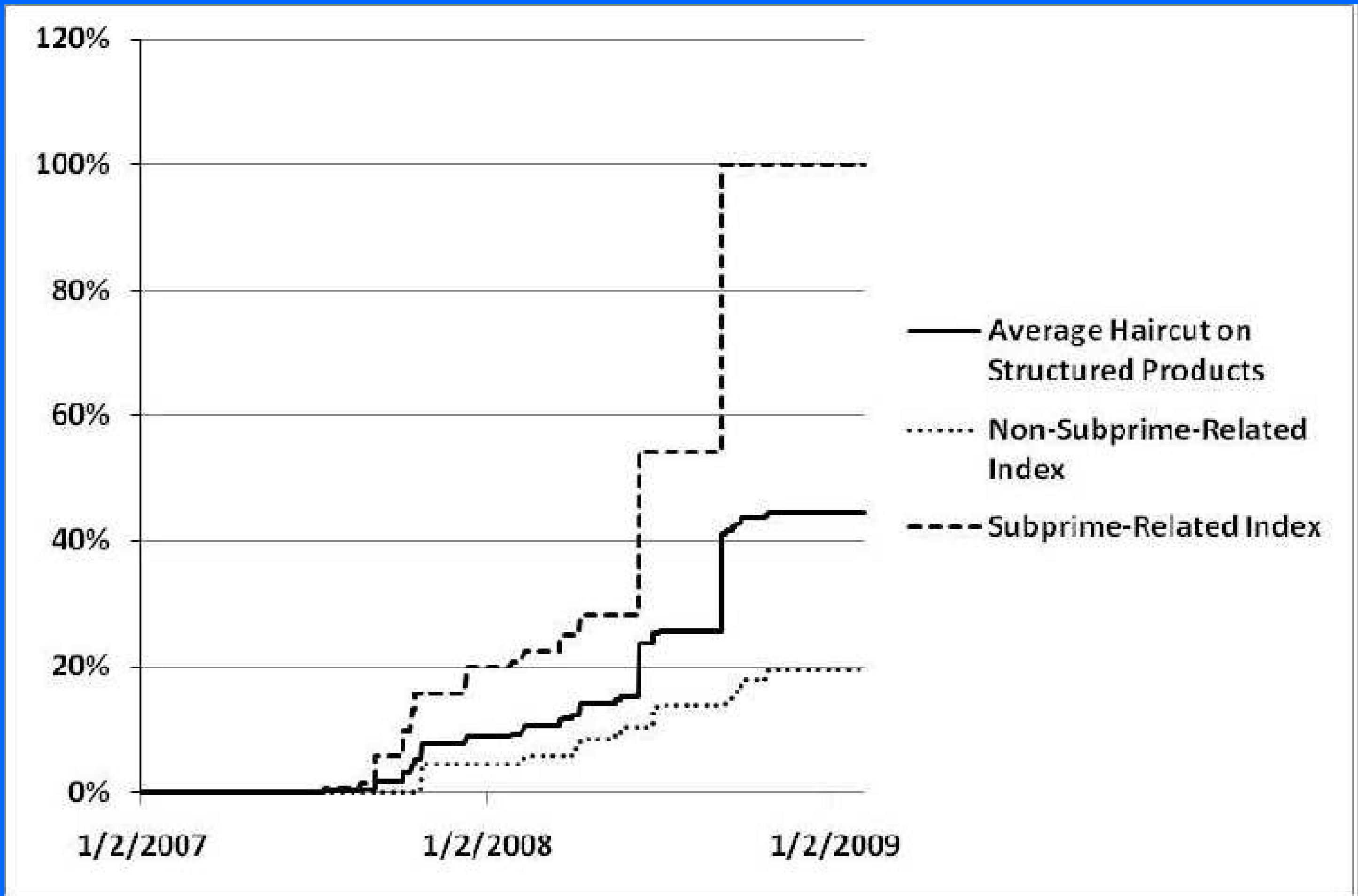
- The savings glut
- Bubbles:
  - The stock market
  - The CDS market
  - The real estate market

Contagion through liquidity squeeze

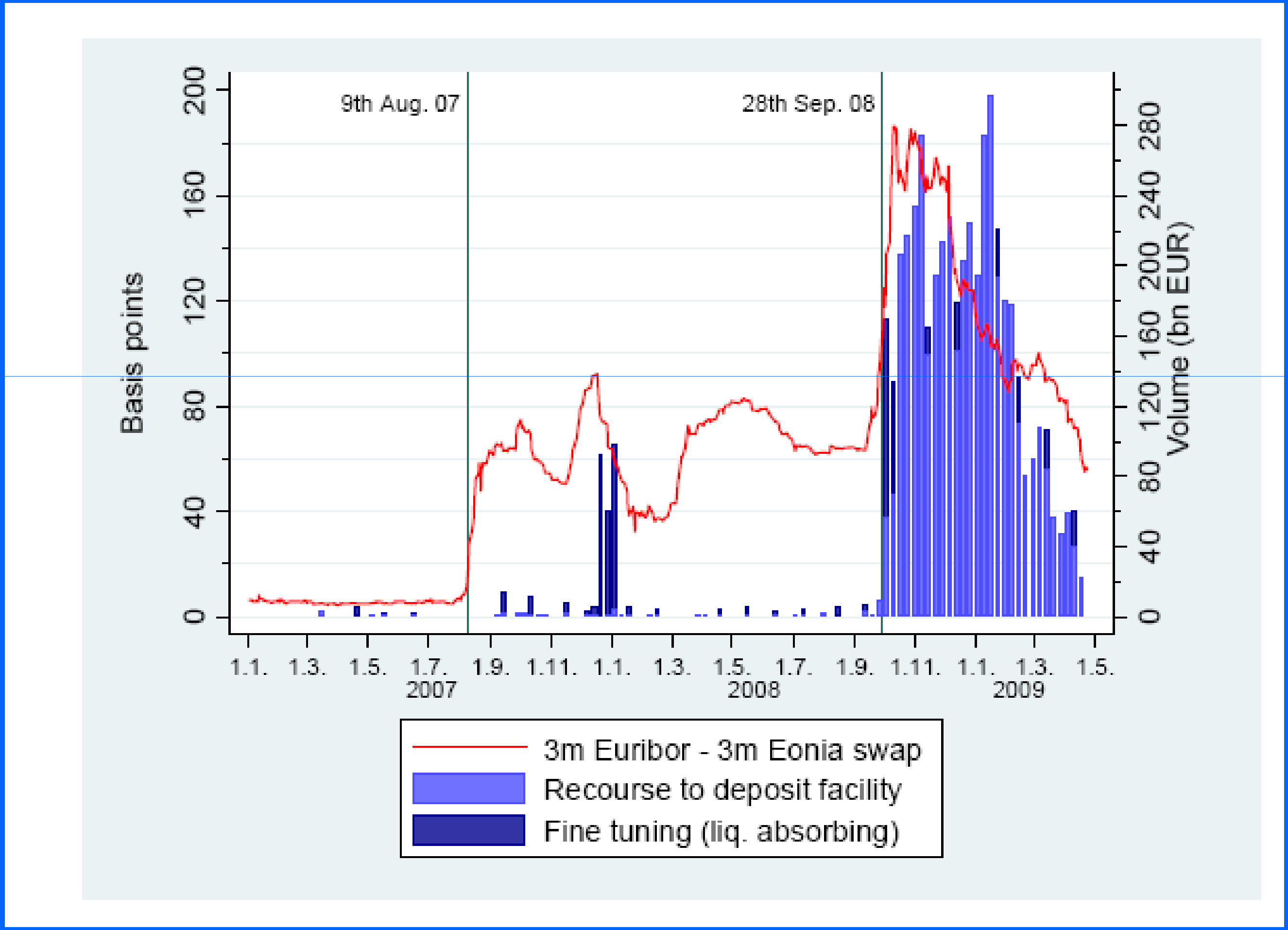
- Liquidity freeze



Haircuts (Gorton 2008)



Hoarding


9th Aug. 07
28th Sep. 08
Basis points
0
40
80
120
160
200
Volume (bn EUR)
0
40
80
120
160
200
240
280
1.1.
1.3.
1.5.
1.7.
1.9.
1.11.
2007
2008
2009
3m Euribor - 3m Eonia swap
Recourse to deposit facility
Fine tuning (liq. absorbing)

Contagion Innovations (II)

- Liquidity driven market contagion
  - Market collapse
  - Haircuts effects
  - Dynamic leveraging
  - Fire sales
  - Hoarding
- Capital driven market contagion
  - Procyclicality

Regulatory failure

Why regulation?

- Standard answer: to limit bankruptcies, contagion and its effects.
- Safety net:

  Supervision

  Deposit insurance

  Capital requirements

  Lender of last resort

  Orderly bail-out/liquidation

Has the safety net failed?

	Pass	Failed
Supervision		X
Deposit insurance	X	
Capital requirements		X
Lender of last resort	X	
Orderly bail-out/liquidation		X

The main issues I: banks' bankruptcy rules

Customers vs. Creditors

Contingent contracts:

- Converse convertibles
- Debt equity swaps
- Good bank/bad bank
- Living wills

Jensen criticism

The main issues II: banks' corporate governance

Who owns a bank?

Shareholders

Debt holders

Taxpayers

Banks' risk taking depend upon corporate governance.

Regulatory Reform

- G-20
- De Larosière (Europe)
- Basel III
- Dodd’s proposal
- Partition the too-big-to-fail banks

Safety Net Recommendations:

- Improving capital requirements

1. Compute anticyclical credit provisions and include an anticyclical mechanism in pillar 2
2. Compute higher weights for OTC derivatives and for quasi-securitized issues
3. Correct the price of collateral for possible bubbles (Moving average, Net present value of future rents,…)
4. Correct for discrepancies between ratings and spreads
5. Compute maturity mismatch capital charge

Safety Net Recommendations (II):

- Orderly bail-out/liquidation

1. Design a specific banks' bankruptcy law
2. Incentive banks to be structured as holding companies that allow for partial merger and liquidations
3. Define an ex ante international burden sharing mechanism with clear cut credible rules

Beyond the safety net

1. Macroprudential policy
2. SIFI (Systemically Important Financial Institutions)
3. Consumer protection

Disclosure and market discipline

- Improve disclosure to the market
  - Simple vs. complex rules
  - Regulate Credit Rating Agencies
- Improve disclosure to the client

The cost of regulation

- Cost of capital increase
- What about Canada or Poland?

Why the current regulatory trend is dangerous

- The reason for regulation is the cost of banks' bankruptcy
- The reason for risk taking is the incentives structure of banks
- The efficient regulatory reform should go to the source of the problem: change bankruptcy rules and corporate governance
- Failing to address these issues will lead to an inefficient banking industry.

Conclusion

- Important changes to come
- Two main roads
  - Extended deposit insurance
  - Contingent claimholder rights