The International Financial Crisis and the Future of Financial Regulation

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LACEA-LAMES 2009

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2 October 2009

"We must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again."

G20 Washington Summit

15 November 2008

"Since the onset of the global crisis, we have developed and begun implementing sweeping reforms to tackle the root causes of the crisis and transform the system for global financial regulation."

G20 Pittsburgh Summit

24-25 September 2009

Introduction

- Major overhaul of financial regulation is under way
- Four “critical areas” noted in the Pittsburgh declaration
  - Building high quality capital and mitigating pro-cyclicality
  - Reforming compensation practices
  - Improving over-the-counter derivatives markets
  - Addressing systemically important financial institutions

Focus of presentation

- Capital requirements
- Liquidity risk requirements
- Counter-cyclical capital buffers
- Systemically important financial institutions

Capital requirements

- Pittsburgh declaration
  - Commitment to adopt Basel II framework by 2011
  - Higher quantity of capital
  - Higher quality of capital
  - Higher capital for risky products & off-balance sheet
  - Leverage ratio as supplement to Basel II
  - Phase in as conditions improve (end of 2012)

Comments on capital requirements

- Adoption of Basel II framework: strongly agree!
  - Basel II should not be blamed for crisis
  - What would be the alternative?
  - Go back to risk-insensitive (Basel I-type) of regulation?

- However: do <u>not</u> underestimate implementation problems

  → Will banks have incentive to report true internal ratings?

Comments on capital requirements

- Higher quantity and quality of capital: strongly agree!
  - Increase reference value (Tier 1 + Tier 2) of 8%
  - Increase Tier 1 reference value of 4%
  - To what level? → I would favor doubling Tier 1 to 8%

- However: won't this lead to huge increase cost of credit?

  → Effect would be relatively small (even without MM)

$$\boxed{\Delta r = \Delta k \times \text{cost of capital} = 0.04 \times 0.06 = 24\text{bp}}$$

Comments on capital requirements

- Higher capital for risky products: strongly agree!
  - Gross underestimation of market risks in Basel II
  - Calibration should be easy: use data from crisis period
- Higher capital for off-balance sheet activities: strongly agree!
  - Problem was (in part) weak enforcement of rules
  - Simple solution: strong enforcement of rules
  - Need to worry about quality of bank supervision

Comments on capital requirements

- Leverage ratio as supplement to Basel II: probably agree
  - Limit to the ability of banks to fool the system
  - It should not be the binding constraint

Liquidity risk requirements

- Unclear what future regulation will be
  - Single reference to "strengthened liquidity requirements"
  - Included in the section on higher capital

Comments on liquidity risk requirements

- What would <u>not</u> be reasonable: minimum liquidity requirements
  - Very difficult to calibrate
  - Goodhart's critique: required liquidity is not usable liquidity
  - With higher capital funding risk should be less of a problem
  - Disciplining role of short-term wholesale financing

    → Huberman and Repullo (2009)

Comments on liquidity risk requirements

- What could be reasonable: capital charge for liquidity risk
  - Put a price on the externalities caused by liquidity risk
  - Based on net short-term wholesale borrowing

Counter-cyclical capital

- Unclear what future regulation will be
  - Confusion among regulators about nature of problem
  - Risk of throwing the baby (Basel II) out with the bath water

Comments on counter-cyclical capital

- What is the problem?
  - Basel II capital requirements are risk-sensitive
  - A lot more capital will be required in recessions
  - Possible credit crunch

    → Repullo and Suarez (2008)

Comments on counter-cyclical capital

- What can be done?
- Two alternatives
  - Smooth inputs of Basel II formula: TTC ratings
  - Smooth output of Basel II formula: macro multiplier
- Regulators worldwide like through-the-cycle (TTC) approach
- This is a very bad idea → risk of throwing out Basel II baby

Comments on counter-cyclical capital

- What is wrong with through-the-cycle (TTC) approach?
  - No consensus on precise meaning of TTC
  - Leaves a lot of discretion to supervisors
  - Risks of un-level playing field

Comments on counter-cyclical capital

- Unconditional (on the state of the economy) risk assessments
  - Go against requirement of using "all relevant and material information in assigning ratings" (Basel II, par. 426)
  - Inadequate for risk pricing and risk management
  - Fail "user test"

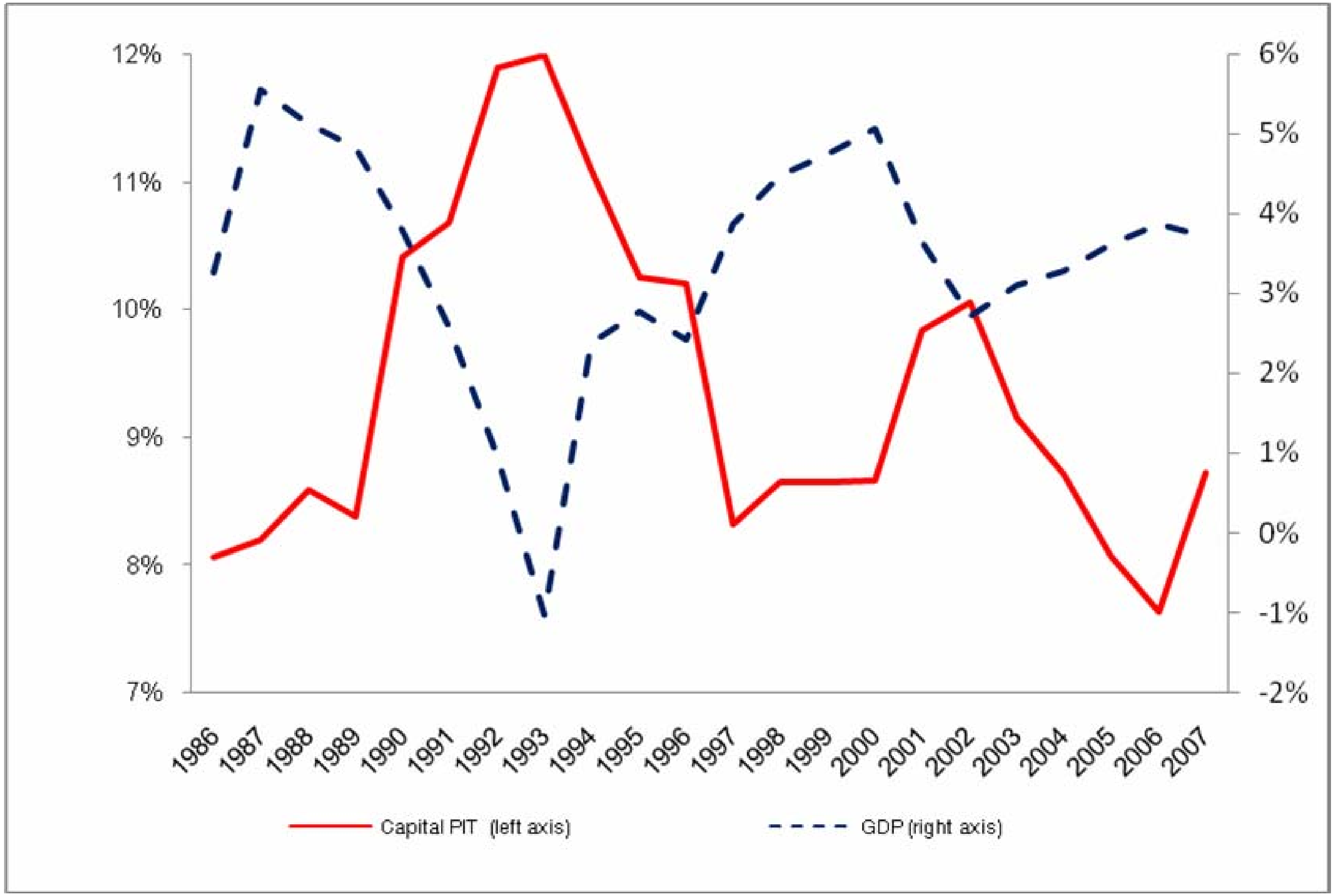
    → Make it difficult to verify truthful reporting of risk

Comments on counter-cyclical capital

- What could be done?
  - Basel II capital requirements correlated with GDP growth

    → Repullo, Saurina, and Trucharte (2009)

Capital requirements and GDP growth



Comments on counter-cyclical capital

- What could be done?
  - Business cycle multiplier based on GDP growth
  - Multiplier greater than one in expansions
  - Multiplier smaller than one in recessions

Systemic financial institutions

- Pittsburgh declaration
  - Prudential standards commensurate with costs of failure
  - Specific additional capital and liquidity requirements

Comment on systemic financial institutions

- What would <u>not</u> be reasonable: use size of balance sheet
  - Large banks are very different in terms of systemic risk
- What could be reasonable: use risk-weighted assets
  - Additional capital charge related to size
  - No specific liquidity requirements
  - But capital charge for liquidity risk

Concluding remarks

- Need proper analysis of regulatory trade-offs
  - → Risk of inefficient (or even counterproductive) regulation
- Do not underestimate self-correcting market mechanisms
- Do not overestimate regulatory and supervisory capabilities
- Significantly increase research budgets
  - → Policy mistakes are very expensive
  - → It makes a lot of sense to invest in crisis prevention