Post Crisis Regulatory challenges

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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
- Insufficient: Macroprudential and SIFIs regulation was missing

The safety net performance

- Deposit insurance and lender of last resort have been crucial in limiting the extent of the crisis
- But Supervision, Capital requirements and bail-out/liquidation were insufficient.

Redesigning the safety net

- Start with efficient bank bankruptcy rules and bank restructuring mechanisms
- Two major roads:
  - Banks are fully insured by taxpayers and should be treated as utilities
  - Banks' liabilities holders should pay the bill, which has implications on banks' shareholders incentives

Banks’ bankruptcy rules

- Distinguish the payment system from banks’ long term liabilities
- Why debt is required: tax shield or agency problems?
- Contingent contracts:
  - Reverse convertibles
  - Contingent Capital
  - Debt equity swaps
  - Living wills and Good bank/bad bank

Supervision failure

- Partial equilibrium is not enough
- Risk models were incorrect as bubbles were not taken into account
- Internally designed stress tests were ineffective
- Inadequate corporate governance
  - Who owns a bank?
  - Internal risk management (fake alpha)
  - Implicit bail-out guarantees
  - Incompetent management (Iceland)

Capital requirements pitfalls

- Measurement errors
  - Tier 1 –Tier 2
  - Liquidity
  - Accounting for asset bubbles
  - Securitization
  - OTC options
  - Procyclicality
    - TTC vs PIT
    - Provisioning

Market discipline

Market discipline is not the answer

Bank runs vs. market discipline

The non-existing role or financial statements reporting in a crisis

The role of Credit rating agencies in delegated monitoring

Multiple regulators in the international set up

Multinational crises

- – Domestic mandate
- – Cross border externality
- – Higher agency costs
- – Higher intervention costs

- A Financial Trilemma (Schoenmaker)

International banks' bankruptcy law

- Territoriality or universality
- A precondition for universality: pre-commitment to a burden-sharing agreement
- Branches vs. subsidiaries
- Create mechanisms to cope with multinational banks crises, starting with a European deposit insurance mechanism

Macro prudential regulation

1. Early warning mechanisms
2. Compute SIFIs risk (CoVar, MES,…)
3. Emergency recapitalization: capital insurance?
4. Monitor financial risk (General equilibrium, liquidity, bubbles) not just banking risk
5. Declare and manage systemic crisis

Disclosure

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

Conclusion

- Important changes to come
- Two main roads
  - Extended deposit insurance and strict regulation
  - Contingent claimholder rights, improved corporate governance and low taxpayers cost