

Systemic Crisis Prevention and Resolution: Towards a More Balanced Architecture

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Outline

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Based on: De la Torre and Ize (2009). "Regulatory Reform: Integrating Paradigms," World Bank Working Paper #4842, February.

Three fundamental drivers of systemic crises

✚ Principal-agent frictions

- ✦ Source of trouble: taking advantage of the less informed or farther removed by levering one-sided bets
- ✦ Moral hazard-driven behavior (including regulatory arbitrage), once in motion, can accumulate risk and make a crisis inevitable, as agents have little of nothing to lose

✚ Externalities (individual-group frictions)

- ✦ Source of trouble: wedge between private and social risks/returns
- ✦ Regulatory arbitrage driven by un-internalized externalities
- ✦ Free riding via high leverage with short-term wholesale funding
- ✦ Fallacy of composition

✚ Mood swings (group-reality cognitive frictions)

- ✦ Source of trouble: getting carried away in the midst of evolutionary uncertainty
 - Limited capacity to understand systemic implications of creativity and innovation
 - Emotional decisions or rational decisions based on deficient information
- ✦ Exuberance on the way up – “this time it is different, things are under control”
- ✦ Panic on the way down – fear of the unknown; acute risk aversion and recoiling

Systemic crises prevention & resolution architecture

✚ Main components

- ✚ Prudential oversight → Ex-ante
- ✚ Lender of last resort (LOLR) } Ex-post
- ✚ Deposit insurance } Ex-post
- ✚ Failure resolution } Ex-post

✚ Soundness of architecture depends on how well it responds to the fundamental drivers of crises

✚ Not an easy task

- ✚ Drivers of crises interact in complex ways
- ✚ Observed facts are consistent with the three drivers (problem of attribution)
- ✚ Tensions and tradeoffs – regulatory policy responses to address problems associated with one of the drivers often worsen problems under the other
 - E.g., safety net raises moral hazard; disciplining runs accentuates negative externalities
 - See tables 2-4 in De la Torre and Ize (2009)

Current architecture is unbalanced

- ✦ Prudential oversight focuses mainly on principal-agent frictions
 - ✦ Capital requirements seen mainly as “skin in the game” to align P-A incentives
 - ✦ Resistance to regulate non-deposit taking intermediaries that borrow from the “sophisticated and well-informed” (wholesale funding markets)
 - ✦ Regulation not explicitly linked to intermediaries’ contribution to systemic risk
 - ✦ No explicit regulatory pricing of LOLR-enhanced option value to lend-short-and-run
 - ✦ Actual resolution regimes in many countries focus on liquidation – i.e., emphasize discipline (no bailout) but are deficient in terms of mitigating contagion risk
- ✦ Externalities do provide a rationale for LOLR and deposit insurance, but focus is on their ex-post role
- ✦ Mood swings completely ignored under current architecture
 - ✦ Mainstream finance has been dominated by “efficient markets” hypothesis

Towards a more balanced architecture

Reducing dynamic regulatory arbitrage

- ✦ In addition to moral hazard-driven arbitrage, focus should also be on arbitrage driven by individual-group wedges
 - ✦ Un-internalized externalities
 - ✦ Free riding
 - ✦ Coordination failures
- ✦ Hence, minimize unevenness in regulation across *all* intermediaries
 - ✦ This is inconsistent with the popular proposal of using “systemic importance” as the criterion to decide what intermediaries should be brought under prudential regulation
- ✦ There is no need to fuel regulatory arbitrage in order to:
 - ✦ Deal with TBTF/TITF issues – instead, put in place suitable ex-post resolution tools
 - ✦ Induce internalization of systemic risk – instead, introduce a suitable Pigovian tax
- ✦ The tradeoff – new regulatory perimeter can hinder competition and innovation
 - ✦ See proposal to mitigate this effect in De la Torre and Ize (2009)

Towards a more balanced architecture

Internalizing systemic risk of ST funding

- ✦ Popular proposal to focus on maturity mismatches is misguided, as it does not take externalities into account
 - ✦ Matching short assets to short liabilities protects an individual intermediary at the expense of exacerbating systemic vulnerability
 - ✦ Under systemic events, short loans become as illiquid as long loans
- ✦ Focus should be on the maturity of uninsured liabilities
 - ✦ ... net of systemically liquid assets
 - ✦ The shorter the maturity the higher the tax
 - ✦ This would induce investors to retain more of the liquidity risk onto themselves...
 - ✦ ...without allowing intermediaries to offset this tax and pass it on to someone else downstream via short lending
- ✦ The tradeoffs
 - ✦ Pigovian tax would increase the *private* costs of maturity transformation...
 - ✦ ... and would limit the ability of principals to use the “short leash” to discipline agents

Towards a more balanced architecture

Dampening mood swings

- ✦ Introduce judgment-based countercyclical prudential norms
 - ✦ Focus: unexpected elements of aggregate cycle dynamics
 - Discretion (depending on circumstances) is needed for real time calibration
 - ✦ Objective: dampen the cycle and enhance systemic resilience to tail events
 - ✦ Function: to overcome coordination failures
 - ✦ Authority: Central bank
- ✦ Develop “scouting capacity” as part of systemic oversight
- ✦ Ex-post: risk-absorption by the government in extreme circumstances?
 - ✦ The Arrow-Lind argument
 - ✦ Balance sheet: Central Bank? Development banks? Ministry of finance?
 - ✦ Should this be clear ex-ante in the law? Or are constructive ambiguity and ad-hoc legal reform once the crisis erupts better?

Towards a more balanced architecture

Improving resolution tools

- ✦ Minimize asset value destruction
 - ✦ Professional asset management
 - ✦ Incentives of stakeholders – i.e., uninsured liability holders, deposit insurance
- ✦ Minimize contagion risk
 - ✦ Balance sheet interconnection; interconnection via markets
 - ✦ Resolution powers should cover all intermediaries
 - ✦ Special powers and options to deal with TBTF/TITF institutions
 - ✦ Netting of derivatives positions (multilateral netting or CCC)
 - ✦ Coordination with CB regarding emergency liquidity
 - ✦ Not too low a deposit insurance limit can facilitate resolution
- ✦ Contain moral hazard
 - ✦ Clear priority of claims ladder for uninsured liabilities
 - ✦ Pre-wiring (e.g., Chile) – uninsured liabilities become “participations in a mutual fund”
 - ✦ Haircuts and partial carve-outs of uninsured liabilities

END

