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The 2007-08 financial crisis: a policy agenda

FSA Congres

Amsterdam
04-21-2010

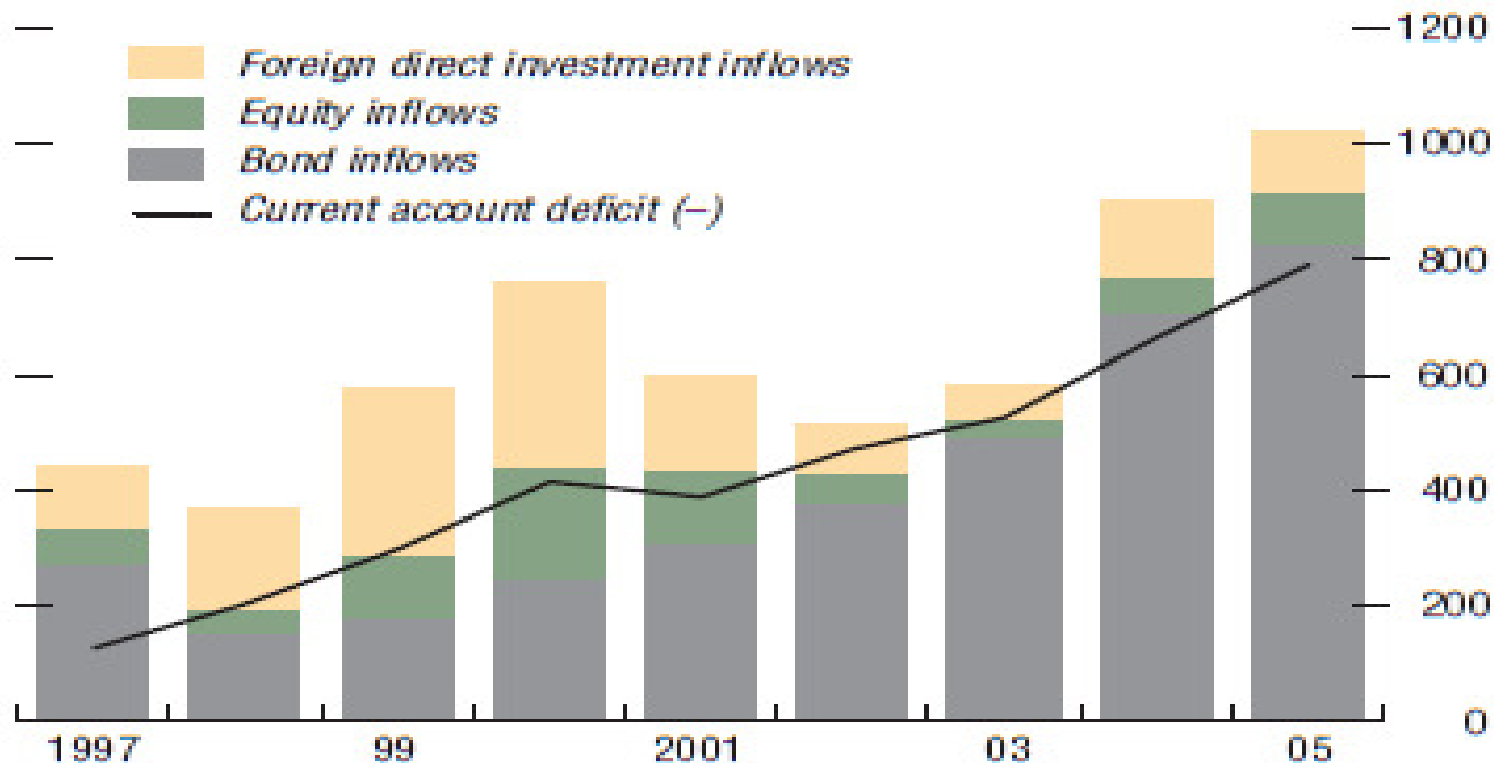


Coen Teulings
Directeur Centraal Planbureau

Global imbalances

source: IMF GFRS Apr. 2007

Figure 1.13. Sources of Financing for the U.S. Current Account Deficit
(In billions of U.S. dollars)

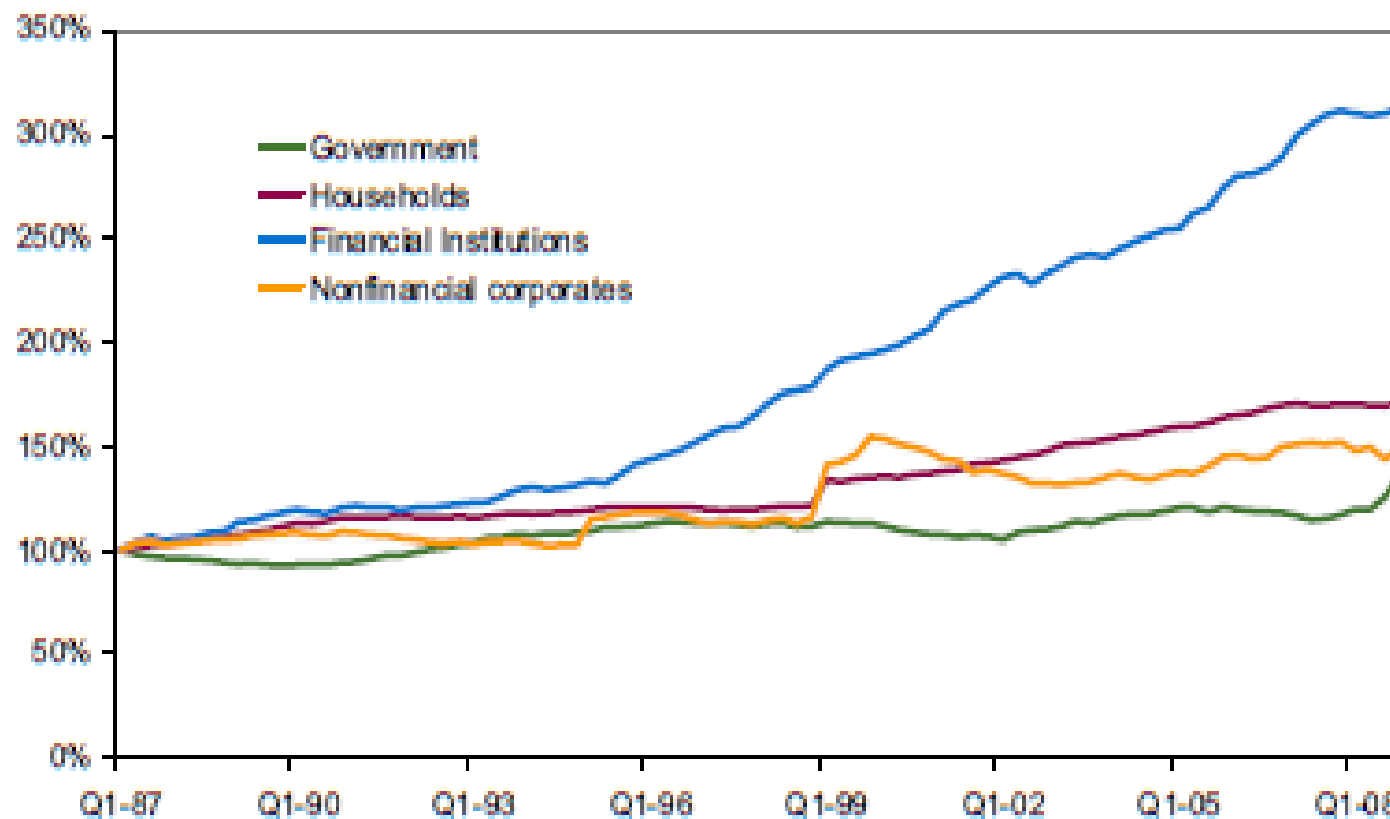


Source: IMF, *International Financial Statistics*.

Rising leverage FI

source: IMF GFRS Apr. 2009

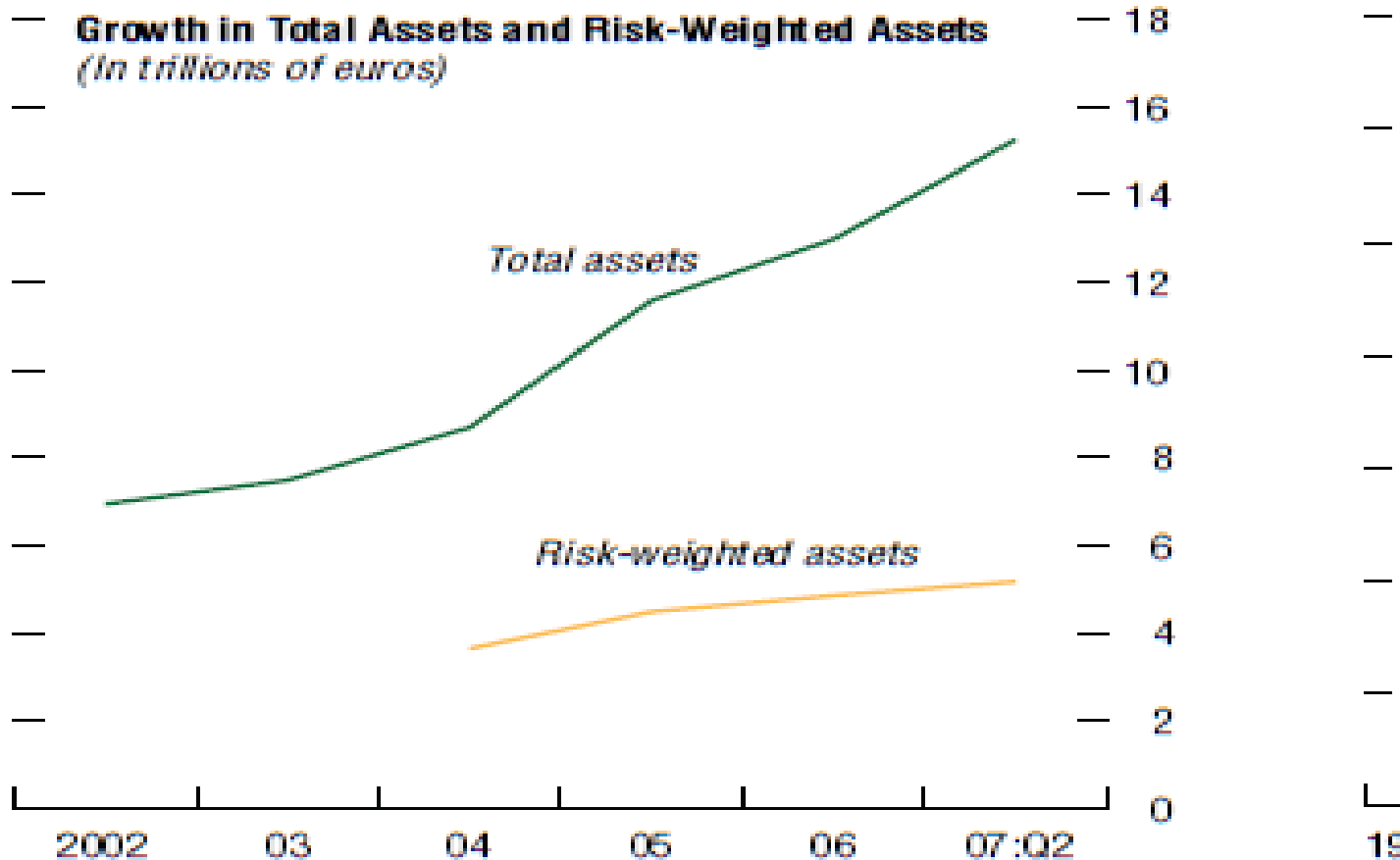
Figure 1.3. Ratio of Debt to GDP Among Select Advanced Economies
(In percent, GDP-weighted, 1987 = 100)



Increasing gap risk-weighted & total assets

source: IMF GFRS Apr. 2008

Balance Sheet Profiles for 10 Large Publicly Listed Banks

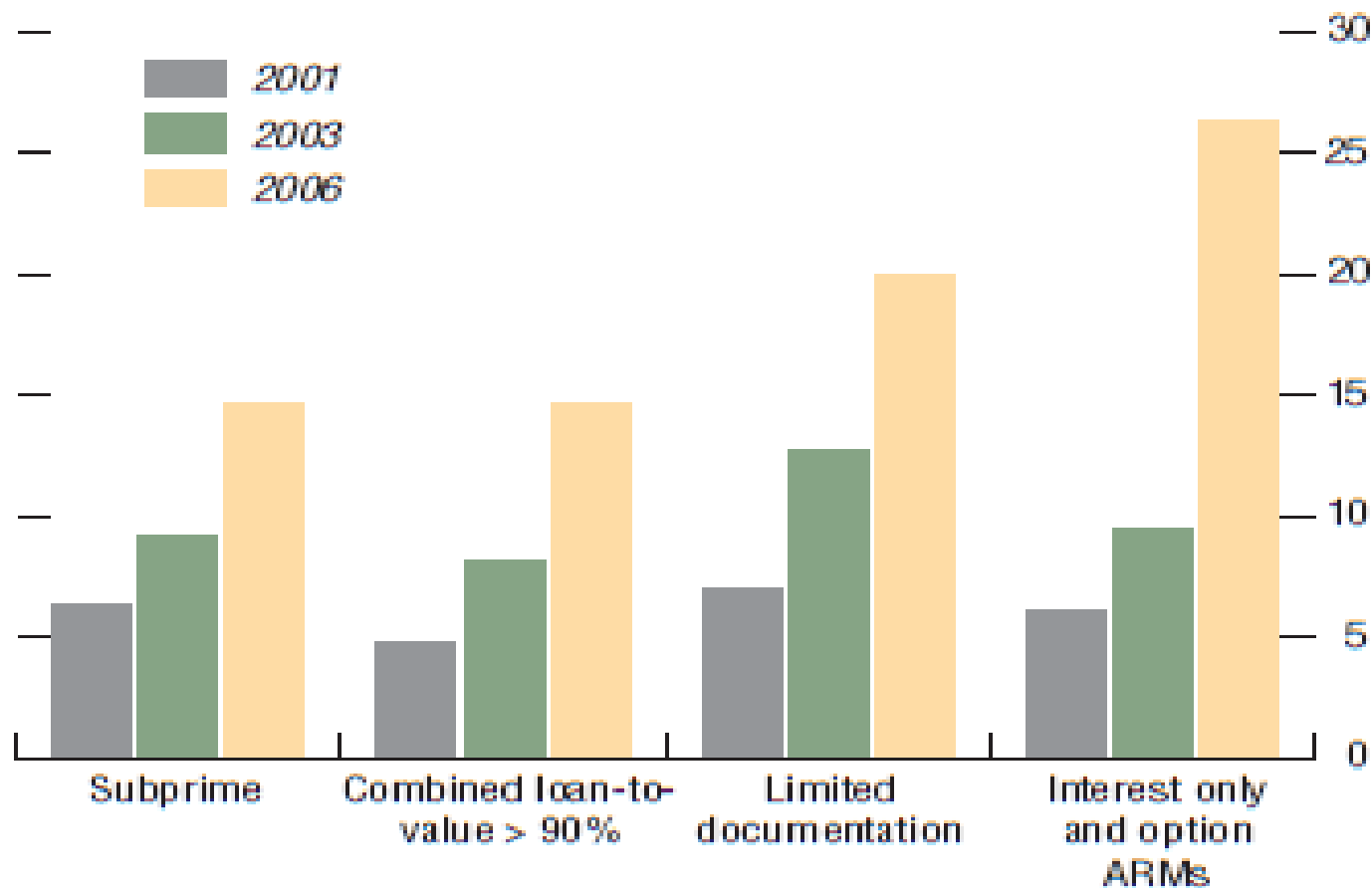


Sources: Thomson Financial; and IMF staff estimates.

Deteriorating quality mortgages

source: IMF GFRS Apr. 2007

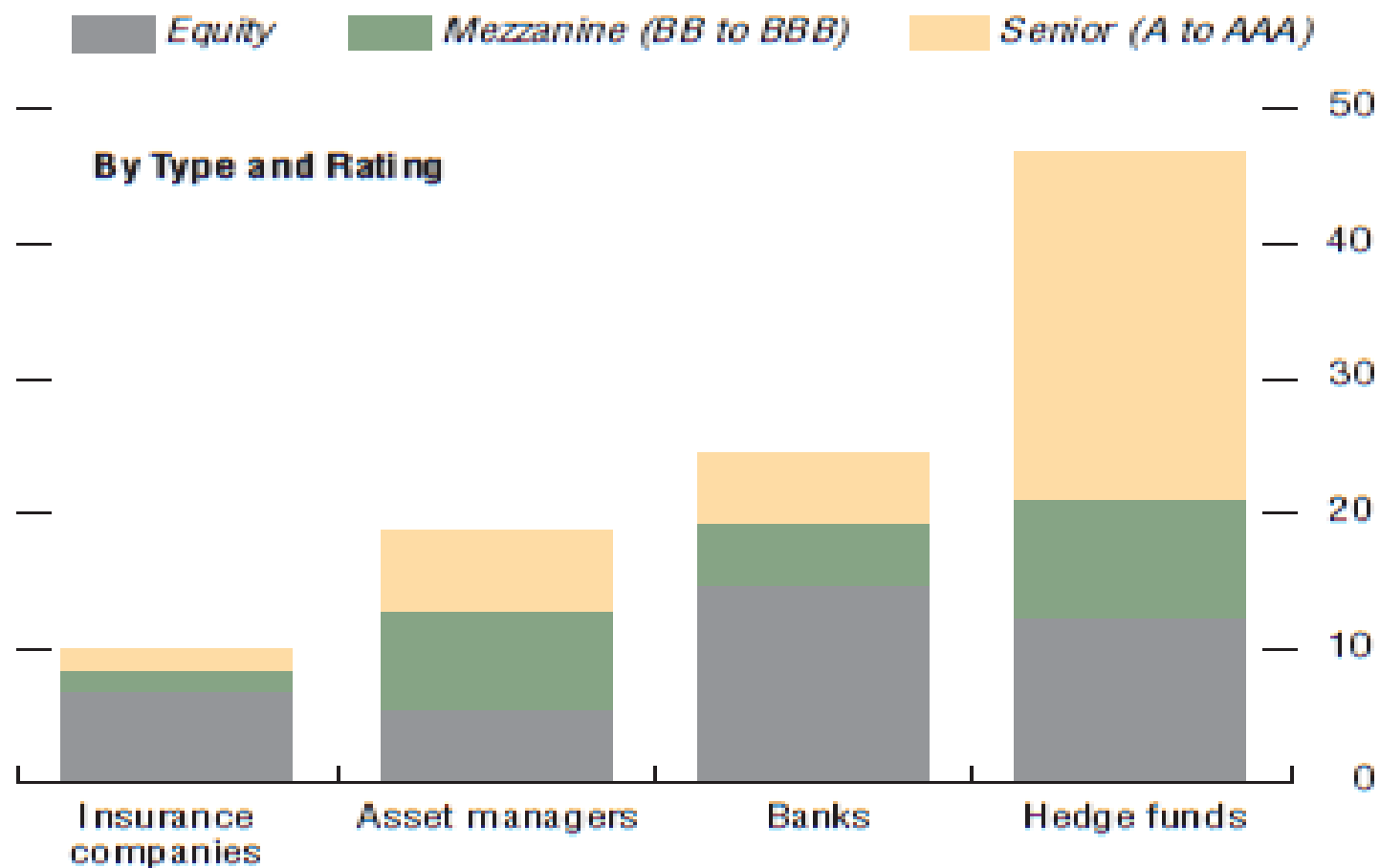
Figure 1.5. U.S. Mortgage Universe
(In percent of total mortgages)



Bought by banks and other FIs

source: IMF GFRS Okt. 2007

Figure 1.11. Buyers of ABS CDOs
(In percent, delta-adjusted basis)



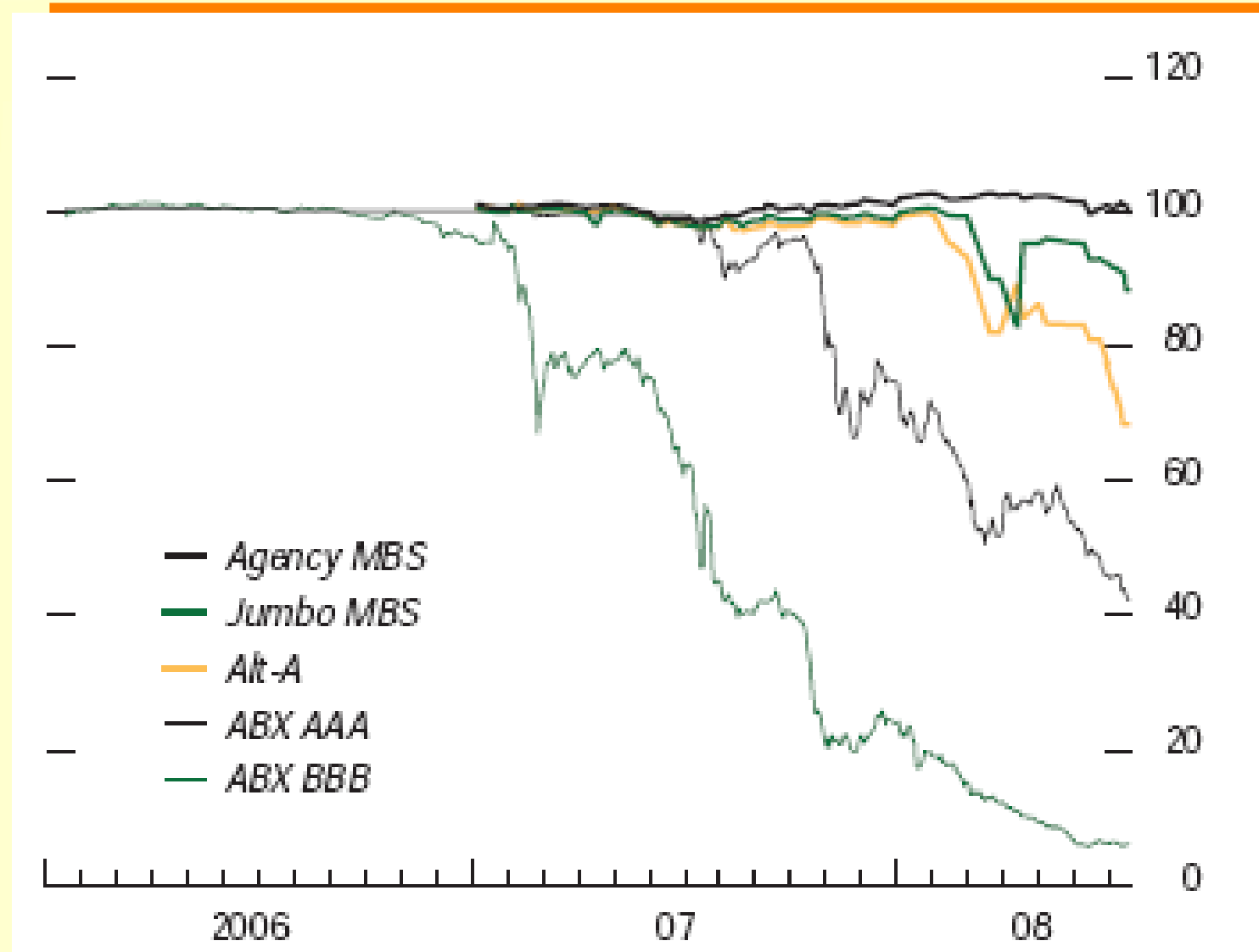
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Market increasingly aware problems

source: IMF GFRS Oct. 2008

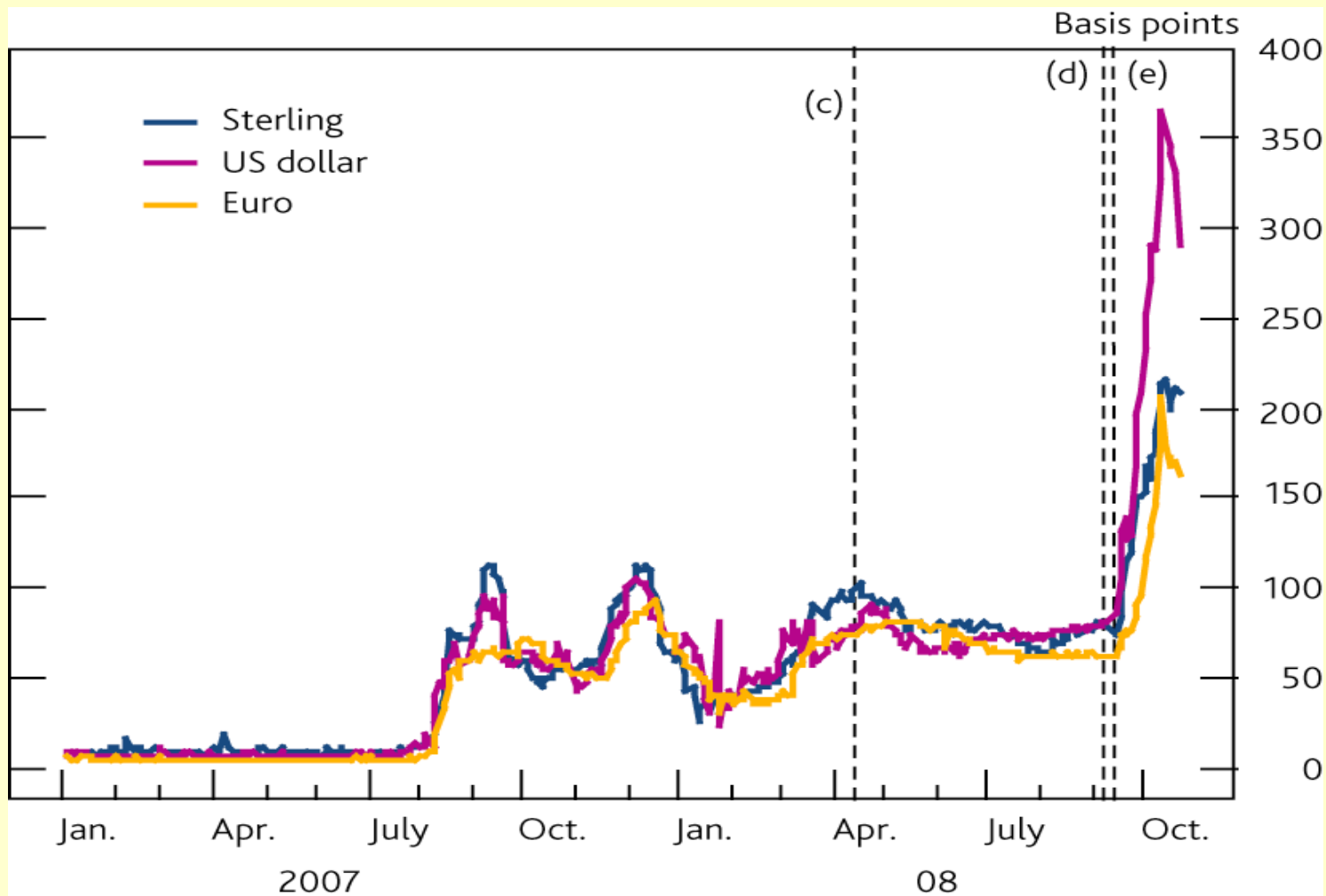
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Gridlock after failure Lehman

source: BOE stability report 2008



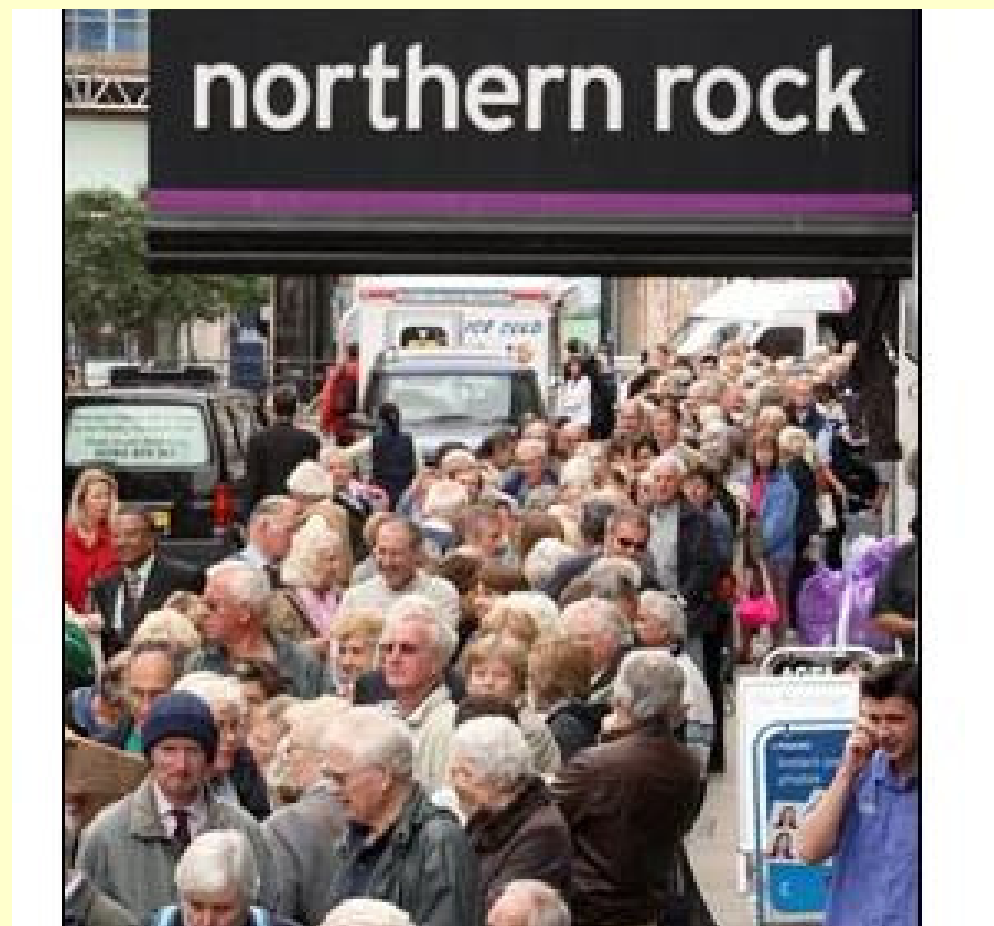
Spread three-month Libor vs.s three-month overnight indexed swap rates.

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The result



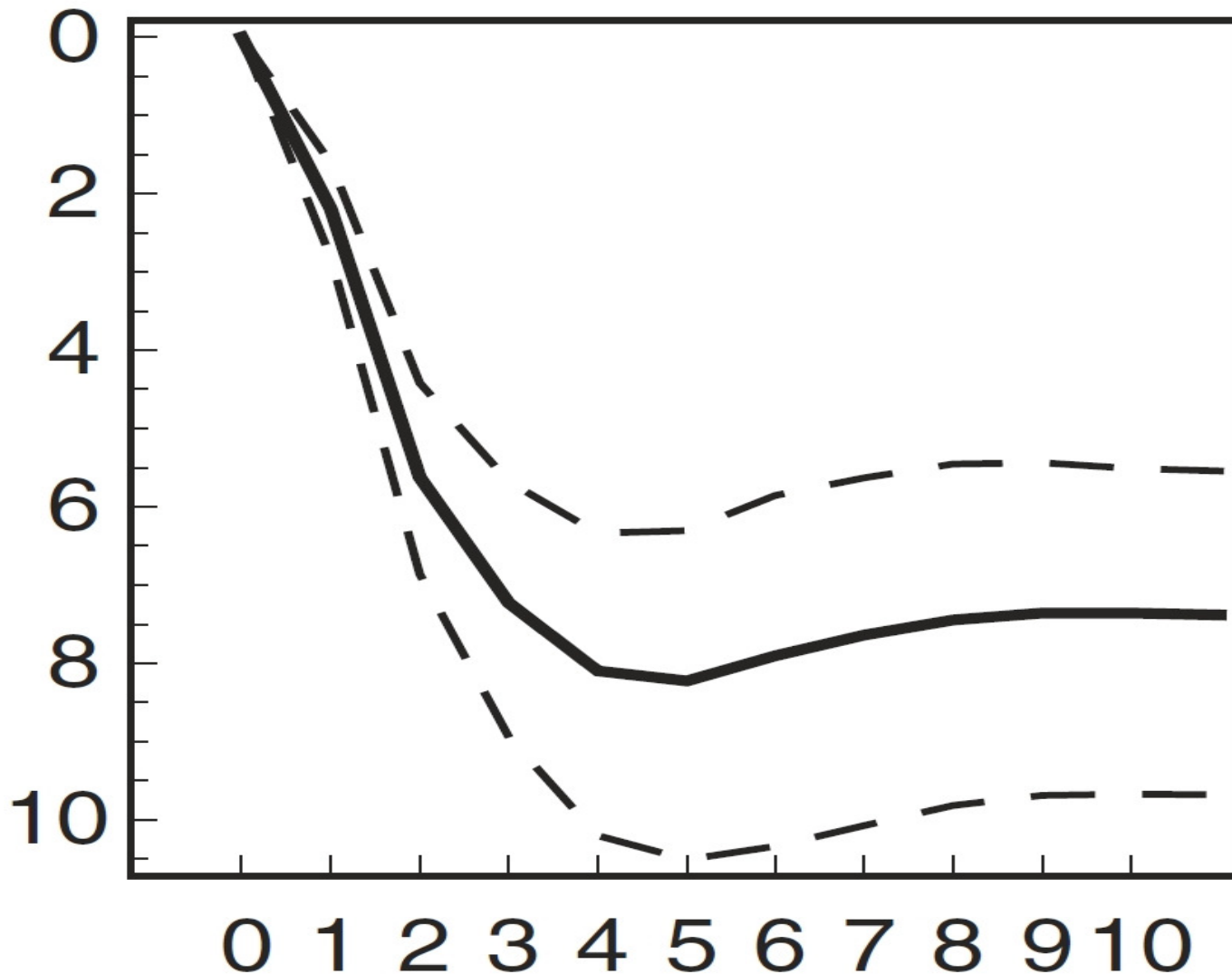
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GDP after a banking crisis

source: The myth of economic recovery



Serious financial crises

Reinhart and Rogoff: average of 15 cases

	Peak to trough	time (years)
Income per head	- 9%	1,9
Percentage unemployed	7%	4,8
Real houseprices	- 36%	6,0
Real stock markets	- 56%	3,4
Real government debt	86%	3,0

Fundamental problem: Free riding in monitoring

- Coordination problem among creditors:
 - ▶ “*All information is in the price*”:
 - no incentive for information collection
 - ▶ Shareholder vis à vis management:
 - Shareholder activism as partial solution
 - ▶ Rating agencies: why paid by debtor, not by creditor?
 - ▶ Securitisation: excess insurance of credit risk
 - Exclusivity constraint: yields efficient risk sharing

- Institutions to handle that problem, e.g. banks
 - Specific monitoring relation with debtors
 - Depositors do not monitor

Fundamental problem: Systemic risk

- Systemic risk
 - ▶ Negative externalities between banks
 - ▶ Source: information spillovers, interconnectedness, fire-sales.
 - ▶ Reason for government intervention
 - ▶ Gambling if 'going concern' value bank is low

- Saving banks increases moral hazard
 - ▶ Banks too-big-too-fail or too-interconnected-too-fail
 - ▶ But anyway, politics unable too commit

Why is recapitalizing so hard?

- Selling assets? Difficult because
 - ▶ Fire sales, adverse selection
 - ▶ Value of assets bank-specific

- Attracting new capital? Difficult because
 - ▶ Signals that bank is in trouble
 - ▶ Debt overhang: new capital partly for creditors
 - Either depositors, or tax payer
 - Hence: at expense of current shareholders
 - Beyond a certain point: infeasible

- Hence: commitment problem supervisors
 - ▶ Intervention before Tier 1 hit lower bound
 - ▶ Requires special bankruptcy legislation

Fundamental problem: Government failure

- Regulatory capture
 - ▶ Career concerns

- Herding
 - ▶ Benchmarking creates incentives to herd

- Commitment
 - ▶ Ex ante discipline requires strict intervention
 - ▶ Absence of commitment
 - ▶ Intervention ex post not credible

- Coordination
 - ▶ Prisoners dilemma

What should change?

■ Bankruptcy legislation

- ▶ U.S. FDICIA ‘prompt corrective action’
- ▶ supervisor can constrain bank managers
- ▶ central principle: reduce systemic risk
- ▶ can expropriate creditors and shareholders
- ▶ Role of market information
 - Hart and Zingales (2009): use CDS market as trigger
- ▶ Rules or discretion?

■ European dimension of regulation

- ▶ “*Banks are international in life, but national in death*”
- ▶ Burden sharing
- ▶ Regulatory competition
- ▶ Lack of information exchange

What should change?

- Should Central Banks fight bubbles?
- Banks
 - ▶ Are foreign branches worth the risk?
 - ▶ Performance pay?
 - ▶ Price systemic externalities
 - Are capital requirements working?
 - Leverage, maturity mismatch
 - How to measure systemic risk?
- Securitization?
 - ▶ Pro: diversification
 - ▶ Con: violation exclusivity constraint
 - ▶ Con: hiding risks for supervisor

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The end

