THE UNFINISHED TASK OF FINANCIAL REFORM: BASEL III, STABILITY AND CREDIT SUPPLY

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Fundamental Changes in Regulatory Strategy from the Mid-1970S To The Mid-1990S

- From mid-1970s: Switching Focus From Liquidity of Deposits to Solvency of Banks
  - Bank Runs and Deposit Insurance
  - Prudential Regulation Plus Safety Net
  - Who Bears the Cost of Deposit Insurance?
- From Mid-1990s: Switching Supervisory Method from Police Action to Market-Friendly Guidance
  - Basel I to 1996 Market Risk Amendment to Basel II

Basel II

- Hailed as evolution compared to B I
- More precise treatment of credit risks
- Market-friendly: based on markets' best practices in risk measurement (inducement instead of compulsion; working through private financial practices)
- Role for market discipline

But also criticisms

- Pro-cyclicality (Goodhart)
- Complexity (“ridiculous” according to head of OCC)
- Too prescriptive (Barth, Caprio, Levine)
- Emphasis on risk measurement
- Difficulties in measuring credit risk
- Weight of operational risk on total capital charges

Cont.

- Excessive demands on Supervisors
- Underestimation of many risks, including liquidity (left to pillar II)
- Systemic risk as an externality: cannot be internalized
- Values and parameters to VaR are not given: they change with banks' behavior

➔ IT DOES NOT GUARANTEE FINANCIAL STABILITY

Basel III

- Narrower definition of capital for regulatory purposes: redefined tier I (from inducement to prudence to sharing the burden)
- Tougher on securitization and ressecuritization
- Rising capital requirements
- Interaction between classes of risk
- Stress tests (normal and abnormal)
- Maintains role of Rating Agencies

Cont.

- Liquidity risks (market and financing)
- “Dry” Leverage ratio
- Feedback effects (eg mark to market) left to pillar II
- Anti-cyclical and anti-systemic risk buffers
- Higher demands on systemically important institutions (But what does “systemically important” means?)

Some Assessment

- Still very complex and demanding
- Capital requirements: how much is enough?
- Insistence on risk measurement as regulatory concern: maintains principle that systemic safety is maintained through private perceptions and measurements of risk
- Endogeneity of parameters in VaR models
- Minskyian concerns? Rediscovery of concern with liquidity, but measurement problems remain; Leverage ratio.

Impact on Growth

- Depression: Rising Liquidity Preference of Banks
- Basel III: Limits on leverage: contractive impact on credit (additional to crisis impact)
- Dilemma: Recover credit supply x prevent new accumulation of the same disequilibria as before?
- Way out: public credit institutions