Discussion of “Resolving the Financial Crisis: Are the Lessons from the Nordics being Heeded?” Claudio Borio, Bent Vale and Goetz von Peter

at

Research Conference on Government Intervention and Moral Hazard in the Financial Sector

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*Represents my views and not those of Federal Reserve Bank of Philadelphia or Federal Reserve System

Paper Summary

- Three principles for banking crisis resolution
  - (1) Speed and (2) depth of intervention, (3)balancing systemic costs with moral hazard.
- These are used to discuss the differences between the Nordic example and the latest financial crisis.
- Paper considers the differences in the two episodes in macroeconomic conditions, global size, asset complexity, and accounting

My comment:

  - Perhaps should be framed more in terms of evolution of the global system of banks and financial markets

Overall comments

- Very valuable comparison
  - Successful Nordic interventions are nice benchmark
- Extremely well-informed and detailed commentary
- Excellent framework
  - Three principles are clearly important
- What are the implications?
  - Are the “Nordic lessons” in need of revision?

Speed of Intervention

- Earlier intervention in latest crisis
- Problems were caused by too-speedy intervention, which limits action

My comments:

- Regulators did not have a choice on speed – collapse after Lehman forced interventions
- Unless we return to a system dominated by banks, this is likely to be the new pattern
- Regulators would like to intervene even earlier!
  - New data collection, increased systemic risk monitoring, stress testing
- Way out of this conundrum not clear: will new liquidation procedures work better?

Depth of Intervention

- In the current crisis:
  - Bank balance sheets not fully written down
    - Accounting rules partially suspended
  - No transfer of bad assets
  - No reduction of excess capacity

My comments:

- Extensive use of securities creates procyclicality and more systemic risk
  - Unanticipated problem: marking to (dysfunctional!) market values
- The “shadow banking” system was the source of much of the failure
  - Do we know how much of the shadow banking system will or should revive?
- Are US Banks too big to nationalize?
  - Big 4 US banks have assets of over $7 trillion

Systemic Costs and Moral Hazard

- Creditors protected in both episodes
- Bank managers and shareholders shielded in latest episode
  - A byproduct of too quick intervention?

My comments:

  - Sub debt is not bank capital
  - Is contingent capital the solution?
  - Penalties have been arguably substantial
  - Will new liquidation mechanism make a difference?

- Big moral hazard risk: “shadow banking” system revival
  - For example, repo market
  - How to price systemic risk (liquidity and credit tail risk) in these markets?

Big Tension: Banks vs. markets

- Borio et al consequence: Regulation has moved backward, not forward!
- Reason: As banks use market-oriented strategies, they and regulators become vulnerable to market procyclicality.
  - The efficiency of markets has an achilles heel in systemic risk externalities.
  - Regulatory arbitrage subsidizes use of markets unless systemic risk is priced.
- Can stress testing and orderly liquidation solve this problem?