Basel II & Market Discipline

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Overview

- ✓ Ideal market discipline in principle
- ✓ Ideal market discipline vs. supervision
- ✓ Concerns about market discipline in practice
- ✓ The Pillar 3 Basel remedy
- ✓ Taking market discipline and corporate governance seriously

Channels of Market Discipline…

- ✓ Direct
  - Prices of debt and equity instruments
  - Quantity rationing
- ✓ Indirect
  - Financial press
  - Securities analysts
  - Ratings agencies
  - Supervisory authorities

Conditions for Effective Market-Based, Self-Discipline

1. Transparency of risk and capital positions
2. Adequate incentives to process information
3. Flexible, unbiased price and quantity adjustments that reflect probability of default
4. Bank board responds to market signals by appropriate reductions in exposure or increases in capital

The Central Role of the Board

- ✓ The Board should ensure that the bank has
  - the financial and human resources and
  - the management information systems that are appropriate for the risks they are taking
- ✓ The Board should
  - Specify explicitly bank's tolerance for risk
  - Oversee the measurement of risk
  - Supervise the management of risk

Market-Based Self Discipline

Supervision vs. Ideal Market Discipline

Supervisory Discipline

- ✓ Episodic
- ✓ Backward looking
- ✓ Bureaucratic
- ✓ Slow to Change
- ✓ Rule-based sanctions, imperfectly risk based
- ✓ Substantial compliance costs

Ideal Market Discipline

- ✓ Continuous
- ✓ Forward looking
- ✓ Impersonal
- ✓ Flexible and adaptive
- ✓ Variable, risk-sensitive sanctions
- ✓ Lighter compliance costs

Supervision vs. Ideal Market Discipline: the burden of proof

Supervision

- ✓ Supervisors need to show an institution is taking excessive risks
  - Subject to review
  - Tendency to delay until damage occurs
  - Undermines corporate governance

Market Self-Discipline

- ✓ Boards need to show they are not taking excessive risks
  - Encourages stronger corporate governance
  - Promotes disclosure
  - Reduces supervisors' liabilities

Burden of proof that the bank is prudently managed should fall on board

Supervision & market discipline should be complementary…

- ✓ Market discipline can enhance the effectiveness of supervision
- ✓ Supervision should enhance the effectiveness of market discipline
- ✓ Supervision should aim to strengthen corporate governance, not undermine it

- ✓ What are the major concerns about market discipline in practice?
- ✓ How can they be addressed?

Concern 1. Lack of Transparency

- ✓ Theory and evidence
- ✓ Data shared by management only with supervisors – not boards
- ✓ Data deficiencies
  - Largely backward looking and lagged
  - Distorted by accounting conventions
- ✓ Insufficient market demand for disclosure

Concern 2. Inadequate incentives

- ✓ Fear of loss
- ✓ Intensive supervision
  - Self-discipline is relaxed
- ✓ Safety nets
  - Explicit deposit insurance
  - Implicit insurance
    - Forbearance
    - Lender of last resort assistance to banks of dubious solvency
    - Guarantees & capital infusions
    - Assisted Mergers
  - Fitch Ratings

Concern 3. Pricing Problems

- ✓ At best reflect only private, not social costs of insolvency
- ✓ Problems in extracting market information regarding probability of insolvency
- ✓ Sanctions ex post, after damage done
  - Slow to reflect reductions in risk
- ✓ Cause destabilizing flows

Concern 4. Ineffectual Influence

- ✓ Safety net shields from market discipline
  - Whenever risk premiums rise, bank shifts to insured sources or
  - Blanket guarantees or
  - State-owned banks
- ✓ Limited direct influence through new issues
- ✓ Indirect influence can compensate somewhat
  - Tie supervisory sanctions to market indicators
    - Allocation of supervisory resources
    - Trigger full-scale Prompt Corrective Action
- ✓ Ineffective boards, perverse incentives

Pillar 3 Addresses Only 1st Concern

- ✓ Departure from traditional reluctance to disclose
  - Bureaucratic control of information
  - Fears about instability
  - Relatively meager voluntary supply

1½ Cheers for Pillar 3

- ✓ More data, but quality and comparability concerns
  - Accounting and provisioning practices
  - Wistful enforcement
  - Opt out provisions
- ✓ Less transparency re: Tier 1 ratios
- ✓ VaR disclosures a step back from IOSCO agreement
- ✓ Omits fx exposure and exposures to sovereigns and commercial real estate

Guidelines for Disclosure Policy

1. Anticipatory, not reactive
2. Broad view of information relevant to valuing bank
   - Mean
   - Dispersion around the mean
3. Standardized definitions, formats and reporting intervals

If Pillar 3 Were Serious About Market Discipline…

- ✓ Strengthen role of boards
  - Require attestations from board re: quality of data and risk management systems
- ✓ Constrain national safety nets
  - Ensure that at least holders of subordinated debt fear loss
  - Enhance resolution tools
  - Produce a contingency plan to wind down any bank
    - Authority to charter a bridge bank
- ✓ Increase the influence of market signals
  - Link PCA-like measures to market estimates of insolvency risk

Supervision Can Achieve More by Doing Less

- ✓ Emphasize board accountability for outcomes, not prescriptive regulations (like Pillar 1)
- ✓ Strengthen incentives for market discipline
  - Ensure that shareholders and uninsured creditors perceive genuine risk of loss
    - Role back safety nets
    - Privatize state-owned banks
    - Improve insolvency resolution mechanisms
- ✓ Make clear that primary responsibility for safety and soundness resides with the board and shareholders, not the supervisory authorities

Enhanced Market Discipline Could…

- ✓ Produce better disclosures than Pillar 3 proposal
- ✓ Improve corporate governance
- ✓ Encourage development of more effective risk management approaches
- ✓ Enhance accountability and performance of supervisory authorities
- ✓ Provide a more effective deterrent to regulatory capital arbitrage
- ✓ Reduce distortions due to Tier 1 & 2 definitions
- ✓ Improve safety and soundness of financial system with markedly lower compliance costs