Markus Brunnermeier
“Financial Crises: Mechanisms, Prevention, and Management”

Discussion by

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Summary: Mechanisms

- An admirably clear summary of the dynamics of the current crisis,
  - The "loss spiral" and the "hair-cut spiral" is a useful distinction.
  - It helps in understanding the suddenness and severity with which the crisis set in.

- This is clear because it was grounded in theoretical analyses of **models** by Brunnermeier and co-authors and also by Shin, Morris, Adrian and others.

- This uses the **system approach** to banking which makes clear how in a market-based system financial system where institutions are interlinked through their trading books and off-balance sheet exposures relying on **collaterlized** transactions an institution may be **systemically vulnerable** (i.e., susceptible to runs) even though they are solvent from the perspective of capital adequacy.

Summary: Prevention

- Brunnermeier puts forward some regulatory remedies,
  - Borrowed from work with co-authors Crockett, Goodhart, Persaud and Shin.
  - Largely in the area of macro prudential regulations originally suggested by Andrew Crockett.
  - Now the center of widespread interest as evidenced by discussions of G-20, the Financial Stability Forum, and, the Turner Report released yesterday.
- As with his "mechanisms" of the crisis, Brunnermeier's arguments in support of his **proposed remedies** are also admirably **clear**.
  - This is for the very same reason.
  - They are rather transparently based on simple <u>**models**</u> in Markus' mind which are meant to capture important features that are present in today's market-oriented, globalized banking institutions.

A Note of Caution

- But a <u>model is a model.</u>
  - It abstracts from many of the complexities of the real world institutions.
  - Will the proposed regulatory remedies put forward by Markus meet the reality test and translate into concrete and useful actions?
- Recall the “Academic Response to Basel II” written by researchers based at LSE in 2001 which argued among other things:
  - “The proposed regulations (Basel II) fail to consider the fact that risk is endogenous. Value-at-Risk can destablise an economy and induce crashes when they would not otherwise occur.”
  - “Heavy reliance on credit ratings agencies for…credit risk is misguided as they have been shown to provide conflicting and inconsistent forecasts of individual clients’ creditworthiness. They are unregulated and the quality of their estimates is largely unobservable.”
  - “Financial regulation is inherently procyclical. Our view is that this set of proposals will, overall, exacerbate this tendency significantly”.
- In retrospect these arguments were remarkably prescient.
  - However they were largely ignored.
  - The only real success the authors had was that they gained the right to say “I told you so.”

Relevance

- Clearly Markus' aspires to have impact on policy.
- The crisis has created the window of opportunity for solid academic arguments to get a more serious hearing.
- The system based approach to financial regulation has much to say for itself.
- But much more work needs to be done to close the gap between theory and practical policies.

Comments 1

- Some of Markus' suggestions for crisis management rely on the distinction between "**crisis situation**" and a "**non-crisis situation**".
  - This applies to Co-Var (Adrian and Brunnermeier discussed below)
  - Also, in the crisis management area, he proposes ***forced*** debt/equity swaps based on automatic triggers conditioned on a crisis event.
  - To be useful policy makers need to be prompt in their response to the onset of a crisis.
  - **But in practice how are they to know?**
- Markus' and related analyses are aimed at **"Systemically Important Institutions" (SII's)**
  - But these arise **endogenously** as a result of separate actions of the banks and non-banks.
  - Identifying them is a dynamic process, i.e., they will be constantly changing.
  - **How is this to be done?**
  - Side comment: I'm not sure the distinction between "systemically important in itself" and "systemically important in the herd" is useful either conceptually or practically. It rather muddies the main issue, which is my next point.

Comments 2

- Who is to identify the SII's?
- There is a wide-spread call for clear responsibility to be vested in a Systemic Regulatory Authority (SRA). But who is this?
  - In the view of Barney Franks (chair of the US House Financial Services Committee) it is obviously this must be the FED.
  - In the UK there is continuing support for the tripartite agreement that would point toward an beefed-up FSA as the SRA.
- Underlying this confusion is an important **conflict of interests** between the **monetary stability** and **lender of last resort** functions.
- Ultimately, the latter is always based a claim on citizens' revenues (whether through explicit taxes or through seigniorage).
- But does not combining this with monetary stability objectives **undermine central bank independence** and politicize many decisions that should be separated from such issues?
  - Looking back at the stop-go of the 1980's (not to mention cases of hyper-inflation) aren't we worried about embarking down that possibly slippery slope?
  - But if the SRA is outside the central bank will it have the economic competence and authority to do the job? Won't the over-smart (and perhaps over-paid) bankers just be able to over-awe regulators as they've managed in the past?

Comments 3

- Regarding Co-var (Markus' work with Tobias Adrian)
  - This is certainly a clever gadget with a memorable name. But,
  - How are the Risk Factors used as the reference to be determined?
  - Should this be done by statistical estimation? Long time series (to avoid procyclicality) will inevitably struggle to deal with financial innovation and other forms of structural change.
  - Can stress tests be employed? How to establish benchmarks on scenario's?
  - This is held out as a means of measuring systemic importance and thus identifying SII's dynamically. But to implement would require estimates for all firms in the shadow banking system. The data needs for this are daunting.
  - If we had all this data, would not tools drawn from network theory be a more hopeful way to proceed?
- Generally, are the instruments for counter-cyclical prudential regulations implementable?
  - For counter-cyclical capital (and liquidity) requirements, who will monitor, using what indicators, and how to implement in practice.
  - Since cycles vary across jurisdictions, how can this be squared with setting a level playing field to avoid "race to the bottom"?
  - Since the memory of the current crisis will one day fade, how can we be sure that the counter-cyclical measures will have teeth through the next boom?

Conclusion

- This is a big agenda to bring macro-prudential regulation into practice.
- Academics need to do their part in pushing this further:
  - More theory to assess robustness of the ideas and proposals.
  - Need dynamic models with greater realism in modelling risk factors to produce more reliable simulations.