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BANKING SECTOR TURBULENCE: LESSONS FOR SUPERVISION AND REGULATION

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Precepts to guide financial stability policy reform

1) You will always bail them out

2) Supervision is essential, but never sufficient

3) Social cost of bank equity is far lower than private cost

Principle: an ounce of prevention is worth a ton of remediation

You will always bail them out

- There is an insurmountable time consistency problem
- Credible commitment to not bail out is impossible
- No one wants to be the parent of the next finance crisis

Supervision is essential, but never sufficient

- Better stress tests are key for ensuring resilience
- Private incentives favor evasion of rules and concealment of risk
- Detecting risky behavior will always be difficult
- Caution and reluctance to imposes remedies rewards risk-taking
- Officials' changing tolerance weakens credibility to sustain rigor

Social costs of capital are far lower than private costs

- M-M fails because of taxation and bankruptcy: neither is a *social* cost
- Bankruptcy distortion greater in finance due to high leverage
- Set capital so *social* costs and benefits are equal $\Rightarrow$ higher than now
- Modify accounting rules to ensure timely resolution

Ensuring resilience

- Regulation and supervision should be
  - More rules-based
  - Simpler and transparent
  - Stricter and more rigorous
- Practical implications
  - Higher capital and liquidity requirements
  - Shift to mark-to-market accounting
  - Stress tests that are severe, flexible, and appropriately transparent