

# Discussion of “Systemic Risk and Regulatory Compliance”

by Ayadi, Ben Naceur, Casu and Quinn

Evren Damar

Hobart and William Smith Colleges and IWH Halle

IWFSAS 2017 Montréal Conference

August 24, 2017

# Overview

- This paper poses a simple question: Does increased compliance with international regulatory standards decrease systemic risk?
- Although the answer might seem clear to some upon first glance, the “track record” of better bank regulation and supervision is mixed:
  - ▶ Little impact on bank-specific risk (Demirgüç-Kunt and Detragiache, 2010; Klomp and de Haan, 2012)
  - ▶ Inconsistent evidence on the impact of bank efficiency (Barth, et al., 2013; Ayadi, et al., 2016; Chortareas, et al., 2012)
- With post-crisis regulatory and supervisory reforms moving well into the implementation phase, understanding the link between regulatory compliance and systemic risk is very important

- The authors use CoVaR (Adrian and Brunnermeier, 2016) to measure systemic risk for a cross-country sample of banks
- This is combined with BCP compliance indices based on IMF/WB information
- Results suggest that BCP compliance leads to *more* systemic risk.
  - ▶ The authors propose a “herding” explanation: in a rush to comply with stricter regulations, all banks choose the same type of assets
- Systemic risk goes down when the *supervisor* complies with BCP but goes up when *banks* comply with BCP

# Impressions

- A very timely paper with clear potential to contribute to the scant literature on this important topic
- The analysis of individual BCP components also allows the paper to look at whether different types of regulations counteract each other
- However, the paper is in early stages
  - ▶ My comments are limited mostly to the empirical setup
- It will undoubtedly become very interesting and appealing once the authors fill out the rest of the paper

# Main Comments: Empirics

- The key variable in the “DinD-type” regression setup is *BCP*
  - ▶ The frequency and construction of this variable is not well-defined. It is called an “annual variable”
  - ▶ Obviously countries do not go through FSAP reviews every year, so does *BCP* only change if/when there is a new FSAP?
  - ▶ How is *BCP* defined during the years between two FSAP reviews?
  - ▶ When exactly does the country comply or improve its compliance?
  - ▶ Or, do the authors possess other information, such as “FSAP Updates” that allows *BCP* to vary more frequently?
- The result is very little time variation in *BCP*, which might be an issue

# Empirics, continued

- In the most extreme case, US seems to have a single *BCP* value for the entire sample, but US banks have very low *CoVaRs*
- Without meaningful time-variation in US *BCP*, it is difficult to argue that the low *BCP* is leading to high *CoVaR*
  - ▶ Perhaps the structure of the US sector is much different
- Are your *BCP* coefficients simply capturing cross-sectional differences in *CoVaR* between the US and the rest of the world ?
  - ▶ Is this why the baseline effect is much smaller for the European sample?
- The sample may not have enough non-US banks to get around this
  - ▶ Around 25% of the G-SIB and over 80% of the North American sample is made out of US banks

- Perhaps, the authors can try to strengthen their case by:
  - ▶ Limiting the sample to countries with a second FSAP and looking at the period before and after the re-evaluation
  - ▶ Re-estimating the G-SIB sample without US banks and seeing if the effect holds up
  - ▶ Providing more summary statistics and country-level information on *BCP*, especially for European countries

# Empirics, continued

- A more drastic (and much more labor-intensive) way would be to start with the FSAP reviews and to use other information to create time-variation
  - ▶ Example from Austria's 2008 FSAP Update: "The authorities have further improved the regulatory and supervisory framework, starting from the high base documented in the 2003 FSAP ... [R]egulations have been amended to reflect a more risk-based approach ... Supervisory practices have become more sophisticated, for example, through stress testing ..."
  - ▶ Can the timing of these changes between 2003 and 2008 be identified and incorporated into *BCP*?
  - ▶ An example of a somewhat similar effort is the cross-country "Changes in Prudential Policy Instruments" database compiled by the International Banking Research Network (Cerrutti, et al., 2017)

# Main Comments: The Big Picture

- The authors find that compliance with capital adequacy requirements is the biggest contributor to higher systemic risk
  - ▶ However, some argue that the Basel III capital requirements are *too low* (Dagher et al. (2016); Passmore and von Hafften (2017))
  - ▶ But if requirements are tightened, will there be more systemic risk? Could this be an unintended consequence of capital regulation?
  - ▶ A clear link to the capital requirements literature will significantly improve the appeal of the paper
- How about the “herding” explanation?
  - ▶ Are all banks buying the same assets due to their low risk weights?
  - ▶ Is this leading to “indirect spillover” effects due to price effects?
  - ▶ Do we now have more smaller institutions that are “systemic as part of a herd” (Adrian and Brunnermeier, 2016)?

# Conclusion

- An interesting paper with a clear potential for significant contributions to the literature/policy debate
  - ▶ The authors may even be “underselling” the capital requirements story at this point
- More refinements to the second step of the empirical analysis can significantly improve the appeal of the paper
- Very much looking forward to reading the next version with more detailed discussions of the findings and policy implications