

Comments on
“Market Discipline under Systemic Risk:
Evidence from Bank Runs in Emerging
Economies”

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Goals

- Why is this research important?
- What did we learn?
 - Interpretation of results
- What could we learn that we didn't?
 - Suggestion for alternative techniques
 - Ideas for future data/research
- How can we use to results to inform policy choices?

Why is this research important?

- Explores the nexus between bank fundamentals-based market discipline and systemic risk.
 - Show definitions of bank fundamentals needs to be expanded to include other risks to test for market discipline.
- Provides evidence that systemic risk can play an important (even dominant) role in bank runs.

What Did We Learn?

- Systemic risks (e.g. macro factors) themselves can be appear to make traditional bank-specific fundamentals appear insignificant, but interaction effects very important.
- During crises, systemic risks used by depositors to gauge bank (system?) risk.

Interpretation Issues

- Definitions
 - Market discipline—private sector participants (bondholders, stockholders, rating agencies, and depositors) face costs that are positively related to bank risk and react on the basis of these costs.
 - Only one such participant used—depositors
 - Systemic risk—viewed as driven by macroeconomic factors.
 - Country risk—sovereign bond spreads
 - Exchange rate risk—currency premium (NDFs-spot exchange rate)

Interpretation Issues

- Systemic risk (vs. systematic/global/domestic) concepts.
 - Liquidity risk (e.g. interbank exposures)
 - “Irrational” or “rational herding” bank runs
- Banks’ systemic risk exposure measures used.
 - Share of gov’t debt/total banks assets
 - Ratio of dollar loans/bank capital
 - Potential problems?
 - What proportion of dollar borrowers have dollar-based receipts (a natural hedge)?
 - Variability of variables low—may not be able to statistically capture anything.

Interpretation Issues

- Definitions:
 - Bank fundamentals (matter to whom?)
 - ROA vs. ROE
 - NPLs often understated and lagging
 - Capital differentially defined over time and for different types of banks (public vs. private)

Interpretation Issues

- How much do the systemic variables matter?
 - Uses “the five largest systemic innovations” from VAR framework and compares statistical response to actual decline of deposits.
 - “Merely 15 systemic events are needed to explain 50 and 20 percent of decline in peso and dollar deposits?”
 - Define “systemic events/innovations”?
 - Can these statistical events be compared to actual events over the entire sample period?
 - How should the dummy variables associated with important news in the VAR system be interpreted?
 - Are the results really additive as Table 7 suggests?

Modeling Issues

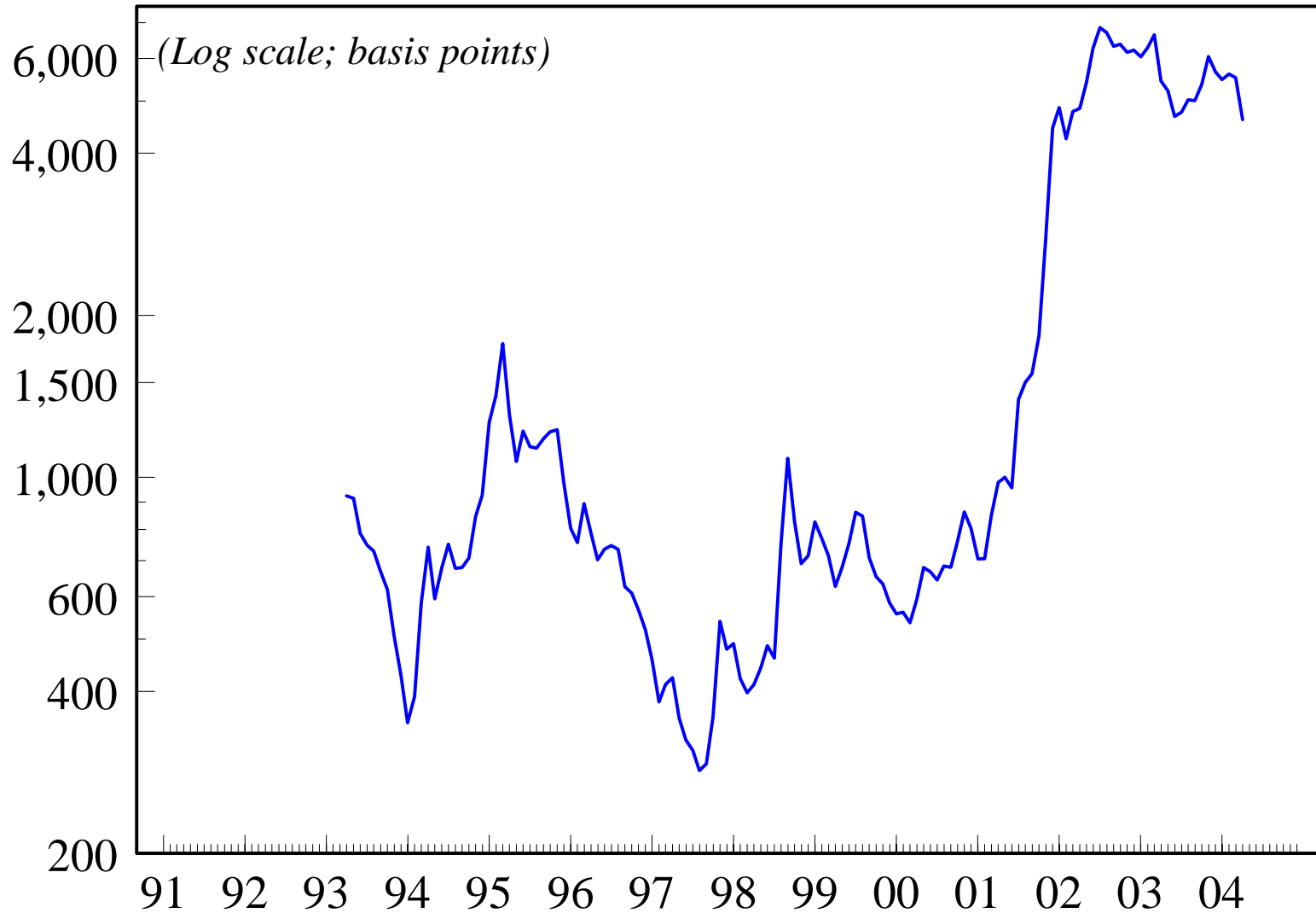
- Endogeneity
 - Lags help.
 - Deposit interest rate—supply or demand-driven?
 - Covered/uncovered interest rate arbitrage.
 - Sovereign risk assessments (e.g. ratings) and thus bond spreads utilize banking system risks (e.g. robustness of banking sector, contingent liabilities to the gov't).

Modeling Issues

- Nonlinearity
 - Regressions and VARs are linear specifications.
 - Evidence from the statistical significance of interactions (e.g. banks' exposures*risk).
 - Spread movements are highly non-linear.

Argentina

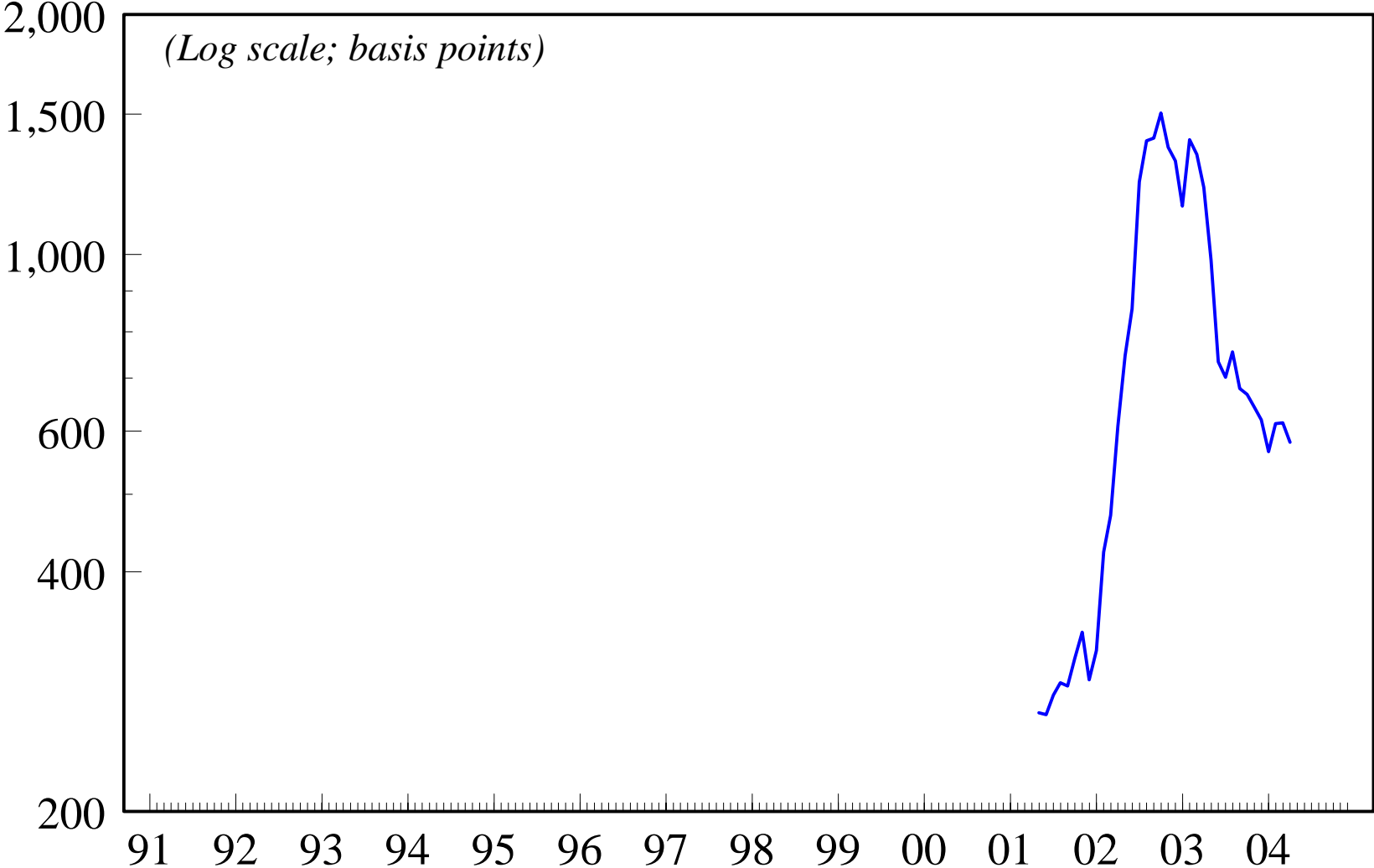
(A) Bond Spread



Source: J.P. Morgan Chase

Uruguay

(A) Bond Spread



Source: J.P. Morgan Chase

What could we learn that we didn't?

- Suggestions for alternative techniques
 - Non-linear specifications
 - Analysis of variance techniques
 - 2-step procedure
 - Step 1: Control for systemic factors in bank fundamentals (see equation #3).
 - $NPL(i,t) = a(i) + b NPL(i,t-j) + c S(t-k) + e(t)$
 - Step 2: Run deposit variables on *estimated* NPLs and systemic variables to find out independent influence of systemic factors.

What could we learn that we didn't?

- Alternative data
 - Depositors concerned with liquidity/large depositor withdrawals.
 - Use liquidity ratios
 - Use “large” deposits or interbank deposits
 - Examine only private banks.
 - Use bank stock prices, if available

What could we learn that we didn't?

- Alternative sample period
 - Bank fundamentals didn't (statistically) matter during this time period (overshadowed by systemic risks).
 - Fundamentals should matter during tranquil period. Do they? Do we have the wrong set of fundamentals for the question posed?

Policy Implications

- Transparency of “traditional” bank fundamentals (maybe) necessary but not sufficient to prevent bank runs.
- Need to include bank exposure to systemic risks in disclosed data.
 - Should banks disclose? Should supervisors disclose?
 - Costs/benefits of disclosure?

The future of market discipline

- Quest for market discipline should not be viewed as less attainable in emerging markets just because systemic risks are greater.
 - Emerging market bank managers *should* take into account their bank's exposure to (higher) systemic risks (limit currency mismatches, limit gov't debt exposures, carry higher capital ratios).
 - Industrial countries' bank managers and supervisors already do this.
 - Either mandated (e.g. supervisory rules on FX exposure limits, creditor exposure limits, liquidity rules, etc).
 - Or voluntarily (e.g. Value-at-Risk, exposure data) released.

Summary

- Research shows the importance of systemic risk (relative to banking fundamentals) for measuring market discipline using a concrete example.
- Suggests need to view market discipline more broadly and consider expanding transparency to include variables measuring exposure to systemic risks.
- Just a start—more evidence on causes of bank runs and usefulness of systemic risk variables to help market discipline work are needed.