Market Discipline under Systemic Risk

Discussion by

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Summary

Levy-Yeyati, Martinez Peria and Schmukler (2004)

• Examines the **extent of market discipline** in the presence of **System-wide risks**, during crisis.

Analyses **depositors' reactions** to traditional **bank fundamentals** and **exposure to systemic risks**, during the bank runs of Argentina and Uruguay during 2000-2.

They find that:

** market response during crises is largely driven by systemic risk factors (see Table 7)

Summary

In particular,

•Traditional bank fundamentals fail to elicit market reaction

•Markets respond to bank exposure to systemic risks

•Systemic risk dominates bank fundamentals in eliciting market response

=> Hence, market discipline is at work during crisis

=> Call for broader definition of market discipline (not just market response to traditional fundamentals).

Summary

Uses unique bank-level data on deposits, interest rates and bank exposures during the bank runs of Argentina and Uruguay.

Applies two methodologies:

- Estimate standard panel regression of market response on bank fundamentals and system exposure.
- Estimate a time-series VAR to evaluate total depositors' reaction to the evolution of systemic risk factors.

Comments

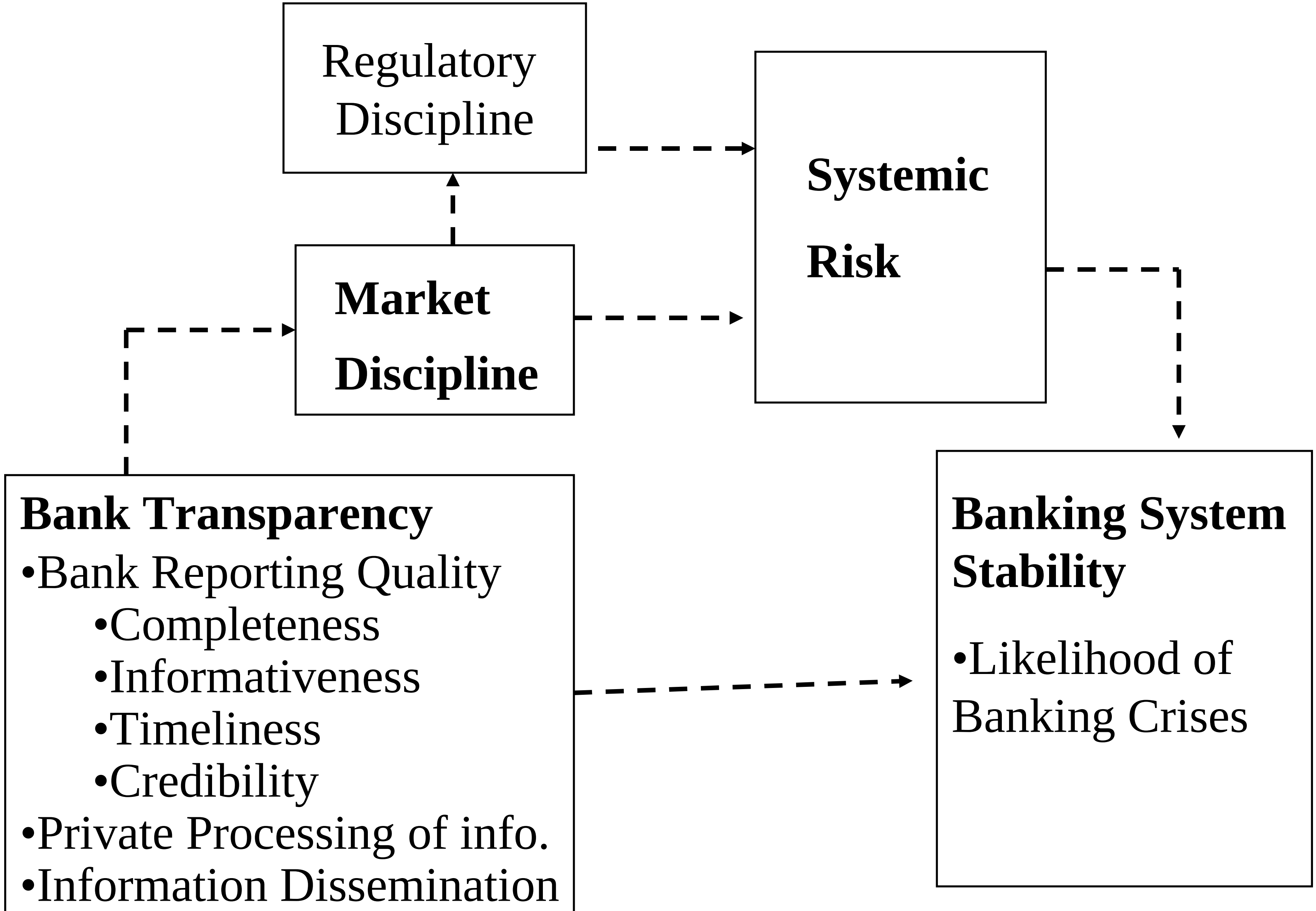
• Important study: enhances our understanding of market discipline during crises

•Previous evidence on market discipline in crisis is too indirect

-e.g., Saunders and Wilson (1996), find that, ex-post, failed banks were weak banks during the U.S. bank runs of 1929 through 1933.

Calomiris and Mason (1997, 2000) – similar findings in the 1932 banking failure in Chicago.

• Other studies show only that banking disclosure reduce the likelihood of banking crises (e.g.,Tadesse (2004))



Regulatory Discipline
Systemic Risk
Market Discipline
Bank Transparency
•Bank Reporting Quality
•Completeness
•Informativeness
•Timeliness
•Credibility
•Private Processing of info.
•Information Dissemination
Banking System Stability
•Likelihood of Banking Crises

Comments

- Market discipline not just market reaction (Bliss and Flannery (2001)
  - Market discipline, broadly defined, is a market-based Governance system.
  - It should induce a change in bank behavior at least ex-post
    - Ex-ante vs Ex-Post
    - Market Monitoring vs Market influence (Bliss and Flannery (2001)
    - Direct vs Indirect (Kwast et al (1999))
  - In some cases, the source of the systemic risk is Institutional
    - e.g., Poor investment climate forces banks to hold government claims, causing sovereign risk exposure.

Comments

Whether market discipline is effective may also depend on the type of systemic risk. Various notions of system risk:

- Systemic risk due to a common macro shock
- Systemic risk due to a chain reaction among interdependent institutions (e.g., because of the inter-bank netting process)
  - Source could be idiosyncratic
- Systemic risk due to contagion (spillovers from other systems, other countries etc.)

Comments

How do you measure a bank's exposure to systemic risk?

How could an institution protect itself from a contagion or chain reaction type of systemic risk?

Comments

How effective is Market discipline relative to Supervisory Discipline?

- Cross-sectional (relative) risk versus Intertemporal risk
- Systemic risk as intertemporal risk
- Market discipline more effective in dealing with cross-sectional risk (Crockett (2002))

Comments

These are some of questions that future research should address.

•From the indirect evidence and the few studies, one can say that there might be a role for market discipline, but probably very limited at least in the direct route

• Greater potential for the role of indirect market discipline

- •Market responses to systemic risk exposure could provide additional information for the benefit of supervisory discipline.

Comments

- To the extent there is a role, how would you strengthen market discipline

  - Enhancing disclosure
    - Supervisory examinations findings
      - Evidence that release of supervisory information on troubled banks during crises improves market discipline (Jordan et al. (1999))
    - Operational Audits (Internal Controls)
    - Counterparty risks

Comments

- Audit Stringency
  - Increases in the scope and rigor of external audit reduces the likelihood of systemic banking crisis (Tadesse (2004))
  - The New Accord focuses on extensive disclosure. It does not require audit beyond that required for financial reporting purposes.

Anatomy of Market Discipline (Flannery (2001))