

## *2015 Banking and Financial Stability Meeting*

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The principal objectives of the meeting are to stimulate policy relevant research in economic science and to generate greater understanding by academic economists of practitioner's environments and vice versa. The most recent Financial System Inquiry (FSI) final report was released in December 2014, and with the consultation period ending in March, now is a good time to discuss some of the key issues and recommendations raised in the report. The selection of research papers today will speak to two key areas of the FSI report:

**FSI Chapter 1 Resilience** “The Inquiry’s recommendations to improve resilience aim to (1) Strengthen policy settings that lower the probability of failure, including setting Australian bank capital ratios such that they are unquestionably strong by being in the top quartile of internationally active banks; and (2) Reduce the costs of failure, including by ensuring authorised deposit-taking institutions maintain sufficient loss absorbing and recapitalisation capacity to allow effective resolution with limited risk to taxpayer funds — in line with international practice.

**FSI Chapter 5 Regulatory System** “Australia needs strong, independent and accountable regulators to help maintain trust and confidence in the financial system. This is critically important for attracting investment and supporting growth. The quality of oversight and supervision is vital in maintaining financial stability and achieving positive consumer outcomes. Appropriate firm culture is critical, but needs to be supported by proactive regulators with the right skills, culture, powers and funding.”

### **Monday 17 August 2015**

**8:30am-9:00am**

**Registration**

**9:00am-9:30am**

**Opening remarks**

Professor Bob Gregory, ANU (Crawford School and RSE)

9:30am-10:45am

***Do financial regulations matter for firm performance? Evidence from systematic banking crises***

**Policy platform:** FSI Chapter 5 Regulatory System, Recommendations 27-31

**Presenter:** Ding Ding, ANU

**Discussant:** Ed Lin (Deakin U.)

**Abstract:** How do financial market regulations affect firm performance? We investigate this question using episodes of systemic banking crises across many countries as identification tools for unanticipated credit contractions and compare firm investment growth during and post crisis periods relative to pre-crisis levels. We utilize variations in our sample firms' degree of external financial dependence and financial constraints to show that credit contractions are costly for firms, and that they are more costly for financially constrained firms and also for firms normally more reliant on the external capital market for financing. Furthermore, declines in investment growth are greater for an externally dependent and financially constrained firm if the firm is also embedded in an ex-ante “repressively” regulated financial market compared to a similar firm embedded in a “reformed” financial market; these terms refer to the degree of financial market liberalization. Our results suggest that specific financial reforms play a significant role in attenuating the propagation of a banking crisis to the real sector.

10:45am-11:00am

**Morning tea**

11:00am-12:15am

***Leverage and speculation***

**Policy platform:** FSI Chapter 1 Resilience, Recommendations 1 and 7

**Presenter:** Guillaume Roger, University of Sydney

**Discussant:** Xianming Zhou (ANU)

**Abstract:** This paper presents a model of an incentive contract between two parties. These parties may be a regulator and a bank, or a board (firm) and an executive manager. The point of the incentive contract is to govern that relationship under moral hazard. Specifically an agent must be offered incentive to (a) exert effort (be diligent) and (b) not take excessive risk (speculate). Effort improves productivity and so is desirable for the principal, but costly to the agent. Speculation improves short-term performance, however at the cost of introducing the risk of very large losses. Inducing effort requires an incentive contract where compensation increases with performance. Such a contract also generates the incentive to speculate because speculation improves that performance – but the agent does not pay the losses. For example a manager of a failing firm does not meet all the losses; a failing bank may be bailed out. Studying this problem over a long-term horizon allows the use of intertemporal incentives

like equity grants and stock option grants. An important result is that the incentives to speculate increase in the agent's leverage: a highly levered bank has stronger incentives to speculate. The reason is that when leverage is high, the upside is attractive and the downside limited. To curb speculation one needs the downside to be also painful to the agent; this requires controlling the leverage of that agent. Hence a bank may be made to reduce the size of its balance sheet (decrease its leverage) to *prevent* speculation. I show when such downsizing is required

**12:15am-1:30pm**

**Lunch**

**1:30pm-2:45pm**

**Key Note Address (Market-Based Finance)**

Professor Mark Flannery

University of Florida and Securities Exchange Commission

**2:45pm-3:00pm**

**Afternoon tea**

**3:00pm-4:15pm**

***The impact of bank liquidity on bank risk taking: Do high capital buffers and big banks help or hinder?***

**Policy platform:** FSI Chapter 1 Resilience, Recommendations 1, 3 and 5

**Presenter:** Eliza Wu, UTS

**Discussant:** Kelly Liu (ANU)

**Abstract:** This study examines the impact of bank liquidity on bank risk taking. Using quarterly data for U.S. bank holding companies from 1986 to 2012 we find evidence to support that more liquid banks take more risk. This key result is robust for alternative proxies for bank risk. An increase in liquidity increases banks' non-performing assets, risk weighted assets and stock return volatility. The relation is stronger for banks with high capital buffers and in the high liquidity post-GFC era. However, our results show that bank size usually limits banks from taking more risk when they are flushed with liquidity but this was not the case during the more recent post-GFC high liquidity sub-period. The findings of this study have implications for bank regulators advocating greater liquidity requirements for banks under Basel III.

**4:15pm-5:30pm**

***Anchoring the countercyclical buffer: The role of market liquidity***

**Policy platform:** FSI Chapter 1 Resilience, Recommendations 1, 3 and 5

**Presenter:** Daisy (Minh-Phuong) Doan, Deakin University

**Discussant:** Robert Powell (Edith Cowan U.)

**Abstract:** We propose market liquidity as an alternative indicator to the Credit-to-GDP ratio, which has been proposed by Basel Committee on Banking Supervision (2010) as a reference point for

accumulating the countercyclical capital buffer (CCB), to anchor the build-up and release of the CCB. We find that our proposed measure of market illiquidity on the basis of a floating lookback option correctly calls over 75% of the pre-crisis boom in the build-up phase of the CCB and helps improve the prediction of a crisis by 57% in the release phase. By contrast, the Credit-to-GDP is a good leading indicator for the build-up phase only for big markets such as Germany, Italy, the U.K. and the U.S. while having limited forecasting power in the release phase. Our study also suggests that the accumulation of the countercyclical capital buffer should be activated when the market illiquidity measure is below its long-trend by at least 3.5 percentage point and the capital buffer should be released if the measure exceeds its long-run trend by 2 percentage point.

**6:30pm**

**Dinner @ Courgette (<http://www.courgette.com.au/>)**