Banking Regulation Fine Tuned*

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Anat Admati – Martin Hellwig
The Bankers’ New Clothes


Anat Admati and her co-author Martin Hellwig call attention to the fact that, since the onset of the financial crisis in 2008, there has been no system-level analysis or any active regulatory measures to make the banking system more secure and less vulnerable.

As the antecedents to the book, the authors were shocked to see in articles and in policy recommendations published related to the crisis that the contents presented to the public were filled with multitudes of improperly used terminology and misinterpreted fundamental principles; they furthermore point out that many opinion leaders and policy makers do not fully grasp the system of banking processes and their risks.

In recent decades, a non-transparent and extremely risky financial system has developed, in which today no one any longer dares to raise fundamental questions about the operation of the banking system, to clearly consider the risk factors and to point out that in the case of the banking system the “king of banking profession has no clothes”.

In their easy-to-understand writing, the authors intend to explain the current operation of the banking system while simultaneously outlining the route that led to the crisis in 2008. Over the long term, they aim to contribute to the renewal of the banking system by ensuring wider publicity.

As the introduction of their regulatory recommendations, they draw the key lessons from the financial crisis in 2007-2009; among the most important elements, they identified

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the covering up and understating of the problems of the financial system, especially with regard to statements about the costs of the crisis. This was the case, because most of the time in the international dialogue the crisis was referred to as a mere liquidity crisis, and therefore the focus was primarily on the short-term debts and the banks’ investments in money market funds. However, these calming, more comfortable answers only quieted the calls for reforms and delayed the transformation of the banking system in a way that would allow it to operate with lower risks and more securely, and thus to carry lower costs for both society and economic agents.

Starting with an analysis of the current situation, Admati and Hellwig formulate forward-looking recommendations, which at once serve the more effective operation of the current system, and at the same time — with a view to the future — would amend the regulations towards stability, thus increasing the reliability of both the banks as institutions and the banking system as a whole.

With their theoretical approach, in relation to the operation of banks, the authors call the attention to the more effective corporate governance and the higher level social responsibility with financial considerations, while they highlight regarding the regulation of the banking system the standardisation of global competition terms, the sectoral equilibrium of national economies, as well as the reestablishment of the relations between the state and the banks.

According to the book, the most important measure would be to increase the equity of the banks and in parallel with this to decrease their debts, i.e. to eliminate the source of their vulnerability. Furthermore, Admati and Hellwig urge defining the rules and the manner according to which the Supervisory Authority should intervene in the case of banks that became vulnerable and are in trouble.

In the interest of strengthening the financial system, as a first step the authors recommend identifying and derecognising insolvent banks even if for the present it incurs greater costs; they furthermore emphasise that the presence of so-called “zombie banks” in the economy represent far larger harm, risk and costs. Following this, they urge strengthening the banks, if necessary by prohibiting payouts as long as the bank does not reach the required capital needs.

In the authors’ opinion, the ratios, reference points and time frames set in the international regulation relevant to the banking system — although there has been a positive turn in its logic recently — are still not appropriate. The experts emphasise that Basel III regulation — beyond the fact that it set the period available for the banks to increase their capital far too long until 2019 — made two additional mistakes.

The regulation sets too low capital requirements, and moreover, it does not establish the majority of these requirements in relation to the share of the bank’s total assets, but sets only the ratio to the risk weighted assets at 7%. Within this, the international regulation
sets the minimal capital requirements in relation to the total assets only at 3%. The authors argue that, a capital requirement of 20-30% in relation to total assets would make the financial system substantially more secure and healthier. They recommend extending the higher capital requirements to every firm providing banking and payment service, and financial institution that has significant role in terms of the system operation, meaning that their payment difficulties, insolvency or bankruptcy would cause considerable swing or damage to the system.

Regarding the implementation the authors emphasise that we need to move on from the simple duplicity as to whether or not there is enough capital available, and must put larger emphasis on what the Supervisory Authority should do in the case when the capital of a bank has decreased. In this respect the authors, while agreeing with the logic of the Basel III regulation, set also special ratios.

The language of Anat Admati’s and Martin Hellwig’s book is easy to understand, however, its message also addresses a wider scope of professionals. One of their key messages is that everyone must assume financial responsibility at their respective level, and for this there is a special set of tools. No matter whether one is a private actor, an entrepreneur, a banking expert or a political decision-maker, as an interesting guide book the writing leads the reader around the special world of banking system, fostering orientation in financial affairs and the global renewal of the banking system.

Following publication of the book the “Banker’s New Clothes” in 2013 – as a recognition of the global attention triggered by her work – Time magazine named Anat Admati one of the world’s 100 Most Influential People in 2014.