The theoretical foundation of states regulatory response to the financial crisis

Business

The Theoretical Foundation of s Regulatory Response to the Financial Crisis s There are many theories which have been put forward by many states as a strategy to regulate the financial institutions when a crisis strikes. These theories includes among others, the Money market operations by the central banks, the Deposit Insurance, Bank insolvency regime, Crisis management among others. This paper will therefore discuss the theoretical foundation of states regulatory response to the financial crisis taking into account how these theories have been applied in different countries like the United States, United Kingdom and Poland.

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Introduction

A financial crisis arises when the demand for money is more than the supply resulting in a liquidity problem forcing banks to borrow to make up for the shortfall and in some cases leading to a collapse of this banks. This results into a financial crisis. It is for this reasons that theories have been developed across the financial field on the regulatory response to the crisis. The following are some of the financial regulations that are being adopted by many nations across the globe in trying to control the financial crisis includes; liquidity risk management, money market operations by the central banks, bank insolvency regimes, financial crisis management, and the deposit insurance. This paper seeks to explore the theoretical foundation of states regulatory response to the financial crisis.

States Regulatory Response to the Financial Crisis

The following are some of the theories of state regulatory response to the

financial crisis, which we are going to look at in this study and their applicability in different nations.

The Deposit Insurance

The Deposit Insurance has been used as a way of regulating the financial institutions to control the financial crisis from inflicting adverse effects on the economy of a country. The deposit insurance is a measure used to protect the bank depositors in case of a financial crisis (Strater and Corneli 2008 p. 46). It protects the investors from losing the money they invest in the banks in case the banks have liquidity problem and become insolvent. The Insurance deposits ensure that the investors recover the money. The deposit insurance operates by allowing the banks to deposit part of the money with the Insurance deposit to cushion them from any financial crisis that may lead to recession and closure of these banks. The United States for example protected the smaller banks from the poor states by adopting the insurance Deposit as a strategy to avert a looming financial crisis (McDonald 1996 p. 19-23).

Liquidity risk management

Liquidity risk management theory is also a regulatory response theory to financial crisis. Liquidity is the ability of a bank to fund its assets and meets its long and short term obligation as and when they fall due. When a bank is faced with a financial crisis, it is not able to fund its assets or meet its obligation as and when they fall due. This therefore call for a liquidity risk management strategies such as the adoption of the liquidity adjusted value at risk and the liquidity at risk to manage the liquidity problem arising from the foreign exchange reserves.(Duttweiler 2009 p. 300).

Money market operations

Money market operations by the central banks are also a theoretical regulatory response to a financial crisis. The central bank is a financial institution charged with the responsibility of issuing the currency and regulation of money supply and the control of interest rates of a country. The central bank also regulates the functioning of all central banks of a country. As a regulatory institution, is charged which the responsibility of supervisory and control by being the lender of last resorts to all commercial banks during a financial crisis. The operation of money market by the Central bank was seen in the North Rock bank, a bank for retailing deposits at one time faced a financial crisis which almost lead to the sale of its assets as it could not obtain funding from the wholesale market which had faced a closure. This prompted an intervention from the central bank to obtain cash to save the bank from collapse by using the open market operations to be able to cope with its short term interest rates. This response of regulation by the central bank through money market operation has been seen to be a good strategy in controlling a financial crisis. This theory was used to control the financial crisis in Poland (Ugolini 1996 p. 9-21).

Bank insolvency regime

Bank insolvency arises due to inability if a bank to meet its obligations as result of liquidity problems. The insolvency of a bank is declared when the obligations of a bank is in excess of its assets. In this case the bank will be declared bankrupt. This therefore calls for the establishment of a bank solvency regime, whether corporate or special. A special bank insolvency regime ensures that a timely action is taken in case of a financial crisis. In

most cases it has been seen to provide consistency between the bankruptcies related functions and supervision. By taking a quick response, this assists in controlling a financial crisis. The Citibank and Bank of America had to adopt the bank insolvency regime at a time this banks were faced with liquidity problem to an extent of becoming insolvent (Crotty 2009 p. 553-580).

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