BANK REGULATION, PROPERTY PRICES AND EARLY WARNING SYSTEMS FOR BANKING CRISES IN OECD COUNTRIES

Ray Barrell, E Philip Davis, Dilruba Karim and Iana Liadze[1]
NIESR and Brunel University

Abstract: Existing work on early warning systems (EWS) for banking crises generally omits bank capital, bank liquidity and property prices, despite their relevance to the probability of crisis in the mind of bankers, policymakers and the public. One reason for this neglect is that most work on EWS to date has been for global samples dominated by emerging market crises. For such countries, time series data on bank capital adequacy and property prices are typically absent, while other variables affecting crises may also differ in OECD countries. Accordingly, we estimate logit models of crisis for OECD countries only and find strong effects of capital adequacy, liquidity ratios and property prices, such as to exclude most traditional variables. Our results imply that higher unweighted capital adequacy as well as liquidity ratios has a marked effect on the probability of a banking crisis, implying long run benefits to offset some of the costs that such regulations may impose (e.g. widening of bank spreads).

Keywords: Banking crises, systemic risk, early warning systems, logit estimation, bank regulation, capital adequacy, liquidity regulation

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[1] Barrell, NIESR, National Institute of Economic and Social Research, 2 Dean Trench Street, Smith Square, London SW1P 3HE, United Kingdom, email rbarrell@niesr.ac.uk Davis, Brunel University, Uxbridge, Middlesex, UB8 3PH and NIESR. e-mail: e_philip_davis@msn.com , Karim, Brunel University. e-mail: dilruba.karim@brunel.ac.uk, Liadze, NIESR, email iliadze@niesr.ac.uk

1 Introduction

There is a large literature on systemic banking crisis prediction via so called early warning systems (EWSs) which utilise a range of estimators from panel logit (as in Demirguc-Kunt and Detragiache 2005, Davis and Karim 2008a) to signal extraction (Kaminsky and Reinhart 1999, Borio and Lowe 2002, Borio and Drehmann 2009) to binary recursive trees (Duttagupta and Cashin 2008, Karim 2008, Davis and Karim 2008b).

The success of these models at predicting crises varies, with the logit and binary trees outperforming signal extraction in terms of type I and type II errors.[2] Nevertheless, a shared feature of these previous studies has been their reliance on heterogeneous economies as cross-sections and a common set of explanatory variables. Following Demirguc-Kunt and Detragiache (1998), banking crises have been explained using macroeconomic and financial variables such as real GDP growth, terms of trade and domestic real credit growth. The reliance on generic indicators stems in part from the dearth of data on more specific banking sector and asset price variables for many emerging market countries, which are nevertheless included in samples to boost the number of infrequent banking crisis observations.

Nonetheless, the specifications of such models are undoubtedly inadequate for two reasons. Firstly, the triggers of crisis depend on the type of economy and banking system. For example, in advanced economies with high levels of banking intermediation and developed financial markets, shocks to terms of trade are less important crisis triggers than, say, property price bubbles. This implies EWS design could be improved by focusing on a certain class of economies and selecting explanatory variables that are relevant to their banking structures and lending behaviour.

Secondly, (and related to the previous point), developed economy banking systems are more likely to be regulated in terms of capital adequacy and liquidity ratios. Financial regulators will be mandated to monitor such ratios to restrict instability, which implies these variables are at least used implicitly as EWSs. Why then have previous EWSs failed to incorporate balance sheet variables as explicit banking crisis predictors? A lack of foresight on the part of regulators may be part of the answer; EWS design never evolved because banking crises in developed economies were viewed as highly unlikely over the past decade and so despite data

[2] See Davis and Karim (2008a) and Karim (2008).

availability, new leading indicators of crises have not been assessed for their explanatory power.

In this paper, we contribute by addressing these deficiencies in EWS design. We develop an EWS for OECD economies which ultimately reveals that unweighted capital adequacy (often known as the leverage[3] ratio) and the liquidity ratio alongside real house price growth are the most important crisis determinants for these countries. Moreover, their importance remains invariant to different robustness tests and we can use the information they convey to predict the sub-prime episode out-of-sample. Since these variables have hitherto been unexamined, our results have important policy implications for financial regulators and central banks; optimising the liquidity and capital adequacy[4] ratios of banks and suppressing rapid property price growth may well mitigate future OECD crises.

The paper is structured as follows, in Section 2 we outline the adopted methodology of the panel logit, in Section 3 we introduce the dataset, in Section 4 we detail the results and In Section 5 provide some analysis of the predictions of financial crises. Finally Section 6 concludes and makes some suggestions regarding policy implications.

2. Methodology and Data

Demirguc-Kunt and Detragiache (1998) used the multivariate logit technique to relate the probabilities of systemic banking crises to a vector of explanatory variables. The banking crisis dependent variable, a binary banking crisis dummy, is defined in terms of observable stresses to a country's banking system, e.g. ratio of non-performing loans to total banking system assets exceeds 10%[5]. Demirguc-Kunt and Detragiache (2005) updated the banking crises list to include more years.

Such crisis dummies generate several problems. Firstly, the start and end dates are ambiguous. It could be a while after the onset of crisis before the crisis criteria are observably

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[3] Note this definition of the banking leverage ratio (i.e. capital/unadjusted assets) operates contrary to normal concepts of leverage, in the sense that a higher "leverage ratio" means lower "leverage" in an economic sense of debt-to-equity. Accordingly we prefer to use the term "unweighted capital adequacy" to avoid ambiguity.

[4] Note that although for data reasons we use the unweighted capital adequacy ratio, we expect that risk adjusted capital is also a crisis indicator. Our overall view is that both ratios need to be borne in mind in assessing crisis risk.

[5] Their actual criteria are: the proportion of non-performing loans to total banking system assets exceeded 10%, or the public bailout cost exceeded 2% of GDP, or systemic crisis caused large scale bank nationalisation, or extensive bank runs were visible and if not, emergency government intervention was visible.

met, and the criteria themselves are static, revealing nothing about when the crisis terminates. Since the end dates are to some extent subjectively chosen there are potential endogeneity problems with estimation: the explanatory variables will be affected by ongoing crises. To mitigate this, in our core results we terminate our sample before the sub-prime episode. Secondly, the timing of the crises is crude in the sense that for annual dummies, a crisis starting in December 2000 would generate a value of 1 in 2000 and zero in 2001. However we are concerned with predicting the *switch* between crisis and non-crisis states and accordingly we assume one year crisis duration. For the example given, we accept our dummy takes a value of 1 in 2000 and zero thereafter, although we will later relax this assumption and show our results remain robust.

Table 1: List of systemic and non-systemic crises

	BG	CN	DK	FN	FR	GE	IT	JP	NL	NW	SP	SD	UK	US
1980	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1981	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1982	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1983	0	1	0	0	0	0	0	0	0	0	0	0	0	0
1984	0	0	0	0	0	0	0	0	0	0	0	0	1	0
1985	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1986	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1987	0	0	1	0	0	0	0	0	0	0	0	0	0	0
1988	0	0	0	0	0	0	0	0	0	0	0	0	0	1
1989	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1990	0	0	0	0	0	0	1	0	0	1	0	0	0	0
1991	0	0	0	1	0	0	0	1	0	0	0	1	1	0
1992	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1993	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1994	0	0	0	0	1	0	0	0	0	0	0	0	0	0
1995	0	0	0	0	0	0	0	0	0	0	0	0	1	0
1996	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1997	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1998	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1999	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2000	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2001	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2002	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2003	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2004	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2005	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2006	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2007	0	0	0	0	0	0	0	0	0	0	0	0	1	1

Note:BG-Belgium, CN-Canada, DK-Denmark, FN-Finland, FR-France, GE-Germany, IT-Italy, JP-Japan, NL-Netherlands, NW-Norway, SP-Spain, SD-Sweden, UK-United Kingdom, US-USA.

Our dataset includes 14 systemic and non systemic crises in 14 OECD countries. Information concerning systemic banking crises is taken from the IMF Financial Crisis Episodes database which covers the period of 1970-2007.[6] Non-systemic crises are collected from the World Bank database of banking crises over the period of 1974-2002.[7] The sample covers 14 countries[8]: Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Sweden, Spain, UK and the US over the period 1980-2007. Table 1 presents the matrix of crises, with shaded observations indicating systemic crises.

Our variables cover the years 1980 – 2007, but the sample is partitioned into 1980 – 2006 for in-sample estimation whilst 2007 data is used for out-of-sample prediction. For bank-regulatory target variables, given the cross country dataset, we have used the unweighted capital adequacy (leverage[9]) ratio and not risk-adjusted capital adequacy for the estimation. The unweighted capital adequacy ratio is the ratio of capital and reserves for all banks to the end of year total assets as shown by the balance sheet. Our corresponding measure of liquidity is the ratio of the sum of cash and balances with central banks and securities for all banks over the end of year total assets as shown by the balance sheet. For all countries apart from the UK, unweighted capital adequacy and liquidity ratios were constructed using data from the OECD income statement and balance sheet database. Any missing OECD database observations, as well as the data for 2006 and 2007, were obtained from individual Central Banks and the BankScope[10] database. The OECD database did not supply figures for the UK. We therefore constructed UK liquidity ratios using Financial Services Authority (FSA) data, where liquidity was defined as the ratio of liquid assets[11] over total assets. The unweighted capital adequacy ratio was defined as before and was constructed using Bank of England aggregate data.

As regards the explanatory variables employed, Demirguc-Kunt and Detragiache (2005), who had 77 crises in their sample, found that crises were correlated with macroeconomic, banking sector and institutional indicators. So for example in terms of the macroeconomy, crises occurred in periods of low GDP growth, high interest rates and high inflation, as well as fiscal deficits. On the monetary side, the ratio of broad money to Foreign Exchange reserves and also the credit to the private sector/GDP ratio, as well as lagged credit growth were found to be significant. Institutionally, countries with low GDP per capita are more prone to crises, as

[6] See Laeven and Valencia (2007)
[7] See Caprio and Klingebiel (2003)
[8] Choice of the countries is limited by the availability of the data for our time period.
[9] See footnote 3.
[10] For the liquidity measure, the ratio of liquid assets to total assets for the top 200 banks in a country in question was calculated.
[11] Sum of cash, gold bullion and coin, central government and central bank loans, advances and bills held and central government and central bank investments (i.e. securities).

are those with deposit insurance. All these results were broadly in line with their 1998 paper which featured 31 crises, except that depreciation and the terms of trade ceased to be significant.

Consistent with this, to align our study with previous work, we also include the explanatory variables used by Demirguc-Kunt and Detragiache (2005) and Davis and Karim (2008a) (see Box 1). These variables are constructed using the IMF's International Financial Statistics (IFS) database and World Bank Development (WDI) data. We did not include some typical variables because they are clearly irrelevant to OECD countries, for example, GDP per capita is broadly comparable across OECD countries, while virtually all OECD countries have deposit insurance schemes. Meanwhile credit/GDP (as opposed to credit growth) may reflect the nature of the financial system in OECD countries (i.e. bank versus market dominated) rather than risk of crisis.

Box 1: List of Variables (with variable key)	
Variables used in previous studies: Demirguc-Kunt and Detragiache (2005); Davis and Karim (2008).	1. Real GDP Growth (%) (YG)
	2. Real Interest Rate (%) (RIR)
	3. Inflation (%) (INFL)
	4. Fiscal Surplus/ GDP (%) (BB)
	5. M2/ Foreign Exchange Reserves (%) (M2RES)
	6. Real Domestic Credit Growth (%) (DCG)
Variables introduced in this study.	7. Liquidity ratio (%) (LIQ)
	8. Unweighted capital adequacy ratio (%) (LEV)
	9. Real Property Price Growth (%) (RHPG)

Turning next to our estimator, we use the cumulative logistic distribution which relates the probability that the dummy takes a value of one to the logit of the vector of n explanatory variables:

$$\Pr ob(Y_{it} = 1) = F(\beta X_{it}) = \frac{e^{\beta' X_{it}}}{1 + e^{\beta' X_{it}}} \qquad (1)$$

where Y_{it} is the banking crisis dummy for country i at time t, β is the vector of coefficients, X_{it} is the vector of explanatory variables and $F(\beta X_{it})$ is the cumulative logistic distribution. The log likelihood function which is used to obtain actual parameter estimates is given by:

$$Log_e\ L = \sum_{i=1}^{n}\sum_{t=1}^{T}\left[\left(Y_{it}\log_e F\left(\beta' X_{it}\right)\right) + \left(1-Y_{it}\right)\log_e\left(1-F\left(\beta' X_{it}\right)\right)\right] \qquad (2)$$

Although the sign on the coefficients are easily interpreted as representing an increasing or decreasing effect on crisis probability, the values are not as intuitive to interpret. Equation (2) shows the coefficients on X_{it} are not constant marginal effects of the variable on banking crisis probability since the variable's effect is conditional on the values of all other explanatory variables at time t. Rather, the coefficient $ß_i$ represents the effect of X_i when all other variables are held at their sample mean values. Whilst this makes the detection of non-linear variable interactions difficult, (the logit link function is linear), the logistic EWS has the benefit of being easily replicable by policy makers concerned with potential systemic risk in their countries.

3 Results

In order to obtain our final model specification, we used a general to specific approach, starting with all the variables listed in Box 1. At each stage, we omitted any variables that were insignificant in the previous stages. All variables were lagged by one period, apart from real house price growth (3 lags), in order to capture developments in the economy prior to the crisis and to avoid endogenous effects of crises on the explanatory variables. Besides being essential to obtain a true "early warning"[12], lagging variables is also theoretically sound since they behave procyclically.

As expected in the context of the OECD, all of the "traditional" variables proved insignificant, despite experimentation with different lag lengths. For example, domestic credit growth was insignificant with a negative sign. Decreasing the order of lags increased its significance, with the current value becoming significant at the 5 per cent probability level, although the negative sign of the parameter was an indication of the scarcity of available credit once the banking crisis materialised. The specific variable deletions and their corresponding t-statistics are listed in Table 2. We test for joint elimination of insignificant variables and the F statistic is insignificant at 0.318.

[12] It is notable that some of the work in this area uses current levels and not lags and so is only providing "Contemporaneous Confirmation Indicators" of crises.

We also applied our final specification to data for 1980 – 2007 (see Table 3) to ensure our conclusions were unaffected by the sub-prime episode. Given that they were not affected , we accepted equation 3 as our final EWS.

Table 2: The General To Specific Approach

LIQ(-1)	-0.118 (-3.55)	-0.124 (-3.55)	-0.137 (-3.64)	-0.135 (-3.55)	-0.135 (-3.45)	-0.144 (-3.39)	-0.147 (-3.25)
LEV(-1)	-0.333 (-2.85)	-0.239 (-1.90)	-0.315 (-2.24)	-0.247 (-1.64)	-0.271 (-1.67)	-0.280 (-1.72)	-0.273 (-1.62)
RHPG(-3)	0.113 (2.8)	0.113 (2.87)	0.104 (2.67)	0.100 (2.59)	0.104 (2.67)	0.108 (2.76)	0.110 (2.67)
DCG(-1)	-	-0.099 (-1.82)	-0.10 (-1.97)	-0.10 (-1.86)	-0.10 (-1.99)	-0.13 (-1.98)	-0.13 (-1.98)
RIR(-1)	-	-	0.084 (1.37)	0.085 (1.40)	0.165 (1.41)	0.173 (1.46)	0.166 (1.30)
M2RES(-1)	-	-	-	-0.00 (-1.0)	-0.00 (-1.0)	-0.00 (-1.1)	-0.00 (-1.1)
INFL(-1)	-	-	-	-	-0.13 (-0.8)	-0.14 (-0.8)	-0.13 (-0.7)
YG(-1)	-	-	-	-	-	0.116 (0.65)	0.125 (0.66)
BB(-1)	-	-	-	-	-	-	-0.013 (-0.1)

Note: estimation period 1980-2006; t-statistics in parentheses; LIQ-liquidity ratio, LEV- unweighted capital adequacy ratio, YG-real GDP growth, RPHG-real house price inflation, BB-budget balance to GDP ratio, DCG-domestic credit growth, M2RES-M2 to reserves ratio, RIR-real interest rates, DEP-depreciation, INFL-inflation.

Table 3: Comparing the Effects of Sample Period on Estimation Results

	Estimation period	
	1980-2006	1980-2007
LIQ	-0.118 (-3.55)	-0.13 (-4.1)
LEV	-0.333 (-2.85)	-0.261 (-2.51)
PHG	0.113 (2.8)	0.106 (2.79)

$$\log\left[\frac{p(\text{crisis})}{1-p(\text{crisis})}\right] = -\,0.333\ \text{LEV}(-1) - 0.118\ \text{LIQ}(-1) + 0.113\ \text{RHPG}(-3) \qquad (3)$$

$$(-2.85) \qquad\qquad (-3.55) \qquad\qquad (2.8)$$

where p(crisis) is the probability of crisis occurrence and t-statistics are given below each coefficient.

The results in Table 2 clearly show that an increased unweighted capital adequacy ratio and liquidity ratio in the banking sector has a beneficial impact of reducing crisis probability.[13] Those banking systems with healthy levels of capital one year prior to the crisis were less likely to collapse, as were those that held relatively high levels of cash and securities on their balance sheets. On the other hand, higher real house price growth three years prior to the crisis suggests a prolonged period of risky mortgage lending by banks will unambiguously increase the chances of borrower default and thus a crisis.

Since the impacts of unweighted capital adequacy ratios, liquidity and house price growth on the log-odds of crisis have not been previously quantified, it is worth investigating their individual marginal effects on crises; simply observing the coefficients in equation 3 cannot produce a meaningful ranking of variable importance. Table 4 shows the marginal contribution of each variable to crisis probability for the entire 1980 – 2006 estimation period. Since the marginal effect of each variable is contingent on the values taken by all other variables, it is customary to compute marginals whilst holding all other variables at their sample mean values.

Table 4. Marginal effect of a 1 point rise in the variable on crisis probability.

	LIQ	LEV	RHPG
BG	-0.17	-0.49	0.17
CN	-0.22	-0.61	0.21
DK	-0.05	-0.14	0.05
FN	-0.23	-0.65	0.22
FR	-0.78	-2.17	0.74
GE	-0.23	-0.65	0.22
IT	-0.17	-0.46	0.16
JP	-0.38	-1.05	0.36
NL	-0.56	-1.57	0.53
NW	-0.33	-0.91	0.31
SD	-0.12	-0.34	0.12
SP	-0.08	-0.24	0.08
UK	-1.19	-3.32	1.13
US	-0.08	-0.22	0.07

Note: percentage points

[13] The corresponding Wald test statistic which tests for the joint insignificance of all other explanatory variables listed in Box1 proves that apart from leverage, liquidity and real house price growth all other variables were insignificant. The actual probability (under the F distribution) was 31%.

Of the three leading indicators, the unweighted capital adequacy ratio consistently exerts the highest marginal reduction on banking crisis likelihood, irrespective of the country in question. The highest impact occurs in the UK and France because their mean unweighted capital adequacy ratio measures were lower than the remaining sample. The implication is that a one point rise in the unweighted capital adequacy ratio alone could reduce crisis probability by at least 0.14 % (Denmark) and by as much as 3.32% (UK). The next highest marginal impact occurs via improved liquidity. If, in aggregate, banks simply increased their holdings of cash and short-term securities by one point, with no attention to other variables, the reduction in crisis probability would be at least 0.08% (USA) and could be as high as 1.19% (UK). Again the effect in the UK is highest due to the lowest sample mean liquidity, whilst in the US it is lowest due to the converse. It is worth noting the apparently high liquidity held in the US was overestimated in the sense that the measure ignored the liquidity risk attached to sub-prime securitised assets and that once this materialised, actual liquidity in the US banking sector evaporated.

Even with no deterioration in the health of bank balance sheets, a point rise in real house price growth is sufficient to raise the probability of crisis by at least 0.07% (US) and by as much as 0.74% (France). This general result conforms to the traditional banking crisis literature on leading indicators of crises including Borio and Drehmann (2009) and recent findings by Reinhart and Rogoff (2008) who note the sub-prime episode was no different from previous OECD cases which were characterised by house price booms in the run up to crises. Whereas Reinhart and Rogoff (2008) simply identify property prices as a leading indicator, we are actually able to quantify their impact and the impact of unweighted capital adequacy ratios and liquidity in the run-up to the sub-prime episode, which we turn to next.

The marginal effects in Table 4 were based on sample mean values of the indicators. However, to assess their true contribution to the current crisis, we should evaluate the marginals on the basis of ex-ante data. This is done in Table 5 where marginals are computed using 2006 data values, because this was in advance of the 2007 sub-prime episode. Hence when we compute the 2006 marginal impacts we are actually utilising 2005 values for liquidity and unweighted capital adequacy ratios (both lagged 1) and 2003 values for real house price growth (lagged 3). Henceforth for ease of exposition we will refer to these as 2006 values.

Table 5:. Marginal effect of a 1 point rise on the probability of a crisis using 2006 data values

	LIQ	LEV	RHPG
BG	-0.27	-0.76	0.26
CN	-0.12	-0.35	0.12
DK	-0.09	-0.24	0.08
FN	-0.32	-0.91	0.31
FR	-0.43	-1.22	0.42
GE	-0.09	-0.25	0.08
IT	-0.64	-1.78	0.61
JP	-0.02	-0.06	0.02
NL	-0.35	-0.97	0.33
NW	-0.65	-1.81	0.62
SD	-0.17	-0.48	0.17
SP	-0.39	-1.08	0.37
UK	-2.38	-6.68	2.28
US	-0.05	-0.14	0.05

Note: percentage point. LIQ and LEV are at 2005 values owing to lag 1 and PHPG is at 2003 levels owing to lag 3

Tables 4 and 5 show there were clear changes in the marginal impacts of liquidity, unweighted capital adequacy ratios and property prices just before the sub-prime crisis relative to the sample mean. Such changes are understood as follows: if the difference between the absolute marginal based on sample averages and the absolute marginal based on 2006 data is positive (ceteris paribus) the variable's impact on crisis probability has increased. This could arise for three reasons: either the 2006 level of liquidity or the unweighted capital adequacy ratio is lower than the sample mean level or by 2006, real house price growth has overshot the average. For example, in the case of liquidity, an increase in the marginal effect would imply aggregate liquidity levels in 2006 were too low and since liquidity was so scarce, a marginal improvement in capital and reserves would have a stronger crisis reducing effect than in other years. A similar story would apply to the unweighted capital adequacy ratio, whilst for real house price growth (which is at 2003 values given the 3 year lag) the converse would be true. Since the house price coefficient is positive, the higher the level of house price growth the greater the marginal impact on crisis likelihood. Thus a positive marginal change describes a situation where 2006 growth rates of house prices were higher than the sample average and consequently, any additional pressure on the housing bubble could have severe consequences for the banking system. To illustrate the changes in marginal impacts, Table 6 computes the difference between the 2006 marginal effects and the marginals based on sample means.

Table 6: Change in the Marginal Impacts in the run up to the sub-prime crisis (2006); All Variables Held at Values Relevant to 2006

	LIQ	LEV	RHPG
BG	0.10	0.28	0.09
CN	-0.10	-0.27	-0.09
DK	0.04	0.10	0.04
FN	0.09	0.26	0.09
FR	-0.34	-0.95	-0.32
GE	-0.15	-0.41	-0.14
IT	0.47	1.32	0.45
JP	-0.35	-0.99	-0.34
NL	-0.21	-0.59	-0.20
NW	0.32	0.89	0.30
SD	0.05	0.15	0.05
SP	0.30	0.85	0.29
UK	1.20	3.35	1.14
US	-0.03	-0.08	-0.03

It should be noted that Table 6 effectively displays the combined marginal effects of all variables in the run up to crises, because all variables take on their 2006 (2005 and 2003) values. Hence, for example when we say the ability of higher unweighted capital adequacy ratios to reduce crisis probability increases ex-ante, we are taking this effect conditional on the fact that liquidity and house price growth were displaying a certain ex-ante behaviour. To isolate the pure change in the marginal effect of a variable on crisis probability, in Table 7 we compute the marginal effect of each variable in 2006, holding the two other variables constant at their sample mean values (Table 7).

Table 7: Change in the Marginal Impacts in the run up to the sub-prime crisis, variable in question held at 2005 or 2003 values; all Other Variables Held at Sample Means

	LIQ	LEV	RHPG
BG	0.01	0.01	0.07
CN	-0.12	-0.09	0.08
DK	0.01	0.09	0.00
FN	0.23	-0.33	0.09
FR	-0.53	-0.32	0.65
GE	-0.12	-0.05	-0.04
IT	0.41	-0.18	0.13
JP	-0.29	-0.57	-0.14
NL	-0.28	0.63	-0.06
NW	0.32	-0.07	0.02
SD	-0.03	0.03	0.03
SP	0.05	0.01	0.14
UK	0.08	-0.10	1.10
US	0.01	-0.13	0.02

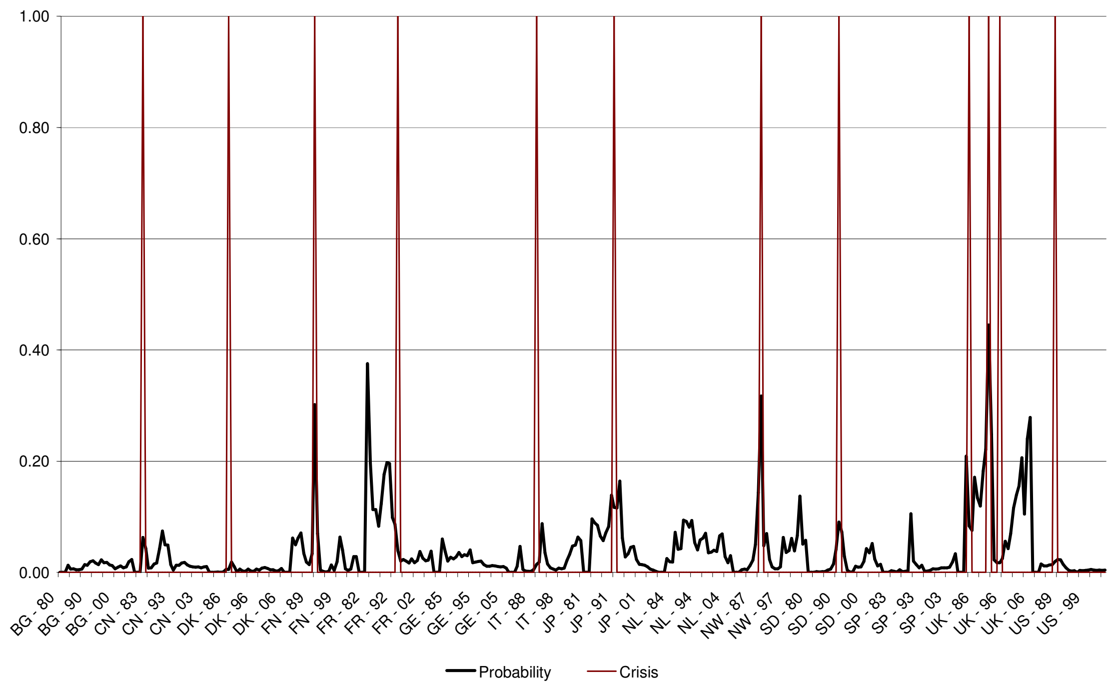
The two tables yield interesting insights into the contribution of each variable to crises. If other variables behave as they do on average, the ability of liquidity to reduce crisis probability increases in 2006 in most countries. For example, a one point increase in liquidity in Belgium would have reduced crisis likelihood by 0.01 percentage points if unweighted capital adequacy ratios and house prices had behaved “normally”. But once we allow these two variables to take on their 2006 values, the liquidity levels in Belgium become much more important for crisis prevention; the marginal effect is now ten times higher at 0.10 percentage points. Similarly significant impacts of liquidity are observed for Denmark and Spain, with the most dramatic effect being observed in the UK. Moreover, the result is heterogeneous because in some countries such as Finland and France, once the other variables were allowed to take on their 2006 values, the marginal effect of liquidity actually fell, whilst in the US the ability of liquidity to prevent a crisis actually fell given the ex-ante dynamics of the other variables. This may be because by 2006, increased liquidity in the banking system may have further fuelled the last phase of the property price bubble.

The marginal impact of unweighted capital adequacy ratios in some countries is even more dramatic than liquidity. For example, in Belgium, once liquidity and house price growth took on their levels relevant to 2006, the ability of higher cash and reserves to bring down the risk of crisis rose from the “average” level of 0.01 percentage points to 0.28 percentage points. Similarly important increases were observed for Finland, Italy, Norway, Spain and the UK, suggesting that intervention to improve the capital base of banks in these countries would have had beneficial effects. Conversely, the marginal impact of unweighted capital adequacy ratios on crisis probability in Canada, France, Germany and Japan actually fell in the run-up to the sub-prime episode, implying at this stage, an improvement in capital could not avert the crisis by much.

The most interesting marginal impacts are those displayed by real house price growth. In most countries, once liquidity and unweighted capital adequacy ratios were allowed to take on their 2006 values, the ability of further house price increases (in 2003) to cause crises increased.

Given the marginal effects described above, we now turn to see which crises were picked up by our EWS. Figure 1 below shows the actual in-sample crisis probabilities against the EWS fitted values. If we use the in-sample probability of crisis as a cut-off threshold[14] to identify which crises are called, for our sample we obtain a cut-off threshold of 0.03 (3%).

Figure 1: Probability of crises according to the logit model



Based on this threshold, our model is able to correctly identify 8 out of the 12 crises, equivalent to a 66% success rate, implying that we would outperform a random naïve model which would only call crises on 50% of occasions. The corresponding type II error rate is 29%, but encouragingly, many of these so-called false alarms actually occur close to the crisis onset, implying the EWS predictions are at least able to distinguish between episodes of financial stability and instability and in many cases can identify actual crisis onset. Table 8 gives details of the in-sample predictive performances for each country and the relation of any false alarms to the timing of crises, and it is clear the false call rate is better described as 25%.

[14] In the manner of Demirguc-Kunt and Detragiache (1998) and Kaminsky and Reinhart (1999).

Table 8: In-Sample Prediction

	Total Calls	Crises	Aftermath of the Crises	False Calls	Timing of False Calls relative to Crisis Onset
BG	0	0	0	0	
CN	6	1	1	4	next year
DK	0	0	0	0	
FN	10	1	1	8	next year
FR	14	1	0	13	
GE	4	0	0	4	
IT	7	0	2	5	2nd and 3rd years
JP	15	1	6	8	Next 7 years, with a break on the 4th year
NL	18	0	0	18	
NW	14	1	2	11	next 2 years
SD	6	1	1	4	next year
SP	2	0	0	2	
UK	20	2	0	18	
US	0	0	0	0	
total	*116*	*8*	*13*	*95*	

Based on these results we would argue that an EWS based on liquidity ratios, unweighted capital adequacy ratios and real house price growth would significantly improve policy makers' abilities to avert crises in the OECD. To verify our claim, we next turn to out-of-sample prediction to see if our EWS is able to detect the sub-prime episode in any of the OECD economies. We base our results on two crises definitions given in Borio and Drehmann (2009). According to Definition 1, crisis occurs in "countries where the government had to inject capital in more than one large bank and/ or more than one large bank failed". By the end of January 2009 this definition classified the following crises: US, UK, Belgium, France, Germany, Ireland and the Netherlands. Definition 2, which is less stringent, states countries experienced crisis when "countries undertook at least two of the following policy operations: issue wholesale guarantees, buy assets, inject capital into at least one large bank, or announce a large scale recapitalisation programme". Under this definition, all the countries previously listed experienced crises but in addition, Australia, Canada, Denmark, Italy, Spain, Sweden and Switzerland also fell into the crisis list.

Using the same cut-off threshold as before, we derived out-of-sample predictions for all the countries in our sample for the years 2007 and 2008. If a crisis was called in any country we then checked the Borio and Drehmann (2009) definition to see if a crisis had actually materialised there or not. The results are given in Table 9 which indicates any crises called by our EWS in columns 1 and 2 and the corresponding crisis occurrence according to the definitions. As can be seen, our EWS was able to call 4 out of 6 crises according to definition 1 and 6 out of 10 crises according to definition 2, with false calls in only two countries. Given that we were able to call 66% of crises in-sample, our model has not lost any of its predictive power out-of-sample. This is the ultimate test of any EWS, in the sense that they are known to have better in-sample performance compared to out-of-sample predictive ability. On the basis of these results, we argue that our EWS specification would be a valuable tool for any OECD policy maker wishing to avert future crises. Moreover, we now go on to show our specification is extremely robust and can therefore be used with confidence.

Table 9: Out of sample predictions

	2007	2008	definition1	definition2
BG	X	X	X	X
CN	-	-		-
DK	-	-		
FN	-	X		
FR	X	X	X	X
GE	-	-	-	-
IT	X	-		X
JP	-	-		
NL	X	-	X	X
NW	X	X		
SD	-	-		-
SP	X	X		X
UK	X	X	X	X
US	-	-	-	-

4. Robustness Tests

Our conclusions do not change when we thoroughly test our coefficients for robustness. To examine the possibility that our results are driven by variable behaviour in an individual economy, we re-estimate the logit equation by dropping the systemic crises economies individually. This results in the deletion of UK, US, Norway and Finland and Japan one by one, yet in each case, all our coefficients retain their significance, sign and order of magnitude. To ensure a further degree of robustness, we also re-estimate the logit function after dropping the US and Japan together since it could be argued that our results are driven by the non-European crises. Again, the separation of crises by region made no difference to the impacts of liquidity ratios, unweighted capital adequacy ratios or real house price growth on crisis probability demonstrating the importance of these variables in all OECD banking crises. The results of the country elimination tests are given in Tables 10.

Table 10. Results for country elimination tests

	Final panel	UK not included	US not included	Japan not included	US and Japan not included	Norway not included	Finland not included	Sweden not included
LIQ(-1)	-0.118	-0.143	-0.125	-0.111	-0.119	-0.124	-0.121	-0.115
	(-3.55)	(-2.99)	(-3.55)	(-3.28)	(-3.29)	(-3.59)	(-3.5)	(-3.41)
LEV(-1)	-0.333	-0.3	-0.339	-0.344	-0.349	-0.282	-0.293	-0.343
	(-2.85)	(-1.78)	(-2.79)	(-2.94)	(-2.86)	(-2.38)	(-2.43)	(-2.87)
PHG(-3)	0.113	0.152	0.119	0.111	0.118	0.089	0.083	0.107
	(2.8)	(3.44)	(2.82)	(2.74)	(2.76)	(2.04)	(1.84)	(2.58)

Next, we turn to crisis dates in recognition of the fact that timing the onset of a crisis relies on some degree of subjective judgement. It could therefore be suggested that our results are dependent on the specific crisis dates we happened to choose. If several different crisis definitions generate the same start date for a given crisis, we would conclude that subjectivity does not distort the timing of the crisis. If however, the same crisis is timed differently according to different definitions, we might worry that subjectivity has biased our coefficients. Accordingly, we turn to the recent work of Reinhart and Rogoff (2008) who examined the causes of OECD crises and compared our crisis dates to theirs. Two of our crises dates now change: Japan and the US which they date as 1992 and 1984 respectively. For additional robustness, we redefine the crisis dummy for Japan (crisis in 1992) and the US (crisis in 1984) but find this makes no difference to our results as can be seen in Table 11.

Table 11. Effect of alternative crisis dates on variable significance

	Final version	Japanese crisis at 1992	US crisis at 1984
LIQ(-1)	-0.118	-0.119	-0.12
	(-3.55)	(-3.56)	(-3.58)
LEV(-1)	-0.333	-0.332	-0.317
	(-2.85)	(-2.85)	(-2.73)
PHG(-3)	0.113	0.113	0.104
	(2.8)	(2.8)	(2.56)

Again in relation to the timing of crises, another criticism of our crisis dummy could be that the one year duration could affect our results. It could be argued that by assuming the dummy takes a value of one in the start for the crisis year only, and zero otherwise, we are relating post-crisis explanatory variables to non-crisis episodes. As explained in the introduction, we initially adopted this procedure to identify which variables contribute to the switch between non-crisis and crisis states, rather than which variables prolong the crisis. Nevertheless, we now relax the assumption that crises last for one year. By looking at our crisis definitions and indentifying the duration of each crisis, we can drop all post-crisis observations for the years in which the crisis persisted. This verifies the insensitivity of our results to crises durations and avoids endogeneity between the crisis itself and the explanatory variables in the post-crisis period. Our results continue to be robust; even when we drop post-crisis observations, the significance of our coefficients does not change as Table 12 shows.

Table 12. Impact of the elimination of post-crisis observations on variable significance

	Final version	Aftermath of the Crisis
LIQ(-1)	-0.118 (-3.55)	-0.111 (-3.48)
LEV(-1)	-0.333 (-2.85)	-0.329 (-2.91)
PHG(-3)	0.113 (2.8)	0.111 (2.74)

Conclusions

In contrast to the existing literature, we have estimated equations for early warning systems for banking crises in OECD countries using not only traditional indicators in that literature but also bank capital adequacy and property prices, which have not before been assessed as indicators. We find that bank capital adequacy, bank liquidity and property prices indeed impact on banking crisis probabilities and tend to exclude more traditional variables such as GDP growth, inflation and real interest rates. Furthermore, the model can be used to detect rises in crisis probabilities out-of-sample, in the run up to the sub-prime episode. Moreover, their importance remains invariant to different robustness tests.

Our results have important policy implications for financial regulators and central banks. The need for high levels of capital in banks is underpinned, as is the need for liquidity on the asset side. Furthermore, suppressing rapid property price growth may well mitigate future OECD crises; given the difficulties of using monetary policy to counteract risks to financial stability and monetary stability with one instrument (e.g. use of interest rates to limit asset price bubbles in a low-inflation context), use of supervisory instruments such as capital adequacy on mortgage loans or limits on loan to value ratios on mortgage lending may be warranted.

The suspicion that bank capital adequacy and liquidity are countercyclical (as is shown for example in Babihuga (2007)) means that measures to restrict procyclicality of the financial system are also validated by our results. There is already an approach in operation in Spain which raises capital adequacy when credit grows rapidly, and this is evidently warranted by our results. Repullo et al (2009) recommend to mitigate procyclicality by adjusting capital requirements using a simple multiplier that depends on the deviation of the rate of growth of GDP from respect to its long-run average. As discussed in Brunnermeier et al (2009), an alternative is a response of capital adequacy to debt-equity, maturity mismatch, credit growth and asset price growth, suitably weighted – a broader approach that our results underpin. Liquidity risk could be reduced by "marking to funding" and capital charges against illiquidity. It is encouraging to see that the latest regulatory response to the global banking crisis, The Turner Review (Financial Services Authority 2009) is consistent with our results, in calling for improved quality of liquidity and capital adequacy in the UK banking system, for countercyclical ratios and also a focus on a unweighted capital adequacy ratio[15] as well as risk adjusted capital adequacy.

[15] To quote the recommendations of the Turner Review, "A maximum gross leverage ratio should be introduced as a backstop discipline against excessive growth in absolute balance sheet size" (ibid, page 7).

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