Financial Regulatory Reforms: Not Far Enough, or Overkill?

A Note for Discussion

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Background

From the early 1980s on, the banking industry has experienced significant institutional and procedural deregulation as well as cost reductions from advances in information and transaction technologies and the evaporation of reserve requirements. As a consequence, the industry started to act globally developing new, and by volume vastly growing, instruments for financial investments and taking on board unprecedented (and not always well managed) risks. Given the regulatory ease on the industry in the past, the financial crisis and subsequent actions to re-regulate banking was hence resented as "overkill" by some; it does not go far enough for others. The divisive positions on banking regulations are typically heightened by emotions resulting from apparent dysfunctions of the industry ranging from supposedly excessive bonuses, speculation on banks' own accounts with risks being shifted to taxpayers, to outright fraud, including the rigging of financial data such as the Libor, an important benchmark for financial dealings. All this has undermined confidence in banking.

Reforming financial regulation is not easy under these auspices. It has to reconcile short-term emergency responses (to reestablish trust and to avoid a meltdown of the financial system) with structural mechanisms of a longer-term bearing and the need to ease transition to a new regime in order to avoid shocks to the real economy that would affect the growth of investments, production, consumption and employment.

While Basel III, the main regulatory codex for banking, was originally conceived in a longer-term framework, it has clearly been sharpened under the impression of the crisis. Additional emergency measures to reestablish trust, such as stress testing, have put new strain on the industry without producing unambiguous results. And the catalogue of further demands for regulation inspired by frantic policy making is long: from controlling bonuses, forbidding certain operations in investment banking (such as short selling; or the "Volcker rule", i.e. making speculative investments on a bank's own account), up to calls for structural changes such as the separation of commercial and investment banking, the obligatory use of central counterparties for trade of certain instruments, or the taxation of financial operations and/or assets. In Europe the discussion is further obscured by proposals to reorganize the supervision of banking institutions at the supranational level.

Assessing the impact of banking regulation

The judgment on whether banks may face "overkill" under recent legislation such as Dodd-Frank in the United States or the pending implementation of Basel III in both the United States and Europe is not easy given that much is still in flux and some measures may still be "watered down" during the process. Moreover not all reform

proposals sketched above are contained in this legislation as yet. This renders it difficult to determine appropriate benchmarks for judgment.

I shall address the subject from a European perspective mainly based on Basel III and other realistic schemes. I shall also look into the more recent proposals for reorganizing banking supervision in Europe and the euro area in particular.

The main pillars of Basel III and farther-reaching reform proposals can be characterized as follows:

- *Raising the quality, consistency and transparency of the capital base* – These measures concentrate on enhancing the quality of capital by harmonizing Tier 2 and eliminating Tier 3 capital. It is hard to argue that these provisions would impair the banking business. On the contrary: they render banking more resilient and vigorous (although it may imply extra costs for some institutions).
- *Enhancing risk coverage* – The provisions zoom in on new risks in the capital adequacy ratio, such as off-balance sheet risks, derivative related exposures, resecuritization, or counterparty credit risk, for instance. Turning the back on such risks proved to be destabilizing during the crisis. The supervisory measures proposed are of course imperfect substitutes for an effective risk management at the level of the firm (which proved, alas, to be deficient), but they contribute to establishing a level playing field and to limiting the danger of a competitive race to the bottom and the playing down of risks. This should be to the benefit of the banking industry in general.
- *Constraining the build-up of leverage and introducing financial safeguards* – These provisions aim at mitigating the risk of a destabilizing deleveraging that could damage the financial system and the real economy; and they are geared toward enhancing transparency. It is arguable what a healthy leverage ratio would be[1], but it is obvious that excessive leverage during the pre-crisis years has exacerbated the crisis, bearing on asset prices, and hence the banks' capital and profitability, and reducing credit availability. Controlling the process of deleveraging is perhaps the greatest challenge for the financial industry, and it will undoubtedly reduce the role of investment banking and constrain the industry's return on capital, needing assistance by monetary authorities (quantitative easing). But the overall gains in long-run stability and profitability are likely to outweigh short-run speculative profits based on excessive leveraging.
- *Providing countercyclical buffers and limiting excess growth of credit* – These measures will certainly interfere with banking operations that benefit from procyclicality. And they will bear on profitability through the need to make forward-looking provisions that can be relied upon under stress. It is obvious that such provisioning will constrain the distribution of dividends, share buy backs and generous compensation payments, and they will be resented for these reasons. Yet they are effective tools to address the relevant market failures, aggravated by herd behavior and collective action, by introducing harmonized minimum standards for all banks, which puts them on equal footings. However uniform rules on capital adequacy ratios may have a price for those institutions that are less exposed to global risks such as savings banks and credit unions.

[1] It should be noted however that the UK bank's leverage, until the 1960s, was about 12 percent (or below before WW I), excepting the two wars. It reached a triple of that value before the financial crisis.

- *Addressing systemic risk and interconnectedness* – The crisis has clearly exposed the systemic role of larger institutions whose risk portfolios are highly interconnected and may collapse under a shock, which jeopardizes financial stability in general. Capital adequacy rules for such institutions are to be increased by combinations of capital surcharges, contingent capital, and bail-in debt. Again, this will bear on these banks' profits and, from their perspective, could be resented as „overkill". But the long-run gains, if not for the industry then definitely for taxpayers, will certainly outweigh the costs. It could of course be argued that these costs are borne unilaterally by systemically relevant institutions, which reduces their competitive position. But the extra costs can be shifted into the price of their sophisticated financial services for which they do not face competition from ordinary banks. Given a heated discussion on the role of systemically relevant banks, subjecting them to macroprudential supervision and higher capital adequacy standards is preferred to radical proposals such as to break them up into smaller units that would be unable to face the challenges of global banking.
- *Introducing a global liquidity standard* – This is an innovative tool in the inventory of banking supervision whose benefits and costs are difficult to assess. Under normal circumstances a bank should manage its liquidity in pure self-interest. But the crisis has revealed the inadequate provisioning of liquidity by individual banks, despite sound capital adequacy, and uncertainties and distrust among banks have produced liquidity shocks on interbank markets that had to be cushioned by central bank intervention. Creating a common framework for minimum liquidity standards is unlikely to hurt the business of banks as it will corroborate the interbank market and hence reduce the costs of providing liquidity under strain. It also sets a level playing field for all, which limits the scope for ruinous competition.
- *Channeling certain OTC operations through central counterparties* – It is obvious that OTC transactions blur market transparency while unfairly benefiting from services provided by central counterparties (such as price setting). Channeling particularly risk-sensitive transactions through institutionalized counterparties may indeed be more costly, because settlement risks now enter the price, but it clearly adds to market transparency and stability. This should benefit all market participants, including banks. Of course the main beneficiaries will be the central counterparties themselves of which banks may be the owners. For the financial industry as a whole the measures are likely to be profitable as the costs can be shifted, at par among banks, onto the final users of the services.
- *Separating commercial from investment banking and banning certain operations* – This topic is highly contentious and, probably, intrudes too far into the structure of the banking sector and its business. However it makes sense to ring-fence depositors and commercial banking from risky financial investments. This could easily be done *within* a bank (as for different lines of business in insurance). The transfer of resources between business lines within the institution should be unrestricted, but be carried out with risk-adjusted transfer prices. This way the overblown profits of investment banking are likely to be reduced in favor of commercial banking. Whether the banks can organize such dealings without common supervisory standards that prevent competitive conflicts among different business lines is doubtful however. Matching commercial and investment banking in a fair play without producing competitive, and inefficient, crowding out of resources remains an unresolved piece of the puzzle where further thinking on supervisory intervention and standard setting is needed.

- As to the banning – or controlling – of certain financial operations, a hands-off approach is likely to be commendable. For instance, if short selling were to be forbidden, an important instrument to counter overheating markets would be eliminated. This can only amplify price bubbles. Innovative products such as derivatives may indeed conceal risks, but they may also be used for hedging risks. The appropriate answer must be proper pricing and a better rating of structured products, in particular where resecuritized, according to rules that convey the lowest rating of components onto the entire package, for instance. The contentious Volcker rule is likely to increase the costs of investment banking, but it needs exemptions and privileges in order to become operational. These will create loopholes that will undoubtedly be exploited aggressively by innovative firms, which will entail new inequities and inefficiencies that do not only harm customers, but the industry more generally.

  Another case in point is high frequency trading. Allegedly needed to secure liquidity, this kind of trading has degenerated into a race, at the speed of electrons, for tiny arbitrage gains to be reaped from automated processing. Only the technologically most advanced banks can compete for such gains where the winner takes all. As an aside, the interplay of complex trading algorithms is suspected to provoke artificial and excessive volatility through unruly non-linearities.

  Whether high frequency trading renders the financial industry more efficient and serves to keep the financial costs for the ultimate user in the real economy at bay is highly doubtful. On the contrary: the fact that central counterparties seem to grant direct access on site to these privileged traders' computers, and even to spy into the order book pre-trading, must be considered discriminatory at least; at worst it could be criminal (analogously to insider trading).

  Such practices must simply be deemed unfair and distorted. They could, perhaps, be best controlled or curtailed by financial transaction taxes whose assessment and collection is embedded in the automaticity of the trading algorithm. Given that transactions costs have fallen dramatically over the years, an additional tax on financial transactions at a tiny rate is unlikely to represent overkill.

Whether the proposed measures in banking regulation are sufficient or do not go far enough remains an open question. But it is definitely counterproductive to insist on micromanaging the banking business from outside through overly detailed supervisory regulation; and it would be counterproductive to push the reform agenda through swiftly as a 'big bang'. Cautious phasing is needed. Managing the transition process gradually is critical because the deleveraging of credits needs time and assistance from monetary authorities to prevent a breakdown of the real economy.

True, there are a number of pending problems to be resolved, especially as to balancing commercial and investment banking, the inclusion into financial supervision of bank spin-offs (such as special investment vehicles), quasi-banks and non-banks (such as hedge funds). In this regard actual supervisory rules and propositions may be regarded as incomplete needing further elaboration. But overall the record of supervisory reforms in banking appears to be balanced and result oriented.

The reorganization of banking supervision in Europe

The crisis has emphasized the need to better control financial conglomerates that operate globally going beyond national borders and employing ever more complex financial products and dealings. And the increasing integration of international financial markets poses additional risks in case one of the important global players fails. Hence global banking represents a macroprudential challenge that can only be addressed conjointly at a supranational level. The reorganization of financial supervision in Europe responds to such challenges.

The previous loose organization of European financial supervision relied entirely on national supervisory bodies with some coordination through three European advisory committees with no legal personality (for banks, the Committee of European Banking Supervisors, CEBS).[2] In 2011 the committees were transformed into full-fledged and independent authorities with legal personality and much broader competences. The European Banking Authority (EBA), successor of CEBS, aims at "preventing regulatory arbitrage, guaranteeing a level playing field, strengthening international supervisory coordination, promoting supervisory convergence and providing advice to the EU institutions in the areas of banking, payments and e-money regulation as well as on issues related to corporate governance, auditing and financial reporting."[3]

EBA still works through national authorities for lack of an own supervisory apparatus, but it has substantial powers in the setting of binding standards and of non-binding guidelines ("legislation"), information gathering, consumer protection, the supervision of rating agencies and even direct supervisory powers in the case of a breach of Union law, action in emergency situations and the settlement of disagreements.

The three authorities cooperate through joint committees on matters of common interest such as anti-money laundering, financial conglomerates, cross-sectoral risks, consumer protection and financial innovation.

In addition a new institution was created to place emphasis on the stability of the financial system as whole: the European System Risk Board (ESRB). Its purpose is to better protect citizens, to rebuild trust in the financial system and to provide macroprudential oversight[4].

The structure of European financial supervision is depicted in the following graph:[5]

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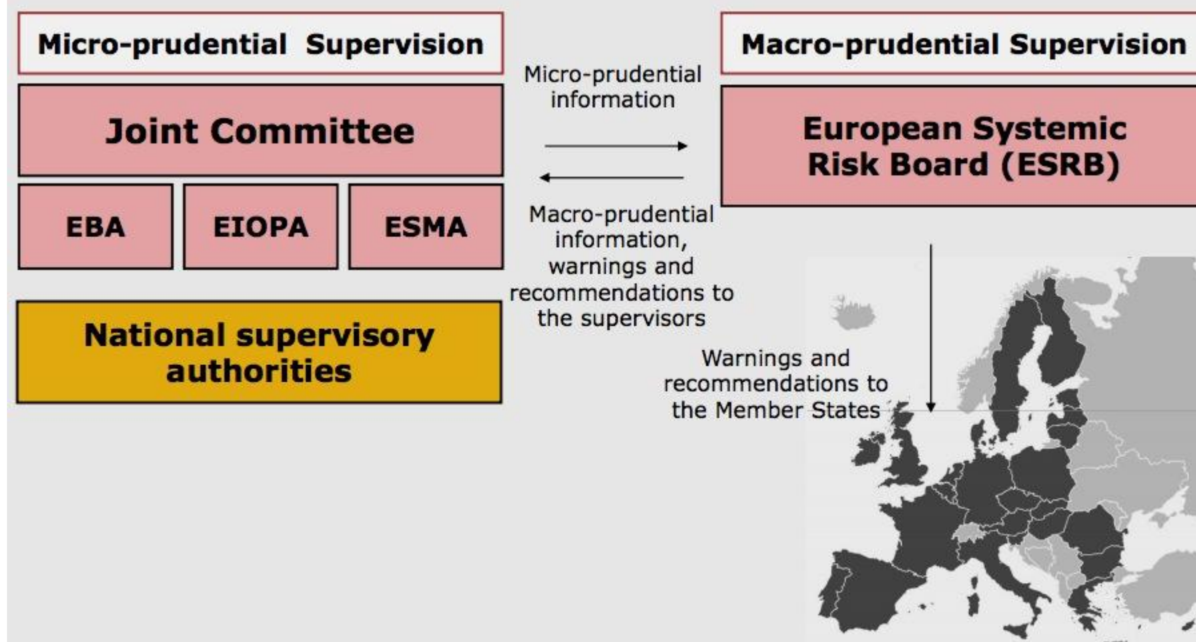
[2] The other two authorities are EIOPA, the European Insurance and Occupational Pensions Authority, and ESMA, the European Securities and Markets Authority.

[3] See http://www.eba.europa.eu/Aboutus.aspx .

[4] According to the ESRB Regulation: "The ESRB shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth."

[5] From Michael Sell, "The New Architecture for European Financial Supervision", ESE Conference, Luxembourg 2011.



The euro crisis has spurred further moves toward centralizing European financial supervision of banks. On September 12th, 2012, the European Commission has proposed establishing a single supervisory mechanism (SSM) for banks in the euro area. In this mechanism, ultimate responsibility for specific supervisory tasks related to the financial stability of all euro area banks rests with the European Central Bank (ECB). National supervisors will continue to play an important role in day-to-day supervision and in preparing and implementing ECB decisions.[6]

The establishment of the SSM is complemented by a single rulebook for banking supervision in the form of capital requirements, harmonized deposit protection schemes, and a single European recovery and resolution framework, which are all considered to be relevant steps toward realizing the “Banking Union” of the euro area. Non-euro countries may join on a voluntary basis. EBA continues to preserve the integrity of the single market, but it cannot overrule decisions by the ECB, which are binding only for euro countries and voluntary members of the club. But it also makes the ECB the dominant leader in EBA decision-making that is likely to prevail in banking supervision for the European Union as a whole. Moreover the ECB will be able to carry out early intervention measures when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action. As a new lender of last resort and its involvement in a single bank resolution process will give it unprecedented powers that have already met criticism.

The criticism is based on fears of a conflict of interest that can not be excluded: As chief warden of the monetary system the ECB has to make decisions that could provoke market reactions that could be politically challenged: for instance to recapitalize some bank, or to close and unwind it. Although there would be a strict separation of supervisory and monetary policy functions within the monetary authority, the ultimate

[6] See http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/953

decision is always with the Governing Council, so conflicting interests could indeed emerge. This calls for an independent legitimate arbiter, which could be the European Commission. But it entails strengthening the legitimacy of European institutions more generally, which has been dragging on for so long.

Finally the Commission’s timetable is extremely ambitious: The new mechanism shall be put in place from January 2013 on for systemically relevant institutions; coverage would be complete by 2014. This timetable is considered unrealistic by some, and the complete coverage is again resented by financial institutions with no or small cross-border risks and/or operations based on deposit taking and mutual arrangements. So the political haggling has just begun.

At whatever speeds the course of creating the Banking Union for the euro area will progress: Its high ambitions have found wide political support, and the gist of the proposals is likely to be enacted progressively. This should silence those who believe that financial regulatory reforms in Europe do not go far enough.