Financial Regulatory Reforms: Not Far Enough, or Overkill?

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The starting point

- The financial industry has experienced a long phase of deregulation and falling refinancing costs, which helped it to expand globally
- The crisis has demonstrated the high vulnerability of the sector, whose causes are multi-faceted
- The political reactions to the crisis were hectic and not always to the point, but the main regulatory codex, Basel III, is still moderate and no “overkill”
- Supplementary measures (e.g. ban of certain financial instruments, Volcker rule, tax on financial transactions) may be questionable, but they reflect serious concerns

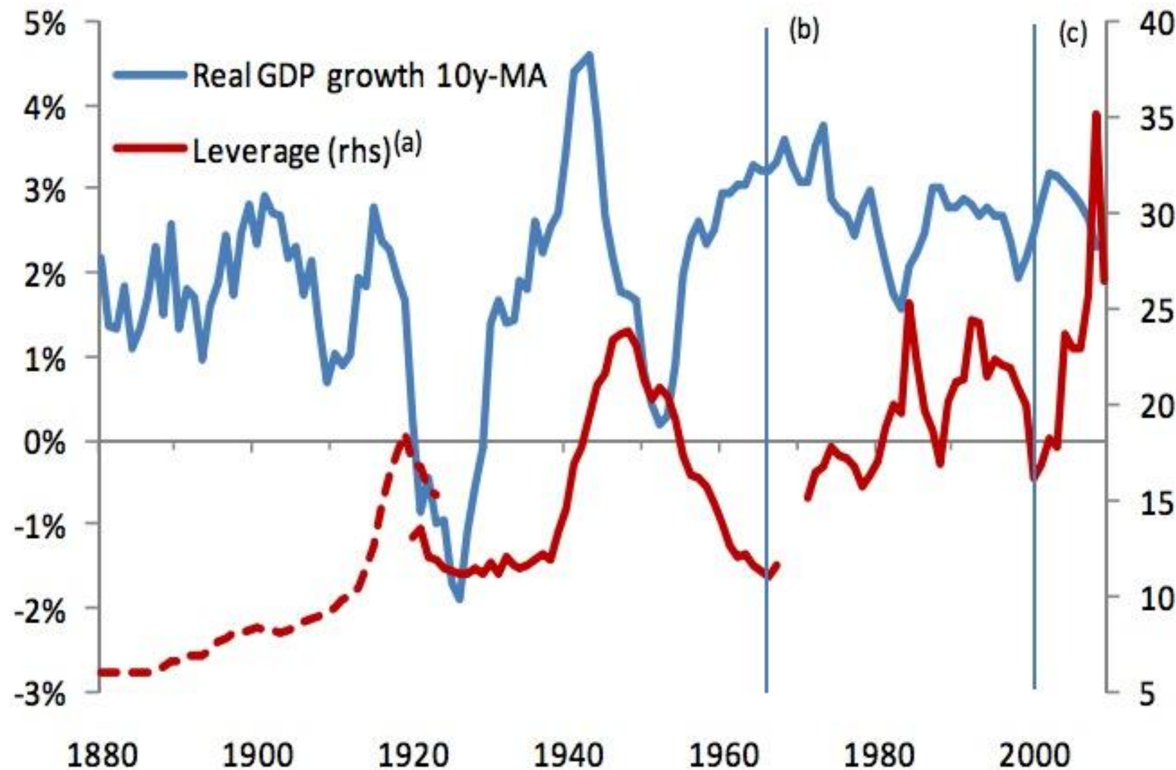
Basel III

- Overall Basel III attempts to establish sound rules for the banking industry, which should be in its own interest
- Indeed one may wonder why some of the new regulatory instruments are needed at all
  - Didn’t banks have their own reliable risk models?
  - Didn’t banks have effective liquidity management?
  - Weren’t banks able to separate lines of business internally through effective transfer pricing?
  - Weren’t they aware of the risks created by spin-offs?
- The main problem is: banks have gambled too much with “moral hazard” and “trust” loosing credibility

Capital adequacy

- Some banks complain about harsher rules on capital adequacy ratios
- Of course the high returns on the banks’ capital are likely to have vanished for good, especially for investment banking
- It is important to deleverage gradually to avoid a credit implosion and adverse effects on the real economy, so capital adequacy cannot be pushed up over night
- However it is good to remind that, historically, leverage was much smaller than more recently, and it could still finance the beginnings of the industrial revolution

UK Banks' leverage and real GDP growth (10-year moving average)



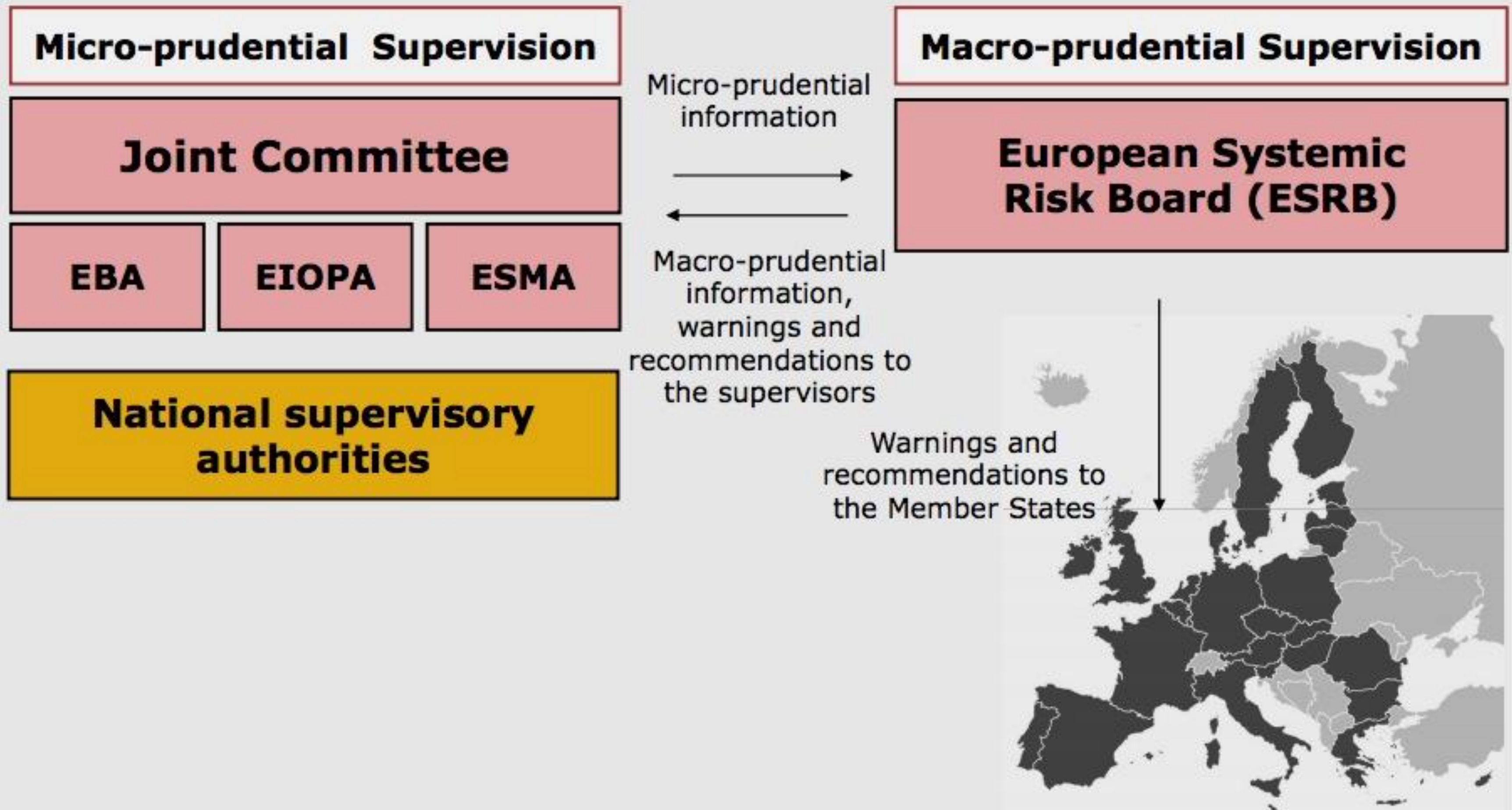
Source: United Kingdom: Sheppard, D (1971), The growth and role of UK financial institutions 1880-1962, Methuen, London; Billings, M and Capie, F (2007), 'Capital in British banking', 1920-1970, Business History, Vol 49(2), pages 139-162; BBA, ONS published accounts and Bank calculations. (a) UK data on leverage use total assets over equity and reserves on a time-varying sample of banks, representing the majority of the UK banking system, in terms of assets. Prior to 1970 published accounts understated the true level of banks' capital because they did not include hidden reserves. The solid line adjusts for this. 2009 observation is from H1. (b) Change in UK accounting standards. (c) International Financial Reporting Standards (IFRS) were adopted for the end-2005 accounts. The end-2004 accounts were also restated on an IFRS basis. The switch from UK GAAP to IFRS reduced the capital ratio of the UK banks in the sample by approximately 1 percentage point in 2004.

From: David Miles, Monetary Policy Committee,
The Bank of England, *Optimal bank capital*, Luxembourg 2011.

Reforming banking regulation in Europe

- Contrary to US banks, European banks act globally, but are faced with 27 regulatory regimes
- Moreover, the recapitalizing, unwinding and closing of banks is still a purely national matter
- In 2011 three independent European authorities with legal personality and broader competences were created
- The European Banking Authority (EBA) 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

European System of Financial Supervision



“Banking Union”

- 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 rests with the European Central Bank
- The SSM will work on a single rulebook for banking supervision in the form of capital requirements, harmonized deposit protection schemes, and a single European recovery and resolution framework
- The SSM still operates through national supervisory bodies

Key problems with the SSM

- Rendering the ECB responsible for banking supervision may inflict upon its independence
- The relationship with the EBA is to be resolved; EBA would still set the rules for the EU as a whole
- However the ECB cannot be outvoted, which gives it a strong voice in banking supervision
- The impact of the SSM is hence much greater than for the euro area alone (potential regulatory conflicts with the UK)
- SSM is also likely to lead to euro-wide deposit insurance and common rules to wind down failing institutions
- The ambitious time schedule (January 1st, 2013) is only a minor point

European sovereign debt crisis

- The sovereign debt crisis has revealed severe shortcomings in banking supervision that Basel III has yet to address (e.g. the zero-weighing of risks associated with government bonds)
- Refinancing of banks by the ECB is wide open (OMT), even if backed by securities that are rated “junk”
- Conditioned access to the OMT/ESM provokes shocks, is politically sensitive, and is counterproductive
- This type of monetary policy may be required to avoid disruptions in financial intermediation, but, as to solving the sovereign debt crisis, it is likely to postpone much needed structural reforms

The need for Eurobonds

- In the United States, monetary policy operates on the basis of Treasury bonds,homogeneous high-quality products
- Europe is in need of such products, “Eurobonds”, but this entails mutual liabilities among governments
- To avoid monetizing low-grade securities, Eurobonds cannot be issued for marginal financing, but only for a regulated stock of “basic” sovereign debt
- Converting the Maastricht criterion into a feasible ceiling for issuing Eurobonds limits its issuance, on average, to about 150 percent of current revenue for any public entity
- There is still a problem of moral hazard and contagion, because segmenting public debt may not be credible to financial markets (but CAC could help)

Conclusion

- The discussion on reforming banking supervision in Europe is still in flux and open for surprises
- Consumer protection has moved high on the agenda
- Britain has ring-fenced retail banking
- Last week the Commission has proposed to break down larger, systemically relevant institutions to protect deposits and credit to commercial and industrial activities (remember Glass-Steagall)
- The first steps toward creating a banking union are promising, but they will trigger their own dynamics that are likely to transform financial supervision in Europe more radically

Thank you for your attention