

Global Financial Situation and Regulatory Reform: A European Perspective

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Outline

- What were the problems?
- *[...and where do we come from?]*
- What would we like to achieve (over the medium-run)?
- What was done on a EU-level (up to now)?
- Does it suffice (open issues/challenges)?

What were the problems?

- ...or what would we like to prevent (given social opportunity costs)?
- Too much leverage – given the system's capacity to absorb shocks
 - leverage, largely created through the interplay between banks and non-banks (= shadow banks, often less, always differently regulated)
- ...and excessive maturity transformation
 - ...in particular with the help of so-called structured products
 - ...being vulnerable to liquidity spirals

Where do we come from?

Basel II [CRD III]

- Three pillars
 - capital requirements
 - supervisory review process
 - market discipline
- **...underlying philosophy:** alignment of economic (micro-perspective) with regulatory capital
- delegated supervision (self-regulation)
- ...building on bank internal models, allegedly sophisticated

...and its flaws

Micro dimension

- Inherent fragility of models to deal with credit risk (RWAs)
 - significant data limitations (too small samples)
 - Value at Risk – simplistic, systemic problems

Systemic, macro dimension

- underestimation of joint downside risks
- pro-cyclicality of capital requirements (unavoidable)
- liquidity (roll-over risk) – largely ignored (funding markets, role of central banks)
- ...known beforehand, now acknowledged

What would we like to achieve?

Purpose of finance

- Efficient allocation of capital
- ...and management of risk
- ...at acceptable cost
- ...not a purpose in itself

(Ben Friedman, Bob Solow, Daedalus
Fall 2010, EU COM 2010,
Responsibility and Competitiveness),

...and financial market regulation

- ...to provide regulatory infrastructure for a robust and performing financial system
- ...**not** to prohibit risk taking
- public intervention called for to cope with inefficient, unstable markets (market imperfections/market failures/missing markets), i.e.
- externalities
- market power
- consumer protection

What has been done – on a EU-level – up to now?

- European Supervisory Authorities (EBA, EIOPA, ESMA)
- Blueprint for supervision in a financially integrated area (centralization, consolidation, decentralized responsibilities)
 - coordination of national authorities
 - structure of EU financial market (national idiosyncrasies)
 - information sharing , colleges of supervisors...
 - home-host dimension (branch vs. subsidiary)
 - fiscal responsibilities
- ensuring coherent application
- additional responsibilities: CRAs, OTC markets, trade repositories, Level 2 role
- ...
- **ERSB**

Basel III/CRD IV/CRR I

Harmonization vs. discretion

- Maximum harmonization (EU COM) vs. national (constrained) discretion
- Core Tier I capital requirement: minimum or ceiling?
 - Diverging positions in Sweden, UK, Netherlands, Austria
 - COM: single rule book, national flexibility in (discretionary) Pillar II (interest rate, concentration risk) or with cyclical capital buffer
 - common criteria, similar instruments
- EU expert commission on structural reforms in EU banking
 - pros and cons of separating banks along business lines, functional subsidiarization
 - ring-fencing to capture implicit subsidy

...incidentally:

- Will the US ultimately apply Basel III ?
- Federal Reserve suggestions on regulation for large financial institutions
 - in the Dodd-Frank framework (under consultation)
 - Objective: create “incentives to reduce systemic footprint”
 - 5% capital requirements (“ensure competitiveness of US banks”), G-SIBs facing a surcharge of 1 to 2.5%

UK ICB's suggestions

British view (“dilemma”)

- Size of British banking sector
 - ...and inherent contingent financial risk
 - ...Switzerland, Netherlands, Austria, a dilemma shared
- Capacity to absorb losses
 - 17 %, up to 20% of RWA
 - liability structure's relevance
- Resolution option (incentive compatibility)
- Curb excessive risk taking

...answers

- Ring-fencing of essential retail services in a separate legal entity, capitalized on an individual basis
- ...”business continuity” (retail banking services, payments etc.)
- ..possibility to impose losses on non-retail business lines
 - moral hazard or competitive pressure?
 - aligning incentives (lengthening managers' horizon, franchise value)
 - in one corporate structure, spillover risk?
 - separation criterion: retail vs. wholesale ...or structured products (shadow banking...)

Does it suffice?

Yardstick (compared to...)

- ...resilient, cost-effective financial intermediation
- impact assessment
 - industry evaluation: substantial macro-economic costs
 - BIS/FSB: costs – but significant net benefits
 - academics (Admati 2010): not merely enough (in particular much higher capital cushion needed)
- Improvement (regulatory, institutional), compared to...
- Enough? Right? To be judged in light of objectives

...open issues

- ...some micro-prudential
 - level of capital and liquidity requirements (“gold-plating”)
 - RWAs (trading book...)
- ...but many systemic
 - G-SIFIs
 - systemic risk charge
 - bank resolution (German *Restrukturierungsgesetz*)
- ...as well as institutional (implementation)
 - ESAs work in practice
 - ERSB
 - deposit insurance in EU
- RoE expectations in industry – substantially above cost of capital
- European variety/heterogeneity (historically rooted, embedded in societal compromises) cum/vs. level-playing field