Global Financial Situation and Regulatory Reform: A European Perspective

OECB-ADBI 12th Roundtable on Capital Market Reform in Asia
Tokyo, February 7, 2012

Hans-Helmut Kotz
Center for Financial Studies, Goethe Universität, Frankfurt
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

...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

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