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POLICY AREA:
Financial Resilience

Financial resilience revisited: Why consistency in regulation is now paramount - across sectors and regions, and over time

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Abstract

In this paper we propose a way forward towards increased financial resilience in times of growing disagreement concerning open borders, free trade and global regulatory standards. In light of these concerns, financial resilience remains a highly valued policy objective. We wish to contribute by suggesting an agenda of concrete, do-able steps supporting an enhanced level of resilience, combined with a deeper understanding of its relevance in the public domain.

First, remove inconsistencies across regulatory rules and territorial regimes, and ensure their credibility concerning implementation. Second, discourage the use of financial regulatory standards as means of international competition. Third, give more weight to pedagogically explaining the established regulatory standards in public, to strengthen their societal backing.

Challenge

Since the start of the crisis in 2007, it has become increasingly clear that a return to a growth-enhancing, yet stable financial system fulfilling its basic functions of risk and maturity transformation, will require a downsizing of the systemic risk threat. Moreover, market discipline needs to be reintroduced into the operation of banks, particularly into their funding business. This can be achieved by eliminating the expectation, widely held before the financial crisis, of a readily available government bailout for large banks. Closely related to the no-bailout rule, a credible framework for orderly resolution of banks, small and large, is desired.

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Most of these exigencies have been addressed over the past several years, notably (in the EU) by adopting the Bank Recovery and Resolution Directive and by establishing (in the Eurozone) centralized supervisory and resolution authorities (SSM, SRB, ESRB). Concurrently, in the US the Dodd Frank Wall Street Reform and Consumer Protection Act was adopted, and several centralized analytical and supervisory authorities were established (OFR, BCFP, FSOC).

There has also been progress in other segments of the financial services industry, aiming for more risk-conscious regulation and supervision. This is notably true for the banking sector (Basel III), the insurance sector (Solvency II), for the asset management industry and the shadow banking sector (MIFID), and for derivatives and bond markets (EMIR).

The worldwide advances in financial market regulation over the past 10 years have been achieved by concomitant activities in a large number of different sectors and countries. Therefore, it is not surprising to find that some of these rules are not fully consistent with each other. However, the existing inconsistencies may not only have an impact on economic performance, they are also likely to erode the financial stability achievements of the past few years.

Proposal

Financial resilience revisited

We define financial resilience broadly as the capacity of a financial system to cope with crises. The term 'to cope' is used in the double sense of preventing crises to happen, and dealing with crises that happen. Resilience is thus the ability to re-emerge from a critical default-like situation, relying on its built-in resources, modalities and adaptabilities. These resources, modalities and adaptabilities comprise financial strength, institutional flexibility, and regulatory action and supervisory foresight. The institutional notion of resilience, as used by us, therefore relies on a sustained support by society's regulatory and political institutions, and ultimately its electorate.

This last condition – which is a problem of public choice beyond just financial economics -- is often overlooked, and may explain why a regulatory rule needs to be both reasonable (in a technical sense) as well as credible (in a politico-economic sense). The first characteristic (reasonable) refers to the quality of the regulation and its ability to shape the desired behavior of market participants. The second characteristic (credible), requires time-consistency, i.e. the confidence that a particular regulatory rule will actually be applied by, even if it may, in that very moment, run against the best interest of the responsible decision maker. This last criterion, the credibility of a regulatory rule, is particularly difficult to fulfill if the responsible decision maker is herself a sovereign state, as is often the case in the EU, or among G-20 members.

Three agenda points for improving financial resilience

Remove inconsistency and incomparability across regulatory measures/regimes

Here is one example of a dangerous inconsistency across financial sectors: the treatment of subordinate bank bonds in the regulation of banks and insurance companies. In banking regulation, the implicit government guarantee has been removed, and is now replaced with a thick layer of loss absorbing capital, TLAC, i.e. by more equity and an additional amount of bail-inable debt.

The credible application of the bail-in requirement needs preparation. At a minimum, the holding of bail-in-able bank debt has to be prohibited for investors who later on, in a moment of crisis, will demand a bailout for themselves and are trusted to get the necessary political support.

As it turns out, bail-in is difficult to practice in real life. Italy in 2015 has produced a good example. The bailing-in of junior debentures by a regional bank was seen as the reason for a tragic suicide of a pensioner who had invested his retirement savings in these junior bond instruments. From this tragic incidence, the public opinion in Italy and abroad had quickly drawn the lesson that bail-in cannot work, and should not be applied.

It is well understood that TLAC investors must be able to withstand a potential bail-in without triggering a systemic crisis in return. Prime examples of suitable investors are therefore long-term asset management institutions, like pension funds, sovereign wealth funds, and in particular life insurance companies. All these investors are by construction less subject to a run risk, and therefore are well suited to be an ultimate holder of bank issued bail-in debt. Contrary to this assessment, however, the insurance sector has concentrated on shielding its investment portfolio against the holding of subordinate bank risk, through its regulation under Solvency II.

Therefore, the regulatory approaches taken vis-à-vis banks and insurance companies are not really consistent with each other. One way out of this impasse requires a revision of the current insurance regulation, explicitly recognizing the stabilizing role played by the sector in a comprehensive view of the financial architecture. This view will cover all financial market segments, from banks to insurance companies and asset trading venues.

In light of a more consistent regulatory effort, insurance companies would be allowed to invest in subordinate (and high yield) bank debt under the condition that expected loss provisioning is built in line with prudent risk management principles.

There are a number of other cases of inconsistent regulatory frameworks that require public attention, and political action. For the purpose of this paper we will merely mention two further examples that both also have serious unintended consequences.

The first is the assignment of a zero risk weight to the government debt of OECD countries in banks' balance sheets. In effect, this debt is therefore not subject to a capital requirement. However, there is positive default risk with some government debt, and the absence of risk weights and, equally, any exposure limits (cluster risk) may seduce banks, perhaps even those with sophisticated risk management, to take excessive exposures in such risks. This is an inconsistency in the application of (otherwise uniform) capital requirement regulation, which may ultimately trigger a government bailout.

A second example concerns the treatment of proprietary trading in some jurisdictions, like the US, Germany, France, and potentially the EU (see Barnier proposal on structural reform in banking). These jurisdictions have prohibited banks to engage in proprietary trading. While forbidding trading on a bank's own account seems reasonable at first sight, there are significant unintended consequences which render the prohibition self-defeating. As is now widely known, proprietary trading that is the so-called 'bad' trading cannot be easily distinguished from 'good' trading, like the hedging of a bank's own risk, or the market making in less-than perfectly liquid asset markets.

As a consequence, banks will shy away from 'good' trading for fear of being charged (incorrectly, but non-refutably) with violating an existing prop trading prohibition. Again, the existing regulation is not

consistently treating different kinds of trading behavior in an attempt to rule out what is deemed to be 'bad' trading. In this case, as in many other similar cases, a better regulation is available, as proposed by the Vickers Commission in the UK, and the Liikanen Commission in the EU, justifying a reform effort.

Discourage the use of financial regulatory standards as a means of international competition

A major achievement of the G20 agenda is the mutual recognition of common regulatory standards among governments, in order to stabilize the global financial system. The 2008 experience of a system-wide threat to the continued operation of global banks, and the deep worries concerning contagious effects on local and retail financial institutions has, for the years following 2008, spurred agreement on a joint action plan. The ensuing G20 meetings have preserved the goal of improving financial resilience through coordinated regulatory efforts.

Basel III and the role of the Financial Stability Board is an important example of this commonality of interest. However, the recent surge in anti-globalization sentiment in some countries, and the commensurate rise of political parties and politicians subscribing to this sentiment, brings back the issue of regulatory fragmentation and, as a possible consequence, the issue of regulatory competition - an issue thought to be passé for the past couple of years.

Regulatory competition undermines financial stability. The reason is that laxer regulation at the bank level decreases the costs of transacting. Cost decreases are not only caused by less red tape, but also and foremost by expanding the bank's choice set. For example, a weakening of capital requirements will allow the bank to increase leverage, or to increase its dividends (rather than building up more capital through retention). The lowering of capital standards may seem acceptable to a regulator if the implied increase in default risk is partly borne by other constituents, e.g. in foreign countries, or if the implied gain in market share and profitability by national banking institutions is believed to outweigh the increased systemic risk.

The regulation of central clearing may serve as an example. It should be remembered that, technically speaking, clearing houses belong to a class of financial institutions that operate a natural monopoly. As such, clearing houses face decreasing average costs, and the bigger they are, the lower is the margin requirement a clearing house has to request from its clients in order to achieve the same level of safety.

Clearing houses were niche players in the years before the 2008 financial crisis, but they have turned into key players for financial system resilience since then. The Dodd Frank Act, and equally the European EMIR regulation stipulate that OTC derivative transactions involving a large class of instruments must be cleared centrally. The clearing house concept thus replaces a network of bilateral derivative exposures by a hub-and-spoke architecture, in which every client has an exposure only with the central counter party, the CCP.

The hub-and-spoke architecture is believed to reduce the systemic risk inherent in an unregulated OTC derivatives markets by an order of magnitude.

Under extreme conditions, however, the CCP itself can become fragile. In this case, unlikely as it may be, a systemic risk event (a 'perfect storm') could happen. A sudden default of a CCP may well cause the default of some of its major counterparties, which in turn may lead to fire sales in some asset markets, and a loss of access to wholesale funding for many institutions.

Margin requirements, which are protecting the CCP, are set such that the risk of a CCP default is very small. However, if there is competition between different CCP, and CCPs are allowed to compete by lowering their margin requirements, then unfettered competition can lead to margin undercutting, possibly creating a true systemic risk. Therefore, regulatory oversight of the margin setting process is a key determinant of financial resilience in these markets.

Unfortunately, regulatory oversight of CCPs by itself cannot always mitigate the systemic risk stemming from CCP competition. This would require close cooperation among supervisors, with an open exchange of data and a common will to fix margin standards uniformly and without regard to the competitive position of its “own”, national CCP. This is not easy to achieve.

Therefore, in order to avoid unfettered CCP competition, margin requirements set by all competing CCPs have to be monitored by a single supervisor, or an operational coalition of national supervisors. Conversely, what is not desired is competing CCPs being supervised by different, possibly national supervisory agencies. Because the competition between the CCPs may be supported by the competition among their respective agencies, this may lead to a classical race to the bottom. This latter case is an example of an inconsistent regulatory architecture, since financial stability is put at risk in the process.

If we apply these considerations concerning CCP competition to the European Union, or global derivative markets, we find that there is indeed a reason to be concerned. First of all, there are many clearing houses in Europe, about 20 in 2017. They are competing intensively for market share, but they are supervised by national agencies only.

The example of the CCPs in Europe can be generalized to other markets, and other areas of regulation. There is a need to align the extent of the relevant financial market with the extent of the applicable legal rule. In the case of CCPs the extension may be limited to the European Union, as the major counterparties of a CCP are headquartered in that area, and their respective fiscal authorities, as backstops, would have to step in were the CCP ever to fail.

The example of the CCP industry in Europe demonstrates that a more integrated view on regulation is needed not only in banking, where the SSM has by and large solved the consistency problem, but also in capital markets where a unified, SEC-like supervisory authority should be created.

Give more weight to explaining, i.e. rationalizing the established regulatory standards

Our last point relates to the need for raising stronger public support for the integrative approach underlying the recent European initiatives in banking (the BU) and in capital markets (the CMU). The build-up of common standards for the functioning of competition in markets can be well motivated and rationalized – it needs, however, constant support from parliaments and policy makers in the affected countries, and ultimately from the electorates.

If we think financial resilience can be supported by consistent regulation and an impartial, unbiased application of rules, and we believe furthermore that these requirements depend on constant support from an informed electorate, we have to care about the presentation and dissemination of the architectural requirements of financial resilience to the broader public.

Financial resilience in the international arena needs a special form of financial literacy. We believe the three themes of our short paper to be closely linked: consistency of regulation, impartiality of supervision, as well as trust in, and comprehension of, the underlying economic logic in the public domain.

What can be done?

Consistency

Set up a task force identifying areas of inconsistency, and suggesting approaches to remove those inconsistencies. The task force could be constructed at the G20-level, in the sense of a High Level Group of experts in financial market regulation, where delegates are carefully selected to represent states and sectorial expertise (e.g., banking and insurance regulation, derivatives, sovereign debt, monetary policy, systemic risk, deposit insurance).

Impartiality

Think about an institutional setup for the integration of supervisory tasks in institutions with a sufficiently wide (in terms of relevant market) mandate, like a pan-European supervisor for all CCPs operating in the area. The influence of competition on regulation, and vice-versa, is likely to become more important in the near future, not least because of the trend to fragmentation and protectionism seen in some regions and jurisdictions. It seems to us of paramount importance to start G20-level thinking about the adverse effects of regulatory competition on financial stability now. Here, as well, an officially mandated High Level Expert Group seems to be the best way to mobilize stronger public attention for these issues.

Literacy

Building and maintaining financial resilience is itself a challenge that requires support in the public realm. Policy makers and the electorate in many countries, particularly those that suffer from an unfit financial system, or from a weak banking system, have to remain convinced about the value and the quality of our financial regulatory architecture. We see this as a matter of financial literacy, and we propose to undertake a set of efforts aiming at a broader and better understanding of financial resilience, and its determinants. Universities and other educative institutions can have a role here. Ideally, the concept of financial resilience should be entering even into secondary school curriculum.