THE NEW REGULATORY FRAMEWORK AND SYSTEMIC RISK

Jean-Charles Rochet
SFI Professor of Banking
University of Zürich and TSE/IDEI

Banque de France Conference
on Financial Regulation
Paris , 28 September 2015

FINANCIAL REFORM: WHERE ARE WE NOW?

Many reforms have already been implemented:

- Switzerland (enhanced capital requirements, Countercyclical Buffer, surcharges for SIBs)
- Dodd Frank (FSOC, OFR,OLA,…)
- UK (reform of BoE, Banking Law,…)
- Europe (ESAs, ESRB, Banking Union…)

FINANCIAL REFORM: WHERE ARE WE NOW?(2)

More reforms are on the way:

- Basel 3 (enhanced capital requirements, LCR, NSFR, leverage ratio, CCB,..).
- EBRR Directive.
- And of course the TLAC for G-SIBs (FSB).

Nonbanks are also the focus of attention:

- Is there systemic risk in the insurance sector?
- What to do with NBNI G-SIFIs?

HAVE ADMATI AND HELLWIG WON?

- Adding up Basel 3 and the TLAC leads to total capital requirements for global banks between **19.5% and 25% of their Risk Weighted Assets.**
- This is close to the recommendations of Admati and Hellwig (A&H 2013).
- Does it mean that global regulators have yielded to popular pressure and decided to be real tough on global banks?
- Not necessarily so, for several reasons.

HAVE ADMATI AND HELLWIG WON?(2)

- Various form of debt, including cocos, will be eligible for the TLAC, whereas A&H insist on equity alone.
- A&H also insist on simple rules, whereas FSB recommendations are complex.
- They come on top of domestic reforms, which have been already implemented .
- As a result, the global regulatory picture is becoming incredibly opaque , which will ultimately benefit big banks.

REGULATION PROCESS HAS CHANGED

Before the Global Financial Crisis, the global regulatory process was reasonably simple:

- Basel Committee was there to set standards and make recommendations.
- Actual regulations were enacted by lawmakers in each jurisdiction and supervision was done at the domestic level.
- This framework did not work well…

THE EMERGENCE OF G-REGULATORS

- One problem is that **domestic regulators** and supervisors are not well equipped to deal with **global SIBs**.
- The Financial Crisis convinced G20 governments to set-up a Global Regulator (the FSB) for promoting global financial stability.
- Is the FSB just like the Basel Committee (i.e. only there to set standards) or is it a true Global Regulator with coercive powers?

THE EMERGENCE OF G-REGULATORS?

A Global Regulator would probably be needed but many questions remain open:

- What is the democratic legitimacy of the FSB?
- Who is it accountable to? (there is no global legislative power).
- What exactly is its mandate (focus on TBTF and G-SIFIs resolution?) compared to Basel committee?

THE EMERGENCE OF G-REGULATORS?

The more serious problem is that the individual members of the FSBs will (legitimately) try to promote the interests of their constituencies.

There is no reason to believe that the outcome will be collectively optimal.

A good illustration is the discussion about Single Point of Entry Vs Multiple Points of Entry for resolution.

AN ALTERNATIVE APPROACH TO SYSTEMIC RISK

- International cooperation for global financial regulation will always be plagued by conflicts of interest between countries.
- Failure of democracy: any regulator who is trying to promote global welfare violates his mandate (Fed currency swaps with other central banks).
- A more pragmatic approach would be that each jurisdiction aims at protecting its own financial system, no matter what other countries are doing.

AN ALTERNATIVE APPROACH TO SYSTEMIC RISK(2)

- Relevant entities for regulators should not be financial institutions (which are often multinational) but domestic financial “infrastructures”: security exchange, interbank markets, credit markets...
- Instead of regulating global financial institutions, each jurisdiction should regulate their access to its domestic financial system.
- Same logic as private clearing houses, that impose collateral requirements depending on participating financial institutions, no matter what these institutions are doing elsewhere.

AN ALTERNATIVE APPROACH TO SYSTEMIC RISK(3)

- Domestic regulators/supervisors are not enough to tame Global SIFIs (similar configuration as the global warming problem).
- Optimistic people may put their hopes in the collaboration between governments (but why would they defend global interests?...).
- Realistic people might be tempted to follow a more autarkic approach: protect one’s country financial system independently of what other countries do…

THE NEW ROLE OF CENTRAL BANKS

- Granting supervisory powers to the ECB, the BoE and to some extent the Fed was generally seen as good (as it is likely to reduce forbearance).
- Each of them is accountable to their legislative power (which does not exist in the case of the FSB).
- This is probably good, but it gives an immense power to the central banks
- Their overall mandate is not completely explicit (non conventional monetary policies, exchange rate interventions…)

COCO BONDS: A FALSE GOOD IDEA?

- Coco bonds seem to strike a great compromise between regulators and banks.
- They behave like debt in good times and equity in bad times.
- In countries where they benefit from tax exemptions, banks have started issuing them.
- But tax exemptions are another form of transfer from taxpayers to banks. They do not increase total welfare.

COCO BONDS: A FALSE GOOD IDEA?(2)

- In spite of a large academic literature, there is not a single clear argument explaining the added value of Cocos.
- In countries where they do not benefit from tax exemptions, banks do not seem eager to issue them.

COCO BONDS: A FALSE GOOD IDEA?(3)

- The claim that they are “prefunded rights issues” providing liquidity when the bank is in distress is just wrong: contrarily to capital insurance contracts (a different object), conversion of Cocos does not lead to any cash injection.
- Cocos are complex instruments and nobody knows the impact they will have on banks lending and overall risk taking.

Macroprudential policy and shadow banks

- One of the fears of regulators is that increased regulation of banks will make it easier for non-banks to provide quasi banking services.
- A case in point is the activation of the countercyclical buffer in Switzerland which has encouraged insurance companies to offer mortgages.
- But this is not necessarily a bad thing.

Macroprudential policy and shadow banks (2)

- It all depends on the ultimate objective of the countercyclical buffer: if it is to avoid real estate bubbles it does not make sense to restrict the regulation to banks.
- The perimeter of macro-prudential regulation does not have to be the same as micro-prudential regulation (deposit taking institutions).

Macroprudential policy and shadow banks (3)

- This shows that the objectives of macro-prudential regulations to be stated precisely.
- We need to establish a true macro-prudential doctrine with clear objectives, instruments and procedures
- For accountability reasons, the objectives i should be easy to assess and the procedures should be transparent.

CONCLUSION

- The global financial crisis has lead to increasing the supervisory powers of central banks and setting up global regulators (FSB).
- This was probably a good thing but we need to clarify the mandate, the governance and the accountability procedures for these powerful institutions.
- We should be aware that the conflicts of interest between different countries will not vanish.

CONCLUSION (2)

- New instruments and new policies are being experimented for promoting financial stability.
- As usual, academics are lagging behind.
- We have no idea of the likely impact of these new prudential instruments on financial stability and social welfare (GDP growth, inequality,..)
- Need to develop realistic yet tractable models for guiding macro-prudential policies and assessing the pros and cons of new measures.