



The future of financial stability: Maintaining effectiveness while reducing complexity

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Regulatory complexity is a top priority for policy makers and the financial industry, both at the global and European level. Regulation is vital to safeguarding financial stability. Regulatory reforms taken after the global financial crisis have made the financial system safer and more resilient, but, at the same time, regulation has reached a high degree of complexity. As the focus is shifting from the regulation phase to implementing and assessing the agreed reforms, it is necessary to consider the trade-offs associated with mounting regulatory complexity over the last years. Policy makers are faced with a dilemma: financial regulation must be straightforward and clear, yet also refined enough to be effective in preserving financial stability. In this policy note we outline options for reducing regulatory complexity without reducing financial stability.

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1. Introduction

The global financial crisis has put the issue of financial stability at the top of the agenda, not only for supervisory authorities, but also for public policy makers more generally. The reason for it are the very high costs systemic banking crisis cause in economic terms (i.e. loss of gross domestic product – GDP) and in terms of fiscal costs.² As a result, European legislators and global standard-setters have substantially strengthened financial regulation since the beginning of the financial crisis. Recent regulatory reforms have significantly changed the way banks operate and have proved decisive for reducing risk in the financial system.

2. Milestones in regulatory reforms

The milestones achieved in regulatory reforms touched upon every aspect of banking. Basel 3 addressed the most severe shortcomings of Basel 2 by strengthening the capital framework and introducing liquidity standards. The framework is still evolving, with the latest adaptation in December 2017 when the Basel Committee on Banking Supervision (BCBS) disclosed its final revision³ designed to reduce the excessive variability of risk-weighted assets.

An important part of the EU's reform package was the establishment of macroprudential supervision, which is responsible for addressing cyclical and structural systemic risk. To complement Basel 3 and macroprudential supervision, European regulators introduced the Bank Recovery and Resolution Directive (BRRD). The BRRD provides resolution authorities with a toolkit to deal with failing institutions by allowing the latter to leave the market without recourse to public money and without causing serious market disruptions.

In response to the sovereign debt crisis, institutional reforms were implemented in the euro area to

strengthen monetary union and break the bank-sovereign nexus with the creation of a fully-fledged banking union. A new supervisory framework was launched, consisting of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), both of which have already been implemented, and the European Deposit Insurance Scheme (EDIS), which has yet to be finalized.

3. In Austria, the benefits of regulation outweigh the costs

In Austria, as an example, the benefits of financial reform have clearly outweighed its costs. Financial reform has substantially helped strengthen Austrian banks' balance sheets, which has led to various rating upgrades for the Austrian banking system and Austrian banks. The tier 1 (T1) ratio for the Austrian banking sector increased from 9.3% of risk-weighted assets (RWAs, consolidated) at the beginning of the reform process in 2009, to 16% at the end of 2018. The increase has accelerated against the EU average, both in absolute and relative terms, since 2015, when a systemic risk buffer of 1% to 2% of RWAs (phased in until 2019) was introduced for 12 Austrian banks. The social benefits of financial reform are large as higher capitalization has substantially reduced the probability of crisis in Austria, while the social costs of financial reform are benign. Higher regulatory capital requirements increase banks' average weighted cost of capital and thus banks' internal hurdle rate for asset generation. The higher weighted average cost of capital for banks is largely intentional as regulation aims to shift the external costs of bank problems from the public back to banks. By contrast, the higher costs related to complexity are not intentional.

4. The costs of regulatory complexity

One of the main concerns about regulatory complexity is that it imposes costs on banks, investors, and supervisors alike. Banks incur higher

² Posch, M., S. W. Schmitz and P. Strobl. 2018. Strengthening the euro area by addressing flawed incentives in the financial system. In: Monetary Policy and the Economy Q2/18. OeNB. 34–50.

³ BCBS. 2017. Finalising post-crisis reforms.

costs with respect to reporting, compliance, and supervisory risk management. For bank investors, bank balance sheets become more difficult to decipher and the information contained in them is more uncertain (e.g. the risk weights and valuation of complex instruments such as interest rate swaps or distressed assets). Complexity in regulation also leads to complexity in financial structures and systems, often driven by market participants' efforts to mitigate the costs and complications induced by regulation.⁴ Furthermore, complexity increases the chances of encountering loopholes in financial regulation, which can be highly profitable for banks to exploit.⁵ Complexity might even become a source of systemic risk.^{6,7}

5. The main reasons for complexity

Complexity has several drivers.

First, bank products and financial systems are innately complex and the regulatory framework mirrors that complexity. During the financial crisis the complexity, size, and interconnectedness of banks were among the main reasons for public bailouts.

Second, complexity is a consequence of conflicting incentives for banks with regard to financial stability. We even argue that flawed incentives are the main cause of regulatory complexity. The divergence between the private and social costs of bank failure incentivizes regulators to minimize the probability of failure, while at the same time encouraging bank stakeholders to take excessive risk. On the one hand, incentives for increasing leverage are created by implicit government guarantees, the tax deductibility

of the cost of debt, and bank shareholders' limited liability. On the other hand, financial regulation aims to limit leverage to counterbalance the negative consequences of flawed incentives. There are trade-offs to be made within the regulatory framework.⁸

Third, complexity partly also derives from regulation that aims at a high degree of risk sensitivity by allowing the use of internal models. To some degree, policy makers deliberately accept complexity in exchange for greater risk sensitivity and less intrusiveness. Current regulation aims for a high degree of risk sensitivity to prevent banks from shifting to riskier portfolios within the very simple approach under Basel 1. As a consequence, the complexity of the framework has increased due to the broad set of different risk weights used in the standardized approach, and even more so by allowing banks to use their internal models to calculate regulatory risk weights.⁹ In this respect, the current regulation incentivizes banks to "optimize" their internal models, forcing supervisors to increase their scrutiny of banks' internal models.

Fourth, complexity results from the Tinbergen rule, according to which there should be a distinct instrument for every aspect that needs to be regulated. This rule states that for policy makers to achieve different objectives, the number of instruments available to them must equal the number of objectives. Accordingly, addressing different objectives by using a single policy instrument would lead to conflicts of interest and ultimately to increased complexity as instruments are being added. However, the different instruments in play today allow policy makers and authorities to

⁴ Spatt, C. S. 2012. Complexity of Regulation. In: Harvard Business and Law Review. Online 3/1.

⁵ Acharya, V. V., P. Schnabl and G. Suarez. 2013. Securitization without risk transfer. In: Journal of Financial Economics 107(3). 515–536.

⁶ Haldane, A. 2011. Capital discipline. Remarks based on a speech given at the American Economic Association in Denver on January 9.

⁷ Freixas, X., L. Laeven and L. L. Peydro. 2015. Systemic Risk, Crises, and Macroprudential Regulation. Boston: MIT Press.

⁸ BCBS. 2013. Discussion paper: The regulatory framework: balancing risk sensitivity, simplicity and comparability.

⁹ Ibid.

act less intrusively and in a more targeted manner. Macroprudential supervision is an example of targeted, evidence-based regulation. Its contingency entails complexity.

There are additional sources of complexity, not least globalization and European integration. The complex interaction between international, European, and national regulators makes the policy process overly bureaucratic and the allocation of regulatory responsibilities sometimes unclear and confusing both to the public and to market participants. This results in greater risk of fragmentation, potential inconsistencies, and conflicts between the various regulatory regimes.¹⁰ European banks often lobby for preserving national specificities, which increases complexity, whereas EU regulators, and the SSM in particular, strive to harmonize regulation.

However, some of the complexity is unavoidable. Financial markets are constantly innovating, recently in light of Big Data and Artificial Intelligence, and institutions are constantly adapting to the new rules. A good part of the complexity comes from this continuous adaptation once rules are implemented. So far, each new Basel standard that corrected unintended consequences of earlier versions has added to the complexity.

6. Current proposals to address complexity

The complexity of recent financial regulatory change has stimulated the G20 regulatory reform evaluation process, spearheaded by the Financial Stability Board (FSB),¹¹ with the aim of examining the effects of regulatory reform on financial intermediation. The European Commission also focused on this topic in its 2015 Call for evidence on its regulatory framework for financial services,¹² which addressed

the cumulative impact of financial regulation and the need for more proportionality (which has informed recent legislative proposals). While there is a strong call from global and European policy makers for greater simplicity, so far only a few policy makers have presented specific proposals to decrease complexity, which suggest reducing risk sensitivity.

One proposal put forward by the BCBS Task Force on Simplicity and Comparability set up in 2012 builds on an increasingly sceptical view of the role and robustness of internal risk models. Simplifying the composition of capital has proved a good starting point. For example, Basel 3 (2010) has significantly simplified the numerator which is used to calculate capital adequacy ratios (the definition of capital), while the latest Basel review aims to reform the denominator (i.e. the risk-weighted asset calculation methods). At the center of the latest reforms is the aggregate output floor, which sets a capital requirements floor of 72.5%, calibrated by using internal models. In the United States, such a backstop was introduced in 2010 with the Collins amendment to the Dodd-Frank Act, which prescribes a 100% floor based on the simpler standardized approach. Having said this, the risk weightings are still rather opaque and the actual effect the introduction of such floors has on complexity depends on their consistent implementation.

Some academics^{13,14} go one step further, suggesting that the leverage ratio should be higher so that weighted capital ratios and unweighted leverage ratios are on an (at least) equal footing. Basel 3 includes a simple leverage ratio as backstop for the complex capital adequacy ratio. The more complex the bank, the stronger this case is. This is a step in the right direction, but the new Basel minimum leverage ratio requirement is only 3%, or about the same as

¹⁰ Wallace, H., W. Wallace and M. Pollack. 2005. Policy-Making in the European Union. Fifth edition. Oxford: Oxford University Press.

¹¹ FSB. 2017. Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms.

¹² European Commission. 2015. Call for evidence: EU regulatory framework for financial services.

¹³ Haldane, A. 2013. Constraining discretion in bank regulation. Speech given at the Conference on "Maintaining financial stability: holding a tiger by the tail(s)" at the Federal Reserve Bank of Atlanta on April 9.

¹⁴ Admati, A. R. and M. Hellwig. 2013. The Bankers' New Clothes. Princeton: Princeton University Press.

that of the largest U.S. banks when the global financial crisis erupted.

There is some selective work underway to simplify rules, but efforts need to be stepped up.

7. What is to be done and how?

The more than ever growing global scale of financial markets and evolving new risks require new rules. Nevertheless, we see possibilities that could help in addressing the root cause rather than the symptom of regulatory complexity without reducing financial stability. First, implicit government guarantees and tax subsidization of bank debt need to be put into question. The debate on fiscal and liquidity backstops for euro area banks highlights the fact that a significant number of banks is still considered to be too big to fail as well as too big to be resolved without recourse to public funds.^{15,16} Similarly, activating macroprudential buffers for other systemically important institutions (O-SIIs) can make an important contribution. If well calibrated, such buffers can reduce the likelihood of bank failure and hence the value of the implicit government guarantee. In the case of a bank's failure, the buffers decrease the capital shortfall, consequently facilitating resolution. Complementary, the systemic risk buffer (SyRB) should aim at addressing systemic vulnerability: banks must be able to withstand the inevitable rise in volatility associated with the market exit of banks. It is also important that insolvency procedures, and – in selected cases – the resolution framework, are both transparent and rule based in order to stabilize expectations. Such gone concern rules are a prerequisite for the risk-sensitive pricing of liabilities that are subject to bail-in in the case of resolution in a going concern scenario.

Second, the risk-bearing capacity of the financial system could be strengthened to enable it to absorb

the costs resulting from bank failures. The minimum requirement for loss-absorbing liabilities (or MREL) would need to be high enough to prevent dependence on public funds. In the same vein, deposit guarantee schemes (DGSs) could be strengthened to ensure credible protection for insured depositors in the event of a bank's market exit, with a view to making sure that systemic risk is not amplified, should a bank become insolvent. Either ex ante funds are sufficiently large to require only small ex post contributions, or banks should hold additional capital to enable them to absorb the contingent costs of substantial ex post contributions, and ex ante credit arrangements should allow the deposit guarantee scheme to raise additional funds in a timely manner.

Third, better disclosure could help increase market discipline and strengthen transparency. More reporting data would need to be made available to the public in the EU, similar to U.S. practice.

Fourth, the size and complexity of banks could be reduced by promoting alternatives to bank funding for the real economy and by establishing a Capital Markets Union (CMU). Fifth, to address the potential build-up of excessive leverage in other parts of the financial system and to forestall a future crisis, it might be necessary to expand the macroprudential regulatory framework to the nonbanking sector. The growing shift from bank-based financing to a more market-based financing model – which is mainly due to the diversification of funding for the real economy, CMU-related incentives, and increased banking regulation – calls for the introduction of new macroprudential tools.

8. Conclusions

If policy makers will not tackle the problem of regulatory complexity, the pressure to deregulate will increase. One of the most efficient contributions

¹⁵ Regling, K. 2018. The future of the ESM. Financial market meeting of the CDU Economic Council in Berlin on March 14.

¹⁶ Mersch, Y. 2018. The limits of central bank financing in resolution. IMFS Distinguished Lecture Series Goethe Universität Frankfurt on January 30.

to reducing complexity is to correct flawed incentives for banks, for instance, by addressing false incentives for banks. Realigning such incentives would increase banks' capital levels. Higher credit costs might induce nonfinancial corporations to substitute bank debt with equity, but also with nonbank credit. New macroprudential measures for the nonbank financial intermediaries would be needed if the move to nonbank credit poses substantial systemic risk. We have argued that, in the medium term, financial regulation should be less complex without increasing systemic risk.

Even if simpler regulation then resulted in more bank failures (in a worst-case scenario), solid macroprudential buffers, a strong deposit guarantee

scheme and a strong resolution regime would be a vital backstop. Once these three conditions are met, the social costs of bank market exit will be substantially lower, like in the U.S.A. As a result, regulation could be greatly simplified. Both the financial sector and bank creditors would internalize the consequences of bank failure. For a successful reform, a new EU initiative along these lines will be necessary.

However, addressing regulatory complexity effectively is not an easy task, which is best described by a quote attributed to Albert Einstein saying "Everything should be made as simple as possible, but not simpler."

About the author

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