SUERF/CBI Conference - Conference Report

Regulation and Banking after the Crisis

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It is quite evident that the 2007-2010 financial crisis will have substantial lasting consequences for banking and financial market supervision and regulation as well as for the future evolution of banks and the financial industry at large. Since the inception of the crisis, a lot of analysis has been conducted on the causes of the crisis and on appropriate remedies; supervisors and regulators have worked hard to fundamentally revamp international regulatory and supervisory frameworks; and banks have embarked on restructuring and repositioning strategies to respond to the changed financial and economic landscape after the crisis. With work being in full progress in these three areas, SUERF found it useful to provide an overview of the current state of play at a conference. Having the Central Bank and Financial Services Authority of Ireland as a partner organisation for the project proved to be particularly valuable, given this institution's fresh and first-hand experience in crisis management. The conference was structured into four parts: The opening and keynote session aimed to provide an overview of the issues in question. Session 1 took the authorities' view in addressing post crisis regulation and intervention strategies. Session 2 adopted a financial practitioner's angle by discussing new business models in the post-crisis financial system. Session 3 provided some thought-provoking ideas on sovereign states' and financial institutions' safety nets and offered insights from the Spanish experience with dynamic provisioning.

SUERF's President, **Catherine Lubochinsky**, opened the conference on behalf of SUERF and raised the issue of increasing complexity of financial systems and financial supervision and regulation. Markets tend to panic, and they continuously look for reasons to panic. She raised the critical issue that Basel III does not seem to impose big new constraints on many banks – many important market participants would have satisfied these rules before the crisis, and continue to do so now. So, will Basel III be capable of preventing future crises?

Frank Browne, Central Bank and Financial Services Authority of Ireland, in his opening remarks welcomed the opportunity to co-organise this conference with SUERF, whose three-pillar approach – bringing together practitioners, academics and authorities - proves to be particularly appropriate and necessary during periods of crises and change. The seeds for the current crisis were sawn in the previous "good" times. Both financial markets and the authorities failed to anticipate or act against the building massive imbalances. An immediate lesson for central banks, regulators and supervisors thus is that they need to be most vigilant when are others least so, they should hold contrarian views and continually question the conventional wisdom about the economy, the banking and broader financial system, and they should operate like financial seismologists. But then they also need to actually take necessary action. Financial stability is a public good which public authorities are mandated to safeguard. Regulation is always a moving target because the financial system will always attempt to circumvent it (as for example the strong growth of shadow banking prior to the crisis was triggered by regulatory arbitrage in the light of Basel II).

Views on the new banking business models which proliferated in the run-up to the crisis are now overwhelmingly negative. But the financial stability assessment of these models before the crisis was actually quite balanced: They could contribute to the resilience of the financial system but also were recognized to bread new risks. For the future, it would be important to distinguish between these new models in themselves and the – flawed – ways in which they were used by banks. The Originate and Distribute (OAD) model became a source of systemic crisis because of the very fact that it ultimately did not sufficiently distribute risk. Financial innovations should not be discarded in general terms but more care should be taken to minimise their negative effects. In fact, in the years ahead banks may only be in a position to originate new loans if they can sell off existing ones, if they are not to become overly dependent on uncertain wholesale funding.

In the keynote session, chaired by Catherine Lubochinsky, Governor **Patrick Honohan** addressed the topic of "Banks and the budget: lessons from Europe". The failure of a number of important banks has also been at the core of budgetary problems in many countries. There

are various channels through which banking problems can affect budgets and the real economy. Those channels are visible both during bubbles and busts. The boom in Ireland brought huge windfall tax revenues. For over a decade, the Irish budget was in surplus. As a result, spending control was relaxed. The apparent solidity of the budget was only a mirage, which became obvious when the bubble burst. Banks had fuelled an unsustainable real estate bubble and not taken sufficient precautions for their balance sheets. The regulatory apparatus did not fully appreciate the extent of the bubble and the risks emanating from it. Current measures aim to eliminate the credit overhang and to recapitalise banks.

Much of the Irish government support for banks will show in the 2010 budget figures. The Government has taken far-reaching and painful spending cuts. Still, a further substantial reprogramming of the budget will be necessary to put the future development of debt on a sustainable path. Economic growth is best served by putting the budget on a sustainable path. No matter how international banks seemed to be, in crises they are national. But the case of Iceland probes the limits of governments being able to save large banks. In many European countries, distressed banks have been forced to shrink back into their home markets.

There are also pressures from the budget on banks. High and unsustainable public debt can sharply raise funding costs for banks, as the past few months have shown. The EU guarantee fund and the ECB's SMP have helped to contain interest rate rises. Furthermore, cross-border holdings of sovereign debt can put pressure on bank balance sheets. Finally, the introduction of various forms of bank taxes to consolidate budgets can be the source of future financial risks if it prevents banks to build up sufficient safeguards or triggers circumvention.

David Llewellyn, Loughborough University and SUERF, talked on "Post crisis regulatory strategy: a matrix approach". He questioned the current consensus that more regulation of the financial sector is needed to prevent future crises and, even if this were to be the case, whether Basel III addressed the right issues. Most of the emphasis in Basel III has been given to pillar 1, very little has been done to improve pillars 2 and 3. Important elements, resolution mechanisms, which Prof. Llewellyn named "pillar 4", are in his view missing altogether. Inevitably, the crisis triggers a major review of financial market supervision – with good reason: Basel I and II not only did not manage to prevent the crisis, but in his view partly caused it: The design of regulation determines the form of the next crisis rather than preventing it. If regulation indeed has a fundamental problem of endogenously shaping the next crisis, then the problem is fundamental and difficult to solve: it is not enough to just amend and supplement Basel I and II.

Any regulatory regime has two basic objectives: to reduce the probability of bank failure, and to reduce the cost of inevitable bank failure. The first is more difficult than the second, and there are also tradeoffs between the two objectives. If one could reduce the costs of bank failures, one could be less concerned about the probability of bank failures, and thus need less intrusive bank regulation. Also, the cost of regulation is often neglected, which is rising over time – because, to keep regulation effective, it needs to become increasingly restrictive over time. Regulation design should be more strategic than incremental (the latter being the case now). The speaker considered six major classes of instruments in a regulatory regime: 1) structural, 2) behavioural, 3) intervention, 4) taxation and insurance, 5) resolution, and 6) living wills. Structural measures, such as Glass-Steagall etc., do not work in practice, because regulation triggers circumvention and future crises itself. The better strategy is therefore to lower the cost of bank failures. Regulators should invest more in resolution, living wills, and taxation and insurance issues. Resolution strategies should thus be Basel's pillar 4. There is currently an excess of expectations of what regulation can achieve. Regulation is necessary but not sufficient. Current thinking on regulation starts out from a problem in the financial sector, and then tries to address it through regulation. But the misbehaviour of the financial sector may – at least partly – be endogenous to the regulatory regime. So, regulation shoots at a moving target, and the costs of regulation continuously rise.

Session 1, chaired by **Frank Browne**, Central Bank of Ireland, dealt with "Post crisis regulation and intervention strategies". **Nigel Jenkinson**, Financial Stability Board, opened the session with an overview on "Future regulation and intervention strategies: key issues". The current supervisory reforms have two dimensions: a time-series and a cross-section one. The first group of measures puts special emphasis on containing systemic risks through introducing countercyclical capital buffers, ensuring earlier loan loss recognition and by installing countercyclical margins and haircuts. The cross-section perspective includes measures to contain spillovers and

contagion, to improve market functioning and incentives (by shaping compensation schemes, improving oversight and reducing the role of rating agencies, by improving market discipline through greater transparency and by improving market infrastructure), and to lower interdependence (by addressing large exposures, introducing constraints or incentives on size and on undesired financial institution structures). Various studies show that the benefits from this new regulation should by far outweigh the potential output costs, both in the long run and in the transition period. In order to reduce failure costs, both the probability and the costs of failure of systemically important banks need to be reduced. Moral hazard from systemically important institutions needs to be addressed and crisis management capabilities need to be strengthened. Systemically important banks should have higher loss absorbency beyond Basel III. Intergroup exposures should be restricted, activities should be clearly separated. Systemic levies should help to contain activities which entail systemic risk and externalities.

Financial regulation is an important element of the regulatory toolkit, but it clearly has its limits. Interconnections between various elements need to be identified, a holistic approach is necessary. Regulatory tools also need to be robust to changing circumstances. Tradeoffs between predictability and adaptability of regulatory frameworks need to be addressed. International consistency needs to be achieved to avoid cross-border arbitrage. Finally, regulation will always need to remain flexible to address ongoing tendencies to circumvent existing regulatory measures.

Aerdt Houben, De Nederlandsche Bank, drew lessons from the crisis with regard to risk identification and mitigation. He conveyed three main messages: First, authorities are not good at identifying and projecting risks. Therefore, second, emphasis should be put on the second and third lines of defence: There should be more emphasis on increasing resilience to absorb threats, and capabilities to manage and resolve crises need to be improved; resolution schemes should be given more substance. Third, financial sector policies should follow the proportionality principle.

In principle, the credit crisis emerged while underlying risks were on policy makers' radar screens and institutional structures were focused on financial stability. There was also growing awareness of systemic risk, cross-border complications etc. Warnings on global imbalances, search for yield and excessive risk taking, the shortcomings of the originate-to-distributed model, risks of credit derivatives, risks from large and complex institutions, asset price inflation and leverage were all there before the crisis. Nevertheless, the crisis, and its severity, surprised everybody: Pro-cyclicality was more serious than anticipated, room for manoeuvre to mitigate the crisis turned out to be quite limited, fundamental uncertainty turned out to be more serious than expected, and various behavioural shortcomings, such as disaster myopia, confirmation bias and cognitive dissonance came into play. Both financial markets and supervisors were subject to over-optimism in good times and neglected infrequent risk.

To improve supervision, the authorities, first, need to change their attitude towards risk: it needs to be more forward-looking, focus on vulnerabilities rather than risks, and to focus on propagation channels and systemic linkages. Second, risk mitigation policies need to be improved and the above-mentioned three lines of defence need to be used more quickly. Third, more emphasis needs to be put on precaution, i.e. precautionary action should be taken even though robust scientific proof of the need to take action may not yet be available for financial stability (much the same as it should, e.g., for global warming and nuclear safety): when in doubt, err on the side of caution.

Pat Farrell, Irish Banking Federation, elaborated on "Banking as a social contract – the new regulatory paradigm". A major challenge now is how banking will again focus on retail business: how will it look in the future? As banks restructure, what effects will this have on the economy and on customers? Banks, the authorities and society at large are linked in a social contract: on the one hand, banks do the risky business of turning liquid savings into illiquid loans. On the other hand, regulation, deposit insurance and central banks' lender of last resort function protect the economy from these risks. Banks have failed to fulfil their part of the social contract, their reputation has been severely damaged.

A banking sector and a new social contract of the future need to comprise the following elements: Banks need to return to the "first principles of banking", i.e. they need to be a safe place for customers' savings, be responsive to customers', the economy's and society's needs, take less risks, diversify their loan portfolio better, and work more closely with regulators, the government and all stakeholders. Rather than focusing on short-term gains, banks need to focus on the longer-term future. Rather

than relying on profits in the real estate sector, banks should develop expertise in modern growth centres and develop their services for SMEs. Lending should focus more on cash flow rather than property or other assets.

A number of initiatives to assist distressed homeowners have been taken to help them manage their mortgage and, if possible, keep their homes. One third of Irish SMEs struggle with loan repayments – banks cooperate with the government to find solutions to this problem. Banks have an important role, both economic and social, to play to bring Ireland forward. Banks need to be strong and safe, and innovative and responsive, at the same time in the future.

Session 2, chaired by **David T. Llewellyn**, Loughborough University and SUERF, addressed "New business models in the post-crisis financial system". **Luc Riedweg**, Banque de France, reported on results from a report on "the future of the financial landscape". No business model came out of the crisis as a clear winner. Market participants expect a diversified banking model to increase in importance at the cost of specialised models. Diversification helps to secure important fundamentals for a bank's business: funding, revenues, and customers. However, some regulatory provisions (limits to size and scope, deduction of banks' insurance and bank equity holdings from Tier 1 capital) might hamper diversification. Universal banks, while remaining diversified, are likely to privilege their core markets, activities and clients: they cannot afford to maintain unprofitable business lines; too broad a spectrum of activities may be difficult to control; in an interconnected world, risk diversification through different business lines and regional activity are smaller than thought in the past. In the next years, specialised banks will comprise, on the one hand, large players with high skills and market power; on the other hand, niche and high-growth players with small capital will either require technological advantages or special expertise and customer relationships. Retail banks will have to deal with possibly low loan growth for some while; investment banking will face volatile sources of financing and less leverage. Banks will try to reap economies of scale, cut costs, profit from cross-selling advantages, scale down low-return business, return to basics in their products and services, improve distribution and sales force productivity. Clients will ask for simple, transparent and low-risk products. In the medium term, customers will again ask for high-yield, tailor made, innovative products. Banks will try to find alternative sources of revenues and generate fee income through new forms of financial innovation; opaque and complex products might thus reappear. The consolidation process among EU banks going on already before the crisis can be expected to continue in the medium term, driven by the need to restore profitability. The recent retrenching to domestic markets is likely to be temporary. Funding will not be as easily accessible as before the crisis and will be more expensive. Given that deposit funding is a part of the current "back to basics" policy pursued by numerous banks and the ongoing work on harmonising deposit guarantee schemes in the EU, which will increase the attractiveness of cross-border deposits for customers, competition for deposits may increase. The new liquidity requirements may have an important impact on the future of the interbank markets as a funding source.

Regarding possible implications for financial stability, the stricter equity and liquidity requirements may lead to regulatory arbitrage (new products, geographical shift of activities, shift to non-regulated intermediaries). Diversification will need to be accompanied by sound risk management practices to ensure financial stability.

David Marqués Ibañez, European Central Bank, talked about "Bank business models and the role of securitisation and OAD". Banking market liberalisation led to larger financial institutions over the last 30 years. Dismantling of the Glass-Steagall Act played an important role in this. Starting in the mid-1960s, banks went slowly back to the security business. With the financial crisis, the separation between commercial banking and securities business is back on the political agenda. Arguments for separation are to keep deposit taking institutions with access to the deposit insurance out of activities that might lead to higher risk taking; and a possible incompatibility of incentives. Arguments for universal banking are informational economies of scope, wider diversification, international competitiveness, and the risk of activities going into the shadow banking system.

The existing empirical literature overwhelmingly shows that the advantages from universal banking outweigh the disadvantages from potential conflicts of interest. But universal banks need to be carefully supervised. Empirical estimates also show that banks with higher lending growth turn out to be riskier. Market funding and new business models had a huge impact on the transmission mechanism via loan supply. Banks more active in securitisation were also more aggressive in syndicated loan pricing.

Patricia Jackson, Ernst & Young LLP, gave a presentation entitled “A false sense of security: lessons for bank risk management from the crisis”. The financial crisis was rooted in disaster myopia and a false sense of security. Therefore, stricter capital provisions are important but by no means sufficient to address problems. A first problem is misleading signals. The management of a large bank depends on appropriate information on risks. The Basel Committee had allowed risk models based on far too short historical time series. Such models in boom periods can be very misleading and nurture over-optimism on correlation and risk. Point in time models (instead of through-the-cycle measures) gave the wrong risk sensitivities and probabilities of default in the case of severe economic downturns. Netting provisions further lowered perceived risk. Also the new countercyclical capital requirements give perverse incentives: banks can compensate the effects of countercyclical regulatory measures. Stress testing now plays a more important role within banks. But tests need to become tougher and more systematic, also putting more emphasis on liquidity stress testing; all business areas – rather than just a limited range of activities - need to be involved. Also, the right risk metrics need to enter into managers’ and staff’s incentive mechanisms. Banks’ boards of management need to ensure a much greater understanding of risk. The speaker emphasised the strong need for standardised formats of prospectuses and contracts as important steps to improve transparency. There is a need for a clearly formulated risk appetite with quantitative metrics.

An important lesson from the crisis is that market failure, time inconsistency and incomplete information were at the core of the problem. There were core failures in the market’s design for structured products: time inconsistency lead to a decline in standards; search costs were too high, thus information was in some cases not easily available. Therefore, the Financial Stability Board should collect information on rapidly growing opaque markets and disseminate it to the market. Clearer and simpler products with guarantees of due diligence are needed.

Session 3, chaired by **Philip Molyneux**, Bangor Business School and SUERF, was devoted to “Regulation and the changing financial landscape”. **Alistair Milne**, Cass Business School, City University London, opened the session with a paper on “Limited liability non-bank government debt for the euro zone”. Starting from the question whether EMU requires fiscal integration, the author argued in favour of putting more emphasis on market discipline and less on fiscal rules. Fiscal federalism is not clearly defined but claimed as a justification for loans and transfers between sovereign states. Fiscal hawks argue for stricter and fully enforced fiscal policy rules. But why are the current weaknesses of fiscal discipline through market forces not addressed instead of focusing on fiscal federalism or fiscal rules? The available literature shows four methods to control fiscal policy: rules, market forces, administrative procedures, and cooperative systems. The USA, Canada and Switzerland (where there is little if any support for states from the central budget in case of financial difficulties) are basically market based systems, whereas Germany and Japan fall under the category where central bailouts are the norm. Loss of fiscal control seems to be far more prevalent in the latter than in the former type of system.

In the author’s view, market discipline on euro area fiscal policy would best be imposed through ex ante rules on debt service and restructuring. In his proposal, debt servicing would be limited to a maximum primary surplus, of e.g. 5% of GDP. Thus, interest payments would be cancelled, and principal payments would be postponed to meet this requirement. There would be limits on bank holdings of government debt. The maturity structure of government borrowing should focus on the long term, whereas a short-term, senior facility would be at a high (i.e. penalty) rate of interest.

Edward J. Kane, Boston College, presented a paper on “Redefining and containing systemic risk”. The taxpayer’s exposure to loss through the financial system’s safety net is the essence of systemic risk. The current crisis reflects uncertainty about the size of the losses and who will bear them. Financial crises are battles over loss distribution, and bailouts are exercises in robbing some agents to pay others. Costs and benefits of tax-transfer programs lack balance. The crisis was not so much caused by de-regulation than by “de-supervision”. The effectiveness of any financial system depends on the vigilance and conscientiousness of bank supervisors, who are subject to various influences and incentives. In the sub-prime bubble, private and government supervisors shut their eyes to regulation-induced efforts to disguise leverage and volume-based compensation schemes that reinforced the short-cutting and outsourcing of due diligence. The major symptom of an impending crisis is the unacknowledged proliferation of institutions not viable without implicit government support.

Systemic risk has two symptoms: the potential for substantial spillovers, and the ability of institutions to command implicit and explicit support from national safety nets: authorities' susceptibility to capture give politically strong firms a subsidized "taxpayer put". Taxpayers as de facto shareholders of systemically important firms deserve more information and accountability. In practice, institutional arrangements do not hold credit rating agencies and other safety-net supervisors accountable for detecting safety-net subsidies or minimising costs for the taxpayer of saving systemically important institutions. Irresponsible financial firms (and governments) should not be saved by the taxpayer. Safety net reform in the US and the EU is therefore on the wrong track. It is economically wrongly focused by relying on expanding incentive-conflicted regulators' power. It is politically dishonest by claiming "never again" and by making no effort to clean up the dysfunctional culture of regulatory capture.

Responses need to include a combination of measures: improving public-service contracting to offset pressures from the industry, e.g. by deferred compensation and by requiring agencies to report fully on non-public interactions with politicians; creating an independent agency monitoring and publicizing safety-net subsidies; and recognizing that private firms are responsible to the taxpayer.

The session was concluded with a paper by **Jesús Saurina**, Banco de España, on "Macroprudential regulation". Lending cycles mean that borrowers and lenders are overconfident about investment projects in booms, while during recessions they suddenly turn very conservative. Empirical evidence confirms such pro-cyclical lending behaviour, e.g. collateral requirements decline and higher credit risk is accepted during boom times. Monetary policy may increase banks' risk taking by maintaining overly long periods of low interest rates.

The Spanish system of dynamic provisioning was installed in mid-2000 and modified in 2004. Banks are required to disclose the amount of the dynamic provisions. Thus, financial statements properly reflect the true financial situation of a bank. The Spanish system allows for an earlier detection of credit losses building up, it is a transparent, rule-based and formula-based system and provides information comparable across banks. It can also be regarded as an early warning system for financial statement users. All in all, the tool proved to be useful but is no silver bullet either. In particular, it cannot be expected to play the role which other tools, such as monetary or fiscal policies, are supposed to fulfil. There are various options for implementing countercyclical aspects into Basel III – as often, the devil lies in the detail. But simulations show that it is possible to substantially reduce lending cycles through such measures.

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The roughly 110 participants clearly benefited from the presentations, as reflected by the vivid exchange of views. By bringing together academic researchers, policy makers and financial practitioners SUERF hopes to have again made a contribution in furthering our understanding of issues central to all three constituencies and to society at large.

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