Managing the unintended consequences of new regulation and supervision

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Session 7: Where to from Here?
What does all of this mean for financial regulatory policy?

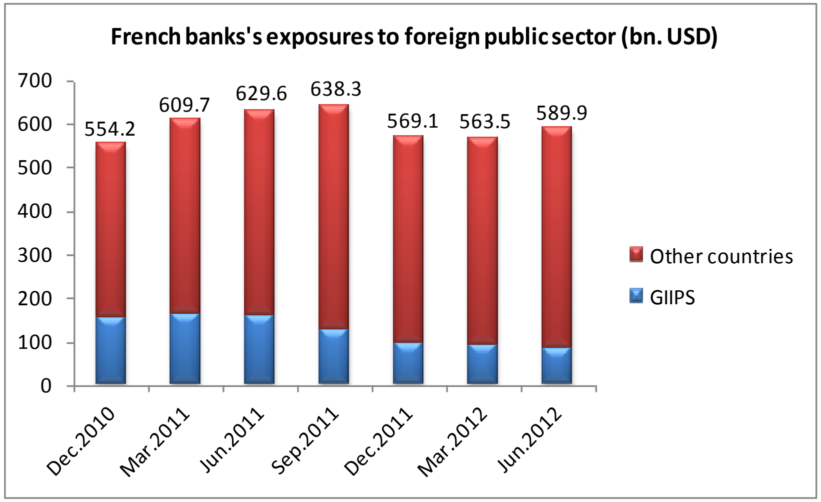
I. **Unintended consequences of new regulations**

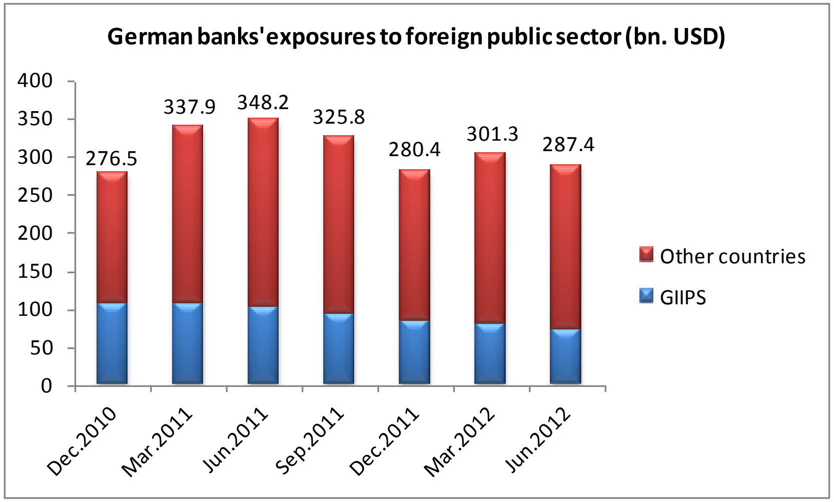
II. Challenges associated with new forms of supervision

Appendix

1. Deleveraging and lending activity

- Requirement for major European Banks to meet 9% core Tier 1 capital ratios, with a sovereign exposure buffer, by June 2012: risk of lending activity disruption.
- At the European level, process followed by the European Banking Authority (EBA).
- Deleveraging/possible credit crunch closely monitored by the Autorité de Contrôle Prudentiel (ACP): limited impact on French SMEs and reduction of risky sovereign exposures:





2. Concerns associated with the implementation of Basel III regulation

a) Liquidity and long term funding needs

- A EUR 1.8 tn. shortfall for international banks (BCBS QIS of Dec. 2011).
- Vigilance required in the implementation of the LCR concerning notably:
  - The strong incentives for banks to increase sovereign risk exposures;
  - The incentives for banks to pledge their less liquid assets at the central bank leading to regulatory arbitrage;
  - The preservation of the level playing field.
- The implementation of the liquidity requirements closely monitored by the ACP:
  - To avoid "deposits war" among French banks actively seeking retail deposits;
  - To limit undesired consequences for some business lines (such as banks' USD funded activities).

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2. Concerns associated with the implementation of Basel III regulation

b) Leverage ratio requirement and regulatory arbitrage

- Proposal to introduce a leverage ratio requirement at the international level.
- However, no consensus relative to the impact of more stringent capital ratios on banking system soundness (Koehn and Santomero 1980, Furlong and Keeely 1989, Rochet 1992, Blum 2003).
- Assessment of the impact of the leverage ratio requirement through quantitative Impact Studies (National supervisory authorities and BCBS):
  - Banks with a lot of exposures subject to low risk weights more likely to be constrained by the leverage ratio.
- The implementation of the leverage ratio requires:
  - To avoid the potential negative impacts on some banks' business model;
  - To avoid the incentives for excessive risk taking behaviours;
  - To consider the ratio as a complement to other prudential tools.

3. Regulatory arbitrage, risks associated with the development of the shadow banking sector, and the structure of banking activities

a) Risks associated with the shadow banking sector

- Transfer of risks to non regulated, or less regulated, entities (finance companies, hedge funds, money market funds…).

- In 2011 the shadow banking sector amounted to:
  - EUR 15 tn. in the US, which is slightly above the size of the regulated banking sector;
  - EUR 10.8 tn. In Europe, about 40% of the total assets of the regulated banking sector.

- At the European level:
  - Proposition for a unified approach across the whole banking sector (credit institutions and investment firms);
  - But need to adopt a broader definition of credit institutions in the European legislative package to include institutions not collecting deposits.

- ACP’s extensive approach of supervision.

3. Regulatory arbitrage, risks associated with the development of the shadow banking sector, and the scope of banking activities

b) Which organisation of banking activity provides the best incentives to ensure financial stability?

- **The Volcker approach:**
  - Restricts deposit-taking banks from engaging in certain types of market or activities (proprietary trading);
  - Prohibits banking entities (with exemptions) from engaging as principal in short-term trading in securities derivatives and commodity futures.
- **The Liikanen proposals:**
  - Mandatory separation of trading activities from retail banking if:
    - Trading portfolios and Available for sales -AFS larger than [15-25%] of total assets or EUR 100 bn;
    - Specific trading assets larger than a certain percentage (to be determined) of total assets.
  - Application of the CRR/CRDIV on a solo basis for the two entities.

I. Unintended consequences of new regulations

II. Challenges associated with new forms of supervision

Appendix

1. New Supervision Methods

a) The growing importance of stress tests

- Under asymmetric information, the disclosure of stress test results may lead to inefficiencies in banks' behavior.

- Efficiency of "publicly announced" stress test exercises may require:
  - Disclosure of aggregated results, detailed description of the individual banks' exposures and publication of remedial measures;
  - A certain degree of international harmonization of practices and methodological improvements.

b) More intrusive approach to supervision

- Consensus emerging for more intrusive approaches.
- French intrusive approach based on relatively high frequency of pretty long on-site inspections.
- However, need to maintain an optimal intensity of both supervisors' audits and internal audits.

2. Divergence between micro and macro supervision

- **Both micro and macro prudential supervision have limitations; for example:**
  - Reduction of lending activity due to micro prudential measures;
  - Possible regulatory forbearance due to macro prudential concerns.

- **For more efficiency, micro and macro prudential supervision should be insured by a single institution or by very close institutions.**

- **Need for coordination:**
  - Same instruments for different objectives;
  - At the international level, need to coordinate macro prudential regulation to maximize benefits and preserve the level playing field.

- **In France, policies in the field of financial stability coordinated by the French Systemic Risk Board.**

3. Managing banks' reporting burden

- **More demand for new reporting and data collection to better track banks' risk taking:**
  - Bottom-up stress tests, QIS and surveys conducted by the ACP on the aegis of the European supervisory agencies (EBA, EIOPA), the European Systemic Risk Board (ESRB) or the BCBS;
  - ACP's weekly survey on net inflows of life insurance companies and monthly survey relating to portfolio allocation;
  - Data gap initiative by FSB/BIS/IMF for weekly reporting of exposures/funding by G-SIFIs.

- **So, need to insure the true efficiency of the new data collection:**
  - Increase costs of new data collection for institutions and risk of erroneous information for supervisors;
  - Creation by the ACP of a Consultative Committee on Prudential Affairs with participants from insurance and banking sectors.

4. Coordinating the European banking supervision: the Banking Union

Implementation of the banking Union:

- A single supervisory mechanism (SSM);
- A single resolution mechanism (SRM);
- A single deposit insurance scheme (SDIS).

Choices for the Banking Union:

- Application area;
- Scope of the supervision;
- Articulation with national authorities and the European Banking Authority (EBA);
- Relationships with 3rd countries' supervisors…

Conclusion

Banking sector in 10 years from now:

- More solvent banks;
- More liquid institutions;
- Banks more focused on their core business;
- Probably a larger shadow banking sector.

Appendix

Banking sector in 10 years from now

More solvent banks

- **Increase in risk-based capital requirements and introduction of the leverage ratio:**
  - From Dec. 2011 to June 2012, EBA requested 116 billions of euros of additional capital for the 27 banks that had to submit capital plans;
  - Resulting total capital injection reached 200 billions of euros;
  - Increase in capital was achieved essentially through retained earnings and new equity.
- **Better crisis management rules and resolution frameworks will have helped reduce overcapacities and close down inefficient banks.**
- **… But need to pursue efforts to minimize the possibility of regulatory arbitrage and unlevel playing field, particularly those which may result from the use of banks' internal models:**
  - BCBS, EBA and national supervisory authorities are managing this issue by peer review analysis of risk weighted assets' consistency.

Banking sector in 10 years from now

More liquid institutions

- **To comply with the LCR, banks need to be able to cover their liquidity needs for a 30 calendar day time horizon:**
  - As of end-Dec. 2011, shortfall of 1.8 trillion of euros for a total of 209 international banks.

- **To comply with the NFSR, banks need to have an adequate maturity structure of assets and liabilities measured on a one-year time horizon:**
  - As of end-Dec. 2011, shortfall of 2.5 trillions of euros for the same 209 international banks.

- **… But need to pursue the improvement of the liquidity requirements' calibration:**
  - For the LCR in particular, improvement of the definition of high quality liquid assets and of the assumptions for inflows and outflows in stressed periods.

Bank sector in 10 years from now

Banks more focused on their core business

- Higher regulatory requirements and proposals to limit proprietary trading (Volcker’s rule, Vickers and Liikanen reports) penalize size and complexity.
- Capital surcharges for systemically important financial institutions (SIFIs) reduce the incentives for banks to increase their size.
- In France, we see now banks:
  - Focusing more on their core business, while reducing excessive complexity and leverage;
  - Reducing market operations and their foreign currency-denominated lending.
- More generally, there is a tendency to focus more on retail (for universal banks) .

Banking sector in 10 years from now

A larger shadow banking sector

- Higher regulatory requirements lead to the transfer of certain risky exposures to the shadow banking system.
- This is not necessarily reducing risk for financial stability, since problems in non regulated, or less regulated, entities, may hit banks (LTCM).
- As a result, more work is needed regarding the regulation/the monitoring of the shadow banking sector.

Thank you for your attention