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Balancing growth and stability in EU financial reform

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Foreword by
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At the present juncture, increasing economic growth and improving financial stability are two of the most important issues facing policymakers across all developed economies, including the EU and its member states. This report examines the impact of financial regulation on financial stability and on growth: given the deep integration of the financial system within a modern developed economy, regulation of the financial sector has repercussions throughout the broader economy.

The report makes the case that policymakers and financial regulators should strike a balance between the twin goals of economic growth and financial stability. In my view, in presenting these goals as conflicting, a false dichotomy has arisen in the policy debate. In fact they are interdependent: financial stability will give businesses the confidence to invest in new jobs and growth; whilst economic growth is essential for European companies and citizens to build the income and wealth that is needed to sustain a stable economy and financial system for the long term.

I welcomed Commissioner Barnier's announcement in April this year of the programme under the Single Market Act "Twelve projects for the 2012 Single Market: together for new growth". The Union and its member states must remain an attractive destination for companies, investors and entrepreneurs, and a magnet for the skills needed to develop the jobs and income on which Europe's future prosperity depends. The private sector, given such a framework, can be empowered to deploy Europe's potential to deliver smart, sustainable and inclusive growth.

There should be recognition by policymakers in Europe that the financial services sector has an important role to play in facilitating that growth. A stable financial system will help to restore confidence, but financial institutions must continue to take the risks which are inherent in financial intermediation: providing capital and risk management to European citizens, companies and governments; and in financial innovation: developing new financial products which support the development of new industries and markets.

This report provides a framework to inform the policy debate on financial regulation in Europe, and by extension the future of Europe's financial system and its entire economy. TheCityUK and its members look forward to engaging with policymakers in the EU and its member states to create the conditions in which Europe's savers, companies and taxpayers regain confidence in the stability of the financial system. And at the same time to create the environment for business – commercial undertakings, employers, employees, and the skills they harness and develop – to succeed and to make the profits that must, ultimately, provide the catalyst for Europe's future growth.

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Executive Summary

- The financial crisis has forced a reappraisal of the regulatory architecture, globally and in the EU and its member states. Around the world, policymakers are proposing significant changes to rules governing the financial sector, with the goal of making the financial system more resilient.
- Given the large and visible costs of financial instability for Europe, it is natural for European policymakers to make the avoidance of financial crises a high priority. But it is also important to recognise that regulation carries a range of costs that can dilute the economic benefits of a competitive and dynamic financial services sector.
- The academic literature has robustly established that financial development is not only the consequence of economic growth but also a driver. If the EU is to achieve the ambitious goals for unleashing private enterprise and creating jobs set out within the Europe 2020 agenda, then it cannot afford to overlook the role of the financial system in fostering innovation and growth.
- As supervisory authorities consider a broad set of proposals to strengthen the regulatory infrastructure, an important question that arises is how to assess the aggregate impact of these various measures. Although each may look sensible in isolation, they could still impose a larger-than-expected burden on the financial system when taken in the aggregate.
- The focus of policy reforms should be on forcing financial institutions to internalise the social costs of their risk-taking decisions rather than suppressing financial innovation. Credible policies to allow the failure of financial institutions would encourage market monitoring of risk-taking, reducing the need for additional prudential regulation and minimising costs to the taxpayer in the event of bankruptcy.
- Policymakers should aim to put in place an objective, sustainable and flexible regulatory regime, as the design of the regulatory framework will play a significant role in the future development of both the financial industry and the wider economy. International consistency in the regulatory reform agenda is also important so as not to risk fragmentation of global capital markets, which bring significant economic benefits to companies and consumers alike.
- The economic and social purpose of financial markets is the efficient allocation of capital, and the regulatory agenda must be framed around this goal. At a time when the European economy is struggling to recover lost ground, changes to the regulatory regime should not unduly restrict the potential of the financial sector to contribute to the continent’s future prosperity.

1 Introduction

Europe's financial sector plays a crucial role as a catalyst for broader economic development. Through its intermediation role, it mobilises savings for productive investment. It lowers transaction costs in the European economy by helping to reduce problems of asymmetric information that are inherent in the relationships between investors and entrepreneurs. It provides payment services in member states and cross border between member states and internationally. It provides the means for companies and consumers to hedge, pool, share, and price risks. An efficient financial sector can therefore reduce the cost and risk of producing and trading goods and services, thereby making an important contribution to raising standards of living.

But the recent crisis has revealed fundamental weaknesses in the financial system, forcing a paradigm shift in the global financial regulatory framework. There is now a broad consensus that the period leading up to the crisis was characterised by excessive credit growth and the build up of systemic imbalances, developments that were facilitated by inadequate oversight of risk management on the part of firms and supervisors. Reforms are therefore required to make the financial system more resilient to future shocks and to protect consumer welfare in Europe and around the world.

Against this background, a range of global public policy initiatives are underway to secure a stronger and better functioning financial system. This includes a large number of initiatives at the EU level aimed at strengthening regulation around a broad spectrum of financial market activities.

The proposed changes to the regulatory architecture are wide-ranging, as prudent action to restore the balance between financial stability and growth is required. Nonetheless, a vibrant financial system remains essential for a sustained economic recovery and for long-term prosperity, so it is important to avoid overly restrictive reforms that unduly hamper access to financial services for companies and consumers.

Nowhere is this truer than in the European Union. The EU is the world's most developed regional economic integration organisation, bringing together member-states with different economic features, and the challenge of managing a common currency across a majority of member-states. If the EU is to achieve the ambitious goals for unleashing private enterprise and creating jobs set out within the Europe 2020 agenda, then it must develop a regulatory framework that allows the financial system to play a full part in fostering innovation and growth across EU member states.

The recent crisis has opened up a broad policy debate within the EU on how to achieve an appropriate balance between stability and growth in economic governance reform[1]. This paper suggests how such a balance may be achieved

[1] For example, see Bertelsmann Stiftung (2011).

within the financial services industry so that it can create sustainable, long-term value for the EU economy.

2 The rationale for financial sector regulation

- Regulation of the financial sector is appropriate to correct for identified market imperfections and failures.
- But financial regulation does also carry a range of costs, for financial firms and for the wider economy, which are important to recognise when framing the regulatory context.

Before considering the scope of regulatory reform, it is useful to review the fundamental rationale for prudential supervision of the financial sector.

2.1 The costs and benefits of regulation

The case for regulation of the financial sector depends on the identification of various market imperfections and failures that, in the absence of regulation, would produce sub-optimal results that reduce consumer welfare. On this basis, the core goals of financial regulation are essentially threefold:

1) Consumer protection
2) Maintaining the safety and soundness of financial institutions
3) Ensuring systemic stability

As with other sectors of the economy, consumer protection issues in the financial industry can arise when a firm's conduct of business with a consumer is unsatisfactory**. Conduct of business regulation** is designed to establish rules and guidelines about appropriate behaviour and business practices in dealing with customers.

"…compared to other sectors of the economy, financial markets are much more interdependent…"

The failure of any firm can also harm consumer welfare, and to this extent financial institutions are not unique. But the potential impact on individual consumers can be greater, particularly when a deposit-taking institution fails. As consumers may not be able to judge the safety and soundness of financial firms (due to asymmetric information), this argues for **prudential supervision** to establish appropriate operational standards.

Regulation for systemic reasons may also be warranted because of the 'externalities' associated with the failure of financial institutions. In other words, the wider social and economic costs of failure of financial institutions (particularly banks) may exceed private costs to the owners of the institutions, and such potential wider costs are not incorporated in the decision making of the firm. In addition, compared to other sectors of the economy, financial markets are much more interdependent, as demonstrated by the very tight interconnections in the interbank market. Events in one financial market or institution may therefore have important consequences for the wider financial system. Moreover, because

of the key role of the financial sector in the efficient functioning of modern economies, such disturbances are also likely to have a negative impact on the non-financial sector. Public policy intervention then is not only a microeconomic question of protecting the welfare of individual savers and investors, but also becomes a macroeconomic issue. **Macroprudential regulators** have been tasked with monitoring and managing these systemic risks.

Against this background, reforms aimed at strengthening the regulatory architecture to ensure a more robust and better functioning financial system are to be welcomed. But there is also a risk, as noted by Goodhart *et al.* (1998), that financial regulation may be wrongly viewed as a 'free good' that imposes no costs upon society. Financial regulation does carry a range of costs, which broadly fall into three categories:

"…there is a risk that regulation may be viewed as a 'free good' that imposes no costs upon society."

- The **'direct' costs** of paying for the financial regulator(s) itself. Even when these costs are recouped through a direct levy on the financial industry, this is likely to feed through to higher prices for consumers of financial products.
- The **'indirect' costs** of regulation, namely the incremental costs to firms and individuals of activities required by regulators that would not have been undertaken in the absence of regulation. For example, these incremental costs may include some elements of a firm's compliance staff, management time, systems, capital, and liquidity. This burden reduces the efficiency of the financial sector, diluting its potential contribution to the wider economy.
- The **'distortion' costs** arising from the way in which regulation may change the nature, behaviour and competition in markets for financial products. This may have a significant effect on the nature and availability of the products provided by the financial services industry, which can also negatively affect economic growth and consumer welfare.

Although most countries have relatively good data on the direct costs of the regulatory bodies themselves, there is little data on the much larger secondary costs of financial regulation. Nonetheless, it is important to recognise that these costs exist when framing the regulatory context.

This discussion highlights the existence of a trade-off between tougher prudential regulations that promote financial stability on the one hand and, on the other, giving proper weight to economic growth by allowing well-managed risk-taking to support innovation and efficiency in the financial sector. The goal of prudential regulation is to sustain the smooth functioning of the financial intermediation process, not to completely remove risk-taking behaviour from the financial system. If financial institutions did not take risks, their social benefits – including the provision of market liquidity, improved risk-sharing, and support for financial and economic innovation – would largely disappear. Achieving an appropriate balance is therefore important to ensure that the regulatory regime does not undermine the potential of the financial sector to contribute to wider economic development.

3 Why a healthy financial sector is important for the EU economy

- Academic studies have robustly established that financial development supports wider economic growth.
- Policies that improve the operation of the financial system are particularly beneficial for the emergence of new 'growth companies'.
- The existence of more developed capital markets can help to explain the productivity growth differential between the US and Europe.

The importance of the financial sector to the EU economy extends far beyond its direct contribution to output and employment, as it represents an important catalyst for wider economic growth.

3.1 The contribution of finance to economic growth

The academic literature of the past decade has robustly established that financial development is not only the consequence of economic growth but also a driver (Levine, 2004). Theoretical work illuminates the many channels through which the emergence of financial instruments, markets and institutions affect economic development. The increased availability of financial instruments and institutions reduces transaction and information costs in an economy, while the presence of well-developed financial markets helps economic agents to hedge, trade, and pool risk.

A growing body of empirical analyses have also demonstrated a strong positive link between the functioning of the financial system and long-run economic growth:

- Financial development supports long-run growth through its influence, among other things, on reducing the cost of external finance to companies (Ranghuram and Zingales, 1998).
- Financial development is particularly beneficial for the rise of new companies, as it removes constraints on high-growth start-ups. Beck *et al.* (2008) use cross-country data to show that financial development exerts a disproportionately large effect on the growth of industries that are technologically more dependent on small companies. This also implies that financial development has sectoral as well as aggregate growth ramifications. In other words, policies that improve the operation of the financial system will tend to boost the growth of small-firm industries more than large-firm industries.
- Wurgler (1999) presents evidence that the allocation of capital is better in countries with developed financial sectors. Across 65 countries, those with

"…financial development has sectoral as well as aggregate growth ramifications."

developed financial sectors increase investment more in their growing industries and decrease investment more in their declining industries.

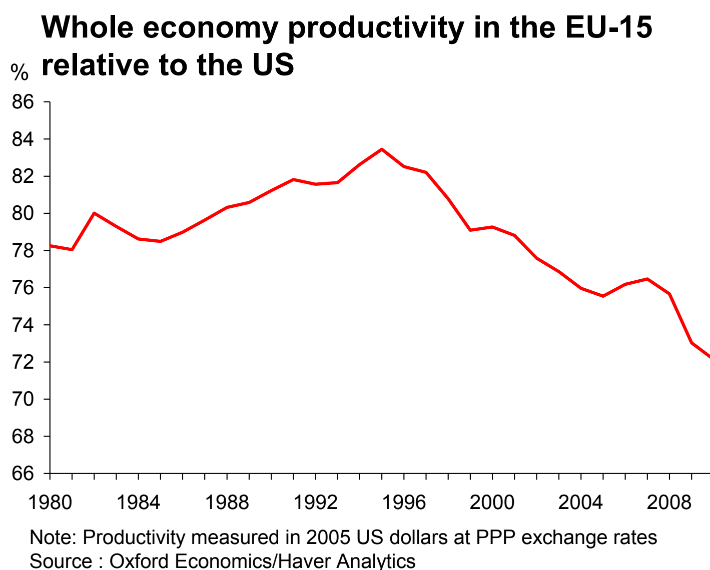
This body of research strongly supports the conclusion that maintaining a healthy financial sector in the EU will be crucial for supporting broad, sustainable economic growth throughout Europe over the long term.

3.2 Unlocking Europe's growth potential

Unlocking Europe's growth potential is particularly important at this juncture, with the Union's economies struggling to deal with the aftershocks of the global financial crisis and the legacy of high public debt levels. Adding more strain to this picture, ageing populations will increasingly act as a drag (albeit unevenly spread among EU member states) on economic expansion in the coming years. The key to maintaining upward momentum in living standards must therefore be found in policies that promote higher productivity growth in the private sector.

"…the financing of innovative ideas by the US venture capital industry has been cited as a driver behind the economy's relatively higher rate of productivity growth…"

Europe's growth challenge is thrown into sharp relief by comparison with the United States. As illustrated by the chart below, the productivity gap between the EU-15 and the US was narrowing up until the mid-1990s, but it has since been widening again. By 2009, productivity in the EU-15 had fallen to just 72% of the levels achieved in the US. There are a number of reasons for this productivity disparity, including the oft-cited need for structural reforms within Europe to encourage greater competition and innovation. As part of this policy debate, the importance of the financial sector to act as a catalyst for growth also needs to be recognised.



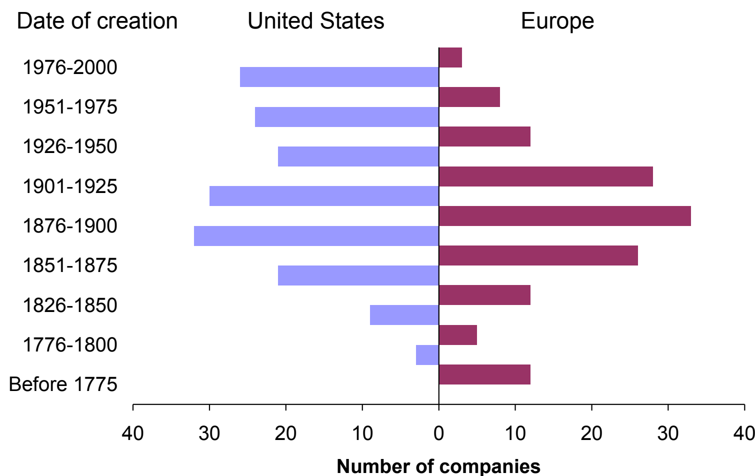
Note: Productivity measured in 2005 US dollars at PPP exchange rates
Source : Oxford Economics/Haver Analytics

In fact, the depth of financial markets in the United States is often identified in policy debates as one of the key reasons for the dynamism of the US economy. For example, the financing of innovative ideas by the US venture capital industry has been cited as a driver behind the economy's relatively higher rate of productivity growth compared to Europe. A recent policy paper by Philippon and

Véron (2008) on behalf of the Bruegel Institute argues that Europe needs to encourage greater innovation in the financial sector to help foster the growth of emerging companies in Europe and thereby raise average economic growth within the EU toward levels in the United States.

The paper notes how, among the world's 500 largest listed companies, only 3 were created after 1975 in Europe, compared with 26 in the US and 21 in Emerging Markets (see chart below). In Europe, the largest companies tend to be much older than in the US, where the rate of turnover among industry leaders is much higher. Research by Bartelsman *et al.* (2004) show that young companies generally find it harder to emerge in Europe than in the US – among those firms that survive beyond the first few years, growth is much higher among the American companies. Their study highlights the role of barriers to firm growth rather than barriers to entry. Europe is therefore missing out on the direct contribution to growth from these young companies, as well as the more radical innovations that they bring (Schneider and Veugelers, 2008).

Age of largest companies in Europe/US



Source : Philippon and Veron (2008), based on FT Global 500 ranking of the world's largest listed companies

"…young companies generally find it harder to emerge in Europe than in the US…"

Although the financing needs of established companies are well catered for by Europe's financial sector, Philippon and Véron argue that emerging companies with high growth potential require tailor-made financial solutions. Small companies do not have access to public capital markets and may have difficulties obtaining private bank financing due to asymmetric information (for example, related to the absence of a track record). The provision of unsecured debt can be important for such firms, especially those within the services industry where investment is mainly in intangibles that can less easily be used as collateral. The corporate finance industry in the US has developed rapidly to provide new solutions such as high-yield bonds, mezzanine debt and private equity. But within Europe, such financing products are less developed. Indeed, a recent European Commission (2010) survey found that 8 out of 10 EU citizens agree that it is difficult to start a business due to a lack of finance.

Financial innovation and risk-taking, with proper controls, are good for growth. They reduce asymmetric information between investors and companies, lower

transaction costs and increase the completeness of markets. The operation of a market economy is based upon the principle that economic agents receive rewards for the risks they accept. Removing downside risk from the system would also have the effect of removing the potential for upside rewards for investors, which lies at the heart of the capitalist system. The outcome would be highly risk-averse investment decisions that would dampen economic growth. This will be particularly detrimental for the emergence of new "growth businesses" that are by definition high-risk/high reward propositions.

The experience of the United States argues in favour of allowing financial markets to play a key role in their strategy to foster wider economic growth in the region. This also implies that the regulatory regime should also take a balanced approach that permits flexibility and innovation in the financial sector.

4 Setting the EU regulatory agenda within an international context

- Regulatory reforms should be objective, proportionate and internationally consistent.
- Reforms should not risk fragmentation of global capital markets, which bring significant economic benefits to businesses and consumers alike.

Objective and proportionate regulation that is implemented on a consistent international basis will be more effective in achieving financial stability and delivering the best outcome for the EU economy.

4.1 International regulation should be consistent

The global integration of capital markets benefits both borrowers and investors. It benefits borrowers by increasing the supply of funds available and by lowering the cost of capital. It benefits investors by providing a wider range of investment opportunities, thereby allowing them to build portfolios of international investments that diversify their risks. Likewise, multinational financial institutions can confer substantial gains to their host economies. This is demonstrated by the example of the transition economies of Central and Eastern Europe, where foreign (albeit mainly EU) banks have played a critical rule in financial development (Bonin and Wachtel, 2003).

As financial services are highly internationalised, they would best be guided by global regulatory principles. Divergent rules increase the cost of offering financial services internationally; this lowers cross-border activity, reducing the range of financial products available in each country and increasing their cost. In turn, this has negative consequences for economic activity and consumer welfare. When considering reform to the financial sector, an important consideration for policymakers should therefore be the cross-country consistency of new regulations.

"…even relatively small regulatory inconsistencies can result in sizeable shifts in financial market activity."

Differences in regulatory approach can create an incentive for capital, financial activity and expertise to migrate to countries where business can be carried out at a lower cost, rather than to where capital can be most effectively deployed to support global or regional economic development. Indeed, regulatory changes can create and destroy markets, especially in the financial industry where factors of production are extremely mobile.

History provides a number of examples of how even relatively small regulatory inconsistencies can result in sizeable shifts in financial market activity. One of the key reasons for the rapid growth of the Eurodollar market (deposits denominated in US dollars at banks situated outside the United States) in the 1960s was the regulations imposed by the Federal Reserve, especially "Regulation Q". This fixed the maximum rate of interest payable by banks in the

US and prohibited payment of interest on deposits for less than 30 days. Whenever these ceilings became effective, Euro-dollar deposits, paying a higher interest rate, became more attractive than US deposits, and the Euro-dollar market expanded. Other US controls and taxes on the export of capital further hastened the market's expansion. For example, the introduction in 1963 of the "interest-equalisation tax" on the purchase of overseas securities inadvertently incentivised companies to issue Eurobonds to avoid the tax. Without these controls, much of the activity in the Eurodollar market would have taken place in the New York money market. By the time these controls had been rolled back, the Eurodollar market had become firmly established.

More recently, the introduction of Sarbanes-Oxley (SOX) requirements in the United States after 2000 increased the attractiveness of the UK's regulatory environment and increased listings of small companies on the London Stock Exchange (LSE) Alternative Investment Market (AIM) at the expense of US Exchanges. This effect has been demonstrated empirically in a paper by Piotroski and Srinivasan (2008). Although their findings demonstrate that the SOX legislation did not affect the listing preferences of large foreign companies choosing between U.S. Exchanges and the LSE Main Market, it did lower the likelihood of a US listing among smaller foreign companies choosing between the Nasdaq and the LSE's AIM. The authors conclude that the negative effect among small companies is consistent with these marginal firms being less able to absorb the incremental costs associated with SOX compliance.

"Looking across countries… financial regulation exhibits clear cycles."

These examples illustrate the need to consider carefully the impact of regulations before their introduction, as they can influence the future shape of the financial industry, with consequences for broader economic activity. Of course, not all regulation needs to be developed at the global level, as many financial activities, particularly within retail banking, are mainly conducted within national borders. But regulatory reforms should not risk fragmentation of global capital markets, which bring significant economic benefits to businesses and consumers alike. Although worldwide harmonisation of financial rules may be difficult to achieve in practice, aiming for international consistency in the regulatory reform agenda is a guiding principle that will help to ensure that any shifts in the competitive landscape are limited. The EU can help to achieve such a coherent international approach by taking a leading role in the G20 and the work of international standard setting bodies.

4.2 Reforms should be objective and proportionate

In the wake of severe financial crises, it is common for trust in the market to weaken as public support grows for a tough stance on regulation. Looking across countries, Gigliobianco (2009) describes how financial regulation exhibits clear cycles. The impulses that generate those cycles are diverse, but crises often act as catalysts to renewed regulatory zeal. This was clearly the case in the early 1930s, when trust in the market was largely abandoned with the introduction of legislation aimed at curtailing risk-taking. The Glass-Steagall Act of 1933 and interwar German and Italian Banking Acts are just a few examples.

More recently, Berg and Eitrheim (2009), studying the Norwegian banking crisis of 1988-92, argue that in the aftermath of the crisis, regulation in Norway was stricter than in most other European countries.

A recent paper by Aizenman (2009) describes how the regulatory cycle arises from asymmetric information regarding the probability of a crisis. A period of economic calm initially leads to an environment of complacency and a tendency toward under-regulation. During this period, the identity of economic agents that benefit directly from crisis avoidance is unknown, while the costs associated with regulatory intervention are clear. As the avoidance of crises is not apparent, the benefits of avoidance are underrepresented in the political discourse and prudential standards are relaxed. Conversely, in the wake of a financial crisis, the case for severely regulating financial intermediation looms large. In this period, the identity of economic agents that benefit directly from financial regulations is known, while the identity of potentially successful entrepreneurs whose projects fail to receive financing is unknown.

The paper by Aizenman presents a concise description of the factors driving the regulatory cycle. Regulatory authorities have significant discretionary power to make new rules binding the financial markets and significant incentives to use those powers in the current environment. Even if the financial sector loses its international competitiveness and business gradually migrates away to other jurisdictions, it is unlikely that this will generate a public outcry. If it were better understood that such developments would undermine future growth in living standards, the public reaction would no doubt be different.

5 Measuring the costs and benefits of regulatory reform

- The Basel Committee compared the potential costs and benefits of reform when calibrating new international standards for bank capital and liquidity
- The EU is considering a number of reforms aimed at strengthening regulation around a much broader spectrum of financial market activities.
- Although each may appear justified in isolation, they could still impose a larger-than-expected burden on the wider EU economy when taken in the aggregate.

In the EU, as elsewhere, effective prudential supervision is crucial to the smooth functioning of the financial system. But limiting the ability of financial institutions to take on risk is not always beneficial in terms of welfare outcomes. A fine balance therefore needs to be reached by EU policymakers in order to address the problem of financial instability while not limiting the ability of the financial sector to sustain economic growth.

Such an analysis presupposes a framework in which it is possible to identify the welfare costs and benefits at different levels of financial stability and efficiency. Yet research into this area has only really started to develop in the wake of the financial crisis.

5.1 Calibration of the Basel III reforms

Revised capital and liquidity requirements for banks are viewed by supervisory authorities as the key building block for a more stable financial system. Indeed, a lack of high quality capital at banks was one of the catalysts for the global financial crisis, so it is right that these standards be raised. Against this background, the Basel Committee on Banking Supervision and the Financial Stability Board set up a team of macroeconomic modelling experts from central banks in 14 countries to inform their calibration of the new 'Basel III' framework.

"Revised capital and liquidity requirements for banks are viewed by supervisory authorities as the key building block for a more stable financial system."

Estimating the economic benefits of regulatory reform involves calculating the expected gain in aggregate output associated with the reduction in frequency and severity of financial crises. This requires estimating both the average cost of crises and the impact of stronger capital requirements on the probability of crises occurring. The total benefits of the proposed regulatory reforms can then be compared to the costs of the regulatory measures in terms of their adverse impact on the price of bank credit, which lowers investment and consumption. This requires the use of a macroeconomic model to estimate the impact on aggregate output.

The results (BIS (2010)) suggested that the net benefits of higher capital requirements are positive for a broad range of capital ratios. The marginal benefits of raising capital standards gradually decline, however, with a plateau reached at around 12% of risk-weighted assets. Their results are consistent with several other studies including Barrell *et al.* (2009) and a recent Bank of England (2010) analysis, which concluded that marginal costs (lower investment and consumption) and benefits (reduced frequency of crises) are equated at capital ratios of between 10% and 15%.

There is still a concern that policymakers at EU or member state level, or financial markets themselves, could force an acceleration of the minimum Basel III implementation period, or put pressure on banks to accumulate an additional capital buffer above the required regulatory minimum. Indeed, a recent analysis led by David Miles (Miles et al., 2011), an external member of the Bank of England's Monetary Policy Committee, has called for much more stringent bank capital requirements in the range of 16-20% of risk-weighted assets.

"It is clear from the multiple reform initiatives being considered that the potential costs of compliance for the financial sector as a whole could be substantial."

The conclusions presented by Miles et al are driven by the specific set of assumptions chosen for the modelling exercise and the conclusions are meant to inform the international policy debate. There is a risk that such studies, taken in isolation, could persuade supervisory authorities to embark on unilateral 'gold-plating' of the Basel III standards. As noted by Kashyap *et al.* (2010), to the extent that larger banks deal with larger customers where competition from other providers of finance (both other banks and potentially the bond market) is more intense, even very small cost-of-capital disadvantages are likely to prove unsustainable.

The downside risks associated with regulatory reform become even more apparent when one considers that the full scope of forthcoming regulatory reforms remains unclear, with a wide range of supplementary proposals being discussed at both the national and international levels. These potentially overlapping initiatives could raise the overall costs of regulation on the wider economy substantially above that imposed by the Basel III measures.

5.2 Wider banking regulation

In addition to the Basel III proposals, banking sector reforms being discussed at both the international and EU level include:

- Mechanisms for cross-border supervision and crisis management.
- Separation of banking activities.
- Restrictions on bank size.
- Restrictions on remuneration and special taxes on bank bonuses.
- Restrictions on dividend payout policy.
- Special taxes on bank balance sheets.
- Changes to accounting rules.

- Macro-prudential regulation.

It is clear from the multiple reform initiatives being considered that the potential costs of compliance for the financial sector as a whole could be substantial. Such compliance costs relate to the costs to firms of those activities required by regulators that would not have been undertaken in the absence of regulation. Examples include the costs of any additional systems, training and management time as well as capital required by the regulator.

Separately and more generally, there is the risk of an overall cumulation effect, whereby the large number of new regulations and taxes will impose an unexpectedly large burden on the banking industry, with the unintended consequence of adversely affecting the flow of credit to EU companies and consumers. This risk is particularly significant in Europe because of the importance of the banking sector as a source of finance - bank lending accounts for around half of the total external financing of the non-financial corporate sector in the EU. In contrast, corporate bonds outstanding in the US are around six-times the size of all bank loans to businesses. The potential cumulative impact of all these regulatory changes on the performance of EU financial institutions and the associated implications for the wider European economy therefore need to be very carefully considered and evaluated.

"…it is important to carefully consider the implications of proposed reforms to financial sector legislation, as there can be hidden consequences for European companies and consumers."

5.3 Other EU-level reforms to financial regulation

The European Commission is also designing reforms aimed at strengthening regulation around a much broader spectrum of financial market activities. For example,

- The new Solvency II Directive, which sets out strengthened EU-wide requirements on capital adequacy and risk management for the insurance industry will come into effect on 1 November 2012.
- The proposed European Market Infrastructure Regulation (EMIR), which sets out who will licence Central Clearing Parties (CCP) and what derivatives instruments will have to go through mandatory clearing.
- Revisions to the Markets in Financial Instruments Directive (MiFID).
- The Alternative Investment Fund Managers (AIFM) Directive, which establishes regulations for a range of firms including venture capital funds, hedge funds, investment trusts, commodity funds, property funds and private equity funds.
- Proposals to create a harmonised framework for the short-selling of securities across Europe.

In fact, as listed in the Annex, there are more than 20 financial sector reform initiatives that have either been passed or are under consideration by the European Commission. Although many of the policy objectives are to be welcomed as seeking to improve financial stability and reduce risks in the financial system, there is a risk that the design of the regulations could have

unintended consequences in some cases, with negative repercussions for European companies and consumers. For example,

- One area of concern is that the EMIR proposals do not account for varying risk profiles across businesses. The current legislation could thus have a disproportionate impact on long-term investors such as insurance companies that use OTC derivatives for hedging purposes. The new rules would require these businesses to mark-to-market their positions regularly and post cash collateral against negative valuation movements. Insurers do not have large cash holdings since they have long-term obligations, so these rules may force them to prematurely liquidate assets. The associated costs are likely to be passed on to EU consumers and could result in a smaller and less diversified product range on European insurance markets.[2]
- Also, the scope of EMIR captures any business structured as an alternative investment fund – a particularly common structure in the property industry. Obligations to post liquid collateral in connection with negative valuation movements on derivatives could devastate returns on these geared funds. This would result in the loss of investment in construction work, new property development and revitalisation of existing urban centres across the EU. Estimates from Chatham Financial (2010) indicate that there could be as many as 122,000 associated job losses.
- Restrictions on short selling that aim to lower market volatility may instead have the effect of reducing market quality. The IMF (2010) has rebutted the suggestion that short-selling was the cause of sharp price movements during the financial crisis, instead attributing the adverse market movements to fundamental factors. Moreover, academic studies of the temporary ban on short-selling that was implemented during 2008, such as Boehmer *et al.* (2009) and Beber and Pagano (2009), have found that the bans were detrimental for liquidity, slowed price discovery, raised intraday volatility, and failed to support stock prices. The proposed short-selling restrictions could thus result in less efficient, liquid and transparent capital markets. This would raise the cost of borrowing for EU companies, with a negative impact on economic growth and employment.

"…proposed short-selling restrictions could result in less efficient, liquid and transparent capital markets."

These examples illustrate how it is important to carefully consider the implications of proposed reforms to financial sector legislation, as there can be hidden consequences for European companies and consumers.

5.4 The uncertain aggregate impact of reforms

Another important question is how to assess the aggregate impact of the various proposed measures. Although each may appear justified in isolation, they could still impose a larger-than-expected burden on the financial system and wider EU

[2] For a more detailed discussion of the potential effects of the EMIR legislation on European insurers, refer to CEA (2010).

economy when taken in the aggregate. In light of the discussion in Section 4 on the importance of capital markets for the provision of capital to European entrepreneurs, these reforms could threaten investment when the EU economy is, as a whole, still struggling to regain lost ground. In fact, the rating agency Standard & Poors (2010) is predicting a refinancing crunch to hit European businesses during 2012/13, when vast numbers of loans issued at low cost before the crisis mature. This legislation could therefore limit the flow of capital and liquidity into the European market just when it is needed most.

European policymakers should seek to promote innovation in capital markets to facilitate funding for segments of the economy held back by capital shortages. But there is a risk that policy reforms will have the unintended consequence of squeezing this source of capital, which will inhibit investment and broader economic growth in Europe. Subjecting all new regulatory initiatives to rigorous analysis of the costs and benefits to both the financial sector and the wider EU economy would help policymakers to avoid such an adverse outcome. This assessment should also take into account the wider regulatory context to measure the collective impact of proposed reforms.

"European policymakers should seek to promote innovation in capital markets to facilitate funding for segments of the economy held back by capital shortages."

6 Towards a balanced EU regulatory regime that supports economic growth

- Policies that allow authorities to credibly commit to allowing the failure of financial institutions would avoid moral hazard, encourage market monitoring of risk-taking and enhance financial stability.
- The new regulatory regime should protect consumer welfare, but allow innovation and diversity of business models.
- A phased approach to introducing new regulations will allow policymakers to better understand their effects and manage any unforeseen consequences.

In the wake of the global financial crisis there is a rare opportunity to shape the regulatory landscape so that Europe's financial services industry can better serve the EU economy for years to come. With this in mind, policy reforms should focus on forcing financial institutions to internalise the social costs of their risk-taking decisions rather than suppressing financial innovation.

6.1 Resolution regimes to enhance market discipline

The recent crisis exposed significant deficiencies in the failure resolution framework for financial institutions and revived the widespread belief that no government will allow the failure of a systemically-important financial institution. This financial safety net was one reason why investment banks had been able to pursue increasingly risky strategies in the run-up to the crisis without a commensurate increase in their cost of funding. In other words, the creditors of these institutions were not monitoring risk-taking as the implicit state guarantee removed the threat of financial loss in the event of the institution's failure.

Curtailing this financial safety net would reduce the need for additional prudential regulations to limit the incentives for excessive risk-taking in the financial system. Specifically, authorities need to credibly commit to allowing financial institutions to fail, with the value of equity being eliminated and haircuts imposed on all holders of debt. Confirming the risk of loss to shareholders will help to engage fund managers and other major shareholders more productively with their investee companies with the aim of supporting long-term improvement in performance. Indeed, promoting the active engagement of shareholders with the Boards of financial institutions was a key recommendation within the UK's Walker Review (2009) of corporate governance.

"Curtailing [the] financial safety net would reduce the need for additional prudential regulations to limit the incentives for excessive risk-taking."

The European Commission will publish a formal proposal addressing bank resolution regimes in the spring of 2011. For these policies to be effective in reducing the moral hazard of bailout will require steps that allow the authorities to credibly commit to allowing the failure of systemically important financial institutions. Regulators must be able to obtain resolution authority over failing

financial institutions. If some of their activities are essential to overall economic health, appropriate mechanisms need to be put in place to keep the core businesses running while placing appropriate losses on debt holders.

"…effective mechanisms do not exist for managing and resolving insolvent financial institutions with significant cross-border exposures."

A key reason why some financial institutions are viewed as too big to fail is that their affairs are considered too complicated to be unwound in a prompt and orderly manner (Lehman Brothers had 600 subsidiaries when it filed for bankruptcy). To tackle this problem, a number of commentators, including the former chief economist of the IMF, Raghuram Rajan (2010), have proposed that these firms be required to meet regularly with supervisors to review their 'living will' – a plan setting out how the institution would be wound up in the event of bankruptcy. This would oblige the institution to carefully monitor and document its exposures in a timely manner. Most importantly, it would help to convey a credible message to markets that regulators are willing to allow these institutions to fail.

The international dimension is also crucial so that global firms can fail and exit the market in an orderly way. The costly and disjointed resolution efforts of authorities during the financial crisis provided clear evidence that effective mechanisms do not exist for managing and resolving insolvent financial institutions with significant cross-border exposures. Significantly increased international convergence and coordination of national resolution arrangements is therefore required to allow the orderly resolution of systemically important global financial institutions while minimising both the systemic consequences of their failure and the costs to the taxpayer.

6.2 An appropriate EU regulatory regime

Resolution regimes should play a key part in a more balanced regulatory architecture that allows the financial sector to support economic growth and serve society at large. Such a regime should be robust, but also able to adapt to the inevitability of change. It should protect consumer welfare, but allow innovation and diversity of business models. Drawing upon the discussion in this paper, the key components for the design of such a regime can be identified:

- Policies that allow authorities to credibly commit to allowing the failure of financial institutions, so as to remove the implicit taxpayer subsidy and restore confidence in the stability of the financial system.
- A holistic approach to regulatory reform, which considers the economic costs and benefits of proposed changes in the aggregate.
- Better monitoring of the interactions between financial institutions and the build up of risk in the overall financial system.
- International coordination of regulatory reforms to preserve the welfare benefits of global capital markets.

Any attempt at regulatory reform should keep in mind the benefits of a deep and efficient financial system for economic development. Reviving and sustaining an internationally competitive European economy requires the support of a dynamic

financial sector so that businesses can access the financial products they require for growth.

Adopting a well calibrated, proportionate and measured approach to regulatory reform of the financial sector will help to ensure the creation of a more stable financial system without unduly hampering economic growth. Given the large number of proposed reforms, a phased approach to introducing new regulations would also allow more opportunity for policymakers to understand their effects and manage any unforeseen consequences. Following implementation of new measures, their impact should be subjected to *ex post* evaluation.

7 Conclusion

The global financial crisis was a watershed event that will result in permanent changes to the regulatory landscape. As supervisory authorities consider a broad set of proposals to strengthen the regulatory infrastructure, an important question that arises is how to assess the aggregate impact of these various measures. Although each may look sensible in isolation, they could still impose a larger-than-expected burden on the financial system when taken in the aggregate. This is true at a global, EU and member state level.

The difficulty of measuring the economic costs of regulations that inhibit financial sector efficiency may encourage policymakers to favour more extreme options to ensure financial stability. But overly restricting the risk-taking activities of financial institutions could stifle beneficial innovation in financial services which contributes to the EU's wider economic growth. An efficient financial system is indispensable for growth and necessarily becomes more complex as the economy develops. If financial institutions are not allowed to take on well-managed risk and foster innovation, this will have negative repercussions for long-term development of the European economy and the Single Market, and for the achievement of the Europe 2020 vision for growth.

Policy reforms should focus on forcing financial institutions to internalise the social costs of their risk-taking decisions rather than suppressing financial innovation. Credible receivership provisions are one such way of increasing the perceived risk of loss for investors and promoting market discipline. International convergence and coordination of national resolution arrangements is also important for tackling the failure of financial institutions with large cross-border exposures.

European policymakers should aim to put in place an objective, sustainable and flexible regulatory regime, as the design of the regulatory framework will play a significant role in the future development of both the financial industry and the wider economy. International consistency in the regulatory reform agenda is also important so as not to risk fragmentation of global capital markets, which bring significant economic benefits to companies and consumers alike.

The economic and social purpose of financial markets is the efficient allocation of capital, and the regulatory agenda must be framed around this goal. At a time when the European economy is struggling to recover lost ground, changes to the regulatory regime must not weaken the potential of the financial sector to contribute to Europe's future prosperity.

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Annex: European Commission legislative proposals for financial regulation*

Measure	**Date of adoption**
Revision of the Deposit Guarantee Schemes Directive (DGS)	July 2010
Revision of the Investor Compensation Schemes Directive (ICS)	July 2010
Revision of the Financial Conglomerates Directive (FICOD)	August 2010
OTC Derivatives – Regulation on market infrastructure	September 2010
Regulation on short selling/credit default swaps	September 2010
Regulation on SEPA (Single European Payments Area)	December 2010
2nd Directive clarifying the powers of the ESAs, particularly with regard to Solvency II ("Omnibus II")	January 2011
Directive on mortgage credit	March 2011
Legislative proposal on access to a basic payment account	May 2011
Securities Law Directive	May 2011
Revision of the Market Abuse Directive (MAD)	May 2011
Review of the Markets in Financial Instruments Directive (MiFID)	May 2011
Legislation on corporate governance in financial institutions	June 2011
Crisis management legislative proposal	June 2011
Revision of the Capital Requirements Directive (CRD4)	Q2 2011
Directive: UCITS – depositories function & remuneration	Q2 2011
Revision to the Directive on Packaged Retail Investment Products (PRIPs)	Q2 2011
Implementing measures for CRA Regulation ("level 2")	July 2011
Implementing measures for Solvency II ("level 2")	Q3 2011
Further amendments to the Credit Rating Agencies regulation	Autumn 2011
Revision of the Insurance Mediation Directive (IMD)	December 2011
Review of the Directive concerning Institutions for Occupational Retirement provisions (IORP)	December 2011
Insurance Guarantee Schemes proposal (IGS)	December 2011

* Source: “Regulating Financial Services for Sustainable Growth”, European Commission, February 2011

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