ARTÍCULO DE OPINIÓN

Better Banking Regulation: Seven Principles

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- Editors Note: The global crisis has raised many questions. High on any list would be how regulators and supervisors missed the warning signs so spectacularly, particularly those responsible for overseeing the dangerously exposed financial system. This column, by one of CESifo’s European Economic Advisory Group, provides a diagnosis of the problem and outlines what can be done about it.

The financial crisis that originated with subprime-loan problems in 2007 and the burst of the real-estate bubbles in the United States and other countries has uncovered severe weaknesses in the regulation and supervision of financial entities. The magnitude of the crisis, the worst since that of the 1930s, was amplified by channels in a globalised market and has thrown a spotlight on financial regulatory reform. Indeed, the failure of Lehman Brothers in September 2008 endangered the stability of the international financial system. The sovereign debt crisis, which started in 2010 with problems in Greece, Ireland, and Portugal and has recently spread to Italy and Spain, has provoked another wave of systemic problems centred on banks in the Eurozone.

Follow up:

Why and how have regulatory mechanisms failed? Have there been new market failures? What can be learned from the crisis? Does it have specific implications for the financial architecture of the European Union and the Eurozone? The answers to such questions will reveal the key issues to be taken into account when designing adequate regulation and will determine whether a radical reformulation of the regulatory framework is needed.

The whole regulatory framework has been called into question by the crisis.

- First, dual regulation allows regulatory arbitrage between the regulated sector of depository institutions and the parallel banking system of structured vehicles and investment banks.
Second, capital requirements in terms of quantity and quality were insufficient, while liquidity needs were disregarded.

In the 2008 crisis there was a double failure of the banks’ ability to bear losses (they did not have enough equity capital to cover the risks taken) and of bank debt, which proved poor at absorbing losses when the layer of equity capital was eroded. To make matters worse, capital requirements and market value accounting have procyclical characteristics and have been criticised on the grounds that they induce more instability and because asset prices in crisis situations may not reflect fundamental values due to coordination problems, information and liquidity frictions (see Adrian and Shin 2010, Allen et al 2009, Plantin et al 2008).

Third, regulation does not give sufficient consideration to systemic risk. The opacity of the parallel banking system and of over-the-counter derivatives markets has helped conceal systemic risk.

Finally, even though credit rating agencies play a very important role in regulation (for example, when determining capital needs), they competed with each other via lower rating standards without the adequate supervision of the regulator. In general, regulation has not paid sufficient attention to conflicts of interest and has relied excessively on mechanisms of self-regulation and corporate governance.

Regulation faces the challenge of making the financial system more robust without hindering development, while also protecting public interest and innovation and preserving globalisation.

Together with the other members of the European Economic Advisory Group, I see no contradiction between the stability of the financial system and economic growth, which is a crucial issue given the key role played by the financial system in economic growth. The financial sector needs to restore investor confidence, rebuild its reputation, and adapt to the new and stricter regulatory atmosphere created as a result of the impression that the sector enjoyed excessive returns from taking excessive risks in the past.

Seven principles for better banking regulation

We think that regulatory reform should be based on a few basic principles:

1. A central regulatory body (such as the central bank) should have a mandate to maintain financial stability and be in charge of macroprudential supervision.

2. Monetary policy is not the appropriate tool with which to recapitalise banks.

3. Regulation and supervision should encompass all entities that carry out banking activities.

4. Expected losses of liabilities guaranteed by the government should be covered by a risk premium determined by the market dependent on the risk assumed by the entity. Banks under the protection
of the safety net need to limit their range of activities because of market hazard (see Matutes and Vives 2000).

5. Institutions that play a key role in the financial system (where the too-big-to-fail doctrine is applied) should be regulated so that they internalise the external effects of their potential bankruptcy (see for example Acharya et al 2010). Regulatory standards should be uniform and accompanied by internationally coordinated supervision.

6. A fragmentary approach to financial regulation does not work. Competition policy should be coordinated also with financial regulation (see Vives 2011 for an analysis of the necessary links between capital, liquidity, and competition regulation). It is necessary to consider together capital and liquidity needs as well as the degree of market liberalisation of the different market segments. Higher prudential requirements are needed in more competitive environments.

7. It is necessary to establish mechanisms to prevent delay of the supervisor's intervention (regulatory forbearance) while the balance sheets of financial institutions deteriorate and capital declines.

Governments have responded to the crisis with initiatives carried out by the Financial Stability Board and the Bank for International Settlements, as well as through proposals and legislative changes in the US, the UK, and the EU. On balance, the reform process seems to be on the right track, with increased capital and liquidity requirements as well as more centralised trading arrangements for derivatives markets, although we will have to await its full implementation to assess its effectiveness. In the Eurozone, with its single currency and many sovereigns however, the wisdom of giving sovereign debt a zero weighting when calculating a bank's risk exposure is questionable. Proper risk weights for sovereign debt should be used to improve the reliability of such calculations.

A new European supervisory framework, the European System of Financial Supervision, was introduced in January 2011 in the EU (see Figure 1). Its aim is to strengthen financial supervision by empowering regulatory bodies and replacing existing ones (that could only issue non-binding guidelines and recommendations), and to ensure the effectiveness of the decisions taken in an emergency situation.
In EEAG (2003), Chapter 4, we argued that there were at least three basic problems with the Eurozone’s financial architecture.

- First, we argued that the existing arrangements might not be adequate for financial stability.
- Second, the arrangements to a large extent hindered European financial market integration; and
- Third, they weakened the competitiveness of EU financial markets and institutions.

We stated that “[t]he present gradualist approach may yield more costs than benefits in the long term and may end up proving ineffective. It would be better not to wait for a major crisis to strike in order to put the house in order.”

Now that a major crisis has indeed occurred, where does this leave us? In our 2003 Report we highlighted the need for clear procedures in the case of crisis lending and crisis management led by the European Central Bank, and for establishing clear principles guiding fiscal help by a transnational institution. We advocated more centralised supervisory arrangements in banking, insurance, and securities in both the mid- and the long term.
The new supervisory framework is a step in the right direction, particularly in terms of crisis prevention, but it still lags behind the reality of financial integration and the possibilities of banking problem contagion in the European Union, particularly in the Eurozone. In the EU crisis, management has proven a source of instability. The EU has tried to achieve compatible financial integration and cross-border banking with national authorities in charge of supervision. Financial stability has suffered as a result. The options now are either to go back on integration or to diminish the role of national authorities. To go forward with integration, burden-sharing agreements for bank resolution are needed, as well as a European resolution and supervisory authority. The present reform of the EU financial architecture takes a middle path, preserving the role of national authorities with the convergence of national regimes, crisis concordats, and expanded coordinating roles for European financial authorities, but no burden-sharing agreements in case of a solvency crisis.

Due to persistent banking problems related to the sovereign debt crisis, the need to reform the European Union's financial architecture is now pressing. The Eurozone should be stabilised with a credible liquidity facility for solvent sovereigns facing speculative attacks, and with a restructuring facility for insolvent countries. Furthermore, its financial architecture must be completed. The ECB should explicitly assume the function of guarantor of the system (in terms of liquidity provision to banks) and wield sufficient supervisory powers over systemic institutions and exert macroprudential control. It would also be advisable to forge closer links between the European prudential authority and the European System of Central Banks. A formal crisis resolution framework should be established, and the chain of command in a crisis situation needs to be clearly identified, with the ECB at its centre. Furthermore, burden-sharing agreements for bank resolution have to be put in place together with a European resolution authority, and accompanied by a European deposit-insurance fund for cross-border institutions.

Author's Note: This column is based on EEAG (2012), The EEAG Report on the European Economy, “Banking Regulation”, CESifo, Munich 2012, pp. 83-97 (http://www.cesifo.org/eeag). The EEAG members are Jan-Egbert Sturm (KOF Swiss Economic Institute, ETH Zurich; Chairman), Lars Calmfors (Stockholm University), Giancarlo Corsetti (Cambridge University), John Hassler (Stockholm University), Gilles Saint-Paul (University of Toulouse), Hans-Werner Sinn (Ifo Institute and LMU University of Munich), Akos Valentinyi (Cardiff Business School) and Xavier Vives (IESE Business School). They are collectively responsible for each chapter in the Report. They participate on a personal basis and do not necessarily represent the views of the organisations they are affiliated with.