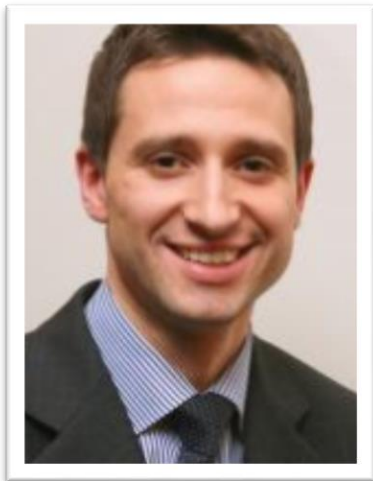
Systemic Risk Protection: Is the Picture Complete? Did We Over or Under Regulate?



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On 12th April 2018, CFA Institute and CFA Society Belgium hosted an evening discussion at the National Bank of Belgium with Vítor Constâncio, former Vice President of the European Central Bank, and Sir Paul Tucker, Chair of the Systemic Risk Council and former Deputy Governor of the Bank of England. The theme for the evening was the evolving state of systemic risk regulation ten years after the global financial crisis. This article reviews the discussion and evaluates the balance of regulation with regard to its ability to mitigate future shocks to the financial system.

The financial and economic crisis that began in 2008 led to a wave of regulatory measures aiming to mitigate systemic risk and strengthen the stability of the financial system. Ten years on from the global financial crisis, developed market economies are experiencing sustained growth, and the course of monetary policy normalisation has begun. While financial markets have performed well, market volatility has returned, and geopolitical risk has risen.

Against this backdrop, CFA Institute and CFA Society Belgium hosted a discussion at the National Bank of Belgium with Vítor Constâncio, then Vice-President of the European Central Bank[1], and Sir Paul Tucker, Chair of the Systemic Risk Council and former Deputy Governor of the Bank of England. These former senior central bankers – two of the foremost authorities on financial policymaking and who held office during the financial crisis – were asked to examine the state of the financial system and assess the adequacy of regulatory reforms put in place to avoid future crises.

To frame the discussion, Messrs Tucker and Constâncio began by taking stock of the macropolitical environment. The rise in nationalism and authoritarianism in parts of Europe has parallels with the political undercurrents of the 1930s, they noted. Moreover, the underlying construction of the euro project continues to be vulnerable, as manifested first by the financial and economic crisis that led to the sovereign debt crisis, and more recently, the European migration crisis that in turn has fuelled the rise in political nationalism.

The panellists noted that price and financial stability are prerequisites for sustainable economic and political order. Even after government authorities arrested the financial crisis and economies returned to stability, the social and political consequences of the crisis continue to be felt and will play out over a much longer time horizon.

The central question posed for the discussion was whether the financial reforms enacted have been sufficient to put the financial system and economies on a path of stability. Have regulatory reforms gone far enough, or have they gone too far?

Mr Constâncio began by acknowledging that much has been achieved in the reform of the banking sector. One of the main factors associated with the financial crisis was the amount of leverage in the financial system. The crisis showed that although banks were compliant with the risk-based capital requirements of Basel II, the absence of a limit on leverage under Basel II allowed banks to become excessively leveraged, which imperilled the financial system. The addition of a leverage ratio under Basel III – set at 3% of tier 1 capital – is therefore a key improvement for the resiliency of the financial system as it acts as a brake on excessive leverage.

The speakers agreed that other important contributions to regulatory reform of the banking sector under Basel III are the liquidity coverage ratio and net stable funding ratio, which are designed to strengthen the liquidity and funding profiles of bank balance sheets.

[1] At the time of the event, Mr Constâncio held office. His term as ECB Vice President ended on 31 May 2018.

During the discussion, Mr Constancio also highlighted the extent to which core capital ratios have strengthened following the crisis. For example, in Europe, at the end of 2017, the common equity tier 1 (CET1) capital ratio was 14.8%, on average, for the 190 banks monitored by the European Banking Authority. For the 160 banks under the supervision of the European Central Bank, the capital ratio averaged 14.3%, and the leverage ratio was approximately 5. In comparison, before the financial crisis, the CET1 ratio of European banks was approximately 7% on average – less than half what it is now – and leverage was significantly higher.

Aside from capital adequacy and liquidity standards, Mr Constâncio noted that some aspects of the banking reform package have been more challenging to reach consensus on, particularly regarding resolution regimes. For example, reform of the Orderly Liquidation Authority in the United States could undermine the "single point of entry" approach to resolution for international banks, which could lead to more ringfencing and fragmentation of banking groups. Recovery and resolution of central counterparties is another area that has not been sufficiently addressed. Principles for CCPs have been established (under the work of the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions – CPSS-IOSCO), although a clear-cut resolution regime remains outstanding. Work continues in this regard and good progress is being made on resolution and on stress testing of CCPs, the speakers observed.

According to the panellists, one area of the financial reform programme that requires more work is so-called shadow banking or nonbank financing. The term shadow banking is used to describe the entities, activities, and financial instruments involved in financial intermediation outside of the traditional banking system and encompasses both wholesale market-based finance (including investment funds) and alternative lending channels. Such nonbank financing involves short-term funding or borrowing to facilitate longer-term lending or investment in less-liquid assets, resulting in maturity transformation, liquidity transformation, credit risk transfer, or leverage.

Mr Constâncio observed that the growth of the nonbank system in Europe has been explosive: assets under management of investment funds have grown from 16% of bank assets in 2007, to 44% of bank assets today. This represents a significant structural change in the financial sector and illustrates the growing relative importance of market finance for the European economy. Mr Constâncio noted that the growth of the investment fund sector is also associated with both maturity and liquidity mismatch; for example, the average maturity of investment fund assets (across all types) is approximately 7 years, but because 98% of investment funds are open-ended, those assets are mostly funded by units or shares (shareholder funds) that are redeemable daily. In a financial crisis, redemption stress may lead to fire sales of assets, exacerbating financial stress. Although investment firms have various tools to manage redemptions in a stressed environment, Mr Constâncio argued that authorities have not been sufficiently empowered to supervise firms and provide guidance around the use of liquidity risk management tools.

Another issue regarding the nonbank sector is leverage in investment funds. Leverage often develops off-balance-sheet and synthetically through the use of derivatives, and according to Mr Constâncio, is often much higher than what is observable in the financial statements. Better monitoring of leverage in investment funds is therefore needed.

When considering the balance of regulation, a common refrain from the financial industry is that too much regulation can stifle commercial activity and, in the case of the banking sector, restrict lending, thereby damping economic growth. But Mr Constâncio asserted that the notion that more finance is both necessary and always good for growth is flawed; indeed, academic studies show that too much finance may be detrimental.

Firstly, explained Mr Constâncio, too much finance, or credit growth that outstrips demand, results in credit being allocated to unproductive enterprises as new financing opportunities recede. Typically, in these situations, credit is increasingly directed towards real estate, which does not contribute to productivity but inflates the value of existing assets. A second undesirable effect is the capture of human capital within the financial sector (which typically pays better), to the detriment of other industries. A third cost associated with excessive finance is rent seeking, in which financial services products or activities are designed to earn fees without reciprocating social utility.

Having assessed the state of the financial regulatory reform agenda, Messrs Tucker and Constâncio next considered the policy environment and the ability of authorities to deal with another shock. The panellists noted that the monetary policy arsenal is depleted with interest rates still low and expected to remain lower in equilibrium than prior to the crisis, reducing the scope for interest rate cuts. Further, fiscal positions remain stretched in many countries and it is unclear whether large scale asset purchase programmes, such as quantitative easing, will be as effective in future.

Given these circumstances, and in the context of political efforts to roll-back parts of the regulatory reform agenda, it is desirable to have a banking system that is more resilient rather than less resilient, the speakers observed.

With the regulatory safeguards now in place, it was suggested that the next crisis will not likely be of the dimension and severity of the crisis just passed. But the importance of preserving, and completing, the core elements of the post-crisis regulatory reform agenda cannot be understated. The resiliency of the financial system and the stability of our economies and societies are all at stake.