



Examining the State of Systemic Risk Reforms – Where Next for Macroprudential Policy?



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On 9th February 2017, CFA Institute and CFA Society Belgium hosted an evening discussion at the National Bank of Belgium with Jean-Claude Trichet, former President of the European Central Bank, and Sir Paul Tucker, Chair of the Systemic Risk Council¹ and former Deputy Governor of the Bank of England, on the state of systemic risk reforms. This article reviews the themes of the discussion and outlines the key regulatory measures needed to maintain a strong and resilient financial system against the backdrop of geopolitical change.

The financial and economic crisis that started in 2007-08 led to a wave of regulatory measures aiming to mitigate systemic risk and strengthen the stability of the financial system. These measures focused on strengthening the capital adequacy and liquidity of banks, resolving distressed firms without taxpayer bailouts, improving market transparency, and strengthening financial supervision. More recently, policy makers' attention has turned to the non-bank sector including the size and activities of asset managers, as well as the resiliency of clearing houses and financial market infrastructures.

¹ The Systemic Risk Council is sponsored by CFA Institute. It is a private sector, non-partisan body of former senior government officials and financial experts committed to addressing regulatory and structural issues relating to global systemic risk.



Despite the myriad reforms already undertaken, the reform process remains incomplete. In the euro area, for example, banks and policy makers continue to grapple with high proportions of non-performing loans. Although the banking union is well-advanced (yet incomplete), the capital markets union initiative is nascent. And the UK's departure from the European Union is likely to necessitate a recalibration of the supervisory architecture, among many other things.

Meanwhile, at the political level, the appetite for further reform is receding due to regulatory fatigue and a return to growth (albeit modest) in advanced economies. Some countries are even considering rolling-back systemic risk protections critical to bank resiliency and orderly resolution authority, creating the risk of vulnerabilities. The regulatory reform process thus stands at a critical juncture – will it be completed, will it stall, or will it go into reverse?

At the CFA Institute and CFA Society Belgium event on systemic risk, Messrs Trichet and Tucker surveyed the political and economic landscape and sought to address the pertinent issues facing policymakers. The post-crisis international policy consensus was built on common regulatory objectives and supervisory cooperation in recognition of the global nature of finance and capital flows. Messrs Trichet and Tucker noted that the breakdown of consensus in the Basel committee was a concerning development, and reflected probable political disagreement over the direction of policy. But they cautioned that a country-by-country approach would lead to a divergence of regulatory standards and weaken systemic risk protections at precisely the wrong time, for three reasons.

First, shocks in one country often spill over to another due to the borderless nature of finance and the global presence of financial firms. As such, developed countries cannot insulate themselves from one another. Therefore, a global approach to regulation, based on high common standards and international cooperation, is likely to be more effective – and to better protect the national interest – than a purely nationalistic approach.

Second, economies are more vulnerable to shocks now than before, given the inexorable climb in gross debt in the financial system. To illustrate this point, Mr Trichet noted that at the global level, the ratio of total public and private debt to GDP has risen from approximately 250% in 2005 to 275% in 2007, to approximately 300% in 2015. According to the most recent data from the Institute of International Finance, the debt ratio now stands at approximately 325%. Further, whilst global indebtedness before 2008 largely came from advanced economies, the augmentation in debt since 2008 is evenly split between advanced and emerging economies. Thus, a future debt crisis could affect developing as much as developed economies.

Third, the macroeconomic policy arsenal is depleted as a result of the prolonged effects of the financial crisis. Policy interest rates remain close to zero in the UK, the euro area, and Japan, and while the US



Federal Reserve has begun to tighten monetary policy, it is pursuing a very gradual path of adjustment. Further, central banks have accumulated vast holdings of government bonds and other securities, reducing bond yields to unprecedented levels across the major segments of the fixed income markets. Consequently, if another crisis were to materialise, central banks would have very little scope to further ease monetary policy, ostensibly placing the onus on fiscal authorities to combat any shocks. However, given the high levels of public indebtedness, governments may lack the ability or willingness to utilise expansionary fiscal policy in the event of another downturn.

Taken together, these arguments underline why now is not the time to ease-off completing financial reforms, Messrs Trichet and Tucker contended. Indeed, given the aforementioned policy constraints, bolstering financial regulation is necessary (but not sufficient) in order to reduce both the likelihood and severity of a future shock.

To further elucidate these views, the Systemic Risk Council published a policy statement in February 2017 that outlined the key elements of a safe and sound financial system.² These elements reflect the fact that international minimum standards and policies are in the common interest given the interconnectedness of global banking and capital markets. They comprise:

1. Requiring much higher common tangible equity in banking groups to reduce the probability of failure;
2. Requiring banking-type intermediaries to materially reduce their exposure to liquidity risk;
3. Empowering regulators to adopt a system-wide view through which they can ensure the resilience of all systemically relevant entities and market activities;
4. Simplifying the network of exposures among intermediaries by mandating central clearing of derivatives via central counterparties that are required to be highly resilient; and
5. Establishing enhanced regimes for resolving financial intermediaries so that, even in a crisis, essential services can be maintained to households and businesses without taxpayer support—a system of bailing-in bondholders rather than of fiscal bailouts.

Turning to Europe, Messrs Trichet and Tucker considered the sovereign debt crisis and the specific reforms needed to reinforce the institutional architecture of the euro. These include strengthening the powers of the executive branch and boosting the democratic legitimacy of the euro area, as well as enhancing its financial and fiscal governance. This could include, for example, revising the Eurogroup (the governance body comprising finance ministers from the euro area) and increasing the oversight powers of the European Parliament. The European Commission's recent paper on the future

² See *The Systemic Risk Council Policy Statement to Leaders of the G20* (<https://www.systemicriskcouncil.org/2017/02/systemic-risk-council-policy-statement-to-g20-leaders/>)



of Economic and Monetary Union³ provides further insights on these topics; for example, it considers the possibility of a minister of finance for the euro, along with a euro area Treasury. The Commission's paper also illustrates the need to tackle persistent economic and social divergences within the euro area and the need for further financial integration.

However, such financial integration is unlikely to be realised without further capital market integration. The Capital Markets Union (CMU) initiative purports to grow the role of capital markets in the financing of the economy by expanding the pool of capital in Europe and increasing financing and investment opportunities for institutions and retail investors. Yet it lacks an overarching framework: to date, the CMU agenda has been characterised by a series of incremental measures to remove impediments to capital flows. These include simplifying prospectus rules for equity and debt issuances, creating a framework for simple, transparent and standardised securitisation, and tackling impediments to cross-border distribution of investment funds, among other initiatives.

Considering the capital markets, Messrs Trichet and Tucker observed that the CMU initiative can have a powerful social purpose: it could facilitate the flow of capital to where it is most needed, thereby financing productive enterprise throughout the EU. The CMU should thus serve as an efficient mechanism for private risk sharing.

But one of the main obstacles is the level of heterogeneity and fragmentation among EU markets, where standards of investor protection differ, as does the rule of law and the effectiveness of financial supervision and enforcement.

Capital Markets Union cannot be realised without more supervisory convergence and catch-up between EU periphery and core. The current divergence is reflected in the relatively low levels of capital raising and liquidity in smaller EU member states. Issuers favour consistent rules and legal certainty provided by more developed markets; post-Brexit, it will become all the more important for the EU to strengthen its capital markets infrastructure to support capital raising and investment opportunities.

An enhanced role for the European Securities and Markets Authority (ESMA) as a centralised supervisor would be an important component of this infrastructure. It would facilitate pan-European investment through more consistent rules and supervision throughout the EU, underpinned by more consistency and predictability in the regulatory environment.

³ European Commission, 2017, *Reflection Paper on the Deepening of the Economic and Monetary Union* (https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en_2.pdf)



Evaluating the state of regulatory reform almost ten years since the onset of the financial crisis, it is clear that whilst much progress has been made, several aspects of the reform programme remain incomplete. The path chosen by policymakers at this juncture will have important implications for firms and investors: all have a stake in building a stronger financial system that facilitates the efficient allocation of capital and serves society at large.