POST CRISIS REGULATORY STRATEGY: The Need for Pillar 4?

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WHY A MAJOR STRATEGIC REVIEW WAS NEEDED

- Fault lines in *status quo*
- Perversity: privatisation of profits / socialisation of costs
- Costs of crisis
- Tax-payer liability / insurer of last resort
- Massive moral hazard
- Distribution of costs: irrational burden sharing
- Endogeneity problem
- TBTF problem and moral hazard
- Inadequate Resolution arrangements
- Cross-border issues

EXECUTIVE SUMMARY

New approach to Regulatory Regime

- Two key objectives: probability and cost
- More emphasis on Objective 2
- *Endogeneity Problem*
- Regulatory Matrix: trade-off
- Optimal regulation for Objective 1 indeterminate without Objective 2
- Primacy of equity capital: is it costly?
- No Resolution arrangements in place prior to crisis
- Holistic/strategic reform agenda
- Limit claim on tax-payer
- Full v. Partial Banking Union
- EU-wide resolution

TWO DIMENSIONS IN REFORM STRATEGY

1. Reduce the probability of bank failures: Objective 1

2. Reduce the social cost of actual bank failures: Objective 2
   - tax-payers/system/other banks/customers/some debt-holders
   - credibility of “no bail-outs”

INCOMPATIBLE TRINITY

1. Integrated cross-border banking markets with externalities
2. Global banking stability
3. Autonomous national regulation/supervision/resolution

Choose any two from three

RISK MIGRATION

"Risk migrates to where regulation is weakest, so there are natural limits to what regulatory strategies can reasonably achieve"

(Haldane *et al*, 2010)

QUOTATIONS

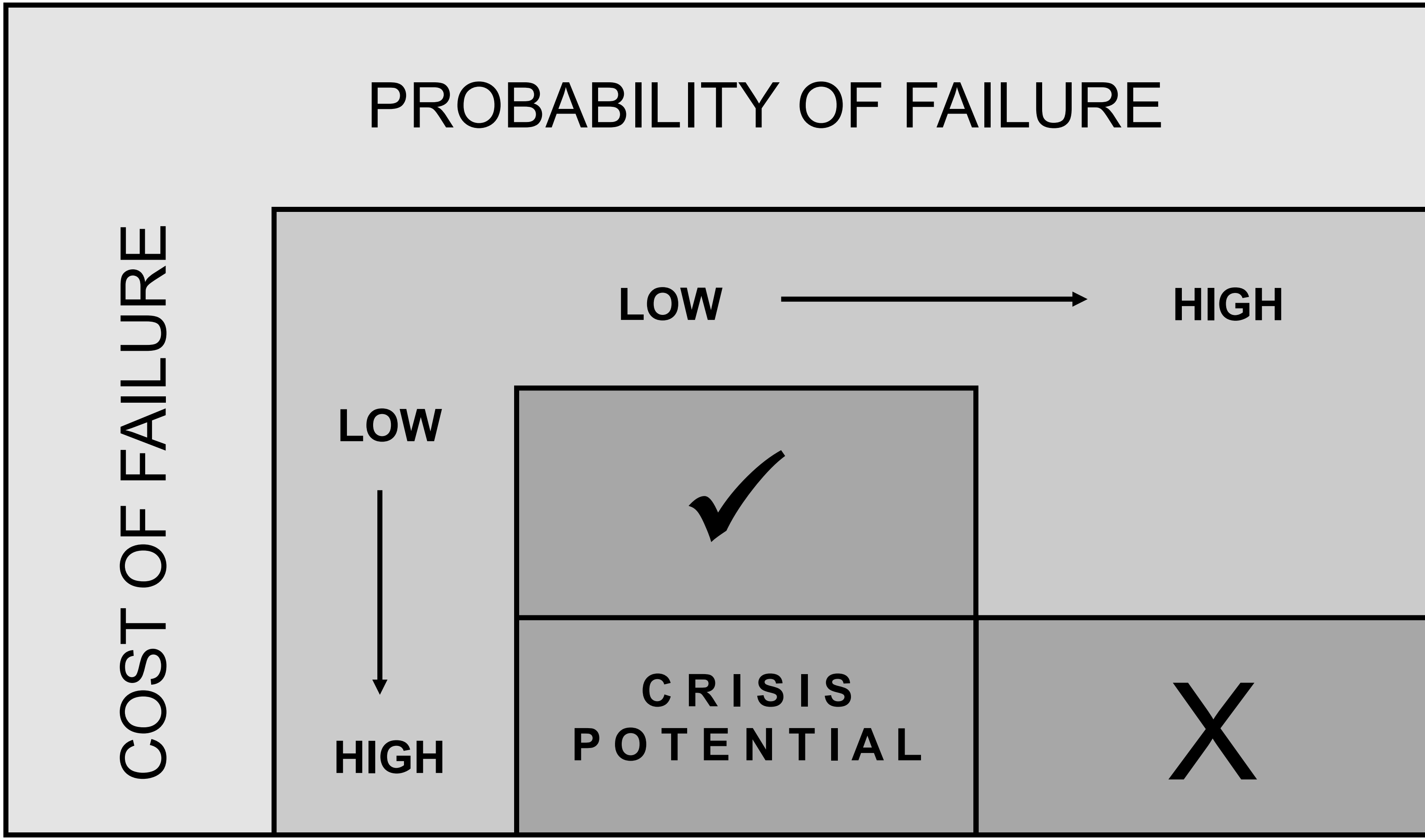
“[We plan] to manage the hell out of RWA”

(Jamie Dimon, CEO of J P Morgan]

“We are scouring the balance sheet and looking for assets that could be structured differently so as to achieve lower risk weights”.

BASEL II INCENTIVES

- Risk weights not reflect true risk: precision v. accuracy
- Remove assets from balance sheet
- Excess gearing
- Securitisation
- SIVs
- Credit risk shifting instruments and derivatives
- Higher risk
- Complexity and opaqueness


PROBABILITY OF FAILURE
COST OF FAILURE
LOW
HIGH
LOW
HIGH
✓
CRISIS
POTENTIAL
X

LOWERING THE COSTS OF BANK FAILURES

If social costs of bank failure were zero:

- No concern about probability of failures
- No tax-payer liability
- No bail-outs
- No moral hazard of bail-outs
- No need for regulation!

OBJECTIVE 1: REGULATION
Less complexity

- Much higher equity ratios
- Enhanced loss-absorbing power: bail-ins / contingent capital / depositor preference
- Taxation of debt bias
- Leverage ratio
- Differential capital requirements: systemic risk
- Liquidity
- Living Wills: Recovery
- Macro prudential

COST ANALYSIS

(1) Exaggerated: cost and availability of credit

(2) Social v. Private costs

(3) Sytemic benefit: cost-benefit analysis

(4) Consumer pays

(5) Stock-adjustment v. steady-state scenario

(6) Redress bias towards debt

(7) Stock-adjustment v. Steady-state

(8) Shareholder incentives

OBJECTIVE 2

- Credible Resolution arrangements: domestic and cross-border
- Ring-fencing
- Living Wills: Resolution
- Bond-holder losses
- Taxation

RING FENCING

Banking services that are critical to an economy are to be ring-fenced into legally, economically, and operationally separate subsidiaries

RING FENCING

- Simplified structure
- Advantages of synergies and economies of scale
- Capital can be shifted
- Advantages of diversity
- Ease of Resolution
- Ease of Separability: which to save
- No investment banking subsidy

TWO NEW INITIATIVES

1. EU Banking Union

2. Bank Resolution

FULL v. PARTIAL EU BANKING UNION

- Common regulation
- Unified supervision
- Single deposit insurance/protection
- Resolution fund
- Resolution authority
- Centralised decisions on resolution/closure regime
- Re-capitalisation decisions (?)
- Centralised management of bank crises
- Mutualisation of liabilities / risks

RATIONALE OF BANKING UNION

- Single market: avoid fragmentation of EU banking markets
- Integral part of a monetary union
- Remove bank supervision from political influence
- Lower forbearance
- Lower expectations of bail-outs and associated moral hazard
- Consistent supervision and enforcement
- Reduce regulatory arbitrage
- Protect against bank/sovereign NFBL
- Pool risks
- Equalise bank funding costs
- Lower country-specific risks

IMPLICATIONS OF BANKING UNION

- Major centralisation of sovereignty
- Sharing / pooling risks
- Sovereignty over bank closures
- Cross-border resolution arrangements
- Cross-border transfers
- Complex fiscal implications

EU RESOLUTION PLANS

- Harmonise key issues: powers / tools / legal authority / closure / authority to take early action
- Clearly-defined closure rules
- Adequate funding mechanisms for bank resolution: a Resolution Fund
- Harmonised resolution triggers
- Banks to have Living Wills
- Resolution plans for each bank
- Early intervention

THE TWO SHOULD BE LINKED

(1) Bank resolution arrangements an integral part of a Banking Union

(2) Incentive structures and conflicts

(3) Cross-border issues

CONSISTENCY AND INCENTIVE STRUCTURES

Centralised supervision and responsibility for systemic stability with national deposit insurance and resolution arrangements are not incentive compatible:

* national authorities could argue that they are forced to act because of supervisory failures by ECB
* tax-payers resist paying for ECB errors
* national authorities have incentive to delay action to minimise own costs and keep bank alive though ECB liquidity
* if ECB does not have resolution powers it may be forced to inject liquidity and keep zombie banks alive
* ECB may have incentive to off-load the fiscal cost of problems to national authorities
* conflict over when resolution is needed: ECB
* ECB focus on EU systemic stability: not shared by national authorities
* national authorities delay action and resist closures: especially of large banks / national champions

15 CORE PRINCIPLES

1. Two core objectives: probability of failure v. cost of failure
2. Systemic focus
3. Regulation by economic substance and systemic potential
4. TBTF addressed
5. Risks to remain private
6. Remove perversity: private profits v. social risk
7. Costs of failure borne by private stakeholders: equity and bonds
8. Limit claims on tax-payers

9. Early intervention: PCA and SEIR
10. Resolution arrangements
11. Moral hazard of intervention
12. Failure without disruption
13. Enhance market discipline
14. Supervision rather than regulation
15. International dimension

FUTURE STRATEGY

BASEL N or PILLAR 4?