BULLETIN

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High Noon in Europe's Financial Regulatory Agenda

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"Is the chicken now coming home to rooster?", asked a senior bank executive at a recent conference on European bank regulations. After four years of an extraordinarily busy agenda of reforming financial regulations, Europe is now struggling with its 4.5 trillion euro question*: what prudential regulations of banks are necessary in order to avoid another financial meltdown? Will authorities succeed in designing a crisis-proof financial system? No. But it could make it safer by addressing the source of systemic instability rather than micro-managing the financial sector.

Several factors conspire to make 2012 a particularly complex year for bank stability. First, the macro conditions for bank financing and market recapitalisation will likely worsen, even if the external assistance to Spanish banks (which will relieve banks from some funding pressure) will be impeccably pursued. Europe's banking sector remains fragile, despite two rounds of remarkably generous financing offers in the European Central Bank's Long Term Refinancing Operations. The ghost of a bank run reinforces funding pressures on banks in the peripheral crisis economies, even if deposit withdrawals appear contained for the time being. The European Banking Authority's requirement on selected banks to improve their core capital positions will soon kick in. For many banks the cost of capital has become prohibitive, forcing them to depress credit rather than shore up funding.

Second, a host of regulatory initiatives is getting closer to decision time. One of them is the fourth capital requirement directive/regulation (or CRD/R IV), based on the Basel III accord, which recently passed a first critical stage when member states signed off on a compromise. Equally important, the European Commission has just released its proposal on crisis management and resolution – how banks ultimately should be wound down rather than bailed out by tax payers. The High-level Expert Group on Reforming the Structure of the EU Banking Sector, tasked to consider policies like the Volcker Rule and the Glass-Steagall type of firewall around consumer banks suggested by the Vickers group in the United Kingdom, will report their recommendations soon after the summer holiday. And if you add to that a possible proposal, or at least a step-by-step sketch, on a banking union with common deposit insurance, it is not an exaggeration to say that the EU is approaching the apex of its post-crisis regulatory agenda.

Would past and planned financial regulations have prevented the past years banking crisis? One response is to point to the Annual Report released last week by the European Systemic Risk Board (ESRB). It is not difficult to understand why the release was a non-event. But it is deplorable, and worrying, that the ESRB, which is the only pan-European macro-prudential body, never was given the powers it should have in order to make the financial system safer. Such regulations are essential for a stabile banking system in a world of highly inter-connected financial institutions. Micro-prudential regulations operate on the hypothesis that you make the banking system safe by making every bank safe. Yet that is a misguided supposition. It is close to impossible to design a system of micro-prudential regulations that creates a stabile banking system without using draconian measures with depressing effects on economic growth.

Without appropriate macro-prudential regulations – and corresponding power for authorities to act – policymakers have tried to paper over the weaknesses by a plethora of new micro regulations. Many of these regulations have gone too far. While some of the new regulations – and especially the drive to harmonize regulations – are clearly justified, it is also obvious that many regulations have been introduced without policymakers knowing if they will have any impact at all on financial stability. In some circumstances, it is clear that policymakers have known that new regulatory efforts have been nothing but a political charade. Too often new micro regulations with little or no effect on financial stability have been introduced without policymakers apprehending their full costs to the economy.

Macro-prudential regulations are important because vicious financial crises, with strongly damaging effects on taxpayers and the real economy, follow boom-and-bust cycles. Such financial crises have their source in macro deficiencies: an asset boom fuelled by rapid credit growth in economies with expansionary monetary policy and huge structural imbalances. In that cycle, banks expose themselves by expanding their balance sheets, moving to short-term funding, and increasing their leverage. The market failure in this cycle is the market punishment of banks that resist these opportunities. Certainly, there are banks that contradict this trend, but the problem for financial stability is that too many bankers and shareholders cannot control temptations for quick profits by capitalising on macro deficiencies. Micro-prudential regulations, when they work, can temper the seduction – but only up to a point. Furthermore, they also face the boundary problem: micro-prudential regulations cannot cover all risk behaviour, and financial activities – like some securitisation in the pre-crisis years – will always pivot to non-regulated areas that can offer higher returns.

The CRD/R IV acknowledges macro-prudential risks – and, like many previous efforts by monetary authorities, will provide another building block towards improved macro stability. But so far activities have been insufficient. Macro-prudential risks will not be properly addressed in Europe. The new rules for capital requirement points to counter-cyclical buffers, but delegate to national authorities to design how these buffers should be achieved. And buffers are only one part of macro-prudential management.

The Eurozone crisis has been a showcase for macro-prudential efforts – or, rather, their absence. Monetary policies in the Eurozone could not slow down rapid credit expansion in some peripheral economies. In some instances monetary policy was pro-cyclical as the traditional central banks tools – interest rates and money supply – run on the basis of a Eurozone average that did not reflect developments in countries like Ireland or Portugal. Banks in other Eurozone countries also expanded their exposure to these high-profit markets. No micro-prudential alarm bells rung. Stress tests of individual banks gave green rather than red signals. Even if capital buffers would have been higher, they could not have prevented the ensuing bust from rippling through the entire Eurozone banking sector. And they certainly would not have had any bite at the intimate relation between sovereign bonds in boom-bust countries and capital structures based on those bonds.

It is time for Europe to establish new macro-prudential policies. Too much of current legislation is focused at the "greedy banker" problems. And too often the negative reaction from the financial industry to new EU legislation seems to presume that flawed regulations would not have emerged if only a French interventionist had not become the responsible commissioner for financial regulations. Both sides miss the point: micro-prudential regulations will be too intrusive and costly – and have marginal effects on financial stability – because macro-prudential risks are not comprehensively addressed.

*4.5 trillion euro is approximately what European taxpayers have spent to save banks.