Global Financial Systems
Chapter 23
Current regulatory developments

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To accompany

Global Financial Systems: Stability and Risk

http://www.globalfinancialsystems.org/

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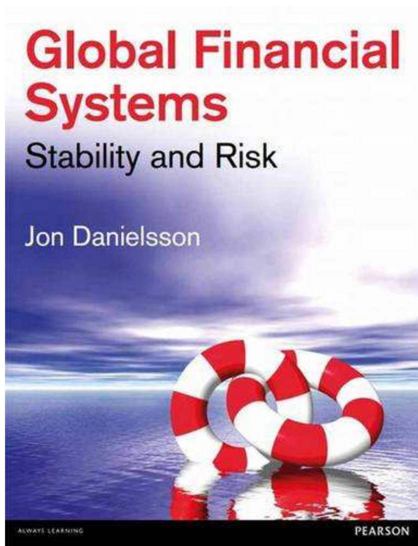
Book and slides



- The tables and graphs are the same as in the book
- See the book for references to original data sources
- Updated versions of the slides can be downloaded from the book web page

  www.globalfinancialsystems.org

Chapter 23

- Version 4.1, November 2016
- The content here combines slides for Chapter 18, "Ongoing Developments in Financial Regulation" and Chapter 23, "Current regulatory developments"
- We present here an updated discussion on compensation that was originally in Chapter 9 "Trading and Speculation"

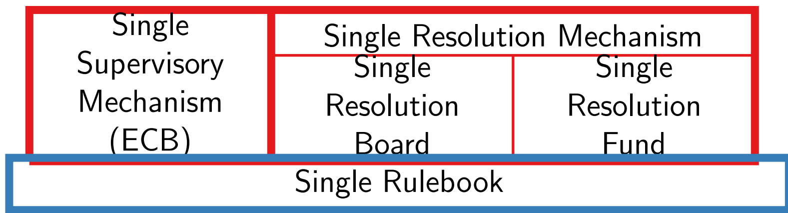
Institutions and frameworks

European Union

- Three main initiatives
  1. Banking Union
  2. MiFID
  3. CRD-IV regulation

Banking Union

- Make banking system unified, more transparent and safer
- *Single Supervisory Mechanism (SSM)*, *Single Resolution Mechanism (SRM)* and *Single Rulebook*
- All euro zone members are part of the BU; all other EU countries can voluntarily join



Banking Union cont'd

- SSM operational since November 2014, applying to all member states
- The ECB is the prudential supervisor of the *123 most significant* banks, which represent about 82% banking assets in the euro area
- Indirectly supervises *less significant* institutions still under the supervision of national authority
- National supervisors will now only assist on day-to-day operations of banks and enforce rules set by the ECB

CRD-IV

- Came into force at the beginning of 2014, full implementation expected in 2019
- Encompasses
  1. Basel III implementation in the EU
  2. Limit to bankers' compensation (broader than under Basel III)

MiFID

- Regulations for financial services provided by financial intermediaries and operations of markets
- Enhances investor protection by strengthening the single market for investment services
- MiFID II came into force in July 2014, implementation expected in January 2017
- Once a firm is covered by MiFID, it is authorized and regulated in their home state but able to provide services to customers in other EU member states (see passport)

United States

Dodd-Frank Act

- Signed into law in 2010
- 2,300 page-long, topics from derivative markets to credit rating agencies
- Improved customer protection, protection against systemic risk, increased transparency of exotic instruments and others
- Responsibilities among old and new regulatory agencies have been changed
- The FSOC is established as the macro–prudential regulator and guarantees coordination among agencies

Extra-territorial rule and the US

- Extraterritoriality is the claim by a nation of direct legal authority over conduct that occurs outside its borders
- American authorities claim that banking is international, so banks can be used for criminal and terrorist purposes
- Large fines to domestic and international banks

American fines of European banks

Financial Institution	Fine	Cause
BNP Paribas	$8.9bn	Violating US sanctions
Credit Suisse	$2.6bn	Tax evasion
HSBC	$1.9bn	Money laundering
UBS	$1.2bn	Libor manipulation
UBS	$780m	Tax evasion
Standard Chartered	$674m	Violating US sanctions
ING	$619m	Violating US sanctions

BNP Paribas

- Fine of $8.9 billion in July 2014 and was banned from American clearing operations for one year
- US authorities claimed it had conducted transactions in USD cleared by the Fed with countries sanctioned by the US, hence the bank violated US regulations
- But BNP Paribas conducted transactions from their European offices!
- And did not break French nor European law

- US argues rules are clear, and banks must comply if they want to operate in the US or transact in USD
- Opponents argue it is a foreign policy tool for American authorities
- Tensions between American and European authorities
- May undermine EU banks rebuilding capital
- But European authorities can appear against in public while *privately applauding*
- Because the US leads the way for global reform

Global Institutions

G20 Twenty most important industrialized and emerging countries coordinating financial regulations and crisis response

FSB Established by G20 to monitor financial system, coordinate with relevant bodies (IMF, Worldbank, ...) and make recommendations

BCBS Purpose of formulating uniform international regulation recommendations, but no legal authority to enforce them

Systemically Important Financial Institutions and Banks

What are SIFIs?

- Financial institutions whose failure might cause a systemic crisis
- Negative impact on financial system and real economy
- Not considered very problematic before 2007
- Highly diversified institutions
- Losses in one domain were assumed to be offset by profits in other domains
- Therefore, very large banks *were* considered safer than smaller banks

Why should we care about SIFIs?

- Banks have incentive to become big, interconnected, dangerous and even badly run
- It is beneficial to become a SIFI/G-SIB
  - Lowers funding costs
  - And provides comfort to counterparties
  - They know that they would receive public aid in case of difficulties (moral hazard)

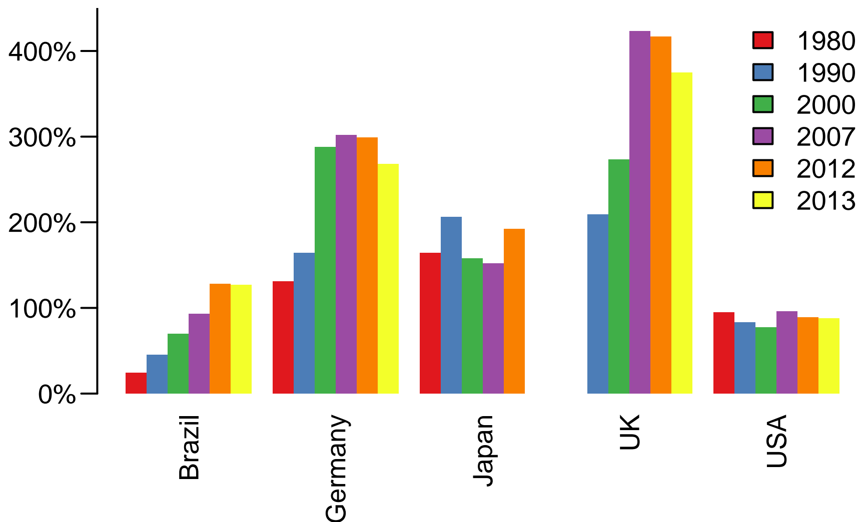
Politics

- Governments like national champions
- "What is good for the national champion is good for finance and the country"
- National banking champions are G-SIB/SIFIs

How to identify SIFIs?

- No compromise on how to identify them
- But one should consider:
  1. Extent of leverage and off-balance sheet exposure
  2. Interconnectedness
  3. Impact of its distress on real economy
  4. Possibility of triggering firesales in the entire system
- Relatively clear classification for banks, less so for asset managers, insurance companies and sovereign wealth funds

Bank assets to GDP



TLAC

- Passed by FSB in 2014
- Supposed to be implemented by 2019
- Forces G-SIBs to maintain additional buffers high enough to be written down or converted to equity if their minimum required capital under Basel III is eroded
- FSB proposal: Common pillar 1 minimum of 16 to 20% of a bank's RWA, and a minimum of twice the Basel III's leverage requirement
- Resolution of G-SIBs without using taypayers' money

Buckets and the capital surcharges

Bucket	G-SIBs
5 (3.5%)	Empty
4 (2.5%)	HSBC, JP Morgan Chase
3 (2.0%)	Barclays, BNP Paribas, Citigroup, Deutsche Bank
2 (1.5%)	Bank of America, Credit Suisse, Goldman Sachs, Mitsubishi UFJ FG, Morgan Stanley
1 (1.0%)	Agricultural Bank of China, Bank of China, Bank of New York Mellon, BBVA, Groupe BPCE, Group Credit Agricole, Industrial and Commercial Bank of China Limited, ING Bank, Mizuho FG, Nordea, Royal Bank of Scotland, Santander, Societe Generale, Standard Chartered, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group, Wells Fargo

"All that is not a bank"

- Further possible candidates for the SIFI status are asset managers, insurance companies and sovereign wealth funds
- Not necessarily highly leveraged nor subject to maturity mismatches like banks
- Other factors might make them systemically important
- But cost of identifying them as SIFI could exceed economic benefit from it

Asset managers

- Asset managers act primarily as agents
- Their losses or gains are borne mostly by the investors rather than themselves
- No proper classification system in place

Insurance companies

- They pool risks of and provide protection to policy-holders
- Long-term contracts make it necessary to hold massive amounts of assets
- Especially fragile in current low–interest environment
- FSB classified nine insurance companies as G–SIIs

Sovereign wealth funds

- Invest on behalf of sovereign
- Recently exempted by FSB from being systemically important

Basel III

Capital requirements

- Capital tiers
  - Tier 1: Cash central banks reserves, marketable securities
  - Tier 2: Government securities, covered bonds and corporate debt securities of AA– or higher ratings
  - Tier 3 capital eliminated (extended tier 2)
- 3 new CET1 buffers (see next slide)
- Leverage ratio

Capital buffer

- Capital conservation buffer
  - *2.5%*; buffer of common equity that can be used to absorb losses during stress;
- Countercyclical capital buffer
  - *0% – 2.5%* of CET1; based on national circumstances;
- G-SIBs buffer
  - *2.5% + 1%*; only applicable to systemically important banks.

Total regulatory capital ratio = Tier 2+ Tier 1 + capital conservation buffer + countercyclical capital buffer + capital for systemically important banks

Leverage ratio

$$\frac{\text{Tier 1 capital}}{\text{Total assets}} \geq 3\%$$

- Trial run: 3% 2013 — 2017
- Before crisis, US preferred LR, Europe RWA
- The LR advantages — less model risk — less scope for manipulation
- Disadvantages — does not distinguish between the most safe government bonds and junk bonds, creates a disincentive to hold safe assets
- Puts LR in conflict with the objectives of the LCR
- The LR problematic for banks holding with large positions in government bonds, like Japanese banks

- If the choice was between either the LR or the Basel ratio, it would be hard to decide between the two
- Both ratios are flawed, but do meet a useful objective
- Currently, both ratios are used simultaneously

Capital-relief trades - CRT

- A bank and investors (hedge fund of pension fund) agree on a formal alignment of interest
- The bank pays the investors to take on its risk with its loans
- This helps the bank meet its regulatory risk-based capital ratio
- Investors could make annual returns as high as 15 to 20 percent on each deal

Liquidity coverage ratio

- The LCR came into effect in January 2015
- The Basel Committee issued the final form of Basel III's LCR in January 2013
- It's the stock of HQLA divided by the total net cash outflows over the next 30 days
- The ratio ensures that a bank has sufficient liquid assets to meet its liquidity needs over a 30-day period in a liquidity stress scenario

Net Stable Funding Ratio

- The standard for the NSFR was released in October 2014 and the NSFR will be introduced as a minimum standard by 1 January 2018
- The ratio of the amount of available stable funding over the amount of required stable funding

Stress testing

Definition

- Stress testing is a quantitative analysis tool to assess the resilience of financial institutions to hypothetical stress scenarios
- Those scenarios are assumed to be "extreme but plausible" economic events
- Example: severely impeded economic growth of home or world economy, large depreciation of domestic currency

Stress testing in the EU

- The EBA, established in 2011 and conducted the most recent stress test in July 2016
- The EBA publishes methodology, shock scenarios and discloses bank-by-bank data
- This is supposed to ensure transparency and compatibility of stress test results among EU banks
- Politization: sovereign debt and Deutsche Bank

Stress tests in the US

- Conducted on a regular basis since the financial crisis 2008
- Recent test included 33 banks, representing more than 80 % of domestic assets
- Only two banks' capital distribution plans were objected by the Fed: Deutsche Bank Trust and Santander

Compensation

- Historically strong reluctance to limit private sector salaries
  - Difficult to enforce
  - Expensive monitoring
- Overcome in financial sector, because it pays above average while receiving public support after being at the heart of the crisis
- CRD IV limits the level of bonuses with respect to the base salary to a ratio of 1:1
- Partially paid as long-term deferred assets
- Controversial

Macroprudential Policies

Financial policy

- Government policies targeting the financial system have three main objectives
  1. Price stability
  2. Stability of financial institutions
  3. Financial stability and prevention of systemic risk
- Each objective corresponds to one policy area
  1. Monetary policy
  2. Micro prudential policy
  3. Macro prudential policy

The macro real estate toolkit

LTV Loan–to–value ratios limit the amount the money that can borrowed against the value of property;

DTI Debt–to–income ratios limit the amount that can be borrowed based on borrowers income;

DSTI Debt–service–to–income ratios limit the size of the payment a borrower has to make relative to income;

Tax–deductible interest rates In countries where interest rate payments are tax–deductible, an effective way to increase the cost of borrowing is to reduce or eliminate the tax deductibility;

Stamp duty The seller and/or buyers pay a portion of the property value as tax.

Challenges

Institutional design

- The question of who should be in charge of macro–prudential policies remains unsettled
- In most Asian countries, the central bank is in charge
- In the UK it is now the central bank
- In the US it is split among various bodies
- In the EU: European Systemic Risk Board (ESRB) and ECB

Instruments design

- It is hard to design effective macro–prudential tools
- Instruments must be flexible to all changes in the system
- Different tools are needed in different countries
- There is no "one size fits all" process
- Identifying the right tool is difficult
- Monetary policy uses the inflation rate as its target variable, and interest rates are the main tools
- Macro–prudential tools must target multiple sources of risk simultaneously
- I.e risky behavious, SIFIs, asset price bubbles, etc.

Instruments overlap

- It can be hard to distinguish whether one instrument is macro or micro
- Most tools can be used for both macro and micro objectives
- Take LTV ratios:
  1. Can be used to reduce each institution's leverage and enhance its resilience to financial shocks (micro perspective)
  2. By reducing leverage, LTV can also reduce the risk of real estate bubbles (macro perspective)
- Categorization of each policy is a subjective process and depends on regulators' point of view

Too big to jail

I am concerned that the size of some of these (financial) institutions becomes so large that it does become difficult for us to prosecute them

— Eric Holder, Attorney General of the US

Too big to jail

- HSBC failed to monitor transactions of US dollar purchases with drug trafficking proceeds in Mexico
- Illegal in the US
- US officials refused to prosecute bank for money laundering in 2012
- Trade–of between rigorously enforcing regulations and risking systemic failure
- In 2016, reports and emails from UK and US officials showed that they were concerned about "financial calamity"