FINANCIAL REGULATION

The 2007 to 2009 financial crisis resulted in the re-emergence of the debate on financial regulation and its relationships with other macroeconomic policies, particularly monetary policy. In Europe, the financial crisis was followed by the sovereign debt crisis, as the bail-out of the financial sector put strains on public finances in several countries. The sequence of events called for a strengthening of the union, ranging from a common framework for supervisory policies that could minimise the risk of unforeseen bank or country defaults to a common resolution mechanism that could set equal rules across countries and reduce ex ante misincentives to risk-taking and moral hazard.

This analysis of the state of and prospects for financial regulation examines the lending and saving behaviour of banks and households, as well as their borrowing activities, in order to understand the conflicting priorities and complicated decisions involved in the development and implementation of financial legislation.

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FINANCIAL REGULATION

A Transatlantic Perspective

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CONTENTS

List of figures *page* vii
List of tables ix
List of contributors x
Foreword – Vítor Constâncio xii
Editors' preface xxi
Acknowledgements xxiv

PART I **Micro- and macro-prudential regulation** 1

1 The road from micro-prudential to macro-prudential regulation
ESTER FAIA AND ISABEL SCHNABEL 3

2 Lessons from the European financial crisis
MARCO PAGANO 23

3 Bank stress tests as a policy tool: the European experience during the crisis
ATHANASIOS ORPHANIDES 49

4 Monetary policy in a banking union
TOBIAS LINZERT AND FRANK SMETS 61

5 Competition and state aid rules in the time of banking union
IGNAZIO ANGELONI AND NIALL LENIHAN 89

6 Bail-in clauses
JAN PIETER KRAHNEN AND LAURA MORETTI 125

7 Shadow resolutions as a no-no in a sound Banking Union
LUCA ENRIQUES AND GERARD HERTIG 150

8 A political economy perspective on common supervision in the Eurozone
TOBIAS H. TRÖGER 167

PART II **Investor and borrower protection** 193

9 Keeping households out of financial trouble
MICHAEL HALIASSOS 195

10 Financial market governance and consumer protection in the EU
NIAMH MOLONEY 221

11 Financial advice
ANDREAS HACKETHAL 245

12 U.S. financial regulation in the aftermath of the Global Financial Crisis
HOWELL E. JACKSON 271

13 Risk aversion and financial crisis
LUIGI GUISO 290

14 Household finance and the law – a case study on economic transplants
KATJA LANGENBUCHER 313

Index 336

FIGURES

1.1 Transmission channels of systemic risk 5
2.1 Two-year moving correlation between bank sector monthly stock returns and 10-year domestic sovereign debt returns and domestic sovereign exposures of banks in the euro-area periphery 27
2.2 Two-year moving correlation between bank sector monthly stock returns and 10-year domestic sovereign debt returns and domestic sovereign exposures of banks in the euro-area core 28
2.3 Bank resolution in the US and EU 36
2.4 Average reduction in the funding costs of banks due to government guarantee (basis points) 37
2.5 Book leverage ratio versus regulatory capital ratio: median of top 20 EU banks 42
2.6 Correlation between the leverage ratio and the regulatory capital ratio for listed EU banks 43
2.7 Global banks' Tier-1 capital as percentage of risk-weighted assets in 2006 45
2.8 Global systemically important banks' leverage ratios in Q2–2013 46
3.1 Economic performance in the US and the euro area 50
3.2 Credit-crunch-induced recession in the euro area 56
3.3 Policy-induced credit crunch in the periphery 57
3.4 The impact of the policy-induced credit crunch 59
4.1 Lending of last resort to markets 71
4.2 Share of the Eurosystem in Euro Area MFI main liabilities 72
4.3 Lending of last resort to individual institutions: ELA 73
4.4 Challenges and risks of financial dominance 74
4.5 Lending of last resort in a banking union 79
8.1 ECB/NCA interplay within the SSM 177
8.2 ECB supervisory decision making 185

11.1 Portfolio return and risk profiles for 3,400 online broker clients (2003–2012) 247
11.2 Comparison of stated risk preferences and average actual portfolio risk 249
13.1 Share of highly risk-averse people in the Survey of Consumer Finances 304

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Frontmatter
More information

TABLES

4.1 The importance of banks for the ECB's monetary policy 65
8.1 Direct ECB supervisory competence according to SSM regulation 173
13.1 Evolution of the distribution of risk preferences among US households 303

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FOREWORD: FINANCIAL REGULATION – THE FIRST MACRO-PRUDENTIAL TOOL

Financial regulation aims to de-risk the financial system by improving resilience and taming the financial cycle. This book provides a broad overview, combining the insights of academic researchers with the knowledge of practitioners of the latest transatlantic developments in this field. It shows how financial regulation must seek to tweak the incentives around banks' private decisions to align them with social welfare. To do this, authorities must intelligently combine financial regulation and the use of broader macro-prudential policies. Financial regulation is about designing a financial system resilient to systemic risk and as such it is, in my view, the first tool of the newly established macro-prudential policy area (see Chapter 1 by Ester Faia and Isabel Schnabel for an expanded examination of the role of macro-prudential policy). Sound shock-absorption capacity needs to be assured before cyclical aspects can be brought into consideration. However, I will argue that macro-prudential policy should also be used assertively to tame the financial cycle that arises endogenously from the financial system. Ideally, financial regulation should be used to induce the banks to internalise fully the costs and benefits of their asset–liability structure. By doing so, they make the financial system more resilient to shocks.

In achieving this, the banking union project and the Single Supervisory Mechanism (SSM) will make an essential contribution (see Chapters 4 and 5 on different aspects of banking union, by Frank Smets and Tobias Linzert, and Ignazio Angeloni and Niall Lenihan, respectively). The absence of European supervision and resolution was an initial design flaw of monetary union. As the crisis developed, this became quite clear. The high degree of interconnectedness in the euro area implies that the impact of supervision affects not only the domestic banking sector but also, as an externality, other countries. With increasing financial integration, pursuing national financial policies will generally not lead to financial stability, because national policies seek to benefit national welfare while not taking into account externalities of national supervisory practices in other countries. This leads to an under-provision of financial stability as a public good.[1]

Banking union has, of course, many other goals:[2] to avoid large financial imbalances among members by taking a European perspective in monitoring the cross-border intermediation by banks; to contribute to financial integration by severing the links between banks and respective sovereigns; to overcome financial fragmentation and improve the transmission of monetary policy; and, finally, to increase the efficiency of the banking system which is the dominant source of finance for the European economy.

The SSM will be a strong and independent supervisor, enforcing supervision consistently across the participating Member States. The SSM will ensure a fully integrated approach to the supervision of cross-border banks. Compared with supervision at the national level, this integrated approach will enable the SSM to detect excessive risk-taking and the cross-border externalities associated with it, and therefore to be proactive if local financial developments threaten broader financial stability.

That said, high-standard banking supervision does not focus on preventing bank failures at any cost. In fact, to effectively perform its tasks, a supervisor must also be able to let failing banks exit the market. This is the reason why the SSM has also been given the competence to withdraw credit institutions' licences to operate. However, given the role of banks in the financial system, and in order to safeguard financial stability, the supervisor has to feel confident that the resolution of banks can be conducted in an orderly fashion. This brings me to the second pillar of the banking union, the Single Resolution Mechanism (SRM).

The establishment of the SRM was the second crucial step towards addressing financial fragmentation and breaking the bank–sovereign nexus. This is because the orderly resolution of banks, even large ones, helps avoid costly rescues by sovereigns that may endanger their own

1 On financial stability as a public good, see, for instance, Beck, Thorsten, Diane Coyle, Mathias Dewatripont, Xavier Freixas and Paul Seabright (2010): *Bailing out the Banks: Reconciling Stability and Competition: An Analysis of State-Supported Schemes for Financial Institutions*, London: CEPR.

2 See Vítor Constâncio: "Reflections on financial integration and stability", speech at the Joint ECB-EC Conference on Financial Integration and Stability in a New Financial Architecture, Frankfurt, 28 April 2014 and "Towards the Banking Union", speech at the 2nd FIN-FSA Conference on EU Regulation and Supervision "Banking and Supervision under Transformation" organised by the Financial Supervisory Authority, Helsinki, 12 February 2013.

finances. This will enable swift and unbiased resolution decisions, which will address notable cross-border resolution cases in an effective manner. In this respect, the SRM should be viewed as a necessary – and logical – complement to the SSM.

Banks' asset–liability structure – ensuring externalities are internalised

When banks fail, systemic consequences often arise for the rest of the financial sector and the overall economy. This can happen as a result of contagion – either directly via write-downs on exposures to the failed bank, or indirectly via confidence effects that can freeze markets and diminish access to funding. The existence of such systemic risks tends to distort the healthy functioning of the financial market. It results in pressures on authorities to save failing banks in order to avoid financial crises and the associated damage to the real economy. Ultimately, this distortion tends to exacerbate private–social incentive misalignment by creating moral hazard among bank managers and investors. Therefore, without adequate financial regulation, the financial system will tend to build excessively risky balance sheets and to grow more than efficiently. How should this problem be addressed?

Enhancing resilience – loss absorbency and asset liquidity

Firstly, rules must be imposed on banks to ensure their balance sheets are not excessively risky. On the liability side, this means that capital requirements should be strengthened. Furthermore, they could be time-variant. Strong capital build-up in good times reduces the frequency of financial crises and contributes to more sustainable economic growth and higher levels of output over the long term.[3]

Authorities must also ensure that banks' broader funding models are stable. This means that funding should be pushed towards longer-term sources that do not disappear rapidly in moments of stress. In addition, banks must hold sufficient liquid assets that can be sold to fulfil funding needs when sources of short-term finance disappear.

[3] A study by the Basel Long-Term Economic Impact Group has estimated that banking crises occur, on average, every 20 to 25 years. This estimate means that there is a 4.6% annual probability of a crisis. The study shows that a 4 percentage point increase in the capital ratio lowers this annual probability to less than 1%.

Much progress has been made in recent years in increasing minimum standards for banks' capital adequacy, funding structures, and liquidity. The agreement of Basel III is the central policy achievement in this area, and it provides a robust basis for the design of minimum requirements worldwide.

However, there is more to be done. In my view, the balance of the academic work on optimal bank capital levels suggests that there is still room for increasing requirements on banks.[4] There may be scope for also shaping the composition of the capital stock to induce more prudent risk-taking behaviour. Recent research has pointed to the importance of a banks' ownership structure in determining their overall risk profile.[5] There may be sizeable scope for designing regulation appropriately to induce a capital and ownership structure that induces prudent behaviour. I call upon researchers to help develop such mechanisms, and for the regulatory community to actively explore how they may be applied to the banking system. Additionally, I note that banks may be manipulating risk-weighting models to reduce the capital they must hold against their assets – as also described by Marco Pagano in Chapter 2. His lesson is to rely on a set of simpler and more robust indicators. I would agree with calls for a stronger leverage ratio, significantly above the initially proposed 3% level for G-SIBs, as this could play an important positive role in mitigating the risk that risk weights are manipulated.

[4] Historical evidence seems to indicate that there is no relationship between the simple ratio of book capital to total assets (or its inverse, with leverage expressed as a multiplier) and economic growth. Indeed, from a social perspective, the cost of highly capitalised banks would seem to be rather low. The relatively cheap cost of debt in comparison with the cost of equity seen currently is due, largely, to the widespread tax advantage that debt financing has over equity. See Haldane A.G. and P. Alessandri (2009): "Banking on the State" London: Bank of England; Miles, D., J. Yang and G. Marcheggiano (2011): "Optimal bank capital", *Bank of England Discussion Paper Series* 32: 6; Kashyap, A.K., J.C. Stein and S. Hanson (2010): "An analysis of the impact of 'substantially heightened' capital requirements on large financial institutions", *mimeo*: 19; Taylor A. (2012) "The Great Leveraging", *NBER Working Papers* 18290, National Bureau of Economic Research; Admati, A.R., P.M. DeMarzo, M.F. Hellwig and P. Pfleiderer (2013): "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive", *Rock Center for Corporate Governance Working Paper Series* 161.

[5] See Laeven, L. and R. Levine (2009) "Bank governance, regulation and risk taking", *Journal of Financial Economics* 93(2): 259–275, who also find that bank executives before the crisis held only small amounts of their own banks' stocks.

Enhancing resolvability – reducing the systemic consequences of bank failure

Secondly, we must implement reforms to reduce the systemic consequences that arise when banks fail. To achieve this goal, a strong bank resolution framework is needed to ensure that the costs of a bank's failure fall where they belong – on its shareholders and creditors. In this vein, Michael Haliassos discusses in Chapter 9 the reason why regulation is needed and how households can be kept out of financial stress. Such an orderly resolution mechanism is an ex post measure with beneficial ex ante effects on private risk-taking decisions. Clarifying that the costs of bank failures will fall on banks' shareholders and creditors sharpens these investors' incentives to monitor and influence banks' decisions on their risk appetite. Excessive risk-taking will not be tolerated by investors who know they will be forced to pay for the negative consequences that may result from that strategy. This injection of market discipline is particularly beneficial in the modern context where deposit insurance has muted the monitoring incentives stemming originally from the risk of depositor runs.[6]

The financial crisis showed us that existing bank resolution systems were inadequate. Banks were structured in such complex ways that it was near to impossible to identify where losses would fall in a case of insolvency. Authorities lacked the necessary powers to act decisively to shut down failing institutions and apportion losses in an orderly fashion. Bail-outs resulted, and moral hazard problems intensified.

I am glad to say we have gone a substantial way to addressing these shortcomings. In Europe, the establishment of the SRM and the Bank Recovery and Resolution Directive (BRRD) are crucial steps, while the Dodd-Frank Act creates a similar resolution framework for US authorities. In this book, Gerard Hertig and Luca Enriques illustrate the details of bank resolution at the level of the EU, and its interplay with resolution at the level of Member States, in Chapter 7, whereas Tobias Tröger discusses the institutional arrangements of the SSM in Chapter 8.

Despite this positive reform, clearly there is still work to be done. Perhaps most crucially, authorities must begin using the resolution tools they have been given – thereby adding credibility to the system. The recent agreement at the FSB and G20 levels to introduce a new

[6] See Demirguc-Kunt, A. and E. Detragiache (2005): "Cross-Country Empirical Studies of Systemic Bank Distress: A Survey", *World Bank Policy Research Working Paper* 3719.

concept of Total Loan Absorption Capacity (TLAC) for Global SIBs was, in this respect, a very important step forward. European regulation now needs to adjust the concept of Minimum Requirements of Eligible Liabilities (MREL) that will be applied to all banks, in order to ensure full compatibility with the TLAC concept. In Chapter 6, Jan Pieter Krahnen and Laura Moretti highlight the need for a clear and credible pecking order when allocating losses and discuss possible formats. Both TLAC and MREL should ensure that sufficient "bail-inable" debt will always exist on bank balance sheets to insulate tax-payers from burdens in all but the most extreme crisis scenarios.

Macro-prudential policy should tame the financial cycle

Together, the measures set out above on increasing the resilience and resolvability of banks will make the banking system safer, more stable, and better equipped to allocate resources efficiently across the economy. Nonetheless, endogenous forces exist within the financial sector that still make the availability of credit pro-cyclical.[7] For instance, easier credit in a boom phase encourages investors to buy more assets, which in turn increases the value of collateral, thereby fuelling the credit boom further. Hence, the expansion of credit in good times can, by itself, lead to excessive leverage in the financial system and increase the probability of crises, only to go into reverse during a bust.[8]

To contain these pro-cyclical forces we need an assertive and pre-emptive counter-cyclical policy. Macro-prudential policy should aim at cutting short credit booms in order to prevent the risk of future financial crises. So what tools are needed to pursue this goal?

We have already discussed how capital requirements help to ensure the resilience of the financial system. However, capital requirements that vary over time are also proposed as a way to smooth the financial cycle – for example, the Basel III framework introduces the Counter-

[7] See Borio, C. (2009): "Implementing the Macro-prudential Approach to Financial Regulation and Supervision", *Banque de France Financial Stability Review* 13; Shin, H.S. (2011): "Macro-prudential policies beyond Basel III", in "Macro-prudential regulation and policy", *Bank for International Settlements BIS Papers* 60.

[8] See Kiyotaki, N. and J. Moore (1997): "Credit Cycles", *Journal of Political Economy* 105(2): 211–248; Bernanke, B.S., M. Gertler and S. Gilchrist "The financial accelerator in a quantitative business cycle framework", in: J.B. Taylor and M. Woodford (eds.), *Handbook of Macroeconomics*, Elsevier vol.1, chapter 21, 1341–1393.

Cyclical Capital Buffer (CCB) as a key counter-cyclical tool. One may be sceptical about the power of using capital buffers for macro-prudential purposes, given the long lag between the imposition, and this ultimately feeding through into lending behaviour. That makes calibration difficult, and thereby creates a bias towards a too timid approach, also to avoid action based on false alarms.

To be effective, macro-prudential policy has to be deployed aggressively and in a timely manner. Instruments with quantitative restrictions such as Large Exposures limits, Loan to Value ratios, and Debt to Income (DTI) ratios may be well suited to allowing authorities to pursue the necessary bold approach to macro-prudential policy. Where these tools have not yet been provided to macro-prudential authorities, they should be granted. Other possible extensions to the toolkit are loan-to-deposit ratios, or the anti-cyclical variation of mandatory margins and haircuts used in some financial markets. Only time will tell if these newly designed tools will be used adequately to make our financial system safe.

Another major area on which macro-prudential supervision needs to focus is so-called shadow banking. The significant expansion of this sector can present systemic risks that need to be detected, monitored and managed. Similar to the traditional financial intermediation activities of banks, "shadow bank" credit intermediation involves credit exposures, normally through purchased securities, that are of a longer maturity and less liquid in nature than short-term and liquid liabilities. Moreover, some of these entities are leveraged, although leverage differs greatly among them. For instance, the majority of the investment funds that are an important part of this sector are of the open-ended type and do not face a problem of leverage, but can become vulnerable because of the degree of maturity transformation they create. In addition, many of the open-ended funds offered by asset management firms, such as exchange-traded funds (ETFs), in essence provide a promise of daily liquidity that they may not be able to deliver under stressed conditions. These are just some examples of the new task of macro-prudential supervision regarding the transformation of the financial system by the unavoidable expansion of the new market-based credit system, also known as "shadow banking".[9]

[9] See Vítor Constâncio, speech "Beyond traditional banking: a new credit system coming out of the shadows" at the 2nd Frankfurt Conference on Financial Market Policy: Banking Beyond Banks, organised by the SAFE Policy Center at Goethe University, Frankfurt, 17 October 2014.

Challenges ahead – integrating academic research into regulatory implementation

As described above, the regulatory framework on both sides of the Atlantic has become more robust since the beginning of the crisis. These positive changes build upon the current state of academic research. Yet, to ensure financial stability in an ever-changing financial landscape, existing regulatory concepts need to be adapted and new issues addressed. This requires continuous improvements in our understanding of the regulatory mechanisms and of the incentives they shape. The interaction of regulation and academic research will therefore remain vitally important for both sides and, ultimately, for the appropriate development of effective financial policy.

A case in point is the field of macro-prudential policy, where central bankers are currently pioneering in unchartered territories. The academic literature has made enormous steps in developing the framework to assess macro-prudential instruments, but the toolkit is still incomplete. Researchers can help policy makers understand what tools to implement and activate, and into which directions to extend.

Some questions concerning regulation drill more deeply into fundamental issues in our economies. The ability of the financial sector to extract excess rents from its clients has often been seen as one of the drivers for excessive risk-taking and risk correlation. It would benefit consumers and increase the stability of the system if this rent extraction was curtailed. This will involve striking a balance between ensuring sufficient competition to reduce overall rents within the banking sector, setting appropriate incentives to reward useful innovations, and ensuring that incentives for prudent risk-taking remain in place. In addition, as Luigi Guiso illustrates in Chapter 13, risk appetite may vary over time, independently from changes in regulation. The co-operation of academic researchers, policy makers, and regulatory practitioners is well-placed to develop such frameworks.

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EDITORS' PREFACE

November 1, 2014: this is the date on which the European banking union entered into force with its first pillar, the SSM. This step bears two important meanings. First, it epitomises the response of European regulators and policy makers to the wave of financial crises that started in 2007–2008. Second, it represents an irrevocable step towards European integration. By setting a level playing field for all banks in Europe, it is intended to foster fairness and competition, and to eliminate the scope for strategic interaction among uncoordinated national supervisors witnessed so far. This book embarks on an assessment of the current state and future prospects of financial regulation on both sides of the Atlantic. The analysis takes a broad view, encompassing banks as well as households in their saving and borrowing activities.

The volume starts by revisiting the logical steps required to move financial regulation from a micro-prudential to a macro-prudential perspective, the necessity of which has been much emphasised following the 2007 crisis, with a view to limiting the scope for further bank panics. A number of chapters are devoted to dissecting actual experiences and crisis events that occurred in Europe, ranging from various debt and banking crises to the experiences gained by the working of bodies such as the European Systemic Risk Board or the Liikanen Group. These analyses draw lessons and conclusions, but also critiques, through the lenses of academic reasoning.

A number of chapters innovate, by blending an economic and a legal perspective when analysing aspects of financial regulation (like banking competition), while others try to envisage how economists and lawyers can work together to design efficient and fair regulations. The book does not neglect interactions between policies: to this purpose, some authors evaluate the delicate role of lender of last resort to complement financial regulation in achieving financial stability.

In its second part, the book sets a pathway for approaching a gaping hole in the current apparatus of European regulation, namely provisions for investors' protection. Indeed, while the Dodd-Frank Act in its Title IX introduces norms and regulations for investors' protection, Europe still features a quite fragmented and insufficient map for regulation of how investors and borrowers can be protected from inappropriate financial products or uninformed usage thereof.

A crucial aspect of the book is that it offers some comparison between the European experience of the financial crisis and subsequent changes in financial regulation and those of other countries, in particular Anglo-Saxon ones. The European regulatory response to the crisis took longer to be completed than that of the United States, where the Dodd-Frank Act was adopted. A good reason for this delay was that it required a massive effort to harmonise the views of different countries on how to deal with capital requirements and resolution mechanisms. In addition, regulators in Europe also had to deal with the perverse nexus that had developed between sovereign and bank risk. On the other hand, the care taken to develop these measures may strengthen their endurance in the future.

While there are differences between the reforms undertaken in Europe and those envisaged, for instance, in the Dodd-Frank Act, there are also many similarities. A strengthening of the capital and liquidity requirements as well as a shift of focus from micro- to macro-prudential regulations are common aspects of regulation in Europe and in the United States. Other similarities emerge in more specific aspects of the financial reforms. One example for this is the design of bail-in clauses. Both Europe and the United States have chosen to design their resolution mechanisms with bail-in clauses that are based on a single point of entry approach (i.e. the parent holding company of large banking groups is responsible for putting up, up-front, enough capital for all foreign activities and branches). In the case of the United States this serves the purpose of limiting the scope of regulatory arbitrage via activities overseas, while in the case of Europe it serves the purpose of limiting the scope of risk-taking in peripheral and more fragile countries.

The last part of the book deals with regulation intended to protect savers and borrowers from mistakes or unsound practices by financial advisors and marketers of financial products. In contrast to the existence of well-developed frameworks for consumer protection against low-quality products and services and against medical malpractice, a sound and comprehensive framework for investor and borrower protection is yet to be developed and widely applied. These aspects, as the ones relating to bank regulation, have very important legal implications, some of which are discussed throughout this volume.

The process of financial regulation in Europe started, and is proceeding, at a good pace. Important milestones have been set and other steps are on the way. For instance, the new SRM Regulation will be applicable from 2016. This book, co-sponsored by the Policy Center of the Research Center SAFE (on a Sustainable Architecture of Finance in Europe) and by the Center for Financial Studies, is the first to address all aspects encompassed by this evolving experience. By placing itself in the middle of this process, it aims to provide useful suggestions, which could be helpful for policy makers in the design of further steps.

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