

OeNB Macroprudential Policy Conference

Financial stability in 2030: Maintaining effectiveness while reducing regulatory complexity

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Regulatory complexity is becoming a concern and top priority for policymakers and the financial industry, both at the global and European level. The speed of the debate has gained pace very recently as the political pressure to deregulate has increased. In light of this, the Oesterreichische Nationalbank (OeNB) hosted a Macroprudential Policy Conference on May 9, 2019, where policymakers discussed the tradeoff between reducing the complexity of financial regulation and maintaining financial stability. At this one-day conference, high-level representatives from finance, politics and academia shed light on the drivers of complexity and explored ways to address them. In three panel discussions, the speakers drew on national and international experience with macroprudential policy to investigate what the future regulatory framework, one that also includes nonbank financial intermediaries, could and should look like. The main conclusion of the conference was a call for a high-level expert group at the EU level to explore the main sources of regulatory complexity and measures to reduce it. With less distortionary incentives for banks as well as effective macroprudential supervision and reliable resolution frameworks in place, supervisors should be able to put more emphasis on reducing the systemic costs of banks' market exit. Less emphasis could be put on keeping all banks in business and regulatory complexity could be reduced without jeopardizing financial stability.

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This article summarizes the results of the Macroprudential Policy Conference organized by the Oesterreichische Nationalbank (OeNB) in May 2019, and is structured as follows: section 1 introduces the overarching theme of the conference and presents the gist of the opening speech. Section 2 outlines the key takeaways of the three policy discussions and keynote addresses. Section 3 presents what remains to be done and provides options for realigning the incentive structure in financial regulation. Section 4 concludes with some preliminary considerations regarding the work ahead.

1 Conference theme and opening remarks

The costs of the global financial crisis have been high in all major economies and particularly high in the euro area. Improving the framework for financial stability has not only helped strengthen European Economic and Monetary Union (EMU) in recent years but has also brought the issue of regulatory complexity to the fore (Posch et al., 2018). Regulatory reforms implemented after the global financial crisis have made the financial system safer and more resilient, but, at the same time, regulation has reached a high degree of complexity. Policymakers are faced with a tradeoff between reducing the complexity of financial regulation and maintaining financial stability. In his opening speech, *Andreas Ittner*, former Vice Governor of the Oesterreichische Nationalbank, emphasized that in the medium term, financial regulation should be less complex while not increasing systemic

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risk but potentially even reducing it; otherwise the pressure on deregulation will mount. To balance this tradeoff, correcting flawed incentives for banks is one of the most effective contributions to reducing complexity. Solid macroprudential capital buffers, a robust deposit guarantee scheme and good resolution planning will be vital to ensure that the impact of a bank's market exit on the financial system and the real economy is reduced significantly. As a result, regulation could be greatly simplified.

2 Key findings of the panel sessions and keynotes

The three panel discussions revolved around the following questions: (1) What works? Effectiveness of macroprudential measures – national and international experiences, (2) Agnostic on nonbanks? The design for a macroprudential framework, and (3) Flawed incentives in banking regulation? – A long-term vision for financial stability in 2030. A keynote address on “Systemic risk, macro shocks and macroprudential policy” rounded out the conference.

Panel 1 focused on the effectiveness of macroprudential measures based on national and international practices. High-level experts representing the IMF, the Česká národní banka, De Nederlandsche Bank and the Sveriges Riksbank shared their experiences in using macroprudential tools and showed that borrower-based measures (BBMs) are an effective instrument (also in a number of advanced economies, e.g. Australia and Canada). Nevertheless, given the lack of consistent definitions of BBMs, there is a need for further harmonization, particularly in the EU. According to the panelists, a mix of measures including fiscal measures and information campaigns is used to support macroprudential policy. This makes it possible to close important gaps in the policy setup between monetary policy, fiscal policy and microprudential supervision. The panelists stressed that macroprudential supervisors should withstand the temptation to micromanage the banking sector and be aware of the danger of doing so. They also highlighted that the EU's legal framework for macroprudential policy should become less prescriptive as the observed costs of inaction outweigh those of excessive macroprudential measures (including potential ring-fencing). In future, macroprudential supervision needs to be more forward looking so that unwanted practices, such as unsustainable lending standards, do not become entrenched. The speakers on this panel concluded that, to date, macroprudential policy in the EU has worked better in practice than in theory.

After that, the panelists turned to the institutional setup of macroprudential policy. They stressed that, here, the main pillars are independence and close coordination. Macroprudential policy is complementary to monetary policy, especially when coordinated properly. In most EU countries, the macroprudential authority and/or the national designated authority is either the central bank (as is the case in two-thirds of EU countries) or a financial market stability council. Clearly assigning the responsibilities for macroprudential policy is considered to be crucial to avoid a “collective responsibility barrier” to decision making and to reduce inaction bias. The panelists plausibly argued that central banks should have a leading role in macroprudential policymaking. Moreover, the macroprudential authority needs to have full access to any information and data necessary for conducting a comprehensive analysis of systemic risk. Today's focus on banks could weaken the effectiveness of macroprudential policy, with the nonbanking sector possibly posing higher systemic risks in the future. Systemic risk analysis should therefore look at the financial system as a whole and also cover tax incentives, e.g. tax deductibility of mortgage

interest payments. The discussants highlighted that tradeoffs have to be made within the regulatory framework (BCBS, 2013). On the one hand, various backstops of the banking system (such as implicit government guarantees, emergency liquidity assistance and deposit insurance), the tax deductibility of the cost of debt, and bank shareholders' limited liability lead to incentives for increasing leverage. On the other hand, financial regulation aims to limit leverage to counterbalance the negative consequences of flawed incentives. Thus, reducing such incentives is a prerequisite for reducing the complexity of regulation.

Panel 2 dealt with the main systemic risks for nonbank financial intermediaries (NBFIs) and explored how to address those risks. In addition, the discussants examined what a macroprudential framework for the nonbanking sector should look like.

In the keynote address held by an industry representative (from BlackRock), leverage and funding liquidity risk were identified as the main idiosyncratic risks in the nonbank sector. Overall, the financial crisis had led to meaningful new microprudential regulation, also in the nonbanking sector. From an industry perspective, the current regulatory measures suffice to address systemic risks stemming from leverage and funding liquidity risk. Given several amendments to different areas of microprudential regulation, complexity has, however, increased substantially for NBFIs. Macroprudential regulation should not be extended to asset managers as owners, and not funds, hold 75% of the respective assets. Thus, even if asset managers incur significant losses, the negative externalities should largely be small. Since NBFIs are very heterogeneous, regulating subsets of NBFIs further would only induce shifts from one subset to another. Instead, a product- and activity-based approach should be pursued to address risks stemming from different products, clients and capital structures. Nevertheless, financial stability reporting requirements and the availability of granular data are essential for monitoring systemic risks that might be building up across the financial system and for understanding the ecosystem as a whole. It was argued that given the current low levels of expected systemic risk in the nonbanking sector, the financial safety nets for banks should not be extended to NBFIs.

The policymakers from the Financial Stability Board, the European Central Bank and the European Commission represented on the panel disagreed with these views. They highlighted how important it is for regulation to have a systemic risk perspective rather than an idiosyncratic focus. Supervisors should focus on those activities that are material to the system. NBFI assets have almost doubled since the crisis, reaching EUR 23 trillion in 2018. NBFIs have become an increasingly important source of funding for sustainable growth. The panelists stressed that, as a capital markets union (CMU) is being pursued, strengthening the macroprudential framework and broadening it beyond the banking sector would be warranted. To address new and emerging systemic risks, it will be necessary to reassess the EU's institutional architecture and further analyze and develop the toolbox. However, ultimately, the need for new macroprudential tools will depend on whether regulatory frameworks for transparency, microprudential supervision and investor protection will be enough to keep systemic risk at low levels. If NBFIs' role in funding the real economy increases, NBFIs' behavior is likely to be procyclical. This might induce destabilizing externalities for the real economy and call for the introduction of additional macroprudential instruments. In particular, leveraged loans, securitization and exchange-traded funds pose new challenges.

The second *keynote address* revolved around systemic risk, macro shocks and macroprudential policy. From the academic perspective, the expectations for macroprudential supervision are probably too high. Furthermore, the past ten years have introduced the element of routine in macroprudential policymaking. Any attempt to regulate systemic risk as such would be doomed even if the authorities were to do more than tick off boxes.

The keynote speaker presented three closely related arguments: First, understanding current systemic risk in the financial system requires continually evolving analysis. In systemic risk assessment, a great many effects need to be considered in a highly nonlinear system which probably has multiple equilibria/behavior constellations in which there is no transparency about the other participants' policy positions and in which these different positions are continuously changing. Various phenomena of systemic risk are linked via risk correlations that are often hidden and are notoriously difficult to estimate even when they are exogenous. Second, regulation should aim for robustness rather than calibration. Empirical research on banks' experiences in the global financial crisis from 2007 to 2009 showed that equity relative to risk-weighted assets had been a poor predictor of institutions' robustness to the shocks that were hitting them. By contrast, equity relative to total assets was a fairly reliable predictor of bank robustness in the crisis. A higher, but simple leverage ratio instead of a complicated risk-weighted capital ratio would reduce complexity substantially. Third, macroprudential policy necessarily involves an element of discretion and judgment. It might be useful to separate analysis and policy decisions. The results of systemic risk analysis should be presented to councils of monetary policymakers, microprudential supervisors and fiscal policymakers. According to the presented proposal, the analysis would remain holistic and clean, while the respective prudential, monetary and fiscal authorities would be responsible for discretionary decisions, especially if these decisions are coordinated, e.g. in a joint committee of central bankers, supervisors and ministries of finance.

The debate in *panel 3* centered on the overarching theme of the conference, with the panelists discussing the root causes of, and remedies for, flawed incentives in banking regulation and reflecting on a long-term vision for financial stability in 2030. Policymakers from the Bank for International Settlements and the Advisory Scientific Committee (ASC) of the European Systemic Risk Board found that due consideration should be given to complexity when designing policy and that incentives play a key role in this context. There would be an illusion of control as additional supervisory instruments also create incentives to game the system, which might even increase systemic risk. It would be advisable to provide for the flexibility to react quickly to unknown contingencies. Panelists stressed the significance of incentives, not just for bankers, but also for regulators, politicians and investors. Furthermore, they called for a differentiation of complexity along two dimensions, namely good vs. bad and essential vs. accidental complexity. In other words, there may be good reasons for complexity (such as different rules for small local banks and large international and complex banks, or multiple risk measures to avoid arbitrage) and bad ones (e.g. national discretions that make national markets less contestable). Similarly, essential complexity refers to complexity that is unavoidable, while accidental complexity is created by regulation itself. Complex regulation dealing with internal rating models under the internal ratings-based (IRB) approach is an interesting example: allowing banks to use internal models instead of regulatory risk

weights leads to essential complexity of the rules that govern the use of elaborate models and the associated processes. Banks can choose between complex rules (IRB approach) and simple rules (standardized approach). Financial regulators could address complexity by setting limits for behaviors and outcomes (e.g. through bank structural reforms) and by providing adequate incentives for regulated entities (e.g. through higher capital requirements). A proper combination of limits and incentives should minimize accidental complexity and would be an adequate response to the significant essential complexity that exists in the financial system already. Policymakers have identified the following as the main root causes of complexity: the (good and essential) complexity of the global banking system and the complexity of the underlying institutional architecture, which often comprises multiple institutions or agencies. Flawed incentives in the financial system have led to essential but bad complexity. In times of crisis, markets tend to revert to simpler measures and quickly lose confidence in complex measures. To remedy this, it would be necessary to emphasize the credibility of simpler and more conservative approaches built into the regulatory framework. The panelists argued that less complex rules may even deliver better outcomes, but simplicity would not be for free. According to a recent ASC report presented at the conference, regulation should be principle based and flexible in dealing with risks, uncertainties and endogenous responses of agents in an evolving framework (Gai et al., 2019).

One panelist representing the banking industry (Erste Bank Group) stressed that, for banks, legal certainty, predictability and transparency are key. He confirmed that bad and accidental complexity renders bank and regulatory resources inefficient and hinders both banks' senior management and supervisors to adequately oversee the risks of banks. Bad and accidental complexity would also entail incomparable results for analysis and credit ratings. The lack of comparability among banks would, in turn, erode confidence in regulatory rules and the data reported by banks. The bank representative flagged three interrelated main drivers for complexity: First, too little consideration has been given to the interplay between micro- and macroprudential supervision, resolution and deposit insurance. Second, all players within the supervisory landscape act within their own fields of responsibility without taking into account the interlinkages with, and impacts from, the other regimes and vice versa. Third, the absence of an overarching strategy has resulted in piecemeal overregulation or even multiple contradictory layers of regulation. In particular, the macroprudential framework in the EU remains too fragmented, and Pillar 2 measures and yearly stress testing exercises are much too complex and costly. The banking industry would like to do away with complex and time-consuming ex ante model applications. Besides, reviewing model applications and related procedures before introducing an additional output floor could significantly reduce banks' and supervisors' administrative efforts and costs. Furthermore, banks should have the option to use IFRS accounting for all financial statements instead of local GAAP. The Erste Bank Group representative also called for one common supervisor and one common resolution body for the whole EU, including a harmonized insolvency law to ensure that creditors are treated in the same way by 2030 at the latest. A comprehensive review of the existing rules might help simplify the regulatory framework. The following two criteria should be used for such an assessment: First, does a rule contribute to financial stability, and second, does the approach feature risk-based differentiation? Finally, ensuring a level playing field for fintechs

and traditional market players should be a guiding principle for future regulation. The panel discussion showed that there is a tradeoff between calls for flexibility and principle-based regulation on the one hand and legal certainty on the other. Any attempt to make legal provisions more flexible is likely to require increased room for supervisory discretion and would, thus, translate into less certainty.

3 What needs to be done to reduce complexity?

The consensus, in a nutshell, is to address the root causes of complexity rather than its symptoms and to make sure to do it in ways that do not reduce financial stability. Here are the main options put forth at the conference.

First, it is important to challenge implicit government guarantees and tax subsidization of bank debt. The debate on fiscal and liquidity backstops for euro area banks shows that a significant number of banks is still considered to be too big to fail as well as too big to be resolved without recourse to public funds (Regling, 2018). Similarly, activating macroprudential buffers for other systemically important institutions (O-SIIs) can make an important contribution. If well calibrated, such buffers can reduce the likelihood of bank failure and hence the value of the implicit government guarantee. In the case of a bank's failure, the buffers reduce the capital shortfall, consequently facilitating resolution. Complementarily, the systemic risk buffer (SyRB) should aim at addressing systemic vulnerability: banks must be able to withstand the inevitable rise in volatility associated with the market exit of banks. It is also important that insolvency procedures and – in selected cases – the resolution framework are both transparent and rule based in order to stabilize expectations. Such “gone concern” rules are a prerequisite for the risk-sensitive pricing of liabilities in a going concern that are subject to bail-in in case of resolution. The underpricing of liquidity risks, among other things, is a common feature of credit booms; that was particularly true in the buildup to the financial crisis (Goodhart, 2008). To reduce the negative-incentive effects of emergency liquidity assistance (ELA), the facility could be priced fairly ex ante or the provision of ELA could be subject to automatic sanctions, e.g. triggering early intervention (BCBS, 2014). In the medium term, ELA provision could revert to its original purpose: to avoid the negative externalities of asset fire sales by offering liquidity to stable banks rather than the failing bank (cf. Thornton, 1802), which enables the former to buy the assets of the latter while reducing destabilizing price volatility.

Second, the risk-bearing capacity of the financial system could be strengthened such that it can absorb the costs of bank failures. The minimum requirement for own funds and eligible, i.e. loss-absorbing, liabilities (or MREL) would need to be high enough to cut dependence on public backstops. In the same vein, deposit guarantee schemes (DGSs) could be strengthened to ensure credible protection for insured depositors in the event of a bank's market exit, with a view to making sure that systemic risk is not amplified should a bank become insolvent. Either ex ante funds are large enough to require only small ex post contributions or banks should hold additional capital for them to be able to absorb the contingent costs of substantial ex post contributions. Moreover, ex ante credit arrangements should allow the DGS to raise additional funds in a timely manner.

Third, better and common disclosure standards without national deviations could help increase market discipline and strengthen transparency. More reporting data would have to be made available to the public in the EU, similar to U.S. and Swiss practice for smaller banks.

Fourth, the size and complexity of banks could be reduced by promoting alternatives to bank funding for the real economy and by establishing a true capital markets union (CMU). This would reduce the negative externalities of bank failure by further increasing the substitutability of bank loans for the real economy. Consequently, the negative externalities of bank market exits would be lower. The focus of regulation could shift away from avoiding market exits at all costs.

Fifth, to address the potential buildup of excessive leverage in other parts of the financial system and to forestall a future crisis, it might be necessary to expand the macroprudential regulatory framework to the nonbanking sector. The growing shift from bank-based financing to a more market-based financing model – which is mainly traceable to the diversification of funding for the real economy, CMU-related incentives and increased banking regulation – calls for the introduction of new macroprudential tools, e.g. for addressing systemic liquidity risk (Houben et al., 2015) that include margin and haircut requirements for derivatives and securities financing transactions.

Not least, when enacting new Basel standards (e.g. the fundamental review of the trading book) into EU supervisory legislation, limiting proportionality to areas in which application to small, noncomplex institutions appears expedient to enhance financial stability could make an effective contribution to addressing regulatory complexity (Boss et al., 2018). Part of the complexity of EU rules stems from applying rules designed for large international banks to all banks. Future regulatory proposals could consider a separate rulebook for small, noncomplex banks.

4 Conclusions

To effectively reduce regulatory complexity, it will take an EU initiative that tackles this problem in a sustainable way. Complexity per se is unavoidable in a complex world, but regulators need to avoid making rules unnecessarily, i.e. accidentally, complex. Better incentives for banks, effective macroprudential supervision and reliable resolution frameworks should empower supervisors to put more emphasis on reducing the systemic costs of banks' market exit. By extension, less emphasis could then be put on keeping all banks in business, and regulatory complexity could be reduced without jeopardizing financial stability. As a starting point, flawed incentives in financial regulation need to be reduced. In parallel to implementing the final package of Basel III (also known as “Basel III finalization” or “Basel IV”), the European Commission should set up a high-level expert group that, much like this conference, brings together all relevant EU and international stakeholders. Such a group could be modeled on the de Larosière group that had done work after the onset of the financial crisis. The new expert group should be tasked with evaluating the options for reducing complexity while maintaining the same level of stability and effectiveness in the financial system. The first step in this process would have to be a thorough assessment of the costs of complexity for banks and supervisors and of the preferences and reasoning regarding tradeoffs between complexity, risk sensitivity, contingency and financial stability. Work in this regard has already started at the Basel level. At the same time, regulators need to step up regulatory review and assessment of financial regulation (including the aspects of interplay and duplication) at the international level and identify how technology may support and accelerate simplification. The commitment of all key stakeholders will be important to make this initiative a success.

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