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Introductory remarks: Preparing banking regulation for the future

Introduction

Major reforms in banking regulation have been implemented as consequences of financial crises, where each crisis revealed further weaknesses and blind spots of the existing regulatory framework. The history of banking regulation provides vivid examples for this intuition: The Glass-Steagall Act of 1933 was introduced in the aftermath of the Great Depression in order to protect depositors and the real economy from turmoil on securities markets. The G20 and the Financial Stability Forum – today's Financial Stability Board (FSB) – were established in 1999 in the wake of the Asian financial crisis. Basel III, the CRD IV and the CRR were introduced after the financial crisis of 2009.

Progress in banking regulation consists of a gradual learning process. A drawback of such a learning-by-doing approach, however, is that the regulatory framework can become quite complex.

So, what can regulators do to prepare financial regulation for the future? In the remainder of this text, I briefly reflect on some principles that I think could inspire future efforts in banking regulation to contribute to the efficient allocation of financial resources and fulfilling its key macroeconomic functions even if financial imbalances and shocks occur. This means that the banking system should consistently direct funds to those activities that deliver the greatest economic benefits. Under conditions of financial stability, economic agents have confidence in the financial system and good access to financial services, such as payments, lending, deposits and hedging, which also contributes to the effective transmission of monetary policy.

Resilience: equity is king

As an immediate response to the global financial crisis, the G20 and the Basel Committee brought on the way major reforms that made the financial sector more resilient to shocks and promoted sound risk management. The European Union implemented legislation such as the Capital Requirements Regulation (CRR) and the Capital Requirements Directive IV (CRD IV). These reforms resulted in significantly higher levels of capital and liquidity than before the crisis and made individual institutions more resistant to shocks.

In addition to minimum capital requirements, Pillar 2 requirements allow for bank-specific liquidity and capital regulations to address bank-specific risks. In the euro area, the introduction of the Single Supervisory Mechanism (SSM) effectively contributed to the harmonization of standards in the setting of Pillar 2 requirements. This does not only lead to an increased loss absorbing capacity of banks. It also contributes to a level playing field and the further integration of the euro area banking system and, by that, to gains in economic efficiency.

The assessment of the Internal Rating Based (IRB) approach for the calculation of risk-weighted assets (RWAs) is a key priority for the SSM in 2017. Both supervisors and investors have expressed concerns about "RWA tweaking", where banks exploit blind spots of the IRB approach to reduce their RWAs in order to reduce their capital requirements.[1] In this respect, I welcome the ongoing Targeted Review of Internal Models (TRIM) and efforts by the Basel Committee to improve the IRB approach[2] so that banks have to calculate

[1] *Le Leslè and Avramova (2012) and EBA (2013).*
[2] *BCBS (2016).*

risk weights and hold capital buffers, which better reflect the risks on their balance sheet.

The global financial crisis also demonstrated that the stability of an individual financial institution is not sufficient to ensure the stability of the whole financial system. The additional dimension of systemic risk was neglected until it materialized during the financial crisis and many banks held not enough liquidity and equity to withstand this shock. Hence, macroprudential supervision was introduced as a key lesson from the financial crisis. By addressing the systemic risk arising from the interconnectivity and inherent cyclicality of the financial system, macroprudential supervision is an indispensable instrument to maintain financial stability.

Preparing banking regulation for future challenges requires to closely monitor trends in financial services and to assess whether the potentially associated risks are captured in the existing regulatory framework. For example, with the rise of FinTech companies new opportunities can arise for consumers and businesses, but new types of risk might gain in relevance as well. Therefore, the OeNB in cooperation with the FMA closely monitors developments in this area within the European supervisory architecture.

Resolution: bank market exit at acceptable social costs

Although banks have become significantly more resilient, some of them will at times have to exit the market. This is the simple logic of a market economy. In this context, maintaining the stability of the financial system and reducing systemic risk associated with bank resolution constitutes the task of macroprudential supervisors and the bank resolution authority. The insolvency of a large and highly interconnected bank could lead to contagion and expose an otherwise healthy financial sector to severe adverse shocks with possibly severe negative repercussions on the real economy. In the past this "too-big-too-fail" problem led to large bailouts. This implied wealth transfers from the public to bank shareholders and worsened the incentive structure for large banks.

After the financial crisis regulators agreed that they never wanted to be in a position again, where banks were "too-big-too-fail". Therefore, the FSB in 2011 published Key Attributes of Effective Resolution Regimes for Financial Institutions, which provided the foundation of legislation such as the Bank Recovery and Resolution Directive (BRRD).[3] The BRRD requires European Member States to implement bank resolution regimes, which ensure that shareholders and certain creditors will bear the burden of failing banks through bail-ins.[4] Such instruments internalize the potential social costs of bank failure by limiting its negative effects to a clearly defined group of stakeholders in the financial sector, which are compensated for bearing that risk. This helps to avoid spillovers to the real economy and lowers the incentives for moral hazard, which makes the BRRD a welcome contribution to a structurally stable financial system.

[3] *FSB (2011).*
[4] *Deutsche Bundesbank (2014) and Deutsche Bundesbank (2016).*

The BRRD requires European banks to hold a Minimum Requirement for Own Funds and Eligible Liabilities (MREL) eligible for bail-in. According to the Final Report on MREL by the EBA European banks are well advanced in fulfilling the MREL requirement and the additional funding needs were estimated between 1.1% and 2% of total RWAs.[5] I expect well-capitalized banks with sustainable business models to be able to fulfil their MREL requirements in a timely and cost efficient way. However, there are still ongoing discussions about procedural issues concerning MREL, which delay the completion of the European banking union with respect to an effective resolution mechanism in the EU. This requires regulators to think about credible tools for the remainder of the current transition phase such as, for example, higher Pillar 2 requirements or significant increases in the systemic risk buffer.

Proportionality: one size does not fit all

Although the reforms of financial regulation in the aftermath of the financial crisis significantly improved the stability of the financial system, they also increased the complexity of regulation. This is the result (i) of the international commitment to risk-weighted capital requirements and internal models, (ii) of the complexity of bank business models, and (iii) of the tension between international harmonization and the heterogeneous nature of national financial systems.

As already indicated in the introduction, the cohesiveness of the current regulatory framework suffers from the gradual extension of existing regulation. Complex rules for the calculation of RWAs of assets and for the governance of the Internal Rating Based approach, and the opacity of the setting of Pillar 2 requirements lead to efficiency costs, which put a burden on financial markets, the real economy, and supervisory authorities.[6] Hence, reducing the complexity of the regulatory rulebook must be a key objective of future regulation. One way to do this could be to rely on more blunt measures such as a substantially higher leverage ratio at the expense of the risk adequacy of minimum capital requirements. But as long as the global regulatory community remains committed to risk-weighted capital requirements and the Internal Rating Based approach, banks and supervisors will have to cope with a certain complexity of bank regulation.

One way to approach this challenge is to strengthen the principle of proportionality in banking regulation. Complex regulatory rules in the European Union put smaller banks at a competitive disadvantage. Hence, they should be subject to simplified reporting obligations in accordance with their size, degree of connectedness and riskiness. In addition, the CRR should recognize the consistent application of the proportionality principle more systematically. Regulators should identify business models, where a more proportionate treatment could reduce compliance costs without cutbacks to the effectiveness of the supervisory regime. In addition, the rules regarding internal governance should consider a more proportionate approach to ensure appropriate management regimes, remuneration and disclosure.

On an international level, coordination and harmonization of regulatory standards must remain a key objective of future regulatory efforts. This would simplify the simultaneous compliance of internationally active banks with dif-

[5] *EBA (2016).*
[6] *Liedorp et al. (2013) and Véron (2014).*

ferent legal frameworks in different markets, reduce their compliance costs and, by that, support both competition and stability across global financial systems.

Concluding remarks

Overall, I regard the current framework of banking regulation to be fit for the future. In fact, much has been achieved since the global financial crisis. Banks are more resilient to shocks because of higher capital and liquidity requirements as well as better supervision of internal risk models. Macroprudential supervision reduces systemic risk substantially. Once the BRRD and the Single Resolution Mechanism (SRM) are fully operative, they will reduce the "too-big-to-fail"-problem. In combination, these reforms massively reduce the probability and potential costs of financial crisis for society. Further cooperation on international regulatory standards will reduce complexity, support competition and contribute to global welfare gains.

The banking sector and the real economy evolve dynamically. Over the next decades technological progress and changing consumption patterns will eventually affect the kind of financial services needed by households and firms. New developments such as the mushrooming of FinTechs affect various areas of the financial system and might lead to significant changes in the structure of the banking business. Therefore, banking regulatory, supervisors, and central banks need to closely monitor these trends to assess their implications for economic efficiency, financial stability, and for the transmission of monetary policy.

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