ICFR | International Centre for Financial Regulation

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Eurozone bank capital deal means G20 next week must promote risk-taking securities markets – not banks – as engine for global growth

The terms of the Eurozone rescue package, in particular the Greek write-down and bank recapitalisation requirements, imply that the G20 must recognise that the banking system cannot be used in future as the main vehicle for financing global growth. The independent International Centre for Financial Regulation (ICFR) is therefore urging G20 leaders to take steps in Cannes to revive risk capital markets and mobilize the end investor for that purpose. Whether or not there is actual shrinkage in bank assets, there is no doubt that lessening the global economy's dependence on banks for credit provision, let alone expansion, is a priority, as banks rethink their business models resulting from new regulation.

Barbara Ridpath, CEO of the ICFR commented:

"We need to rebalance global finance to reduce systemic risk and bolster growth. The G20 has three main priorities in Cannes. Firstly, it needs to give global underpinning to the EU deal, in order to overcome the short term crisis. Secondly, it needs to fully deliver on implementation of the key regulatory initiatives still underway, such as cross border resolution, so supervisors have the toolkit to address the next financial crisis.

"But thirdly, and most importantly, G20 leaders need to take steps to revive risk capital markets to finance global growth. Apple's initial financing did not come from bank credit. In current conditions, with EU bank capital buffers lifting the core Tier 1 ratio to 9%, the banking system cannot be effectively, or safely, used as the sole or main means of credit expansion.

"Certainly banks will be discouraged by policymakers from shrinking their balance sheets and the ECB, while not being tied to the EFSF, will likely in the interim keep buying the bonds of Greece and Portugal to provide liquidity until the details of the EFSF are settled. Moreover, bank bond issuance may receive government guarantees (for a fee) in order to facilitate wholesale funding markets. But all this does not alter the big picture – banks will be seriously capital constrained and business will need more risk capital in the form of equity and debt to power meaningful economic growth, especially, but not only, in the developed economies.

"Recognising this means all parts of the financial system need to contribute to financing growth – in other words, G20 policymakers need to work out how to incentivise the asset management and insurance industries to invest for the long-term in risk-bearing equity and bonds to finance companies, especially growth companies.

"A major challenge, however, is that well-functioning securities markets need liquidity and market makers; proposed rules make it very expensive for regulated banks to make deep and liquid markets in securities. This implies that non-bank market-makers may again become more important.

“We need to distinguish better between instruments at the heart of the financial crisis and classical debt and equity markets. It’s critical that G20 leaders recognise the role of securities markets in raising finance for companies, and providing long-term investment returns for investors and savers. They also need to make the positive case with the public for well-regulated securities markets, and for greater understanding of the nature of long-term risk transfer. The G20 have got to keep their ‘eye on the prize’ of how good regulation can support growth, and those from the emerging markets at our conference foresee the emerging markets members of the G20 making that case in Cannes, to avoid simply concentrating on the fallout from a North Atlantic financial crisis.”

At its recent annual Regulatory Summit in Berlin (18-19 October), the ICFR brought together about 150 senior participants in global financial regulation, including supervisors, industry participants, academics and professional bodies, on the theme of “what does good regulation look like?”.

Delegates at the conference also discussed the breakdown of trust between financial regulators and those they regulate.

Ridpath continued: “There was a strong feeling that we need to recreate an adult conversation between regulators and the financial industry, with constructive dialogue, getting people out of their bunkers and rebuilding trust.

“Another topic that was covered was the differing views on the role of transparency, with securities regulators seeing maximum transparency as a way to improve good practice, while macroprudential regulators are naturally concerned about the ‘announcement effect’ of their views on market behaviour. Getting the balance between effective macroprudential supervision and governance of that process will be crucial.”

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