



International Centre for
Financial Regulation

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Regulation without Borders - G20 Ideals and National Interests

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Session Bibliographies

**Expected Regulatory Outcomes – Impact on the
Financial System and its Stability**

8 November 2010**15:30 – 17:00****Expected Regulatory Outcomes – Impact on the Financial System and its Stability**

“We will also make regulatory regimes more effective over the economic cycle...” – G20 Washington, November 2008

Much progress has been made on regulatory change since the original G20 declarations in 2008. Debate remains on what both the economic impact of such changes will be, and whether they will really alter the frequency or intensity of financial crises. This session will discuss these issues together with how the financial system will be reshaped by proposed regulatory changes and what are the “unintended consequences” of the new rules?

Session Background and Points for Consideration

The regulatory and legislative response to the financial crisis has focused on changing the manner in which the financial industry carries out its business. The intention of proposed rules on capital requirements, splitting commercial banking from proprietary trading, and mitigating risk from OTC markets, for example, is to rein in some of the risks that exacerbated the last crisis.

The aim of this session is to discuss where different sectors of the industry – banking, insurance and asset management – see their futures, as a result of the intended – and unintended – consequences of new regulation.

How, then, will the different sectors of the industry respond to such rule changes? How will the industry look once the changes are implemented? Will the proposed changes serve to create a more robust financial system, and if not, where will the new weaknesses lie?

Whilst there are many possible areas for discussion on this topic, here are some key areas for consideration:

- What businesses will the different sectors of the financial industry carry out in the future?
 - Will regulatory changes force the sell-side to exit businesses entirely?
 - Will regulatory changes force the buy-side to stop using certain products?
 - Will new requirements force the industry toward homogeneity in the business it can profitably provide?
- Should regulation be directed at legal structures or products?
 - Will imposing regulations on particular legal structures (e.g. banks) push transactions outside of the regulated sphere?
 - Will regulation focused upon particular products serve to put such products out of reach of certain end-users?
- How much will regulatory changes cost to the industry?
 - Is the main cost a monetary one? What else will suffer?
- Will the function of banks, asset managers and insurance firms change?
 - Where will the credit of the future come from?
 - Will there be a change in the businesses conducted by banks, asset managers and insurance firms? Will one sector be better placed to offer business that has, up until now, been offered by another?

- How will the proposed regulatory changes affect the stability of the financial system?
 - As a result of the multi-pronged initiatives targeting all areas of the financial system, how will new regulation offset risk concentration in the financial system?
 - Will the new regulations lead to new financial products which could in turn lead to a new threat to the financial system?
 - Do proposals to break up the traditional and risky operations of banks aid or hamper financial sector resilience?

Bibliography:

The ICFR has prepared a core bibliography on works relating to reform of financial regulation. Many of the works in that bibliography have sections relevant to this topic.

Financial industry as a whole:**Friexas et al. (2005): *Regulating Financial Conglomerates***

- **Link to the publication:** http://siteresources.worldbank.org/INTFR/Resources/Regulating_Financial_Conglomerates.pdf

This paper looks for optimal ways of regulating a financial conglomerate which comprises of a bank and non-bank institution, through analysing risk-taking activities. The incentives that a conglomerate has for risk taking depends upon the level of market discipline it faces – and this is determined by the conglomerate’s liability structure. The paper shows that for a given risk profile, integrated conglomerates have a lower probability of failure than either standalone or decentralised firms. However when risk profiles are endogenously selected, the conglomeration may extend the reach of the deposit insurance safety net – and so incentivise risk taking – and as such, the paper suggests, they should attract higher capital requirements, whereas decentralised conglomerates attract lower capital requirements as a result of holding assets in a socially more efficient place. As such, the paper continues, regulatory arbitrage is “welfare-increasing”¹ – which has significant policy implications.

International Monetary Fund (IMF) (2010): *Redesigning the Contours of the Future Financial System*

- **Link to the publication:** <http://www.imf.org/external/pubs/ft/spn/2010/spn1010.pdf>

This paper “explores the responses of the private and public sector to the crisis and some of the probable outcomes.” According to this study some of the key aspects of the future contours of the financial system are likely to be that: (i) as stricter regulation limits risk taking banks are expected to return to their traditional ways; (ii) greater competitive advantage accruing to the non-banking sector in supplying credit and providing investor services; (iii) extended perimeter of financial regulation to take into account risks in the non-banking sector; (iv) push for more transparency and clarity to make financial systems safer will lead to market infrastructures focusing on investor protection; (v) the global financial system is expected to be smaller, less levered and could be less innovative and dynamic, at least in the near future.

Banking:**Boot et al. (2008): *The Accelerating Integration of Banks and Markets and its Implications for Regulation***

- **Link to the publication:** http://www.accf.nl/uploads/boot-thakor-OUP-Handbookbanking-rev-jan30-2009%20_2_.pdf

This paper looks to use existing literature to analyse the implications of the increasingly intertwined nature of financial institutions and markets, competitive pressures within the sector, and the overriding concern for stability. In discussing the economic role of banking, the paper concludes that the increasing interdependency between banks and markets is at the root of the 2007-2009 crisis; whilst the integration can act to allow individual market participants to become better equipped to manage their risks, reducing the risk of an individual bank failing due to an idiosyncratic shock, there is an increase in the probability that a shock to a

¹ Quotations in all the summaries are from the works summarised

small subset of banks could generate systemic effects throughout the financial market. As such, the paper states, regulators are now in the position of needing to ensure that, in promoting safety and soundness of the banking system, they have oversight of financial markets – even though the participants may be outside of their regulated sphere.

Kay J (2009): *Narrow Banking: The Reform of Banking Regulation*

- **Link to the publication:** <http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf>

This paper sets out the argument for “narrow banking” – that is, a strict separation between retail and investment activities – as focused on the UK. It argues that such a separation is key in ensuring that radical reform that the sector requires is carried out, whilst at the same time ensuring “better value for money” for the tax payer. This view – which is mirrored in the US Volcker rule, for instance – is also gaining ground in the UK, with people such as Lord Turner and Mervyn King being recorded as extolling at least some of the elements of the strategy.

UK HM Treasury:

(2010) *Budget Report, Chapter 3: Reforming Financial Services*

- **Link to the publication:** http://www.hm-treasury.gov.uk/d/budget2010_chapter3.pdf

(2010) *Discussion Paper on Non-Bank Lending*

- **Link to the publication:** http://www.hm-treasury.gov.uk/d/non_bank_lending_discussionpaper.pdf

(2009) *Pre-Budget Report, Chapter 3: Reforming Financial Services*

- **Link to the publication:** http://www.hm-treasury.gov.uk/d/pbr09_chapter3.pdf

(2009) *Pre-Budget Report, Chapter 4: Supporting Business and Growth*

- **Link to the publication:** http://www.hm-treasury.gov.uk/d/pbr09_chapter4.pdf

These documents detail the requirements that the UK Government have placed on banks regarding lending for SMEs and consumers, and the analysis that has been done by the Treasury on non-bank lending channels. A key message to come out of all of these documents is that non-bank lending channels in the UK, whilst of interest to companies, are still more costly than using banks and that more needs to be done to promote alternative means of capital raising. When considered in light of the lending commitments that Lloyds Banking Group and RBS have had to agree to and the creation of a Small Business Credit Adjudicator to review lending decisions by banks in relation to SMEs, it is clear that the UK Government is keen to underscore the primary role of UK banks as that of lenders.

UK HM Treasury Select Committee (2010): *Too Important to Fail - Too Important to Ignore*

- **Link to the publication:**
<http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/261/261i.pdf>

This paper is the summary report of the review done by the UK Treasury Select Committee on the financial crisis, focusing particularly on the size of financial institutions in the UK. In a report that covers many areas, the committee were, as many other policy makers seem to be, keen to promote the narrow banking model (as written about by John Kay), and highlight the importance of a wide debate of structural reform as a means of finding the most appropriate solution for the UK.

Wagner W (2009): *The Homogenization of the Financial System and Financial Crises*

- **Link to the publication:** <http://people.pwf.cam.ac.uk/ww243/div.pdf>

This paper looks at the extension of traditional banking activities into other areas – as a result of increased homogeneity throughout the sector. Despite the diversification gains – including the ability of increased risk sharing amongst the firms – there is a concern that stability fails as a result. This is because the institutions' incentive for taking on risk and supplying liquidity deteriorate. As such, the paper argues, regulation should not provide relief to firms for increased diversification.

Insurance:**Comité Européen des Assurances (CEA) (2010):** *Why Excessive Capital Requirements Harm Consumers, Insurers and the Economy*

- **Link to the publication:**
http://www.cea.eu/uploads/DocumentsLibrary/documents/1268293182_cea-capital-requirements-report.pdf

Increased capital requirements, may adversely affect investors with consequent reduction in new capital investments in the industry. Additionally, European insurers will be at a disadvantage in global markets as Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) advice papers take a more conservative approach to capital requirements than US or Asia. On the same note, qualified employment opportunities and growth of the insurance industry in years to come would see reduction in Europe in favour of the US and Asia. It is reported by CEA that “policyholders, both private households and commercial buyers, would suffer the most from overly prudent capital requirements”. Direct negative impact would also be felt at the macro-economic level (negative impact on GDP growth) as “more conservative capital requirements would restrict the role of the insurance sector not only as a risk-absorber but also as an institutional investor and as a provider of risk and venture capital to finance long-term economic development.” We are yet to see how and to what extent CEA's report, if at all, will be taken into account for the assessment in the final round of Solvency II calibration, especially before the next industry-wide quantitative impact study (QIS 5) takes place. An impact assessment was also undertaken by the European Commission in 2007 to assess the financial effects of Solvency II.

Liedtke P (2010): *The Geneva Reports: Anatomy of the Credit Crisis*

- **Link to the publication:** <http://www.palgrave-journals.com/gpp/journal/v35/n1/pdf/gpp200940a.pdf>

This group of essays focuses on the potential changes that the insurance industry should consider as a result of the credit crisis. Key to these thoughts is the fundamental statement that “insurers are not banks”, something which has been up to date overlooked – and should have profound implications for any future regulation on areas such as capital requirements for the two industries. Similarly, if the insurance industry is to be the reliable bearer of long term risk, then regulatory and legal systems need to be able to facilitate this. The credit crisis did not lay bare the basic business model of the industry – that is to say, insurance risk underwriting. The future for insurers may well hold a return to such core business, pursuing conservative investment strategies.

Speeches:

Bini Smaghi L (2010): *Matching Stability and Performance: The Impact of New Regulations on Financial Intermediary Management*, Delivered in Milan

- **Link to publication:** <http://www.ecb.int/press/key/date/2010/html/sp100929.en.html>

This speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB, covers the topics of Basel III and monetary policy. His speech pivoted around liquidity standards, which he states “have received less attention”. The implementation of those standards will cause banks to change their investment behaviour and may change the structure of some financial market segments, thereby affecting the transmission channels of monetary policy. He covered a list of implications that the proposed liquidity regulation might have on different areas of the financial system.

Cecchetti S (2010): *Strengthening the Financial System: Comparing Costs and Benefits*, Delivered at the Korea-FSB Financial Reform Conference

- **Link to the publication:** <http://www.bis.org/speeches/sp100903.pdf>

In this speech by Stephen Cecchetti, Economic Adviser and Head of Monetary and Economic Department of the BIS, prepared for the Korea-FSB Financial Reform Conference. The speech addresses financial sector vulnerabilities and spillovers. The speech begins by emphasising three points: (i) the best way to prevent instability from spilling from one country to another is to prevent problems from arising in the first place; (ii) to reap the benefits of a globalised economy we have to maintain the momentum towards global financial integration; (iii) given proper implementation of capital and liquidity standards, stronger standards should provide benefits. The speech then delves into the macroeconomic costs of the new regulation referencing the recent FSB and BIS report on the macroeconomic costs of higher capital standards.

Cecchetti S (2010): *Current Efforts to Enhance Global Financial Supervision*, Delivered at the Federal Reserve Bank of San Francisco Asia Banking and Finance Conference

- **Link to the publication:** <http://www.bis.org/speeches/sp100608.pdf?noframes=1>

This is a speech by Stephen Cecchetti the Economic Adviser and Head of Monetary and Economic Department at BIS. The speech starts off with a few observations arising out of the financial crisis in that it has provoked a “rethinking of assumptions about the interaction between the real economy and the financial system. Regulatory and supervisory frameworks are especially overdue for re-evaluation.” One place where a rethink is required is the cost versus benefits of global financial integration. However, the author argues that “we can ensure that the benefits of global financial integration outweigh the costs. Keeping local problems from turning global requires both strengthening and harmonising financial supervision across borders.” But this should not happen without considering the side-effects of stricter regulation especially on lending which has the potential to damage economic recovery.

Haldane A (2009): *Rethinking the Financial Network*, Delivered at the Financial Student Association, Amsterdam

- **Link to the publication:** <http://www.finextra.com/Finextra-downloads/featuredocs/speech386.pdf>

This speech by the Executive Director of financial stability at the Bank of England uses network theory to discuss the way in which the financial system has grown in order to explain the recent crisis. As a result of increasing complexity and homogeneity within the network, it has become both “robust and fragile” – a “complex adaptive system”, comparable to a tropical rainforest. In such systems, “connections serve as a

shock-absorber” up until a crucial tipping point, where these same connections will “serve as shock-amplifiers”. This interconnectedness also appears robust so long as the central points of connection do not become subject to stress or fail. Finally, the more interconnected a system is, the greater number of links there are between one “node” and another; should a node fail in a highly interconnected system, it is likely to affect several others in apparently unrelated systems.

Miles D (2009): *The Future Financial Landscape*, Delivered at Bloomberg

- **Link to the publication:**
<http://www.bankofengland.co.uk/publications/speeches/2009/speech418.pdf>

This speech by the member of the Monetary Policy Committee (MPC) at the Bank of England, discusses what will happen to the financial industry as a result of the crisis. It argues that, without a doubt, the banking sector will become smaller, as banks themselves “become less important as financial intermediaries”. This will happen for several reasons, including increased capital requirements, a lack of sufficiently liquid assets, as well as an understanding of the implications of an implied government support in times of difficulty. He then reviews the impact of a smaller banking sector on non-financial firms and households, as well as at a macroeconomic level and in terms of monetary policy implications. Whilst the adjustment might mean higher costs of debt for the SME and individual in the short term, as well as less saving and less home ownership, a smaller sector might ensure fewer crises, enabling more sustained growth in the long term.

Subbarao D (2009): *Should Banking be Made Boring? – An Indian Perspective*, Delivered at the International Finance and Banking Conference on “Banking - Crisis and Beyond”, Mumbai.

- **Link to the publication:**
<http://www.eSocialSciences.com/data/articles/Document125112009530.7613336.pdf>

This speech by the Governor of the Reserve Bank of India, looks at the various calls made recently to make banks “boring” – that is to say, to split deposit taking from proprietary trading activities – specifically with reference to how that would affect India. It clearly states that to split banks in such a way is not a solution to the issues that raised the crisis or a means of recovery – “...clearly the answer is not to adopt Luddite solutions that take us back decades. The solution is to look ahead to what we need.” What we need, Subbarao argues, is to build on the innovations of the past few years, correcting them for the experiences that we have lived through. According to the speech what the Indian banking model needs to provide is: increased financial inclusion, improved infrastructure financing, better risk management and efficiency improvements – there is a need for a reduction of costs for both depositors and lenders. However, international proposals for higher capital standards, liquidity and leverage ratios, as well as a more cautious approach to risk will serve to raise costs further.

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