BEST FIT FINANCIAL REGULATORY PRACTICES:
AN EU AND UK PERSPECTIVE

SESSION 3

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Best Fit Financial Regulatory Practices: An EU and UK perspective

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What do financial regulators do?

Authorisation
Information
Guidance
Surveillance
Enforcement
Policy
Theory and rationale of financial regulation

Market failure
- Absence of markets
- Information – apples v medical care
- Asymmetric information
- Monopolies and other market distortions
- Externalities – systemic and *macro-prudential* risks
International financial regulation

Regulators trapped in national jurisdictions

Domain of the regulator should be the domain of the market that is regulated

If activities relatively immobile then tendency to over-regulation in the attempt to limit systemic risk

If mobile then regulatory arbitrage results in lowest common denominator regulation, or market segmentation
Global regulatory reform agenda

Global consensus on need for more effective, better coordinated macro- and micro-prudential regulation and supervision

Legal reform necessary to ensure effective macroprudential regulation to monitor and control systemic risks

Regulatory restructuring - International, EU, National

- Global: Financial Stability Board (FSB), Basel III, IOSCO & IMF
- EU: European Systemic Risk Board & European Supervisory Authorities, Banking Union
- UK: 2 new micro-prudential regulators, a macro-prudential regulator & ring-fenced banking
- USA: Dodd-Frank Act – Financial Stability Oversight Council
International regulation

✓ Capital
✓ Liquidity
✓ Leverage
✓ Governance and risk management
✓ Enhancing micro-prudential regulation
✓ Developing macro-prudential regulatory instruments
The quality of capital will improve

**Basel II**

Total requirement 8% of RWA

- **Tier II**
  - Absorbs losses in “gone” concern
  - Limited loss absorption: Hybrid Tier I in going concern
  - Core Tier I: Fully absorbs loss in going concern

- **Tier II**
  - 4%

- **Hybrid Tier I**
  - 2%

- **Core Tier I**
  - 2%

**Basel III**

- **Tier II**
  - Loss absorbent at Point of non-viability

- **Hybrid Tier I**
  - Loss absorbent at point of non-viability

- **Common equity Tier I**
  - Fully absorbs loss in going concern
  - 4.5%

- **Total Tier I** = 6% of which at least 75% must be CET1

- **Total capital** = 8% of which at least 75% must be Tier I

*Excludes capital conservation and countercyclical buffers*
Recovery and resolution plans (‘living wills’)

- Recovery plan
  - Recovery Capital Plan
  - Recovery Liquidity Plan
- Resolution Plan
  - OPTIONS
    1. Liquidation/Deposit pay-off
    2. Deposit transfer
    3. Bridge bank
    4. Bail-in
      a. Stay
      b. Conversion
    5. Bail-out
- Plan to sell businesses/subsidiaries
- Plan to wind down/liquidate trading book
European Union/ Euro Area
EU central banks

ESRB

EU supervisors

Joint Committee

EIOPA EBA ESMA

Macro prudential

Micro prudential
New EU Structure of Financial Supervision

**European Systemic Risk Board (ESRB)**
- Identifies potential financial stability risks (macro-prudential oversight)
- If necessary, recommends action to EU or national authorities

- **Information exchange**
- **Advice and warnings**

- **EBA**
  - European Banking Authority

- **EIOPA**
  - European Insurance & Oc. Pensions Authority

- **ESMA**
  - European Securities & Markets Authority

- **Send Board Members**
- **Decisions in specific cases**

- **National Supervisors**
  - Responsible for day-to-day supervision, cooperating in colleges

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ESRB and macro-prudential regulation

- Designed to control systemic risks, which includes risks from within the financial system (interconnections and contagion between banks) and between banks and other non-regulated entities and shadow banks, and between the system and the real economy.

- 3 principles for macro-prudential policy
  - **Flexibility** in the available policy tools to prevent and mitigate specific risks, and the **discretion** to require additional disclosures and tighten temporarily a diverse range of requirements
  - **Scope to act early and effectively** before the build-up of significant imbalances or unstable interconnections
  - **Efficient ex ante coordination** between states to limit cross-border externalities and unintended effects
UK Financial Services Act 2012
Finance (Banking) Act 2013

Parliament
Parliament sets the legislative framework and holds the Government to account (for the regulatory framework) and holds the regulatory bodies to account (for performance of their functions)

The Chancellor of the Exchequer and the Treasury
The Chancellor is responsible for the regulatory framework and for all decisions involving public funds

UK regulatory system

Bank of England
protecting and enhancing the stability of the financial system of the United Kingdom

FPC
identifying and monitoring systemic risks and taking action to remove or reduce them (including through directions and recommendations to the PRA and FCA)

PRA
prudentially regulating banks, insurers and complex investment firms

FCA
protecting and enhancing confidence in financial services and markets, including by protecting consumers and promoting competition

Source: HM Treasury
Cm 8083, June 2011, p. 8
UK Institutional restructuring

**Bank of England** - protecting and enhancing the stability of the UK financial system, working with other bodies (BoE, PRA, FCA & Treasury), special resolution regime; clearing & settlement; payment system

**Financial Policy Committee (FPC)** – macro-prudential oversight. Identifying and monitoring systemic risks and taking action to remove or reduce them (including through directions and recommendations to the PRA and FCA) and devising macro-prudential tools

**Prudential Regulatory Authority (PRA)** (a ‘subsidiary’ of the Bank) - prudentially regulating banks, insurers and complex investment firms; objective of safety and soundness of individual firms

**Financial Conduct Authority (FCA)** - protecting and enhancing confidence in financial services and markets, including by protecting consumers and promoting competition; can use financial product banning orders; regulates exchange trading and consumer credit

- **Judgement-led supervision (forward-looking); ‘not legalistic, bureaucratic and backward-looking’**
Macroprudential Regulatory Tools

Affect balance sheets of financial institutions

**Capital requirements** - counter-cyclical capital buffers to dampen credit cycle. Restrictions on distributions & remuneration

**Liquidity tools**: Time-varying liquidity buffers, liquid assets, bank funding restrictions/limits, maximum leverage ratios

**Forward-looking loss provisions**: required to set aside provisions against potential future losses on their lending

Affect terms and conditions of transactions

**Loan to income ratios/Loan to value ratios.**

**Collateral requirements** (higher if lending above trend)

**Securities lending limits and margining requirements**

Affect market structures

**Clearing houses; trading venues/capital controls; settlement, central securities depositories**
Other challenges of macro-prudential regulation

Macro-prudential regulation is less amenable to the international environment

– which macro economy? Stress tests?
– home-host and the lender of last resort
– rules based
– closely linked to other aspects of national policy (macro-economic management) and international macroeconomics

Price-based v quantity-based or structural approach to regulation

– Price-based approach essentially accepts the current structure of markets, and seeks to make them “work better”.
– Quantity-based approach seeks to alter both industrial structure and the domain of the market. US Volcker rule, UK bank ring-fencing
Effective regulation & supervision also depend on

Culture
- Shareholder stewardship (sustainable profits and mitigate social costs)
- Firms should address conflicts of interest and consumers’ need for timely, accurate and intelligible information

Focus
- Pro-active oversight of whole financial system (macro-prudential)
- Forward looking assessment of potential risks (not backward looking legalistic rules)
- Rigorous challenge of bank risk models and governance

Philosophy
- Macro-prudential systemic risks and controlling externalities
- Firms should act honestly, fairly and professionally in best interest of customers
- Exercise of supervisory judgement based on discretionary powers
Legislation can influence culture, focus and philosophy

Setting clear objectives

Effectively allocates powers and responsibilities

Establishes appropriate system of accountability of regulatory bodies to the Treasury and Parliament, yet retains independence of judgment
Expanding the Toolkit?

- Since 2008, some financial regulators have begun looking at – and acting on – the links between *systemic* environmental risks and financial stability.

- The redesign of international financial regulation – macro-prudential focus – offers opportunity to link-up different sectors of economic governance:
  - financial inclusion-financial regulation
  - foreign investment/regulation-human rights
  - environment-financial regulation

- However the fragmentation of international financial governance poses obstacles to international coordination/cooperation in banking and environmental/social regulation.

- How to integrate environmental and social risks into financial regulation?
  - International Finance Corporation/Sustainability Banking Network
  - The role of the Basel Committee
State practices outside the Basel Committee in addressing environmental and social risks

China – Green Credit Guidelines
- Promoting bank lending to environmentally sustainable economic activities
- Requiring banks to include in their loan documentation covenants to comply with environmental standards
- Collect data to inform of progress and breach of environmental regulation violations

Brazil
- Using Pillar 2 to require banks to assess exposure to carbon risk
- Guidelines relating to Supervisory Review for how to consider banks’ exposure to environmental and social risks
- Using Pillar 3 to require public disclosure of exposure for market discipline

Peru
- Environmental and social due diligence approach for projects
- Driving analysis and awareness
Summary

− The crisis demonstrates the need for regulators to address macro-prudential risks

− Regulatory toolkit expanding to include macro-prudential tools

− European Union and UK offer a useful approach

− Yet many gaps – and the importance for developing countries to address environmental and social risks
Further readings


