



- Course on BANKING REGULATION
- (R. Maserà, Lesson 6)

Financial regulation, banking activity and credit supply in the EU:

an overview

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References

1 – Introduction

- ↘ As already indicated, notably in Lesson 1, the borders between financial intermediaries and markets are blurred by financial innovation: in particular, operators attempt to game costly regulation.
- ↘ This is the fundamental reason for the need for proportionality in regulation, as stressed in the de Larosière Report (2009).
- ↘ The links are particularly relevant in the relationship between traditional and shadow banking.
- ↘ The US experience is significant, as explained in the papers by Cetorelli recalled in Lesson 1 (Chart 15-23).
- ↘ Banks and shadow banks are closely connected and, notably in the US, banks remain an integral part of the new models of intermediation.
- ↘ Banking, shadow banking, financial markets and derivatives regulations are intertwined.
- ↘ This Lesson focuses on the many interactions and on the implications for banking activity.
- ↘ Banks are directly and indirectly subject to a very large part of financial regulation (see below).

2 – Capital regulation, SMEs and infrastructure financing

- ↘ CRR/CRD IV is now in operation:
 - Strong increase in capital and quality of capital
 - One-size-fits-all approach
 - Stringent liquidity and maturity transformation requirements
 - Extreme complexity
- ↘ Basel IV is de facto already under way.
- ↘ It has been underlined that the new capital regulation affects negatively two principal areas of banks' credit support to the economy:
 - SMEs and Long Term Funding, Infrastructure Financing
- ↘ SMEs continue to encounter severe difficulties in the EU. This aggravated the recession and delays the recovery.

2 – Capital regulation, SMEs and infrastructure financing

↘ The relevance of SMEs in Europe can be summarised by the following Table:

SMEs represent :

- 98% of EU firms
- 70% of EU labor force
- 60% of EU private value added.

SMEs are crucially dependent on bank financing (>80% of external finance*).

Following the enactment of CRR/CRD IV, a capital reduction factor for bank lending to SMEs (SME supporting factor) was introduced to provide relief for this sector of companies. Paradoxically, regulators are considering abolishing this support. On these points see Jacques de Larosière, Lesson 6 and EBA (2016).

3 – The Long-Term Financing of the European Economy

- To cope with the need for long term and SMEs finance, the Commission prepared a Green Paper and proposed an ELTIF (European Long Term Investment Funds) Regulation (approved by Parliament and Council on April 20th, 2015).
- The Green Paper [COM (2013) 150 final] was motivated by the need to restore sustainable growth and investment in Europe.
- As indicated, there is a potential inconsistency between some features of the CRR/CRD IV regulations and the aim to stimulate investment, growth and employment: crucial difficulties lie in SMEs access to finance and in capital charges and maturity transformation charges for infrastructure investment.
- The key proposal of the Commission to attempt to overcome the inconsistency consisted in incentivizing the creation of LT investment funds, open to both professional and retail investors.
- This would have required regulatory intervention in the functional chain in credit intermediation (Lesson 1 – Masera – Chart 18).

3 – The Long-Term Financing of the European Economy

- ↘ More generally, the new emphasis on functional intermediation has been paralleled by a fundamental shift in the assessment and regulatory evaluation of shadow banking [COM(2013) 614]:

«The shadow banking sector should not be seen solely in terms of the risks that it poses; it is also essential to acknowledge the important role that it plays within the financial sector. It constitutes an alternative financing channel that is essential to the real economy, particularly at a time when traditional actors in the banking system are reducing financial support».

- ↘ But, regulatory constraints continue to hinder investment expenditure, as was recently indicated by Jacques de Larosière (Eurofi 2015, see Annex to this lesson).

4 – Shadow banking

↘ Entities, operators and activities outside the regulated banking system.

Operators/Entities which:

- Raise funds with deposit-like characteristics
- Perform maturity and liquidity transformation
- Perform credit and credit risk transfer functions
- Use leverage

Activities comprise:

- Securitisation, securities lending, repo/reverse repo transactions, collateral-based operations

NB: Any undertaking which simultaneously performs deposit-taking and credit activities is qualified as a bank (credit institution) under CRR.

4 – Shadow banking

Operators/Entities include a wide range of vehicles, which fall under different regulatory/supervisory regimes:

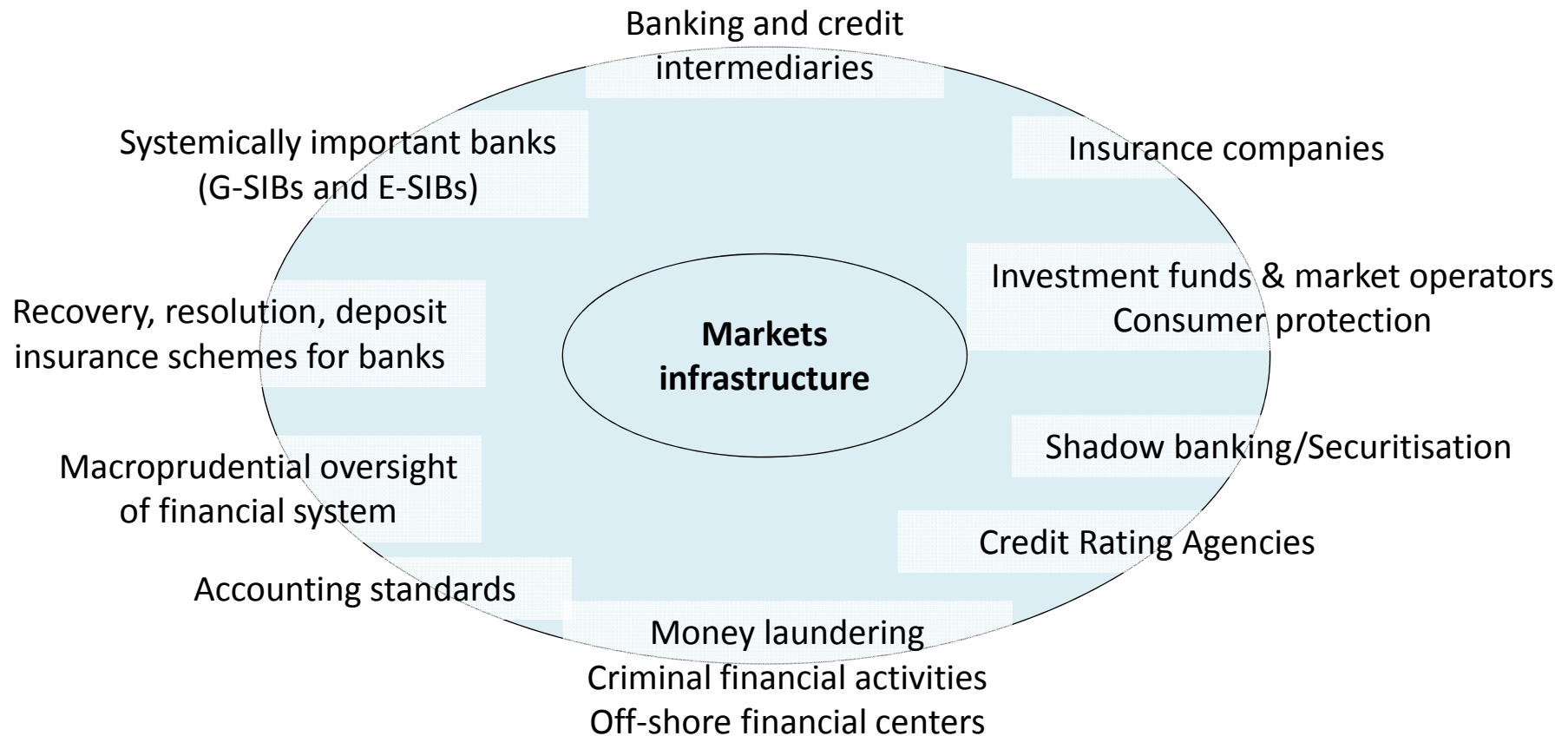
- Securitisation vehicles/conduits (SPVs)
- Money market funds
- Investment funds that provide credit and are leveraged (certain hedge funds and private equity funds)
- Financial entities that provide credit and/or credit guarantees (notably through CDS)
- Insurance/reinsurance undertakings (Solvency II)

NB: There are close interactions between shadow banking and (alternative) investment funds/investment fund managers.

Credit Rating Agencies play a crucial role in shadow banking, notably in securitisation processes

5 – The intertwining of banking and financial regulation in the EU

Chart 1 - Financial sectors/operators



5 – The four pillars of financial regulation in the EU

New rules for more efficient, resilient and transparent financial markets, investments, operators

1. MiFID I and II: regulation of investment services
2. UCITS: regulation of retail investment funds (money market funds and shadow banking activities)
3. AIFMD: regulation of alternative (other than retail) investment funds (fund managers)

EuVECA, EuSEF, ELTIF (venture capital, social entrepreneurship, long-term investment funds)

The harmonised authorisation and supervision procedures for AIFM shall be supplemented with special authorisation procedures for such funds

4. EMIR: regulation of market infrastructure and of derivatives

6 – The intertwining of banking and financial regulation in the EU

Table 1 – The EU banking and financial regulatory framework*

Scope of regulation	References
1. Banking & credit intermediaries	CRR/CRD IV , Banking Union <i>(see Lessons 4 and 5)</i>
2. Insurance companies	Solvency II
3. Investment funds & market operators Consumer protection	Investment funds: overview UCITS MiFID II/ MiFIR MAD II/ MAR EuVECA EuSEF ELTIF AIFMD
4. Shadow banking	AIFMD MiFID II AIF Proposed securitisation regulation

* A click on the references (right-hand side of the table) opens an hypertextual link which provides official sources.

6 – The intertwining of banking and financial regulation in the EU

Table 1 – The EU banking and financial regulatory framework (ctd.)

Scope of regulation	References
5. Credit Rating Agencies	CRAR
6. Money laundering, Criminal financial activities, Off-shore financial centers	DPM LTF FATF
7. Accounting standards	IAS/IFRS standards (IFRS 9/10/11/12/13)
8. Recovery, resolution deposit insurance schemes for banks	BRRD, Directive 2014/49/UE
9. Macroprudential oversight of financial system	ESRB
10. Systemically important banks (G-SIBs and E-SIBs)	BCBS , FSB , EBA
11. Infrastructure	EMIR CSDR MiFID II Derivatives and CC Houses

ACRONYMS

AIF/AIFMD	Alternative Investment Fund/Alternative Investment Fund Managers Directive
BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive
CC	Counterparty clearing
CRAR	Credit Rating Agency Regulation
CRR/CRD IV	Capital Requirements Regulation and Directive
CSDR	Central Securities Depositories Regulation
DPM LTR	Prevention Money Laundering and Terrorist Financing Directive
EBA	European Banking Authority
ELTIF	European Long Term Investment Funds
EMIR	European Market Infrastructure Regulation
ESRB	European Systemic Risk Board
EuSEF	European Social Entrepreneurship Funds
EuVECA	European Venture Capital Funds
FATF	Financial Action Task Force
FSB	Financial Stability Board
IAS/IFRS	International Accounting Standards/International Financial Reporting Standards
MAD/MAR	Market Abuse Directive/Regulation
MiFID/MiFIR	Markets in Financial Instruments Directive/Regulation
UCITS	Undertakings for Collective Investment in Transferable Securities

7 – Concluding remarks

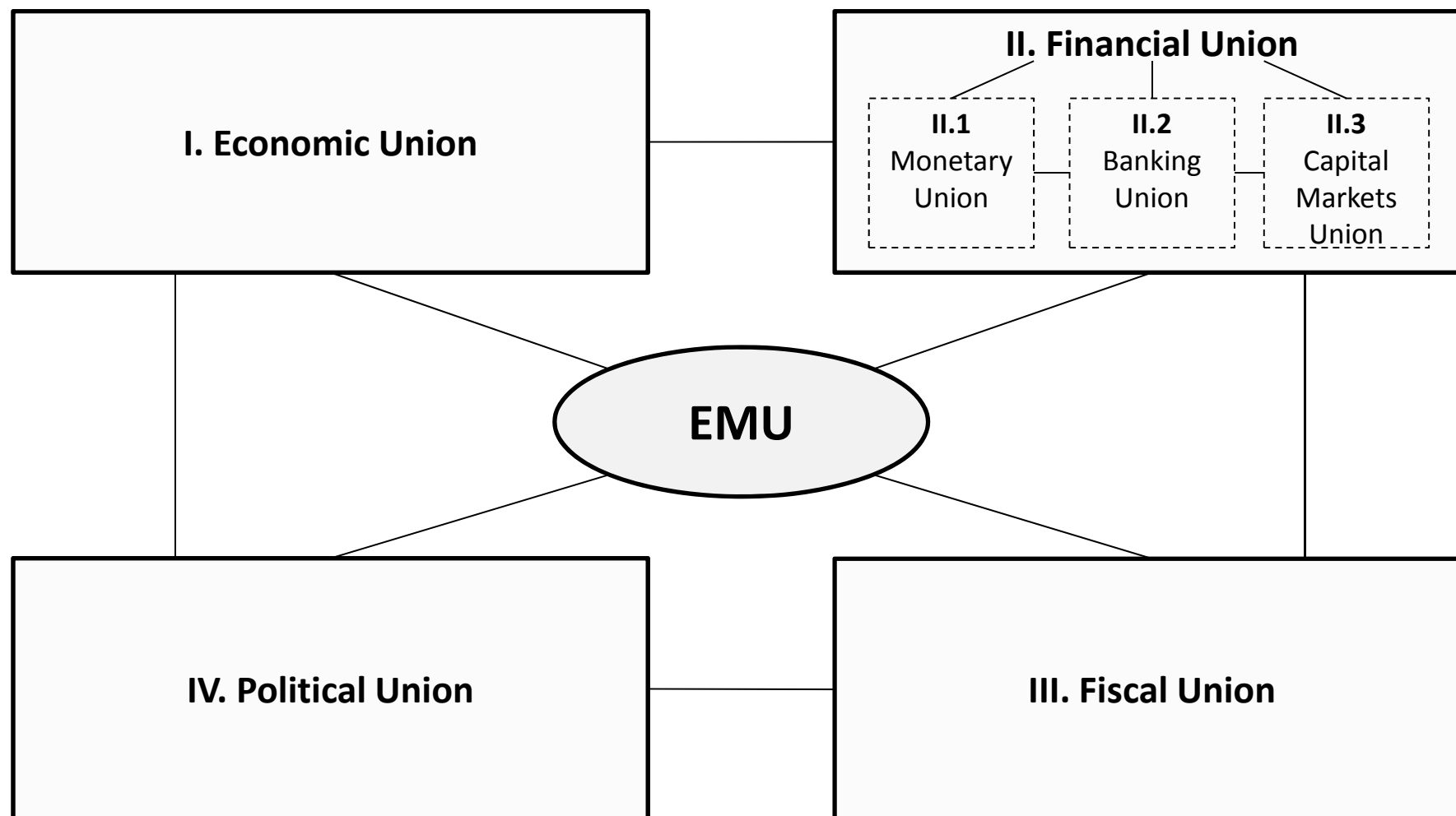
- ↘ This lesson provides an overview of the (rapidly changing and evolving) complex regulation of banking and financial operators/markets in the EU.
- ↘ It offers evidence of the scope and wide range of financial repair.
- ↘ It also highlights that banking firms are directly and indirectly heavily affected by all main areas of re-regulation.
- ↘ There is ample agreement that the European system of financial intermediation should evolve towards a less bank-centric structure and a better balance between markets' and intermediaries' finance.
- ↘ However, the necessary move towards a more effective Capital Markets Union should not imply excessive restrictions on bank activity and lending.
- ↘ Small banks suffer because of the unitary regulatory approach adopted in the EU and the consequent exceedingly high compliance costs.

7 – Concluding remarks

- ↘ Very large banking groups are directly influenced by regulatory constraints in all areas of financial intermediation. They have also to cope with more and more stringent requirements because of their “systemic relevance”.
- ↘ The broad focus of regulatory reform was in the right direction.
- ↘ The Banking Union framework represented a welcome structural change, which will be complemented by the Capital Markets Union, as indicated by the Five Presidents’ Report (2015) and as is graphically indicated in Fig. 1 below.

7 – Concluding remarks

The Five Presidents' Four interdependent Unions to transform the euro area into a "Genuine Economic and Monetary Union"*



*«All four Unions depend on each other. Therefore they must develop in parallel and all euro area Member States must participate in all Unions for the euro area to gradually evolve towards a genuine Economic and Monetary Union ... After many years of crisis, governments and institutions must demonstrate to citizens and markets that euro area will do more than just survive» (Juncker et al., 2015 p. 5).

Source: Masera (2015)

7 – Concluding remarks

- ↘ But the issue is now whether the costs of further complex and onerous regulatory action exceed benefits.
- ↘ It is not a question of long term benefits vs. short term costs. Broader and more relevant issues must be taken into account, as was outlined in the previous lessons and as indicated by Jacques de Larosière (2016).
- ↘ A key point is that capital is costly, notably in condition of distress, contrary to the extreme propositions of Modigliani-Miller.
- ↘ One of the reasons is the fiscal disincentive to equity finance, which should be corrected in the Banking Union.
- ↘ There are also problems of possible fallacies of composition, as originally underlined by Crockett (2000).
- ↘ Equally important is the issue that capital constraints may have large unintended consequences on the effectiveness of monetary and credit policy processes (“excessive collateral damage”).

7 – Concluding remarks

- ↘ More broadly, as underlined by many [notably IMF (2012)¹ and de Larosière (2015 and 2016)], there is the risk of discouraging investment and economic activity, hence long term growth and employment.
- ↘ Additionally, the complexity of the rules and their special impact on the banking sector bring to the fore the problems of proportionality.
- ↘ Finally, contrary to some official views [see for instance Nouy (2016)], the capital and other regulations continue to be modified and made more stringent and complex (as was recalled in Lessons 4 and 5 with reference to the Basel IV framework, which is de facto currently emerging).

[1] «It is essential to avoid a synchronised, large scale, and aggressive trimming of banks' balance sheets that could do serious damage to asset prices, credit supply, and economic activity in Europe and beyond» (Global Financial Stability Review 2012).

7 – Concluding remarks

- ↘ As we have seen regarding Solvency II, the original starting date was postponed for 2 years to January 2016, with a number of key points which still require clarification.
- ↘ In April 2016, the IMF in its half early Global Financial Stability Report indicates, however, that «the contribution of the insurance sector to systemic risk has increased... these findings suggest that a more macroprudential approach to supervision and regulation of insurance companies should be taken».
- ↘ In sum, CRR/CRD IV and Solvency II have barely reached the implementation phase, and their premises are already put into question.
- ↘ Evidently this is not conducive to financial stability, notably in the presence of endogenous risk. The burdens and uncertainty for banking and insurance firms are inevitably multiplied.

7 – Concluding remarks

- ↘ All in all, the viewpoint that the current and perspective regulatory system has led to a stable financial system should be subject to critical scrutiny, as has been clearly explained by de Larosière (see Annex to this Lesson).

Annex

A hope for Europe

Foreword by Jacques de Larosière

[Excerpts from the full foreword]

The European Union has to remove the regulatory constraints which currently hinder investment.

Several disincentives should be addressed.

In Europe, equity is systematically discouraged versus debt. This is true for taxes: taxation provides issuers with an advantage for bond financing over equity since the interests served can be deducted from revenues.

This is also true for financial regulation: for example, Solvency 2 is charging traded equity holdings by an insurance company a marginal rate of 39% of regulatory capital (49% for unlisted equities), while holdings of government debt instruments are charged 0, and BBB ten year corporate bonds are charged 10,5%.

A hope for Europe

Capital charges related to infrastructure investment are a second issue. The creation of an infrastructure asset class recently proposed by the Commission would be an important contribution to the encouragement of investment. Indeed, it acknowledges the lower level of default and the high rate of recovery observed in infrastructure financings in the EU. However, at this stage, capital charges still outweigh the actual risks fostered by investing in an asset class which also suffers from too narrow a definition. An effective breakthrough would require policy makers to take greater account of the consequences for the economy of unnecessarily costly and restrictive prudential regulations.

The regulatory framework of banks and of securitisation, which is encouraged in the CMU to support bank financing provides another matter for concern.

By extracting credits from the balance sheets of banks and allowing their sale on the capital markets, securitisation indeed has the potential to unlock additional sources of funding.

However, regulators, issuers and investors are at present facing certain challenges. Not only might the Simple, Transparent and Standardised (STS) criteria be too prescriptive, narrow and burdensome in some cases, but the financial regulation across assets and financial institutions is insufficiently consistent. This is due in particular to the calibration of the regulatory capital for securitised products in the EU Commission's proposal. Although a more risk-sensitive prudential treatment for securitisations has been introduced, it is based on the principle of non-neutrality, which requires securitised products to post regulatory capital many times higher than the corresponding assets before securitisation, despite the application of a demanding set of STS criteria. At this stage, the capital requirements for a STS securitization are on average still 1.5 to 7 times those required for the (high quality) underlying assets.

A hope for Europe

More generally, the doubling of capital charges for banks in a very short time-span, following the implementation of Basel III, is a major concern in a context where banks will most certainly remain the main providers of credit for SMEs and infrastructure projects. The increase of capital charges has already led banks to reduce lending to non-financial institutions by 2.5% per year from 2011 to 2014.

Moreover, the negative impact on investment of the forthcoming “wave” of regulation (TLAC, MREL, the review of the standard approach for credit, market and operational risks....) should not be underestimated according to several industry leaders... Due to the unprecedented reinforcement of bank capital and liquidity reserves already achieved, this new wave of regulation will probably only marginally increase their resilience, but it will trigger a new wave of deleveraging, The EU review of the possible cumulative impact of financial regulations, considering the impact of regulation on jobs and growth should help to better evaluate such risks.

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