# Benoît Cœuré: The known unknowns of financial regulation

Panel contribution by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the "Rethinking Macroeconomic Policy IV" Conference, Peterson Institute for International Economics, Washington DC, 12 October 2017.

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Financial intermediation is at a crossroads. Arguably, never before in history have banks faced as many significant challenges as they do today. Exceptionally low interest rates and more rigorous post-crisis regulation are weighing on banks' earnings and limiting, at times, their ability to make full use of their balance sheets. Technological change too is threatening incumbents in many ways. Although technological progress has often probed the adaptability and flexibility of financial intermediaries in the past, the speed and scope of current innovations has the potential to change more radically the way financial services are provided to households and firms.

These circumstances naturally also create challenges for regulators, central banks and other policymakers. Ten years after the start of the crisis, it is time to take stock of the impact of the wealth of rules and regulations that have been adopted since then. The Financial Stability Board (FSB) has initiated important work in this direction and is expected to conduct a thorough evaluation of the effects of the G20 financial regulatory reforms.

The paper presented by Andy Haldane and co-authors at this conference is a powerful guide to these evaluations.[1] They conclude, correctly in my view, that the loudly voiced concerns about higher capital requirements leading to lower lending do not seem to have materialised, giving some credit to the claims that capital requirements could have been calibrated at a higher level, even though the combined impact of the total loss absorption capacity and capital requirements remains to be fully understood.[2] Moreover, Haldane and colleagues emphasise the complementary nature of the existing rules and provide empirical evidence in defence of the current "multipolar" (that is, silo-based) regulatory regime. Their work further strengthens the case for any review of the new regulatory framework to err on the side of conservatism, and to withstand pressure from vested interest groups.

In my remarks today I cannot pay justice to all dimensions of Andy's paper but I plan to do two things. First, I will expand on one of the paper's key aspects, namely the potential trade-offs involved in multipolar regulation. And, second, I will touch on one issue that has arguably received less attention so far – the effects of financial regulation on financial structures, in particular at times of fast technological change.

Allow me to explain these two observations in more detail.

## A holistic view on regulatory trade-offs

Over the past ten years, the financial market landscape has changed significantly, both in terms of how risk is being transformed and how it is being pooled and managed. On the intermediation side, the non-bank financial sector has substantially increased its share of the market, from 43% in 2008 to 55% in early 2017. On the risk management side, central clearing houses have emerged following the introduction of mandatory central clearing for standardised over-the-counter (OTC) derivatives – as agreed by the G20 at its Pittsburgh summit in 2009.

These changes have also impacted the nature and scope of financial regulation. For example, the FSB has progressed towards tighter regulation of market-based finance, while CPMI-IOSCO and other international bodies have worked tirelessly since 2012 to establish a regulatory framework that makes central clearing counterparties (CCPs) more resilient and easier to resolve.[3]

A more diverse financial sector, however, also means that regulatory spillovers have become both more likely and more difficult to identify. Let me take the example of CCPs and their interactions with the Basel III leverage ratio. Because clearing services require clients to post collateral, the non-recognition of such collateral in the leverage ratio framework may cause banks to scale back their clearing services, potentially leading to an unhealthy concentration of clearing services.

In other words, there is a risk that the leverage ratio could potentially make our markets more, not less, risky. Some have publicly concluded on this issue, asking the Basel Committee to consider how it could be amended. Others are still reviewing these dynamics, including an FSB-led review of incentives to centrally clear, the Derivatives Assessment Team (DAT).

So, different from regulation for one category of financial players, such as banks, where overlapping rules may be desirable for the reasons explained by Andy and colleagues (the "Tinbergen" and "Brainard" rules applied to financial regulation[4]), regulatory spillovers across financial players may be more a source of concern.

Ideally, quantitative models would support policymakers in characterising and overcoming such trade-offs. This approach, however, faces two high hurdles. The first is that policymakers would need to specify better their loss function, giving clear weights to different, and potentially conflicting, objectives. This is a highly delicate endeavour, however. And, second, even if we could spell out our objective function, the way our quantitative models depict the financial sector lacks the granularity needed to quantify trade-offs in a sufficiently precise manner. So, at the end, I generally agree with Andy's conclusion that we will likely keep shooting in the dark, which means shooting many arrows at the same target.

Ultimately, however, potential adverse spillovers cannot be an excuse to undo what has been achieved since 2009. But when adverse spillovers are obvious, such as in the case of the leverage ratio and central clearing, then we should not hesitate to correct them. This also relates to the undesired consequences of a lack of international cooperation in some pockets of the regulatory domain. Consider again CCP oversight and supervision. Some CCPs are clearly global in nature in view of the range of clearing members they serve or the markets and currencies they clear.

It would therefore be important for all jurisdictions to recognise the need for non-domestic supervisors and central banks to be involved in the oversight of such global CCPs, and in establishing cooperative oversight arrangements where relevant. A supervisory approach that recognises the legitimate interests of non-domestic authorities is vital for tackling the global repercussions of a potential CCP failure, including its recovery and resolution.

The European Commission proposal to amend the EMIR regulation is a case in point. After the UK's decision to leave the EU, and with UK CCPs clearing approximately 90% of the euro-denominated interest rate swaps of euro area banks, there would be clear risks in allowing the current EU arrangements for the supervision of third country CCPs to continue as they are. The proposal provides EU supervisors and the relevant central banks of issue with the tools they need in order to monitor and address risks to the EU's financial system.[5]

So more, not less, international cooperation is crucial to safeguard financial stability. This is a point worth emphasising, particularly at times where a push-back from internationally agreed standards is being discussed openly. In an integrated global economy, financial regulation *has* to rely on internationally agreed standards. Turning back the clock on international financial regulation would revive distrust, create financial fragmentation, and risk regulatory arbitrage and a race to the bottom.

## Effects of financial regulation on financial structures

Let me now turn to another challenge the regulatory community faces in my view, namely the impact – whether desired or not – of regulation on the financial structure of our economies.[6] There are two broad ways in which the regulatory framework is likely to affect the funding mix of firms and households. The first one works through some forms of financing receiving preferential treatment. The second works through protecting incumbents from new competitors. Both channels can be intended or unintended by regulators, and both can ultimately steer an economy towards adopting a financial structure that may look different to the one it would have adopted were market forces left to their own devices.

Despite these allocative effects, regulation is rarely based on first principles. In fact, regulators are caught between a rock and a hard place. Ignoring the effects of regulation on our economies' financial structures is likely to be naïve and delusional – we may not know the speed and scope of the impact, but we can be relatively certain that the effect will not be neutral. At the same time, internalising the effects would make it increasingly difficult to distinguish between prudential and industry objectives. This could create misplaced incentives and can run the risk of failing to fulfil the financial stability mandate.

The good news is that academic research has long been suggesting that even if financial rules were to distort the first-best allocation, the impact on growth and society in general would likely be immaterial.[7] The assertion is that both bank and market-based finance tends to support economic development and living standards in similar ways.[8]

More recent research, however, challenges these findings. Evidence is growing that large banking systems are associated with more systemic risk and lower economic growth, in particular as countries grow richer.[9] Other research suggests that deeper equity markets are more effective in bringing economies closer to the technological frontier.[10]

On balance, therefore, empirical research is increasingly probing the role and importance of banks in developed economies, both in terms of their marginal contribution to growth and as shock absorbers. This is also reflected in the political discussion. The European push towards a capital markets union reflects not only the need for increased cross-border risk-sharing in a currency union, but also the understanding that a more balanced funding mix is better at helping to absorb economic shocks, much in line with Alan Greenspan's "spare tyre" hypothesis.[11] There is also the hope that deeper and better integrated equity markets will support innovation and productivity growth in the European Union.

In addition, we can see that banks are increasingly challenged by technological shifts. New competitors are emerging rapidly and threaten to conquer banks' market shares in some of their core income-generating areas. Crowd funding or peer-to-peer lending, for example, has the potential to affect bank lending services. E-trading or robo-advisory, meanwhile, may crowd banks out of typical investment management or advisory functions. Other areas of competition involve the provision of payment services.

This, of course, does not mean that banks have become redundant or a drag on society. Banks play a key social role of pooling savings and engaging in maturity and risk transformation, and they should continue doing so. But it does raise two important questions: first, are we at a tipping point where the future of banks is challenged? And second, should regulators care? That is, should we protect banks from recent technological shifts and the emergence of new competitors? Should regulators have a preconceived idea of which financial structure is best for society, bearing in mind the trade-off I mentioned before?

So far, the regulatory approach has generally been built on the assumption that opening up market access to new fintech companies will increase social surplus and spur innovation, similar

to what we have seen in other network industries. At the same time, rules are still in place that protect incumbents. For example, fintech firms lack access to the customer transaction data they would need to provide a broader range of financial services – data that banks can use to cross-sell financial services at a price that might be higher than if information-sharing was less restricted.

As an example, the revision of Europe's Payment Services Directive (PSD2), due to be implemented by EU Member States in January 2018, is designed to introduce more competition by requiring banks to share account information. With access to such data, fintech companies could increasingly shake up the banking sector.

In this regulatory landscape, I see two broad scenarios for the future. In the first one, incumbents rise to the challenge. They join forces with start-ups, embrace new technologies, cut costs and gain new sources of revenue. Some of these partnerships are happening as we speak. The outcome under this scenario is generally benign as, first, new technologies are likely to spread more rapidly through banks' existing networks, fostering productivity and growth, and, second, as current prudential regulation is already geared towards banks, thereby preserving financial stability.

However, I can already see one challenge for regulators, which is to let banks reap the economies of scale inherent to digital technologies while not recreating risks of too-big-to-fail. This scenario also crucially assumes that banks are profitable enough to carry out the necessary investments, which in Europe involves reducing costs and addressing forcefully non-performing loans.

In the second scenario banks remain more defensive or, as they would probably like to argue, stifled by regulation and the low interest rate environment. As a result, they increasingly risk failing to meet the changing demands of customers, who, in a digitalised world, expect financial services to be available in real time, anywhere and at any time. This scenario could be a real threat to incumbents, in particular if digital giants, who already have access to large amounts of customer data, were to start targeting parts of the banking value chain, which would limit banks' ability to cross-sell and, ultimately, crowd banks out of a large swathe of financial services.

For society as a whole, would this scenario be worse? Firms and households could benefit from a growing number of financial products and services, lower prices and faster provision. The problem, however, would be that banking services would likely migrate towards the less-regulated parts of the financial system where many fintechs – as non-deposit takers – still operate.[12] This is what Charles Goodhart coined the "boundary problem"[13] of financial regulation. In this case, to avoid regulators once again being "bloodhounds in pursuit of greyhounds"[14], current regulatory loopholes would need to be closed to ensure that financial intermediation outside the banking sector remains safe and sound.

Here is where normative questions might arise, however. The reason is that financial regulation may affect the direction and rate of change at which financial structures evolve. On the one hand, pre-emptively drawing in the reins in the name of financial stability could stifle innovation and prevent fintechs from growing important economies of scale. So it could also put small businesses and households at a disadvantage as they would potentially benefit from faster technological progress, provided it remained safe. On the other hand, allowing risks to accumulate in the unregulated sector could lead to over-exuberance, recreate risks to financial stability, and forego the benefits of past regulatory efforts.

Finding the right balance and identifying the risks in real time is an inherently difficult task, of course. I have no quick or easy solutions to offer. But what we should do, in my view, is to more systematically encourage more research on these important matters.

Central banks are not innocent bystanders in this process. We have to be mindful about the

impact of our own decisions on the future of financial structures. Digital currencies, for example, could undermine commercial banks' monopoly on creating inside money.[15] Negative interest rates, meanwhile, can have adverse consequences for banks' profitability over time despite being extremely effective in complementing other non-conventional monetary policy instruments and helping central banks overcome the zero lower bound constraint. So far, the general equilibrium effects of negative rates have clearly dominated. More generally, it is hard to believe that central banks keeping very large balance sheets for a considerable amount of time will not have an impact on financial intermediation.

Looking forward, low productivity and ageing societies may mean that our economies have gravitated towards a low growth, low interest rate environment that may weigh more permanently on banks' profits and, hence, financial stability. Monetary policy, in turn, may have to resort more often to non-standard measures to meet its price stability mandate. In these circumstances, we need to be mindful of risks to financial stability. A too protracted period of asset purchases, for example, may cause financial imbalances to build up with potentially adverse consequences for price stability.

## Conclusion

Let me close.

Preserving financial stability has become a much more complex and intertwined endeavour than it was 10 or 20 years ago. These interconnections can profoundly change the balance of regulatory trade-offs across major financial market participants. What is more, the financial system is evolving quickly. Intra-temporal trade-offs are made worse by appreciable inter-temporal trade-offs, where policymakers need to keep a watchful eye on the allocative repercussions of their regulatory decisions.

In this environment, there are no quick fixes or easy solutions. But there are two principles on which we should continue to build. The first is cooperation among regulators, both within and across borders. Only by joining forces will we be able to break up remaining silos and identify common solutions to the challenging trade-offs we face. The second is cooperation across policymakers. Conferences like this one bring together policymakers from different fora – monetary policy, fiscal policy and financial stability. They force us to think beyond our usual boundaries and have the potential to raise awareness and sensitivities.

I would therefore like to thank Olivier Blanchard and the Peterson Institute for International Economics wholeheartedly.

Thank you for your attention.

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1 See Aikman, D., A.G. Haldane, M. Hinterschweiger and S. Kapadia (2017), "Rethinking Financial Stability", Bank of England, mimeo, October.

2 See Admati, A. and M. Hellwig (2014), "The Bankers' New Clothes: What's Wrong with Banking and What to Do about It: with a new preface by the authors," Princeton University Press; and Kashkari, N. (2016), "The Minneapolis Plan to End Too Big to Fail", speech at the event "Too Big to Fail at the Economic Club of New York", Economic Club of New York, 16 November.

3 See Cœuré, B. (2017), "Central clearing: Reaping the benefits, controlling the risks", Banque de France, Financial Stability Review, No. 21, April. On market-based finance, see, e.g., the Financial Stability Board's 2017 policy recommendations to address structural vulnerabilities from asset management activities

4 The Tinbergen rule states that different policy objectives call for different policy instruments, while the Brainard rule states that the choice of instruments depends on the type of uncertainty surrounding their effects, see Aikman et al. (2017, op. cit.).

[5] See ECB Opinion on a proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 and Regulation (EU) No 648/2012 with regard to the procedures and authorities involved for the authorisation of central counterparties. In June the ECB Governing Council unanimously adopted a recommendation to amend Article 22 of the Statute of the European System of Central Banks (ESCB) and of the ECB to provide the ECB with a regulatory competence in the area of central clearing.

[6] On financial structures, see Claessens, S. (2016), "Regulation and structural change in financial systems", ECB Forum on Central Banking, June.

[7] For an excellent review of this topic, see Popov, A. (2017), "Evidence on finance and economic growth", in Beck, T. and R. Levine (eds.), *Handbook on Finance and Development*, forthcoming.

[8] This conclusion is supported by both micro and macroeconomic evidence and is robust across a wide set of economies and sectors (see, e.g., Arestis, P., P. Demetriades and K.B. Luintel (2001), "Financial development and economic growth: The role of stock markets", *Journal of Money, Credit, and Banking*, 33, 16–41; Beck, T. and R. Levine (2002), "Industry growth and capital allocation: Does having a market- or bank-based system matter?", *Journal of Financial Economics* 64, 147–180; and Beck, T. and R. Levine (2004), "Stock markets, banks, and growth: Panel evidence", *Journal of Banking and Finance*, 423–442.)

[9] See Langfield, S. and M. Pagano (2016), "Bank bias in Europe: Effects on systemic risk and growth", E*conomic Policy*, 31(85), 51–106; and Demirgüç-Kunt, A., E. Feyen and R. Levine (2013), "The evolving importance of banks and securities markets", World Bank Economic Review, 27(3), 476–490.

[10] See Hsu, P., X. Tian and Y. Xu (2014), "Financial development and innovation: Cross-country evidence", *Journal of Financial Economics*, 112(1), 116–135.

[11] See Greenspan, A. (1999), "Do efficient financial markets mitigate financial crises?", speech before the 1999 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia, 19 October.

[12] Depending on the type of activity they carry out, many fintech companies are already subject to one or more pieces of EU sectoral financial services legislation.

[13] See Goodhart, C. (2008), "The Boundary Problem in Financial Regulation", *National Institute Economic Review*, 206, 48–55.

[14] See Eichengreen, B. (2009), "The financial crisis and global policy reforms", Federal Reserve Bank of San Francisco Asia Economic Policy Conference, 18–20 October, quoted by Aikman, D. et al. (2017, op.cit).

[15] See, e.g., He et al. (2017), "Fintech and Financial Services: Initial Considerations", IMF Staff Discussion Notes No. 17/05.