The impact of the regulatory framework on investment in the European Union

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(based on a joint paper with F. Allen and T. Beck)

The paper

1. Describes the main regulatory reforms/proposals over the past five years
2. Assesses possible impact of these reforms for
   - the structure of the financial system
   - corporate finance decisions and real investment

- Caveat: Any assessment can only be speculative
- Significantly different views among economists
- **Our opinion:** Banking union will have the <u>largest</u> impact and will overshadow the other reforms

Regulatory reforms in the banking sector

1. Capital Requirement Directive IV (CRD IV) – Capital and liquidity requirements, size restrictions and bonus restrictions
2. Vickers and Liikanen report – Activity restrictions
3. Banking union – SSM, resolution and deposit insurance

- Main goals
  - Strengthen banks' resiliency to micro and macro shocks
  - To achieve a genuine Economic and Monetary Union
  - To break the feedback loop between sovereigns and banks
  - Prevent forbearance and regulatory capture
  - Improve effectiveness of supervision – single rule book

  → Reduce taxpayers' burden in the future

Regulatory reforms in the financial sector

1. Short-sale restrictions
2. Trading of OTC contracts on exchanges and centralized clearing
3. Financial transaction tax
4. Solvency II directive and IFRS 9 for insurance companies
5. Investment Fund Management Directive
6. Securitisation disclosure and minimum holdings

- Main goals
  - Avoid price volatility and manipulation in financial markets
  - Increase transparency
  - Provide better incentive among agents to reduce risks

Short-term impact on the financial system

- Disintegration of the common market in banking (due to supervisors’ moral suasion, currency risk, regulation, etc.)
  - Link between sovereigns’ and banks’ fragility
  - Weak monetary policy transmission
  - Need of mutualisation?

- Transition to more stringent capital and liquidity requirements
  - Deleverage, new funds or asset risk-reallocation?

Long-term impact on the financial system

- Difficult to obtain clear-cut implications
- Many regulatory reforms interact with each other
- Overall, no major changes in the structure of the financial system are foreseen
  - No significant shift towards equity market or private equity
  - Banks will still dominate the market for funding
- Structure of banking sector may change somewhat
  - *Example*: Greater capital requirements will have different effects for larger and smaller banks
  - More competition among banks but also higher compliance costs
  - Overall effect is unclear

Regulatory reforms and investment I

- Different conclusions across studies

Table 3 **Summary of Findings of Effects of Regulatory Changes on Lending Rates and GDP**

Study	Rise in bank lending rates, % points	Decline in GDP level %
TCH/Oxford Economics 2013	1.1	-1.0
IMF Elliott et al. 2012	0.3	n/a
IIF 2011	4.7	-2.7
OECD Slovik and Cournède 2011	0.6	-0.6
BIS 2011	0.7	-0.5
MAG 2011	0.2	-0.2
BoE Miles et al. 2011	0.4	-0.3

Source: Based on Summary Table on p. 4 of TCH/Oxford Economics (2013) using midpoints of the moderate scenarios.

- Significant effect for IIF, much less for the others

Regulatory reforms and investment II

Table 4 **The Impact of Major Regulatory Initiatives on the Cost of European Financial Institutions (ordinal scale from +10 to -10)**

	Commercial Banking		Investment Banking	Universal Banking	Life Insurers	Non-bank Financials	Capital Markets
	Large	Small					
Higher capital requirements	10	10	10	10	-2	-8	-10
Higher liquidity requirements	10	10	10	10	-4	-6	-10
Tightening of derivatives regulation	5	2	10	7	-2	-3	-4
Accounting changes	2	2	2	2	1	4	2
Changes to securitisation regulation	2	2	2	2	1	4	3
Enhanced consumer protection regulation	2	1	1	2	1	4	1
Expansion of the regulatory perimeter	-1	-1	-1	-1	0	4	1
Higher taxes or fees facing financial institutions	3	2	3	3	1	3	-1
Changes in crisis management and resolution regimes	4	3	3	3	-1	-1	-2
Tougher regulation of credit rating agencies	1	1	1	1	1	2	2
Structural changes to banks and activity limits	1	0	1	1	0	0	0
Changes in regulation of compensation and governance	1	0	2	2	0	-1	-1

Source: *Elliott et al. (2012), Appendix 1, Table 15A, p. 69.*

Regulatory reforms and investment III

- Overall modest impact on cost of funding, and thus on level of investment and aggregate output

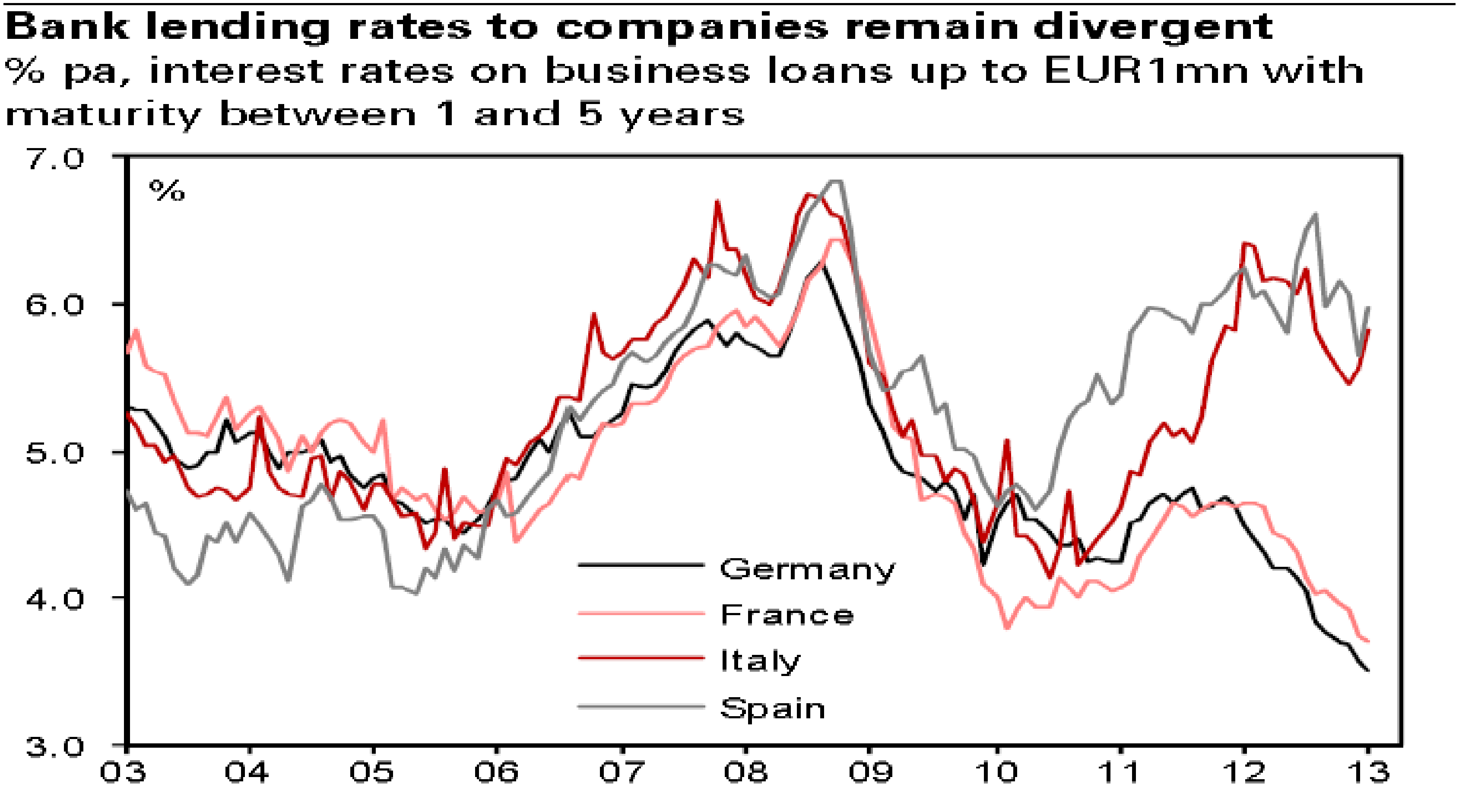
Table 6 **Cumulative Impact of Regulatory Reforms on Lending Rates (in basis points)**

	Europe	Japan	US
Capital	19	13	40
Modigliani-Miller pass-through	-9	-7	-20
Liquidity Coverage Ratio (LCR)	8	1	11
Net Stable Funding Ratio (NSFR)	10	11	16
Overlap of LCR and NSFR actions (half of smallest)	-4	0	-5
Derivatives	1	N.A.	3
Taxes and Fees	6	0	4
Total gross effects	31	18	49
Expense cuts (at 5% for Europe, 10% for US)	8	8	15
Other aggregate adjustments	5	3	5
of which: Planned capital mitigating actions	3	N.A.	2
Total adjustments	13	10	20
Net cost	18	8	28

Source: *Elliott et al. (2012), Table 14, p. 63.*

Banking union and investment I

- Significant fragmentation of firms' cost of funding



Source: GS Global ECS Research.

Banking union and investment II

- It is **crucial** to
  - Avoid re-nationalization of banks’ activities (matching of assets and liabilities within countries)
  - Crowing-out of investment finance by sovereign finance
    - Weak sovereigns, regulatory reasons, etc.
- A “full” (3 pillars) banking union seems necessary
  - Fiscal backstops are necessary for credibility
  - Past versus future
  - Legacy, asset quality review and stress tests

In conclusion

- Difficult to assess the overall impact of regulatory reforms for investment
  - Many reforms interact with each other
  - Assumptions behind models and calibrations may be unrealistic
  - Current studies only estimate moderate effects of regulatory changes
- The resolution of the Eurozone crisis and the creation of the banking union seems the most important regulatory reform going forward
  - To break loop banks/sovereigns
  - To restore flow of funds to the real economy