Industry and Parliament Trust

Resilient Futures: Finance

European Commission

Contents

The Industry and Parliament Trust's Resilient Future's programme provided a forum for discussion to explore different perspectives on both our energy and financial futures. The finance strand of the Resilient Futures programme explored financial regulation inside and outside of the EU, harmonisation of banking regulation, the prospect of a Capital Markets Union, and the concept of Too Big to Fail. The finance strand of IPT's Resilient Futures programme was conducted in collaboration with the European Commission, supported by BBA and the University of Birmingham. Contributions to this report should be considered as the authors' own individual views, and are not necessarily the views of the Industry and Parliament Trust or other persons and organisations who have contributed to the booklet.

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The voice of banking

Introduction

The banking industry has changed a great deal over the past decade, with key measures introduced in both the UK and EU to make the financial sector more stable and secure. Banks have substantially increased the amount of capital they hold, whilst legislative changes will ensure that the taxpayer never again has to bail out a bank.

However since his appointment, Lord Hill, European Commissioner for Financial Stability, Financial Services and Capital Markets Union, has called for the completion of the post-crisis regulatory framework and a renewed focus on banks' contribution to jobs and growth. In light of these comments, the Industry and Parliament Trust's Resilient Futures programme provides a timely opportunity to debate the future of financial regulation.

This booklet points to a number of key regulatory developments such as bank structural reform, recovery and resolution, and banking union. However, as well as examining the resilience of financial institutions and markets following the crisis, the programme looks ahead to explore how the industry can drive economic growth in the UK and EU. A key aspect of this effort will be Capital Markets Union – a central aim of the Commission's investment plan for Europe. As discussed in this booklet, if developed appropriately, CMU has the potential to deliver economic prosperity for European citizens throughout the continent. It is this task which the industry will focus on over the next decade.

Anthony Browne, *CEO, BBA*

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Financial Regulation and Harmonisation In The EU – 11 March 2015

A Resilient Future For the Eurozone: The Greek Effect

The euro area is still grappling with the second wave of the Greek problem but must soon begin to act on the lessons learnt for the future economic governance of the area. Those lessons will be political, economic and financial. They have the potential to have a profound effect on the UK's relationship with a rapidly evolving euro area that is placing enhanced competitiveness at the heart of its economic policy.

The Greek crisis tested the economic governance system of the euro area as never before. But it was Greece 2010 that created it in the first place and Greece 2015 is likely to force a further revision. The Economic and Monetary Union (EMU) edifice was built on the foundation stone of sound public finance – epitomised by the key entry requirement of a budget deficit below 3% of GDP, and a small surplus in normal times. If members compiled (and reported) their data accurately and kept this simple rule, debt ratios would fall over time and they would have pooled minimal sovereignty.

In 2010, Greece stunned the euro area when the new incoming government announced that it had studied `the books' and found the deficit was not 3% of GDP, but 12%. A ferocious crisis was unleashed instantly upon an unsuspecting euro area. The "six pack/two pack/fiscal compact" governance system was progressively cobbled together over the next couple of years to give collective oversight of economic policy. Ironically, the Fifth European Semester concluded at the same European Council meeting in June that it had to deal with the peak of the second wave of the Greek crisis.

The Five President's Report

The same Council meeting should have devoted much attention to the "Five President's Report"[1] on Completing Europe's Economic and Monetary Union. It seems to have been nodded through yet it proposes far-reaching changes in governance over the next decade. In a fifteen-year span from the onset of its crisis, Greece may turn out to have triggered a profound revolution in Europe's political structure. The European Council requested Finance Minsters to "examine the report rapidly" and the Eurogroup swiftly announced its "strong support".

The basic outline of the report should not come as a surprise as the principal author was Commission President Jean-Claude Juncker. He stood for election to the post in 2014 on a manifesto that included "A fourth priority for me will be to continue with the reform of our monetary union, and to do so with Europe's social dimension in mind". He was then overwhelmingly proposed by the European Council (with the dissenting vote of Prime Minister Cameron and Hungary). He proposed his political programme to the new European Parliament and was formally elected by 422 votes to 250. He was therefore given the democratic mandate for action; a year later he launched the programme and has now four years left to get legislation enacted – even if implementation is some years later. It is reasonable to expect at least some significant action, which the box below provides a summary for.

ECOFIN 14 July 2015

The economic and financial crisis has exposed a situation where unsustainable policies in some member states can undermine the development of the euro area as a whole. It has uncovered shortcomings in the EU's economic governance framework. Despite progress made in recent years, EU economic and monetary union (EMU) remains incomplete.

The Five Presidents' Report identifies measures to remedy the situation, to be implemented during three stages:

Stage 1:

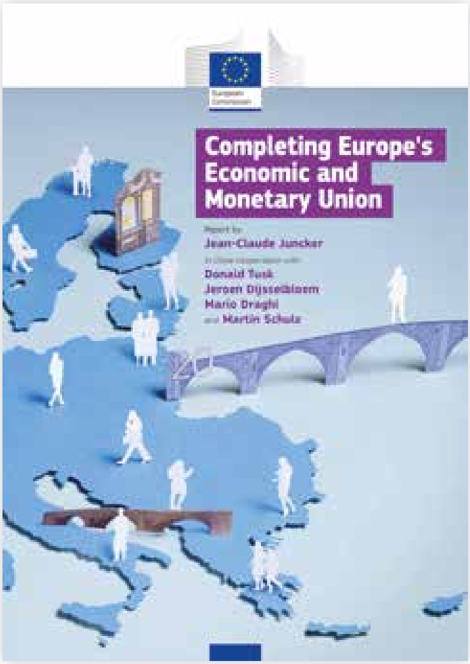
(1 July 2015 to 30 June 2017): Using existing instruments under the current EU treaties to boost competitiveness and structural convergence, achieving responsible fiscal policies, completing financial union and enhancing democratic accountability;

Stage 2:

More far-reaching actions will be launched to make the convergence process more binding, through, for example, commonly agreed benchmarks for convergence that would be of a legal nature, as well as a treasury for the euro area;

Final Stage:

(at the latest by 2025): Once all steps have been taken, a deep and genuine EMU would provide a stable and prosperous place for all citizens of member states that share the single currency. It would be an attractive union for other EU countries to join if they are ready to do so.



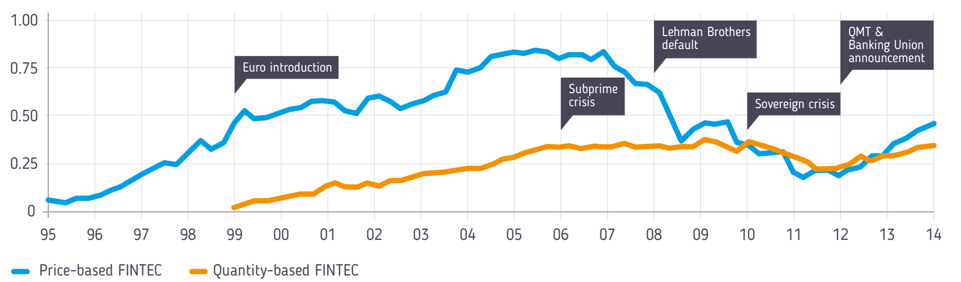
Progress on financial integration: the scoreboard on the way to CMU

Capital Markets Union (CMU) featured heavily in President Juncker's Political Guidelines and that cannot be surprising as the financial crisis struck a huge blow to the progress of financial integration in the euro area – a prime objective of monetary union and the Single Market.

As CMU came onto the radar screen in mid-2014, I coined the following 130-word definition to reflect the breadth of the concept: "It is the smooth flow of capital – at savers' own risk - from them directly to users throughout the European Union, so both stakeholders in society benefit from cutting the cost of intermediaries. The credit standing of users will range from outstanding to just-acceptable, and the maturity of transactions will range from overnight to decades. The financial institutions that intermediate these flows will be regulated by the EU's single rulebook for all participants in financial markets. As savers are taking the investment risk, they must be suitably educated/informed but protected against non-investment risks. CMU would complete financial integration and bolster financial stability, as well as promoting the effective implementation of euro monetary policy in all parts of the eurozone economy. Crucially, it is profoundly de-centralising of economic, and thus political, power."

It is clear from bond yield spreads that integration has recovered substantially – assisted by specific policies to foster it: OMTs and now QE; banking union; and now CMU is getting underway. Even the second Greek shock failed to dent this recovery process. The ECB's financial integration index (FINTEC) gives an encouraging overview of the progress in restoring integration even before CMU becomes operational. Despite the recovery, there is still a mountain to climb in creating a single, borderless capital market – shown starkly in the index below which measures cross-border holdings.

Price and quantity-based FINTECs



Source: ECB

What is FINTEC?

The price-based Financial Integration index is constructed from a selection of price-based indicators that cover the four main market segments: money, bond, equity and banking markets. The quantity-based FINTEC uses intra-euro area cross-border holdings expressed as a percentage of euro area total holdings. Complete integration would be an index of 1.00.

The ECB's "Financial integration in Europe- 2015"[2] and the European Commission's "European Financial Stability and Integration Review – 2015"[3] were published in April – providing a treasure trove of data and analysis on these developments.

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These reports are a useful cross-sectional analysis of progress in a wide variety of financial areas as it is all too easy to exist in a particular industry silo without seeing the linkages to all the other inter-connected fields. The central message of `the crisis' was that the financial world is now highly inter-connected. Moreover, these statistical exercises also show where the gaps are in regulators' understanding that may – in the heat of the crisis – open up the critical regulatory `underlaps' that proved so destructive.

As the UK now contemplates an In/Out referendum on EU membership, City players should be fully aware of the precise policy goals that underpin the seemingly-disparate torrent of policy proposals. As the EU's only genuine pan-European policy operator, the ECB's views are particularly interesting in the light of the extensive powers given to it by banking union. We are well on the way to learning the true meaning of the concept of a single rule book for banking. The goal for Capital Markets Union is no less ambitious.

"In order to achieve these objectives, CMU needs to be pursued with a high level of ambition. In the ECB's view, a genuine CMU would mean achieving full financial integration, which is achieved when all market participants with the same relevant characteristics face a single set of rules; have equal access to a set of financial instruments or services; and are treated equally when they are active in the market. The CMU therefore needs to be underpinned by a single and appropriate legal and regulatory framework that provides a level-playing field, and allows markets to develop. This would ultimately imply more steps towards greater harmonisation of insolvency law, company law and taxation of financial products. It is key that the definition of CMU should be included in the introduction of the upcoming proposal on CMU to clearly delineate the necessary level of ambition and to define the key steps leading to this final objective."

The ECB's report focuses more on historic, statistical analysis whereas the Commission's counterpart can place more attention on the analysis that underpins Capital Markets Union proposals. So the Commission's EFSIR includes comparative studies on SME credit registers; longevity risk and the private sector debt overhang. Commentators focus on the level of public debt so it comes as a surprise that the average public debt/ GDP ratio of just under 100% turns out to be the minimum for private debt – with Luxembourg leading the rankings at 400%.

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However, there is a weakness in such analyses. Naturally, they focus on historic data about the past behaviour of markets rather than looking forward to the ending of the ECB's non-standard monetary policy measures. The initial impact would most likely be manifested in a widening of yield spreads – thus apparently reducing financial integration, so there should be no complacency that the crisis is over. The Five Presidents' Report is designed to allay any fears of such complacency and should encourage investors that the chances of a renewed crisis for the euro area as a whole are modest.

Is this the time for the euro area to look again at my proposal for a Temporary Eurobill Fund[4] (TEF) to provide a post-QE foundation for Capital Markets Union whilst underpinning financial stability in the event of a renewed financial crisis? My detailed plan for a TEF explicitly provides the "concrete mechanism for stronger economic policy coordination, convergence and solidarity" that is being sought by the Five Presidents. It can be initiated as a small step towards integration; be scaled up to become a de facto European Treasury and even provide a modest `fiscal capacity'; but it can be reversed easily – even to extinction within two years.

All in all, the two Greek crises may turn out to have promoted a powerful move to enhanced integration in the euro area to force an improvement in competitiveness. This is a necessary condition for a resilient euro area.

Graham Bishop,
Independent Consultant on EU Integration

Financial Regulation and Harmonisation in the EU

A core goal of the 'EU Project' has been to create a 'single market' in financial services to complement the founding pillars of free capital and labour flows, and the wider single market in goods and services. Towards this end, the new President, Jean-Claude Juncker, of the European Commission launched a new 'Capital Markets Union (CMU)' project in November 2014 in light of the perceived 'credit crunch', or extreme rationing of the supply of credit to micro, small and medium sized enterprises (MSMEs), following the 2007-9 'Global' financial crisis (GFC) and the subsequent 'Eurozone crisis'.

After the GFC, 'micro-prudential' regulation and supervision of banks and other financial institutions has been complemented by new 'macro-prudential' regulation and supervision; which aims to prevent the build-up of 'systemic' financial risks and to help protect taxpayers from having to bail-out banks again. Because they can raise capital more cheaply, 'too big to fail' banks, which are implicitly insured by tax payers, enjoy a competitive advantage over potential competitors, including 'challenger banks'. In response to this, capital adequacy and liquidity requirements have been raised for all banks with supplementary requirements on strategically important financial institutions (SIFIs), most of which are big banks.

Within the Eurozone, a Single Supervisory mechanism (SSM) was implemented in November 2014 with the ECB at its centre assisted by the national central banks of Eurozone member countries. In addition, banks are being encouraged to issue ('contingent convertible or 'co-co') bonds that can convert into equity, or be wiped out, if capital ratios fall below announced thresholds; and the member states are increasingly requiring bank bond holders, as well as shareholders, to bear losses, through 'bail-ins', before taxpayer money is used in any bank bail-out.

Structural reforms in banking have also been proposed in the October 2012 'Liikanen Report', but only the UK is advanced in implementing proposals to 'ring fence' retail oriented commercial banking from more risky financial instrument trading and investment banking activity; as proposed in the September 2011 Independent Commission on Banking (ICB), or Vickers', Report and endorsed by the December 2013/January 2014 Parliamentary Commission on Banking Standards (PCBS) Report. The UK, however, suffers from a lack of diversity in banking due to the high level of concentration in the banking sector, which increased as a result of bank failures and assumptions by stronger banks during the GFC, and the decline in its mutual banking sector as a result of the 'de-mutualisation' of a number of the larger building societies following the 1986 liberalisation. In contrast, Germany has strong savings and co-operative banking sectors and the US, has a strong mutual banking (particularly credit unions) and also community and regional banking sectors.

Diversity in banking helps to increase access to finance for households and MSMEs. In the UK it seems that the big banks have become less interested in lending to micro and small enterprises (MSEs) due to the fixed costs involved in loan origination-it is cheaper to make a smaller number of larger loans. Tougher post crisis capital requirements have arguably added to the costs of MSE lending. Community Development Finance Institutions (CDFIs), 'challenger banks' and internet based 'crowd funders' and 'invoice discounters' are starting to fill the void, but it is a big one. Community banking development needs a further push, as in the US, where the 1977 Community Re-investment Act assures that deposits taken from a neighbourhood are, at least in part, re-invested in it.

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'Fragmentation' in the banking markets was a big issue during the Eurozone Crisis (EC). The 'interbank' markets through which banks lend short term funds to each other to manage their liquidity, had been impaired since the onset of the GFC in August 2007; but after the onset of the EC in May 2010, it became more expensive for MSMEs in 'periphery' countries, such as Spain and Greece, to borrow from banks than in the 'core' countries, particularly Germany. This was inconsistent with the free flow of capital and a common, interest rate setting-focused, monetary policy in the Eurozone. In effect, there was 'capital flight' from the periphery to the core within the Eurozone and the ECB had to intervene by introducing a Long Term Refinancing Operation (LTRO) and ultimately 'Quantitative Easing (QE)', from March 2015, to supplement its supply of cheap short term funding to banks; in order to combat fragmentation in the money and short term credit markets. Fragmentation was aggravated by the 'doom loop' involving banks holding increasing amounts of bonds issued by their national governments; which were becoming more risky given the increasing probability that those governments might be called upon to bail out the big banks head quartered in their countries.[5]

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Since the 'resolution' of the Spanish banking sector difficulties following the announcement of a loan from the European Financial Stability Facility (EFSF) to be taken over by the European Stability Mechanism (ESM), which was to be established in September 2014, and Mario Draghi's promise to 'do what it takes to save the euro' in July 2012[6], the proportion of national government bonds held by domestic banks, particularly in the 'periphery' (including Greece) has continued to increase. Until the re-emergence of the Greek crisis in 2015, this proved beneficial as capital gains for the banks holding the bonds resulted from bond price increases as a result of falling bond yields. Further capital gains are likely for banks holding government bonds unaffected by the crisis as the ECB bids to buy government bonds to achieve its QE targets. The premium on Greek, over German, bond yields (over 9% in March 2015) is a notable outlier, indicating that Greece is in the grip of the doom loop; rather than the virtuous spiral resulting from capital gains on government bond holdings. It is clear that the Greek government cannot afford to bail-out its big banks, which are under pressure from deposit withdrawals and supported by the national central bank within the European central banking system. Furthermore, in March 2015, the ECB barred the Greek banks from buying more Treasury Bills or short term debt issued by the government.

The widening of the yield 'spreads' between Eurozone member state government bonds during the Eurozone crises raises the issue of whether the government bonds should be zero risk weighted for the purpose of setting required 'Basel' capital ratios. If not, then the current risk weights are distortionary and appropriate risk weighting should be introduced to serve as benchmarks for corporate bonds within the proposed CMU.

The grand CMU project smacks of ‘financial engineering’. Its aim appears to mimic the US, where there is much less reliance on bank financing of MSMEs. But the US system evolved over a long period in an environment heavily distorted by post 1930s regulations on bank branching and interest rate setting and separate regulation of mutual banks, as well as the separation of commercial from investment banking in the 1933 Glass-Steagall Act; which was repealed in 1999. In reality, larger companies can issue bonds and equity in the EU and it is a matter of debate how credit constrained MSEs really are in the EU.

Rather than a gap in the supply of loans or credit to MSEs, it seems more likely that there is a gap in equity finance for start-ups and early stage ‘growth’ MSEs. This seems to be a conclusion drawn by the recently established UK government-backed British Business Bank (BBB) as it gears up its activity. For more established firms too, the venture capital (VC) sector in Europe also clearly lags that in the US. Europe-wide alternative investments markets are unlikely to be the answer, but crowd funding might be part of the solution and will need little CMU-style design, since organic growth seems more appropriate, as are local exchanges for alternative investments. Following the BBB initiative to co-finance VC Funds (VCFs), as well as previous initiatives led by the European Investment Bank (EIB), national investment banks, including the KfW in Germany, seem better placed to lead such developments in capital markets for MSEs in the EU.

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There is a concern that regulations designed to make large shareholder-owned banks safer is reducing diversity in banking. This is an issue being addressed by the US Congress in 2015 and some regulatory relaxation for the popular community banks seems likely in a country where they are already underpinned to some extent by a CRA. Perhaps the EU needs its own CRA? There is a potential trade-off between a freer flow of capital that would result from progress with the CMU and local and regional development. There is a risk that the rest of the EU might follow the UK in developing an over-concentrated banking system with an overly strong financial centre and centralised capital market, ‘The City’; which has sucked capital from the regions for international investment from the colonial era to this day. A CMU, whether centred in London or another European capital city, may well be a mixed blessing without a strong CRA and an active regional policy backed by a co-ordinated EU wide system of development banks.

Finally, to reduce the tendency for 'over-leveraging' and encourage greater use of equity financing, the 'tax-deductibility' of interest paid as a 'business expense' should be removed. This could start with banks, which are at the epicentre of leveraging and credit creation, and then extended to business enterprises as equity-like alternative sources of finance become more widely available.

There is a risk that the rest of the EU might follow the UK in developing an over-concentrated banking system with an overly strong financial centre and centralised capital market, 'The City'; which has sucked capital from the regions for international investment from the colonial era to this day.

An international agreement would be required to make this possible. In the face of the likely small business opposition, an interim step to 'level the playing field' between debt and equity, by offering equivalent deductibility on payments on equity, could be considered. The decision to remove deductibility could then be taken, having first removed the bias towards debt over equity, in order to remove the subsidy to leveraging; which encourages over-reliance on external funding, rather than re-investment of retained profits. To further encourage re-investment, capital allowances could be increased and Capital Gains Tax (CGT) could then be aligned with higher level income tax to further remove distortions. Again, EU-wide, and preferably fully international, tax and allowance harmonisation would be optimal.

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Capital Markets Union: Creating Resilience and Preventing Crisis - 24th March 2015

Capital Markets Union

Fundamental to the healthy functioning and growth of a modern economy is the ability to dynamically reallocate resources in response to market conditions. Reallocating resources across space, time and industrial sector is a basic function of the financial system that is enhanced by greater capital mobility. Improving capital mobility within European markets is one of the key goals for the creation of a European capital market union; however, with greater market union comes greater interdependence between those markets. While a certain level interdependence can enhance financial stability, too much interdependence can increase the risk of cascade failures (see e.g. Acemoglu, Ozdaglar, and Tahbaz-Salehi, 2013).

By lowering barriers to accessing capital markets, a Capital Markets Union aims to improve matching of savers and borrowers as well as improved private-sector risk sharing. Anderson, Brooke, Hume, and Kürtösiova (2015) write,

"In Europe, savings are concentrated in the banking sector, the counterpart being that, with the exception of insurance, savings held in other investment vehicles, such as mutual funds and pension funds, are relatively small — at around 50% and 35% of US equivalents, respectively."

An over reliance on banking finance may be linked slow recovery due to reduced lending to innovative enterprises (Allen and Gale, 1999). However, the banking sector is superior when information cost is high.

The potential to increase the diversity of funding sources for entrepreneurial activity is a definite advantage of a Capital Market Union. This diversity includes international markets. The literature regarding gains from international risk sharing are mixed. Lucas (1987) found that the potential welfare gains are small and Artis and Hoffmann (2012) found gains are greater at longer horizons. Key to maximising gains for international risk sharing are twofold: first, standardised regulation and credit reporting standards a crossed all jurisdictions within the credit market union; second, sufficient safeguards are put in place to prevent cascade financial system failures within the union.

Elliott, Golub, and Jackson (2014) found that the risk of cascading financial market failure is dependent on integration, i.e. the level of interdependence, and the ability to diversify away systemic risk. Obviously, integration and capital mobility are positively related. Unfortunately, diversification of systemic risk does not necessarily follow from lowering barriers to accessing capital markets.

Capital Market Union has great potential to benefit the European economy, but it also possesses several down sides. Those down sides can, however, be mitigated by proper regulatory oversight.

Dr. Logan Kelly,

Director, Center for Economic Research, Associate Professor, College of Business and Economics, University of Wisconsin Riverfalls

An over reliance on banking finance may be linked slow recovery due to reduced lending to innovative enterprises (Allen and Gale, 1999). However, the banking sector is superior when information cost is high.

How Resilient is the Financial System Compared to 2008

This article looks at, in a very general way, how resilient the financial system is now compared to 2008, and both of the good and bad factors which might affect this. It was written in the week that the Greek crisis was rumbling towards some sort of conclusion, and a conclusion which might have consequences so huge that worrying about 'regulatory failure' might, by publication day, appear to be rather quaint. If the "past is a foreign country" the future may be too.

At a conference in London in 2014, that went under the heading "Space weather and Financial Systems: Findings and Outlook" which rather neatly makes the point that the range of potential threats to the financial system can come from virtually anywhere. If dust storms on Mars could knock us out then what hope have we got?

But, as sports psychologists are fond of saying, focus on the things you control or can change, so even if one can ignore Pluto, for now, that still leaves a lot to worry over.

As we were reminded in one of the Industry and Parliament Trust meetings, a lot has been done since 2008:

- Increased capital reserves
- New legal procedures and mechanisms to deal with bank insolvency
- New requirements to split banks between 'utility' banks and investment/trading banks
- Controls on the incentives given to bankers and a massive extension of personal accountability on the part of bankers
- New regulatory structures and powers
- Market specific reforms, for example for derivatives, and restrictions on non-open market trading
- Reviews of the roles and methods of sub regulatory bodies such as the credit rating agencies.

There has been no shortage of legislative effort on the part of the authorities here and abroad.

- The EU's financial crisis work programme resulted in over 20 Directives or Regulations to be implemented by Member States.
- The UK has passed five major pieces of banking/financial regulation reform since 2008
- In the US the principal piece of legislation – the Dodd-Frank Act – is so large (well in excess of 1,500 Sections plus subsidiary regulations) that a small industry has grown up to help banks 'navigate' it.

But will it all work? In a sense it is too early to tell. Many of the measures are yet to be enacted in full – we will not know what ring fencing will look like for some time - and dozens of detailed requirements, at all levels, have yet to be finalised and turned into workable rules.

But, there are 'reasons to be cheerful'

- The UK's and the EU's Resolution and Recovery Regimes and the associated 'living will' requirements address what was already known long before the financial crisis: that the standard insolvency procedures do not work for banks. The RRR cannot but make the system more robust and predictable. If a bank or other body fails, the next steps should be more obvious to both the bank and its regulator, without the need for the all night crisis meetings beforehand.
- The crisis highlighted the utility role that banks play in society as holders of money and the payer of bills. Undeniably, society look at banks differently now. The enforced split between these and investment activities (irrespective of where precisely the line falls) and the acknowledgement of payments as a regulatory function may yet change.
- Financial institutions will have more capital to support losses than they routinely held in 2007, indeed much more and of better quality too.

...but not to celebrate – yet!

- We have been here before. The UK financial regulatory system regenerates every ten years or so as the new, improved system is either found out (crises) or becomes unusable (product or technical changes).
- There has been so much legislation and rule making everywhere that no-one can have read it all so we have yet to discover what gaps there are or what irreconcilable demands exist – particularly between jurisdictions.
- The financial community are known for "squeezing between the wallpaper and the wall" when it comes to working the rule book.
- Already new challenges – Bitcoins, crypto currencies, the growth of new populous lending platforms have emerged as issues since the new rules were written. In ten years there will be other issues and developments we won't have thought about now.

We may know a lot more about resilience in a shorter time frame than one might expect. At this time of writing, when the future of Greece has yet to be decided, we may discover whether the contagious link between public finance and state banking systems has truly been contained. Quite whether the new powers given to, in particular the ECB, work in crisis mode and the extent to which other countries, especially Spain and Portugal remain insulated better than they did in 2009 we have yet to discover.

An undeniable fact is that another round of bank failures would not be set against the booming economic background which was the prehistory of the 2008 crisis but against the anaemic and stuttering growth performance of a world which has not shown the sort of rebound one might typically expect post-recession.

Not only that, but any further pressure on public finances would be set against a background of economies which had already taken out most of the easy public finance reductions possible and, like in Greece currently, the impact of any remaining cuts would start to show up not in car show rooms or shopping precincts but in hospitals, with the mortality statistics reported by the Financial Times on 25 June 2015

"It was when young children began arriving at his hospital without rudimentary vaccinations that Anastasios Yfantis realised the dangerous extent to which Greece's welfare state has been gutted".

But even if such comments can be dismissed as alarmist – the inescapable fact is that most easy savings in public budgets are gone and, according to forecasts, the ongoing economic prospects are for permanently lower growth rates and productivity growth in some of the main economic blocs. The IMF's April 2015 World Economic Outlook summarises the gloomy news ahead:

analysis suggests that potential output growth in advanced economies is likely to increase slightly from current rates as some crisis-related effects wear off, but to remain below pre-crisis rates in the medium term. The main reasons are aging populations and the gradual increase in capital growth from current rates as output and investment recover from the crisis. In contrast, in emerging market economies, potential output growth is expected to decline further, owing to aging populations, weaker investment, and lower total factor productivity growth as these economies catch up to the technological frontier.

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With the 'fat' already cut and economies merely chugging along, the world simply may not be able to afford another collapse. Rather like the boxer floored early on in the round, the world economy desperately needs time to clear its head to, first, survive, and later recover.

Looking across the horizon now there are storms in the form of Greece (obviously), in Eastern Europe (possibly) but some of these will require political solutions, factors in financial regulator's control must clearly focus on the financial market activity as it recovers its nerve. So what do we make of headlines such as this one from Global Week in June 2015?

The RMBS machine was up and running this week, with two UK buy-to-let transactions announced and one issuer offering the full stack of a German RMBS — the first in years in the asset class.

Is this a comforting signal that normal activity is back, or oh no, not again? Oh well, according to online social-media sources (denied by NASA) there's a massive asteroid on course for earth in September 2015. Now that is something to worry over.

Timothy Edmonds,

Business & Transport Section,
Company & financial services specialist,
House of Commons Library

The Debate On Capital Markets Union Moves On

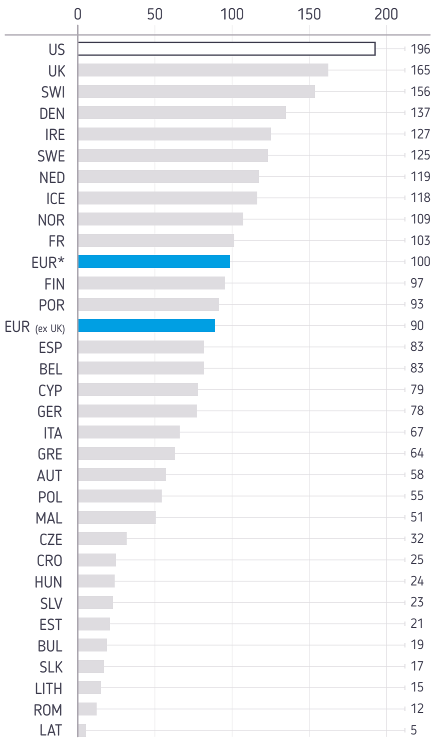
The debate has evolved since the Industry and Parliament Trust's March seminar which considered the theme of Capital Markets Union in Europe. The Green Paper Consultation closed on 13 May and, judging from the fact that over 432 responses have been published (although we understand the European Commission received nearer 700 responses), it is clear that interest in how to deliver Capital Markets Union in Europe is high.[7]

Further to the IPT's meeting, New Financial has prepared some further analysis on the extent of capital markets development and contrasted this with the US.[8] Much of their findings further explore the points discussed at the seminar. Indeed they note that "there is a far wider range in the depth of capital markets between different countries in Europe than there is between Europe and the US. European capital markets are on average just over half as deep as the US, but this disguises a wide spectrum (see Figure 1)".

They also note that "the UK is nearly twice as developed as the rest of Europe, and a small number of large economies also have highly developed capital markets, such as Denmark, Sweden and the Netherlands. Several large economies have relatively undeveloped markets, such as Germany, Italy and Spain. Many countries in central Europe have only nascent capital markets."

Capital Markets Disunion

Relative depth of capital markets in different countries across 23 metrics over the past five years.
Rebased to Europe = 100



*We define Europe as the 28 EU members states + Iceland, Norway and Switzerland

Source: New Financial

Clearly, there is much to be done, however, New Financial also helpfully can put a figure on what is at stake and notes that if "over the past five years, if all the countries with less developed markets had instead had pools of capital that were the same depth as the European average, there would be more than €6 trillion in extra capital from pensions, insurance and retail funds available to invest in the European economy. Capital Markets Union could help unlock trillions of euros in long-term capital."

On 8th June 2015, the European Commission held a public hearing to continue the dialogue further. From across Europe, the message is that the European Commission is on "the right track", targeting "the right areas" and adopting the "right approach" – a step-by-step methodology. Lord Hill can certainly be congratulated for this. It is important to note that there are still those who are sceptical such as Finance Watch who noted they felt there was little benefit in CMU for the retail investor. Indeed, it will be important to tackle head-on some of the concerns they have, which may reflect the wide-held view that the EU and national authorities need to tackle financial literacy to improve confidence among retail investors generally, in order to ensure they can actively participate and benefit from CMU.

Whilst the EU institutions are by their nature more geared towards legislative solutions, delivering CMU will require using the full toolkit at the disposal of the Commission. Helpfully, Lord Hill made very clear at the hearing that he was keen to "give time to recent market-led initiatives from the industry to allow them to bear fruit rather than regulating". This is the case for private placements, for example, where both France and Germany have developed national markets. In the medium term, therefore, the European Commission wishes to study European best practices and will judge whether these can be replicated across the continent. Indeed crowd-funding, peer-to-peer lending and angel investing will be the best candidates for this kind of attention. Furthermore, it appears likely that the European Commission will not shy away from some of the more difficult yet long-term objectives. There seems to be a broad agreement that for CMU to be viable, taxation will have to be examined. Double taxation was mentioned, such as withholding tax procedures, but the main topic throughout the day was the tax bias towards debt versus equity. Many expressed the need to improve insolvency procedures and the length of time it takes and despite the complexity of this task, early indications seem to suggest the European Commission will actually take some steps in this area. As such, pragmatism and a flexible approach to using legislation versus other tools will be key.

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From the BBA perspective, members considered long and hard what measures would be most likely to deliver CMU[9]. The BBA are calling on the European Commission to:

1. Develop a 'pre-Capital Markets Union' focussed on scaling EU cross-border angel investment to support small and high growth firms through incentives and enterprise capital fund action by:

- Developing a pan-European Angel Co-Investment Fund, to address the lack of early stage development capital;
- Removing barriers to cross-border business angel activity by setting a common framework to support cross-border angel syndications; and
- Incentivising 'Corporate Venturing' to address the follow-on funding gap and exit route by promoting and exemplifying best practice across markets.

2. Develop a simple, transparent and standardised securitisation market, including shorter-term ABCP conduits, which converges to internationally agreed standards, basing the capital requirement on a standardised, rather than a ratings-based, RWA calculation. Address prudential weightings in the CRR and Solvency II to further facilitate supply. Ensure support is given to non-bank as well as bank securitisations and to a broad range of asset classes.
3. Consider the appropriate means to incentivise businesses to seek finance through equity investment, by coordinating incentives across the Member States based on existing national best practice. Alongside this, increase the knowledge amongst SMEs of the various forms of finance and encourage business to use the right mix of finance to support growth.
4. Establish an Expert Group to provide the European Commission with recommendations based on principles of best practice in market behaviours currently in existence in Member States. Such areas include crowd-funding, peer-to-peer lending, private pensions, and mentoring. This should include consideration of passport options.
5. Build investment capacity through ensuring liquidity is available to support market-makers and the specialist debt financiers so crucial to the development and evolution of the small cap markets and alternate business funding sources.
6. Implement the European Fund for Strategic Investments and target further solutions with the EIB and national promotional banks to support a greater risk appetite from the institutional investor base into infrastructure, securitised and long-term assets.
7. Review State Aid rules to ensure these remain fit for purpose and supportive to growth and job creation.
8. Undertake a horizontal review of post-crisis legislation to ensure that recently adopted legislation, and proposals still under development, do not have an unintended effect on growth or undermine efforts that would help deliver the Capital Markets Union.

9. Further develop the Better Regulation agenda by implementing a new cost benefit analysis at the end of the co-decision process and before adoption of legislation. At Level 2, BBA has proposed the EU ensure that the European Commission and EU institutions reflect on whether the way in which the implementing measures are shaped might unintentionally effect the objectives of the CMU. We propose that the European Commission REFIT programme be extended to Financial Services in order to reduce excessive administrative burdens.

10. Foster internationally competitive capital markets by:

- Taking a stronger role in the global policy agenda to ensure EU policy aligns with other global players;
- Improving the EU equivalence processes, migrating towards an outcome based approach;
- Encouraging further initiatives to pursue market access through bilateral and multilateral agreements, such as the Trans-Atlantic Trade and Investment Partnership (TTIP); and,
- Support export growth through ensuring the regulatory liquidity and leverage parameters under CRDIV and EMIR support Export Credit Agency activity and the long term needs of business in export project finance.

11. Reconsider the impact of the proposed Financial Transactions Tax, particularly on investors seeking to be active across borders within the EU.

12. Propose the creation of an effective EU-wide corporate rescue mechanism (similar to UK administration or US Chapter 11) to maximise the potential for the sale of a business as a going concern rather than by disposal of its assets.

13. Target smaller and more feasible steps in the longer-term priorities of the CMU, for the benefit of investors, such as by bringing forth a proposal that ensures all insolvency proceedings within the EU are concluded within a specified number of years.

14. Encourage the European Supervisory Authorities (ESAs) to refocus resources on promoting supervisory convergence to ensure consistent application of the Single EU Rulebook. Furthermore, we encourage the ESA to further develop best practice and information sharing amongst relevant national bodies involved in retail investor education.

15. Consider whether it would be appropriate for the ESAs to be given the power to issue ‘no-action letters’ when problems are identified in the implementation process, similar to those issued by the SEC.

Victoria Powell,

Policy Director, Capital Markets, BBA

Quo Vadis? – The road ahead for a Capital Markets Union

Introduction

The "Investment Plan" developed by the European Commission[1] has the potential to be one of the most important and radical changes to how the European Union (EU) will operate in the next twenty five years. The development of the Investment Plan is set against the backdrop of the global financial crisis. Since 2008, the EU has faced a growth crisis where economic output is stagnating, unemployment levels are high and investment is falling. A collective and coordinated effort at a supra-national level has been required to reverse this downward trend and put Europe on the road to economic recovery.

The Investment Plan is designed as a proactive and strategic way to reverse the trend of falling investment, boost job creation and aid economic recovery, without adding additional stress to national budgets or public debt.

The Capital Markets Union ("CMU")[11] is based on the following key principles:

- meeting the long term needs of the economy and generating competitiveness;
- strengthening the production capacity within Europe and its infrastructure especially building a more interconnected single market;
- maximising the benefits of capital markets for the economy, to boost growth and jobs;
- building on the foundations of financial stability, with a single rulebook for financial services which is effectively and consistently enforced;
- ensuring an effective level of consumer and investor protection;
- helping to attract investment from around the world;
- contributing towards enhancing EU competitiveness.

It is this desire for a more interconnected single market upon which the concept of the CMU is based. The CMU is the flagship of the Investment Plan and provides a way in which the financial sector can play a central role in economic revitalisation. It is clear that the CMU has great potential whilst at the same time facing significant challenges. The CMU provides a "once in a generation opportunity" for European policy makers to explore ways of reducing fragmentation in financial markets, diversifying sources of finance and improving access to finance for businesses, particularly small and medium-sized enterprises ("SMEs"). In this way the CMU seeks to:

- create a more diversified financial system, remedying the perceived over reliance on bank lending to develop stronger capital markets;
- realise capital from around the EU which is currently illiquid, providing individual savers and businesses alike with more options for investment and funding at reduced costs; and
- establish a genuine single capital market in the EU where investors are able to invest their funds across borders and where businesses can raise the required funds from a diverse range of sources irrespective of their geographical location.

As the recent crisis in Greece has demonstrated, Europe's financial sector is still rebuilding itself after a sustained period of turbulence. Regulatory reform has created a new framework designed to make the financial system safer and more transparent. However, it has to some extent reduced the capacity to fund growth through both banks and capital markets. As a result, advancing the CMU in this still tumultuous environment will not be straightforward. Provided that the European Commission is clear about the aims and objectives of the CMU and shows a clear commitment to the process, we see no reason why the CMU cannot be implemented successfully. Above all, we envision the CMU as an exciting opportunity to revitalise and re-energise the European financial markets at a time when they need it most.

Building a Capital Markets Union

The CMU seeks to achieve a more integrated, deeper and diversified capital market by breaking down the barriers that had led to market fragmentation and products being underdeveloped or underutilised. In developing other sources of finance, the CMU could have a cushioning effect on the market so as to spread risk more widely, allowing points of market disruption to be less debilitating.

As set out above, the wider aims of the Investment Plan in general and the CMU in particular are to improve access to finance. This is especially true of SMEs where their innovation and high growth rate make financing a priority. Another aspect of the Investment Plan is to boost long-term financing, including infrastructure investment and institutional funding. The plan identifies a number of initiatives aimed at improving the functioning of the wider financial markets. Such initiatives include a review of the Prospectus Directive, changes to securitisation, enhancing private placement markets and improving the availability of credit information. We will discuss each of these initiatives in turn. The scope for change in capital markets is significant with long-lasting ramifications.

Prospectus Directive[3]

The Prospectus Directive governs the form and substance of the prospectus required of issuers when raising funds by means of a public offer of securities or through admitting their securities to a regulated market in the EU. The directive is the cornerstone of EU regulations and is due to be reviewed in January 2016. Whilst it is important to review the Prospectus Directive to see if it is possible to reduce the burdens on issuers, it is also crucial that investors must be protected and must have access to key information prior to making an investment. This is a critical balance that must be struck with respect to the Prospectus Directive.

Similarly, any regulatory change, especially to something as significant as the Prospectus Directive, cannot be considered in isolation. Instead, it must be considered alongside other elements of the regulatory toolkit such as intermediation provisions in the Markets in Financial Instruments Directive ("MiFID"). Also, the extent of disclosure required, which would help in bringing new transactions to the market, needs to be carefully considered. For example, the need to achieve a balance in terms of the information required of SMEs has been a perennial dilemma, which has meant that it has been difficult to balance disclosure and the ease of issuance pursuant to the requirements under the Prospectus Directive exactly right.

The European Commission, as part of its review of the Prospectus Directive, aims to introduce a more streamlined and effective regulatory regime. This would certainly ease the burden on issuers, especially SMEs, and hopefully increase the consistency of approach to sanctions under the Prospectus Directive across EU member states. At the same time it is essential that consumer and investor protection is not weakened as a result of these measures.[13] This may result in insufficient demand for any new financial instruments that are devised, which would in turn weaken the state of the European capital markets. In order to ensure that the market is attractive for both issuers and investors, the needs of both groups must be accounted for.

Developing Securitisation

Securitisation is a process that pools assets owned by an originator and repackages them into a tradable security. That security can then be bought by investors, which diversifies the credit risk by the asset pool or geographic location.

It is clear that a safe, high quality securitisation market is central to the function of the CMU. In particular, the U.S. sub-prime mortgage crisis has resulted in securitisation suffering significant reputational damage. Accordingly, the European securitisation market has shrunk significantly in terms of issuance, from €367 billion in 2009 to €156 billion in 2014 with barely half of that volume placed with investors.[14]

Despite this, securitisation has a key role to play in managing and transferring risk in the financial system, lowering the cost of funding and restoring growth and jobs. The European Central Bank, the Bank of England and the European Banking Authority have sought to revive the EU securitisation market focused on safe, high quality securitisations.[15] The CMU sits very much at the centre of plans Europe-wide for growing and developing the securitisation model.

Private Placement Market

Private placements are where a company makes an offering of securities to an individual or a small group of investors through means other than public markets. They provide financing for mid-market listed and private companies providing a cost effective way for such firms to raise funds.[16] This market acts as a point of diversification for large scale investors.

The Pan European Private Placement Working Group was set up in 2014 to establish a guide to best practice and standardising documentation.[17] It is worth noting that private placements are more developed in France and Germany and the UK can use those EU member states as an example of best working practice. The private placement market is very investment friendly and it is in the interest of market participants to encourage such areas of growth to provide further development.

Credit Information on SMEs

Credit information on SMEs is often very limited and is usually held by banks. Whilst bank lending is obviously a very important option for SMEs, especially on a relationship level, capital markets funding must play an important role, especially in start-up or early stage firms.[18] The methods by which an investor can obtain financial information on a company differ depending on member state. Whilst it is important to ensure that a bank's expertise in lending to SMEs is not lost, there is no reason why the investor base for SMEs cannot be widened to provide more attractive finance options. The European Commission's proposals to develop a minimum set of standards regarding the availability of credit information would enable investors to compare and assess SMEs for investment. This would provide a benchmark for companies to aim for and seek to harmonise the standard of credit information across the EU.

It is this desire for a more interconnected single market upon which the concept of the CMU is based. The CMU is the flagship of the Investment Plan and provides a way in which the financial sector can play a central role in economic revitalisation.

High Yield

The CMU presents a noteworthy opportunity for the high-yield bond market in particular. At present, once adjusted for GDP, the European high-yield market is one-third of the size of the U.S. high-yield market.[19] The consolidation and coordination of the CMU has the potential to kick-start capital markets activity in parts of Europe that are not traditionally associated with this type of funding.

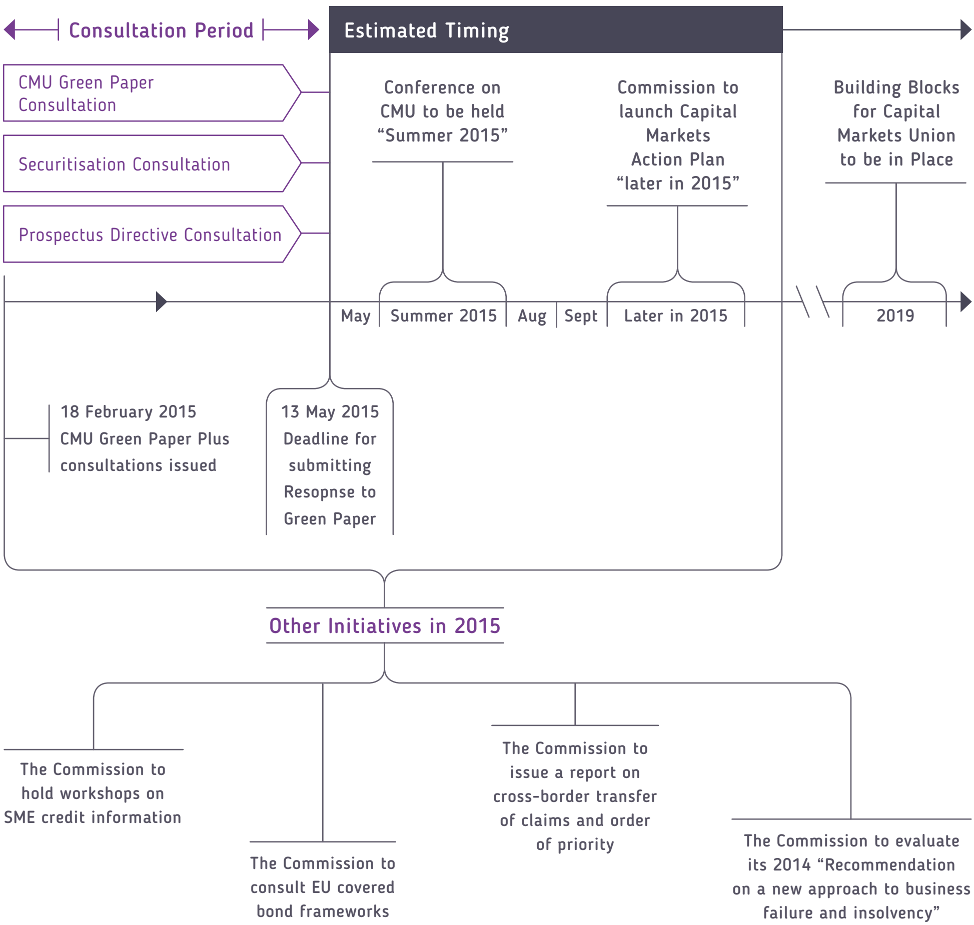
Through the looking glass – key considerations when looking at regulatory harmonisation

The concept of regulatory harmonisation across Europe, while having its challenges, is not a new concept, and the EU has been taking steps towards achieving some form of a Capital Markets Union. Post-financial crisis years have witnessed a tendency to over-regulate. Lack of clarity in any new regulations would only impact the European capital markets further and may also result in transactions taking a longer time to bring to market. For example, the debt capital markets have only in the past year come to terms with the requirements of the current Prospectus Directive regime following an extensive review in 2012 which particularly impacted issuance under debt programmes. Issuers may need to brace themselves for yet more, potentially substantial, changes to the regime in the near future.

The Road Ahead

The Green Paper on Building a Capital Markets Union was issued on 18 February 2015. The closing date for feedback on the Green Paper was 13 May 2015.[20] Based on the feedback received, the Commission proposes to adopt an action plan to be carried out over the next five years.

Implementation Timeline



ReedSmith

In practical terms, the provisions implemented as part of the wave of overregulation following the financial crisis should be reviewed. Also, pre-crisis obstacles to the cross-border flow of funds should be addressed.

Capital markets cannot and should not be perceived as a replacement of the banking sector, but should rather complement it as an alternative source of funding. The state of development of capital markets varies considerably between Member States, and the needs, cultures and priorities for Member States without developed markets will differ significantly from those such as the UK. It is hoped that the building blocks of CMU should create a situation where: SMEs can raise financing more easily than today; costs of investing and access to investment products converge across the EU; obtaining credit through capital markets is increasingly straightforward; and seeking funding in another Member State is not impeded by unnecessary legal or supervisory barriers. Whilst these changes will help capital markets to play a larger role in channelling financing to the economy, banks will remain key players in capital markets, as issuers, investors and intermediaries. Banks will continue to play a major role in credit intermediation through their role in funding and information provision.

Bringing together and establishing a workable CMU is a pursuit both fraught with difficulty and brimming with opportunity. Whilst the consultation process has distilled out the key issues, much more remains to be done. This will require a coordinated effort from all quarters of the market including, amongst others, governments, financial institutions, investors, regulators, lawyers and other key stakeholders. With such a large number of stakeholders, the CMU should set out to be a prime example of developing consistent international financial standards. In short, the CMU presents a tremendous opportunity for Europe to develop both continental capital markets and the global economy.

Ranajoy Basu, ***(Partner)***

Nathan Menon ***(Associate),***
Reed Smith LLP

Ending Too Big To Fail - 14th April 2015

Thoughts On "Too Big To Fail" and Other Existential Topics

Modern economies need large, sophisticated financial intermediaries. These institutions foster economic activity via pursuit of business activities not provided by smaller banks. Regulation must not be so tight as to coerce these intermediaries into straightjackets that forego their contribution to economic activity. At the same time, modern economies need regulatory policies that, when and where necessary, cut through asymmetric information, moral hazard, and principal agent problems so as to foster financial resilience. In this direction, following the recent global financial crisis (GFC), the United States moved first with the Dodd-Frank legislation, and the EU is following.

Today, the crucial issue in "Too Big to Fail" is whether the cessation of operations by a financial institution might disrupt financial markets, that is, the presence of "systemic" risk. Size matters: small institutions—banks, hedge funds, insurance companies and other financial intermediaries—typically cease operation without disruption. As of this writing, in my opinion, best-practice for large insolvent institutions (short of purchase by a healthy institution) is to place the institution into a conservatorship operated by its regulator. Ordinary bankruptcy is to be avoided because it shifts the fiduciary duty of directors from maximizing returns for equity holders to maximizing residual values to debt holders, thereby likely sharply increasing counterparty risk and, perhaps, freezing short-term money markets.

Today, the crucial issue in "Too Big to Fail" is whether the cessation of operations by a financial institution might disrupt financial markets, that is, the presence of "systemic" risk.

A decade ago, the issue was quite different: debate raged about whether regulators would (or should) impose losses on shareholders and debt holders of insolvent financial institutions. (This was the prominent concern, for example, in Stern and Feldman's important 2004 book Too Big to Fail: the Hazards of Bank Bailouts.) The GFC confirmed opinion that imposing such losses does not generate systemic risk when the "rules of the game" are known in advance by all parties. Financial regulation since the GFC, at least in part, might be interpreted as seeking to balance a regulatory dialectic. On the one hand, regulators have sought to minimise "systemic risk" to the financial system by strengthening the perception that large institutions are less likely to fail: examples include higher capital ratios, increased liquidity requirements, and restrictions on proprietary trading and market-making restrictions. On the other hand, regulators have sought to remove the perception that large institutions are backstopped by hidden government guarantees, thereby increasing the perception that such institutions might fail. A clearly articulated conservatorship policy, in my opinion, can reduce the tension between these two paths.

Modern economies with large banks are best discussed as complex dynamic systems. The banks have at least four roles: (1) to settle payments, (2) to intermediate default risk, (3) to intermediate maturity, and (4) to intermediate liquidity. When risk is accepted as an asset class, the primary difference between large and small banks is that the former buy and sell risk. The market for risk resembles other markets in that when well-informed adults exchange goods and services without coercion we assert they feel better off for having done so. There is no reason that risk is not one of those goods. The scale, growth and wealth of financial intermediaries, including both the chartered, regulated banks and their tied-at-the-hip cousins in the "shadow" system testifies to its value to market participants of all stripes. When regulators second-guess their actions they are second-guessing the market with respect to the correct pricing of risk. The too-big-to-fail problem is the task of making our dynamic, interconnected system of large banks robust against the "failure" of one or more of its nodes – and doing so at the lowest possible cost to the economy (that is, the taxpayers). Because large banks perform services not viable for smaller institutions, simply "making large banks smaller" is not a reasonable policy option.

Dynamic banking systems can both overshoot and undershoot our judgments of appropriate behaviour. We label the former periods as "credit-fuelled booms" and the latter as "financial crises." We know that such patterns have occurred in the past under a variety of structural and regulatory schemes – some financial historians, in fact, mark the 1825 financial panic in Britain as the first modern panic (e.g., Neal). Former Federal Reserve chairman Alan Greenspan addressed this issue some years ago at the Federal Reserve's annual Jackson Hole conference prior to the most recent financial crisis: Memorably, he noted that history had not been kind, in the aftermath, to nation's that had under-priced risk. The 2012 Likanen Report carefully documents the cost being paid today by the EU for under-pricing risk in the past. Greenspan also noted, in an earlier talk, that leveraged financial systems are not 100 percent reliable – occasionally, their operation hits rough patches. For this, we have central banks as lenders of last resort. Recall that the core of the 2008 financial crisis in the United States did not begin with runs on charted, regulated retail commercial banks – large or small (although there was some flight to liquidity in late 2007, satisfied by the TAF lending program, a good deal of which was to foreign banks). Instead, it was a "run on repo," that is, runs at large, unregulated, highly leveraged financial intermediaries (specifically, American investment banks) that often, in fact, held portfolios of poor-quality assets. (Former New York Federal Reserve President and Treasury Secretary Tim Geithner notes in his recent book that most financial banks – and bank runs in general – have a rational beginning in rumour and suspicion that one or more banks are insolvent: Essentially, Warren Buffet's famous comment that you do not know who is swimming naked until the tide goes out…) Only later, after several retail banks had purchased other failed institutions (Wells Fargo, Bank of America, Citibank) did problems arise at retail banks. In addition, at Citi, initial problems were generated within a separate segment of the holding company – casting some doubt on the power of a recommendation in the Likenan report.

The broad pattern of financial crises is familiar to students of banking history. Euphoria appears. Visions of future economic activity and profits brighten. Earning projections and collateral values rise. Lending, on or off balance sheet, increases. Leverage increases. Eventually, a shock hits the real economy. Euphoria dims. Earnings projections fall. Collateral values decrease. Lending decreases. Previously brilliant debt now appears less brilliant. Highly leveraged firms fail. Economic activity falls further. We must be on guard that we do not attribute in a "causal" fashion the subsequent decrease in economic activity to the financial contraction. In my opinion, the authors of the Likanen Report do this too strongly. We must always guard against post hoc ergo proptor hoc.

Dynamic banking systems can both overshoot and undershoot our judgments of appropriate behaviour. We label the former periods as "credit-fuelled booms" and the latter as "financial crises."

We must also today separate bank failures (measured by insolvency) that occur during a financial panic from those that occur during ordinary times. Assets that carry strong market prices during normal times may see their prices decreased rapidly in panics. Large banks, due to the nature of their business, are more sensitive to such price fluctuations than small banks. Here, I commend the British Government's policy actions of 2008: mark assets to a regulatory price list, allow the institution to raise capital privately if feasible, and if not insert a conservator who recapitalises by issuing preferred stock (that is, junk bonds) to the government. I feel this model might be improved, however, by borrowing the concept of "debtor in possession" financing from the American bankruptcy code. In a priority of financial claims, preferred stock ranks below all debt, allowing extant debt holders priority over newly injected government funds. Debtor-in-possession makes all existing debt and equity holders subordinate to the newly injected funds. Perhaps the proposed EU "bail-in" concept is a satisfactory substitute, but I have my doubts: it is a difficult-to-price option and seems unnecessarily (perhaps fatally) complex. The new EU regulatory regime (BRRD) perhaps assists this process by requiring complex banks to compile a business map ("living will") helpful to any future conservator. It is arguable that if such a document had existed in September 2008, American regulators might have been more reluctant to shutter Lehman Brothers because it would have revealed the scale and complexity of the firm's worldwide business.

Finally, I wish to mention two examples from banking history, one from the United States and one from Japan.

Modern use of the phrase "Too Big to Fail" dates from the 1984 failure of Chicago's Continental Illinois National Bank. The history of this bank reveals the same issues the EC is debating today. It is well-known that, at failure, the bank was considered too interconnected to shutter. A quiet bank during the 1960s, aggressive managers appeared in the mid-1970s that were praised in the financial press. By 1981, the bank was the nation's largest C&I lender; its Return on Equity between 1977-1981 was 14.35%, bested only by Morgan Guaranty (14.8%) and better than Citibank or 1st Chicago; and, its capital ratio had increased between 1976 and 1982 from 3.55% to 4.31%, among the best among large banks. Cracks appeared in late 1981 with losses in energy and LDC lending. Later, a reliance on short-term funding allowed an electronic run – "rumour driven" despite regulator assurances. Eventually, the FDIC recapitalised the bank by buying $4.5 billion of bad loans at a 25% discount to face value and investing $1 billion in capital for 80% ownership. The event raised the issue of the effectiveness of supervision – why had regulators not seen these risks? Regulators argued that they saw some risks but performance was strong and management was handling the risk: How then should regulators intervene when a bank appears to have adequate risk management practices and industry-leading performance? Note that regulators did not rescue all large banks during this period and uninsured debtors did incur losses: the Federal Deposit Insurance Corporation (FDIC) closed 13 large banks during 1983-84 and paid uninsured debt holders less than full value of their claims. In 1984, the FDIC feared ripples: 1st Pennsylvania, 1st Chicago, Manufacturers, Hanover, Bank of America. The bank's extensive correspondent business suggested extensive market disruption if the institution suddenly ceased operation.

The US Congress responded by passing in 1991 the FDIC Improvement Act (FDICIA) which took a middle road. It did not seek to forbid TBTF, knowing that was not credible. But it increased the hurdles, requiring least-cost resolution and forbidding the Federal Reserve to lend to failing banks. Such a middle road is commendable. In seeking to end the problem of "Too Big to Fail," policymakers must avoid both extremes, neither saying that they stand always behind the banks for the good of the economy (as American officials did in 2008 when unwisely advocating TARP funds to purchase suddenly toxic assets from banks – only to be trumped by the British one day before announcement) nor say that they will never stand behind the banks, that no one is "too big to fail." Neither promise is credible, and policymakers should always avoid such promises.

Modern use of the phrase "Too Big to Fail" dates from the 1984 failure of Chicago's Continental Illinois National Bank. The history of this bank reveals the same issues the EC is debating today.

I also wish to mention Japan, which learned during the 1990s, by experience, the difference between too-big-to-fail and too-big-to-cease-operating, while also learning that conservatorship, recapitalisation and open-bank assistance sometimes is good policy. It is now well-recognised that the resumption of Japan's economic growth was delayed during the 1990s by the lack of political will to address banking issues, a circumstance of the public's "resolution fatigue." In the early 1990s, the government resolved the jusen, specialized bank-connected housing lenders, with some criticism. In late 1994, the Bank of Japan extended assistance to two urban credit unions, Tokyo Kyowa and Anzen, with sharp criticism. In early 1997, Nippon Credit Bank was rescued with ¥211bn in private funds and ¥80bn from Bank of Japan funds, again with criticism. The precipitating learning event was the failure on November 3, 1997, of Sanyo Securities. A relatively small firm, Sanyo filed for ordinary bankruptcy protection because there was no financial sector specific resolution regime. In so doing, Sanyo defaulted on a small amount of repayments to creditors – and Japan's money market immediately froze up as market participants and policymakers learned the power of elevated fears of counterparty risk. The lesson was not lost on policymakers: Three weeks later, when Yamaichi Securities acknowledged its insolvency, it was assisted and wound down gracefully. Finally, Long Term Credit Bank failed in 1998 with ¥26 trillion in assets but ¥50 trillion derivative contracts. The bank limped along, with private and perhaps some unattributed Bank of Japan assistance, until the Diet passed the Financial Reconstruction Law; and it was nationalised October 23, 1998.

In seeking to end the problem of "Too Big to Fail," policymakers must avoid both extremes, neither saying that they stand always behind the banks for the good of the economy (as American officials did in 2008 when unwisely advocating TARP funds to purchase suddenly toxic assets from banks—only to be trumped by the British one day before announcement) nor say that they will never stand behind the banks, that no one is "too big to fail." Neither promise is credible, and policymakers should always avoid such promises.

One final comment: Capital for a bank is a liability, not an asset. Capital regulations affect the mixture of a bank's liabilities. Liquidity regulations affect the mixture of a bank's assets. These concepts sometimes are clearly and correctly applied in EC/EBA documents (see references below) and sometimes they are not. Even the respected "DealBook" page of The New York Times makes this error at times: On April 10, discussing GE's announcement that it will sell most of GE Capital, James Stewart wrote:

"Regulators have squeezed risk out of the financial system by requiring banks and other large financial institutions to hold higher levels of capital, which has driven down profits since assets sitting on the balance sheet are unlikely to generate much profit."

Confusion of this type between the separate roles of capital and liquidity is dangerous. An old axiom in banking went that "You could not be illiquid if you were solvent." Financial crises, including the most recent, prove that this is not so.

Professor Richard G. Anderson,

Senior Research Fellow and Adjunct Professor of Economics, Robert F. Plaster School of Business and Entrepreneurship, Lindenwood University; and former Vice President and Economist, Research Division, Federal Reserve Bank, St Louis, USA.

Ending Too Big To Fail: Bank Structural Reform

Of all the issues that have occupied the minds of policy makers since the crisis, this is the dominant one.

In addition to the big structural reforms that have been debated (in the UK for example) and put into law, it wouldn't be a huge stretch to say that the vast majority of other regulatory tweaks, certainly on the prudential side, have also been driven from the central agenda of ending 'too big to fail'; removing the implicit government guarantee; getting the taxpayer off the hook for the next banking crisis

The Story so far

To date, there have been three main strands to this:

1. **Structural reform** – isolating the parts of banks which ostensibly pose the greatest risks of failure from the parts that ostensibly need to be protected from such failure – in the UK this has taken the form of the ring fence

2. **Prudential reform** – mandating a sufficient equity and liquidity cushion, on both sides of the fence where there is a fence, to further reduce the risk of failure

3. **Resolution reform** – ensuring that even so, in the event of failure, banks can be resolved (closed, broken up, swallowed up, etc.) in an orderly fashion, with minimal threat to financial stability, and hence with no need for recourse to taxpayers.

Of these, only the second has progressed very far, primarily through the Basel reforms, the rollout of various stress testing regimes and, in the Eurozone, the move to a single supervisory mechanism.

The first has not been widely adopted internationally, and where it has (in the UK) there is still a debate about its efficacy.

The third is still very much unfinished business . Crudely, although there has been considerable progress on this in the US, UK and Switzerland, Europe is playing catch-up and Asia has yet to get out of the blocks.

On this basis, you could say that 'too big to fail' will only be consigned to history when at least 2 and 3 (and on one school of thought 1 also) have been fully put to bed. A variation on this is that, with 2 largely complete, and with 3 actually being the catalyst for a set of bank structural responses that will actually make 1 redundant, all the focus now should be on 3, Resolution. And with that job done (albeit still with an execution timeframe measured in years) we will be able to declare victory in ending 'too big to fail'.

Outlook

But is it as simple as that? One problem with any major reform programme is that the beast doesn't stay still. Remember that the public policy goal in all of this was never about the size of banks per se, or even their complexity, systemic importance and aggressive funding structures (which is nearer the mark), but rather it was and remains about the threat to financial stability posed by the structure of the industry more broadly. Fair enough, when the reform journey began immediately post-crisis, the biggest threat to financial stability in this context arguably was that the banking industry was still dominated by a set of big, complex institutions whose failure could trigger further ructions. But this doesn't mean that the restructuring of those banks, if and when that job is done, will have solved the underlying problem. Moderated it, maybe, but possibly also moved and mutated it.

It could be, for example, that new threats to financial stability will just pop up outside the immediately regulated banking sector (many would say they already have) such as in the so-called ‘shadow banking’ sector, or amongst the growing number of Financial Market Utilities (FMUs) which – paradoxically – have been brought into existence precisely to make banks safer. An obvious and predictable response to this would be to badge these firms also as ‘too big to fail’, bring them into the regulatory net – bank style – and embark on further rounds of structural reform. But where would this end?

Re-framing the problem

While keeping the underlying issue of financial stability in mind, perhaps it needs to be re-framed from one of narrow institutional resilience (and resolvability, if it comes to that) – important though that is – to one of wider system resilience. A subtle change maybe – since the notion of ‘systemic importance’ is already a central feature of the supervisory landscape – but an important one whereby the problem is characterised less by the size of institutions and more by (i) their criticality (whether they be big or small) to the efficient and orderly functioning of the system and (ii) the features of the system that give rise to that.

How would the regulatory community adapt to this shift? Surely not just by expanding the list of supervised firms, but rather by taking a wider system view of resilience and arming itself with a wider array of intervention mechanisms. Which is to say, it would need to concern itself more with regulating the system itself (drilling into points of system weakness, not just arising from institutional failure but from any form of system discontinuity) than with regulating the individual institutions that make up the system.

This characterisation seems to better fit the way the world (and financial system) has changed and is changing. Yes, banks are becoming safer, less complex, and more resolvable. In this process, by the way, they are also gradually becoming more focused and efficient, which is good news for their customers and shareholders. In themselves, banks are posing less of a threat to financial stability and this is undoubtedly a good thing, as far as it goes. But the journey cannot end there because the financial system, meanwhile, is becoming more interconnected, more specialised, more complex, more fragile in its vulnerability to new points of failure and its reliance on ‘new’ things (new components, new technologies, a new operating code), and this is presenting or exacerbating new systemic risks (cyber, for example). It is arguably becoming less resilient, even as many of the institutions within it are becoming ore so.

This increase in operational risk at the system level is a real worry, particularly as it is hard to see where the responsibility lies for managing it, or much evidence that it is being managed really at all. The hope is that with these changes the system is also developing a degree of natural immunity and capacity for self-repair. But it is no more than a hope at this stage, so this is where the attention now needs to turn.

So, back to the question of ending ‘too big to fail’; to invoke the politician’s prerogative, it is looking increasingly like this is no longer the right question.

In that sense, it has ended already.

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The Too Big To Fail Excuse

The global debate on the finance-growth relationship six years after the 2007-2009 financial crisis is ongoing, due to the difficulties in developing a common agreement, and the absence of a notable and credible theoretical backbone of the finance-growth relationship. When systematic issues triggered by the financial system affect the economy, policymakers and scholars find it extremely difficult to understand the complexity of this relationship. Usually, political economy analysis has a monetarist or neoclassical footprint, such as that used in the European context. But the recent chain of events questions the validity and efficacy of this standard approach. The notions of the "neutrality of finance" or the "independence of the money making process from the credit making process" (Modigliani-Miller, 1958), underlying the mainstream theory of finance, distort the correct interpretation of economic dynamics. This constrains the identification of the problem and its resolution. Important responsibility lies on the shoulders of financial economists, macroeconomists and decision-makers for what happened. They did not (or would not) understand the reality of the close relationship between finance and growth, focused as they were upon building their careers either as economists or politicians, and developing and/or applying elegant models without any connection to realistic assumptions able to describe real finance-growth dynamics.

They have been, and still are, part of the problem, rather than being part of the solution (Krugman, 2012). They prefer to defend the positions they took pre-crisis, giving questionable explanations rather than admitting they were, and still are, wrong on their approaches to macroeconomic finance and policy, instead of moving on to investigating what went wrong and why. The reliance on the efficient markets theory, the perfect rationality of financial agents, the CAPM model and so on have made them underestimate the size of the problem and undermine the ability for resilience of the financial and economic systems.

Some studies demonstrate a link between growth and finance but have been unable to identify the financial causes of the economic disequilibrium. This unresolved question has become a central problem when financial instability appears. The presence of "bank money" in the economy and in a financial system that is technologically advanced and also contains non-bank financial institutions, fundamentally changes the nature of credit.

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The modern financial system is characterised by financial innovation and speculation. There is also a profound difference between sociological and technological definitions of it. In other words, economic growth increases proportionally to the growth of the financial institution (Levine, 1997, p. 703), with technological innovation playing a crucial role.

However, technological development does not seem to have been accompanied by an adequate level of civilised behaviour. It has produced an economy characterised by “greedy” institutions. In particular, the financial sector seems to have the power, through financial innovation, to spread this “self-seeking” behaviour in the economic system, distorting the original function for which the financial institutions were founded. This confirms the “animal spirits” idea argued by Keynes (Keynes, 1936).

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The integration of financial institutions and markets has increased the level of instability, rather than promoting the stability and development of the economic system, which was originally the main idea supporting the development of an integrated global financial system. As the 2007-2009 financial crisis has shown, a collapse in one part of the global economic system has a pandemic effect upon the entire economy. And as Stiglitz (2010) claims, diversification and contagion are different sides of the same coin. The will to diversify risk by complex financial integration of the economy is accompanied by the risk of associated externalities; in particular, negative externalities appear when we are in the presence of a greedy advanced financial system able to reduce the level of perception of uncertainty among agents. This can increase and concentrate the market/political power of the financial markets (creating a monopoly), and this power concentration can be manipulated to satisfy private interests rather than to be socially oriented. The notion that seems to emerge is that risk increases with integration.

The belief that the presence of a “big” (too big to fail) financial system is useful for the economy no longer seems to be so true after the financial crisis of 2007-2009. Economies of scale (and scope) are unlikely to be sufficient to justify such large “universal banking” financial institutions, for which managerial diseconomies seem evident. An interesting discussion has arisen about the excessive size of the financial sector in advanced countries, regarding the possibility of applying regulatory restriction forms (Turner, 2010). Personal motivations might have supported the emergence of the “too big to fail” policy model in order to generate sufficient surplus to compensate risk taking, transforming the banking business into a money market mutual fund for optimising self-seeking profit interests rather than serving the function for which the financial system was developed, that of being a system for financial resource redistribution to the productive system (a socially-oriented function). For the same personal motivations, the financial sector was and still is, excessively protected. The "too big to fail" institutions expect that government policies will protect them from all losses that might occur in a critical scenario (abuse of lender of last resort methodology). Therefore, the financial institutions, as a part of the new OTD (Originate-To-Distribute) model, are paying less attention to potential risks. They are reducing the levels of control and making loans or taking part in other financial activities that have a higher risk of failure. It is possible to talk about size distortion, when the monopolistic financial power concentration of bigger banks allows them to follow self-gain interests, making some institutions more powerful thanks to their closer relations with the government, and thus giving them more protection (Beck et al., 2013).

The oversized financial sector has gradually extended its scope beyond the traditional banking activity of intermediation, towards non-intermediation financial activities. As a result, in the modern financial system, the traditional measures of intermediation activities do not reflect reality and we can find an interesting gap that needs to be filled in both the academic and policy environment concerning, in particular, the impact of financial sector "size" (size concept) on growth and volatility (Beck et al., 2013).

Most economists agree that macro-imbalances increased when the financial system as a whole made widespread recourse to financial innovation tools. Restoration of the basic role of the system

The belief that the presence of a "big" (too big to fail) financial system is useful for the economy no longer seems to be so true after the financial crisis of 2007-2009.

(to finance productivity and support economic development) is an urgent priority. However, how this can be done remains a widely discussed subject. It is important to stress that a major structural change has occurred in the last 20 to 30 years and that the financial system as a whole has been able to concentrate monopolistic power, with the "excuse" of being "too big to fail". The modern relationship established between finance and growth can affect the business cycle positively or negatively. In particular, the "boom and bust" effect is observable when the financial system uses its increasing power to capture financial resources from the economic system and to divert them from productive to speculative purposes.

Without doubt, future policies for recovering the economy adequately need to consider two fundamental problems: a) the multi-leveraging effect present within the financial system and its multiplier effect; and b) the role of highly-interconnected and highly-technologically advanced financial innovation within the financial architecture (Lauretta, 2014).

Last but not least, it is vital to rethink the finance-growth relationship in "green" terms, given the urgency of addressing the problem of "sustainability". Policymakers not only need to work on post-crisis resolutions, but they also need to develop channels and sets of regulatory tools to help the harmonization of a new structural economic need, characterized by the complex gearing of the linked components of the financial system, eco-innovation and sustainable growth.

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Banking Recovery And Resolution: Comparing Regulation Inside and Outside the Eurozone – 21 May 2015

Ring Fencing Banks in the Uk

When I spoke at the Industry and Parliament Trust's event looking at EU Bank Structural Reform in April 2015 – between the dissolution of Parliament and the day of the General Election – I declared myself relatively agnostic over the EU proposals.

My reasons were entirely pragmatic: firstly, I did not believe that the EU would impose 'structural reform' on a basis comparable to the UK given the view in a number of Member States that it cuts across the benefits of universal banking; and, secondly, I believed that the incoming Government would confirm its intention to press ahead with UK ring-fencing as designed by the Independent Commission on Banking (ICB) set up five years ago under the chairmanship of Sir John Vickers and since passed into UK law in the form of the Financial Services (Banking Reform) Act 2013.

In terms of the EU proposals, the European Council has since – on 19th June 2015 – agreed 'its negotiating stance' on structural measures 'to improve the resilience of EU credit institutions'. It is interesting to note that the proposal is more closely aligned to the pre-existing Bank Recovery and Resolution Directive and, instead of mandating automatic separation based upon size, it identifies criteria which would involve additional reporting requirements and escalating supervisory actions, potentially including separation in the event that banking supervisors considered that an institution's trading activities were considered a source of undue risk. While the draft regulation provides for the mandatory separation of proprietary trading, this is much more limited in scope than the division of core retail activities from investment banking activities that we will see in the UK.

As predicted back in April, the European Council draft provides two options for addressing excessive risk taking from trading activities: through national legislation requiring the ring-fencing of core retail activities, or through measures imposed by the relevant authorities in accordance with the regulation. In other words, they do not propose to require separation, but equally do not propose to stand in the way of the UK proceeding as planned.

The European Council position is only their 'negotiating stance'. However, parallel proposals continue to be discussed in the European Parliament with opposing political factions so far proving to be deadlocked. Should a breakthrough be found upon the return to business post the summer recess, then the Luxembourg Presidency would be given the task of blending the two into a single coherent legislative proposal under the European 'trialogue' process over the course of the second half of the year, most likely then handing over to their Dutch counterparts as the Presidency once more changes hands at the turn of the year.

Here in the UK, the Chancellor took the opportunity at his Mansion House speech in June to reaffirm that the Government would press ahead with ring-fencing. This had been a manifesto commitment and so hardly came as a surprise. As explained to the IPT, the BBA has been working on the assumption that ring-fencing will be brought into play within the 2019 timeline set by the ICB since September 2011 – the point at which their final recommendations were published and gained all party support.

Since then our approach has been to work with government, regulators and the industry to bring about a logical division based upon the guiding principles set out by the ICB, which boil down to our largest banks – i.e. those with 'core' deposits above £25bn – dividing their services, in particular, between retail and SME services on the one hand and investment banking services on the other, and in the process placing limitations on the services that the 'core retail bank' can provide and who they can do business with. This division is intended to aid recovery and resolution in the event of financial difficulty and in the process ensure the continued provision of core banking services to retail and SME customers.

What is simple in concept though is both complicated and time consuming in practice. Parliament witnessed this as part of its many reviews and scrutiny of the governing legislation. The task then got more intricate with the parliamentary draftsmen needing to define in secondary legislation banking services that previously had been expressed only in regulatory terms – and the two do not naturally translate. It takes only a cursory glance at the 'Core Activities Order' and the 'Excluded Activities and Prohibitions Order' completed in summer 2014 to see how tightly weaved the legislative text quickly becomes.

It is critically important though, since the secondary legislation defines what a ring-fenced bank can and cannot do. It determines, for instance, the product range that can be provided to customers from within the ring-fenced bank in areas such as trade finance and 'simple' derivative hedging, and has been characterised as setting the 'location' of the ring-fence. It therefore sets the scene for the services that ring-fenced banks will be able to provide to their customers once the new arrangements are put in place.

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With the secondary legislation completed, attention then turned to the regulatory regime needed on the part of the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). This has been characterised as the setting of the 'height' of the ring-fence. This was marked by the PRA publishing the first of a series of consultations on the regulatory regime for ring-fencing in October last year on governance, legal structure and operational issues.

Three further consultations are needed to complete the regulatory regime: a second consultation from the PRA on intragroup arrangements, prudential requirements and interbank payment systems, an FCA consultation – currently open – on consumer disclosures by non-ring-fenced bodies and a joint consultation on the 'Part VII FSMA transfer processes' which will govern the transfer of accounts and contracts between the ring-fenced and non-ring-fenced parts of the banking group.

We are expecting to see the remaining consultations within a matter of months now and for the final regulations to be published in the first half of next year – ideally sooner than later. The banks subject to ring-fencing will then be in a position to operationalise their plans, putting in place the structure of the future bank and finalising allocation of their activities between the 'ring-fenced' and 'non-ring-fenced' parts of the group. The legal process involves independent assessment and Court approval and can be expected to take us significantly into 2017. Restructuring will then involve the granting of regulatory permissions and approvals.

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Banks have not been idly standing by since the passage of the primary legislation and have been working up their strategic plans and getting to grips with what ring-fencing means for the running of their business and the services they can provide to customers. But there is only so far that they can go before they have sight of the final regulatory rules and regulatory sign-off for the way in which they would like to proceed.

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Financial Policy Challenges for the European Union and the United Kingdom

The immediate task facing policymakers in 2008-9 was to stop the financial system imploding. Next came the need to nurse some very sick banks, provide liquidity, unfreeze the capital markets, and prevent a sudden decline in national income. Soon after this, new aims emerged: to restore order in public finances which the crisis had shattered, to revive healthy economic growth, and, above all, to do everything possible to prevent a repeated banking crisis in the future. Though the impact of this global crisis was felt first in the U.S., was worst (per head) in Iceland, and varied greatly across countries, those tasks would preoccupy finance ministries and central banks in almost all advanced economies. The EU's institutions and capitals, and particularly the international institutions - the Bank for International Settlements (BIS) and the IMF - were no exception. Basel, Brussels, Frankfurt and London policymakers laboured hard in close harmony with colleagues in Washington and elsewhere on this urgent work. This story is well told by Allen and Moessner (2010).

The immediate task facing policymakers in 2008-9 was to stop the financial system imploding.

Banks had collapsed when they lacked the capital buffer to withstand the shock. All policymakers agreed, therefore, that raising banks' minimum capital requirements was crucial. But doing so too early could tip the weakest banks towards insolvency. It would in any case also limit bank lending, which had fallen badly after 2008. In addition, many jurisdictions taxed financial institutions lightly. Meanwhile, most governments needed much more tax revenue because the crisis had raised their debts so much. But taxing banks more heavily too soon, the obvious response, would squeeze their lending. And it would make a return to healthy solvency for weak banks, as well as stiffer capital requirements on all of them, even more of a challenge. Awkward trade-offs like these were soon unveiled. And because the finance industry was so global and so footloose, policies had to be coordinated internationally. Introducing them in only one part of the world could achieve little. It might well simply encourage arbitrage.

To have a good chance of working, therefore, new policies for the financial sector had to be coordinated with all major financial centres. This point was, unfortunately, to form one point of friction between London and the European Commission. Financial institutions were largely or wholly exempt from VAT (or its near cousin, GST, Goods and Services Tax). GST/VAT was applied on most service industries' products in India, China, and almost every advanced economy except the United States. The crisis had centred on banks, and many governments had spent vast sums on repairing the resulting damage. Voters were crying out for punishment.

Under the influence of Commissioner Michel Barnier, a former Gaullist deputy and minister, Brussels came to favour a Financial Transactions Tax (FTT), and urged its application throughout the EU. FTT would tax all (or most) trades in stocks, bonds and foreign exchange, as well as their derivatives. London's reply was fourfold. First, it argued that this was essentially a dagger pointed at the City of London, which dominated all such trades within the EU, and hence, depending on how it was implemented, might easily have the effect of diverting substantial scarce resources from the UK to other EU countries, as well as damaging the UK economy directly. Second, it pressed for an alternative tax, such as a Financial Activities Tax (FAT), which would be based on the salary bill and profits of all financial institutions. That would make it work quite like VAT, and hence come nearer to meeting the precepts of "fiscal neutrality" as between different services industries. London's third objection was that if FTT had to come in, it should be applied almost everywhere, and at broadly similar rates, to block arbitrage. The fourth objection was based on the fact that one relevant European precedent was negative. Sweden introduced a FTT for a while, and found it yielded so little (mainly because of arbitrage) that it later had to be abandoned.

In recent years London has sharply increased its own unilateral levy based on banks' liabilities, which is a stock rather than the flow of salaries plus profits, which it otherwise broadly resembles. It applies to banks with liabilities above £20 billion, and long term liabilities are charged at half the new 0.21% rate applied to short term liabilities. So it imposes the biggest penalty on large banks that rely on less secure forms of borrowing. The bank levy is not the same as a FAT. But it is much closer to a FAT than to a FTT.

The view from London is that other EU national governments should be free to apply a similar levy on their own, rather than have FTT imposed from Brussels.

The other financial policy issue on which Brussels and London are in some disagreement is about bonuses paid to bank staff. The European Commission has favoured a strict ceiling on bonus payments for any year equal to the individual's base salary that year (or double, if with the approval of at least 65% of its shareholders). The British view is that this seemingly wise rule for limiting bonus payments may be counterproductive – as it might easily be circumvented by generating dangerous increases in base pay. It is the total maximum remuneration that matters, London argues – and bonuses have the advantage that they are compressible shock absorbers. Unlike base pay, they can be cut or withdrawn whenever they appear to be unmerited or if times are bad.

Both London, and the EU authorities are in full agreement, however, on the important issue of allowing bonuses to be paid only gradually. That would allow claw back, if necessary or appropriate, in later years. The possibility of subsequent claw back would temper the incentive to gamble on an annual basis (heads I win, tails I lose nothing), through the imposition of subsequent partial forfeiture when that is called for. That way, rewards are based on the more reliable metric of longer term performance, and less sensitive to temporary swings in luck.

Yet there are other major areas of agreement on financial policy between London and other EU capitals and institutions. Real estate imbalances in many economies lay at the centre of the Global Financial Crisis. For several decades, the prices of dwellings have risen sharply, if unevenly, in relation to incomes in most of the OECD area. From 2001 to 2008, these increases were especially rapid. The house price boom was fuelled by a number of factors, plentiful credit, and lower interest rates, among them. Within the EU, Germany displayed the smallest increases, and Greece, Ireland, and Spain the largest, with the UK not far behind. Hand in hand with the sharp jumps in house prices, in most countries, went a boom in construction. Not all undulations in GDP relative to trend coincided with ups and downs in the housing credit – real estate cycle. But the biggest ones tended to. This was especially true in the early 2000s.

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Since 2008, policymakers across the world have reacted in various ways. One has been to devise new macro-prudential instruments, and set up new institutions to apply them. The European Union quickly established the European System of Financial Supervision (ESFS), which included all 28 member countries, and, importantly, not just those in the Eurozone. Under the ESFS umbrella, new EU-wide bodies multiplied: the European Systemic Risk Board, which started work in 2010; the European Banking Authority (EBA), headquartered in London, and tasked with harmonizing prudential rules and moving towards greater similarity in supervision arrangements; and new European Authorities covering securities, financial markets, insurance and pensions.

A variable ceiling on the “LTV” ratio of a mortgage loan to the market value of the property being purchased is an example: this can be raised when house prices are outpacing nominal incomes, for instance, and lowered when they are lagging. Within the Eurozone, Finland, Ireland and the Netherlands has been joined by the 8 smallest member countries in applying this in different ways. All but one EU country outside the Eurozone has also implemented LTV ratio limits. As Akinci and Olmstead-Rumsey (2015) show, LTV limits have been the commonest macro-prudential control instrument around the world for some while. Countercyclical capital buffers are the cornerstone of the new regulatory framework being forged by the Financial Stability Board at the BIS; within the EU, the Czech Republic, Denmark, the Netherlands, Sweden and the UK have been pioneering their application. The European Commission and the European Central Bank have recently been as active in several of these areas as the national central banks across the EU and elsewhere.

A future challenge posed for Frankfurt and London (inter alia) by the welcome proliferation of macro-prudential policy instruments is this. The transmission mechanism of monetary policy has relied heavily on the propagation of interest rate changes through the real estate – construction (REC) sector. With REC subject to new macro-prudential policy instruments, monetary policy may unfortunately operate more slowly and less effectively than in the past. This would come to pass if a sluggish macroeconomic position coincides with an overheated real estate market, for example, or if construction is quiet when other sectors are booming. Such situations are not historically uncommon.

Another development in the UK, mirrored by much of the Eurozone and North America, has been the pronounced long term increase, over 50 years or more, in the allocation of bank loans to housing and commercial property, as against loans for plant and machinery or working capital to the business sector. In the 1960s, Western Europe's retail banks held deposits placed largely by households, and used most of them to finance lending to companies. In the 2010s, household mortgages had come to dominate the banking sector's assets, while corporations had morphed, by and large, into its biggest creditors. This curious trend reflects risk-aversion on the part of banks – they like their loan portfolio to be as "safe as houses" and not messed up with large amounts of complex commitments to little firms of whose inner workings they are increasingly unaware.

That trend is not limited to the UK or North America. Many other EU countries show signs of it. There appears to have been several unfortunate effects. When coupled with the bias towards profit distribution inherent in current legal, tax and boardroom remuneration frameworks, one is that investment has stagnated. Another has been to starve smaller companies of external finance: little businesses pay much more to borrow from banks, and with stiffer conditions. This is partly because they are riskier. But there is another reason. Unlike them, bigger companies cannot be overcharged as easily, since they have the option of access to equity and debenture markets. Small companies usually do not.

Adverse repercussions do not end there. Smaller companies tend to create more jobs than big ones, and they are also disproportionately likely to invent and innovate. So costlier borrowing for these businesses serves to squeeze the economy's growth rate, and to discourage job-creation. Yet a further unwelcome by-product of the growing bias towards property lending has been the large increase over 50 years – a trebling in many EU economies – in the ratio of house prices to incomes. Housing credit mainly serves to push up the value of dwellings. Older house-owning generations have enjoyed huge capital gains. But tenants have lost out, inequality has risen within and across generations, and, unless they are housed or assisted by their parents, the young have come to face really severe housing cost burdens. Low birth rates are just one of the disagreeable consequences.

The 2010 Mirrlees Review took a hard look at taxation in the UK. Mirrlees et al (2011), which summarizes the Review's key proposals, argue that a good tax system would apply taxes equivalent to VAT on both financial services and housing. They contrast this with the current tax system applying in the UK (and many other advanced countries) where financial services and housing both gain exemptions. Ideally, they suggest, we should tax land.

If the generous tax privileges accorded to housing and finance came to an unexpected, sudden halt, however, property values would collapse and many financial institutions would go down with them. 2008 could turn out to be a tea-party in comparison. So a key challenge affecting policymakers, whether in Brussels, Frankfurt, London or beyond, must be to evolve a gradual transition to a more rational, less distortionary system of taxation and finance.

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Achieving that would be quite a task. Asset prices do not just depend on today's yield – the expected time-path of future yields matters too. Suddenly committing credibly to tax the land component of dwellings down the road for example, much more heavily than current council tax arrangements, could only cut land and house prices right now. And creating expectations of heavier tax financial institutions now, or in the future, would have regrettable side-effects (less room to lend to businesses large or small, a reduced buffer against adverse shocks, and an enhanced risk of insolvency for the weaker ones). Charting the best path between all these ills will no doubt exercise policymakers throughout the EU, and far beyond, for many years to come.

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Contemplating The Development of Financial Regulation in the Eurozone

Is banking regulation in the Eurozone different from the rest of the EU? Do new Euro area structures herald a two-speed Europe? What does this mean for the UK? These were the questions discussed during the IPT's Resilient Futures session on 21 May 2015.

To answer these questions you must first understand the challenges posed by the Euro crisis. Before the introduction of the Euro, Euro area governments paid very different costs to borrow. This dispersion in spreads was eliminated with the introduction of the single currency, but reappeared in the financial crisis. Investors became concerned that countries on the periphery of Europe did not have the ability to support their weak banks, driving up the cost of borrowing for banks, countries and ultimately businesses. Policymakers clearly needed to break the link between banks and their sovereigns.

Banking union was the Euro area's answer. Removing responsibility for the oversight of banks from national authorities would give markets confidence that problems were not being hidden, reducing the fear that was driving up borrowing costs and lending rates. Does this mean that Eurozone regulation is different? No. Banking union is built on the foundations of the rules which apply across all European Member States. At its simplest, banking union is a change to the application of rules, not the rules themselves.

Banking union is currently constructed of two pillars, with a possible third on the horizon. The starting point is the centralisation of responsibility for the supervision of banks at the ECB. Under a compromise reached during the negotiation of the Single Supervisory Mechanism, the ECB has direct responsibility for the largest, most significant Eurozone banks and the ability to step in and take control of the oversight of any others. The rules applied are the same as those which apply in the UK, or any other European country under the Capital Requirements Regulation.

The second part is the creation of a single authority with responsibility for dealing with failing banks. The Single Resolution Board has responsibility for applying new tools and powers intended to end the problem of some banks being considered too big to fail. To ensure it can operate, the SRB can access a new €50bn resolution fund built up from contributions made by banks in Euro area countries. The Bank of England is responsible for the powers in the UK and they apply in all other Member States under the terms of the Bank Recovery & Resolution Directive.

The early thinking on banking union included a single deposit guarantee fund. Progress on this has stalled in light of the enhancements made to DGS funds across all Member States and the possibility that a single fund would lead to fiscal transfers between participating countries.

So, the way the rules are being applied is different but the substance of the rules is the same. Does that mean those who worry about a two-speed Europe are wrong? European rules are agreed via a process of qualified majority voting or QMV. The countries who participate in the banking union have a majority of the votes under this system. This raises the possibility that they could agree rules that are in the interest of the Eurozone but detrimental to the rest of the countries in the Single Market. The new arrangements include some safeguards to prevent this happening at the European Banking Authority, which sets detailed rules for bank regulation, but there is nevertheless the risk that those outside the Eurozone could be outvoted in the European Council.

What can be done about this? Interestingly, fairness between Eurozone 'ins' and 'outs' is a central theme of the Government's strategy to renegotiate the UK's terms of membership of the EU. It is too early to see what the Government might achieve but there are a number of steps the UK can take which wouldn't require any changes to the rules. Most importantly, the UK can increase its level of influence on European financial policy. British influence is already high, with many Member States welcoming the UK's expertise on finance matters. Nevertheless, the number of British nationals working in the European institutions responsible for financial policy is low, and has declined over a number of years. This has been recognised by a number of important Parliamentary reports and steps are being taken to change this. The appointment of Lord Hill as European Commissioner with responsibility for financial services policy is a major development.

Before the introduction of the Euro, Euro area governments paid very different costs to borrow. This dispersion in spreads was eliminated with the introduction of the single currency, but reappeared in the financial crisis.

Much has changed since the financial crisis and there are clearly still issues to work through. In dealing with the remaining issues it will be important for the UK and other countries outside the banking union sphere to make the case for rules which work for the Single Market as a whole. The level of influence the UK wealds on banking regulation should not be underestimated. The UK must ensure this remains unchanged.

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Footnotes

1. Report on completing Europe's economic and monetary union
2. https://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope201504.en.pdf?cc6dd7683457c947e7fd1748d102f7da
3. http://ec.europa.eu/finance/financial-analysis/docs/efsir/150427-efsir-2014_en.pdf
4. A Plan for Eurobills: The next step for the euro area? http://www.grahambishop.com/ViewArticle.aspx?ID=27764&CAT_ID=438&Search=
5. Professor Mullineux also contributed a guest blog, discussing whether Greece could escape the Eurozone's 'Doom Loop'? Please find this guest blog here: http://www.ipt.org.uk/can-greece-escape-the-eurozone%E2%80%99s-%E2%80%98doom-loop%E2%80%99.aspx
6. Ibid
7. To view the responses published: https://ec.europa.eu/eusurvey/publication/capital-markets-union-2015?surveylanguage=en
8. "Decoding Capital Markets Union measuring the potential for growth across Europe's fragmented capital Markets" June 2015 by William Wright and Laurence Bax. For further information on this excellent study please visit New Financial's website www.newfinancial.eu, where you can also access more details on the methodology and the full list of sources used to develop their analysis.
9. [https://www.bba.org.uk/policy/capital-markets-infrastructure/capital-markets-union/bba-response-to-the-european-commissions-public-consultation-building-a-capital-markets-union/]
10. http://ec.europa.eu/priorities/jobs-growth-investment/plan/index_en.htm
11. http://ec.europa.eu/finance/capital-markets-union/index_en.htm
12. Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are to be offered to the public or admitted to trading and amending Directive 2001/34/EC
13. BlackRock ViewPoint, The European Capital Markets Union: an investor perspective (February 2015) http://www.blackrock.com/corporate/en-nl/literature/whitepaper/viewpoint-cmu-investor-perspective-february-2015.pdf
14. Bank of America Merrill Lynch, Saving the European asset-based finance markets, 20 February 2015
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16. R. Basu and M. Dupont-Barton, 'The rise of private placementsas an alternative source of funding: a time for innovation and growth, Butterworths Journal of International Banking and Financial Law, (February 2015)
17. International Capital Markets Association, 'Trade bodies join forces to promote EU Private Placement market' (12 June 2014) http://www.icmagroup.org/assets/documents/Regulatory/Private-placements/Trade-bodies-join-forces-to-promote-EU-Private-Placement-market_ICMA14052014.pdf
18. COM (2015) 63 FINAL, Initial reflections on the obstacles to the development of deep and integrated capital markets: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=COM:2015:63:FIN&from=ES
19. G. Jackson, 'Europe's corporate borrowers look to capital market union', Financial Times, 27 May 2015
20. http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_en.htm

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