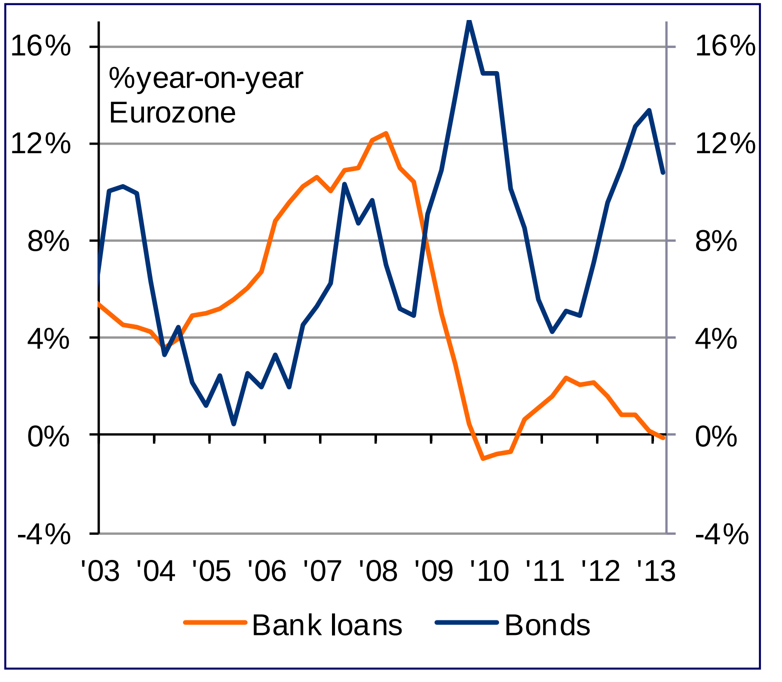
Capital markets and the financial crisis

[From cause to solution?]



Mark Cliffe
Chief Economist ING Group

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A growing list of regulation

1. Basel III - higher capital and liquidity buffers
2. Recovery and resolution / Bail-in / Crisis management
3. Bank taxes and levies
4. EU Banking Union – Supervision, DGS, Resolution
5. Structural reforms/separation - Volcker / Vickers / Liikanen
6. Shadow banking
7. Insurance companies (Solvency II), pension funds
8. Market infrastructure – improve transparency, reduce risks
9. Other regulatory initiatives – asset managers, financial advisers reforms on fees, transparency, consumer protection, CRAs)
10. Macroprudential policy/Financial Stability central bank initiatives on systemic stability

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Financial Regulation – All at ‘C’

1. **Confrontation** - politicised and emotional (greedy banker narrative demonizes size and risk-taking)
2. **Confusion** – What are we trying to achieve? Uncertainty about end point, multiplicity of regulations some proposals still vague, others subject to negotiation
3. **Competition** - fragmentation, nationalism, arbitrage, loss of diversification
4. **Complexity** – multiplicity of regulatory changes are coinciding, with little consideration being given to their interaction, leaving the outcome unpredictable
5. **Cost** – higher funding costs (bail-in), compliance burden especially for smaller players
6. **Cyclicality** - so far *pro-cyclical*, not counter-cyclical – ECB forced into ‘unconventional’ measures to support peripheral banks, distorting market prices
7. **Capital markets** – supposed to step in, but ‘derisking’ is constraining growth…

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Balkanisation: shattered dreams…

- **Dream** that the EU was heading towards **a single banking and financial market** was driving the development of large cross-border banks…
- …this has been rudely shattered by the financial crisis
- Amid political reluctance to share burdens of losses, regulators have competed to defend national taxpayers' interests:
  - restrict cross-border liquidity and capital transfers
  - pressure to buy home sovereign debt (increasing cost of funding for banks and corporates in periphery)
  - pressure to lend domestically (buy 'riskless' home sovereign debt)
  - shift from bail-out to bail-in of creditors (including depositors)

- All of this encourages banks to "**stay at home**", restricting growth by refocusing on core markets while reducing cross-border presence.
- Progress ***is*** being made towards Banking Union, but painfully slowly, with minimal cross-border burden sharing

Capital markets constrained: who can take risk?

- **Eurozone capital markets are growing, driven by investor and issuer demand**

BUT - growth is constrained…

1. **Regulation – penalising holdings of capital markets instruments**
   - **Banks – capital charges (hurt liquidity), LCR**
   - **Insurance companies – Solvency II: higher risk weighting, p&l volatility**
2. **Market infrastructure needs developing and harmonising**
   - **No single market –** Different legal frameworks (insolvency regimes) for companies across countries; makes pooling loans difficult
   - **Mandates –** ABS need to be in certain indices to qualify
   - **Company info –** Proper lender information on SMEs is often lacking or not public
3. **Governments reluctant to underwrite risky loans**
   - development banks finance mezzanine/junior tranches of capital structures
   - introduce or expand government guarantees or tax incentives

Bottom-line: policy-makers have to confront the dilemma of promoting the risk-taking needed for growth while deleveraging and derisking the financial system

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