THE REGULATORY OUTLOOK FOR 2017[1]

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The London-based Centre for the Study of Financial Innovation (CSFI) is a non-profit think tank established in 1993 to look at future developments in the international financial field, particularly from the point of view of practitioners. The CSFI regularly publishes a unique survey on banking named "Banana Skins," which describes the most threatening risks facing the global banking industry, as perceived by a wide range of bankers, banking regulators and close observers of the banking scene around the world. Since 2000, ten "Banking Banana Skins" surveys have been published; among the 13 most oft-cited risks, regulation has ranked three times in first and twice in third place. Only credit risk has been cited more frequently, while macroeconomic risk has appeared just as often as regulatory risk. Naturally this does not prove the perils of regulation per se, but it does perfectly demonstrate the importance of the risks attributed to regulation. This article attempts to provide a panoramic view of the state of the regulatory reforms launched after the Great Financial Crisis, and the outlook for 2017 and beyond.

JEL codes: G28, L51

Keywords: bank regulation, Basel Accords, capital requirements, deposit insurance, deregulation, Dodd-Frank, economics of regulation, Federal Reserve Board, policy, regulation, supervision

From a regulatory perspective, 2017 is shaping up to be a year with more than the usual uncertainty, as in the assessment of **Deloitte**'s latest **Regulatory Outlook**.[2] From where does this uncertainty come? My experience has taught me that, contrary to common belief, financial regulation is primarily a political issue disguised in apparently very technical matters. Accordingly it is always the *political context* that influences most future tendencies in the regulatory area. Predicting the political outlook is, however, always a very tricky issue. *Napoleon*

1 The text is an annotated version of the author's lecture delivered on 22 March 2017 at the Foreign Bankers' Club of the Hungarian Banking Association in Budapest. Since the delivery of the lecture, some important events that were mentioned have since taken place with a quite favourable outcome. Nevertheless, much of the unveiled risks still persist, and thus most of the caveats and conclusions, in the opinion of the author, remain valid.

2 Deloitte: Navigating the Year Ahead – Financial Markets Regulatory Outlook 2017. December 2016; https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-emea-regulatory-outlook-2017.pdf

Bonaparte quite aptly remarked once: "Simpletons talk of the past, wise men of the present, and fools of the future."[3] To avoid this trap of foolishness, I will focus today on the present – that is, on the "known knowns" – and make any prediction only under the premise of a disclaimer borrowed from *Dan Brown*'s *Digital Fortress*: "Everything is possible. The impossible just takes longer."[4]

In my presentation I will first provide a broad view of the issues which influence the regulatory environment, and will then go on to look at four main themes which have the strongest impact on the regulatory outlook.

1. REGULATORY AND ENVIRONMENT

1.1 The political context

Let us start with the political sphere. In June of last year we were confronted with the shocking outcome of the British EU referendum, and for the past few months we have experienced tectonic changes following the elections in the U.S. This year will be no less challenging for Europe: the political climate will be shaped by elections in four important Member States, and their outcome may have a deep impact on the future. After last week's Dutch elections, in April and May we will face the outcome of the two rounds of the French presidential elections. The German federal elections are set for September, and possibly a general election will fall due in Italy. These four countries together represent 51% of the combined EU27 figure in terms of population, and 71% in terms of GDP, and collectively contributed 65% of EU funds between 2008 and 2015 (representing six times the amount Hungary received from the EU pots in the same period). These figures indicate how decisive the outcome will be for the future.

A week ago in **the Netherlands**, Prime Minister *Mark Rutte*'s centre-right party came first in the parliamentary elections but lost seats, as did junior coalition partner the Labour Party, so that it will take a long time to forge a workable coalition; besides which it may become fragile and may not last long. Two things are bound to remain unchanged: one is that macroeconomic policy will remain in austerity mode, and the other is that it will in turn further fertilize the breeding ground for anti-elitist, anti-euro right-wing scapegoating.

Another side effect of the election is that the Eurogroup must soon find a replacement for its current chairman, the caretaker Finance Minister *Jeroen Dijsselbloem*, because the challenges faced by the eurozone require strong, continuous leadership.

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3 *Napoleon in his own words, from the French of Jules Bertaut* (2010): Nabu Press (19 August).

4 Dan Brown (2009): *Digital Fortress.* Transworld Publishers, London 2009, p. 36.

Ahead of us is the start of **Brexit negotiations** and this also requires the leaders of the EU27 to **"relaunch Europe"** when commemorating the 60th anniversary of the Treaty of Rome. The conclusions are still being drafted, but as agreed at the Council meeting of 9 March they will focus on four key areas: security, growth, social issues and the EU's global role. In addition, the eurozone has to urgently tackle the **Greek debt crisis**. A closely related topical challenge is the **waning political support for the single currency**. In France and Italy, there is now strong support for candidates who advocate withdrawal from the euro. Remarkably there are two diametrically opposite political poles advocating the dismantling of the euro: one side laments the stealthy introduction of a transfer and liability union, while the other is rebelling against the demolition of Europe's welfare states, the cementing of disparities between successful creditor states and stagnating crisis countries through the common currency, and against the democratic disempowerment of the crisis states. However, the two poles dismiss in unison the further development of the eurozone along the lines of deeper integration as a possibility, and their anti-euro sentiment has found its way onto strong political platforms. Financial markets have started to price in the risk that the eurozone could fall apart.

2. THE OUTLOOK IN THE FINANCIAL SECTOR

There is no doubt that even here we are living through a transition that feels cataclysmic in nature – disruptive, challenging and pretty much perilous. Let me cite some scary facts: if someone invested €100 in European banks 10 years ago, it would be worth €59 today. The same amount of money invested in the overall market would be worth €134. In other words, banks have destroyed value on an epic scale. While their share prices started to climb rapidly in the U.S. by the end of 2016, by contrast the European banking industry suffered a significant setback last year. Revenues declined across the board, cost reductions were unable to keep pace and loan loss provisions rose. As a result, net income fell by almost half. Banks resorted to aggressive de-risking, but a shrinking equity base meant that capital and leverage ratios stagnated for the first time since the financial crisis. Thus the European banking industry is hardly able to absorb significant further tightening of capital requirements. Despite their dire situation, however, European banks have remained extremely important to markets and economies: they still account for about one-fifth of the market valuation of equities, and in countries like Italy and Spain, this percentage is considerably higher. For all the efforts by the European Commission to establish a capital markets union, 70% of all credit and loans to consumers and corporates is still provided by the banking sector.

The impasse in discussions at the Basel Committee following the U.S. elections in particular over the new output floor for risk-weighted assets provided some relief to European banks; consequently the finalization of Basel III will occur well behind the end of 2016 deadline. Since the crisis, U.S. regulators had been the driving force behind global regulation of the banking industry, but the new administration now takes a different course, aiming at some easing of the rules. However, the path is far from clear – thus all global banks are now governed by a complex network of policymakers with competing objectives and an equally complex network of regulations that produce multiple binding constraints. The highly anticipated 19 March meeting between global bank supervisors has been postponed for the second time, highlighting regulators' increasing difficulties in finalizing Basel III capital rules. Nevertheless, the Baden-Baden Communiqué of G20 Finance Ministers and Central Bank Governors of 18 March emphasized "support for the Basel Committee's work to finalize the Basel III framework" – adding, however, "without further significantly increasing overall capital requirements across the banking sector, while promoting a level playing field."[5]

2.1 The current state of the European banking sector

How can the current state of the European banking sector be summarized in terms of its influence on regulatory efforts? To formulate it politely, as management consultants are accustomed to doing: "There is still plenty of room for improvement." Substantial changes are necessary in four areas in particular:

- **Europe is "overbanked"**: Alongside the 126 largest banking groups, there are around 3,300 smaller ones (about 50% of them alone in Germany) – too many to generate decent returns for shareholders, especially when interest rates are low. We may reckon, therefore, on a very significant increase in bank mergers, involving listed and unlisted players.
- **There are far too many branches**: from about 200,000 branches of domestic credit institutions in the EU, thousands will likely disappear in the coming years, especially in countries where the number of branches in relation to the number of inhabitants is comparatively high.
- **IT systems are messy and/or broken, and vulnerable to cyber-attacks**, thus banks must overhaul them quite soon at great cost.
- Last but not least, **non-performing loans** to a value exceeding €1 trillion strain the books of European banks. They represent 5.4% of total loans, a ratio three times higher than in the U.S. According to the IMF, a ratio between

5 Communiqué of G20 Finance Ministers and Central Bank Governors Meeting in Baden-Baden, 17–18 March 2017, http://www.g20.utoronto.ca/2017/170318-finance-en.pdf

5% and 6% starts to have a serious negative impact on the ability of banks to lend and to support the economy.[6] In addition, the problems of NPLs are unevenly distributed, with ten Member States with a ratio above 10%, Hungary unfortunately among them. While it is a favourable development that this ratio is gradually decreasing, the process is extremely slow. It took more than 15 years to deal with problem loans in Japan, to the major detriment of its macroeconomic performance. If the EU proceeds only at the current pace, it will take longer than in Japan to complete the adjustment and reach pre-crisis levels. Accordingly, there is an urgent need for policy action. At the minimum, it is important to define common European blueprints for national asset management companies.

These four issues alone impose quite a lot of homework, even if the pressure from regulatory changes eases. But in addition, from next year on, the new accounting standard **IFRS 9 Financial Instruments** will force banks to take an upfront charge to cover losses expected in the first year of new loans and to fully provision for losses expected over the lifetime of existing loans that have soured. In an economic downturn, this could lop between a quarter and a third off EU lenders' common equity Tier 1 capital. On top of this important change, the European banking supervision will soon roll out – combined with on-site inspections – its multi-year **Targeted Review of Internal Models (TRIM)** to assess the adequacy and appropriateness of Pillar 1 internal models, and this may impose additional strains.

3. MAIN THEMES THAT WILL SHAPE THE EUROPEAN BANKING LANDSCAPE

After the big picture, let us now take a closer look at **four main themes** that will shape the European banking landscape.

3.1 What are the likely impacts of Brexit?

Financial services constitute a strictly regulated industry, thus cross-border trade depends on the mutual recognition of regulatory regimes around the world. Inside the EU, the UK has emerged in recent decades as a dominant financial centre. Currently some **5,500** financial services concerns, among them around

6 See European Parliament Briefing: "Non-performing loans in the Banking Union: stocktaking and challenges," 18 March 2016, http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574400/IPOL_BRI(2016)574400_EN.pdf

40 banking groups, use London as a gateway to the EU market with so-called "passports" that give them access to the 31 (EU27 + 3 EFTA + Switzerland) countries of the European Economic Area. Under the present regime, the UK exported financial services worth **€31 billion** to the EU27 in 2015. This export generated a fifth of UK banks' and around 15% of US investment banks' annual revenues. Given this imbalance, the Brexit negotiations are likely to become highly political. The UK financial community has more or less swallowed that continued passporting of services will be impossible; consequently, many smaller players will withdraw from cross-border activities. For larger institutions, market access in the wholesale business could be partly retained provided the European Commission deems the regulatory and supervisory regime in the UK to be equivalent to that in the EU. However, it is questionable whether equivalence decisions offer a stable footing for the long-term location decisions of banks. Equivalence depends very much on the specific conditions of individual sectors and countries, and if these change, the situation needs to be reassessed. Brexit will cut through a sector that is currently deeply connected. Hence after the "divorce," the landscape of wholesale markets in the EU27 will become considerably different. According to estimates, the UK's currently dominant 90% market share would plummet to 60%. The biggest likely winners would be Germany, France, the Netherlands and Ireland, whose combined share would jump from 6% to 34%–36%.

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Table 1
Scenarios for migration of wholesale markets

	Current situation (% of market)	Scenario A: Fragmentation (% of market)		Scenario B: Integration (% of market)	
	Total European market	*Total European market*	*EU27 market*	*Total European market*	*EU27 market*
United Kingdom	90%	60%	–	60%	–
Germany	2%	18%	45%	14%	35%
France	1%	8%	20%	8%	20%
Ireland	2%	6%	15%	7%	18%
Nether-lands	1%	4%	10%	5%	12%
Luxem-bourg	1%	1%	3%	2%	4%
Italy	1%	1%	3%	2%	4%
Spain	1%	1%	3%	1%	4%
Other EU	1%	1%	1%	1%	3%

Note: The current market shares are based on *Goodhart* and *Schoenmaker* (2016).[7] In both scenarios, 35% of the UK market moves to the EU27, so that 60% of the current European wholesale market stays in London. Scenario A assumes fragmented markets in the EU27, leading to concentration. Scenario B assumes an integrated market for the EU27, allowing a geographically spread industry.

Source: Bruegel

3.2 Will regulation continue to broaden and deepen?

The EU currently has an **acquis** – a body of common rights and obligations that is binding on all Member States – which consists of 20,833 pieces of legislation, of which only 559 (2.7%) are dedicated to financial services. While this is indeed only a tiny fraction, it nevertheless covers some very crucial rules.

The backbone of European banking regulations is the **Basel Accords**. Some of us may remember that the first Accord, adopted in 1988, was only 30 pages long. The third Accord, agreed in 2011, comprised 616 pages, almost double Basel II, adopted

7 André Sapir, Dirk Schoenmaker and Nicolas Véron (2017): "Making the Best of Brexit for the EU27 Financial System," 6 February, p. 5, http://bruegel.org/wp-content/uploads/2017/02/Bruegel_Policy_Brief-2017_01-060217.pdf

in 2004.[8] The length of the Basel rulebook still understates the complexity of the new rules. This is evidenced by the number of individual regulatory changes[9] that banks must track on a global scale: these have more than tripled since 2011 to a shocking average of 200 revisions per day. A similar increase is reflected in the number of restrictions imposed by US financial regulators – counted by words such as **"may not," "must," "shall," "prohibited,"** and **"required"** that impose legally binding obligations: these grew from 55,000 in 1997 to 65,000 in 2010. This corresponds to an average annual growth rate of 1.4%. After adoption of the Dodd-Frank Act in 2010, restrictions swelled at an annual rate of 9.8%, a seven-fold acceleration.[10]

While these figures are indeed shocking, they also call for sober judgement: *First*, it must be conceded that it is not only the financial sector that is characterized by an increasing number of regulatory restrictions. *Second*, it would be a serious mistake to attribute all blame for the vast complexity merely to extensive regulation. The *Tinbergen Rule* – formulated by the Dutch Nobel laureate *Jan Tinbergen* – predicates that there must be at least as many policy instruments as there are complex sub-components of a system, if risks are to be monitored and managed effectively. Over the course of the two-decade bull run from the 1988 peak in interest rates until the outbreak of the Great Financial Crisis, banks and insurers became much larger and more complex. The number and sophistication of products they offered vastly increased; new distribution channels (such as GSM and internet) mushroomed, exposing them to cybercrime attacks and IT disruptions; and, last but not least, the institutions expanded at great speed across borders. In terms of complexity, financial services not surprisingly rank ahead of all other industries today. Consequently, while the magnitude and velocity of regulatory changes will decelerate, the future undoubtedly holds more financial and non-financial regulation, reflecting the ever-increasing complexity of financial services.

Beyond complexity, the perimeter of regulation is also inflated by public sentiment, which after the financial crisis became less tolerant of bank failures, and of the use of public money to salvage them. Moreover, governments are also exerting regulatory pressure in other forms. Banks are increasingly required to

8 Andrew Haldane and Vasileios Madouros (2012): The Dog and the Frisbee. A paper presented at the 2012 Jackson Hole conference, http://www.kansascityfed.org/publicat/sympos/2012/Haldane_final.pdf

9 Regulatory change is defined here broadly: it includes any new local, national or international policy, ruling, reform, action, law, ban, comment, announcement, publication or oral guidance that the compliance department of a bank would be expected to note and monitor.

10 Mercatus Center, George Mason University (2014): Measuring the Dodd-Frank Act (and Other Major Acts) with RegData 2.0; 23 September, https://www.mercatus.org/publication/measuring-dodd-frank-act-and-other-major-acts-regdata-20

assist in crackdowns on illegal and unethical financial transactions by detecting signs of money laundering, sanctions-busting, fraud and the financing of terrorism, as well as to facilitate the collection of taxes. Governments are also demanding that banks comply with national regulatory standards wherever they operate in the world. For example, banks operating abroad must already adhere to US regulations concerning bribery, fraud and tax collection. Since 2007–2008, regulatory enforcement has brought banks cumulative financial penalties of roughly $321 billion (through the end of 2016) for misconduct.[11] While US regulators have imposed most of the fines, their counterparts in Europe and Asia are also stepping up the pace. Managing these costs is a major burden for banks, requiring the creation of a strong non-financial risk framework to avoid the errors of the past.

Regulations relating to employment practices, including remuneration, environmental_standards and financial inclusion, are also swelling. Moreover, banks' behaviour toward their customers is also coming under stronger scrutiny. The terms and conditions of contracts, marketing, branding and sales practices are regulated in most jurisdictions, and rules protecting consumers are likely to be further tightened. Banks will probably be closely examined for information asymmetries, barriers to switching banks, and inappropriate or incomprehensible advice, as well as for non-transparent or unnecessarily complex product features and pricing structures. The bundling and cross-subsidizing of products could also become problematic. In certain cases, banks might even be obliged to offer their customers more suitable products with better terms. (Utility suppliers in some markets are already obliged to do so: consider, for example, the case of roaming tariffs in the EU, or Hungarian utility cost reductions.) Tightening of the regulatory environment makes the traditional model for managing regulatory risks unviable. Risk functions must not only ensure compliance with existing rules, but must also review the entire sales-and-service approach through a broad, principle-based lens.

3.2.1. What made proportionality a buzzword in the regulatory business?

Proportionality stands as shorthand for a constellation of closely related principles and values, which regulators and supervisors have a duty to serve: equality, legal certainty, individual rights and good administration. This concept of proportionality has recently become a major theme in pan-European discussions of banking regulation – and for good reason. It subsumes more specific discussions on better regulation, simplification and the need for differentiation.

11 EPRS (2017): Briefing Fines for misconduct in the banking sector – what is the situation in the EU?" Brussels, 29 March, http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602070/IPOL_BRI(2017)602070_EN.pdf

And it provides a framework for the evaluation of existing rules and practices, and a compass for their elaboration and improvement.

Article 5 of the Treaty[12] clearly states that "the use of Union competences is governed by the principles of **subsidiarity** and **proportionality**." The same provision further clarifies that "under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties."

Why has this debate gained momentum now, and not in the past? There are three specific aspects of the post-crisis regulatory architecture which explain, and also justify, the emergence of proportionality as a core concern in European banking regulation:

- The shift from the old approach to prudential standard-setting for credit institutions, which was based on minimum harmonization at the European level, to a new system of almost full Europeanization of the applicable norms. The intensive legislative activity which followed the Global Financial Crisis, culminating in the enactment of the **Capital Requirements Directive IV** and the **Capital Requirements Regulation**, has resulted in much greater uniformity, moving to full harmonization of regulatory norms. The new state of things is epitomized in the construction of a **Single Rulebook** of pan-European applicability, with the European Banking Authority (EBA) acting as the rulebook's custodian and key developer.
- The considerable expansion of the prudential regime to cover new aspects of a bank's organization and business activity. This thematic extension is evident both in the Basel regime, which, beyond the usual capital adequacy requirements, now encompasses global standards for liquidity and leverage, as well as in the host of European legislative initiatives of recent years. As a result, the net of supervisory controls over the activities of credit institutions and other financial intermediaries has become much denser than before. This makes the question of proportionality of regulatory requirements all the more pressing.
- The move from a system of national responsibility for supervision to the streamlined, and largely centralized, new supervisory architecture of the Banking Union.

More generally, there is now an increased scepticism with regard to the one-size-fits-all approach to regulation – an approach whereby uniform prudential standards are set at the same level for all credit institutions, as well as for other financial institutions such as investment firms. In particular, scepticism is directed

12 Treaty on European Union: https://www.math.uni-augsburg.de/emeriti/pukelsheim/bazi/OJ/2012C326p13.pdf

at a uniform model-based approach to financial risk, grounded on the generic risks faced by a notional universal banking group of unspecified (but probably large) size, carrying out mixed activities including extensive securities and derivatives exposures, and displaying a relatively high degree of interconnectedness with other participants in financial markets.

While the industry's opinion on the impact of regulation continues to gradually soften, the **Duff & Phelps Global Regulatory Outlook**[13] survey also unveiled that significant ambivalence remains. Leading organizations are particularly doubtful about the benefits: half of top senior executives take the view that recent regulation will do little or nothing to promote stability, while 18% say it will make it less stable – more than two-thirds in total. Understandably, it becomes a key issue for society and stakeholders whether the objectives of regulation could be achieved by alternative measures – by less complexity or less detailed regulation – or by rigorous application of the Proportionality Principle to a greater extent.

According to surveys, the overall **cost of regulatory compliance** is already substantial: today, the most common spending on compliance among banks, brokers, asset managers and others is up to 4% of revenues, and this is expected to rise to up to 10% in the coming years. This finding is consistent across geographies. On the one hand, this effect can be reduced when operating across multiple jurisdictions when consistent standards are applied. On the other hand, compliance burdens can be reduced if excess complexity is adequately addressed. There seems to be some unexploited potential for cost savings even if the same level of benefits and regulatory goals should be maintained. This insight motivated the September 2015 launch of the **Call for Evidence**,[14] a public consultation on the overall regulatory framework for financial services. The European Commission invited all interested stakeholders to provide feedback and empirical evidence on the benefits, unintended effects, consistency and coherence of the more than 40 new pieces of EU legislation adopted in response to the financial crisis.

3.2.2. What were the main findings of the Call for Evidence?

Overall, the majority of respondents signalled support for the financial reforms undertaken in response to the crisis. However, stakeholders also identified examples of possible frictions, overlaps and other unintended interactions between different regulations.

13 Duff & Phelps (2017): Global Regulatory Outlook 2017, 27 February, http://www.duffandphelps.com/assets/pdfs/publications/compliance-and-regulatory-consulting/2017-global-regulatory-outlook-viewpoint.pdf

14 European Commission (2015): Call for Evidence: EU regulatory framework for financial services, 30 September, http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index_en.htm

Based on a thorough review of all received responses and provided evidence, the Commission will take work forward in the following four areas:

- Paying greater attention to areas where the rules may be impeding the flow of finance to the economy.
- Enhancing proportionality in the regulatory framework as part of the wider aim to better balance financial stability and growth objectives: EU financial rules should not create unintended barriers to new market players, and should recognize the diversity of financial institutions in the EU.
- Reducing red tape and designing rules that achieve their objectives at minimum cost for firms and, ultimately, their clients.
- Ensuring consistency of the overall framework, addressing the remaining risks in the financial system, further enhancing investor and consumer protection, and keeping the regulatory framework up to speed with technological developments.

The specific actions were set out in a Communication issued in November 2016. These range from legislative reviews to ongoing policy work. Going forward, the Commission will monitor progress in implementation of the respective policy commitments and will publish its findings and next steps in November.

Together with this Communication, the European Commission unveiled a **banking reform package**.[15] The package of measures comprises amendments to four different measures: the **Capital Requirements Directive** (CRD IV) and **Regulation** (CRR), the **Bank Recovery and Resolution Directive** (BRRD), and the **Single Resolution Board Regulation** (SRBR). Multiple objectives are being pursued by the amendments. *On the core capital requirements side*, there is the further alignment of EU rules with the Basel rules, in the leverage and net stable funding ratio, for example, and in the softening of capital requirements for trading positions. *On the resolution side*, there is the alignment of the bail-in standards **TLAC (total loss-absorbing capacity)** and **MREL (minimum requirement for own funds and eligible liabilities)** – an issue for large, globally active banks. And on the bank business models side, there is the recalibration of the capital requirements for bank exposures to SMEs and the introduction of proportionality in rules. So, for example, proportionality will be applied in remuneration, where it is proposed that EU rules on the deferral of the variable element of remuneration should not be applied to small and non-complex banks.

The measures proposed are also part of the Commission's ongoing work to reduce

15 European Commission (2016): EU Banking Reform: Strong banks to support growth and restore confidence, 23 November, http://europa.eu/rapid/press-release_IP-16-3731_en.htm

risk in the banking sector, as set out in the 2015 Communication "**Towards the completion of the Banking Union**."[16]

The new legislative proposals were submitted to the European Parliament and to the Council for their consideration and adoption. These institutions started to deliberate on the proposals. Their entry into force is expected in 2019 or later.

The Commission plans to submit a White Paper in 2017 setting out the next measures to be taken with a view to completing EMU, including Banking Union ("Stage 2" of the Five Presidents' Report). A European Deposit Insurance Scheme (EDIS) and a common backstop for the SRM are still to be put in place. Given the ensuing controversy, so far no progress has been achieved, and thus further efforts are required. The main con is that EDIS would lead to further – unbalanced – mutualisation of bank risks. In particular, the increasing concentration of national assets (the so called "sovereign-bank loop") in the books of national banks may lead to a distortion that makes it difficult to advance towards balanced mutualisation and risk sharing. Limits on asset concentration for national public debt in the respective bank systems therefore seem to be indispensable in order to move forward.

Finally a few words about the fate of the financial transaction tax (FTT), which was proposed by the Commission in 2011 under the so-called enhanced cooperation procedure "to make the financial sector pay its fair share." Negotiations among the ten Member States still pursuing the FTT appear to have stalled, and it seems unlikely that an agreement can be reached soon.

4. THE PROSPECTS OF THE EURO

"One Market needs One Money!" This was the key motto of the influential 1990 report by the European Commission.[17] A closer scrutiny of the report, however, reveals that the key argument was the other way around: one money would create one market. Unfortunately, the proponents of the single currency did not realize that without an adequate institutional setup and strongly coordinated governance, "one money" would promote enormous cross-border financial flows that would

16 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions (2015): "Towards the completion of the Banking Union," 24 November, http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A52015DC0587

17 Commission of the European Communities (1990): "One market, one money: An evaluation of the potential benefits and costs of forming an economic and monetary union," European Economy, No. 44, October, http://ec.europa.eu/economy_finance/publications/pages/publication7454_en.pdf

lead one day to a painful financial crisis. This ignorance (or blind optimism) is the main root of the current problems of the eurozone that must now be cured.

A key question is whether the enduring economic underperformance in some Member States is really due to the "straitjacket" imposed by the euro. The cases of Ireland and Spain suggest that a sustainable recovery is possible within the euro area. Seen through this prism, the main problem of the euro is rather a political one: in countries with economic problems and an incessant lack of growth, like Italy and Greece, the euro and its rules offer an ideal scapegoat to mask the inability of the national political and social structures to solve the deep-rooted shortcomings first and foremost due to internal structural causes, most notably low investment in capital (physical, human or knowledge-based) and correspondingly poor ability to innovate.

The World Economic Forum's annual **Global Competitiveness Reports** or the World Bank Group's regular **"Doing Business"** surveys clearly reveal that differences among institutions (e.g. in the judicial system, public administration, education) and their performance explain the lion's share of the cross-country differences in competitiveness, growth and income. The importance of institutional and cultural factors is clearly felt at micro level in M&A transactions, where successful post-merger integration has always required appropriate alignment and amalgamation of corporate culture and institutional architecture. On the macro level, country-specific recommendations are intended to foster the eradication of these kinds of shortcomings in competitiveness. A benchmarking exercise demonstrated that if Member States were to close half of the observed gaps on the best performers in areas such as market competition and regulation, labour market and skills upgrading, tax structure and R&D, the euro area's GDP would be boosted by nearly 6% in ten years.[18]

It is obvious that much more effort is required to address the unveiled deficiencies, partly by establishing national productivity boards according to the September 2016 recommendations of the Council. How rapidly progress can be achieved very much depends, of course, on the choice among the five scenarios[19] of the White Paper on the Future of Europe.

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18 See European Commission Staff Working Document (2016): "Report on the Euro Area concerning the Recommendation for a Council Recommendation on the economic policy of the euro area," 22 November, http://data.consilium.europa.eu/doc/document/ST-14808-2016-INIT/en/pdf

19 According to the White Paper on the Future of Europe, these are: 1. "Carrying on", 2. "Nothing but the single market", 3. "Those who want more do more", 4. "Doing less more efficiently", and 5. "Doing much more together." See: European Commission: White Paper on the Future of Europe – Reflections and Scenarios for the EU27 by 2025, 1 March 2017, https://ec.europa.eu/commission/sites/beta-political/files/white_paper_on_the_future_of_europe_en.pdf

5. RECENT DEVELOPMENTS IN THE US

The economic relationship between the United States and the European Union is the most developed and most integrated in the world. Complex and interdependent ties cover a large number and type of financial activities, which intertwine the financial markets on both sides of the Atlantic. Large US banks have a strong presence in the EU, foremost in the wholesale and investment banking business, while some large European banks have strong footholds in the US. Due to this interdependence, the two financial markets have been moving quite similarly, in spite of significant differences in terms of the size of their capital markets and the structure of their banking systems. The strong ties explain, on the one hand, the intense regulatory cooperation both on the multilateral and bilateral level, and on the other hand why developments on the US financial market are so relevant for the EU.

5.1 Regulatory developments in the US

While in Europe regulators endeavour to keep banks on a tighter rein so as to avoid any recurrence of the financial crisis, in the United States things now seem to be moving in a different direction. President Donald Trump recently signed an executive order to review the regulatory framework of banks.[20] Although the edict does not explicitly mention the Dodd-Frank Act, it is mainly aimed at this law. Many banks, especially smaller ones, loathe this act and its ensuing rules spanning over 22,000 pages of regulatory content. And it is worth remarking here that, according to the US law firm **Davis Polk**, 111 of Dodd-Frank's 390 "rule-making requirements" have not yet even been finalized.[21]

Prior to this executive order, there was little interest in the broad-based legislation known as the **Financial Choice Act**,[22] let alone hope that it would direct policy in the coming years. The brainchild of Jeb Hensarling (R-TX), chair of the House Financial Services Committee, the legislation was largely seen as an ideological wish list for financial market regulation reform; a document indicating what the Committee, along with its leadership and staff, believe financial regulatory policy should do to address perceived regulatory excesses and anaemic growth. But the

20 The White House (2017): Presidential Executive Order on Core Principles for Regulating the United States Financial System, 3 February, https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states

21 *The Economist* (2017): Remaking American financial regulation, 11 February, http://www.economist.com/news/finance-and-economics/21716622-donald-trump-starts-long-struggle-overhaul-dodd-frank-act-remaking

22 US Congress House Financial Services Committee (2016): The Financial CHOICE Act, as of 12 September 2016, http://financialservices.house.gov/choice/

prescribed review by President Trump and the preserved Republican control of both the House of Representatives and the Senate have given this legislation new significance. The Financial Choice Act is as wide-ranging as Dodd-Frank. The Act's 16 sections cover everything from bank regulation to fiduciary duty rules, and small company funding to the definition of accredited investors and abolition of Dodd-Frank's rules on conflict minerals.

Although the bill has largely flown under the radar of capital market participants, it gained notoriety last June as a consequence of three proposed changes to the regulation of big banks. The first would give banks the option to avoid the more active regulatory oversight of their lending, investing and funding activities that they currently endure if they choose to maintain a minimum of 10% shareholders' equity. The second proposal would also repeal the **Volcker Rule**, cited in the bill as not only a hindrance for bond market liquidity but, increasingly, as a heavy regulatory burden for small banks that have to justify their investment securities activities to regulatory examiners. Last, but by no means least, the proposal aims to replace Dodd-Frank's Orderly Liquidation Authority with a bankruptcy-based structure that would impose meaningful losses on the creditors of failed banks.

It is still too soon to make a final assessment of the review ordered by the US President because we don't know exactly what in the Dodd-Frank Act the US administration really wants to change. The act contains many national rules, which, if revoked, would have no impact on Europe as such. (Some others were felt to have gone too far in pushing the European banking industry to play by American rules, which led to tensions between the US and EU regulators late last year — even before questions were raised over the direction the US would take under President Trump.) European regulators will of course thoroughly monitor what changes will be proposed in the end, striving to ensure that a regulatory race to the bottom is avoided and promoting consistent global implementation of the mutually agreed rules. In doing so, however, we must be fully aware of the **globalization trilemma**[23] – namely, that we cannot maintain all three things at once: (1) full, global market liberalization; (2) national sovereignty; and (3) democracy. There is no way around it: politicians and regulators must choose two of these three priorities, and give one up. In addition, it must be kept in mind that as the EU's share in the world economy declines (even irrespective of Brexit), so the European influence on shaping the global rules is fading.

23 See Dani Rodrik (2007): The inescapable trilemma of the world economy, 27 June, http://rodrik.typepad.com/dani_rodriks_weblog/2007/06/the-inescapable.html

5.2 New appointments to the Board of the Fed

It is not only changes in regulation that pose challenges to the global and in particular the European banking system. Within the next 12 months, the US President may be able to appoint five or even six members to the Fed's seven-person Board of Governors, including the Chair, Vice Chair for monetary policy, and a new Vice Chair for banking supervision (a role so far performed by departing Governor Dan Tarullo). Alone in the next month, there will be three vacancies on the Board of Governors for President Trump to fill. Based on Trump's past comments, his choice of economic advisors and appointments, and the political leanings of Congressional Republicans, it seems that he may prefer candidates who: (**1**) have significant experience in markets and/or business (i.e. a market practitioner rather than an academic economist); (**2**) do not have strong hawkish leanings that would work against the president's growth agenda; and (**3**) do not forcefully reject greater congressional oversight of the Fed.

The latter aspect is all the more relevant as President Trump may also be able to sign into law a bill that alters important aspects of the Fed's operating procedures and accountability to Congress, based on the **Fed Oversight Reform and Modernization** (FORM) Act[24] proposed and pushed through by the Republican Party, notwithstanding the concerns emphasized by the Fed Chair that it would politicize national monetary policy.

At first sight, any *curtailment of central banks' privileges may be sensed as a sort of blasphemy*. However central bank independence is not the natural order of things and is also not carved in stone. For a long time central banks used to be government agencies, which had to follow political guidance usually from the finance minister. They became independent after a period of price instability in the 1970s and 1980s that produced a consensus in many countries about what a central bank should do. If almost everyone agrees on the goal of a technically complex policy, then – so the argument in favour of central bank independence goes – we are better off leaving the implementation of the policy to experts, confined to a core mandate. However, recently some politicians have concluded that central banks have obtained too much power, enabling them to bend governments without having political accountability, while proving incapable of coping with the problems of secular stagnation by massive **quantitative easing** (the ECB alone has bought more than €1 trillion in government and corporate

24 H.R.3189 – Fed Oversight Reform and Modernization Act of 2015, 17 December 2015, https://www.congress.gov/bill/114th-congress/house-bill/3189

bonds, corresponding to 4% of credit institutions' total assets) or appeasing people with a protracted zero interest-rate policy.[25]

In five thousand years of record keeping, debt has never been cheaper than today.[26] Recently applied monetary policies have fuelled skyrocketing valuations across the full spectrum of asset classes (stocks, bonds, real estate, commodities, etc.), invoking credit bubbles, all the more because banks happily lend against them. In addition, the recent unconventional monetary policies may have unintended and undesirable consequences by penalizing savings and pension providers, and by augmenting inequality; both issues of major concern for constituents. The recognition gradually emerges – partly due to the latest inflation jump mainly reflecting increases in energy and food prices – that there is room for higher interest rates, even if small compared to historical interest rate levels, and thus central banks should be constrained to pursue a corresponding rate-setting policy.

While for the aforementioned reasons the standing of central banks is now undergoing a reassessment almost everywhere, any touching of the five main pillars of the ECB's independence[27] (/**1**/ Institutional, /**2**/ Personal, /**3**/ Functional and operational, /**4**/ Financial and organizational, /**5**/ Legal) remains a very delicate matter, as this institution has to serve 19 countries with different economic situations, so that utmost caution is warranted before any modification.

5.3 Why are the imminent appointments so significant for the EU?

Financial conditions in the US have been affecting Europe for decades. Experts talk about transatlantic rates of interest, which have an impact only in one direction: American interest rates affect European ones; the inverse effect is hardly noticeable. Consequently, the findings of a recent BIS study are not surprising: namely, that the cross-border effects of the Fed's purchasing programme on inflation and economic growth are much greater than the cross-border effects of the ECB's bond purchase programme.

This immense asymmetric influence is not only affecting Europe; the Board of the Federal Reserve has extreme influence over global monetary conditions.

25 Communiqué of G20 Finance Ministers and Central Bank Governors Meeting: "Monetary policy will continue to support economic activity and ensure price stability, consistent with central banks' mandate, but monetary policy alone cannot lead to balanced growth."

26 See David Keohane (2015): Compare and contrast, 5,000 years of interest rates. FT Alphaville, 18 September 2015, https://ftalphaville.ft.com/2015/09/18/2140402/compare-and-contrast-5000-years-of-interest-rates/

27 See ECB (2017): Why is the ECB independent? 12 January, https://www.ecb.europa.eu/explainers/tell-me-more/html/ecb_independent.en.html

Because of this sway, the Fed may shape the growth path of global aggregate demand more than governing bodies of any other central banks. Not by accident was the global influence of the US captured for generations by the long-standing adage that "when America sneezes, the world catches a cold."[28] It is therefore quite understandable why it is deemed so important to know who is appointed to the Board, and to be aware of whether they are hawks or doves.

6. CONCLUSION

While pervasive new regulations are unlikely to come into effect this year, the conditions determining the final scope of regulatory initiatives in the pipeline might change significantly. Accordingly, bankers must remain open towards changes in any direction. This advice may not sound very helpful, but at the current juncture this is the best guidance that can be given.

I started by quoting Deloitte's latest Regulatory Outlook. Let me now conclude with three apt findings of the **Global Risk 2017** report[29] of the **Boston Consulting Group (BCG)**: "*First*, while many of the major, top-priority reform packages are already in place, banks will now face the burden of implementing technical regulatory measures and responding to audits. *Second*, actions by individual jurisdictions, rather than by globally coordinated initiatives, will remain the source of most new and changing requirements that banks must comply with. *Third*, the influence of regulation on strategic and operational planning will continue to be significant; for example, regulation still consumes the largest share of banks' project portfolios. For all these three reasons, tracking and complying with regulation needs to remain high on banks' agendas."

28 See Essay UK (2017): The US Sneezes, The World Catches a Cold, visited on 1 April 2017, http://www.essay.uk.com/free-essays/business/the-world-catches-a-cold.php

29 BCG (2017): Global Risk 2017 – Staying The Course in Banking, 1 March 2017, http://image-src.bcg.com/BCG_COM/BCG-Staying-the-Course-in-Banking-Mar-2017_tcm9-146794.pdf