DEUTSCHE BUNDESBANK
EUROSYSTEM

Financial Regulatory Challenges

Panel discussion

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Assessing the effects of financial regulatory reforms requires a structured evaluation process.

- **Comprehensive reforms have been launched to enhance the stability of the financial system and to ensure its contribution to economic growth.**

- **Reforms sometimes entered into unchartered territory:**
  - How do **financial structures** and regulatory reforms interact?
  - What are the **cross-border effects** of regulatory reforms?
  - How to link the micro- and the macro-level to analyze the **overall effects** of reforms?
  - How to balance different **policy goals**?

➢ **Answering these questions requires a structured process of policy evaluation.**
  - Rigorous testing of reforms **ex ante** has not been feasible.
  - Evaluation **ex post** and **causal impact assessments** are needed.

A stylized evaluation process

Step 1: Specify the objective of reforms

- Micro- versus macroprudential
- Interaction with other policy goals (e.g. competition policy)

Step 2: Define intermediate targets

- Objectives are not directly observable and can only be analyzed over time: Intermediate variables needed to monitor effects of reforms.

Step 3: Calibrate instruments, assess impact ex ante

- Calibration requires models which allow taking features of financial systems into account.

Step 4: Assess impact of reforms ex post

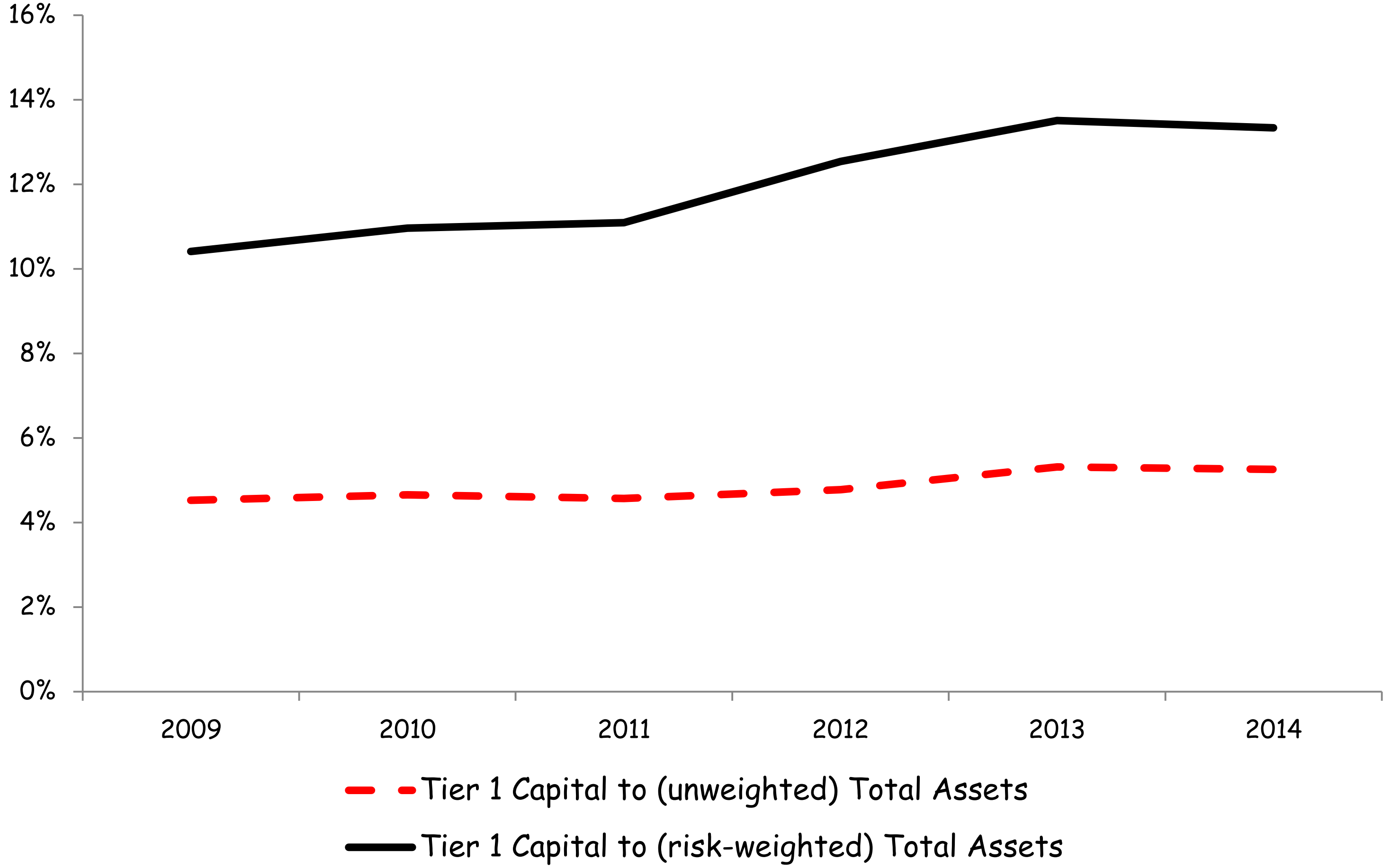
- Did instruments achieve the objectives of reforms?
- Potential re-calibration without compromising on resilience

A stylized evaluation process

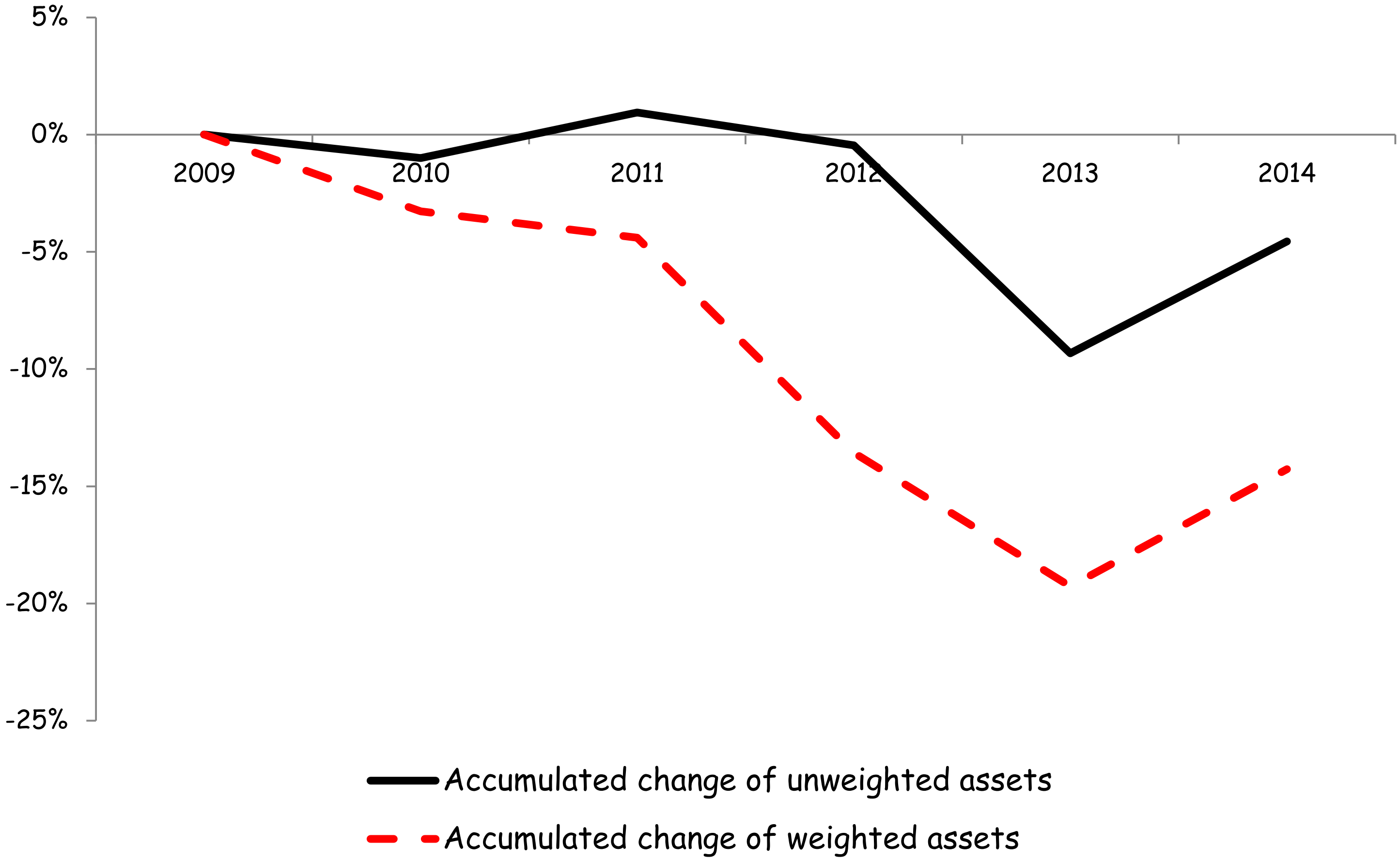
- **Policy evaluation can be mis-leading if it is based on time series indicators and if it does not take the structure of the financial system into account.**

- **Two examples:**
  - #1 Deleveraging and capitalization across countries
  - #2 Bank profitability and financial stability

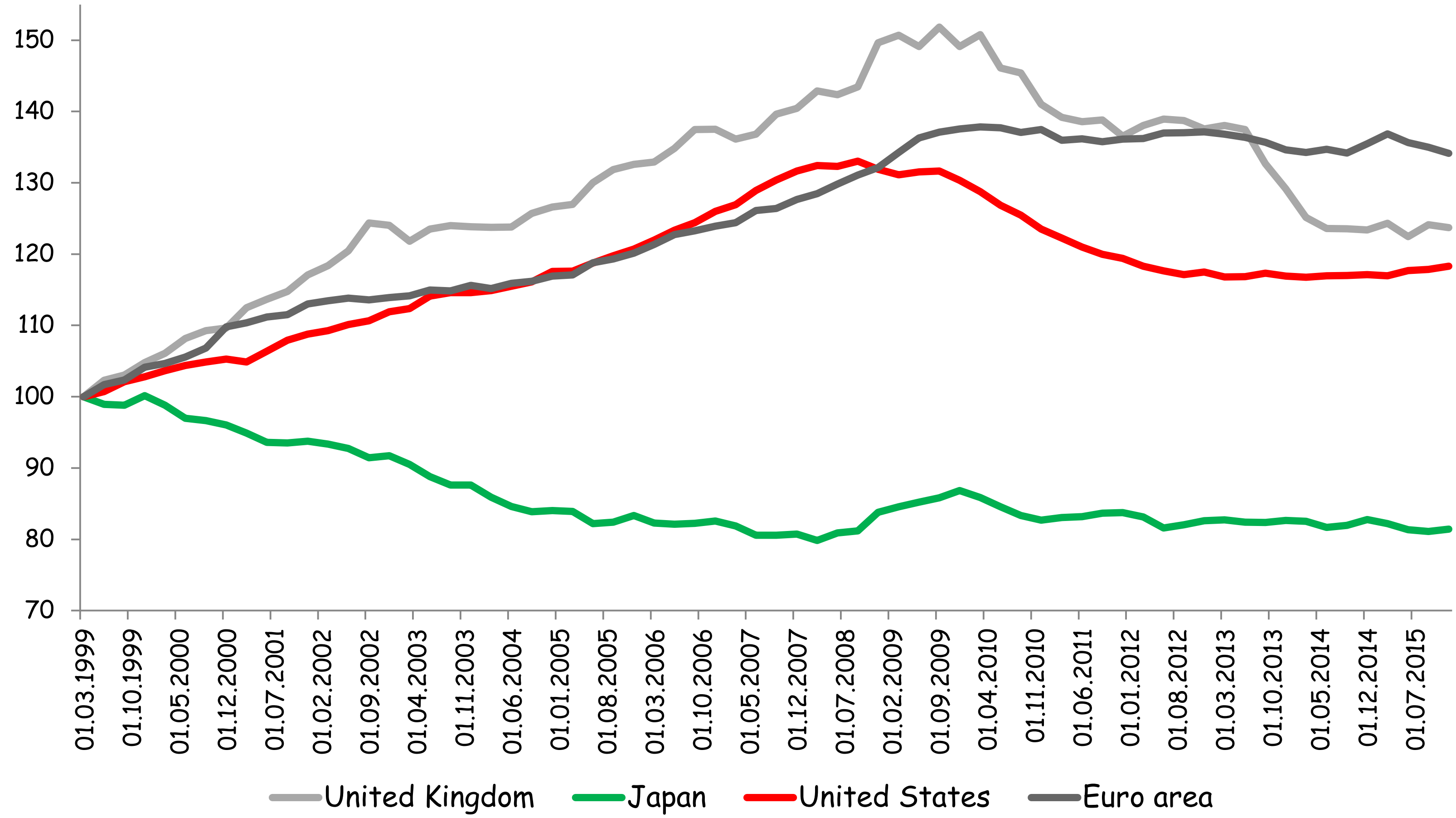
The capitalization of (European) banks has increased since the crisis.



Risk-weighted assets have declined by more than unweighted assets.



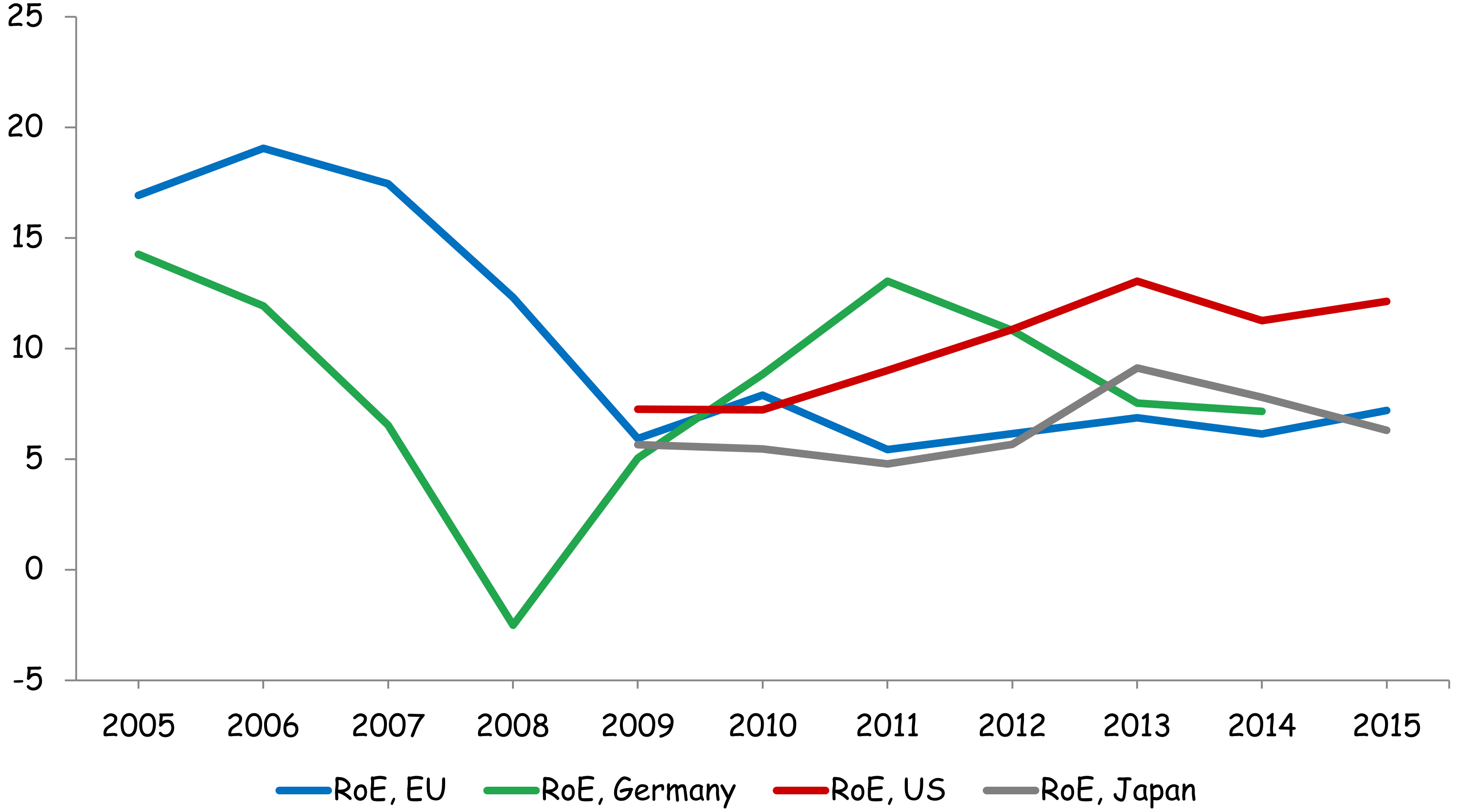
The degree of private sector deleveraging differs across regions.



The effects of regulations on bank lending differ significantly across countries and financial institutions.

- **In 2012, the International Banking Research Network was founded in order to improve our understanding of drivers of (cross-border) bank lending, the role of international banks, and policy spill-overs.**
  - The IBRN brings together central bank researchers from more than **20 central banks**, the **BIS**, the **IMF**, and the **ECB**.
  - It coordinates common research, using **micro-data** on global banks.
- **Cross-border effects of macroprudential tools differ significantly across countries, institutions, and policy instruments.**
  - Lending response to capital requirements, exposure limits, loan-to-value caps, and reserve requirements, depends on the s**trength of banks' balance sheets**.
  - Spill-overs through affiliates of foreign banks are more frequent than those through domestic banks.

Banks' return on equity has fallen since the crisis.



Bank profitability is an insufficient indicator of the strength of the financial system.

- **(Declining) bank profitability is often interpreted as an indicator for the effects of regulatory reforms and the stability of banks.**
- **Yet, changes in bank profitability can have different causes:**
  - **Regulatory reforms** affect bank profitability through higher equity capital and a reduction of TBTF subsidies
  - **Monetary policy** affects bank profitability and risk-taking in the short- and the long-run.
  - **Structural changes** in the real economy and the financial system drive returns and costs of banking activities.
- **Empirically, the link between bank profitability, the structure of banking markets, and (systemic) risk is not clear-cut.**

Summing up

1. **Regulatory reforms need to be assessed against their impact on banks' resilience in terms of lower (systemic) risk and higher capital.**

   – Consistent and credible application of the new rules is crucial, addressing both, the stock and flow adjustment in the financial sector.

2. **Impact assessments need to follow a structured process.**

   – This allows taking into account the timing of reforms, the structure of the financial system, and drivers of heterogeneity.

3. **Discussions on financial sector reforms need to be embedded into the broader context of the real economy.**