Ten years ago, the meltdown: Regulating finance and new issues

Preface

Bruno Le Maire, minister of the Economy and Finances

Introduction

Christophe Moussu, ESCP, LabEx ReFi, and **Pierre-Charles Pradier**, Université Paris 1 Panthéon-Sorbonne, LabEx ReFi

1 – The crisis narrative and regulatory responses

The financial crisis and depression: Can lessons be drawn from the Great Depression?

Pierre-Cyrille Hautcoeur, EHESS-PSE

The recessions during the periods in the 1930s and starting in 2008 are compared on two points: *a)* public authorities' reactions at the peak of these two banking and financial crises (which differed significantly thanks to what both the United States and Europe had learned during the Great Depression); and *b)* the financial regulations adopted in reaction to the 2008 meltdown. In the main, the regulations adopted during the Great Depression were gradually lifted between the 1950s and 1990s, thus doing away with many inconsistences and sources of inefficiency but also recreating considerable fragility – as became apparent in 2008. Owing to the political and scientific context, the long stagnation after 2008 has not (yet) set off a regulatory trend on as large a scale as during the Great Depression.

The complexity of regulatory responses to the crisis

Pierre-Charles Pradier, Université Paris 1 Panthéon-Sorbonne, LabEx ReFi

The 2008 financial crisis broke out in the United States but had repercussions worldwide, evidence of this being the role played by the G20. Although insufficient supervision was at the origin of the meltdown, a formal consensus formed around an agenda for reforming finance, in the broadest sense of the word, via a global governance shaped around the G20. The sense of emergency led to significant advances, especially for regulating financial institutions, fighting against tax havens and fostering a convergence of interests. Since then however, this momentum has been quelled; and cooperation has yielded to forms of competition, now appearing, for example, in innovations in digital technology. Since changing regulations shifted problems more than it solved them, the principal achievement seems to have been the development of forums on the scale of the G20.

Optimization, a cover for speculation

Christian Stoffaës, honorary chairman of the Centre d'Études Prospectives et d'Informations Internationales

The ideas of economists lead the world, and the ideas of the economists who listened to the Sirens of the banking industry are very likely the source of the 2008 financial meltdown. Fortunately, engineers and economists remain who are concerned with the real economy – of technology and investments, of factories and infrastructures, of people and social relations. They must speak up to modify the world view that resulted in the contemporary Great Recession.

Small lessons from a very big crisis

Jean-François Boulier, Association Française des Investisseurs Institutionnels

The very big crisis of 2008 is of the one-in-a-century kind, all its aspects and effects out of proportion. Reactions, fortunate but belated, of public authorities have ended in an excess of regulations. But have we drawn all the lessons from this worldwide maelstrom? The *a posteriori* analysis of a hundred chronicles published in *Option Finance* during the period from seven years before the meltdown till seven years afterwards shows not only how difficult it is, even for professionals, to predict the scope of a looming crisis, but also how effective managerial methods based on economic fundamentals and a long-term approach can be. These after-the-fact considerations, however useful they might be, will not ward off the next recession. Hopefully however, they might help attenuate its effects.

Will postcrisis regulations help manage the risks created by systemic institutions?

Olivier de Bandt, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

The 2008 meltdown was marked by large-scale public interventions for saving systemic institutions – the financial institutions with a systemic impact, *i.e.*, those too big to fail, whose problems cause problems for other institutions or have negative effects on the real economy. The capital injected by public authorities in some of these institutions deepened public deficits. Although these injections amortized the systemic shock, it has also fostered a moral hazard. During the period right after the meltdown, a program of financial reforms was implemented on the initiative of the G20. This assessment of certain reforms concentrates on two aspects: the regulation of systemic institutions in

order to limit their impact on the financial system; and the adoption of measures facilitating settlement and clearing operations in systemic institutions.

2 – Economic agents coping with the new regulations

Banks since the meltdown

Jean Beunardeau, HSBC France

Economic and banking crises are usually set off by the financing of unprofitable investments, which result in losses. The 2008 meltdown is no exception. Owing to its severity, governments and regulatory authorities had to deeply change the banking industry's regulatory framework: higher solvency ratios, modified rules for weighting risks and tighter supervision. The arrangements for handling financial crises were also altered with the aim of keeping the financing of emergency interventions from running though government budgets. This new environment is, for sure, much more robust than what previously existed. However some questions have been left hanging, in particular, about the possible consequences of regulatory differences between monetary zones on the effectiveness of financing the economies of the countries concerned and of allocating savings worldwide. Other questions have to do with the usual models of correlation for measuring risks and the possibly procyclical nature of accountancy standards.

New challenges for financing the economy

Marie-Anne Barbat-Layani, general manager of the Fédération Bancaire Française

A paradox: American banks have come out of the crisis stronger than before, even though the 2008 meltdown started in the United States. Unlike other economies in the eurozone, France did not experience a credit crunch during the meltdown: access to credit remained open, and the conditions for obtaining loans remained favorable. France is the only country in the eurozone where the financial crisis cost taxpayers nothing. French banks have come through the crisis. Their profit-earning capacity, though it has decreased in the meantime, is higher and less volatile than in equivalent countries in Europe. In the past ten years, banks have had to cope with major regulatory changes. The eurozone's Banking Union has instituted a system, unique in the world, of supervision and of arrangements for preventing and managing banking crises. It has made the financial system more solid. The big systemic banks have bolstered their equity and reduced eventual risks to their balance sheets, while dynamically financing the economy. European banks must now adopt a new model for financing the economy (more funding via the market, less via loans) and for regulations. Regulations (in particular, the Basel Accords) following the meltdown have tended to fall in line with the American model, whence several challenges for European banks: regulatory, economic (during a long period of low interest rates) and digital. However the digital challenges are also an opportunity for improving customer services.

The Cost of Regulation

Michala Marcussen, Société Générale's Group Chief Economist

Tighter regulation inevitably carries a cost, but must be weighed against the benefits of greater financial stability. Estimating net benefits is, however, a complex exercise and while consensus is that in aggregate these remain positive, gains could be made by improving efficiency and addressing leakages. Moreover, structural reform, and not least completing the European Banking and Capital Markets Unions, would do much to alleviate downside risks and lift growth.

History teaches that ensuring economic prosperity and financial stability over time requires more than a set of regulatory safety margins. The revival of macroprudential regulation aims to address past errors with a flexible and forward-looking approach. These tools are still largely untested and at risk of unintended costs. Overall optimisation of the net benefits from regulation requires an iterative and co-ordinated approach. The potentially most damaging costs stem from regulatory protectionism. Recent trends are worrying and could, if confirmed, also forewarn of a less co-ordinated G20 response to the next crisis.

The regulatory avalanche: The example of the insurance industry

Arnaud Chneiweiss, chief representative of the Fédération Française de l'Assurance

French insurance companies are coping with a "regulatory avalanche", an unprecedented accumulation of uncoordinated rules and standards. This overregulation (with many sources: national, European, international) is somewhat of a tribute to the key role this industry plays in contemporary society. However it is dangerous for growth, since useless regulations can hamper growth and innovation. It is essential for regulatory authorities to better coordinate their actions and for regulations to be jointly worked out with the major stakeholders.

The regulation of fintechs and the "fintechnization" of regulations

Héloïse Berkowitz, CNRS (UMR 5303 TSM-Research) and Institut Barcelona d'Estudis Internacionals; and **Antoine Souchaud,** NEOMA Business School and LabEx ReFi

The word "fintech" sounds like the name of a chimera – a Minotaur, a combination of two protean elements each of which arouses fear as much as hope. Regulating fintech firms implies the ability to define unstable phenomena, the capacity for creating policy networks and innovative forms of organization among emerging stakeholders and, finally, the capability of taking account of, and coping with, the anxiety felt by regulators about their utility. The fintech trend forces regulators to ask questions about themselves and about the need to "fintechnize" financial regulations.

3 – Major projects under way

Banks and tax havens

Vincent Bouvatier, Université Paris-Est Créteil (ERUDITE); **Gunther Capelle-Blancard**, Université Paris 1 Panthéon-Sorbonne (Centre d'Économie de la Sorbonne), Paris School of Business and Labex ReFi; and **Anne-Laure Delatte**, Cepii and CNRS

The UBS affair in 2008, Offshore Leaks in 2013, Lux Leaks in 2014, Swiss Leaks in 2015, Panama Papers and Football Leaks in 2016, Paradise Papers in 2017… Since the worldwide financial crisis, scandal after scandal, it is increasingly evident that banks have actively set up shell companies, abetted tax evasion, laundered money and dodged international regulations, even though it is still hard to accurately document these actions. Since 2016, the European Union has managed to require banks to publicly release information on their activities in all countries where they do business, including, therefore, in tax havens. According to the information gleaned from this country-by-country reporting, tax havens account for 18% of the revenue of European banks, for 29% of the profits earned abroad, but only for 9% of their work force.

Capital and the RoE in banks: False beliefs and financial instability

Christophe Moussu, professor, ESCP Europe, LabEx ReFi

We must admit that the conception of banks about their performance objectives and the optimal level of their equity has changed little since the 2008 meltdown. Nonetheless, several academic studies on equity in the banking sector have shown that the most capitalized banks are the banks that best stand up to shocks, are the most efficient, and have the largest market shares and market value. RoE (return on equity) is still the best indicator of a bank's performance (on which incentive payments to senior executives are based). Empirical studies have shown that the RoE leads to risk-taking in banks – risks to the detriment of shareholders during crises and, during normal periods, risks that add no value. These beliefs affect the choices banks make for allocating assets and devising a financial policy; and they deviate the thought given to working out a strategy. Ten years after the financial meltdown, it is time for these beliefs to evolve, even more so since the absence of antagonism between the private interests of the banks' shareholders and of society has been proven.

An innovative fiscal policy for making European banks more stable and competitive

Michael Tröge, ESCP Europe

Following a series of tax and bookkeeping reforms since the 1980s, corporate taxes induce firms to prefer debt as a means of funding. This bias for indebtedness forces banks to adopt a very high level of indebtedness in order to remain competitive. As empirical studies have recently shown, this is a major reason for the financial system's fragility. There are, however, simple tax and accountancy reforms that could nullify this bias or even reverse it so as to create a preference for equity funding. These reforms would not only help align tax incentives with the objectives of financial regulations but also (and above all) give a substantial competitive advantage to the banks that face stiff international competition.

Preventing systemic risks

Jean-François Lepetit, chairman of the Comité de Contrôle Interne des Risques et de la Conformité, BNP-Paribas

The 2008-2011 financial crisis served to justify the implementation of regulations that, by focusing on the role of banks as financial intermediaries, have reduced as much as possible the likelihood of a systemic crisis sparked by intermediation. This is a fortunate result. As a consequence of this protection of the banking industry however, market intermediation has increased under conditions that make it an even greater systemic risk. Although the 2008 meltdown was a systemic crisis of the markets in which banks should never have been involved (had they been properly regulated), the subprime crisis would still have been systemic owing to the vulnerability of market intermediation. Influenced by the American model, the world of finance and the European Union have, nonetheless, decided to shift procedures for market intermediation in a more systemic direction than previously. Flooded with liquidities owing to the policy adopted by central banks, debt markets will inevitably undergo a new systemic crisis that will push Western countries to regulate the whole financial system (what they should have done)… or to nationalize it.

Banks and markets, alternatives for financing the economy?

Laurent Grillet-Aubert and **Pierre-Emmanuel Darpeix**, Autorité des Marchés Financiers (AMF)

In contrast with bank loans, the markets allow, in principle, for allocating savings to investments without any intermediation. Policies since the 2008 meltdown (the capital markets union, securitization reform, monetary easing, etc.) have led to financing the economy via the markets, in particular via indebtedness, even as questions are being raised about the optimal allocation of funds and the financial system's resilience. Nonetheless, pointing to the cleavage between banks and financial markets (or "nonbanks") is reductionist. It is necessary to have a global view of the various sources of financing (including equity) and to take into account interconnected networks and chains of intermediation (between banks and nonbanks) in order to increase the system's efficiency and improve risk management.

4 – A Europe of finance still being built

The meltdown and cooperative solutions: The eurozone since 2008

Jérôme Creel, ESCP Europe, LabEx ReFi and Sciences Po, OFCE

As always since a start was made at building a united Europe, the European Union is advancing step by step, crisis by crisis. The last crisis has brought to light inconsisten-

cies in Europe's economic governance. The meltdown of banks in the United States in September 2008 deeply affected the eurozone. The first phase (2009) of the recession was global; but it brought a second phase (2012-2013) that would be European, a phase that followed on a coordinated enforcement of restrictive budgetary policies. When this budgetary policy failed to halt the crisis, the European central bank was forced to adopt exceptional measures; and the European Stability Mechanism was set up to coordinate the management of economic crises. In addition to these steps forward, reforms are still needed to improve the coordination between monetary and budgetary policies and with the structural reforms undertaken in Europe.

"Macroprudential" measures, a tool in the eurozone's macroeconomic policy

Agnès Bénassy-Quéré, École d'Économie de Paris, Université Paris 1 Panthéon-Sorbonne

Following the 2008 financial meltdown and even more the eurozone crisis, several innovations were made in economic policies in Europe: in particular "macroprudential" policies and procedures for coping with macroeconomic instability. However these arrangements for coordination and supervision are not optimally articulated. Each measure should be clarified by stating its objectives, tools, scope, overall indicator and the institution in charge of supervision.

The capital markets union: A vantage point

Christian de Boissieu, professor emeritus, Université de Paris I Panthéon-Sorbonne

The capital markets union (CMU) and the banking union are major programs concerning the EU's financial sector. The CMU seeks to stimulate investments, growth and employment thanks to more efficiency and an increased integration of European financial markets. What are the objectives of the CMU, its approach and means? What are the obstacles to overcome before realizing this ambitious program?

Post-crisis Regulation of Asset Management

Luca Enriques, Oxford, and **Gerard Hertig**, ETH Zurich

While asset managers' behavior has not been among the root causes of the financial crisis, their industry's size and structure have generated financial stability concerns among policymakers. Global regulatory bodies nowadays agree that asset management activities are "systemically important." On the other hand, the growth in retail activities has prompted regulatory and self-regulatory bodies to enact new rules relating to conduct of business, advice and best execution.

Our essay briefly reviews global reforms affecting the asset management industry, focusing first on systemic interventions and then discussing investor protection reforms. To conclude, it addresses some emerging issues that we expect to be on policymakers' agenda in the future.

*Issue editors: **Pierre-Charles Pradier** and **Christophe Moussu***