

Policy & Regulation

4 Key Questions



Why do banks need to be regulated?

In []:

What is the difference between regulation and policy?

In []:

What is a central bank?

In []:

What are the main challenges of policy and regulation?

In []:

Map

1. Foundations
2. Main pillars of regulation
3. Institutional architecture
4. Emerging challenges



1. Foundations



Why Regulate?

Banks are not just private firms; they perform **core functions for the economy**.

Regulation ensures that these functions serve the **public interest** rather than amplifying private risks.



Main Reasons for Regulation

1. **Market failures**
2. **Public good role of banking**
3. **Systemic and economic externalities**
4. **Economic integrity**



Market Failures

Information asymmetry - borrowers know more about their projects than lenders
→ credit rationing and mispricing of risk.

- **Moral hazard** - deposit insurance and limited liability may encourage excessive risk-taking.
- **Adverse selection** - in opaque markets, safe borrowers exit, risky ones remain.



Unregulated markets may misallocate credit and mismanage real risk.



Public Good Role of Banking

Money - banks create and distribute the dominant form of money (**deposits**).

Payments - provide the backbone of the economy's transaction infrastructure.

Credit - channel savings to productive investment.

Trust - confidence in banks sustains financial and economic activity.



These functions are systemic public goods — their breakdown affects all sectors.



Systemic Risk and Economic Externalities

Financial Fragility - banks fund long-term assets with short-term deposits
→ vulnerable to **runs** (Diamond–Dybvig).

Interconnectedness & Contagion - banks are linked through interbank lending, derivatives, and payment systems.
→ distress in one institution can propagate through the network (e.g. Lehman Brothers 2008).

Real-Economy Spillovers - financial distress triggers layoffs, investment cuts, and lower growth.
→ bank distress reduces lending to firms and households
→ **credit crunch** deepens recessions.



Individual bank failures can create macro-financial feedback loops, justifying prudential and macroprudential regulation.



Economic Integrity

Gatekeepers - banks serve as entry points to the financial system and monitor the legitimacy of transactions.

→ controls aim to stop **money laundering, terrorist financing, fraud, corruption, and sanctions evasion.**

System legitimacy - strong integrity frameworks preserve the **credibility and reputation** of the financial system.

Global coordination - international AML/CFT standards (e.g. FATF) ensure consistent enforcement across jurisdictions.



Ensuring integrity means preserving public trust in finance, without which monetary stability and market efficiency cannot be sustained.



Policy vs Regulation



Public authorities shape the financial system through two complementary layers of action:

- **Policy** defines the **vision and objectives**
 - Ex: *maintain financial stability, foster competition, or prevent financial crime*
- **Regulation** translates these objectives into **concrete, enforceable rules and mechanisms**
 - Ex: *capital buffers, disclosure duties, or KYC requirements*

Goal: ensure that the financial system serves both **economic efficiency** and **public trust**.



Aspect	Regulation	Policy
Definition	Binding rules that specify what financial institutions must or must not do.	Strategic framework or objectives guiding desired economic or social outcomes.
Nature	Legal and enforceable (laws, directives, supervisory rules).	Strategic and goal-oriented (principles, objectives, priorities).
Issuer	Regulators and supervisors (central banks, authorities).	Governments, central banks, international institutions.
Example	Basel III capital requirements, AML obligations.	Financial stability policy, innovation policy, inclusion policy.
Objective	Ensure compliance and sound practices.	Define desired outcomes and balance trade-offs.

2. Main Pillars of Regulation

Banks are subject to **multiple layers of regulation** — each addressing a different dimension of risk and public interest.

These pillars ensure that the financial system remains:

- **Safe and sound** (prudential)
- **Fair and transparent** (conduct)
- **Clean and trustworthy** (integrity)



Complementarity of the Pillars

Each pillar targets a **different source of risk** — solvency, behavior, or integrity.

Together, they form a **comprehensive regulatory architecture**.

Effective supervision requires **coordination** across prudential, conduct, and integrity domains.



Balancing Objectives

Regulators must navigate key **trade-offs**:

- **Stability vs Competition:** excessive competition can erode stability but lack of competition can increase rents
- **Integrity vs Inclusion:** prevent illicit finance but risk excluding legitimate users
- **Innovation vs Safety:** strict rules may stifle technological innovation
- **National vs Supranational control:** international coordination challenges



Overview of the Main Pillars

Pillar	Objective	Focus	Examples of Frameworks
Prudential Regulation	Financial stability and solvency	Capital, liquidity, leverage, risk management	Basel III, CRR/CRD, BRRD
Macroprudential Policy	System-wide stability	Buffers, systemic surcharges, stress tests	ESRB, FSOC, Basel III add-ons
Conduct Regulation	Fair treatment of customers and market participants	Disclosure, suitability, governance	MiFID II, Retail Banking Directives, CFPB (US)
Integrity Regulation	Prevent misuse of the financial system	AML/CFT, sanctions, market abuse	FATF, AMLD, MAR, OFAC



1. Prudential Regulation



1.1 Basel Framework (Global Standard)

International banking regulation is built on a **common prudential standard** developed by the **Basel Committee on Banking Supervision (BCBS)**.

The Basel framework sets the rules that determine how much **capital and liquidity** banks must hold to remain safe and resilient.

It is implemented through national laws — such as **CRR/CRD** (Capital Requirement Regulation and Directive) in the EU.



Core Elements

1. **Capital Requirements** - setting of

- Minimum **Common Equity Tier 1 (CET1)**: 4.5% of risk-weighted assets.
- **Total capital ratio**: 8% plus applicable buffers.

2. **Leverage Ratio** - caps on total assets relative to capital, limiting excessive balance-sheet expansion.



3. **Liquidity Ratios** - setting of

- **Liquidity Coverage Ratio (LCR):** enough high-quality liquid assets to survive a 30-day stress.
- **Net Stable Funding Ratio (NSFR):** ensures stable long-term funding over a 1-year horizon.



Macro-Prudential Buffers

In addition to minimum capital ratios, banks must hold **extra capital buffers** to absorb losses and smooth the financial cycle.

These buffers also come from the **Basel III framework** and are implemented in the EU through the **Capital Requirements Directive (CRD)**.



Main types:

- **Capital Conservation Buffer** – baseline cushion (2.5% CET1) to absorb unexpected losses.
- **Countercyclical Buffer** – built up in good times, released in downturns to support lending.
- **Systemic Risk Buffers** – higher requirements for systemically important or structurally risky banks (G-SIBs, O-SIBs).

Who sets them?

National or EU **supervisory authorities** (e.g. ECB/SSM, ESRB) decide when and how buffers apply.



1.2 Resolution & Deposit Protection



Bank Recovery and Resolution Directive (BRRD, EU):

Core framework for managing failing banks **without taxpayer bailouts**.

- Requires **recovery and resolution plans** (“living wills”) to ensure orderly wind-down.
- Introduces the **bail-in** tool: shareholders and creditors bear losses before public funds are used.
- Establishes the **Single Resolution Mechanism (SRM)** with a central **Single Resolution Board (SRB)** in the Eurozone.



Deposit Guarantee Schemes (DGS):

Protection for retail deposits:

- In EU up to **€100,000 per depositor per bank**
 - Harmonized across member states
 - Funded by the banking sector, not taxpayers since 2014
- Aim to **preserve confidence** and **prevent deposit runs** during crises.



2. Conduct and Consumer Protection



While prudential rules safeguard the **soundness of banks**, conduct regulation protects the **users of financial services** — ensuring that markets operate fairly and customers are treated honestly.

These rules promote **transparency, accountability, and trust** in the relationship between banks and their clients.



Main Frameworks

- **MiFID II (EU):** sets standards for investor protection, product governance, and trading transparency.
- **Retail Banking Directives (EU):** govern disclosure, fair treatment, and mortgage credit practices.



3. Economic Integrity Regulation



Beyond stability and consumer protection, financial regulation also safeguards the **integrity of the financial system**.

Banks and market participants must ensure that finance is **not misused for illicit purposes** such as money laundering, terrorist financing, or market manipulation.

Integrity rules preserve **trust, reputation**, and the **legitimacy** of the financial system as a whole.



3.1 AML/CFT Frameworks

The **Anti-Money Laundering (AML)** and **Countering the Financing of Terrorism (CFT)** frameworks form the backbone of **economic integrity regulation**.

They aim to prevent the financial system from being used to disguise criminal proceeds or fund illicit activities.



Main Frameworks

- **EU AML Directives (currently 6th AMLD):** harmonize national laws on customer due diligence, reporting, and beneficial ownership transparency.
- **FATF Standards:** global benchmark setting 40 Recommendations for AML/CFT policies adopted by most jurisdictions.



Core Requirements

1. **Know-Your-Customer (KYC):** verify customer identity before entering a relationship.
2. **Customer Due Diligence (CDD):** assess and monitor risks associated with clients and transactions.
3. **Suspicious Transaction Reports (STRs):** report unusual or suspicious activities to national **Financial Intelligence Units (FIUs)**.
4. **Beneficial Ownership Registries:** identify the real individuals behind corporate entities.



3.2 Sanctions Compliance

Sanctions regimes are a key component of **economic integrity** and **international security policy**.

They restrict access to the financial system for **blacklisted individuals, entities, or countries** involved in terrorism, corruption, or breaches of international law.



Main Frameworks

- **United Nations (UN)** – global sanctions adopted by member states.
- **European Union (EU)** – common sanctions policy across all member countries.
- **United States (OFAC)** – extensive financial and trade sanctions enforced worldwide through the **Office of Foreign Assets Control**.



Implementation in Banking

- Banks must screen clients and transactions against official sanctions lists.
- Breaches can lead to **severe fines and reputational damage**.
- Compliance requires ongoing monitoring, reporting, and internal controls.



3.3 Market Integrity and Transparency



Market integrity rules ensure that **financial markets remain fair, transparent, and free from manipulation.**

They protect investors, support price discovery, and sustain confidence in the financial system.



Main Framework

- **Market Abuse Regulation (MAR, EU):**
 - Prohibits **insider trading, unlawful disclosure of information, and market manipulation.**
 - Applies to all instruments traded on EU markets, including derivatives.



Core Principles

1. **Transparency:** timely disclosure of relevant information.
2. **Fairness:** equal access to market information and trading conditions.
3. **Surveillance:** continuous monitoring to detect abusive behavior.



3. Institutional Architecture

1. Regulatory Landscape in Europe



Key Institutions



The European regulatory architecture rests on a **multi-level framework** that combines EU-wide coordination with national implementation.

Each institution plays a distinct role in maintaining **stability, consistency, and oversight** across the banking system.



European Central Bank (ECB):

- Conducts **monetary policy**
- Ensures **banking supervision** through the *Single Supervisory Mechanism (SSM)*.
 - Directly supervises the largest and most significant Eurozone banks.

European Banking Authority (EBA):

- Promotes **regulatory harmonization** across the EU through the *Single Rulebook*.
- Conducts **EU-wide stress tests** and develops technical standards.



European Securities and Markets Authority (ESMA):

- Regulates **capital markets, securities trading, and market infrastructure** (MiFID II/MiFIR, MAR, EMIR).
- Ensures **investor protection** and consistent application of market rules across the EU.

European Systemic Risk Board (ESRB):

- Oversees **macroprudential risks** and systemic vulnerabilities in the EU financial system.
- Issues warnings and recommendations to national authorities.



European Anti-Money Laundering Authority (AMLA): *(under establishment)*

- Will oversee **AML/CFT supervision** of high-risk institutions and coordinate national FIUs.
- Aims to ensure **consistent enforcement** of AML rules across the EU.

National Competent Authorities (NCAs):

- Implement EU rules and supervise **smaller domestic institutions** under ECB oversight.
- Adapt and enforce regulation at the **national level**.



2. Central Banking and Supervision



Central banks stand at the **core of modern financial governance**.

They are not only responsible for **monetary policy**, but also for **financial stability, crisis management**, and — increasingly — **regulatory supervision**.

Their actions shape the overall stability, efficiency, and integrity of the financial system.



Core Roles



Central banks fulfill several critical functions that go far beyond setting interest rates:

1. **Government's Bank:**

- Manages **public debt**, issues government securities, and holds the state's accounts and reserves.
- Acts as fiscal agent for the Treasury.

2. **Banks' Bank:**

- Provides liquidity to commercial banks through **lending facilities** and **lender-of-last-resort** operations.
- Ensures the stability of the banking system during crises.



3. Money Supply and Monetary Policy:

- Controls the quantity and price of **base money** (reserves and cash).
- Uses policy tools to steer short-term interest rates and influence inflation and credit conditions.

4. Payments and Infrastructure:

- Oversees and operates **payment and settlement systems** to guarantee their safety and reliability.
- Example: TARGET2 in the Eurozone, Fedwire in the US.



5. Integrity and Stability:

- Monitors the **soundness of the financial system** and helps prevent its misuse for illicit activities.
- Coordinates with supervisors and FIUs on AML/CFT matters.



Principles of Central Bank Design



A well-designed central bank must balance **independence** with **accountability** to maintain legitimacy and effectiveness.



Independence

- Shields monetary policy from short-term political pressures.
- Essential for **price stability** and the **credibility** of commitments.

In the EU: the Treaty on the Functioning of the European Union (TFEU) guarantees the ECB's institutional and operational independence — no government may seek to influence its decisions (Article 130).



Accountability

- Central banks must explain and justify decisions to parliaments, governments, and the public.
- Strengthens democratic oversight.

***In the EU:** the ECB reports regularly to the **European Parliament**, including quarterly hearings and publication of its **Annual Report** submitted to both Parliament and the Council.*



Transparency

- Regular communication through **minutes, forecasts, and forward guidance**.
- Reduces uncertainty and anchors market expectations.

***In the EU:** the ECB publishes detailed **accounts of monetary policy meetings, press conferences** after each Governing Council decision, and **forward-looking projections** to clarify its policy stance.*



Monetary Policy Framework



Monetary policy provides the **set of tools and operations** through which central banks influence **liquidity**, **interest rates**, and **credit conditions** in the economy.

Its design evolves with crises, financial innovation and macroeconomic conditions.



Conventional Monetary Policy



Conventional instruments operate through **short-term interest rates** and liquidity management.

They are used in normal times to steer inflation and stabilize the business cycle.

Main tools:

1. Open Market Operations (OMOs)

- Buying or selling government securities to influence short-term interest rates and bank reserves.
- Example: the ECB's *Main Refinancing Operations (MROs)* and *Long-Term Refinancing Operations (LTROs)*.



2. Standing Facilities

- **Lending Facility** - banks borrow overnight at a penalty rate.
- **Deposit Facility** - banks earn interest on excess reserves, setting a floor for market rates

3. Reserve Requirements

- Minimum reserves that banks must hold with the central bank; affect money market liquidity.



Non-Conventional Monetary Policy



When conventional tools reach their limits — notably at the **zero lower bound** on interest rates — central banks resort to **non-conventional measures** to maintain stability and support economic activity.



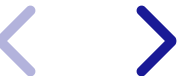
Key instruments

- **Forward Guidance**

- Communication strategy that commits to setting interest rates for a defined period.
- Shapes market expectations and reduces uncertainty.
- Example: ECB guidance post-2013 and during the COVID-19 pandemic.

- **Quantitative Easing (QE)**

- Large-scale purchases of government or private securities to inject liquidity and lower long-term interest rates.
- Example: ECB's *Asset Purchase Programme (APP)* and *Pandemic Emergency Purchase Programme (PEPP)*.



- **Targeted Lending (TLTROs)**

- Long-term loans to banks at favorable rates, conditional on lending to the real economy.
- Supports credit flow to households and firms.

- **Negative Interest Rates**

- Imposing a small cost on excess reserves held by banks to encourage lending.
- Example: ECB deposit rate below 0% between 2014–2022.



Policy Objectives

Across both conventional and non-conventional tools, the central goals remain:

- **Price Stability:** maintaining inflation close to target ($\approx 2\%$ in the Eurozone).
- **Financial Stability:** preventing credit bubbles and ensuring liquidity in stress periods.
- **Sustainable Growth:** supporting economic recovery without compromising long-term stability.



Monetary vs Fiscal Policy



Monetary and fiscal authorities share overlapping goals but rely on **different instruments** and **time horizons**.

- **Fiscal Policy** uses **spending and taxation** to influence demand and redistribute resources.
- **Monetary Policy** uses **interest rates and liquidity** to stabilize prices and the credit cycle.



Fundamental Tension arises when governments pressure central banks to keep rates low to reduce debt costs.

- Leads to inflationary risks and undermines credibility.



Central bank independence is crucial to prevent fiscal dominance and preserve long-term stability.



4. Emerging Challenges



1. New Frontiers



The financial system is evolving rapidly under the influence of **technology, data, and sustainability concerns**.

These developments challenge traditional regulatory boundaries and call for **new frameworks** to ensure stability, fairness, and resilience.

The new frontiers of regulation address **three major transitions**: digitalization, cyber resilience, and climate sustainability.



Fintech & Digital Finance



Innovation is reshaping how financial services are delivered and how risks emerge.

Regulation aims to foster innovation **without undermining financial stability or consumer protection.**



Crypto-assets and tokenization:

- The EU's **Markets in Crypto-Assets Regulation (MiCA)** provides a harmonized framework for crypto-asset issuance, trading, and service providers.
- Covers stablecoins, utility tokens, and crypto-asset platforms.

Open Banking and Data Sharing:

- **PSD2 (Payment Services Directive 2)** requires banks to open customer data (with consent) to licensed third parties via APIs.
- Encourages competition and innovation in payments and financial services.



New Entrants:

- Licensing of **neobanks**, **payment institutions**, and **BigTechs** entering finance.
- Raises questions about **level playing fields**, **data concentration**, and **cross-sector oversight**.



Operational Resilience and Cyber Risk



As finance becomes more digital and interconnected, **technological failures** and **cyberattacks** represent growing threats to financial stability.

EU's Digital Operational Resilience Act (DORA):

- Establishes a unified framework for managing ICT and cyber risks across all financial entities.
- Covers incident reporting, digital continuity, and oversight of third-party service providers (e.g., cloud computing).



Climate and ESG Risks



Sustainability concerns are reshaping financial regulation as climate change introduces **new forms of systemic risk** and **market disruption**.



EU Green Taxonomy:

- Defines which economic activities qualify as environmentally sustainable to guide investment and disclosure.

Disclosure and Reporting:

- The **Sustainable Finance Disclosure Regulation (SFDR)** and **Corporate Sustainability Reporting Directive (CSRD)** mandate transparency on ESG risks and impacts.



Climate Stress Testing:

- Central banks and supervisors (e.g., ECB, BoE, NGFS) test banks' exposure to physical and transition risks.
- Encourages integration of climate considerations into risk management and capital planning.



2. Policy Trade-offs

Financial regulation is about **managing trade-offs** between competing public objectives. No single policy goal — stability, innovation, integrity, or inclusion — can be achieved in isolation.

Effective governance requires regulators to **balance risks and benefits** across these dimensions, adapting rules as technology and markets evolve.



Stability vs Innovation

- Strong prudential and conduct rules protect the system from excessive risk-taking.
- Yet, **overly restrictive regulation** may discourage experimentation and slow financial innovation.
- Example: strict capital rules can limit bank investment in fintech partnerships or new payment solutions.

→ *Challenge: support innovation while preserving financial stability.*



Integrity vs Inclusion

- AML/CFT rules safeguard economic integrity and prevent illicit finance.
- But strict compliance can lead to **de-risking** — banks withdrawing from high-risk regions or clients, reducing access to finance.
- Particularly affects **small remittance providers** and **emerging economies**.

→ *Challenge: fight financial crime without excluding legitimate users from the system.*



National vs Supranational Oversight

- In the EU, financial supervision is shared between **national authorities** and **EU institutions** (ECB, EBA, ESMA, AMLA).
- Coordination ensures consistency but can also slow decision-making and create accountability gaps.

→ *Challenge: align diverse national interests under a unified European framework.*



Privacy vs Security

- Data-sharing and surveillance are essential for detecting financial crime and systemic risks.
- Yet they can conflict with **data protection** and **individual privacy** (e.g., GDPR constraints vs AML monitoring).

→ *Challenge: find the right balance between public safety and fundamental rights.*

