I-1.39: An illustration of regulation's irony: how Moody's downgraded 12 German banks after regulatory change.

Margot Sève, Junior Editor and Member of the Editorial Committee

Driven by the will to achieve market stability -financial regulation's main objective- States and/or regulators have taken since the 2007-? financial crisis several post-crisis regulatory measures to both prevent and cope with financial crisis. Indeed, some efforts have already been put into the re-regulation of our previously de-regulated system, whether through the enactment of new regulatory rules (e.g. on bank capital requirements[1], credit rating agencies[2], hedge funds[3]) or through the implementation of new supervisory frameworks (in Europe[4], France[5], United States[6]).

Yet, while there is a consensus on the urge to enhance the financial system's regulation[7] in order to reach market stability[8], the act of regulating markets may sometimes not only have an economic cost[9], but may also comprise certain downsides, due to the complexity of the economy and the latter's **financialization**[10].

A recent decision taken by the credit rating agency Moody's to take rating actions on 12 German banks depicts what one might call the "irony of regulation", i.e. how sometimes regulations may end up having implications that differ from their original -regulatory- purpose.

On 1 January 2011 came into force in Germany a **new bank resolution regime**, which changed German banks' support environment. The new regime allows the regulator to only support the systematically implicated part of the bank, while imposing losses on all its other debts through a partial liquidation of the bank. But credit rating agencies' methodology for bank rating takes into account "the support uplift" available to public-sector banks (i.e. the chances that banks will be rescued in case of failure); consequently, Moody's immediately acknowledged such regulatory change: "the steps being taken by authorities to reduce the likelihood, predictability and extent of future support has prompted today's rating actions" [11].

More specifically, Moody's published that "the change in Germany's legal environment is more than just a symbolic step towards enhancing financial discipline". Indeed, Moody's took the view that it did "not rule out that bondholders, including senior creditors, may have to shoulder some of the cost of future bank bail-outs", especially as regards the European-wide policies put in place to "have bondholders share the burden of future bank support, in the interest of taxpayers"[12]. *Inter alia*, Moody's also seemed to believe that, under the new regime, even more uncertainty could arise for bondholders as the European Commission, the approval of which is mandatory for all public support awarded to a bank (i.e. state aid), could deny approval for support in future cases of distress[13].

Simply put, it was the new German bank resolution regime that drove Moody's to "reduce Support Assumptions for German Landesbanken", and therefore take rating actions on 12 German Landesbanken (public-sector banks).

Yet, this is not the first time credit rating agencies, which do no more than express an opinion on financial institutions' solvency based on the latter's economic and environment indicators, happen to take rating actions due to regulatory changes.

A similar example can be found in Moody's decision of 21 September 2011 to downgrade the American bank Citigroup, firstly in response to the State's post-crisis intent to suppress moral hazard, and secondly to the new resolution regime implemented by the Dodd-Frank Act. Indeed, although Moody's continues to see the probability of support for highly interconnected, systemically important institutions in the United States to be very high (which had led it in the past to incorporate the expectations of such support in its positive ratings), it nonetheless believes that, from now on, in the current post-crisis environment, the government might allow a large financial institution to fail, believing that contagion could be limited.

More importantly, Moody's decision to downgrade Citigroup reflects the consequence of the enactment of the Dodd-Frank Act. Indeed, the rules recently finalized by the *Federal Deposit Insurance Corporation* (FDIC) led Moody's to believe that "the orderly liquidation authority included in Dodd-Frank demonstrates a clear intent to impose losses on bondholders in the event that a systemically-important banking group (such as Citigroup) was nearing failure. If fully implemented, the provisions in Dodd-Frank could further lower systemic risk by reducing interconnectedness among large institutions and could further strengthen regulators' abilities to resolve such firms"[14]. Moody's therefore resorted in this case to the same reasoning it applied to the German banks' issue.

A last example drawn from the new Basel prudential requirements depicts how credit rating agencies take into account banks' regulatory environment in their ratings. Indeed, while Moody's downgraded in April 2011 the Italian bank Intesa Sanpaolo, it also underlined how the bank's further compliance to new regulations may change such rating (i.e. how the agency would take into account the impact of regulatory measures on the institution).

Indeed, after Intesa announced a capital increase bringing the Core Tier 1 capital ratio to 9.4%, compared to 7.9% in 2010, Moody's said that it viewed "positively this capital increase, bringing capital adequacy to a level that provides a significantly higher buffer to absorb potential losses, and positions the bank more favourably for the introduction of Basel III"[15].

Furthermore, in response to the bank's announcement and the bank's business plan (which projects the Tier 1 ratio remaining at around 10% in coming years), **Moody's made clear that Intesa's rating would greatly depend on its compliance to Basel III standards**: Intesa would be upgraded in the event that the bank maintained, *inter alia*, a core Tier1 ratio higher than the 10% targeted, but would be downgraded further in case of failure to complete the capital increase or maintain the targeted core Tier 1 capital ratio of 10%.

Such practical examples show that while the financial crisis had already shed the light on the **complexity** of the financial system, following regulatory decisions' implications also demonstrated how such **interconnectedness** between all actors on the market, whether public (regulators) or private (financial institutions), are indubitably linked.

Consequently, the decision of one actor, such as the implementation of a new bank resolution regime in the view of **suppressing moral hazard** to prevent market failure and preserve market stability, can subsequently lead to the weakening of such institutions and the **indirect volatility** of the market due to its automatic downgraded rating. Regulation can therefore take an ironic turn when regulatory decisions, which aim at ensuring that financial institutions will not, once more, endanger the financial system, actually end up contributing to its instability.

Moving further from credit rating agencies, other examples of regulation's irony have been underscored by the economic literature, and have proven the difficulty of re-regulating without leading institutions towards new risk of market failure nor bringing additional market distortions.

For example, one can underscore the irony lying under our current **prudential standards**, as they drove banks towards buying **sovereign bonds** (deemed less risky according to such standards) rather than corporate bonds (deemed more risky by regulators), consequently **increasing the risk of a sovereign**

debt crisis' occurrence[16] ; or the irony of the impact that new **capital requirements** are currently having on **credit cost**[17] (although such costs do not outweigh the costs of financial crisis[18]) ; or the mere risk of having re-regulated entities driven towards unregulated vehicles [19] (i.e. towards the so-called "**shadow banking**", which should therefore also be concurrently regulated in order not to make new regulations void[20]).

Therefore, although the issue of regulations' "side-effects" was already well-known to economists, it nonetheless needs to be treated with specific caution in cases such as when our financial regulatory framework lets three types of risk in[21]: regulatory arbitrage, moral hazard and de/self regulation (elaboration of standards delegated to the private sector).

Indeed, and back to credit rating agencies, the most striking example of regulatory irony probably lies in the fact that it was our own laws and regulations that first tied financial institutions to the harshly criticized credit rating agencies, by giving them, through Basel II standards, a role in the standardized approach to credit risk[22].

By **linking regulatory riskweights to credit ratings**, regulators granted to rating agencies a systematically important market role that they had not searched for, and, most importantly, by doing so, introduced a greater **procyclicality of capital requirements** (one of many negative externalities contributing to market failure)… When it comes to financial regulation, the road to hell really is paved with good intentions…

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[1] See European Commission's Communications : COM(2011) 452 of 20 July 2011; COM(2011) 453 of 20 July 2011.

[2] Regulation (EU) n° 513/2011 (OJ L 145 of 31 May 2011, p. 30).

[3] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers.

[4] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board ; Regulation (EU) No 1094/2010 of the European Parliament And of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority) ; Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) ; Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority) ; Council Regulation (EU) No 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.

[5] *Ord. n° 2010-76, 21 janv. 2010 portant fusion des autorités d'agrément et de contrôle des banques et de l'assurance : Journal Officiel 22 Janvier 2010 ; L. n° 2010-1249, 22 oct. 2010 de régulation bancaire et financière : Journal Officiel 23 Octobre 2010*.

[6] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173) of July 21, 2010.

[7] whether through rules or through supervision ; See THE FINANCIAL CRISIS INQUIRY COMMISSION, "Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, The Financial Crisis Inquiry report", January 2011, available on the FCIC's website: http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf ; see also RAMEIX G., « La crise nous montre qu'il ne faut pas forcément réguler davantage. », Revue Lamy Droit des Affaires, 2009, n° 35.

[8] Comprising banks, financial markets and insurance, see AKINBAMI F., "The global financial crisis: causes, effects and issues to consider in the reform of financial regulation", in International Banking in the New Era: Post-

Crisis Challenges and Opportunities, *International Finance Review*, Vol. 11, p. 167-190.

[9] POLLIN J-P., « La nouvelle régulation bancaire microprudentielle : principes, incidences et limites », in Les politiques de Sortie de crise, *Revue d'économie financière*, n°103, octobre 2011, pp. 145-169.

[10] WONG L., "Returning agency back to finance: the critical role of politics and governance in financialization", in Credit, Currency, or Derivatives: Instruments of Global Financial Stability or Crisis?, *International Finance Review,* Volume 10, 545-573

[11] MOODY'S INVESTOR SERVICE, "Moody's Reduces Support Assumptions for German Landesbanken", November 16 2011.

[12] MOODY'S INVESTOR SERVICE, "Moody's Reduces Support Assumptions for German Landesbanken", November 16 2011.

[13] Although Moody's, as for the moment, acknowledges that "the European Commission may be less restrictive in approving bank support during the current sovereign debt crisis". Id.

[14] MOODY'S RATING ACTION, "Moody's downgrades Citigroup Inc to P-2; Citibank Prime-1 affirmed; all long-term senior ratings confirmed", Global Credit Research, 21 Sept. 2011

[15] MOODY'S RATING ACTION, « Release: Moody's downgrades Intesa Sanpaolo to Aa3/C+; outlook stable", Global Credit Research, 13 June 2011

[16] Such analysis had led the economist Patrick Artus to predict, in 2010, the occurrence of the 2011 European sovereign debt crisis: « *Les régulations des banques et des assurances qui sont aujourd'hui mises en place (Bâle 3, Solvabilité 2) découragent la détention des actifs qui financent les entreprises (…) par les banques et les sociétés d'assurance, et encouragent la détention des titres publics. Mais, aujourd'hui, la situation financière des entreprises s'est considérablement améliorée (…) tandis que celle des Etats s'est considérablement détériorée. S'il y a une prochaine crise financière, elle viendra très probablement d'une crise des dettes publiques des Etats trop endettés. Mais puisque les régulateurs poussent les intermédiaires financiers*

à détenir davantage de titres publics, présumés être sans risque et être une réserve de liquidité, ils sont en train d'aggraver la prochaine crise en ayant le regard sur la crise passée ». ARTUS P, « Encore une fois, les régulateurs empêchent la crise passée et non la crise future de se produire », Flash Economie Natixis, 2 dec. 2010, n°. 650, available at http://cib.natixis.com/flushdoc.aspx?id=55630

[17] ARTUS P., « L'interaction entre les ratios de fonds propres et les ratios de liquidité de Bâle III », Flash Economie Natixis, 15 june 2011, n°447, available at http://cib.natixis.com/flushdoc.aspx?id=58732

[18] ANGELINI P., CLERC L., CURDIA V., GAMBACORTA L., GERLI A., LOCARNO A., MOTTO R., ROEGER W., VAN DEN HEUVEL S., VLCEK J., "Basel III: Long Term impact of economic performance and fluctuation", *BIS Working Papers*, No 338, February 2011.

[19] MISTRAL J., "Re-réglementation financière international: un défi transatlantique", in Le risque systémique, vol. 1 Repenser la finance, *Revue d'économie financière,* n° 100, dec. 2010, pp.141-161, spec. p. 156-159

[20] POLLIN J-P., « La nouvelle régulation bancaire microprudentielle : principes, incidences et limites », in Les politiques de Sortie de crise, *Revue d'économie financière*, n°103, octobre 2011, pp. 145-169, spec. p.163

[21] NOYER C., "Régulation et confiance", in Le risque systémique, Vol. 1 Repenser la finance, *Revue d'économie financière*, n° 100, dec. 2010, pp.111-122, spec. p.116

[22] VAN ROY P., "Credit ratings and the standardised approach to credit risk in Basel II", *European Central Bank Working paper series*, No. 517, August 2005 ; NOYER C., "Régulation et confiance", in Le risque systémique, Vol. 1 Repenser la finance, *Revue d'économie financière*, n° 100, dec. 2010, pp.111-122, spec. p.116