UNECE Real Estate Market Advisory Group

The Impact of Energy Prices on Housing, Land Management and the Real Estate Market: Different Perspectives

A side event of 83rd session of the UNECE Committee on Urban Development, Housing and Land Management meeting
Organized by REM – Real Estate Advisory Group

UNECE

The Impact of Energy Prices on Housing, Land Management and the Real Estate Market: Different Perspectives

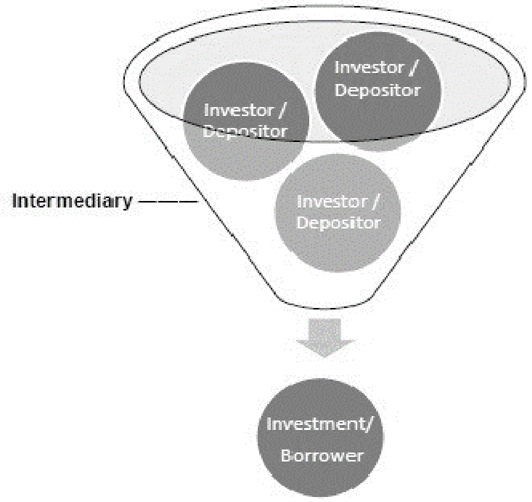
A side event of 83rd session of the UNECE Committee on Urban Development, Housing and Land Management meeting
Organized by REM – Real Estate Advisory Group

The Impact of Energy Prices on Finance and Regulation

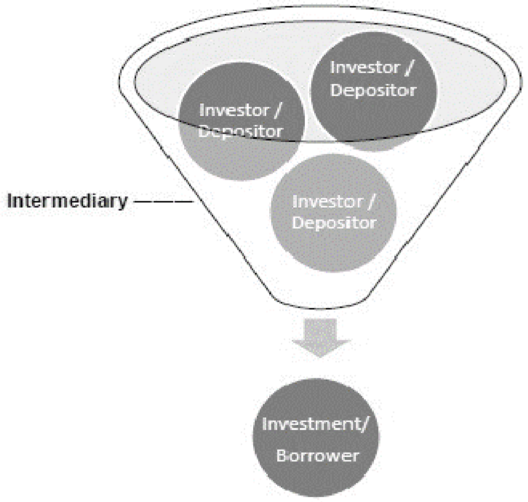
Michael P. Malloy
Distinguished Professor of Law,
University of the Pacific – McGeorge School of Law

- Banking and financial services are essentially ***intermediary*** in their economic functions.

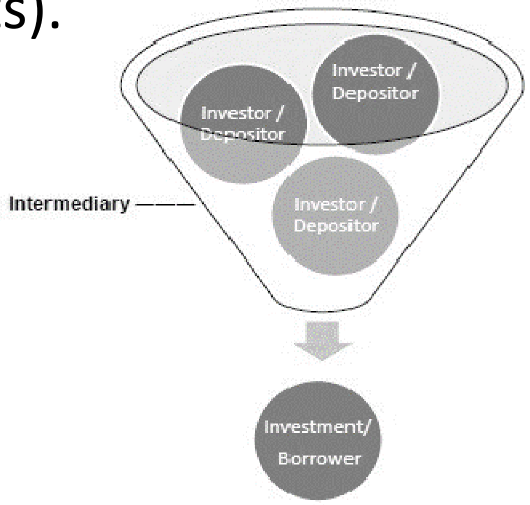
- Banking and financial services are essentially ***intermediary*** in their economic functions.



- Banking and financial services are essentially ***intermediary*** in their economic functions.
  - They interconnect efficiently those with assets to invest with those in need of investment for their economic activities.



- Banking and financial services are essentially ***intermediary*** in their economic functions.
  - They interconnect efficiently those with assets to invest with those in need of investment for their economic activities.
  - Banks are both ***debtors*** (to their depositors and investors) and ***creditors*** (to their borrowers and investments).



- Because of the importance of this intermediary role in enhancing the efficiency of financial markets, banking is consistently treated as a ***regulated*** industry, subject to both national and international systems of regulation and supervision.

- Because of the importance of this intermediary role in enhancing the efficiency of financial markets, banking is consistently treated as a ***regulated*** industry, subject to both *national* and *international* systems of regulation and supervision.
- *See Bank for International Settlements, Core Principles for Effective Banking Supervision (2012)*, Principle 5: Licensing criteria

> The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance . . . , ***risk management and projected financial condition*** (***including capital base***).

- This pervasive system of regulation covers the entire life of the regulated entity

- This pervasive system of regulation covers the entire life of the regulated entity:
    - Limits on entry into the industry, subject to regulatory approval (*i.e.*, chartering).

- This pervasive system of regulation covers the entire life of the regulated entity:
  - Limits on entry into the industry, subject to regulatory approval (*i.e.*, chartering).
  - Limits on growth, both geographically (*e.g.*, branching) and organizationally (*e.g.*, merger, consolidation, and acquisition).

- This pervasive system of regulation covers the entire life of the regulated entity:
  - Limits on entry into the industry, subject to regulatory approval (*i.e.*, chartering).
  - Limits on growth, both geographically (*e.g.*, branching) and organizationally (*e.g.*, merger, consolidation, and acquisition).
  - Restrictons on permissible activities (*e.g.*, “incidental powers,“ “closely related activities), to confine banks to their core functions.

- This pervasive system of regulation covers the entire life of the regulated entity:
  - Limits on entry into the industry, subject to regulatory approval (*i.e.*, chartering).
  - Limits on growth, both geographically (*e.g.*, branching) and organizationally (*e.g.*, merger, consolidation, and acquisition).
  - Restrictons on permissible activities (*e.g.*, “incidental powers,“ “closely related activities), to confine banks to their core functions.
  - Regulatory oversight of their withdrawal from banking (*e.g.*, voluntary and involuntary termination or liquidation, ***both*** subject to regulatory approval).

- One key legal standard that is a condition for approval in each of these events – ***safety and soundness of the bank and of its operations.***

- One key legal standard that is a condition for approval in each of these events – ***safety and soundness of the bank and of its operations.***
  - Core Principles, Principle 1: Responsibilities, objectives and powers

    An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to . . . address ***safety and soundness concerns***.

- In the context of lending – a fundamental "permissible activity" of banks – the concern with safety and soundness is manifested in several ways

- In the context of lending – a fundamental “permissible activity” of banks – the concern with safety and soundness is manifested in several ways:
  - Banks are required to develop and apply reliable policies as to the creditworthiness of any potential borrower and of each loan.

- In the context of lending – a fundamental "permissible activity" of banks – the concern with safety and soundness is manifested in several ways:
  - Banks are required to develop and apply reliable policies as to the creditworthiness of any potential borrower and of each loan.
  - In setting the price of this service, banks are required by law to evaluate:
    - The credit risk of the borrower (*i.e.*, the risk of counter-party failure to perform)

- In the context of lending – a fundamental "permissible activity" of banks – the concern with safety and soundness is manifested in several ways:
  - Banks are required to develop and apply reliable policies as to the creditworthiness of any potential borrower and of each loan.
  - In setting the price of this service, banks are required by law to evaluate:
    - The credit risk of the borrower (*i.e.*, the risk of counter-party failure to perform)
    - The asset risk of the transaction (*i.e*., the risk of declining value of the object of the loan)

- In the context of lending – a fundamental "permissible activity" of banks – the concern with safety and soundness is manifested in several ways:
  - Banks are required to develop and apply reliable policies as to the creditworthiness of any potential borrower and of each loan.
  - In setting the price of this service, banks are required by law to evaluate:
    - The credit risk of the borrower (*i.e.*, the risk of counter-party failure to perform)
    - The asset risk of the transaction (*i.e.*, the risk of declining value of the object of the loan)
    - The market risk of the transaction (*e.g.*, interest rate fluctuation, adverse governmental action, and the like)

- In the context of lending . . .
  - In addition to risk analysis in pricing, banks have traditionally been required to maintain, on the debit side of the balance sheet, a reserve for possible loan losses.

- In the context of lending . . .
  - In addition to risk analysis in pricing, banks have traditionally been required to maintain, on the debit side of the balance sheet, a reserve for possible loan losses.
  - If a loan fails, the bank may be able to offset this asset loss by debiting the reserve, rather than incurring a deficit in their capital accounts, which would render it insolvent.

- In the context of lending . . .
    - Since the early 1980s, banks have also been subject to mandatory capital adequacy requirements, calculated as a ratio of capital over total assets.

- In the context of lending . . .
  - Since the early 1980s, banks have also been subject to mandatory capital adequacy requirements, calculated as a ratio of capital over total assets.
    - These requirements were extensively developed and expanded by a committee of the Bank for International Settlements and imposed under individual national laws of over 100 states.

- In the context of lending . . .
  - Since the early 1980s, banks have also been subject to mandatory capital adequacy requirements, calculated as a ratio of capital over total assets.
    - These requirements were extensively developed and expanded by a committee of the Bank for International Settlements and imposed under individual national laws of over 100 states.
    - Significantly, the assets included in the denominator of the ratio is ***risk-weighted*** to ensure that relatively riskier loan assets are covered by more capital than a relatively safe loan asset would be.

- In the context of lending . . .
  - Since the early 1980s, banks have also been subject to mandatory capital adequacy requirements, calculated as a ratio of capital over total assets.
    - These requirements were extensively developed and expanded by a committee of the Bank for International Settlements and imposed under individual national laws of over 100 states.
    - Significantly, the assets included in the denominator of the ratio is ***risk-weighted*** to ensure that relatively riskier loan assets are covered by more capital than a relatively safe loan asset would be.
  - Core Principles, Principle 16: Capital adequacy

    The supervisor sets prudent and appropriate ***capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates***. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable [BIS capital adequacy] standards.

- This is the basic approach to risk management in the bank regulatory system

- This is the basic approach to risk management in the bank regulatory system –

Core Principles, Principle 17: Credit risk

The supervisor determines that banks have an ***adequate credit risk management process*** that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (***including counterparty credit risk***) on a timely basis.

- This is the basic approach to risk management in the bank regulatory system –

Core Principles, Principle 17: Credit risk

The supervisor determines that banks have an ***adequate credit risk management process*** that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (***including counterparty credit risk***) on a timely basis.

Core Principles, Principle 18: Problem assets, provisions and reserves

The supervisor determines that banks have adequate policies and processes for the early identification and ***management of problem assets***, and the maintenance of adequate provisions and reserves.

- This is the basic approach to risk management in the bank regulatory system . . .

Core Principles, Principle 19: Concentration risk and large exposure limits

The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate ***concentrations of risk*** on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

- This is the basic approach to risk management in the bank regulatory system . . .

Core Principles, Principle 19: Concentration risk and large exposure limits

The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate ***concentrations of risk*** on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Core Principles, Principle 21: Country and transfer risks

The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate ***country risk*** and ***transfer risk*** in their international lending and investment activities on a timely basis.

- This is the basic approach to risk management in the bank regulatory system . . .

Core Principles, Principle 23: Interest rate risk in the banking book

The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate ***interest rate risk*** in the banking book on a timely basis. . . .

- This is the basic approach to risk management in the bank regulatory system . . .

Core Principles, Principle 23: Interest rate risk in the banking book

The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk in the banking book on a timely basis. . . .

Core Principles, Principle 24: Liquidity risk

The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. . . .

- This is the basic approach to risk management in the bank regulatory system, but notice that for each of these –
  - Mandatory creditworthiness policies
  - Mandatory reserve for possible loan losses
  - Mandatory capital adequacy requirements

- This is the basic approach to risk management in the bank regulatory system, but notice that for each of these –
  - Mandatory creditworthiness policies
  - Mandatory reserve for possible loan losses
  - Mandatory capital adequacy requirements

  the focus is upon the risks associated with typical banking transactions –
  - counter-party failure
  - asset value deterioration
  - adverse market impact on the transaction

- This approach is poorly adapted to handle *systemic risks* – dysfunctional energy prices, global pandemics, or illicit invasion of one U.N. member state by another.

- This approach is poorly adapted to handle *systemic risks* – dysfunctional energy prices, global pandemics, or illicit invasión of one U.N. member state by another.
    - Financial services firms are affected by the volatility of energy prices as much as any direct or indirect consumer of energy.

- This approach is poorly adapted to handle *systemic risks* – dysfunctional energy prices, global pandemics, or illicit invasión of one U.N. member state by another.
  - Financial services firms are affected by the volatility of energy prices as much as any direct or indirect consumer of energy.
  - However, as regulated entities, these firms are required to establish and apply policies to address the additional, ***indirect*** risks that a systemic crisis might have on the value of their financial assets.

- This approach is poorly adapted to handle *systemic risks* – dysfunctional energy prices, global pandemics, or illicit invasión of one U.N. member state by another.
  - Financial services firms are affected by the volatility of energy prices as much as any direct or indirect consumer of energy.
  - However, as regulated entities, these firms are required to establish and apply policies to address the additional, ***indirect*** risks that a systemic crisis might have on the value of their financial assets.
  - Thus, this requirement adds a ***regulatory risk*** to the general economic risks of energy costs in the housing and real estate market.

- *Systemic risks* – dysfunctional energy prices, global pandemics, or illicit invasion of one U.N. member state by another –

    . . .

    - So far, national and international regulatory regimes have had little success in delineating the approach banks must take to ***identify***, ***quantify***, and ***manage*** systemic risk.

- *Systemic risks* – dysfunctional energy prices, global pandemics, or illicit invasion of one U.N. member state by another –

  . . .

  - So far, national and international regulatory regimes have had little success in delineating the approach banks must take to ***identify***, ***quantify***, and ***manage*** systemic risk.

Core Principles, Principle 22: Market risk

The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.

- In the midst of a global crisis over energy prices – exacerbated by the pandemic and the illegal invasion of Ukraine by Russia, with its impact on the energy market – the banking system does not have an effective tool to respond to a systemic crisis.

- In the midst of a global crisis over energy prices – exacerbated by the pandemic and the illegal invasion of Ukraine by Russia, with its impact on the energy market – the banking system does not have an effective tool to respond to a systemic crisis.
- Instead, we see hastily improvised measures undertaken by governments to support banking and financial services firms by easing regulatory requirements, offering financial assistance to relatively small community-oriented firms, and trying to isolate and sanction the sources of the energy crisis.

- In the midst of a global crisis over energy prices – exacerbated by the pandemic and the illegal invasion of Ukraine by Russia, with its impact on the energy market – the banking system does not have an effective tool to respond to a systemic crisis.
- Instead, we see hastily improvised measures undertaken by governments to support banking and financial services firms by easing regulatory requirements, offering financial assistance to relatively small community-oriented firms, and trying to isolate and sanction the sources of the energy crisis.
- For the future, we need to consider a regulatory requirement of capital reserves specifically for potential systemic market risk and transnational risk. Otherwise, we have learned nothing from the current crisis.

Thank you!