Does financial reform entail real change? For whom, by whom and how

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"Then I heard the voice of the Lord saying, "Whom shall I send? And who will go for us?" And I said, "Here am I. Send me!"". Isaiah 6:8.

An overview

The financial reform entails a real change for entities, regulators, supervisors and, most importantly, for consumers and the society as a whole, whose adequate protection is the ultimate goal of the reform both directly and also indirectly through ensuring financial stability. There is no doubt that entities will have to develop their businesses in a completely different and demanding regulatory framework, but above all they will need to go back to basics and put the client at the centre of their activity. Moreover, sound ethical banking conduct and culture should make the difference in a context where bank reputation has been extremely damaged. Financial entities must lead the change in order to reap the benefits arising from the financial reform. In that sense, paraphrasing Isaiah's Book, they are *the ones to be sent* to help society to maximize the positive effects of the financial reform, because financial entities act as a catalyst for enhancing the aggregated welfare of people.

Regulators and supervisors have now the daunting task of implementing the myriad of rules they have created, such as the bail-in and capital requirements, to mention just a few, as well as to adapt to a new reality where digital players emerge with all its strength. This will require a big effort in terms of time, resources and human capital for the authorities due to the overhaul in regulation but at the same time it will promote stable and durable economic growth. The challenge is to strike a balance between financial stability and economic growth so as not to stifle the social role that banks have to play in society that is channelling funds from savers to entrepreneurs.

Stability cannot be achieved by regulating only banks. The last crisis showed that instability can emerge from all the actors of the financial system, banks and non-banks (i.e., securitisation of subprime loans). Furthermore, stability is a necessary but not a sufficient condition for a healthy financial system. Indeed, the final goal of the reform is the enhancement of aggregated social welfare of society, mainly through the provision of loans and payments services.

In principle, consumers and investors may benefit from this regulatory tsunami as the level of protection increases and bad practices are bound to be punished. Their decisions will be more informed, so they can better understand the risks they are taking. Taxpayers are also better protected, as they will be no longer bearing the burden of banking crisis to be borne instead by private creditors. However a number of forces, including unintended consequences of regulation, might erode these benefits.

To shed some light about whether financial reform entails real change, for whom, by whom and how, I have structured my comments in four main parts: i) trust and ethics in the financial industry; ii) capital requirements,; iii) resolution regimes and iv) digital transformation in banking.

Trust and ethics must make the difference in the financial industry

Regulation and governance are not a panacea for solving all the past excesses related to misconduct. Sound and clear values and principles that reflect bank's culture transparently is an essential pillar. Regulation and supervision are also helpful on a secondary level.

In that sense, it is worth noting that banks play an essential role in society. Their main function is to help companies and people to bring their projects to fruition, not only through lending, but also by investing in human capital, financial inclusion, financial literacy and social programmes. Clients and the society must be at the heart of all our actions. The banking business relies on trust. And, as we have seen, trust is hard to earn but easy to lose, if conduct and values are not at the forefront of all operations with clients.

The solution to reputational challenges lies in the financial sector itself. **Banks have to assume their leadership via self-regulation in order to restore confidence and credibility.** Enhancing a culture of greater transparency and integrity must be determined, sustained and encouraged from the top and percolate down to the bottom. **Board and the senior managers are the first line of defense for ethical behavior and cultural change**. Moreover, they are the primary actors in identifying and changing business habits that are flawed or unacceptable. More broadly, they have to undertake their duties ethically and lead by example.

Transparency, integrity and prudence lead to proper conduct in situations not covered by the law. These three key components also contribute to deal appropriately with essential issues of the banking business, such as corporate governance, risk culture and remuneration policies, which are strongly correlated to incentives to take on risk.

Moreover, **regulation and supervision are useful complementary tools,** and they can make a helpful contribution to improving banking conduct and culture. On the one hand supervision can help via ex-ante monitoring of entities to prevent non-desired behavior, such as lack of transparency, bad governance or weak risk management practices. On the other hand, regulation can provide ex-post support via requirements and sanctions.

It is worth insisting on one essential point: regulation and supervision are just complements, and not substitutes, for conduct and ethics. "Complying with the regulation" does not (always) mean "acting ethically". As C. Lagarde stated recently "*regulatory and governance framework must be in place to support the ethics of behavior of individuals, yet the opposite is also true. Without individual integrity, even the best regulatory and governance structures can be gamed*."[1]

Capital requirements: searching a stable equilibrium between stability and growth

The recent crisis has been a litmus test for financial stability. Major failures of regulation and supervision, plus reckless and irresponsible risk taking by banks and other financial institutions, created dangerous financial fragilities that contributed significantly to hugely negative impacts on the financial system and on the real economy. **The response by the authorities was indeed very ambitious** from damage control and countercyclical policies to financial reform.

In its early stages, financial reform was focused on building higher capital and liquidity buffers to strengthen the resilience of the financial sector. The implementation of Basel 3 by end-2012, with higher and better capital requirements, countercyclical buffers together with strengthened liquidity risk requirements, seeks to create a **financial system better prepared to withstand shocks**.

However, its implementation is not easy in a complex political economy environment. **Policy-makers have been tempted to overreact and move the pendulum of regulation far beyond what Basel 3 dictates.** For example, in January 2011 the Bank of England released a discussion paper which created much of a stir in the financial community. It proposed that

[1] C. Lagarde, International Monetary Fund, "The role of personal accountability in reforming culture and behavior in the financial services industry" (November 5, 2015)

"the optimal bank capital should be around 20% of risk weighted assets".[2] The rationale of the proposal was based on the controversial Modigliani-Miller theorem, which supposes that - in the absence of taxes, bankruptcy costs, agency costs, and asymmetric information, and in an efficient market - the value of a bank is unaffected by how that bank is capitalized and funded. Despite being a valuable principle in an efficient market, the real situation of debt and capital markets across the world is far from being efficient and homogenous. In particular in Europe, unconventional monetary policy measures implemented by the ECB in the last years and the sovereign-bank vicious circle are, among others, a kind of elements that call into question the Modigliani-Miller theorem as a policy guide.

Higher capital requirements undoubtedly benefit the economy by reducing the likelihood of a banking crisis. However, **higher levels of capital are also likely to have unintended side-effects.** In fact, excessive capital requirements may increase banks' overall funding costs which in turn could push up their lending rates and the cost of capital, reducing at the end of the day the potential economic output. Somewhat ironically, a recent document published by the very same Bank of England puts the appropriate level of capital in the range of 10 to 14% of risk weighted assets, not far from the levels that most banks have already in place.[3]

Finding the right balance between financial stability, a public good as Prof. Siniscalco points out**, and economic growth** is not an easy task. Scrutinizing this balance on a continued basis is key.

In this spirit, European Commission launched in September 2015 a call for evidence on how the financial reform is affecting the ability of the economy to finance and growth in the right direction.[4]

Resolution regimes reduce moral hazard risk and tax payers' costs

The second key piece of the financial reform, which should be analysed together with capital requirements, is the new resolution regime. Covering with capital at a hundred per cent any potential extreme event is neither efficient nor credible. Tail risks may always happen. Thus, policy makers should ensure that **banks are viable to face severe crises, but, at the same time, they should also be resolvable in case of a "tsunami" occurs.**

[2] Bank of England (January 2011), Discussion paper Nº 31 on "Optimal Bank Capital"
[3] Bank of England (Dec. 2015) " Measuring the macroecomic costs and benefits…", Financial Stability Paper N.35
[4] http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index_en.htm

The recent crisis has shown that dealing with failed banks could become a difficult and a costly task, especially in the case of systemic, large and complex ones. Failures of large banks are costly, not only in terms of value destruction, but also destabilising the financial system at large.

To address the risks, the new resolution framework sets out responsibilities, instruments and powers to enable authorities to resolve failing financial firms in an orderly manner, by protecting critical functions and without exposing the taxpayer to the risk of losses.

During the crisis, many European banks lost access to liquidity and funding. In some countries the financial system as a whole had to be rescued with national state or European rescue funds. In some peripheral countries, national support contributed to the vicious circle between sovereign and banks. As from January 2016, this should not happen again in Europe.[5] Any **banking rescue will have to be borne in the first instance by shareholders and private creditors,** through the instrument known as the bail-in tool, instead of bail-out – which in other words means avoiding taxpayers' support.

The new paradigm radically changes the fundamentals of banks' liabilities (senior debt, derivatives, unsecured deposits, etc.) as they are more likely to suffer losses in case a bank has financial problems. As a consequence, bank investors, especially fixed income investors, would demand higher profitability to face higher risk. Moreover, credit rating agencies are changing their methodologies and banks' credit ratings will be adapted to the new resolution regimes.

As tax-payers will not have to shoulder the cost of bank failures, shareholders and debt investors would **focus more on banks' fundamentals, encouraging positive discrimination between issuing entities. Thus breaking the sovereign-banking link and, increasing market discipline throughout the sector.**

In a nutshell, moral hazard problems and irresponsible risk taking habits will tend to disappear as bank managers and debt investors would be accountable for their management and oversight.

[5] The Bank Recovery and Resolution Directive fully entered into force in January 2016.

Digital transformation in banking: rethinking the financial reform

The regulatory response to the crisis has been focused on a traditional way of doing banking in terms of products and actors. However, **the digital transformation of financial services is revamping the way in which the financial system creates value for their clients** by designing and delivering outstanding digital products and services with an improved user experience.

Digital innovation, (internet, mobile devices, and bid data combined), is at the service of consumers and jointly with financial education, are essential tools to-move closer to an efficient financial system characterized by low costs and low interest margins.

The new ecosystem offers untold possibilities for improving the agility, the quality, the convenience and the price of financial services. This will ultimately benefit consumers all over the world. Consumers wish to satisfy their financial needs anywhere and anytime and through any device. The exponential growth of mobile payments and mobile banking is a clear example of this trend. The usage of big data has brought a paradigm shift in the way we understand client and market behavior. Last but not least, fast-moving startups and lighter banking structures increase the competitiveness and productivity of the industry. At a macroeconomic level, productivity and efficiency gains pave the way to higher levels of welfare. All this is good for consumers and good for the financial system, but challenging for banks.

As mentioned above, since the beginning of the crisis, policy-makers have been focused on two issues: i) how to avoid unfair, deceptive and fraudulent business practices, and ii) how to strengthen the financial sector and deal with systemic risk. Thus, after several years thinking on risks, **the approach to regulating the digital transformation by banks is understandably cautious.**

Financial regulators are now confronted with the challenge to provide a regulatory framework that balances the **promotion of these digital value propositions and the protection against the associated risks**, notably in terms of consumer protection and financial stability.

In this regard, given the diversity of providers willing to participate in this new digital ecosystem, there is need for a competitive environment in which similar products or services receive identical regulatory treatment. That is, a level playing field based on genuine competitive advantages has to be the prevailing approach. In that sense, regulation should consider specific cases and business models, regardless of the nature of the provider offering them (banks and non-banks).

Clearly, the task of authorities is a very difficult one. But due to the - exponential pace of the digital transformation, the **regulatory/supervisory response should be flexible and fast enough** to keep pace with technological change, while protecting consumers and ensuring financial stability.

To sum up, it is time for a regulatory pause to analyze side effects and an adequate calibration of the financial response

In 2015 the global economy might have reached its lowest growth rate since 2009. The improved performance in developed countries has not been sufficient to counterbalance the emerging markets adjustment. Financial-stability tail risks have already been overcome by the global financial regulatory reform and financial sector adjustment. Promoting stable and durable growth and higher levels of welfare must be now the number one priority. Moreover, one of the most straightforward ways to promote growth in the current context is fostering the digital transformation of the banking system.

As mentioned above the financial reform is focused on banks but its effects go far beyond them. All stakeholders are affected – bank employees, managers, authorities, investors, customers, etc. Whilst tougher prudential requirements (capital and liquidity), a credible resolution regime, and a more ethical approach will reduce the impact of malpractices or financial crisis on the society, and tax-payers in particular, any regulatory excesses could lead to a reduction of credit flows and, at the end of the day, impinge upon the provision of financial services to society. After 8 years of regulatory tsunami, a regulatory pause is needed in order to reassess the whole picture and the cumulative impact of the reforms as well as to recalibrate them.

Finally, restoring reputation remains one of the biggest challenges for the financial industry. The financial system wields immense power over societies, economy and people. This implies a great responsibility to uphold the highest ethical, cultural and behavioral standards. **Impeccable conduct, balanced regulation and a swift digital transformation is what the banks need in order to be able to fulfill their social function while putting persons/clients at the very center of the banking business.**