# FINANCIAL STABILITY REGULATION – THE VIEW FROM THE INDUSTRY

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# Introduction – the financial crisis has radically changed the way the world thinks about Financial Stability

- The financial crisis caused a collapse of Financial Stability in most of the Western world, at huge cost to economic growth and government budgets

- The regulatory response has been radical – a total change in the global consensus on regulation with almost all areas of regulation affected (including how regulation is enforced)
  – This change has in turn radically reshaped the financial services industry

- Today, I want to draw 6 lessons (and a question) from a practictioner's experience of working with banks and regulators through this process, and discuss how South East Asia (as an area relatively unaffected by the financial crisis) can learn from this journey

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# Recap – the financial crisis saw a widespread set of bank failures, at huge cost to taxpayers

## Summary bailout expense estimates

Europe: ~€ 1,935 BN

US: $431 BN
*Disbursed out of $700 BN authorized under TARP*

## Detailed bailout expense – UK (peak period support)

| Bailout item | Amount, GBP BN | |
|---|---|---|
| **Sector wide support schemes** | **513** | |
| Credit Guarantee Scheme | | 250 |
| Special Liquidity Scheme | | 200 |
| Asset Backed Securities Scheme | | 50 |
| Unused recapitalisation fund | | 13 |
| **Other direct support to specific institutions** | **649** | |
| **Royal Bank of Scotland** | | **256** |
| Asset Protection Scheme | | 202 |
| Royal Bank of Scotland Ordinary and B shares | | 46 |
| Contingent capital | | 8 |
| **Lloyds Banking Group** | | **276** |
| Asset Protection Scheme | | 255 |
| Lloyds Banking Group shares | | 21 |
| **Northern Rock and Northern Rock (Asset Management)** | | **60** |
| **Bradford & Bingley** | | **46** |
| **Insolvent firms** | | **11** |

Sources: UK National Audit Office, Congressional budget office (USA), European Commission (used state aid 2008-14)

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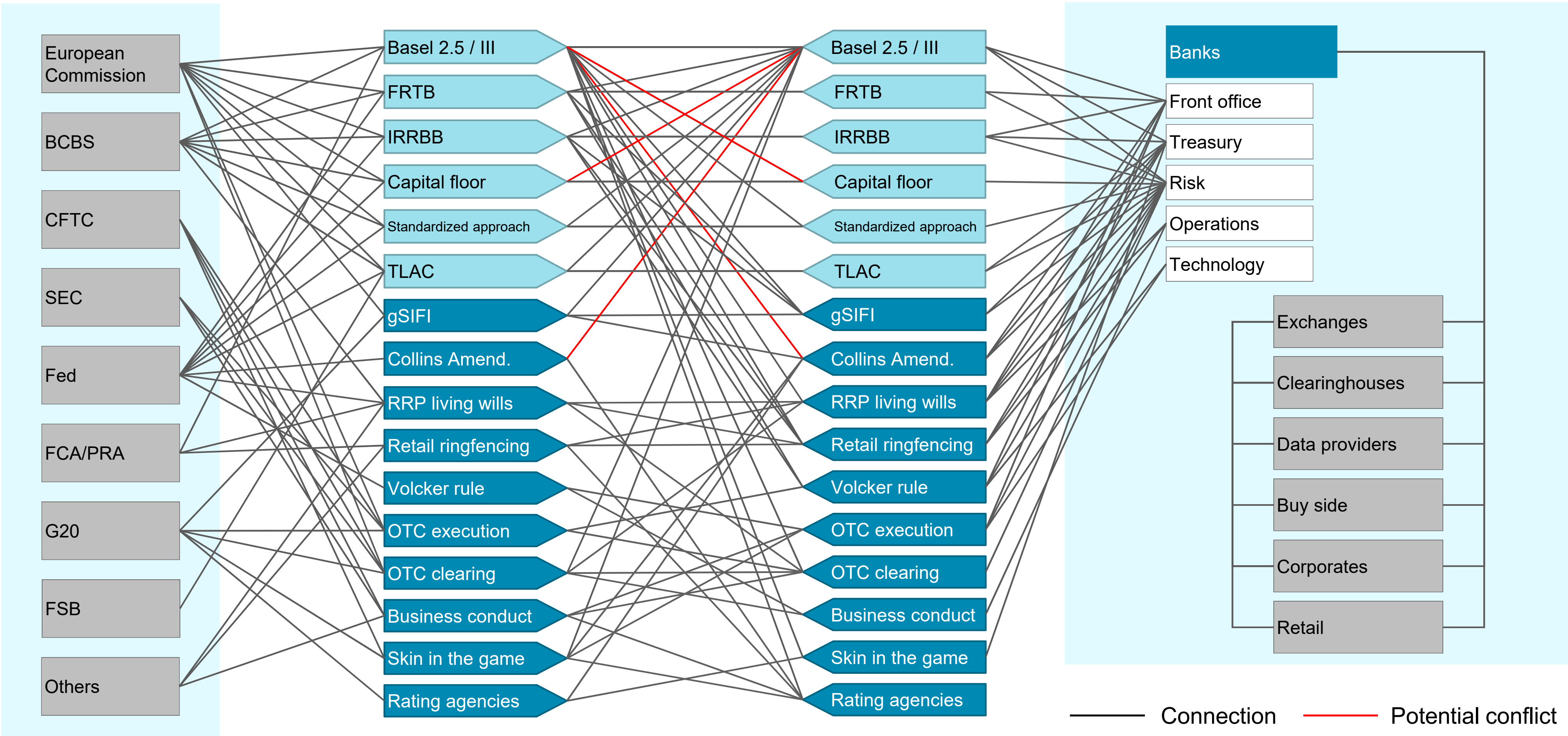
# This prompted a regulatory revolution that has changed nearly all aspects of the financial services industry

**1. Regulators**
Multiple conflicting objectives, different political processes

**2. Post-crisis regulation**
Vast, thousands of pages, high impact, overlapping, conflicting, different across regions

**3. Banks and the financial system**
Revolutionises wholesale business, new operating models, front/mid/back office redesign, disentangle and understand regulation to adapt




## The average G-SIB spend on complying with these regulations has been comfortably in excess of $5BN over this period

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## What can this teach us? | 6 key lessons – and a question!

# Lesson 1: 'Market discipline' doesn't work


- Pre-crisis presumption that shareholders and debtholders would impose discipline on banks, with bank management finding a balance between stakeholder objectives
  - The invisible hand of the markets at work!

- The financial crisis blew that assumption out of the water:
  - Implicit state support for "too big to fail" institutions resulted in skewed incentives with management over-incentivised to take risk for short term gain
  - Primacy of shareholder perspectives not aligned to regulator priorities
  - Management incentive structures generally short-term and focused on (at best) ROE, with little long-term accountability (and at worst, asset/ balance sheet growth)
  - In reality, management do not always behave in a rational stakeholder-driven model, but have personal agendas

- Post-crisis regulation has looked to align incentives – but usually with an acceptance that there is no pure market solution
  - RRP and ring-fencing aimed at removing the implicit state subsidy
  - Regulation of management compensation and incentives
  - …But an ongoing intrusive approach to regulation

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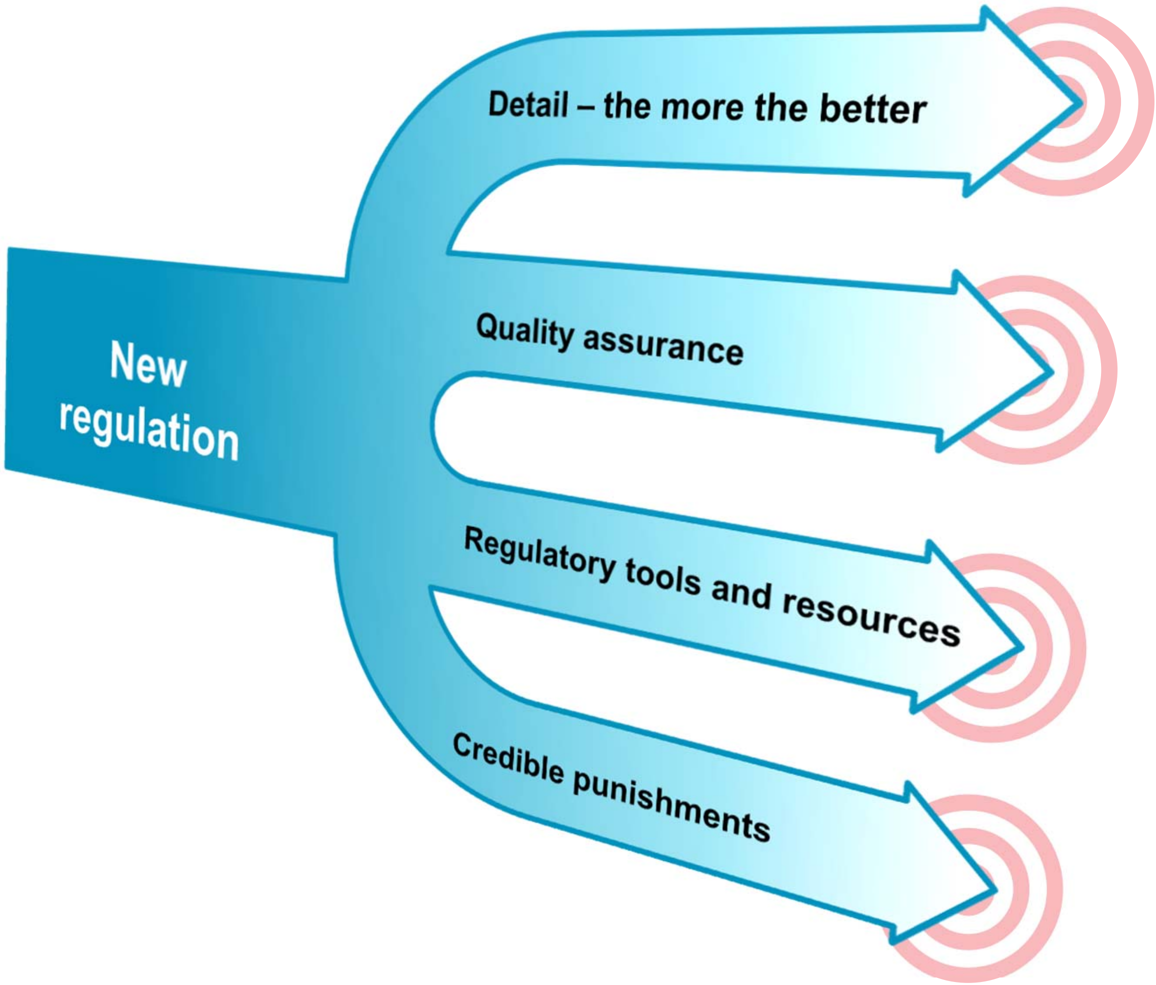
# Lesson 2: Regulation works, but rigorous execution is at least as important as the rules

**Plan** | **Execution**




**Banks prefer to know where they stand!**

- More detailed regulatory requirements are easier for banks to plan and execute around
- Process is a major recurring challenge:
  - Realistic timeframes result in better compliance
  - Change should be realistic about the current state of play (data, analytics, people)

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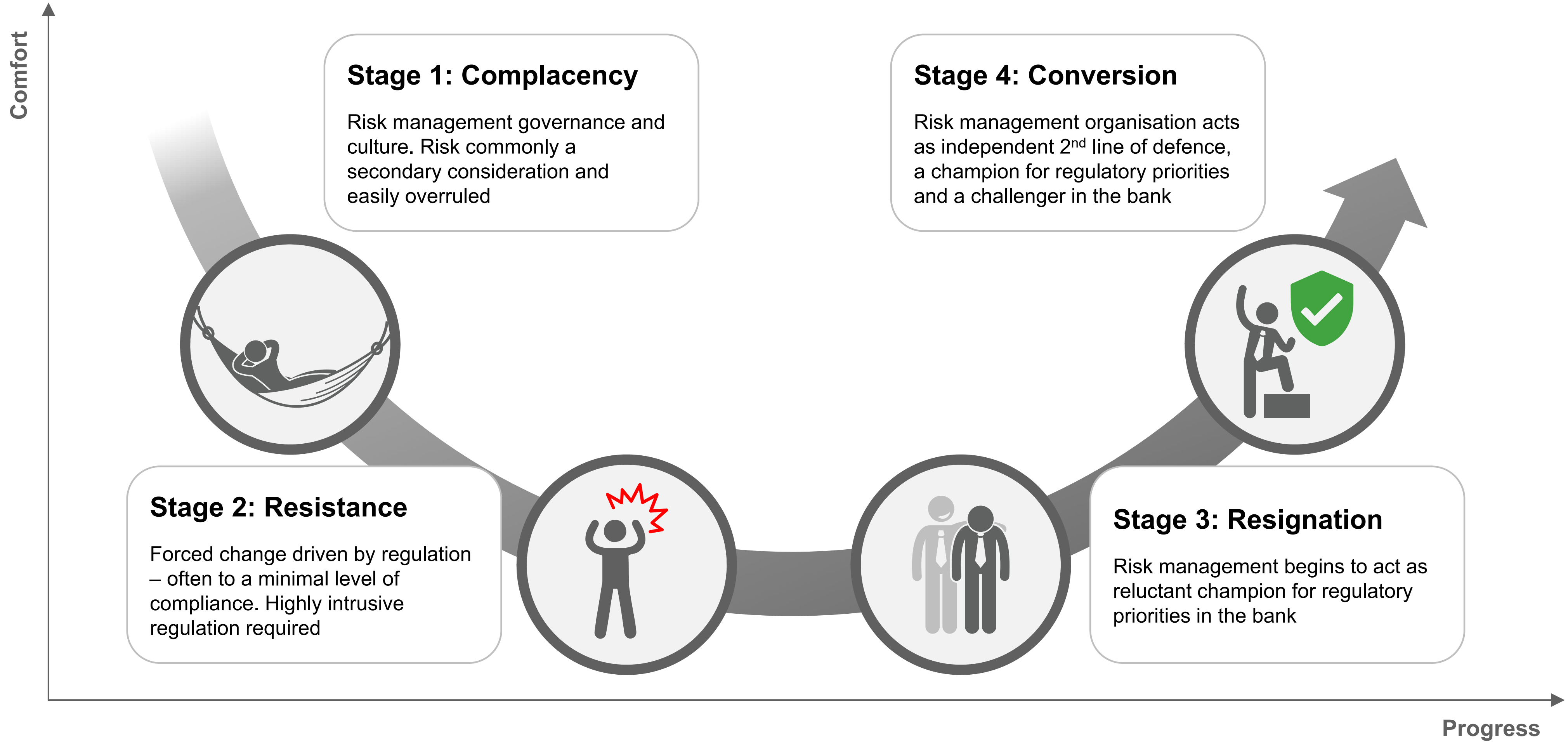
# Lesson 3: What’s more, regulators can force banks to think differently for themselves – but this takes time and effort




**This journey will not happen by itself – major regulatory intervention and perseverance needed to break resistance**

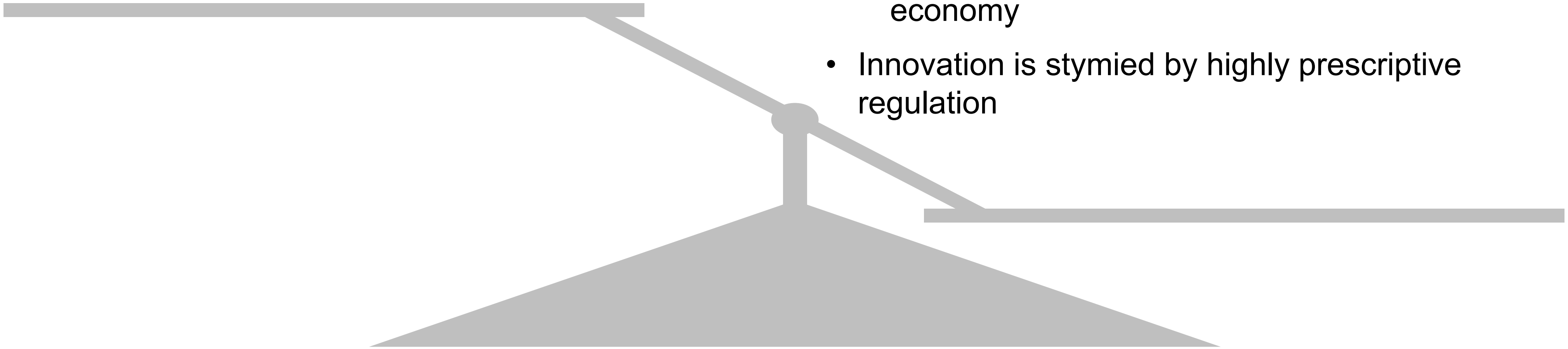
# Lesson 4 – High regulation comes at a cost to innovation and growth

### The benefits are big!

- Reduced probability of financial crisis – safer GDP progression
- Reduced taxpayer liability in the event of banking crisis
- Better recognition and pricing of risk improves the efficacy of financial intermediation

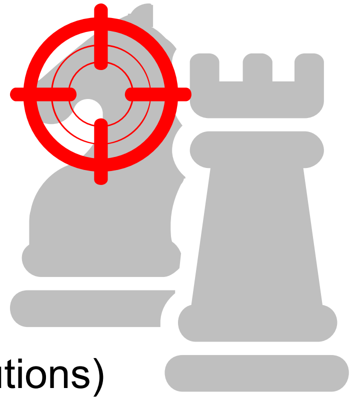
### But so are the costs!

- High regulatory burden means a crowding out of non-regulatory initiatives – usually growth and innovation
  - This is true both in the front office and (especially) non-regulatory risk developments
- Financial resource constraints limit balance sheet growth
  - Reduced capacity of banks to serve the real economy
- Innovation is stymied by highly prescriptive regulation



South East Asia is in aggregate underbanked, making this an important trade-off

# Lesson 5 – In a crisis, be decisive



- Pre-emptive and decisive action pays dividends e.g. Spain, Ireland, Iceland, UK, US
  - Well orchestrated action across Government, Central Banks and Regulators given the numerous challenges that are implied in a decisive strategy (e.g. system –wide solutions)
  - Robust asset re-valuation as part of stress testing process
  - Recapitalisation or forced sales/restructuring
  - Entry of non-banking capital or liquidity into the system
  - Forced creation of improved capabilities (NPLs, liquidity)
  - System-wide mechanisms
  - New business less encumbered by legacy
- Incremental and indecisive response creates escalating broader economic costs e.g. Italy, Greece
  - New credit flow hampered by risk aversion/capital constraints, creating material economic costs for SMEs and Consumers, as well as creating a negative feedback loop on NPL levels
  - NPL management is a management distraction, and suffers from low levels of professionalism
  - Limited "new capital" comes into the system
  - Liquidity on constant life support
  - Costs of intervention gradually escalates, ability of strong players to absorb weaker players reduces
- Many forces argue for incremental approaches – not least supervisory "self preservation" – and therefore requires strong central steering to mobilise and prepare for change

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# Lesson 6 – Traditional approaches to bank resolution do not work with large banks in the 21st century

### The traditional approach

- Regulator-led
- Sale of bank to larger institution preferred, otherwise resolve over a weekend with a large last minute data management exercise
- Operational complexity, but possible if managed well

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- Though easy to get wrong!!


### The new approach?

- Failure of large, complex and interconnected institutions defies this model:
  - Resolution is too complex for regulator to handle – or at a minimum requires a lot more data well before problems arise
  - Sale of failing bank to another bank will only lead to pollution of larger bank
  - Contagion risk from uncontrolled failure too high to ignore
- Increased focus on pre-emptive data collection, planning, monitoring – often bank led
- Larger, more complex banks held to a higher standard (TLAC, US Resolution rules, etc.)


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# And a question – where is the risk?


### Risk is gone?

- Some of the manufactured risks of the pre-crisis era have certainly disappeared
- In many cases regulation has reduced bank risk appetite – but at what cost to the real economy?


### The ‘shadow banking sector’?

- Regulatory-advantaged institutions increasingly own banking risk (asset managers, hedge funds, insurers)
- Is this a problem or a good thing? Reduced systemic risk, but also reduced oversight

### Back to customers?

- Bank reactions to regulation in many cases has been to reduce risk transformation activity – reduced maturity lending, uncommitted lines, tighter T&Cs
- This has the effect of passing these risks back to customers and the real economy – at what cost?

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