SOME REFLECTIONS ON THE POST-CRISIS *REGULATORY REGIME*

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OPENING THOUGHTS

- Biggest-ever banking crisis produced the biggest ever change in the Regulatory Regime
- Detailed regulation and supervision did not prevent the crisis or its costs: something was wrong with regulation and supervision
- But what?: detail (Basel N) or fundamental?
- What are we trying to optimise?: Objective 1 and Objective 2
- Inadequate resolution arrangements
- “greatest moral hazard in history”
- Credibility of no-bail-out policy: only if low social costs of bank failures – yet to be tested!
- Pendulum effect in regulation
- Faith in markets has given way to faith in regulation
- Endogeneity problem

THE PENDULUM EFFECT

- Availability heuristic
- Ideology of the time
- Bargaining
- Learning process in a world of uncertainty

ENDOGENEITY PROBLEM

- Symbiotic relationship between regulation and bank business models and strategies
  - bank business models endogenous to the regulatory regime
  - regulatory regime endogenous to business models
- Regulators / supervisors are always shooting at a moving target
- The target moves because of regulation
- Regulatory escalation

IMPLICATIONS FOR REGULATORY STRATEGY

- Limits to what regulation for Objective 1 can achieve
- Regulatory escalation
- Tendency to excess complexity
- Focus also on Objective 2
- Optimise the *Regulatory Regime*

FOUR ISSUES FOR THE FUTURE

1. Proportionality

2. Diversity

3. De-Anthropomorphisation

4. Culture as a supervisory issue

POTENTIAL FOR DISPROPORTIONALITY

- Availability heuristic
- Regulatory pendulum
- Regulation perceived as a free good
- Endogeneity problem: symbiotic relationship produces escalation
- Trade off between Objectives 1 and 2?
- Diminishing marginal returns
- Individual v. aggregate cost benefit analysis
- Excess harmonisation
- Risk-averse regulators
- Excess complexity

THE FIVE PILLARS OF PROPORTIONALITY

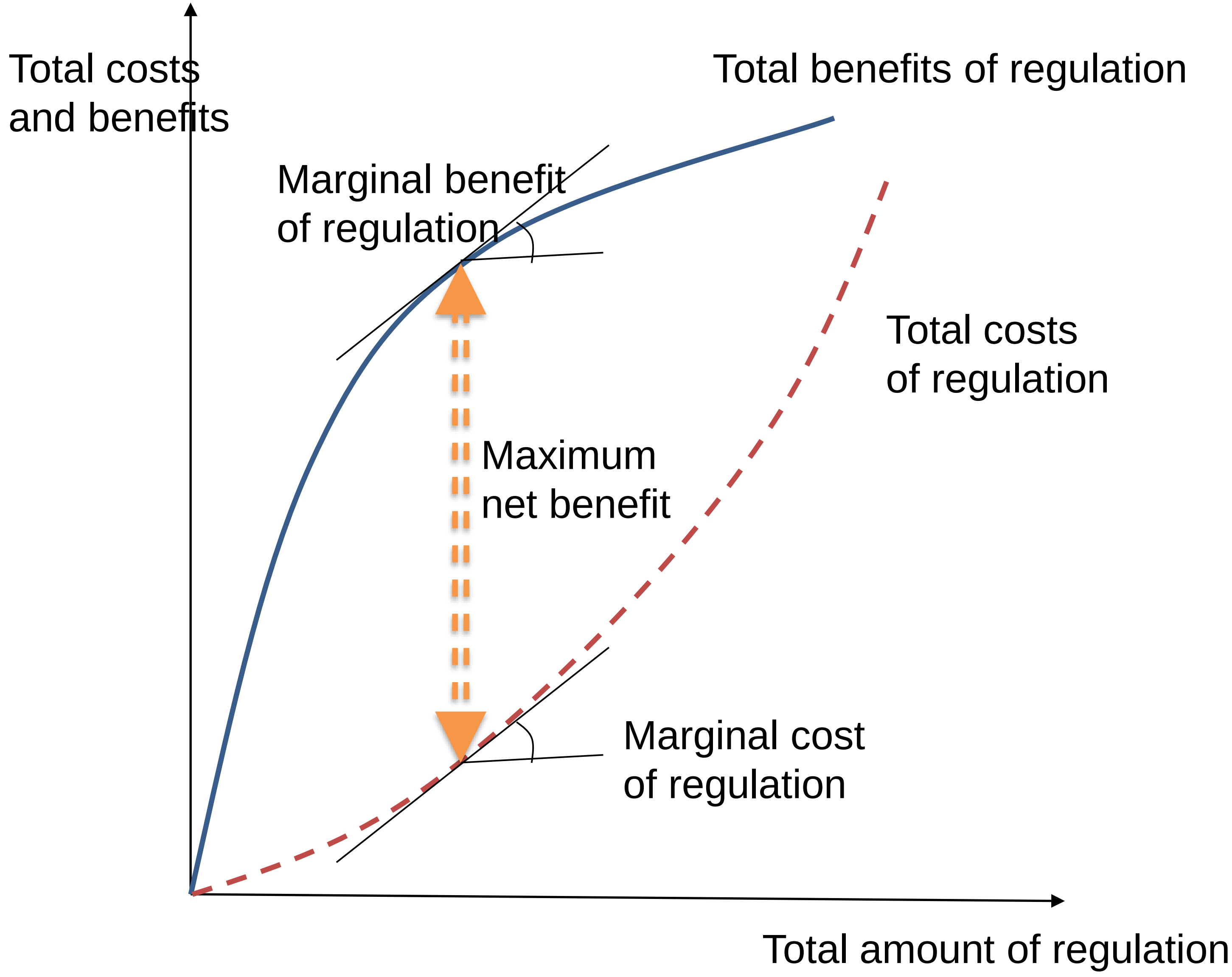
(1) Objectives: Cost Benefit Analysis

(2) Totality of regulation: diminishing returns

(3) Excess complexity

(4) Differentiations

(5) Materiality


Total costs
and benefits
Total benefits of regulation
Marginal benefit
of regulation
Total costs
of regulation
Maximum
net benefit
Marginal cost
of regulation
Total amount of regulation

EXCESS COMPLEXITY

- Costs of compliance
- Small firms disadvantaged
- Entry barriers rise
- Compliance may become superficial: box - ticking culture
- Costs of information collection and processing
- Regulatory arbitrage
- Opacity

BENEFITS OF DIVERSITY IN BUSINESS AND OWNERSHIP MODELS

- Competition via business models
- Stability characteristics of diverse banking systems
- Lower risk profiles

DE-ANTHROPOMORPHISATION

- Banks do not make decisions
- Focus more on individuals
- Incentive structures
- Culture

CULTURE HAS BECOME AN IMPORTANT ISSUE

- Creates business standards
- Influences employee behaviour
- Limits of regulation: culture too fundamental to be enhanced via regulation and supervision
- Avoidance of individual responsibility
- Trust and confidence erosion

GROUP OF THIRTY REPORT

***Banking Conduct and Culture: A Call for Sustained and Comprehensive Reforms*, 2015**

- Crisis revealed a multitude of cultural failures
- Lead to reputational damage
- Trust and confidence eroded
- Costly for firms: fines, etc and more demanding regulation and supervision
- Also costly for consumers
- Reform is a long-term process
- Must improve culture and ethical standards

REGULATION v. CULTURE

Might detailed, complex and intensive regulation be hazardous for "good culture"?

* banks focus on letter of the law
* behaviour acceptable if not covered by regulation
* usurping role of management
* box-ticking mentality

"regulation based on detailed prescriptive rules has undermined rather than enhanced ethical standards by substituting compliance for values" (Angeloni, 2014)

THE FUTURE CHALLENGE

How to manage the interface between culture, incentive structures, regulation and supervision

- is culture a supervisory issue?
- values rather than regulation as basis of behaviour