SUERF THE EUROPEAN MONEY AND FINANCE FORUM

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Banking Reform

Insights from the conference organised by SUERF, hosted by EY
London, 3 December 2015

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Dame Colette Bowe (BSB), Michael Power (LSE), Allard Bruinshoofd (Rabobank and SUERF), Roger Steare (Cass)

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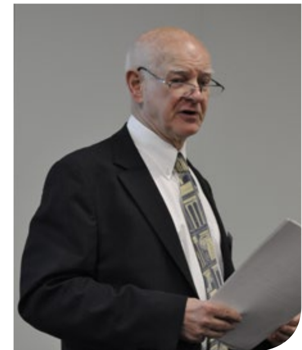

Sir Howard Davies (RBS)

Conference Report

By Patricia Jackson, EY and SUERF, and Clement Wyplosz, EY

*On 3 December EY hosted a SUERF conference on banking reform with **Sir Howard Davies**, the Chairman of RBS, and **Dame Collette Bowe**, the Chairman of the Banking Standards Board, as the two key note speakers. Professor **David Miles** gave the SUERF 2015 Annual Lecture on Capital and Banks.*

Overall

There was consensus that the period since the crisis had seen necessary increases in the capital and liquidity of banks, which diminish both the probability, and severity of further crises. However, there was much less agreement regarding the future path of reform of the banking sector. The area where there was the least agreement was in terms of the appropriateness of requiring banks to hold even higher levels of capital than currently, including both higher levels of equity and the new TLAC. A number of the speakers touched on this issue – Sir Howard Davies, David Miles, **Charles Goodhart** and **Harald Benink**. There were contrasting views between those who thought the industry could and should hold significantly more capital with the extra cost being small and others who thought that the transition to higher equity would drive significant further deleveraging, given the incentives for shareholders, to the detriment of the real economy. **David Llewellyn** and **Thorsten Beck** looked at the issues around the need for proportionate regulation which included weighing up the need for complexity. The distortionary effect of capital requirements that are too high for particular portfolios was discussed by **Patricia Jackson** and **William Perraudin**. Simple requirements like the leverage ratio were attractive but the evidence that they

are superior to risk- based requirements is flawed – none of the papers on this topic have compared risk sensitive requirements under Basel II to the leverage ratio, for example. Also the trend in regulation to add arbitrary floors to different risk-based measures is a backwards step which will distort the playing field across banks and distort the lending markets.

The challenges of structural reform were discussed by Charles Goodhart, **Tom Huertas** and **Simon Gleeson** with the consensus being that it was hard to see that the proposals for ringfencing will bring added stability. On the regulatory agenda one repeated message was that the industry needs time to absorb the changes to date and that a halt to regulatory driven change was needed.

A further topic was the pressure on banks' business models from a range of sources. The consensus was that banking business models were under pressure from shadow banks, fintech and the threat from lower cost challenger banks. Banks were also struggling to produce high enough returns to satisfy investors given the higher capital under Basel III – despite the industry now being safer. This was discussed in a panel including **Andrew Bailey**, **Richard Portes**, **Anthony Thomson**, **Desmond McNamara** and **Jacob de Haan**. One aspect of pressure highlighted is the conduct failings which have come to light which have affected the industry reputationally and financially though fines. The issues around ethics and culture in banking were discussed by Dame Collette Bowe, Allard Bruinshoofd, Michael Power and Roger Steare. It was recognised by a number of speakers that while substantive action has been taken, more work remains to be done in the industry on areas such conduct and governance.

Capital

Most controversial was the question of the composition and calibration of capital requirements. It was recognised by all that an important element behind the financial crisis was a pre crisis regulatory system that allowed banks to operate with minimal amounts of equity (particularly post the move in 1998 to allow hybrid capital into Tier1), enabling banks to use debt to finance risky and hard-to-value portfolios. It was argued that what lay behind this was the widespread notion that higher equity capital requirements would lead to sizeable increases in funding costs. However, one speaker set out calculations to show that, in theory at least, doubling equity would only lead to a small increase in overall funding costs. On this basis, and assuming that banks' equity is not costlier than in other industries it was suggested that an optimal level of equity capital would be around 20% of RWAs (using different assumptions, another participant cited a 40% target). Another speaker pointed out that these calculations looked at two different equilibrium states – a low capital state and a high capital state. They did not look at the process of transition from one to the other. Rather than the move to much higher capital imposing limited costs it would impose costs on the economy because the incentives for the current shareholders would be to try to avoid dilution and therefore they would favour deleveraging as the means to achieve the higher requirement. Indeed banks were deleveraging but home authorities were leaning on banks to keep domestic lending unchanged; d- deleveraging therefore was focused on non-home markets, affecting global financial links. Another point was that it was important to recognize that the problem in the crisis was one of liquidity not capital for many banks. Greater capital requirements in an illiquid system could lead to fire sales.

One area of focus since the crisis has been complexity versus simplicity. Some papers in the past such as the 'Dog and Frisby' have concluded that the leverage ratio pre crisis was a better predictor of survival /non survival in the crisis than risk based capital requirements. Thinking has now turned more towards having both a leverage ratio and risk-based capital requirements, but the question still remains whether the leverage ratio is superior. Because the IRB under Basel II was introduced in 2008, the papers conducted to date have in fact focused on Basel I versus the leverage ratio rather than the Basel II IRB versus the leverage ratio. The results are also dominated by the inclusion of US securities firms and banks with large securities arms, effectively testing the market risk treatment under Basel I, known to be inadequate and since changed, against the leverage ratio rather than the credit risk treatment. The lack of comparability of the leverage ratio between the US and Europe was discussed because the US banks do not hold prime mortgages or high quality corporate on their books, the two lending books that have significantly lower capital requirements under the IRB. To even the playing field, if the leverage ratio bites, the EU would have to get the mortgage securitisation market going again.

One speaker pointed to the gradual decline in bank capital to total asset ratios over the past 150 years and the higher ratios in other industries and saw the cause lying in implicit guarantees, including deposit protection, tax incentives for funding through debt and so on. One important factor in the future would be to make risk weights forward rather than backward looking. Higher equity was important and TLAC was not a substitute because it is only effective in resolution. He thought other elements of supervision were important to break the 'doom loop' such as Banking Union in Europe, ring fencing and living wills.

The future path of capital regulation, with the greater use of regulatory floors going forward within the risk-based requirements was seen by some as a wrong turning. The floors are often arbitrary and with standardised approaches depending on capital look-up tables and risk-weightings for which no justifications have been provided; they tend to distort the playing field as the resulting requirements create uneven capital increases across different banks and portfolios. In any case, the belief that regulators can devise appropriate risk weight calibrations for all banks in all jurisdictions may be "hubris". If so, a more appropriate response to concerns about comparability would be to encourage more industry benchmarking exercises, and put in place a stronger supervision of these exercises. Another point made was that regulators should not distort the risk-based models because this in turn would affect the risk signals in the bank- the introduction of the IRB had substantially improved the risk information in banks.

Proportionality

There was a discussion of proportionality in regulation with the case being made that currently it is not proportionate, with the nexus of a wide range of regulations making it too complex. The marginal benefits of more regulation are decreasing while the marginal costs are increasing. This lack of proportionality was due to the perception of regulation as a free good, the symbiotic relationship between regulators and banks with misbehaviour leading to more regulations, giving more potential for misbehaviour, and a failure to recognise the tradeoffs between growth and stability. It was suggested that going forward banking regulation should be more differentiated to reflect differences in business models, size, risk profile etc. Another speaker made the point that the main areas /solutions to focus on in terms of capital regulation are-

- Complexity v simplicity, simple measures are harder to evade , but more complex ones can better capture risk
- Macro-prudential regulation to ensure that the system itself is stable.
- A dynamic regulatory perimeter to capture new players taking risks, not just trying to prevent the last crisis
- Focus on resolution

Structural reform

Ring fencing proposals (e.g. Vickers, Liikanen) were seen as problematic in several respects. By concentrating housing finance in the retail ring fenced banks, ring-fencing proposals tend to exacerbate, rather than alleviate, liquidity risk and therefore potential financial system instability. More generally, the separation of commercial and investment banking activities may not bring more stability. The assumption that commercial banks are safer than investment banks is not always warranted. Ring-fencing is also likely to introduce greater complexity in the structure of banks, which may enhance resolvability of individual units, but not necessarily of the group as a whole. Similarly, the "balkanisation" of banks (for example through the Fed's requirement that FBOs form an Intermediate Holding Company (IHC), or the proposal in Vickers that ring-fenced banks cannot have foreign branches or subsidiaries) is misguided. Not only does it wrongly assume that foreign activities are necessarily riskier than domestic activities, it also risks creating a home country bias, such that the resolvability of home entities may be enhanced, but global resolvability could be compromised. Bans on proprietary trading may not be a panacea for improved stability either. The Volcker rule, for instance, is too complex to be useful. For example, the distinction it draws between proprietary trading and market-making is fuzzy, and legislation to address this is likely to be so complex as to be largely ineffective. Likewise, the blurring of the distinction between bonds and loans makes bans on proprietary trading ineffective (if the ban applies only to securities) or counterproductive (if it applies to any instrument that trades).

Opinions were more divided concerning regulatory developments around resolution. Giving preference to

depositors in resolution is inadequate, as it may reduce the risk of deposits, but not necessarily of the bank as a whole. Similarly, while it facilitates resolution for deposits via a bridge bank, it still leaves the rest of the assets and liabilities in the rump to be liquidated over time – a process that is likely to increase losses to creditors and could disrupt financial markets and damage the real economy. Diverging arguments have been made concerning bail-in during a resolution. On the one hand, the limitation of bail-out could be dangerous as is it concentrates losses on a small number of pension funds and insurance companies rather than a large band of taxpayers. On the other hand, reordering of the creditor hierarchy through bail-in could be seen as the most promising structural reform, since it reduces risk and enhances resolvability of the whole bank (as opposed to the ring-fenced bank only) – if so it is not clear whether separation would still make sense.

Customers are likely to be treated in ways they do not expect leading to lawsuits. And host jurisdictions are likely to face many difficulties in resolution.

Challenge to bank business models

It was recognised that there are clear challenges to bank business models. Indeed pressure from non-bank financial institutions, challenger banks, and Fintech firms are likely to transform the banking sector, and in so doing will change banking but also pose challenges to the financial system. Data were presented showing the sharp growth in shadow banking in Europe and the US. While regulators are becoming more familiar with these participants, their activities remain comparatively under-regulated and opaque. Not enough data are available to estimate the financial health of these firms (or traditional banks' exposure to them), and therefore to determine the potential system impact of the failure of some non-banks. For example, one speaker to pointed to the fact that we do not know how to measure (and compare) leverage in shadow banks. As these firms grow in importance, they will become more involved in the broader banking system with increased exposures of banks too them. Also they will increasingly be assuming critical functions for example becoming leading suppliers of credit in some areas – which could create macro-prudential risks if they suddenly withdraw from making credit available. It is already hard currently to determine the size of exposures of the banking sector to shadow banks.

Non-traditional institutions have distinct advantages over established banks, particularly since they do not have to contend with legacy real-estate, legacy infrastructure and systems, and legacy balance sheets. While incumbents will feel the pressure, it is worth noting that the improvements in risk management that traditional banks have made in response to the post-crisis regulatory environment now put them in a better place to drive change and innovation.

Banks with higher capital to remunerate are exiting areas of activity in both lending and market making. This is decreasing market liquidity. One question posed was why European investment banks are struggling more than US investment banks and whether this was because US banks had a much larger home securities market. Competition from tech firms (especially in the area of payments) could be an important driver of change. Banks could be driven more to becoming utilities. One point of view was that the emergence of banks with new business models could take the place of some traditional banking but this will result in more not less competition and consumer choice. However, established banks also believe they can transform and embrace the new technologies.

Risk culture

The importance and difficulty for banks in changing their culture was emphasised. Such a change is key to banks regaining the public trust that has been lost with the financial crisis and the conduct problems since. By satisfying regulators that the banks have grasped the importance of culture and ethics, cultural change may also give the industry a chance to influence the rising tide of increasingly prescriptive regulations. In the UK the Banking Standards Board has asked the major banks what they are doing to define culture, how they intend to deliver a change in culture and how they will determine when a new culture has been implemented. Because culture is ultimately carried by individuals, efforts to bring about cultural change must be effective at the level of the individual. Some key areas to address are incentives, going beyond compensation to promotion and hiring, leadership and openness, culture in the round and ethics.

There were two very different areas of focus within the

discussion. One was on the importance of information. Adequate information is necessary to encourage/reinforce good behaviour. The quality and assembly of information plays an important role in managing risk. From this perspective, a key task for banks is to create cross-functional networks to coordinate information throughout the organisation. Inadequate information damages the governance structures – the role of the board for example. An important problem is that information is typically put together by relatively junior people, who have disproportionate influence. Risk appetite is also appetite for knowledge about what is going on within the firm. The other perspective was that culture is a reflection of power relations and in this sense it is created and shaped by leaders. Therefore to improve culture it is necessary for leaders down through the organization display the right values. An important obstacle is that whereas in home life individuals are driven by compassion and caring for others, at work, there is a widespread idea that compliance with rules and targets come first, and caring for others is of secondary importance. In turn, the focus on compliance, on respecting the rules, on "doing the numbers", instils a culture of fear. Accordingly, changing culture in banks requires an acknowledgement that values in the workplace should be the same as those in life, such that professional behaviour should be driven by integrity rather than fear. In turn, this requires that leaders have the courage and character to "do the right thing" – and to put integrity before profits.

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