The Impact of Supervisory Reform on the Banking Sector

‘10 years improving economic policy’

Bruegel event

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1. Reflections on regulation

Worldwide, a regulatory reform agenda was agreed within the G20 after the financial crisis

- Regulatory reform was necessary
  - to **reduce** the **likelihood** and **severity** of future crises
  - to install adequate **crisis management** frameworks
- A new perspective was added: **macro** financial stability on top of **micro** financial stability

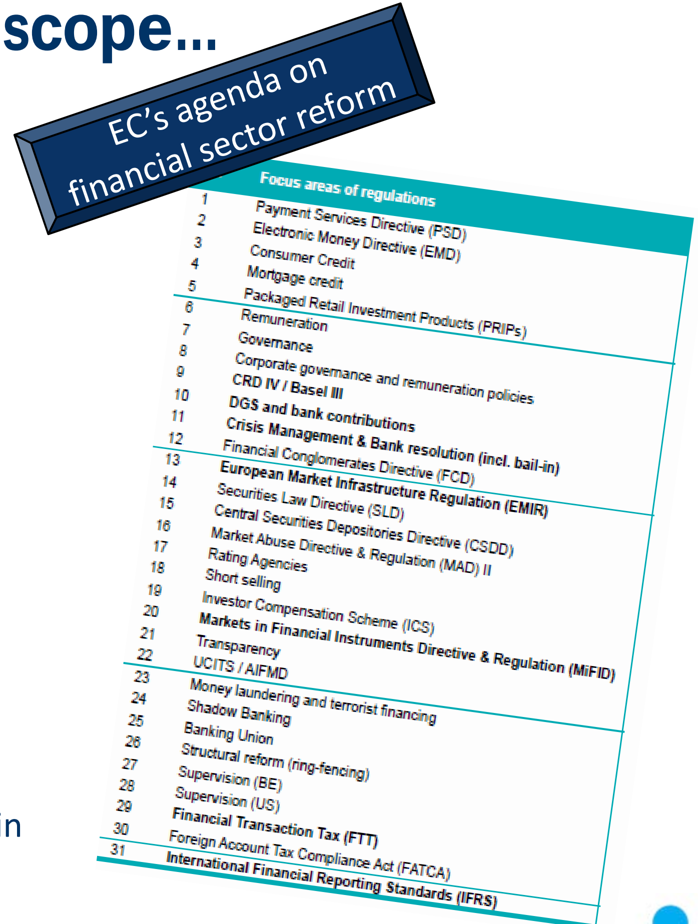
A 'new deal' was needed,
*setting financial services back **at the service of the real economy** and **customers** and **preventing tax payers** from the need to bail-out failing banks*

1. Reflections on regulation

Regulation took a really broad scope…

- Bank regulation
  - More and better quality capital
  - Liquidity requirements
  - Counter-cyclical and preservation capital buffers
  - Additional requirements for important institutions
  - Resolution plans and bail-in capital
  - Governance and remuneration requirements
  - …
- Financial market and market actors regulation
- Product regulation and consumer/investor protection
- …

with enhanced focus on more centralized/unified regulation in the EU (less directives, more regulations)



	Focus areas of regulations
1	Payment Services Directive (PSD)
2	Electronic Money Directive (EMD)
3	Consumer Credit
4	Mortgage credit
5	Packaged Retail Investment Products (PRIPs)
6	Remuneration
7	Governance
8	Corporate governance and remuneration policies
9	CRD IV / Basel III
10	DGS and bank contributions
11	Crisis Management & Bank resolution (incl. bail-in)
12	Financial Conglomerates Directive (FCD)
13	European Market Infrastructure Regulation (EMIR)
14	Securities Law Directive (SLD)
15	Central Securities Depositories Directive (CSDD)
16	Market Abuse Directive & Regulation (MAD) II
17	Rating Agencies
18	Short selling
19	Investor Compensation Scheme (ICS)
20	Markets in Financial Instruments Directive & Regulation (MiFID)
21	Transparency
22	UCITS / AIFMD
23	Money laundering and terrorist financing
24	Shadow Banking
25	Banking Union
26	Structural reform (ring-fencing)
27	Supervision (BE)
28	Supervision (US)
29	Financial Transaction Tax (FTT)
30	Foreign Account Tax Compliance Act (FATCA)
31	International Financial Reporting Standards (IFRS)

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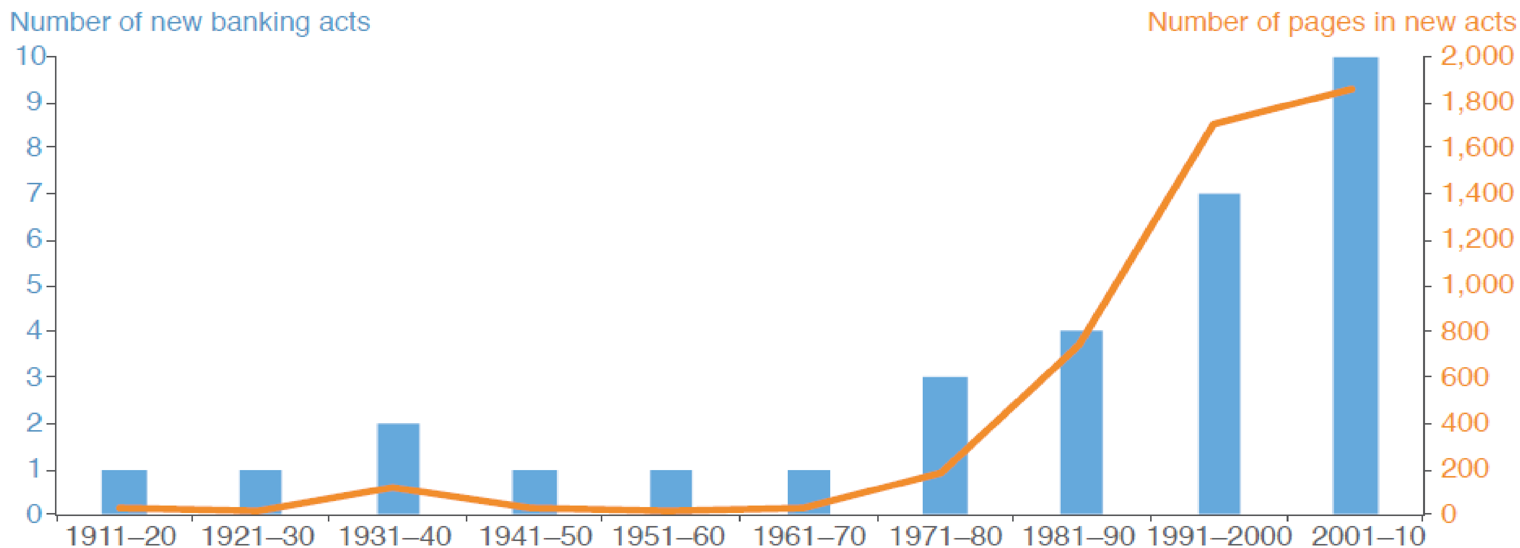
… resulting in soaring legislative complexity

Some figures for the US… the EU is probably at least as 'productive'



SOURCE: Federal Deposit Insurance Corporation, Important Banking Legislations.

Source: Dallas Fed, Financial Insights, 31st December 2015

As of today, the impact is most visible in the banking sector

- Worldwide, banks have
  - built higher and better quality capital buffers, largely through retained earnings, reducing leverage and disposals
  - improved funding profiles
  - improved risk management, governance and compensation structures to reduce incentives for excessive risk-taking
  - systemically important banks are subject to resolution planning requirements, additional regulatory minimum capital requirements and more intense supervision
- Progress of regulatory reform of non-bank domains is less advanced, e.g.
  - implementation of over-the counter derivatives reforms is uneven and behind schedule
  - implementation of new policies with respect to shadow banking (e.g. money market funds) is generally at an early stage.

Source: "Implementation and effects of the G20 financial regulatory reforms. Reform of the Financial Stability Board to G20 Leaders, 9 November 2015.

The 'De Larosière Report'(2009) listed many pre-crisis failures in supervision in the EU…

1. Lack of adequate macro-prudential supervision
2. Ineffective early warning mechanisms
3. Performance failure of individual national supervisors
4. Failures to challenge supervisory practices on a cross-border basis
5. Lack of frankness and cooperation between supervisors
6. Lack of consistent supervisory powers across Member States
7. Lack of resources in the committees
8. No means (legal power) for supervisors to take common decisions

… which was responded to by the creation of a new "European System of Financial Supervision" (ESFS)

- ***Micro**-prudential*
  European Supervisory Authorities (ESAs)
  - European Banking Authority (EBA)
  - European Insurance and Occupational Pensions Authority (EIOPA)
  - European Securities and Markets Authority (ESMA)

Tasks

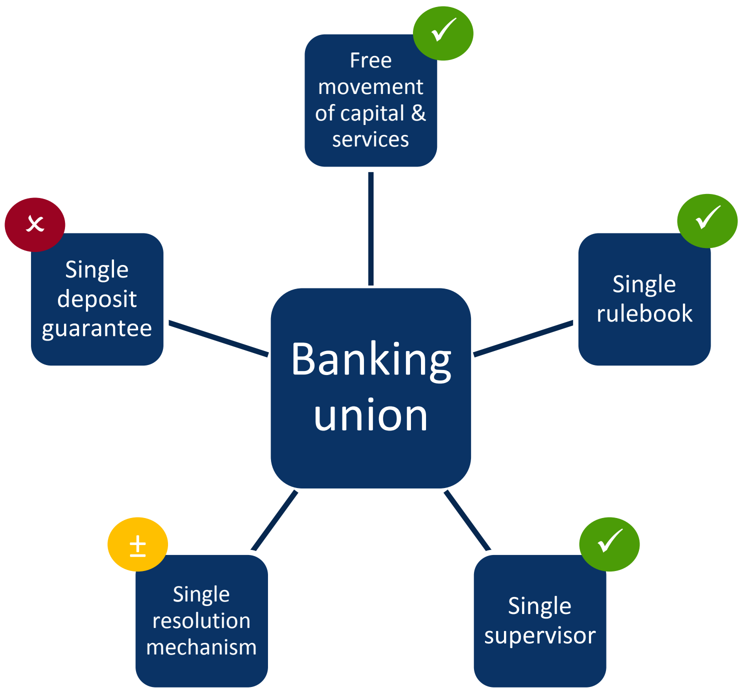
- Closer cooperation and exchange of information
- Facilitate solutions of cross-border problems
- Advance coherent interpretation and application of rules

- ***Macro**-prudential*
  European Systemic Risk Board (ESRB)

- Provides early warnings of system-wide risks
- Issues recommendations for actions to deal with these risks

2. Reform of supervision

The SSM: a major step towards a supervisory 'level playing field'…

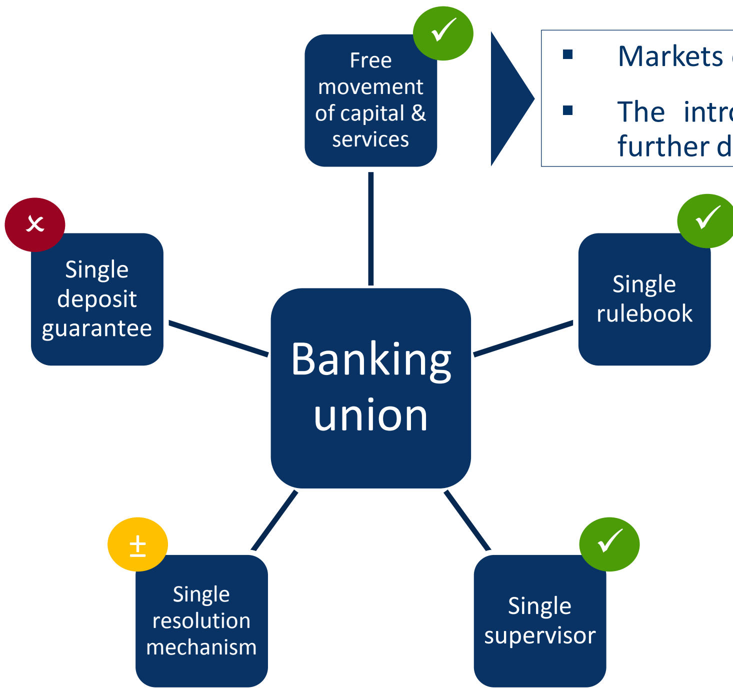


✓ Mostly realized
± More or less realized
× Work in progress

- Undoubtedly, the banking union – though not yet fully completed – will significantly contribute to financial stability in the Eurozone
- I also welcome the banking union as it will contribute to the creation of a regulatory and supervisory level playing field
- Yet, many challenges remain…
- … which we particularly experience as we are not only a bank, but a bank-insurer, not only active in the Eurozone, but also in non-Eurozone markets

2. Reform of supervision

The SSM: a major step towards a supervisory 'level playing field'… with remaining challenges



- Markets continue to be fragmented by national regulation and fiscal law.
- The introduction of a financial transaction tax in 10 EU-countries will further distort the market.

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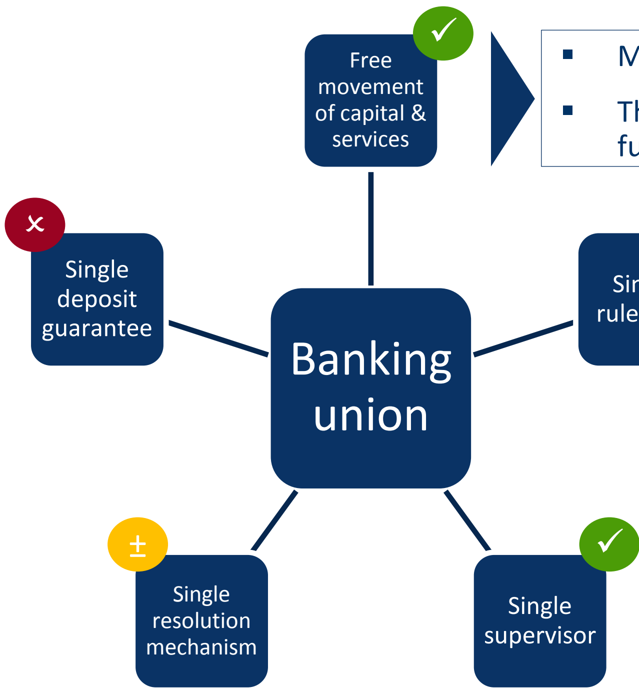

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More 'single' in name than in fact:

- Gold plating and different national interpretations
- SSM needs to develop a common approach towards 150 'options and national discretions' (ONDs), which grant member states the explicit freedom to decide how to apply a specific requirement.

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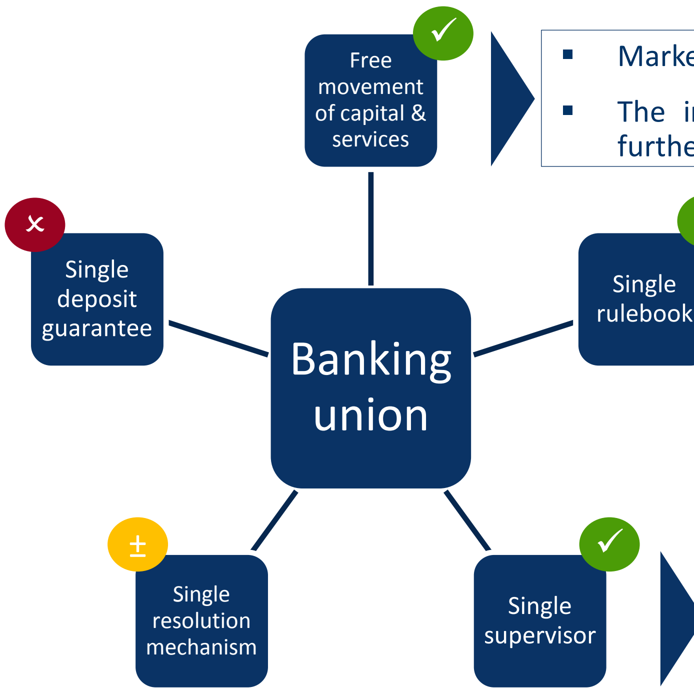

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- Remaining differences in regulation, uneven economic growth and different legacies from the crisis across euro area countries complicate the SSM’s Pillar 2 capital requirement setting.
- Through a transparant ‘Supervisory Review and Evaluation Process’ (SREP) the SSM tries to build a level playing field, yet at the cost of additional data requirements for banks.
- Some national pre-SSM supervisory practices are enshrined in national law, limiting the range of options for supervisors

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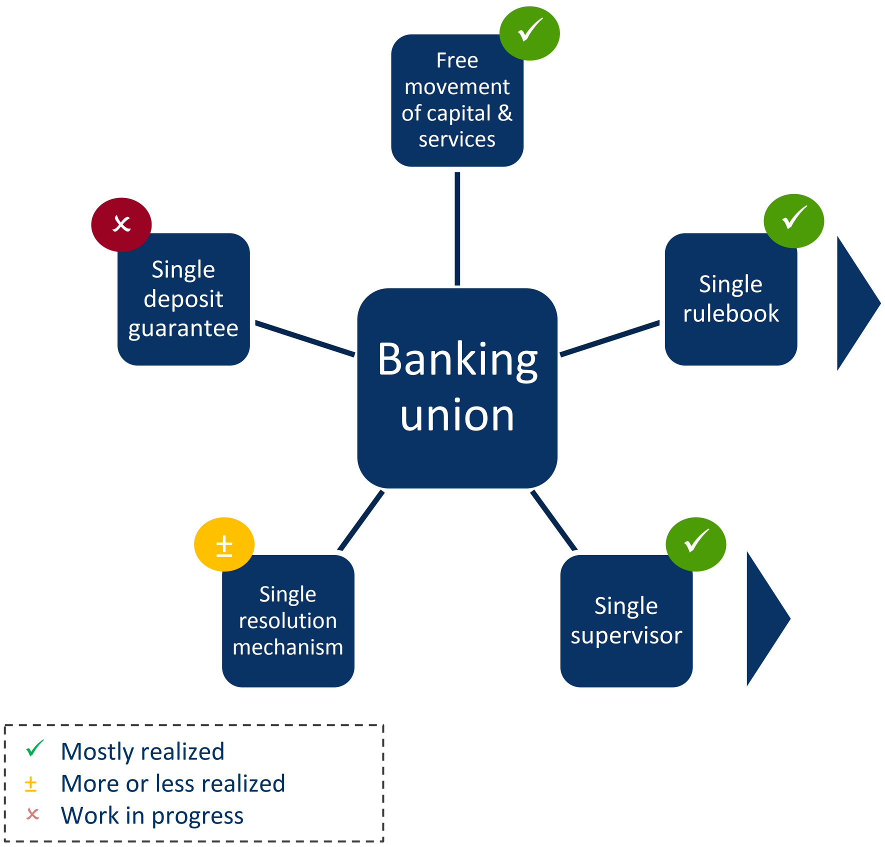
3. Impact of supervisory reform

A 'holistic approach' not yet within reach…



- Results in a less 'holistic' approach than one would expect at first sight…
- … as ongoing regulatory initiatives give continuously birth to new and ever demanding requirements, e.g.
  - total loss absorbing capacity (TLAC) for GSIBs
  - minimum required eligible liabilities (MREL)
  - RWA harmonization
  - …
- … inspiring market investors and rating agencies to further raise the bar.

… particularly not for a cross-EU bank-insurer

- **Bank and insurance** supervision are **separated** at the European level.

  In fact, in Belgium, we, as a bank-insurer, lost our 'single' supervisor at the start of the banking union. Indeed, the implementation of the 'twin peaks' model on 1 April 2011 brought the micro-supervision of banks and insurance companies together within the National Bank.

- Being active both **in and out the euro area** we still have to deal with national supervisors.

- Some micro prudential supervisory topics (money laundering, consumer protection) and macro-prudential **supervision** are **at the national level**, also implicating involvement with national supervisors

- The SSM is in fact an additional supervisory level
- Like regulation, the supervisory structure is complex, entailing large administrative burden
- Efficiency depends on close cooperation

Impact is manifold

Impact of regulation and supervisory requirements

- Balance sheet
  - Capital, liquidity, bail-in debt, risk weights & modelling, …
- Bank structures
  - Resolution schemes, prohibited activities, ringfencing, …
- Governance & remuneration systems
  - Internal control systems, sales incentives & fair customer treatment, line management risk responsibility,…
- Reporting and transparency requirements
  - Supervisory Review and Evaluation Process (SREP), Mifid, …
- Banks as ‘supervisors’ of the outside world
  - Know your customer, money laundering, implementation of official sanctions, …

Impact on :

- **Business models**
- **Strategy**
- **Culture**

Impact comes on top of many other challenges

'New normal' challenges for financial institutions

- Low economic growth
- Low interest rates
- Changing customer needs as digital becomes the new normal
- Fintech and new entrants
- Business continuity challenges stemming from cyber risk, terrorism, …
- Investors' ROE expectation
- Society's social responsibilities' demands
- …

Impact on :

- **Business models**
- **Strategy**
- **Culture**

Too much of a good thing ?

- Reforms aim to deliver greater **financial stability** and **sustainable economic growth**…
- … resulting in **wide economic and social benefits**…
- … with many of the **costs** of the reforms being **private costs** to financial intermediaries.

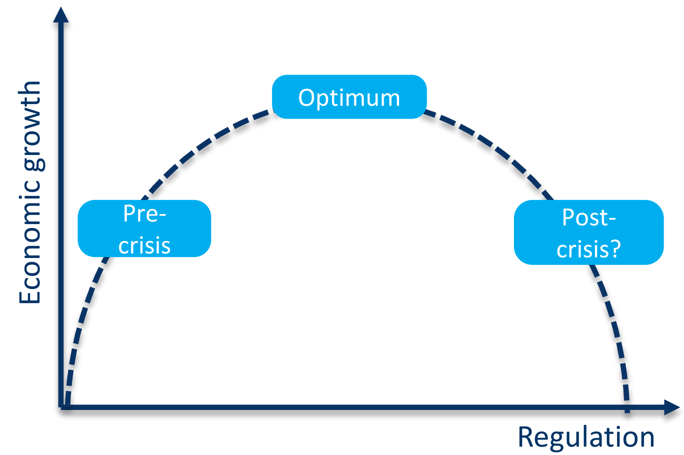
"Regulation paradox"

Overly demanding regulators and supervisors can **end up with the opposite of what they aim for**:

- Shift of activities to non-regulated sectors
- Overly risk-averse banks, leaving customers with unhedged risks and unfulfilled credit needs'
- 'Too big to fail' banks as 'too small to succeed' banks disappear

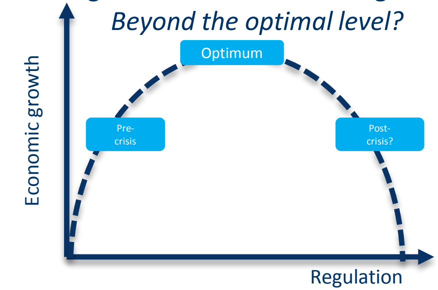
Regulation versus economic growth

Beyond the optimal level?



3. Impact of supervisory reform

Supervisory requirements need to be consistent



To achieve policy objectives supervisory requirements need to be **mutually consistent**

An insufficient '**holistic approach**' might result in one regulation counteracting policy objectives of other legislation

- E.g. with the **Capital Markets Union** the EC aims to strengthen the economy by making risk capital easier available to the real economy. This is a much needed evolution in the European financial landscape and banks can play a material role in this transition… at least if regulation (e.g. on bank structures) doesn't unduly impact banks' ability to transact in capital markets.
- In that respect, also the introduction of an ill-designed **Financial Transaction Tax** can be extremely harmful, particularly if only implemented by a number of countries.
- In the US, a recent Dallas Fed study argued that excessive supervisory burden on small community banks is behind their declining market share. Nevertheless, this type of banks are deemed to "play a unique and vital role in the US economy". Banks are '**too small to succeed**'.

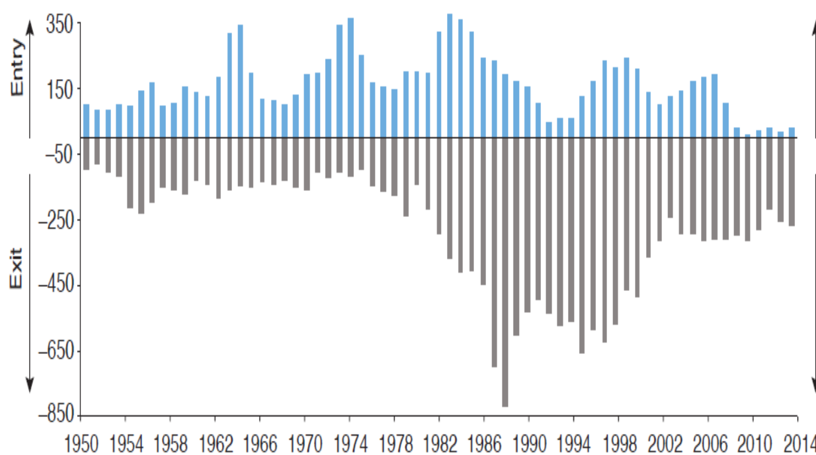
3. Impact of supervisory reform – lesson from the US ?

In search of the optimal scale: ‘Too big to fail’… and ‘too small to succeed’

In the US, the dramatic fall in new bank entries and a declining number of small banks, is associated with excessive supervisory burdens…

… also in the Eurozone the fall in the number of banks tends to support the trend of banks becoming larger

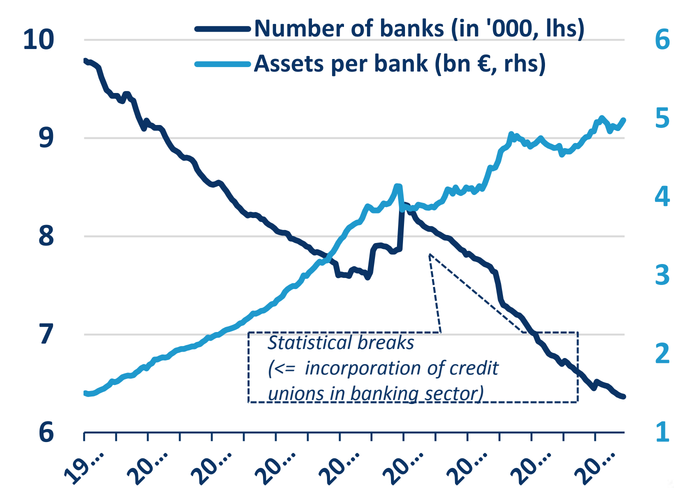
US: bank entries and exits



SOURCE: Federal Deposit Insurance Corporation, Statistics on Depository Institutions

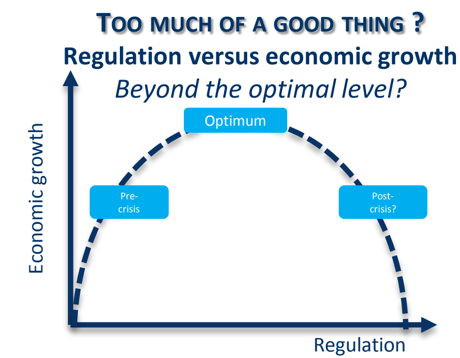
Source: Dallas Fed, Financial Insights, 31st December 2015

Eurozone: number of banks & average size



3. Impact of supervisory reform

Supervisory requirements need to be simple, clear, stable and certain



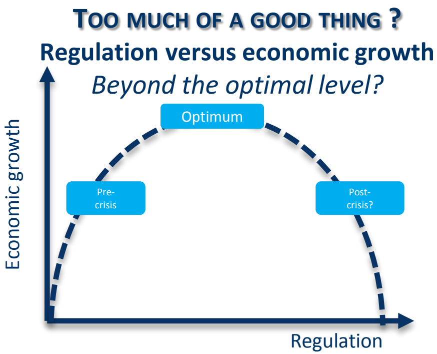
To achieve policy objectives supervisory requirements need to be
mutually consistent

To contain complexity and compliance costs
banks need clarity and certainty

- The risk of a prolonged period of regulatory reform is that it creates a **moving target**, which prevents the industry from settling into sustainable new business models.
  - E.g. the Net Stable Funding Ratio supported business model switches towards more retail deposit funding. Now, the Total Loss Absorbing Capital Rules entails the need to issue more unsecured long-term debt.
  - Ever increasing capital and loss absorbing capacity requirements comes at the risk of undermining lending capacity of banks.
- A '**pause**' in new requirements would allow
  - banks to fix business models and strategies
  - supervisors to get to grips with the significant supervisory reform agenda
  - regulators to assess their impact on the sector and the broader economy.
- This might be of particular importance, as overly detailed and harmonized **regulation could also increase risks**, if it would prove to be ill-designed.

3. Impact of supervisory reform

What about clients comfort and change of the financial industry's mindset



What is the impact of supervision/regulation for **customers comfort ?**

- A strong and resilient banking landscape is the ultimate goal of all supervisory and regulatory efforts
  - On the back of the financial crisis' experience, a strong signal towards society at large was necessary
  - The financial industry is build on trust. Strong Capital and liquidity positions combined with a sustainable profitability, fosters trust amongst customers

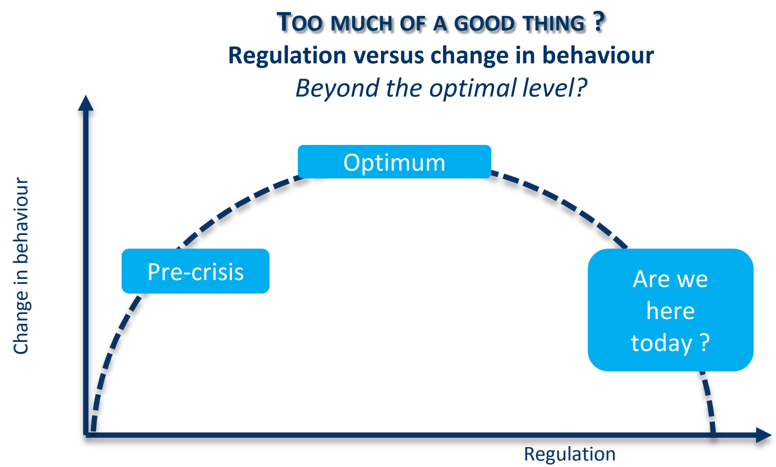
What is the impact of supervision/regulation on the client relationship ?

- What if regulation or supervision starts to hamper the client relationship ?
  - Customers are no longer accepting purely administrative burden generated by banks.
  - Banks are adjusting their risk profile according to regulation. Who's taking the the risk ?

3. Impact of supervisory reform

"culture eats strategy for breakfast"

Does current supervisory approach change culture ?



Conclusion

Welcome to the banking union as a major step towards
a supervisory 'level playing field'
(notwithstanding remaining challenges)

Supervisory requirements :
avoid 'too much of a good thing'

Supervisors, financial institutions and clients would benefit from
simple, clear and consistent regulatory requirements

A **pause in new initiatives** would allow
financial players to fix business models and strategies and
supervisors get to grips with the significant supervisory reform agenda

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Thank you