

How do we get banks to better serve the real economy: ethics, incentives, and the role of supervisors



FIFTEENTH ANNUAL INTERNATIONAL CONFERENCE ON POLICY CHALLENGES FOR THE FINANCIAL SECTOR

CHANGING LANDSCAPE OF FINANCIAL INTERMEDIATION: IMPACT AND IMPLICATIONS FOR RISK MANAGEMENT, REGULATION AND SUPERVISION

JUNE 3 - 5, 2015, WASHINGTON, D.C.



1. The financial crisis highlighted severe weaknesses and excesses in the banking system

➤ **Badly managed or even uncontrolled financial innovation:**

- business model change: from "originate to hold" to "originate to distribute" and an illusion of risk transfer
- high risk market activities and strong financial incentives for traders but low incentives to assess risk and foster risk culture
- Loose valuation assumptions for "less" liquid structured products
- overall inadequate risk assessment and capital amount

➤ **Governance issues:**

- concentration of powers in the hands of only one person (chairman of the board + CEO) and limited countervailing powers
- conduct risk materialized in a number of ways recently: benchmark indices, payment protection insurance contracts, sub primes, counter-terrorism rules...

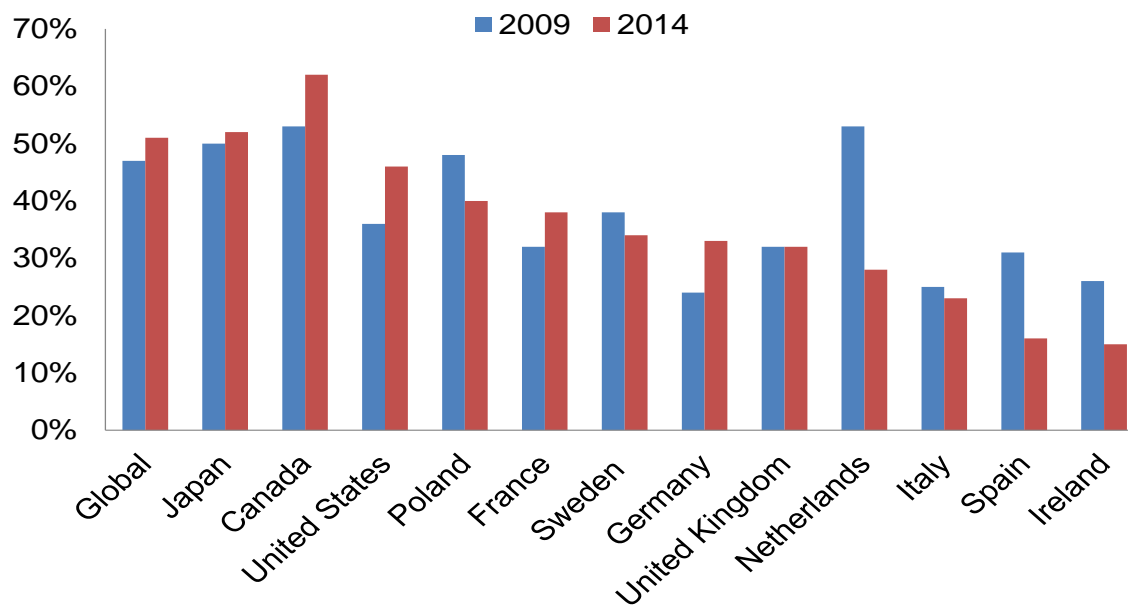
➤ **'Too-big-to-fail' banks:** impact on the global economy and costs for tax-payers.

The crisis has destroyed confidence in the financial system

2. Restoring citizens' and customers' confidence in the financial system (1/2) - concerns

➤ Conduct of business risks cannot be disregarded:

- Large transfer of risks to customers (incentivized distribution of mutual fund shares instead of bank deposits, of unit-linked instead of dollar or euro denominated life insurance contracts, etc.)
- May impact on institutions' financial positions (operational losses, fines...)
- And may finally threaten financial stability (e.g. US sub primes...)



Trust in banks around the globe (Edelman Trust Barometer, nine point scale)

2. Restoring citizens' and customers' confidence in the financial system (2/2) - objectives

- **To recover the confidence of citizens in the financial system and to support the return to stability in the short and long term:**
 - strengthen banks' resilience
 - improve banks' management and internal control framework to reduce moral hazard

- **Additional constraints on banks:**
 - capital buffers for Important Financial Institutions (systematically and others)
 - resolution plans and bail-in rules

- **An ambitious agenda of reforms aimed at cleaning up and reinforcing the banking system and ensuring it can meet the credit needs of the economy:**
 - conduct of business regulation and consumer protection
 - remuneration
 - enhanced governance and diversity in board members
 - increased transparency

3. The regulatory response and its consequences on the real economy (1/3)

- **New regulations are constraining business models:**
 - Either exerting pressures on the cost base (e.g. requirements for an increased proportion of high quality capital, bail-in instruments and liquid assets)
 - Or imposing an adverse prudential treatment of some specific activities (proprietary trading, trade finance, OTC derivatives trading, credit to local public authorities, project finance and consumer finance...)
 - **Which might result in the shut down or the reduction of business lines, while some of them are useful for the real economy or ensure the resilience of the financial sector (market making activities).**

- **Other regulatory initiatives might directly impact banks' business models by forcing them to adjust their operating structure:**
Vickers/Volcker/Liikanen proposals ; recovery and resolution plans

- **Meanwhile, need to acknowledge that these new regulations incentivise banks to refocus on safer activities** (retail and commercial banking, insurance and private wealth management...).

- **How should we strike the right balance?**

3. The regulatory response and its consequences on the economy (2/3)

- **The transition to the new framework may raise some questions:**
 - in the long-run, a more resilient banking system is the best way to ensure the financing of the economy
 - **but** in the short run, it could have some adverse effects, especially on the credit supply by banks
 - phase-in arrangements are thus pivotal

- **The implementation of the new rules needs to be closely monitored by supervisors to notably avoid:**
 - an excessive deleveraging process
 - potential negative impact on some banks' business model

- **The new regulations have been calibrated to consider these issues:**
 - limiting the impact on the economy: supporting factor for SMEs in Europe
 - preserving some business models: marginal adjustments to LCR, leverage ratio...

3. The regulatory response and its consequences on the economy (3/3)

➤ Possible transfer of activity to:

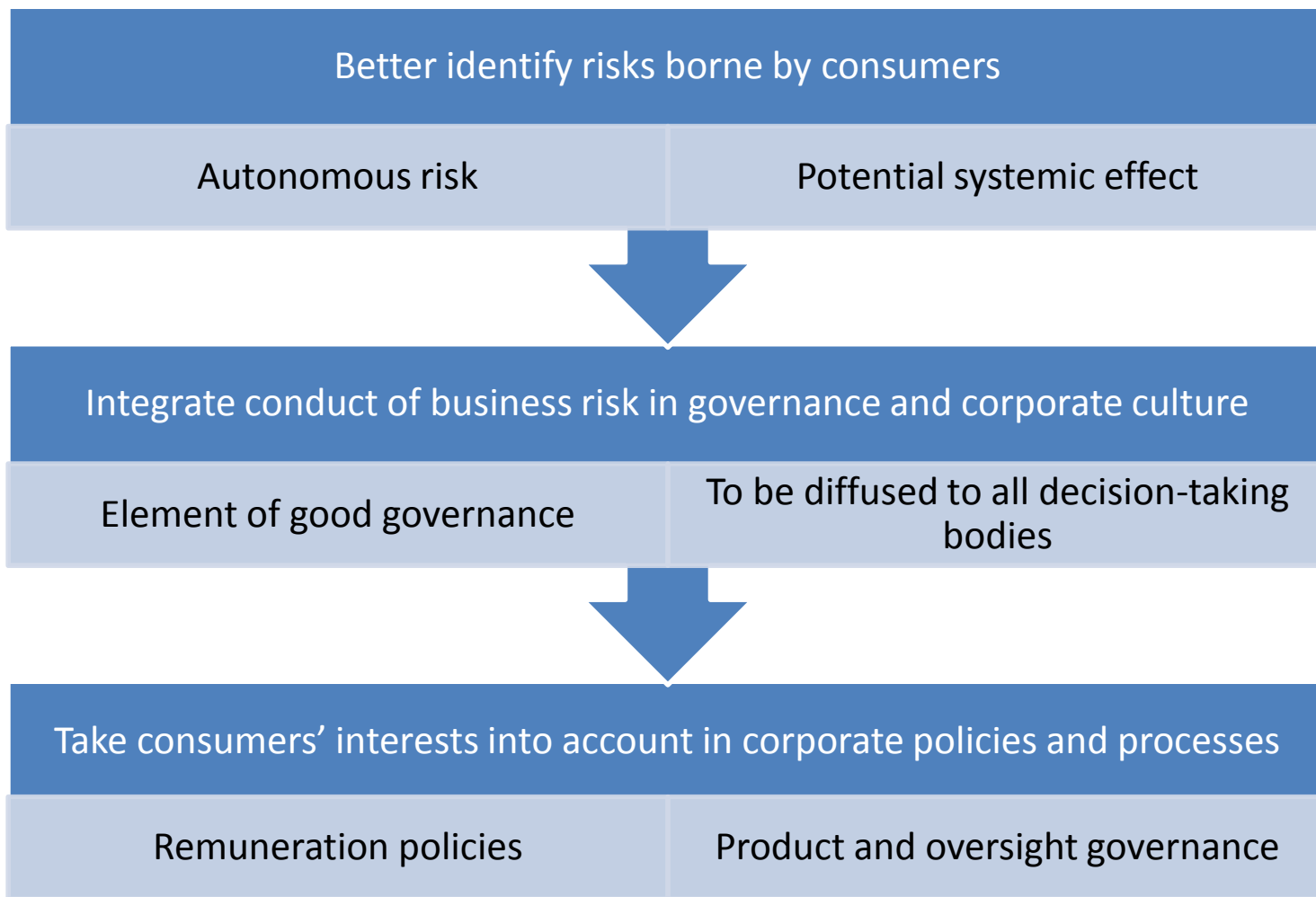
- other areas of the financial system that are subject to different regulatory requirements (e.g. insurance) or less regulated financial entities (shadow banking)
- unlevelled playing field across jurisdictions
- risk of regulatory arbitrage or leakages

➤ Consequently, relevance of an extensive approach of supervision:

- add macro prudential supervision to micro prudential
- supervision of highly interconnected banks and insurance companies under the same authority
- uniform application of the Basel 3 rules across the EU banking sector (all credit institutions + investment firms) + Single Supervisory Mechanism (4 November 2014) for the Euro area

➤ Regulators are also defining the scope of banking activity

4. Role of supervisors to foster public's trust in financial system (1/4)



4. Role of supervisors to foster public's trust in financial system (2/4)

➤ **Convergence of business conduct regulations**

- An enhanced and deepened cooperation between supervisory authorities
- A comprehensive approach targeting banks, insurance companies and financial services providers
- A harmonisation of provisions in all three sectors of the financial system

➤ **Resources dedicated to conduct of business supervision**

➤ **Enhanced harmonisation throughout financial markets aim at:**

- Better taking into account consumers' interests
- Encompassing the whole life cycle of financial products
- Diffusing conduct of business rules in governance processes of financial institutions

4. Role of supervisors to foster public's trust in financial system (3/4)

- **Remuneration policies often create conflicts of interests between clients and commercial staff**

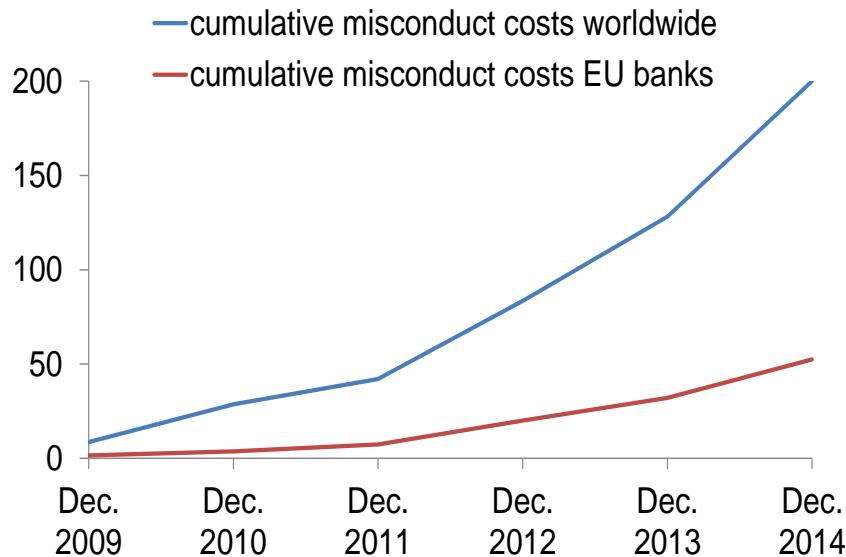
- **At the international level:**
 - FSB's principles and implementation standards to promote the adoption of sound compensation practices in the banking industry
 - OECD's high-level principle #10 on consumer protection recommends that commercial staff remuneration shall foster a responsible behaviour vis-à-vis the client

- **Rules have been implemented and reinforces by the EU:**
 - CRDIV contains stricter requirements on remuneration for categories of staff whose professional activities have a material impact on the risk profile on the institution
 - In March 2015, the European Banking Authority proposed Guidelines to specify the implementation of these rules (including scope)

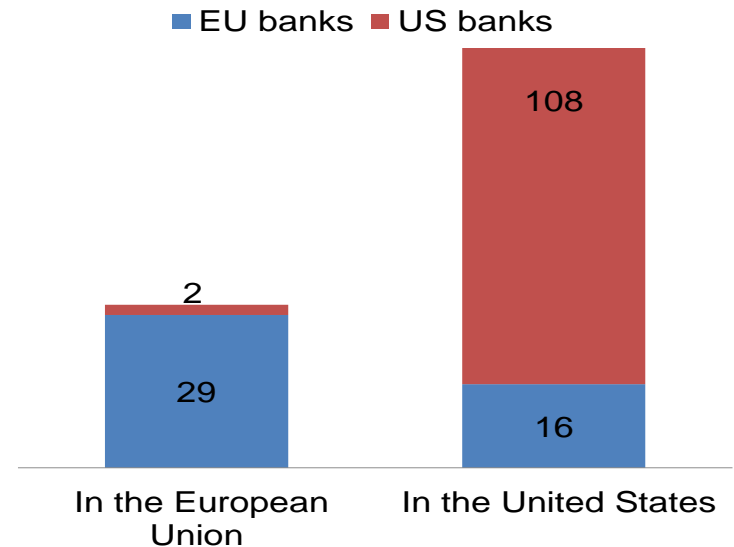
4. Role of supervisors to foster public's trust in financial system (4/4)

- **Misconduct at banks imposes costs on society, because of the loss of confidence**
- **Penalties can be used to prevent the issue**

Cumulative misconduct costs for banks since 2009 (EUR billions)



Fines, settlements and redress costs as a result of US and EU authorities (EUR billions; 2009-14)



Sources: CCP Research Foundation (<http://conductcosts.ccpresearchfoundation.com/index>), Financial Times

Concluding remarks

- **Banks are a major component of the economy and society**
 - Ensuring that the different regulations do not impair long-term financing and financial market liquidity
 - Ensuring that funding sources do not shift on a large scale to unregulated or under-regulated sectors
- **At the same time, the crisis highlighted unethical and illegal behavior**
 - Renewing the focus on issues of culture in banks
 - Integrating culture into supervisory frameworks

Thanks for your attention

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