Evolve or Perish
The Global Forces Changing the Business of Banks

Robert Fay and
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About CIGI

We are the Centre for International Governance Innovation: an independent, non-partisan think tank with an objective and uniquely global perspective. Our research, opinions and public voice make a difference in today’s world by bringing clarity and innovative thinking to global policy making. By working across disciplines and in partnership with the best peers and experts, we are the benchmark for influential research and trusted analysis.

Our research programs focus on governance of the global economy, global security and politics, and international law in collaboration with a range of strategic partners and support from the Government of Canada, the Government of Ontario, as well as founder Jim Balsillie.

About the Global Economy Program

Addressing limitations in the ways nations tackle shared economic challenges, the Global Economy Program at CIGI strives to inform and guide policy debates through world-leading research and sustained stakeholder engagement.

With experts from academia, national agencies, international institutions and the private sector, the Global Economy Program supports research in the following areas: management of severe sovereign debt crises; central banking and international financial regulation; China’s role in the global economy; governance and policies of the Bretton Woods institutions; the Group of Twenty; global, plurilateral and regional trade agreements; and financing sustainable development. Each year, the Global Economy Program hosts, co-hosts and participates in many events worldwide, working with trusted international partners, which allows the program to disseminate policy recommendations to an international audience of policy makers.

Through its research, collaboration and publications, the Global Economy Program informs decision makers, fosters dialogue and debate on policy-relevant ideas and strengthens multilateral responses to the most pressing international governance issues.
About the Authors

Robert (Bob) Fay is director of CIGI’s Global Economy Program and is responsible for the research direction of the program and its related activities. He has extensive experience in macro- and micro-economic research and policy analysis. Prior to joining CIGI, Bob held several senior roles at the Bank of Canada (BoC), most recently as senior director overseeing work to assess developments and implications arising from the digitization of the Canadian economy. Prior to joining the BoC in 2001, Bob was an economist at the Organisation for Economic Co-operation and Development. Bob holds an M.A. in economics from Queen’s University and an undergraduate degree in applied studies (economics) from the University of Waterloo.

Angelo Federico Arcelli is currently a senior fellow with CIGI’s Global Economy Program and a full professor of economics of international institutions at Guglielmo Marconi University in Rome. Federico has served in several adviser roles, including at the European Investment Bank and at the Independent Evaluation Group (World Bank Group) and as a member of the executive board of the World Bank (in Washington, DC, 2008-2009) and of the consultative committee (“Osservatorio”) on the European constitution in Italy’s Ministry of EU Affairs (2002–2004). In the private sector, he currently holds positions at Oliver Wyman and Marsh and McLennan Group. He holds an M.Sc. degree in economics and a Ph.D. in economic history, both from Bocconi University in Milan.
Introduction

Following the 2008 financial crisis, the Group of Twenty (G20) embarked on an ambitious financial regulatory reform plan that has seen many banks worldwide make substantial progress in terms of both capitalization and governance. Over this period, banks have also become increasingly exposed to business risks from digitization, artificial intelligence and cybercrime, and major investments are necessary to manage these risks. New regulations such as the General Data Protection Regulation (GDPR), Markets in Financial Instruments Directive 2, and Bank Recovery and Resolution Directive legislation have been introduced in the European Union to reduce these risks, but their associated costs have potentially created a lasting competitive disadvantage for European banks. This situation has raised some key questions that deserve to be discussed and investigated: How does regulation — including that outside the sector — affect banks’ ability to compete globally? What will be the impact of fintech players as well as globally active banks from China and other emerging markets? Can the Basel regulatory framework and Financial Stability Board (FSB) ensure a level playing field globally or has the regulatory pendulum swung too far? How will the supervisory approach need to be adapted to the changing structure of the global financial system? Moreover, how will the implementation of Basel reforms affect the industry? These and other questions remain about the effectiveness of the already-achieved reforms as well as their future direction.

These issues were at the core of CIGI and Oliver Wyman’s fifth annual Financial Regulatory Outlook Conference, held in Rome on November 28, 2018. This conference report summarizes the key points of discussions at the conference, with a special focus on the 10 years of regulatory reform that was conducted under the auspices of the FSB and the new forces that are currently affecting banks and could have an impact on the future. The first part of this conference report gives an overview of the discussion around the main regulatory changes that have taken place over the last 10 years and outlines outstanding areas that need to be monitored. The second part focuses on the main changes taking place in the industry, including the rise of new players in fintech and in emerging markets. Finally, the transforming effects of technology and digitalization on the banking industry and supervision are addressed.

Ten Years of Regulatory Reforms in the Banking Sector: Past, Present and Future

Post-crisis, the G20 international regulatory reform of banks led by the Basel Committee on Banking Supervision culminated in Basel III and the pursuit to end “too big to fail.” Ten years after the onset of the global financial crisis, that agenda is largely complete. Only market risk or the fundamental review of the trading book is still outstanding — the key measures of Basel III and some additional considerations have been taken up. Banks today are now much more resilient, and this is consistent with the “never again” mentality that guided the political response and then the regulatory response to the crisis, reflecting the huge economic, fiscal and, of course, social costs of the crisis. Nevertheless, we are still dealing with some of those costs and, arguably, with the political ramifications of the crisis today.

This is most apparent in Europe, where the sequence of events that took place in the two-and-a-half decades following the Maastricht Treaty — increased European integration, the creation of the euro and the crisis of 2008 — has
put a strain on economic and political structures. The result is a dramatic asymmetry between the dimension and density of the problems and the present political capability to manage them. Indeed, Europe needs more coordination of the public budgets of member states, a European fund that is empowered to issue Eurobonds and more solidarity toward states in crisis.

Having these structures in place takes on even greater importance given the sharp rise in public and private debt and the ramifications that it raises in the event of rising interest rates or an economic downturn. World debt stands, according to International Monetary Fund figures (Mbaye and Moreno Badia), at US$184 trillion and it is much higher than at the height of the great financial crisis 10 years ago. If the global economy slows down, the risks of an abrupt deleveraging process are high. Worldwide, the two asset classes, debt and equity, are declining simultaneously. This is very rare and may signal that markets fear there could be some substantial problems ahead. Institutions now hold about US$1.1 trillion of leveraged loans in the United States, double the pre-crisis level. Junk bonds have reached US$1.2 trillion. These assets have found their way into mutual funds, insurance companies and pension funds through collateralized loan obligations posing new risks for the sector.

Against this background, major revolutionary change is under way in the financial sector and this creates new challenges and new difficulties, but also new opportunities.

First, the full and consistent implementation of Basel III across all jurisdictions — a milestone in financial regulation — is necessary to ensure consistency. Nevertheless, while Basel rules were tiered in the United States, in Europe it was decided that they would have to apply to all banks in the name of competition. In the United States and in Europe, there are also notable differences in the resolution process as applied to large and small financial institutions, which, in practice, imposes significant constraints around allowing a bank to fail.

Second, the monitoring of new risks in the financial sector is essential. New business models have emerged in the banking sector, and some of them are an intended result of regulatory reform. Nevertheless, some activities have also migrated to the less regulated part of the financial sector. The rise of the digital economy has also led to a new set of operators in financial markets that may fall outside the regulatory perimeter. In addition, new technologies have led to the rise of big data and artificial intelligence and the consequent concerns over how individual data may be used by firms, especially those in fintech that fall outside regulation. This has led to new regulations outside the financial sector, such as the GDPR, but with potentially negative implications for financial institutions in terms of elevated costs.

Third, technology is changing the face and the risks around the financial sector and banking. Technological innovations provide important benefits in terms of cost reduction and expanding the range of services to bank clients and the unbanked, but they also pose serious risks, including the risk of cyber attacks, that can erode trust. Individual institutions, in particular small banks, may not have the expertise to invest in technology or may underestimate its importance. Yet the crisis taught the importance of identifying and understanding interlinkages and these may have increased with technology and new players in the sector. As a result, there is likely a socially inefficient

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1 The idea of a unified Europe came out of World War II and was a political entity based on three landmark ideas. The Ventotene Manifesto, drafted in the winter of 1941, is considered the origin of peace and freedom. Ventotene eliminated the divisions between the defenders of European nation states and promoted the dream of a united Europe. The second landmark was the Treaty of Rome, signed in March 1957. It was a confederal framework among six sovereign states devolving to Brussels legislative and administrative competencies to construct the European market. The treaty generated an institutional structure similar to a pyramid — broad at the bottom and small at the top. A key point, direct accession, was symbolically conserved at a national level as a basis for no taxation without representation, the essence of democracy. The political spirit of the treaty was absolutely democratic and led to 40 years of economic and social progress. Third, the Maastricht Treaty was signed in February 1992, 500 days after the fall of the Berlin Wall at a time when “globalization” was the international mantra. It gave to Brussels the power of representing the entire European continental structure, to dialogue with other continents and defend individual signatory states. Consequently, Europe went beyond the defence of national interests and started to design — within a post-modern logic — the perfect European society.

2 Eurobonds were proposed informally first in 1994 by European Commission President Jacques Delors, then again officially by the Italian presidency of the European Union in 2003 and, again, in 2010 for financing infrastructure and European defence.

3 This is clearly indicated in the report of the High-Level Group on Financial Supervision in the EU (known as the de Larosière report) and is the basis of the Dodd-Frank Act. The Dodd-Frank Act clearly stated that proportionality was a fundamental issue not only for banks but for the financial system as a whole.
level of investment in guarding against cyber risk. This is an economic rationale for regulators to ensure that all banks are taking effective measures to safeguard against cyber attacks.

Finally, there is the difficult trade-off between stability and efficiency (where, admittedly, efficiency is defined narrowly in the use of capital to generate assets). Before the crisis, the financial system was, by this measure, incredibly efficient. Unfortunately, it was also incredibly fragile. The question today is whether we have struck the right balance between stability and efficiency.

The crisis not only tarnished the cachet and credibility of banks as prudent stewards of savings in the eyes of the general public and many policy makers, it also revealed misconduct before the crisis in terms of loan-pushing and disregarding minimum basic loan standards (the so-called Ninja mortgages). Thus, in terms of stability, there is a broad range of issues to address, including conduct, culture and governance, and there is a potential tidal wave of regulation covering everything: benchmark rate reform, data privacy, market misconduct and prescriptive corporate governance reforms. How these will interact with each other and their overall impact will have to be carefully tracked and examined.

Macroprudential policies have also been implemented in many jurisdictions as part of the regulatory response to the crisis, and some tentative conclusions from lessons to date show that macroprudential measures typically work much better in expansionary phases than in contractionary periods. Macroprudential tools matched together with monetary policy are relatively more effective. It is also known that measures such as credit limits — loan-to-value ratios, for instance — have a direct effect on borrowing and, therefore, are better to restrain credit growth, whereas capital measures are better to increase the resilience of the system. Macroprudential policies do not have unlimited powers and unlimited capacities, and little is yet known how they would work in an economic downturn nor how they would interact with other policies. Following Basel 3.5, there will be a strong focus on leverage ratios complementing the usual capital measures, going from one focus indicator to a more holistic approach, including cyber risk, market risk and anti-money laundering supervision.

How Digitization and Emerging Markets Are Changing the Banking Sector

Digitization in financial services is no longer a new topic. Technology has been evolving apace and is deployed much more extensively now in financial services. There has been a proliferation of the use of open application program interfaces by banks and other financial services providers, connecting in third parties and creating all types of new offerings and services for consumers. Smart data and algorithms are used more and more for unpacking and improving some of the core decisions that drive financial services (for example, credit decisions, financial advice decisions, fraud and risk management decisions). Even more significantly, blockchain now has real and meaningful application in critical infrastructure in financial services around the world.

Incumbent financial institutions have often started with experiments around the digital customer experience and then have examined where they can drive both shareholder benefits and cost savings. There has been increasing focus on how companies can use digital offerings in ways that the big technology firms do and find new sources of value for customers by solving important problems for them. That has led many to consider greenfield operations, such as starting new banks or new insurers from scratch with entirely new, modern technology platforms. Successful players have emerged on the scene in a variety of areas such as fintech, regtech and suptech.

Fintech is growing. In 2017, there was a market of US$30-$31 billion mergers and acquisitions in terms of venture capital investments. This is a big market that is becoming more mature. From the initial start-ups operating only payments, there have been developments in many other areas — regulation, cyber security and mortgages, for example.

In addition to those smaller innovative players, tech giants such as Google, Amazon and Facebook are dipping their toes into the waters of financial services. This phenomenon is most pronounced in Asia, where many of the Chinese players are...
bringing to market quite amazing offerings in financial services. Peer-to-peer lending in China has grown thirtyfold over three years. Players such as WeChat and Alibaba have taken their platforms and used them as a doorway into payments, utilizing their huge databases on consumers as the basis for lending offerings. WeBank, the banking subsidiary of WeChat’s business, has evolved from infancy to now one of the most substantial private sector lenders in the consumer and small business space in just a few years.

In parallel, regulators have hired teams of experts, set up advisory bodies and external panels, engaged with industry and, increasingly, looked at ways in which they can facilitate innovation. They have produced some significant new policy changes that are reshaping the outline of the industry (for example, the Payment Services Directive in Europe and the GDPR, as mentioned earlier) outside financial services, but with significant implications for banks.

There is still a substantial difference between traditional banking and the new digital world, but the gap is growing smaller. When traditional incumbents decided to go in the direction of open cooperation with fintech, they started to learn how to successfully work together. This revolution is ongoing.

Digitization could also help to boost profitability in the sector by containing costs and boosting margins. One critical cost issue in Europe is the continuing fragmentation of the banking sector and how to manage costs with such fragmentation. This has contributed to the low return on equity — for example, the average return on equity of a large panel of European banks today is around six percent. In the United States, 10 years ago the five largest banks had a market share of 40 percent of the US market. In Europe, the comparable figure for the five largest European banks was around 18 percent of the European market. Today, in the United States, the five largest US banks have a 60 percent market share while the five largest European banks still only have around 20 percent of market share. In Italy, for example, there are about 45 branches for 100,000 inhabitants.

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4 That low profitability has various explanations. On the revenue side, this can be explained by the negative and low interest rate environment and the pressure from the new entrants that have set new standards in terms of pricing. On the cost side, there has been an increasing cost of doing business as well as continued fragmentation.

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### What Has to Change in Banking Supervision

The main force driving the change in the financial industry now and in the foreseeable future is technology, which is permeating all aspects of life. Finance is very much involved in the evolution of technology — both in the demand by consumers and in the supply of products on the part of financial firms.

Consumer habits are evolving in reaction to the new products that they can find in the market. Fintech and introtech are transforming the financial landscape all over the world. Thanks to their digital technological skills, they are able to put lenders and suppliers of funds into direct contact with utilizers of funds. Banks — in particular, big American, Japanese and even European banks — have reacted by buying start-ups in the fintech world.

Financial regulation and supervision need to adapt to such rapid and radical changes as fast as possible. There is a trade-off: on one side, technological progress leads to a greater offering of services to the public; on the other side, regulators should pursue their mission of protecting users of financial services against a micro and macro crisis or misconduct in the market, concentrating on high-level issues such as governance and conduct, while also keeping an eye on the use of the granular data that is now requested from the industry. On top of that, supervisors should adopt new digital technologies, an issue that is being explored via suptech.

The European institutional setting for financial sector supervision is too complex, could be more efficient and is not favourable to the emergence of strong and efficient global players in the banking industry. While the financial sector is deeply interlinked, supervisory responsibilities are split between many bodies, authorities and boards: some are split at the national level, some at the European level, with overlaps, creating gaps and difficulties with co-operation. The simplification of the institutional supervisory landscape is an imperative in the coming years. Indeed, the banking sector and technology are both areas where economies of scale play an important role, and the European banking industry today is not ready to take full advantage of the technologies.
available, for two main reasons. First, in the eurozone there are still 19 different legal and insolvency jurisdictions without common denominators for data classifications, thus without common entity identifiers across different jurisdictions. This makes it almost impossible for the technology to exploit all the benefits that can be seen in other industries. Second, there is uncertainty related to future equity requirements due to the ongoing changes in bank regulation. The last 10 years of almost continuous bank regulations have caused uncertainty, and banks have become more prudent in using their liquidity. As a consequence, in Europe this appears to be having a contractionary impact on bank lending and on the economy.

Not long ago, people were predicting that everything would move to purely digital banking, and incumbents would lose clients and market shares. This has not happened yet, but it has had an impact on the margins. It has not changed banks’ market share, but instead has changed client expectations of what they should provide. Regulation does not have to be an obstacle; the way you deal with regulation can become a plus rather than an obstacle.

In terms of setting regulations in a digital era, there are five important principles to consider:

→ Maintain a level playing field. Do not privilege a domestic player over an international player, or vice versa, because every player will bring its own power, functionality and innovation to the table.

→ Governments should ensure the free flow of data. Privacy and data protection are obviously critical, but there are methods that allow for data to continue to flow open and securely.

→ Invert the current trend around the world toward localization, in particular with respect to data infrastructure.

→ Maintain interoperable standards. Do not mandate a particular technology that could become obsolete right away. Without an interoperable and open loop system, the likelihood for irrelevancy increases for consumers.

→ Finally, when considering product development and regulation, the experience of, and benefit to, the consumer should be the ultimate consideration.

Summary

Looking ahead, digitization will continue to be a major theme in the financial services sector. It will have implications for the ways of doing business by banks, insurers, investment funds and other participants. It will have implications for the issues on which regulators and supervisory bodies need to focus as well as how they conduct their own business. The complex challenges that digital technologies present are areas where new technologies can assist, for example, in regtech and supertechnology. All of these developments are taking place against a background of political and economic challenges that also affect the sector. These complexities provide ample scope for a continuing dialogue on financial sector topics. Globally this conference, the fifth co-sponsored by CIGI and Oliver Wyman on financial regulation topics, has proven again to be an effective forum for discussion on relevant policy-making matters from global and European perspectives. A sixth conference is planned for late 2019 that will examine the most pertinent issues facing the financial sector.

Work Cited

Agenda

November 28, 2018

11:30–11:50 a.m. Registration and appetizers

11:50 a.m.–12:00 p.m. Welcome

12:00–12:15 p.m. Opening address
  → Giulio Tremonti, Former Deputy Prime Minister and Minister of Finance of Italy

12:15–13:30 p.m. PANEL I: Taking Stock of the G20 Financial Regulatory Agenda — Ten Years Later
  → Pedro Duarte Neves, Advisor of the Board and Former Vice-Governor, Banco de Portugal
  → Robert Fay, Director of the Global Economy Program, CIGI
  → James A. Haley, CIGI Senior Fellow and Former Executive Director for the Canadian-led Constituency at the IMF Washington and Special Advisor, Regulatory Affairs, Scotiabank
  → Rainer S. Masera, Dean of Economics, Università Marconi, Rome and Former Minister of Budget of Italy

13:30–14:30 p.m. Networking lunch

15:00–16:15 p.m. PANEL II: How Digitization and Emerging Markets Are Changing the Industry
  → Federico Ghizzoni, Chairman of the Board of Directors, Rothschild S.p.A.
  → Jacob Hook, Managing Partner Asia Pacific, Oliver Wyman
  → Demetrios Marantis, Senior Vice President, Global Government Relations, Visa Inc.
  → Nicolas Namias, Chief Financial Officer, Member of the Management Board, Groupe BPCE
  → Ben Richmond, Founder and CEO, Cube

16:15–16:45 p.m. Coffee break

16:45–18:00 p.m. PANEL III: Banking Supervision 2025: What Has to Change
→ René Brülhart, Chairman, Financial Intelligence Authority of the Holy See and the Vatican City State
→ Megan Butler, Executive Director of Supervision — Investment Wholesale and Specialists Division, Financial Conduct Authority
→ Boštjan Jazbec, Member of the Board of the Single Resolution Board
→ Robert Ophèle, Chairman of the Autorité des Marchés Financiers, France
→ Salvatore Rossi, Senior Deputy Governor, Bank of Italy

18:00–18:20 p.m. Closing remarks

→ Carlo Cottarelli, Director of the Italian Public Finance Monitor, Università Cattolica del Sacro Cuore di Milano