Bank business model transformation and financial stability consequences I. Over-regulation, optimal simplicity, interactions between prudential instruments

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Background

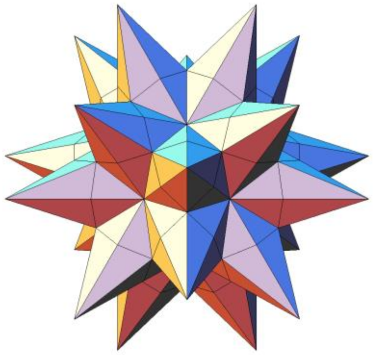
- My background:
  - Member of ESRB Advisory Scientific Committee
  - Co-author of e.g. ESRB ASC reports No 8 (2019) "*Regulatory complexity and the quest for robust regulation*" and No 12 (2022) "*Will video kill the radio star? – Digitalisation and the future of banking,* author (2017) of "*Systemic Risk: A Practitioner's Guide to Measurement, Management and Analysis*"
  - Actuary with a background in investment management
- Potential focus of this panel session
  - Regulatory complexity
  - Macroprudential toolkit and interactions between regulatory constraints
  - Digitalisation in finance

Regulatory complexity (1)

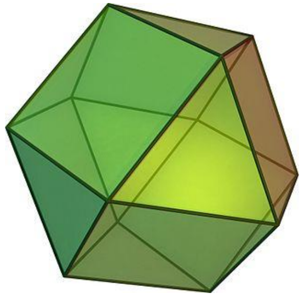
- Financial regulation often seems complicated

- But
  - The system being regulated is also complex
  - Stresses it has faced have come from multiple directions
  - Big discontinuities arise from regulatory perimeters
  - The inherent justification for regulation is information asymmetry. This can be between firms and their customers but also between firms and their regulators/supervisors.

Regulation needs to be appropriate to the system being regulated. Is the financial system very complex / discontinuous / difficult to predict?



Or simpler / smoother / more predictable?



Regulatory complexity (2)

- Some initial thoughts:
  - Basel II under-emphasised liquidity risk (hence introduction of tools such as LCR and NSFR)
  - Firm franchise value usually small after business model failure
  - Regulatory capital requirements should ideally emphasise intervention ladders and ultimately ability to transfer assets and liabilities to a (willing) third party with only modest haircuts / support from third parties
  - Risks are usually fluid so ideally should be handled holistically, c.f. IRRBB and CSRBB

Principles in ESRB ASC Report No 8 "*Regulatory complexity and the quest for robust regulation*"
Adaptability
Diversity
Proportionality
Resolvability
Systemic perspective
Information availability
Non-regulatory discipline

Effectiveness of (existing) macroprudential toolkit

- Banking has special characteristics:
  - Extensive safety nets, high integration with real economy (lending provision, crisis links)
  - Hence development of a macroprudential toolkit, which currently emphasises capital buffers
- Ideally, banks would be sufficiently well capitalised to reduce need for (additional) buffers
  - In the meantime, buffer usability a high priority
  - An outside perspective: a multiplicity of buffers with relatively similar purposes and with very complex interactions with e.g. MREL, TLAC, liquidity requirements, …?
  - Activity-based tools come from a different angle and may help address regulatory perimeter effects
  - Capital Markets Union goals might deemphasise banking, as might digitalisation developments

Implications of digitalisation in finance for regulation

- ESRB ASC Report No 12 "*Will video kill the radio star? – Digitalisation and the future of banking*" notes:
  - Likely increased importance of non-financial risks
  - Issuance of Central Bank Digital Currencies (CDBC) and/or Big Tech envelopment strategies could be very disruptive for incumbents, depending on regulator attitudes and perspectives
  - Regulatory perimeters (and associated access to safety nets) become even more important, e.g. how best to handle non-financial firms providing either:
    - IT infrastructure services to large numbers of financial services providers, or
    - Quasi-financial services to end customers
  - Extra need for orderly exit mechanisms if incumbent business models are disrupted