The Financial Industry in the 21st Century

Introduction

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General remarks

Dear Colleagues

Let us assume that we are in the year ***2100***, at the Jubilee International Conference of Banking Supervisors, if there still exists such exotic institutions as banks or financial services providers and, hopefully, their supervisors. The chairman of the day has mandated his historians to retrieve the minutes of the ICBS 2000. If our workshop papers and discussion-records have not been destroyed, our successors will certainly have a good laugh at what we thought were the trends and challenges of the Financial Industry in the 21st century. If you look back at the dramatic changes in the 90s, even a decade ahead is probably beyond our imagination. Hence, we must be prudent - a natural characteristic of all supervisors - and conscious of the limited use of our forecasts. In any case, we are constantly reminded by the industry, that we are “behind the curve”, neither visionaries nor drivers of innovation. However, we seem to have a longer memory than most bankers, which occasionally enables us to prevent them from repeating the same mistakes. In addition, we can remind our banks of the eternal wisdom, that the past is not necessarily a reliable guide to the future and we can build in capital cushions for unknown risks. But whatever goes wrong, we are sure to get the blame, and this may be the only constant over the next hundred years. However, this challenge is no reason to despair, because we would not have such fascinating jobs as supervisors, if we knew everything in advance.

Having all these caveats in mind, we have selected six workshop topics, which are partly interrelated and overlapping. Admittedly, the choice is somewhat biased by the situation in the ***Swiss financial sector*** and the issues which we at the Swiss Federal Banking Commission and the Swiss National Bank are confronted with today or in the foreseeable future. Switzerland is the home of two global giants, UBS and Credit Suisse Group, which account for more than half of the relevant domestic Swiss markets. So there is a high concentration at the top end, but we still have 370 other banks and 90 licensed non-bank securities firms. This creates tension in a regulatory and supervisory system which should cater for institutions of such different nature, size, sophistication and complexity. It also raises the topic of the regulator’s role in banking insolvencies, especially when dealing with large institutions and cross-border issues. In addition, Credit Suisse Group is a financial conglomerate, in which banking and securities business remain predominant, but which is in the process of integrating insurance into a combined financial services business unit. On the other hand, we witness the growing appetite of insurance groups for banking subsidiaries. In our capacity as securities regulator, we would no longer be surprised if market forces in the form of cross-border alliances and mergers of exchanges and ultimately clearing and settlement systems were making national regulation and supervision obsolete. Compared with such a sweeping prospect, the idea of a supranational regulator for the super-league of global financial service providers, our last workshop topic, does not seem so radical anymore. Last but not least, e-banking and e-trading are prominent on the agenda of every supervisor, because at a minimum his domestic consumers can be accessed by the internet from all over the world.

Now, let us have a quick look at each of the six workshop papers, which hopefully present the right issues in an objective way.

A. Supervising financial conglomerates: is an integrated financial regulator the right answer?

Since financial conglomerates, more integrated financial products and combined business units are a reality today, we have to resolve the practical question, how such complex groups can best be supervised and how to surmount the traditional sectorial barriers in regulation and supervisory techniques. The main challenge is between banking and insurance, whereas banking and securities business are more similar, at least from a European perspective; our US, Canadian or Australian colleagues may have a different story to tell. Basically, there are ***two approaches***:

- Efforts to coordinate supervision in the different sectors, without merging the respective sectorial authorities. Such coordination may consist in a joint approach or a so-called solo-plus system whereby the lead supervisory authority or coordinator is granted some additional powers. One could call it the "***Joint Forum approach***", which is still the predominant model in a majority of countries.
- Promotion of a cross-sector approach involving one integrated supervisory authority with broad responsibilities in the wider financial sector. It could be labelled the "***all in one approach***" and is followed e.g. in Scandinavia, the United Kingdom and Japan.

The pros and cons of the two basic models are discussed under various aspects: relevance, magnitude, market demand, expertise, consistency, flexibility, efficiency, international cooperation, concentration of power and customer protection. Whatever route one chooses, it is going to be a strenuous and lengthy trip to bridge the gap or even merge the different cultures.

B. Supervisory treatment of insolvent banks

Coping with insolvent banks is as morbid a subject for supervisors as for a surgeon whose patient dies under his scalpel on the operating table. We prefer to deal with fairly healthy or at least not mortally ill patients. But the ***Core Principles*** for Effective Banking Supervision rightly acknowledge that a prompt and orderly exit of institutions, that are no longer able to meet supervisory requirements, is a necessary part of an efficient financial system and that supervisors should be responsible for, or assist in, orderly exit. If banks are so different from other commercial enterprises to justify licensing and ongoing supervision, then it is logical to ask whether they also need a special regulatory framework for dealing with their insolvency. What ***action*** can the supervisor take to pre-empt or resolve a bank insolvency and which powers should be vested within the supervisory authority? A number of measures are discussed to gain breathing space, provide legal or economic incentives for a reorganisation or to avoid the additional losses of a piecemeal liquidation. ***Deposit insurance***, a vast subject of its own, is only briefly touched upon, mainly in the context of possible limitations in the case of a large bank failure or a systemic crisis. At the end follows the most daunting challenge: how to resolve the ***failure of a multinational bank***, or to make it even harder, of a complex financial group with global activities and business units cutting right across a multitude of legal entities incorporated all over the world. We are reminded that consolidated supervision is based on the assumption that such a group forms a single economic entity. Yet, this assumption is no longer valid in a bankruptcy scenario, where the group is split up into its many legal entities and where foreign branches are liquidated as separate units. The

interaction of different liquidation regimes and other relevant national laws is a nightmare, which could only be overcome in a futuristic universal proceeding. Unfortunately, we haven't made much progress since the Basel Committee's paper of 1992 had identified these issues.

C. Simplification of regulation and supervision

Simplicity versus risk sensitivity and complexity of regulation was already prominent in yesterday's discussion on the review of the Capital Accord. But the New Accord is only the top wave of a ***giant flood of regulation*** which is constantly pouring out on the financial sector. The production of papers and website-pages containing minimal standards, guidelines, best practices etc. from supervisors and industry groupings is at an all-time high and still growing at an exponential rate, not least because the number of so-called G-groups and Fora is proliferating rapidly. This raises the question, who can still read or digest, let alone implement such a mass of regulation and advice. The mere mention of the word "Basel" in the context of banking regulation provokes sorrowful looks and groans among domestic Swiss bankers. The main reproach from ***medium and small*** banks is that most of the regulations were designed for large internationally active banking groups with a broad scope of sophisticated, risky activities and highly complex organisations. They are perceived as a burdensome regulatory overkill for their own simple domestic business and lean organisation. I am sure you are familiar with these arguments, because such institutions still form the vast majority in every part of the world. There is a grain of truth in this criticism and we should therefore take the ***call for simpler regulation*** seriously: "one-size-fits-all" is no longer sustainable in a banking population of such variety. And as national regulators we cannot blame the Basel Committee, if we tend to apply the international standards in a uniform way to all banks we supervise. There is quite a difference between flying a jet-fighter, a Jumbo or a glider-plane, although some basic laws on traffic, aero-dynamics and weather are the same.

The three solutions presented in the workshop paper demonstrate that simplification is not that simple.

D. Electronic banking and electronic trading

E-Banking was already on the agenda of the ICBS 1998 in Sydney, under the general heading of operational risk. It will be the next top-priority of the Basel Committee, right after the review of the Capital Accord. We are only beginning to adapt our regulation and supervisory tools, which were built for the "old economy", to this major challenge. In this sense, the workshop can merely touch upon a few of the many questions to be resolved.

The first chapter deals with ***competition*** issues: Traditional distribution channels facing increased competition from "click and mortar" banks and securities dealers, other financial service providers such as insurance companies, and new entrants, including IT and TMT companies, but also large retailers. Additional costs of maintaining multi-distribution channels, the cannibalisation of traditional business and the erosion of margins due to enhanced competition, combined with the high up-front investments in technology and advertising, may reduce profitability and warrant a more attentive review of business plans by supervisors.

On the ***Risk Management*** side, the main risks still appear to be operational, reputational and legal risks. However, increased outsourcing of core technology to third-party service

providers and growing reliance on partnerships with technology firms may lead to a dependence on and a risk concentration with such third-parties. Know-your-customer principles are more difficult to implement in a digital world which consequently increases the potential for money laundering.

The borderless business in a world of borders raises the fundamental question whether the traditional licensing requirements on the establishment of a commercial presence abroad can still be applied to ***cross-border*** electronic banking and trading services. In any case, in cyber-space the need for a closer coordination and cooperation among supervisory authorities becomes evident, as does their demand for joint training programmes and closer contacts with the industry in order to keep pace with the rapid development of technology.

E. Concentration in the banking industry

The strong trend towards a more concentrated banking and securities sector all over the world, not only at the national level, but increasingly also cross-border and cross-sector, does not need further illustration. The ***frantic race to stay or arrive at the top*** of the market leaders seems to be the main driver of merger-mania and take-overs, which produce ever larger institutions. The challenges and concerns raised by this concentration process are analysed under three broad categories:

- ***Competition*** issues arising from the decline in the number of market participants and the increasing market power of the largest institutions.
- The threat to ***systemic stability*** caused by the dominance of only a few very large players. The notion of "too big to fail" may be politically incorrect among supervisors and central bankers for reasons of moral hazard, but it clearly is back on the political agenda, at least in smaller countries such as Switzerland. Since a bailout of a very large bank can be extremely costly, the question could rather be, whether such a bank is "too big to be rescued".
- The difficulty of ***regulating and supervising*** increasingly large and complex global institutions.

Fortunately, we are still rather far away from the ***ultimate logic*** of concentration, where we have only one bank left, which combines in-house the only securities exchange as well as the clearing and settlement system. The remaining outsiders would be the customers, if they haven't all merged either, and a single regulator. This extremist vision brings us to a more moderate utopia.

F. Supranational regulator

Financial market regulators and supervisors, especially in the banking sector, have over the last 25 years developed and constantly refined an international framework of core principles, minimum standards and cooperative arrangements. This framework is still characterised by a ***decentralised organisation of national authorities***, combined with adherence to internationally agreed standards and an intensive cross-border and cross sector cooperation. This system has worked reasonably well in the past and is permanently being upgraded, reviewed for remaining gaps and extended worldwide. However, in view of the afore-mentioned trends, the question arises, whether more of the same is good enough for the

future, or whether we need a radically different approach to large, complex global financial institutions.

The principle is well established that the ***home supervisor*** is responsible for global consolidated supervision of a banking group. But it is not always that clear what "home" is, when the main activities and risks are outside the jurisdiction of the parent company or corporate centre of a truly global firm. It may also not be fair or politically feasible to let the home country carry the whole burden of a rescue operation if fatal losses were incurred far away from "home". Furthermore, consolidated supervision is still at a very early stage for insurance-dominated financial conglomerates and some securities regulators are even opposed to it with regard to investment banking groups, which also raises level-playing field concerns vis-à-vis bank-dominated groups.

Do we therefore need a ***supranational regulator***? According to the generally accepted principle of ***subsidiarity*** there is no reason to centralise supervision of purely domestic institutions or even the vast majority of internationally active financial service providers. The question can thus be focussed on a relatively small number of large, globally active financial groups, which are of systemic relevance at a global level. For this top tier of sophisticated global players, a ***global super-league***, one could imagine a special regime, under which they would be subject to a special set of rules applied and monitored on a consolidated basis by a supranational regulator. In essence, the supranational regulator would exercise the same functions as a (national) home supervisor under the present framework. of consolidated supervision. He would thus be responsible for rule-making, monitoring of compliance, coordination with national host and sectorial supervisors, crisis management and coordination of a global winding up or liquidation of the group. After listing the pros and cons of this futuristic idea, the issue probably boils down to the ***political question***, which countries would be ready to give up their powers over the biggest, most sophisticated flagships, especially if this were to mean losing sovereignty in the decision over the injection of public funds or liquidation. Therefore, one cannot expect national supervisors to show a lot of enthusiasm for the prospect of being relegated to a local league and the role of junior partner to some remote super-body.

If workshop participants are not as pessimistic, they can proceed to the more practical question, ***who could be the supranational regulator***. The most pragmatic approach would favour an existing body, already familiar with supervisory and/or central banking issues. My personal favourite is the ***BIS***, as it is competent, powerful, wealthy and truly global, not because it happens to be so close to Berne. To avoid any misunderstanding: I have not consulted the BIS management when writing the workshop paper and I take the sole responsibility for its content.

If we find the right answers to all of the 76 workshop-questions in only one hour and thirty minutes, we may consider ourselves fit for the 21st century. I wish you good luck.