Klaas Knot: Can intensive regulation and MSME financing coincide?

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the Conference on "The future of banking", organized by the Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO), Amsterdam, 12 November 2012.

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Your Royal Highness, Ladies and Gentlemen,

I'm very pleased to be here today to speak on this important topic: the future of banking. Today, we will exchange views on the changing banking sector and the role of regulation in that sector. And I will share some thoughts on how we can make the banking sector in this part of the world healthy again. The key question I will seek to answer is: "Can intensive regulation and Micro-, Small-, and Medium-sized Enterprise (MSME) financing coincide?" But before answering *that* question, let me first sketch how this intensive regulation came about.

Over the past few decades, banking in most developed economies has become increasingly complex, interwoven, innovative and international. Furthermore, the focus of many Western banks has gradually shifted away from what their core task should have been: Namely, to service the real economy and its customers. Instead, these banks increasingly engaged in the lucrative business of making money with money. This change of policy created unnecessary risks for their entire portfolio. Risks that couldn't be mitigated by the existing regulations. And we all know what problems arose as a result.

One of the answers to those problems was more and intensified regulation. Higher capital requirements, minimum liquidity requirements, extra buffers are but a few examples of the measures standard-setting bodies developed. Most of these measures are currently being drafted in national legislation in many countries around the world. Will intensifying regulation help solve some of the problems in the developed banking sector?

Yes, I believe so.

For, indeed, there <u>was</u> a shortage of capital and liquidity in the banking sector. And the leverage <u>was</u> generally way too high, not just for large, international banks. Increasing capital buffers; establishing resolution regimes; reducing systemic relevance of banks, are some of the important recent initiatives designed to make banks healthier.

Thanks to these measures, banks will be better positioned to absorb losses and become less dependent on government support. And thanks to these measures, trust in the financial sector will eventually be restored. I therefore wholeheartedly support these initiatives.

Of course intensified regulation will come at a cost. For banks, profits will go down. Generating double digit profits will become an unrealistic target if the underlying real economy the bank is servicing does not generate such high profits either. For customers, it means that financial products and services will become more expensive. And investors will come to realize that investing in a bank is a long-term undertaking, rather than a quick and easy way to make money.

Intensified regulation will also make some business models less appealing. But let us not forget that those are exactly the business models we are worried about. Funding an extremely long-maturity asset portfolio with very short-term paper used to be quite common for a while for many larger banks in developed economies.

But this is undesirable.

However, understandably, many are worried that this intensified regulation will hurt MSME financing. MSMEs are generally treated either as corporate or as retail clients. If they are treated as corporates, MSME loans may in some cases be considered riskier than loans to large corporates. Such as when the MSME loan is provided in a country with a high sovereign risk.

An ECB study published last week[1] showed that access to bank loans in the Euro area, including MSME loans, was becoming slightly more difficult. Moreover, the survey pointed to somewhat higher rejection rates for loan applications. Meanwhile, the percentage of respondents reporting access to finance as their main problem remained broadly unchanged. The demand for external financing showed even a slight decline.

I think that regulators and supervisors must continuously evaluate how risky banking activities really are. This is a learning process. If by evidence it turns out that some activities are less risky than initially considered, we should consider treating such activities more favorably. For instance, through lowering risk weights. If they turn out to be riskier, we should treat them with more caution, whatever the activity concerned, MSME loans included. To me this is the proper approach to making sure banks are sound and the financial system stable.

I think, though, that MSME lending will ultimately not be *disproportionately* affected. Let me explain this:

First of all, all new regulation will be phased in only gradually. For some measures even over a period of up to 10 years. This should give banks, investors and customers, including MSMEs, sufficient time to adapt to the new requirements. In addition, this gradual phasing in will also allow the banking sector to benefit again from an economic upturn. This hadn’t been possible if the new requirements had come into force with immediate effect.

Second, although the bar will be raised for all banking activities, the new regulation is primarily targeted at the riskiest activities. Systemically important banks, trading assets, complex securitizations, those are the type of banks and activities that will be experiencing the highest impact. Those are the activities that will become least appealing to banks. Not the traditional, plain vanilla banking business, which includes MSME lending.

And third, I believe that all new regulation explicitly allows for a proportionate implementation. This means that emerging market economies are permitted to use a risk-based approach with respect to the tasks of the supervisor and the standards that they impose on banks. Even in the latest EU legislation, proposals have been made to ensure that capital requirements for MSME financing do not grow as rapidly as those for other banking activities.

I find it encouraging to learn that the Basel Committee on Banking Supervision, starting even this year, will develop guidance on how to apply such a proportionality principle. For emerging markets this guidance is most welcome.

So altogether I think that intensified regulation, provided it is implemented proportionately, can continue to go hand in hand with sufficient MSME financing. In the end, sounder and healthier banks will enhance financial stability. This, in turn, will benefit the entire financial sector, and hence also the MSME business.

If you ask me if I think that intensifying regulation will solve all of the problems? No, it definitely won’t, I’m afraid!

If only, because intensifying regulation does not necessarily motivate the banking sector to move back towards its core task of servicing the real economy and its customers. Take, for example, proprietary trading. This is when a bank trades financial instruments with its own money instead of its customers’ money, sometimes even following an investment strategy it doesn’t advise to its customers. As a result, the bank makes a profit for itself instead of for the customers. Such a disconnect between the interest of the bank and that of the customer still occurs too often.

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[1] “Survey on the access to finance of small and medium-sized enterprises (SMEs) in the euro area”, 2 November 2012.

Ultimately, going back towards their core task of servicing the real economy and its participants is where the future of banking lies. No bank will survive that does not set its clients' interests center stage, instead of sales targets or profits.

I find it encouraging to learn that in many emerging markets clients are still put first. This most likely explains in part why the banking sectors in many emerging market economies have weathered the financial storm much better than in developed economies. Other factors that have contributed to their stability is that many banks in emerging market economies still engage predominantly in plain vanilla banking activities…. …and that they are strongly funded by wholesale funding.

Furthermore, I find it encouraging that banks in emerging market economies have remained stable despite the fact that they have used quite innovative ways of banking. Many emerging markets use ICT solutions that are very advanced. Such as mobile banking, which allows individuals and MSMEs to access and transfer money without needing to travel to a branch. Your own country, governor Velarde, may serve as a fine example here. In your country branchless banking may have been borne out of necessity. But in recent years, this has proved to facilitate access to finance for great many MSMEs.

You have also shown that regulation, even if intensified, can be designed to accommodate these innovative ways of banking while still protecting customers and safeguarding financial stability. Customer protection in your country is even set as a top priority. It calls for banks to formally assess the financial situation of the client in order to avoid over-indebtedness. Such initiatives have vastly helped to establish a solid MSME business and sustainable growth in your country.

I am therefore quite confident that also in developed countries, we shall manage to combine intensified regulation with sound MSME financing. And that we shall also manage to ultimately motivate our banks to move back towards their core task of servicing the real economy and their customers.

Ladies and gentlemen, let me conclude.

Today's conference coincides with the opening of the Dutch National Money Week, later today. During this week, we teach our youngsters how to deal with money in a responsible way. For today's youngsters create the demand for financial products and services of tomorrow. And many of them will become entrepreneurs, setting up MSMEs themselves. By educating young people in money matters, I hope we can empower them to *shape* the banking sector to their liking and to their demands, instead of merely enabling them to *use* what banks have to offer.

I thank you all for your attention, and I wish to you all a very interesting and fruitful conference.