Ed Sibley: Transforming banking for customers - a regulatory perspective

Speech by Mr Ed Sibley, Deputy Governor of the Central Bank of Ireland, at the Banking & Payments Federation Ireland (BPFI) National Conference, Dublin, 20 October 2017.

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Good morning. It is a pleasure to be here today, and I am grateful to the BPFI for the invitation to speak to you all.

The overall theme of 'Transforming Banking for Customers' is a very important one, as is the topic for this particular discussion – drivers of transformation: regulation, policy and data analytics.

In my remarks today, I will cover:

- the need for transformation
- the interaction of prudential and conduct regulation and the Central Bank's vision for the banking sector
- drivers of change
- regulatory change and complexity
- culture

The need for transformation

While there have been material changes in banking in recent years, there is a clear necessity for the sector to undergo further transformation.

As Benjamin Franklin apparently once said, 'those who are finished changing are finished'. There are a multitude of examples of firms and industries that have proven the wisdom of these words, and it is clear that the pace of and pressures to change are accelerating. Obsolescence is an existential threat.

Moreover, it is evident that, in numerous ways, the banking industry has consistently failed its customers over the last decade. This is evident both in Ireland and internationally and is not sustainable.

One of the fundamental expectations of banks is that they can be trusted. Trusted with the funds that they hold, trusted that they will be there in the morning, and trusted to respect the primacy of their customers' needs.

The events of the past decade have severely damaged this trust. Firstly, the trust in the soundness and prudence of the banking system was shown to be entirely misplaced. Subsequently, the succession of conduct scandals, such as: LIBOR rigging; mis-selling of PPI; setting up of false accounts to overcharge customers; and, closer to home; the tracker mortgage issue; and many more besides, has eroded customers' trust in their banks.

While much of the discussion today focuses on the necessary digital and innovation driven change, which I will come to, cultural change is also required to repair and restore trust.

Restoration of this trust is necessary for the delivery of the Central Bank's vision for financial services as a whole, including banking – specifically, that it functions well, is well-managed and well-regulated and it serves the needs of the economy and its customers over the long term. Undoubtedly, rebuilding trust is in all of our interests.

Prudential and conduct regulation

Effective regulation has a part to play in this restoration of trust. To this end, the Central Bank has recently restructured it financial regulation function into two distinct pillars: prudential regulation and financial conduct.

The restructuring reflects the critical and equal importance of both our financial stability and financial conduct mandate, the ongoing evolution and increasing complexity of Ireland as a financial services centre, and a strengthening of our approach to conduct supervision, over and above our longstanding work on, and commitment to, consumer protection.

The two pillars are working as equal partners to drive delivery of our mandate of safeguarding stability and protecting consumers; and that vision of a financial services sector that serves the needs of the economy and its customers over the long term.

The new structural arrangements are designed to enhance how we operate as one Bank, recognising the interlinkages, dependencies and need to challenge each other across financial stability, prudential regulation and financial conduct disciplines.

Drivers of change

I will turn now to the drivers of change in the banking sector. There are many, but in the interests of time, I will limit myself to three: macro-financial; technology and regulation.

1) Macro-financial dynamics of change

There are two key macro-financial dynamics driving business model transformation in the banking sector across the euro area:

- firstly, there is a cyclical aspect driving change affecting business model development; and
- secondly, structural factors, such as the state and make-up of the market, are also relevant drivers of change.

From a European perspective, the protracted low interest rate environment means new lending and investments are yielding lower income. This has led to profitability pressures. Such cyclical dynamics have also led to a faster transition towards more market-based finance[1]. The resulting increased substitutability of finance and hence more competitive environment can make it difficult to accumulate capital over the longer term.

The IMF, ECB, and indeed the Central Bank of Ireland have been highlighting many of these aspects as a major concern for some time now [2].

From a global perspective, European banks still underperform versus their US counterparts with respect to profitability and forecasted Return on Equity (RoE)[3].

As you all know, improved profitability will typically lead to improved market perception for debt and equity. This in turn will lead to reduced funding costs and lower cost of equity. Fundamentally, this facilitates capital accretion, which in turn puts institutions in a stronger position to meet regulatory requirements. Ultimately, this 'virtuous circle' should ensure the supply of reasonably priced credit to the consumer and economy more broadly.

In some cases and in the short term, volume growth can offset these pressures. Furthermore, improvements in impairments in some countries with high non-performing loan (NPL) stocks is also helping drive a recovery in profitability.

However, it is clear that macro-financial dynamics have had, and will continue to have, a considerable impact on profitability.

Turning now to structural factors – features of national systems such as legal frameworks, impediments to cross-border mergers and acquisitions, and government policies challenge financial performance, and hence business models[4]. In several euro area countries over-banking is a problem and further consolidation is required[5].

The legacy of NPLs coupled with lower growth in some countries could lead to some banks that lent at higher rates to forbear, or possibly relax credit standards. This is compounded by other structural factors such as legal, judicial and extra judicial frameworks, which impede NPL workout, for example[6].

Notwithstanding the challenge to business models, monetary policy has provided a blanket of stability for the financial system in recent years – although creating different financial stability risks in turn. A change in euro area monetary policy, and / or increase in market based funding costs, would present new and different risks and prompts questions such as:

- Is your firm effectively managing this complexity, and identifying and managing the associated risks?
- How is your firm transforming its business model accordingly to deliver sustainable outcomes for its customers, for the stability of the financial system and for the economy as a whole? and
- In line with a theme at this year's Annual IMF meetings, while there is a broad based global recovery, there are significant risks to growth – has your firm taken the opportunity to fix the roof, before new storm clouds arrive?

2) Technology as a driver of change

For the financial system, technology-driven innovation will be increasingly transformative. The Payments Services Directive 2 (PSD2), for example, will come into force in the EU in January 2018. Under PSD2, banks will be obliged to share their customer information with third parties; such as payments firms.

This will result in increased competition in the financial sector with banks no longer just competing with other banks but also with non-banks and financial technology ('fintech') firms, which will have easier access to the market.

A failure by banks to develop strategies enabling them to realise commercial opportunities arising from PSD2 could be a risk to long-term viability, particularly with net interest margin, and risk weight pressures incentivising banks to try to generate more fee income, including from this aspect of their business.

Fintech is blurring boundaries and changing barriers to entry[7]. New business models, products and services are emerging, driving competition and changing the way users interact with the system. Opportunities for innovation are abundant as, fundamentally, the sector revolves around recording, analysing and interpreting transactions and managing associated information flows. With no physical products to manage, these processes readily lend themselves to improvements via digital technologies.

Fintech presents an opportunity for the financial sector to become more efficient and generate value for its customers. This requires business model adaptation. For example, for retail banks, this may result in a further reduction in the branch network in banks across the euro area.

I would ask:

- How are your firms developing technology to truly transform banking for customers?
- How are your firms adapting their business models to this innovative and-ever changing landscape?

3) Regulatory drivers of change

The crisis and the monetary, financial and indeed regulatory response, has, and continues to have, a profound effect on banks.

From a regulatory perspective a veritable 'alphabet soup' of regulations, implementing technical standards, accounting and supervisory policies have come down the tracks in recent years. The list of acronyms is long and confusing – CRD/ CRR, BRRD, MiFID II, EMIR, IFRS9, GDPR, TRIM, PSD2, etc.[8]

Managing and embedding such regulatory change is, I recognise extremely difficult. Managing the complexity is, in itself, challenging, and analysing emerging risks across a broad and ever-changing financial system is no small task either.

Some have suggested the pendulum has swung too far, others not far enough.[9]

My own view is that given the scale of the financial crisis, radical and far-reaching reform has been required, but not everything has been calibrated perfectly and further evolution is required. In the same way that the financial system as a whole and its component parts continues to change, so the regulatory regime needs to adapt and evolve. However, significant easing should be resisted.

'Complexity theory' may provide a useful metaphor in this regard[10]. The essence of complexity theory is that rather than view the system as in equilibrium, it views the economy as a complex adaptive system perpetually constructing itself.

And in this context, it is worth asking why have we got to this circumstance, and how the system will continue to reconstruct itself, either by accident or design? If we look back to the 'light touch' regulation of yesteryear, while there was an extensive rulebook, there was a catastrophic over reliance on banks, their management and the market as whole to act in a certain way that would avoid the build-up of undue risk. As an aside, one could argue about whether banks' behaviour was actually rational or not, given the implicit taxpayer support. Roll forward 10 years and there is now a very heavy reliance on rules, thousands upon thousands of pages of rules.

The construction of today's system has, therefore, clearly been driven by the lessons of these last 10 years. Regulation has been successful in improving the safety and soundness of banks, governance and risk management arrangements, and reducing (but not yet removing) contingent taxpayer liabilities connected with failure. Regulation has also driven greater transparency, disclosure and consistency in product design and literature, and some enhancements in suitability assessments.

Moreover, these drivers should not be viewed in isolation. For example, the current macro-financial environment outlined above, masks how certain regulatory changes will really alter firms' incentives over the medium term.

Our ability to fully assess the resilience and effectiveness of Basel III developments such as the Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR) and High Quality Liquid Assets

(HQLA) for example, or indeed liquidity risk in the non-bank sector, will really only become apparent when there is a normalisation in the monetary environment.[11]

Culture

Nonetheless, I would strongly argue that the enhanced regulatory environment has made the banking system safer, particularly from a prudential strength perspective. However, there is a common failure at both ends of this spectrum. Neither has delivered an appropriate culture.

Leading up to the onset of the crisis, the prevailing culture in the banking system resulted in a collective groupthink failure, an excessive build-up of heavily correlated risks, and a disregard for customers. While I do not want to tar all with the same brush, in too many banks today, I see an overly legalistic approach, that focuses too much on whether something is legal or not and not sufficiently on the outcomes – either for the long-term safety and soundness of the bank or the interests of the customer.

I have seen too many examples where firms (in fairness not only banks) are having to be pushed too hard by the regulator to address failings and remediate issues, where the focus is on the letter of the law and not the desirable outcome.

There are numerous examples, where if problems were recognised and accepted at the time they were first raised, the outcome and costs to both the firm and its customers could have been materially lower, through earlier acceptance of the problem and prevention or earlier fixing of the problem. In the very recent past, this incalcitrant attitude has led directly to firm failures. It was, and still is in cases, prevalent in the approach to addressing non-performing loans (a European and not just an Irish experience). It has led to catastrophic failings in dealing with customers impacted by the tracker mortgage scandal, which has done further lasting damage to the reputation of the Irish banking sector. I could go on.

So, the policy and supervisory response has been to develop tighter regulations to force regulated firms down the requisite route. This undoubtedly increases regulatory costs – both in terms of undertaking business and in the regulatory levies needed to pay for the supervisory intensity required.

To this end, my energies are focused on ensuring that the Central Bank has a robust, fit for purpose regulatory framework, and is delivering an effective, intrusive, analytical and outcomes-focused approach to supervision, which remembers the lessons of the past, anticipates future risks, and continuously improves.[12]

For those who complain about the pendulum swinging too far, and of over prescriptive regulation, I would ask, what have you done to restore trust in the system? What have you done to drive permanent and robust change in the culture of the banking system, so that it can be trusted not to fail, to hold sufficient capital, to manage risk effectively, and to put your customers first?

To truly transform the banking industry for your customers, radical cultural change is needed. Having mission statements and strategies that espouse being customer centric, is meaningless if they are not supported by the underlying culture. In other words, the questions that should be most prominent in banks are not ones relating to compliance with regulatory requirements (important as they are), but rather:

- Is this sustainable?
- Is it in the long-term interests of our customers?
- Does this fit with our espoused values?
- Is this right?
- How are my staff incentivised to act?

Conclusion

I will conclude here.

We live in complex and undoubtedly interesting times. As none of us can predict the future with any degree of certainty, we all need to embrace this complexity, and be as adaptive as the financial services system that we work in is.

Environmental, cyclical, structural, technological, and regulatory change pressures will continue to drive the transformation of the banking sector. The pressure for cultural change is also sizeable. It is arguably the most important. It is definitively the one that is most in your control. I urge you to act.

Thank you for your attention. I look forward to the discussion.

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1 See ESRB, 2016, 'Macroprudential policy issues arising from low interest rates and structural changes in the EU financial system' November 2016. Joint Task Force of ESRB Advisory Technical Committee (ATC), ESRB Advisory Scientific Committee (ASC), and ECB Financial Stability Committee (FSC). Available here.

2 See, for example, the IMF GFSR: IMF Global Financial Stability Report, (2014), "Moving from Liquidity- to Growth-Driven Markets", April 2014 International Monetary Fund. Available here. Also, ECB, (2014) Financial Stability Review, November 2014, European Central Bank. Available here. Also, Central Bank of Ireland, (2014), Macro Financial Review 2014: II, November 2014. Available here.

3 See IMF, 2017, Global Financial Stability Report: Is growth a risk? April 2017, International Monetary Fund Available here. Looking at RoE (2016 Underlying, 2019 Consensus Forecasts, and Management Medium-Term Target) of US versus EU G-SIB, Figure 1.8 shows most US G-SIBs should reach profitability targets, but European and G-SIBs face significant gaps.

4 See IMF, 2017, 'European Banking Systems: Addressing Structural Challenges', Global Financial Stability Report: Getting the Policy Mix Right, October 2017, International Monetary Fund. Available here. Also see ECB, 2015, Financial Stability Review, Special Feature 'Bank profitability challenges in euro area banks: the role of cyclical and structural factors', available here, for a broader discussion and empirical investigation of cyclical and structural factors affect bank business models. See ECB Financial Integration Report, 2017, 'Special feature: Cross-border bank consolidation in the euro area', May 2017, European Central Bank Available here. Also see Nouy, Danièle, 2017, 'Too much of a good thing? The need for consolidation in the European banking sector', speech at the VIII Financial Forum, Madrid, 27 September 2017. Available here.

5 See for example ESRB, (2014), 'Is Europe Overbanked?, Reports of the Advisory Scientific Committee, European Systemic Risk Board, No. 4/June 2014. Available here.

6 See for example ECB (2017), 'Stocktake of national supervisory practices and legal frameworks related to NPLs', June 2017, European Central Bank Available here.

7 See Dong He, Ross Leckow, Vikram Haksar, Tommaso Mancini-Griffoli, Nigel Jenkinson, Mikari Kashima, Tanai Khiaonarong, Céline Rochon, and Hervé Tourpe, (2017), Fintech and Financial Services: Initial Considerations, IMF Staff Discussion Note, June 2017 SDN/17/05. Available here.

8 The Capital Requirements Regulation (EU) No. 575/2013 (CRR) and Directive 2013/36/EU (CRD IV) came into effect on 1 January 2014. The CRR is directly applicable to all Member States while CRD IV has been transposed into Irish national law via Statutory Instruments 158/2014 & 159/2014 [European Union (Capital Requirements) (No.2) Regulations 2014]. Further information available here. The Bank Recovery and Resolution Directive (BRRD) provides national resolution authorities with comprehensive and effective powers for dealing with failing banks. This framework and related legislation enhances both the resilience and the resolvability of EU institutions and in-scope investment firms, which will be better prepared to deal with, and recover from, a crisis situation. Moreover, in the event that an institution does fail, the impact associated with that failure should be minimised. See here. MiFID II contains new EU-wide rules governing investment firms, credit institutions, trading venues and market structures, as well as third-country firms providing investment services or activities in the EU. It significantly broadens the scope of MiFID by bringing new activities and firms into scope, removing or narrowing exemptions and covering new financial instruments and products. See here. Regulation 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories ("EMIR") implements increased

transparency in respect of derivatives by imposing requirements concerning reporting of all derivative contracts (including exchange traded derivatives) to Trade Repositories (TRs); clearing those OTC derivatives subject to the mandatory clearing obligation; risk mitigation techniques for non–centrally cleared derivatives, and setting out requirements for both Central Counterparties (CCPs) and TRs. See here. IFRS 9 is a new accounting standard that will be effective from 1 January 2018. It introduces an expected credit losses model (ECL) which may lead to higher impairment provisions and more volatile impairment charges with a consequent impact on capital ratios. The SSM has committed to undertake a targeted review of internal models (TRIM) for banking groups. See here. The General Data Protection Regulation (GDPR) is the first major reform of European data protection legislation in 20 years, comes into force on 25 May 2018. All companies who collect and process personal data in the EU will need to work out what data they hold on their customers, where they hold it, if they have permission to do so, whether it is stored safely, and how they can extract it in an easily "portable " form or delete it if requested. The Payments Services Directive 2 (PSD2) will come into force in the EU in January 2018. Banks will be obligated to share their customer information with third parties; such as payments firms. See here.

9 See for example Lautenschläger, Sabine, 2017, 'Walled off? Banking regulation after the crisis', speech at the Institute of International and European Affairs, Dublin, 13 March 2017.

10 See for example, Battiston, Stefano, Farmer, J. Doyne, Flache, Andreas, Garlaschelli, Diego, Haldane, Andrew G., Heesterbeek, Hans Hommes, Cars, Jaeger, Carlo. May, Robert, and Scheffer Marten, (2016), 'Complexity theory and financial regulation', INSIGHTS | PERSPECTIVES, February 2016, Vol. 351, issue 6275. Available here. Also see for example, Arthur, W. Brian, (2014), From Complexity and the Economy, Oxford University Press, 2014. Also see Kirman, Alan P. (2010), Complex Economics: Individual and Collective Rationality. Routledge: Abingdon. Available here. Also see OECD, (2016), 'New Approaches to Economics Challenges: Insights into Complexity and Policy'. 29–30 September 2016. Available here. Also see Haldane, Andrew G. and Robert M. May, 2011, 'Systemic risk in banking ecosystems', Nature, Vol. 469 p351, 20 January 2011. Available here.

11 See Donnery, Sharon (2017), 'Central bank risk management in a changing institutional and regulatory environment', speech at the joint Banco de Portugal – European Central Bank Conference on Risk Management, Portugal, 26 September 2017. Available here.

12 See Sibley, Ed, (2017), 'The Irish Financial Services sector: a Prudential Regulation Perspective', speech at the Financial Centres Summit, Dublin here.