Salvatore Rossi: Which new frontiers in banking?

Speaking notes by Mr Salvatore Rossi, Senior Deputy Governor of the Bank of Italy and President of the Institute for the Supervision of Insurance (IVASS), at the 2018 Conference on "New Frontiers in Banking: from Corporate Governance to Risk Management", Faculty of Economics, La Sapienza University, Rome, 16 March 2018.

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In the banking business, the concept of frontier – and its crossing – can be intended in several ways.

Let's start with **size**. After the global financial crisis, banking systems in the large advanced economies have undergone a substantial consolidation process. The number of small banks has decreased; concentration ratios – measured as the share of banking system assets held by the largest five banks – have increased both in the euro area and in the United States. In Italy, at the end of 2016, the share of total assets accounted for by the five largest banks amounted to 43 percent.

This process is still under way, and will presumably continue in the foreseeable future.

It's not always a good thing. From a financial stability perspective, big banks should ideally be highly diversified and less exposed to idiosyncratic risks. However, the Lehman crisis proved that big banks may end up holding very similar portfolios, in which case they might become more vulnerable to adverse systemic shocks. In other words, the reduction in idiosyncratic risk might come at the cost of an increase in total risk on their balance sheets.

Furthermore, the bigger a bank, the greater the "implicit subsidy" it enjoys in terms of higher likelihood to be rescued in case of distress, either being bailed out or, in Europe, resolved rather than liquidated. It's the well-known "too-big-to-fail" problem.

All in all, big banks are not necessarily safer from a systemic perspective. It's something that should be evaluated case by case.

What about **business models**? Another "new frontier" for the bank of the future could be a fundamental change in its business model, for instance from traditional retail banking to asset management or corporate/investment banking.

The issue there is profitability, and it has very much to do with rules. The current weakness in bank profitability, particularly in Europe, not only depends on macroeconomic cyclical factors, which were very unfavorable in past years, but also on the new requirements in terms of capital and liquidity, that were the regulators' response to the excessive risk-taking of the pre-crisis era.

I don't think the banking sector could ever be back to the double-digit returns of the past 20 years. It may rather converge to a "new normal" with more low- consuming-capital activities. In any case, a sustained profitability must require cutting operational costs, as well as a lot of investment in new technologies.

New technologies are probably the most important new frontier for banks, and I will dwell on them in a minute.

Let me first widen the topic of this roundtable a little bit, to the **financial system** at large. Banks aren't the only financial players, nor should they be, in perspective, the largely dominant ones, at least in countries like Italy.

In this country the financial structure is already evolving, though at a still moderate pace. Nonfinancial firms, especially the biggest ones, are now using equity and bond markets much more than in the past for their financial needs, although still not enough, in my opinion.

But in Italy we may need not just more markets. Non-bank intermediaries, such as private equity and venture capital funds, are still underrepresented in the financial landscape.

However, from a prudential point of view there's a delicate balance to strike between a more articulated financial structure, which is desirable *per se*, and the need not to give "shadow banking" unlimited freedom. We are working, together with our colleagues in the world regulatory circles, on such a difficult puzzle.

Let me conclude with some words on the third and most important new frontier that I've mentioned before for the financial system: technology. Again I'll look at this issue from a regulatory point of view.

We are observing how digitalisation is already changing the financial business. Although many of our intermediaries, particularly the smallest ones, are lagging behind in the process of digitalisation, the road ahead is clear: we are talking about technologies that are well consolidated, they are not "new" anymore.

Fintech firms are a step forward. In a stricter sense, Fintech firms are new players aiming at crowding out traditional intermediaries like banks. Banks are reacting in different ways: some are buying Fintech start-ups and trying to internalize them in their business models, others are establishing partnership agreements and externalizing part of their production function, others are trying to internally develop Fintech-like business units. We don't know which approach will prevail.

What we know is that part of the intermediation chain and of the payment system is moving outside the traditional financial ecosystem. Incumbents are feeling the pressure of these changes.

The potential for efficiency gains, increased accessibility to financial services and lower end-user costs are great, but great opportunities always come with great risks. Safeguarding against risks without curbing innovation is the challenge regulators will face in the near future.

Existing rules have been designed for traditional activities and intermediaries. It is more and more difficult to understand how, when, and to which agents they can be applied.

The temptation to over-regulate, minimizing the risks at the expenses of innovation, may be great. This, however, would not only be against the public interest, but also probably impossible, given the liquid nature of innovation. What regulators may reasonably do is to adopt a pragmatic, flexible approach, coordinated

across jurisdictions and based on a continuous dialogue with the industry, as was recently suggested by the FSB.

For the time being, approaches and stages of development vary considerably across jurisdictions. The majority of supervisors are still in the early stages of understanding the new phenomena.

Continued sharing of supervisory practices in this area is crucial.