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"The future agenda for financial sector reforms; Financial stability and regulatory developments for the financial industry"

Speech by Klaas Knot at Spring Meeting IMF,
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At the IMF Spring Meeting in Washington of April 2019, Klaas Knot gave a lunch speech on the future agenda for financial sector reforms. After taking stock of the current state of the international financial sector, Klaas Knot outlined the main economic and technological changes that will shape both the financial sector and the regulatory and supervisory priorities.

During the last two years, there have been numerous seminars, speeches and roundtables to mark the ten year anniversary of the financial crisis. These events began in the summer of 2017 by recalling the first signs of stress in 2007 at Bear Stearns, BNP Paribas and Northern Rock. Last year saw reflections on the historic collapse of Lehman Brothers on 15 September 2008 and on the financial panic in the months that followed. The most recent 10-year landmark looked back on the G20 London Summit on 2 April 2009. This Summit marked the beginning of the global financial reform program and the regulatory response to the crisis.

The same summit in London also resulted in the creation of the Financial Stability Board. The FSB replaced the Financial Stability Forum. It received a stronger mandate, broader membership and enhanced capacity to monitor and promote global financial stability. An honourable task that is now taken forward under the leadership of my colleague Randy Quarles of the Board of Governors of the Federal Reserve System here in Washington DC.

The FSB's role is unique. It identifies - from a macroprudential perspective - new risks and vulnerabilities across all sectors and jurisdictions. It fosters international co-operation, to promote global financial stability. I am chair of the Standing Committee on Assessment of Vulnerabilities (SCAV) and have recently been appointed vice-chair of the FSB. This is a great honor, and I am pleased I can contribute to its work and share our main priorities here with you.

Together with the G20, the FSB has played an essential role in pushing through financial sector reform in the last decade. We have responded to the lessons of the crisis. After ten years our reform agenda is almost complete. Now, it is time to look forward and discuss the future challenges for financial sector reform. This implies a new agenda for you within the sector, as well as for us, the regulators and supervisors.

Today, I want to take stock of the current state of the financial system and the main challenges that lie ahead. Economic and technological changes will shape the financial sector that you work in. This implies a new agenda for you within the sector, as well as for us, the regulators and supervisors. So let's discuss this new agenda and start with a stocktake of the current situation in the financial sector.

1. Current state of the financial system

Much has been achieved in the last decade. The capital framework has been revised with a new Basel Accord. New liquidity requirements are in place. The regulation of the financial sector is better and stronger. The scope of financial supervision is also broader to include a wider perspective of the financial system. We now look at financial stability through a macroprudential lens. Moreover, international co-operation has improved, and new resolution frameworks have been created across all jurisdictions. Within Europe, the Banking Union has been created.

As a result, the financial system is now clearly stronger and more resilient than before the crisis. Banks maintain capital levels that are three to four times higher than before. Also, the financial sector is better able to withstand shocks and contain negative contagion effects, including through the introduction of central clearing of derivatives. Risk monitoring has improved and authorities are better able to handle an orderly resolution of troubled banks, limiting negative effects to the financial system and the economy.

However, risks are gathering. So let me highlight some important challenges to the current financial system.

2. Challenges to financial stability

We are at an important juncture, where less benign macro-economic developments and structural changes in the financial sector meet.

2.1 Macro-economic risks

From an economic perspective, the most important risks to the financial sector do not only seem to derive from idiosyncratic risks within financial institutions. They rather also seem to derive from developments within the macro-economy and financial sector as a whole. Accommodative and unconventional monetary policy has made an important contribution to economic recovery after the global financial crisis. However, this prolonged period of low-interest rates also leads increasingly to unintended side effects in financial markets.

This includes a search for yield, asset price inflation and misallocation of resources. Once conditions allow, monetary authorities face the challenging task of developing a clear path toward monetary policy normalization. The steps we must take need to be well-communicated and flexible, taking into account developments in the outlook for inflation and growth in the economy.

Yet, this normalization process may be accompanied by an increase in risk premia and periods of increased volatility. The growth of the world economy also depends on developments in financial markets. Credit conditions are more sensitive to risk premia. Both developed as well as emerging economies are vulnerable to negative shocks in their macro-economic fundamentals. This is reinforced by indications that lending criteria have recently deteriorated.

Moreover, there is an increase in economic and financial uncertainty, which can create global spillovers. This includes uncertainties over global trade and trade tensions between the US and China.

Within Europe, the outcome of the Brexit discussions is a prominent issue. The necessary preparations to maintain financial stability have been taken at European and national levels. But there may still be some market disruption in the short-run in the event of a disorderly Brexit. In the long-run, the trade barriers between the UK and EU will have negative economic effects on productivity growth in both the UK and the continental European economy.

Economic slowdown is occurring at a time when public and private debt levels are still high. Many countries – including within Europe – have not taken full advantage of the recent favorable economic growth to strengthen their fiscal position. This does not directly lead to financing problems in the short run, given the abundance of liquidity and low interest rates. However, if interest rates were to rise, businesses would be in a more vulnerable position and the sustainability of government debt may come under pressure. This is particularly important in Europe, where the interconnectedness between banks and their sovereigns has not yet been adequately addressed.

Finally, the energy transition presents a structural economic challenge for the financial sector. Through their direct and indirect exposures, financial institutions face potential technological and policy shocks as a result of climate change. Last year, the Dutch central bank conducted a climate stress-test to look at potential risks. The scenarios show that a disruptive energy transition can have a significant impact on the financial position of banks. These shocks materialize across the entire economy and not only in selected industries. Losses for financial institutions can be manageable, if they are adequately accounted for in risk management frameworks.

2.2 Changing financial landscape

These economic developments coincide with structural shifts within the financial sector. Technological innovation leads to changes in the structure of the value chain of banking services. This puts existing business models under pressure. The market entry of new financial technology firms can change the financial sector.

Against this backdrop, various scenarios can develop. First, technological development may lead to integration, when existing banks take over new FinTech firms and absorb them into their organizations.

Second, it can also lead to new types of co-operation, when new technology firms develop a close working relationship, and function as new partners that carry out specific services within the supply chain. This could for example include outsourcing of certain tasks.

Finally, FinTech may lead to more competition, when major technology firms, or BigTechs will challenge the activities of existing banks and compete for their business. It is unclear how the financial sector will develop along these lines of integration, co-operation or competition. However, one thing is clear: the financial sector will change as a result of a combination of these trends. The FSB carefully monitors and analyzes the effects of these technological developments. The aim is to strike a balance between regulating possible risks, while promoting the benefits of FinTech. The FSB SCAV committee I chair recently published a paper on the emergence of BigTech and third-party dependencies on cloud services. These firms operate on the line of what constitutes a financial service. BigTech firms have access to big data, sophisticated technologies, and substantial funding.

At the same time, the growing adoption of cloud services can create concentration and systemic risks. Banks do not currently have "core" systems in the cloud, but in the future, this may well be the case. This can lead to new operational risks, for example when new single points of failure are created, when a small number of cloud providers become dominant in the market. Operational resilience will thus become more important for financial stability, especially when these new institutions operate outside the regulatory perimeter.

Non-bank financial intermediaries play a growing role in the financial system. This can produce what is known as a 'waterbed effect' of regulation, when bank regulation is strengthened and activities like liquidity and maturity transformation are shifted outside the regulated sector in response. Market financing could contribute to a more stable financial system as a result of suitable maturity transformation, and thus less liquidity risk, lower leverage and reduced contagion effects. Particularly in Europe, bank financing is currently very dominant and capital markets are not well-developed. A further strengthening of the Capital Market Union would promote a more diverse financing structure and contribute to a more effectively functioning integrated financial market. At the same time, there are unanswered questions about potential systemic risks originating from the unregulated sector. This may lead to a mispricing of risks, or new interconnections within the financial system.

These structural trends will shape the financial landscape and the business model of banks. At the same time, the regulatory reform agenda will also enter a new phase.

3. Regulatory priorities

As regulators, we must make sure the next steps we take have a sound analytical basis. In this post-crisis era, the following priorities will determine our reform agenda for the financial sector over the coming years.

First, as a precondition for financial stability, the focus will continue to be on effective implementation. The G20 reform program has been largely completed. It is important that all jurisdictions promote and sustain the full, timely and consistent implementation of the agreed measures. This includes efforts to minimize specific national elements that would undermine the level playing field and international harmonization. The FSB fulfils an important role in the monitoring of implementation. This is for example carried out through its peer review program, which consists of country peer reviews and thematic peer reviews. Through close co-operation with other international institutions, the FSB promotes adherence to international standards. Regular progress reports on the status of implementation are reported and discussed at the G20.

Second, the FSB will further enhance its role in risk identification. The Standing Committee on Assessment of Vulnerabilities will strengthen its surveillance framework to facilitate a structured and in-depth monitoring of potential risks to the global financial system. In this context, more work will be done on analyzing the developments and possible systemic risks resulting from the noticeable increase in issuances of collateralized loan obligations, or CLOs. The FSB has also recently published a report on market fragmentation. Finally, the FSB will continue monitoring non-bank financial intermediation, which would benefit from enhanced data collection, improved risk analysis and identifying appropriate policy measures.

Third, the FSB will continue its work on the evaluation of reforms. This should occur after policy measures have been given a reasonable amount of time to take effect. Evaluation is a natural progression in the process of implementing reforms. Policymakers can assess whether the reforms have achieved their intended goals, and if there are any unintended consequences. This analysis should be evidence-based, and focus on data and facts, rather than guided by sentiment to roll back regulatory reforms. The goal is to ensure more effective regulation; not fewer or more relaxed regulations.

The FSB has already carried out two evaluations on the impact on infrastructure finance and OTC derivatives. The FSB is currently evaluating the impact on SME financing, to determine whether the enhanced capital regulation has affected lending to SMEs. The preliminary finding is that the increase in capital requirements may have lead to a short-lived reduction in credit availability, including lending to SMEs. The finding of reduced lending holds particularly for capital-constrained banks. However, this effect is neither material nor permanent. In the long run, a more sound financial sector contributes to a stable supply of credit to the real economy. The FSB also recently started an evaluation of the policies to address the too-big-to-fail banks. This evaluation will look at the effects of higher risk buffers, intensified supervision and the resolution framework to reduce the potential failure of systemic banks and enable an orderly resolution when necessary. Finally, the FSB will strengthen its outreach to non-member jurisdictions and strengthen its communication and transparency towards external stakeholders.

Strengthening the consultation process and improving information sharing would contribute to stronger stakeholder involvement, thus improving the work and understanding of international reforms.

4. Conclusion

We must appreciate the achievements of the financial reform agenda in the last ten years. The costs of the global financial crisis have been extraordinary. Nowadays, we have a much more resilient financial system. This has not come without a cost during the transition period, but it benefits the financial sector and the world economy in the long run. We must therefore remain vigilant and maintain a strong regulatory framework to withstand new shocks. Particularly because these shocks will probably come from unexpected sources, or from different places to where they have come from in the past, because of the new structural changes that occur in the financial sector.

This does not mean, however, that after concluding major reforms, we cannot look at ways to improve how regulation meets our objectives. And as well as improving its efficiency and effectiveness, we can also strive to minimize unintended external effects.

The FSB is pressing ahead with an ambitious work program of implementation, evaluation and identification. Within this process, the FSB will continue to actively seek input from you, based on your expertise and experience within the financial sector. Co-operation, not only between jurisdictions, but also with relevant stakeholders will help us to strengthen our regulatory framework and contribute to global financial stability.