BANK FOR INTERNATIONAL SETTLEMENTS

The new supervisory agenda

Keynote address by Agustín Carstens
General Manager, Bank for International Settlements

13th ASBA-BCBS-FSI High-level Meeting on Global and Regional Supervisory Priorities

Nassau, 30 October 2018

Introduction

Ladies and gentlemen, good morning. Thank you for the kind introduction. I wish to express my gratitude to the organisers for making this event possible and to our host, the Central Bank of the Bahamas, for its extraordinary hospitality.

Ten years after the collapse of Lehman Brothers, we, as regulators, must be proud of the substantial reform performed in the financial system, which has already had a visible impact on the resilience of systemic institutions and market infrastructures worldwide. Moreover, witnessing the recovery of global economic activity – partly due to the extraordinary actions taken by central banks – is quite satisfying.

Nonetheless, the long period of low interest rates and ample liquidity has encouraged increases in the indebtedness of governments, corporates and households to unprecedented levels in many jurisdictions. In some emerging market economies in particular, this expansion has been in part financed through external borrowing that has not necessarily been accompanied by a similar increase in foreign exchange reserves or export revenues, giving rise to external imbalances.

As a result, although banks have higher capital buffers and are in a better position to absorb losses today in comparison to the period before the crisis, they are now often exposed to more leveraged counterparties. In addition, some of those counterparties have significant external refinancing needs at a time when their domestic currencies have experienced large depreciations as a result of economic and political turbulences.

The vulnerabilities built up over the last decade have the potential to lead to financial instability depending on the scenario going forward. For example, a number of emerging market jurisdictions may experience significant capital outflows and further depreciation in their currencies in the case of a reversal in investors' risk appetite. In fact, this has already happened to some jurisdictions that have shown more pronounced external imbalances. A sudden tightening of financial conditions in the course of the monetary policy normalisation process that is under way in some advanced economies, together with widening credit spreads, could also have adverse consequences for highly indebted borrowers with short-term rollover needs. An additional escalation of protectionist measures could further affect companies in those economies that are more reliant on external trade, thus putting added pressure on their ability to repay their debts.

The financial sector is facing the challenges posed by macroeconomic developments in a period of substantial transformation. Authorities are now in the process of implementing the different elements of the international regulatory reform, and banks are adapting their strategies and business models to the new regulatory environment. In addition, the market for banking services is being disrupted by innovative technologies. Some of these changes have the potential to increase the efficiency of the industry, enlarge the services provided to customers and make finance more accessible and affordable. At the same time, regulators and supervisors can and already do benefit from innovative technologies to improve their oversight function. The flip side, however, is that new technologies also imply new risks that could potentially affect consumer protection and the stability and integrity of the financial system.

Given this scenario, policymakers in emerging market economies should remain vigilant to address outstanding risks for financial stability and, more generally, for the adequate functioning of the financial industry.

I will focus my subsequent remarks on possible ways to mitigate both the previously identified risks which led to the Global Financial Crisis and also the emerging risks arising as a result of innovative technologies. With respect to the former, I would like to discuss the relevance of achieving a timely and adequate implementation of the post-crisis reforms, with an emphasis on the role that proportionality could play in dealing with some of the challenges that may arise in this implementation process. As for the emerging risks, I would like to elaborate on the potential disruption that innovative technologies may cause in the financial system landscape and how to go about regulating them in order to maximise their benefits and to minimise their risks.

Implementation of reforms

Let me start with implementation. The finalisation of the Basel III framework in December last year is a milestone achievement for bank regulation. The agreed regulatory framework addresses the key shortcomings exposed by the Global Financial Crisis.

With the bulk of regulatory changes broadly complete, the focus shifts to implementation into national law, which must be consistent and timely. This is particularly important for internationally active banks to assure a level playing field, but many of the elements of this package are also relevant to banks which are not internationally active.

In fact, a forthcoming FSI survey on the implementation of the Basel framework shows that many non-Basel Committee members in Latin America have implemented or are in the process of implementing relevant pieces of the Basel III framework. The most common elements implemented or in the pipeline are the definition of capital and the revised operational risk framework. In contrast, the survey also shows that most of the surveyed jurisdictions in the region do not seem to be prioritising the implementation of the liquidity standards at this moment.

One of the possible reasons for the delay in the implementation of some of the post-crisis reforms is the complexity of the new standards and the consequent regulatory burden.

Arguably, Basel III has meant a significant increase in the sophistication of regulatory requirements. That comes with a cost – in the form of higher compliance costs – which is disproportionately high for those entities that, due to their size, are less able to take advantage of economies of scale. To the extent that those institutions do follow relatively simple business models, those additional costs associated with increased complexity are not always justified on prudential grounds.

As a result, many jurisdictions have started implementing simplified prudential approaches for small and less complex financial institutions. This is a legitimate approach that may foster the diversity of the banking industry by correcting the possible competitive distortions that could be generated by the application of the new regulatory framework.

Yet it is important to bear in mind that a simplified approach does not mean less stringent regulation. In fact, in several jurisdictions that have implemented proportionality in prudential regulation, simplified approaches are typically more stringent than international standards. Indeed, it would be a mistake to accept lighter regulatory controls for the safety and soundness of small institutions – which affects both solvency and liquidity – on the grounds of their size or complexity. Additionally, the adoption of a proportionate regulatory approach should avoid over-protecting inefficient institutions from competitive forces. Those forces are likely to be especially relevant in a context in which technological innovations are likely to alter in a significant way the competitive position of different types of financial institutions, thereby leading to a substantial modification of the structure of the banking industry. Let me now refer, more generally, to the challenges posed by technological developments.

Innovative technology

The financial industry has recurrently been exposed to technological change. Most relevant innovations have traditionally helped institutions to become more efficient and have, in general, facilitated the access of customers to banks' products and services.

Let's take automation and their impact on physical branches as an example. About two hundred metres from the BIS Tower building there was – up to a couple of years ago – a fully fledged branch of a large commercial bank. The branch had a number of employees who customised services to retail customers, including asset management. Nowadays, the human presence has been replaced by ATMs. These machines cover less than 20% of the space previously occupied by the branch, with the rest being leased to a fast food restaurant.

From the bank's perspective, this change implied reducing the payroll and maintenance costs associated with running this branch's operations. From the customer perspective, they are now able, at any time of the day, to withdraw or deposit cash, make payments, transfers or investments. Moreover, some of the bank's savings may have been passed on to them, thus making the services more affordable.

That type of technological innovation has undoubtedly implied relevant challenges for banks. Banks have had to modify their commercial strategies, operating procedures and internal organisation. Also, the automation of banking services may have had an adverse impact on specific segments of the population, such as the elderly, who may encounter difficulties performing their regular operations without human help.

In the past, the prevailing view was that technological developments – such as the ATM example – did not modify the nature of the banking business in a substantive way and that the entities, their customers and the regulators were able to gradually adjust to the new environment without much distress.

So what is different this time?

Differences are numerous and profound, to the point of making the new technology able to disrupt the current organisation of the market for financial services. The combination of increased availability of data and larger capacity to process these data is modifying the financial system through four main channels. First, an unprecedented increase in the supply of services and products, including new lending, insurance and investment products, payment facilities and securities trading mechanisms. Second, the redefinition of the set of providers of financial services beyond regulated financial institutions. Third, the increasing relevance of new distribution channels, mostly based on virtual networks. And fourth, the change in the internal operating procedures by financial institutions, including the adoption of new methods to assess credit quality and the enhanced reliance on third-party providers of data storage and software facilities.

All those changes are likely to trigger substantial social benefits. In particular, the increased supply of services enlarges the opportunity sets of consumers and investors. The lowering of barriers to entry that technology enables will increase competition and lower prices. Moreover, the technical innovations have the potential to provide banks with new opportunities to increase their operational efficiency and improve their ability to assess credit and market risk. More importantly, the enlarged sets of products and providers would facilitate access by wider segments of the population to financial services, thereby improving their economic prospects.

At the same time, the new technological environment may pose some relevant challenges for the pursuit of public policy objectives. For example, while the new entrants will bring competition in the market for some non-core financial services, it may also trigger more concentration on traditional intermediation activities, as technology will normally increase economies of scale in the provision of those services. In addition, the increased participation of non-regulated (or lightly regulated) institutions in activities like the provision of payment services, or the creation of opaque means of payment through distributed ledger technologies, may support some illegal activities. Also, a rapid and disorderly development of new investment products could weaken consumer protection. Furthermore, a generalised reliance of financial institutions on a small group of third-party providers of technological services generates business continuity risks that could become systemic. More generally, the intensive use of automated systems by financial institutions and other providers of financial services does exacerbate cyber-security risks and challenges the protection of customers' data.

What should policymakers do about it?

Given the risks posed by technological development for the adequate functioning and eventually also for the integrity and stability of the financial system, effective regulatory action seems indispensable to promote the orderly assimilation of innovations. Moreover, the regulatory perimeter in some policy domains may need to be enlarged to accommodate new entities in order to ensure a level playing field. This objective is often linked to the concept "same activity, same regulation". However, the alternative concept of "same risk, same regulation" is more accurate as we know that the same activity may generate different risks depending, for example, on the leverage of the institutions that perform it.

Effective regulation should, in any case, satisfy a number of conditions.

First, it should be proportionate. Regulators need to strike the right balance between addressing emerging risks and support socially desirable innovations. The timing of the regulatory intervention should be adequately chosen, especially in order to avoid acting too early, before sufficient evidence on a potential adverse impact on a particular business development is available. Waiting too long could, however, also entail risks, as the discontinuation or a substantive modification of new services, activities or internal procedures associated with new technologies may be more difficult and costly once they consolidate. A case in point is certainly the emergence and proliferation of different types of cryptoassets. I think that, by now, there is sufficient evidence that those instruments do threaten a number of policy objectives – such as market integrity, consumer defence and even environmental protection – and bring little benefits. Therefore, swift regulatory action – like that which has been undertaken in several jurisdictions – is already justified.

In general, close cooperation between regulators and firms developing innovations may steepen the learning curve for public authorities and, thus, facilitate the required proportionality of the regulatory action. This is why the creation of regulatory sandboxes, sponsored in many cases by the regulators themselves, is a valid initiative. At the same time, there could be a risk for financial regulators to play an excessively prominent role in national strategies to improve the competitiveness of the domestic industry by promoting innovative firms or activities, in competition with other jurisdictions. Purely industrial objectives may occasionally conflict with the traditional remit of financial sector regulators.

Second, the regulatory approach should be holistic. Since the potential implications of technological developments span over a number of policy domains, regulatory action should aim to address all relevant concerns and mitigate potential conflicts across objectives. The latter may easily emerge, for example, between the goal to foster competition between banks and fintech firms in some market segments and that of data protection when considering rules for the sharing of banks' information on customers. Possible conflicts could also emerge between financial inclusion and consumer protection objectives when dealing with conditions for the provision of specific services to unsophisticated individuals.

And finally, but very importantly, regulatory actions should be coordinated at the global level as much as possible. Technological development is a global phenomenon as innovations are rapidly spread out internationally and providers of new services and products often act on a cross-border basis, taking advantage of the new virtual distribution channels. It is therefore essential to guarantee appropriate cooperation among relevant authorities worldwide and, once sufficient experience is accumulated, to start developing new global regulatory standards to address the relevant policy issues. The international cooperation arrangements already in place, that we call the Basel Process, are well suited to facilitate the required interaction among regulators. Yet, given the multidisciplinary nature of the policy challenges, the existing structures may have to be adjusted to ensure sufficient involvement of all relevant players beyond financial regulators.

Concluding remarks

I have stressed in my presentation how regulation should respond to both the old sources of risks that triggered the financial crisis and the new risks emerging from technological developments. In the first case, the focus should be on adequate implementation of the new international standards. In the second case, the objective should be a proportionate response to the adverse implications of innovation, following a holistic approach and seeking, when relevant, international cooperation. Swift action in both domains seems essential, in particular to ensure that the financial system keeps the strength required to face, in particular, the challenges posed by the remaining vulnerabilities in the macro-financial environment.

However, in order to maximise its benefits, regulatory action should be accompanied by a strong supervisory framework. That requires supervisors with a solid institutional charter including effective independence from governments and powers to act swiftly and in a timely way. We know, in particular from the Financial Sector Assessment Programs of the International Monetary Fund, that this is still a challenge in a number of jurisdictions around the globe, including several in Latin America.

But beyond improving the institutional issues, there is a need for supervisory authorities to ensure sufficient capacity to address the oversight of the new, more numerous and more sophisticated regulatory requirements and the new risks associated with the disruptive effects of technology. In addition, supervisors need to embrace the new technologies that could help them strengthen their own oversight methods and procedures. That implies that supervisory agencies should be able to attract and retain talent, but also that they should intensify their capacity-building activities and their interaction with other foreign supervisory agencies to share experiences.

At the BIS, we aim at contributing directly to the required capacity-building effort through our own Financial Stability Institute (FSI). As you know, the FSI is mandated to assist central banks and supervisory authorities worldwide in strengthening their financial systems through the timely and adequate implementation of international regulatory standards and the adoption of sound supervisory practices. Through its policy implementation work, training activities and outreach events – such as this High-level Meeting – the FSI facilitates the exchange of supervisory experiences and approaches. No doubt the FSI mission becomes particularly relevant in the new regulatory and technological environment.

With that, let me wish you a fruitful meeting.

Thank you.