COMMENT & PROFILES / BRACKEN

# How to restore the lost faith in banks

José María Roldan | 2/09/2019 9:00 am

**As trust in banks has slumped, the regulations policing them have proliferated. Restoring this reputation is crucial to prevent rules becoming increasingly stringent and complicated, says José María Roldan of the Spanish Banking Association.**

Things have changed a lot for the banking sector in the past two decades. Regulation today is much more invasive and complex, while the architecture of regulation favours arbitration and the emergence of shadow banking.

A recent invitation to deliver a speech at a financial institutions conference that was celebrating its 20th anniversary gave me the occasion to reflect on the changes we have seen in the past 20 years. At that time, I was a young commissioner at the Spanish Securities and Exchange Commission, and later on I would chair the now-defunct Banking Advisory Committee, the Committee of European Bank Supervisors and the not-yet-extinct Financial Action Task Force and Joint Forum. After that, I ended up chairing the Spanish Banking Association.

**A different landscape**

Twenty years ago, the Basel Committee started discussing Basel II. In those days, regulators were seduced by the science of finance, its pricing models, and the risk management abilities of big banks. Accordingly, they were prepared to let those banks use internal models for computing the probability of default, exposure at default and loss-given default for regulatory capital purposes. To sum up, we regulators had blind faith in the technical competence of big banks.

Big banks were ambitious enough to want even more flexibility than that given by Basel II. Their aspiration was for a Basel III that would allow them to use the diversification that exists between different portfolios towards capital adequacy calculations on the whole balance sheet.

Twenty years later, we do have a Basel III but of a totally different nature. This Basel III, by far much more intrusive than prior regulations, reflects a total loss of faith by supervisors regarding the competence of the financial industry. In fact, it is even worse: they have also lost faith in the character of banks and in their capacity to deal with simple principles, such as avoiding conflicts of interest or respecting the fiduciary duty towards clients. This has been a devastating loss for the banking industry.

It explains why we have not just higher capital requirements (higher in volume and quality) but also liquidity requirements; resolution rules that include staggering requirements in terms of resolution capital as the minimum requirement for own funds and eligible liabilities, or MREL; stress tests; requirements such as the internal capital adequacy assessment process and the internal liquidity adequacy assessment process; governance rules, and so on.

Things are not better in the area of conduct. Here we have the second iteration of the Markets in Financial Instruments Directive, MiFID II, and rules on packaged retail investment and insurance-based products – immensely complex and intrusive regulations that offer no relief to the industry.

**Drowning in data**

There are two particularly worrying aspects of regulation after these 20 years. First, the complexity of the new rules is immense. The Basel III consolidated text just released a few weeks ago by the Basel Committee has 1868 pages; MiFID II reaches 5000 pages of text; updates on rules on capital requirements and resolution, related guidance by the European Banking Authority and national authorities and other regulatory and technical standards, add another 1300 or more pages.

As Bank of England governor Mark Carney recently said: "The bank now receives 65 billion data points each year of firm-related information. To put that into context, reviewing it all would be the equivalent of each supervisor reading the complete works of Shakespeare twice a week, every week of the year."

**Cause for concern**

Why does this complexity matter? Because it is almost 'mission impossible' to understand how the interactions of all these rules work. It is a black box for both regulators and regulated firms.

The second aspect of concern is the architecture of regulation: we regulate by type of financial institution, and not by type of activity. And the problem of this kind of regulation is that it is very prone to arbitrage, something we saw back in 2007. AIG, the monolines, the structured investment vehicles, Lehman Brothers and Bear Stearns were neither banks nor subject to bank regulations: they were insurance companies, broker dealers and special purpose vehicles. Now, in this world of technical revolution that is blurring the frontier between financial firms and technological firms, the new regulatory model will be very prone to capital arbitrage and to the appearance of risks within the unregulated shadow banking sector, including fintechs and big techs.

But our main challenge lies in the character aspect. If we want to survive the next century, we need to restore the standing of banks with regulators, politicians, the judiciary and society as a whole. Otherwise, we can expect future regulations to become even more stringent, inflexible, complex and overwhelming in the next 20 years.

*José María Roldan is chairman and CEO of the Spanish Banking Association.*