The Institute of International Finance, Inc.
THE GLOBAL ASSOCIATION OF FINANCIAL INSTITUTIONS

Structural Challenges in Banking

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Three broad areas

1. Impact of current and prospective regulatory reform on banks
2. Impact on channels of intermediation
3. Unresolved issues in resolution

1 Impact of current and prospective reforms on banks

Two perspectives:

1 Shortcomings in regulation clearly contributed to the crisis

There is real momentum for reform which will be lost if we delay

A race to the top is a healthy form of regulatory competition

Capital and liquidity can be readily raised at low cost

2 Regulatory reform is indeed a strong imperative

But don’t underestimate the potential impact in terms of deleveraging

That has a macroeconomic impact which in turn affects asset quality

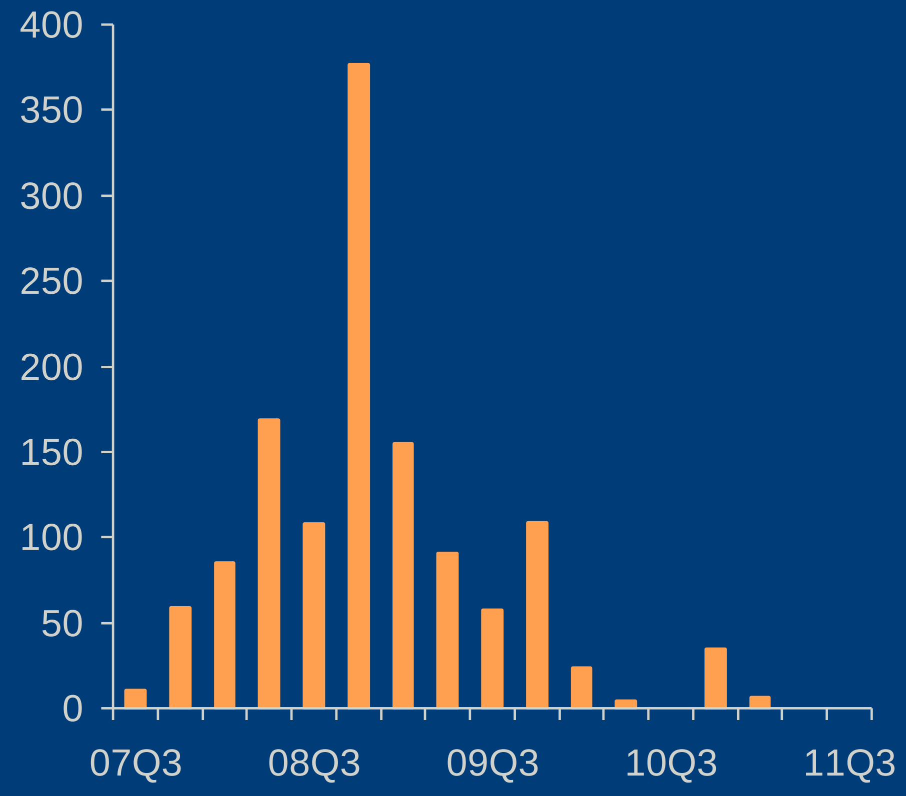
Missed opportunity to create profitable, well managed, well supervised banks

Global net new capital issuance ($bn)

Regulatory reform inevitably entails costs

Evidence does not necessarily support the view that these are low

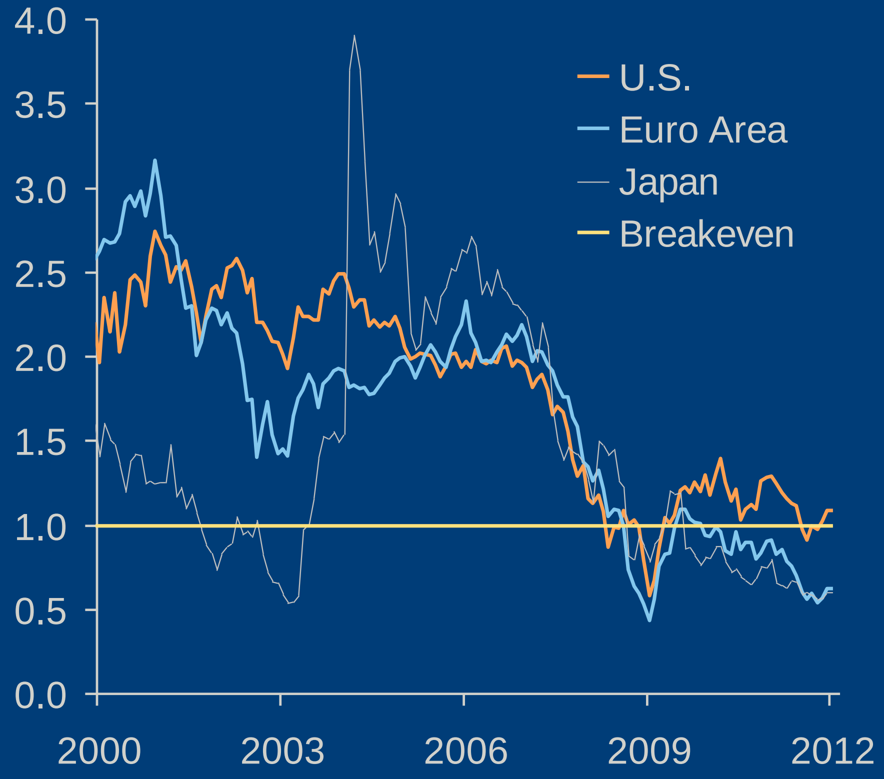
Very little capital raising to date



Bank valuations are persistently low

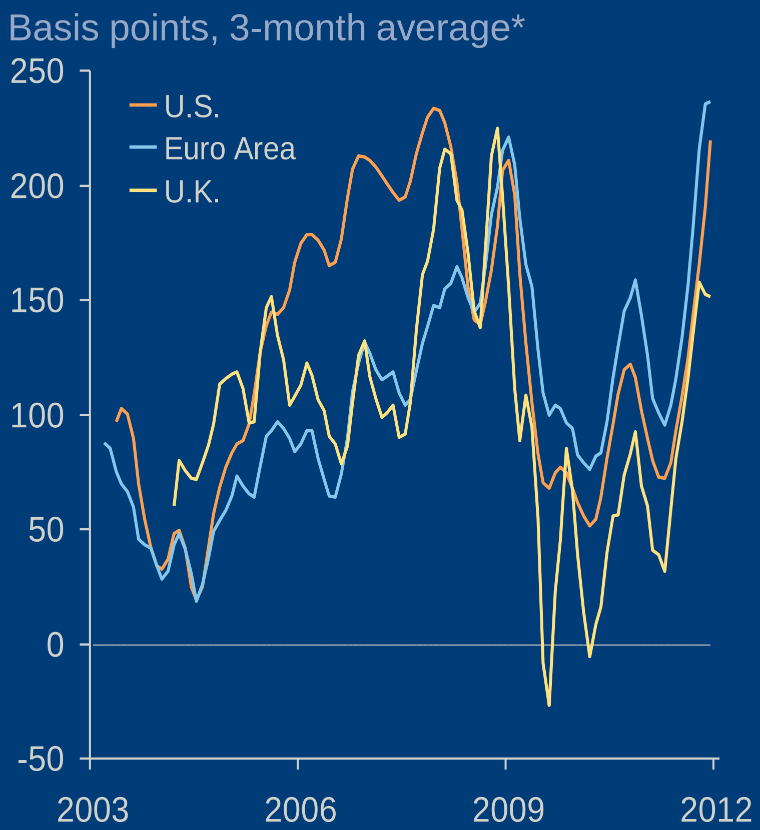
Banks are not seen as good investment opportunities

Implications for business models



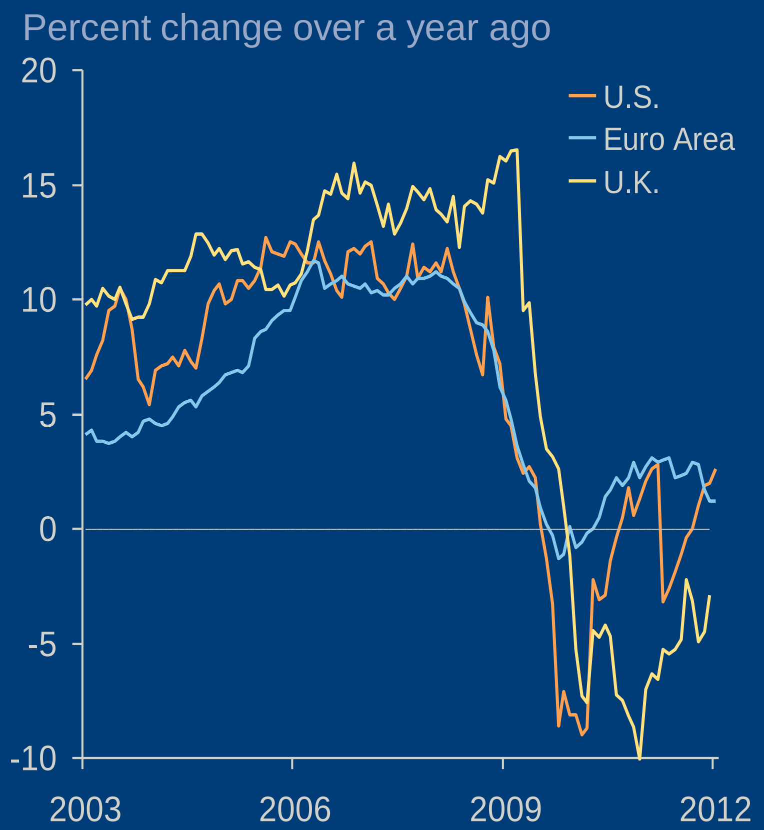
Impact on Lending Rates and Availability

Bank Lending Spreads



*Difference between average of mortgage rate and interest rate on corporate loan and 10-year government bond yields

Bank Credit to the Private Non-financial Sector



Implications for structure

Regulatory reform is affecting banks. Two perspectives

Interpretations

1 They will be stronger and more resilient in future

Useless leverage and trading activity will have been reduced

Race to the top (global standards+) will promote strong and stable banks

2 Damage is being done to the intermediation process (including GSIBs)

It is increasingly hard to see what viable business models look like

We risk creating a spiral of tougher regulation leading to balance sheet deterioration ..

.. a problem intensified by extraterritoriality

2 Impact on channels of intermediation

Inevitable that regulation on this scale will impact intermediation channels

- ‘Shadow banking’ not a helpful term
- What is needed is a ‘forensic’ approach to activities that can have a systemic impact
- Focus needs to be on systemic risk – maturity transformation, leverage, imperfect credit transfer are a good starting point
- The regulatory response will be the key
    - Knee jerk strengthening of existing regulation
    - Extend regulation to ‘shadow banking’ entities or activities
    - Macroprudential – or something else

Implications for structure

Inevitable implications for structure. 2 interpretations

1 Regulation gets it right – proportionate regulation attuned to systemic risks. Comparable activities get comparable regulatory treatment

  Non-bank intermediation channels are welfare-increasing and risks are contained

2 Untargeted regulatory response such as:
  - Onerous requirements on already regulated population
  - Creation of further perverse incentives

3 Unresolved issues in resolution

Real progress by the FSB in defining goals (implementation just beginning)

- Harmonization of national laws/creation of a toolkit
- Development of bail-in ideas
- Criteria for resolution
- Development of RRPs
- Emphasis on critical functions
- Development of limited/bilateral resolution protocols

Resolution (continued)

But some way further to go

- Harmonization and bilateral arrangements are not sufficient for dealing with global groups

- Common standards needed for creditor protection; triggering of resolution; RRPs

- Some kind of global framework is needed to secure collective approaches to key issues
    - Creditor protection (‘no creditor worse off than in liquidation’)
    - ‘Suspensory’ powers (stays on transactions, cross default clauses)
    - Asset allocation issues
    - Group-wide fairness for all claimants on NCWO basis, avoid ringfencing

Resolution (continued)

Critically:

- Firms are currently structured differently for good reasons (‘archipelago’ versus ‘continental’ models)

- Resolution must respect these, not prescribe structures which are judged to be resolvable

- Resolution plans need to reflect group structure

- In extremis, structures may be judged irresolvable, in which case required restructuring *only* where consensus among key resolution authorities exists:
  - that this is required
  - on what form restructuring should take
  - Restructuring is the only feasible solution

Implications for structure

Resolution issues will profoundly affect structure. 2 interpretations

1 Good prospect of truly resolvable structures which:
- Respect/accommodate legitimate differences in business structures
- Embed conventions or other ways of creating certainty in resolution
- Permit rational regulation of globally active firms

2 Insufficient progress on resolution – especially cross border aspects
- Regulation reflects lack of confidence in resolution structures
- No clear basis for firms' resolvability assessments
- Forced structural change as a substitute for getting resolution right

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