ECB Forum on Central Banking, Sintra: *Financial Regulatory Challenges*

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Where Regulation Has Succeeded

- Higher capital ratios
- Defined liquidity standards
- Pushing Total Leverage Ratios
- Corporate Governance change
- Greater attention on conduct/protection of retail interest, plus heavy fines on AML, Terrorist Funding, Sanctions, Corruption

Where Regulatory Outcomes Have Flaws

- Bankers feel micro-managed by complex regulations, whereas asset management & FinTech have much less regulatory burden and no limits on remuneration – talent loss to non-regulated fields
- Operational risks – Stream of new regulatory + technology changes made bank legacy IT systems obsolete, fragile and complex, prone to cyberattacks, failure and non-interoperability
- Risk models (too many and flawed) cannot cope with radical uncertainty from changing geopolitics, UMP + NIRP, FinTech + Blockchain challenge to legacy HR costs
- NPLs rising due to Deflation and asset bubbles reversing

Multi-layer New Economy of Multi-side Platforms – from Hardware to Software

Software + Sharing economy: Efficiency + Convenience + Green (Personalization of data/service – Many to One to Many

New Value

Multi-sided platforms – Alibaba, Amazon – consumer focused – finance follows product

Financial service – payments, credit, investments (duplicated hardware – low usage of data analytics

Hardware: Telco platforms; railways; electricity grids

Financial regulation is still regulated old single-sided finance

Five Radical Uncertainties Changing Normal in Financial Regulation

1. Financial markets are now driven by geopolitics (e.g. Brexit, terrorism, Middle East, South China Seas etc)
2. ZIRP and negative interest rates are conflating business models of banks (interest-rate margins), insurance and pension funds and fund managers – who wants to pay for management fee of 1.5%, when returns are zero?
3. Deleveraging due to Capital + Regulatory Requirements pro-cyclical on secular deflation
4. FinTech + Blockchain making traditional business models obsolete. Combination of complex regulations and complexity in UMP exits diverting key attention from huge risks building up in system as a whole
5. Creative destruction in Old Economy forcing losses that banks and industry have not yet recognized

We need to look at risk + uncertainty within the system as a totality, not partially that assumes away externalities or spillovers

Major Questions

- Risks versus Radical Uncertainty
- What is level playing field when financial markets are very hierarchical?
- What is Fair Value when Discount rate = 0 or negative?
- If another mid-sized financial crisis occurs, and everyone rushes for Dollar and German bonds, rising interest rates and devaluation in others would cause meltdown in non-$ markets?
- What if, in event of war or big natural disaster, one major financial centre implodes?
- If real sector is going through secular deflation, how can financial sector escape creative destruction losses?

Are we tinkering at the margin and pretense of perfection by pushing the complexity envelop?

Why We Need Alignment of Policies

- To expect policy coordination across sovereign nations with conflicting interests will be not get us very far
- Chances of world sliding to global secular deflation is increasing
- Collorary of Minsky dictum – stability creates instability – managing micro-risk creates macro-uncertainty
- Need to align incentives between central banks, regulators and industry to give priority to which key areas need urgent reforms. We cannot do all the current regulatory reforms at the same time
- Needs leadership to reach out to the banking community to address smooth transition in major transformation in both real economy and financial system

Thank you

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