SUERF
The European Money and Finance Forum

SUERF Policy Briefs
No 134, July 2021

Future Challenges: Old Problems in New Shapes*

By José María Roldán
Spanish Banking Association (AEB)

JEL codes: G21, G23, G28.

Keywords: Regulation, banks, bigtechs, fintechs, shadow banking sector, digital, ESG.

The regulated financial system, and in particular the banking sector, has performed extremely well during the pandemic. From being a problem in the Great Recession to being a source of strength and part of the solution during and after the pandemic. The financial regulatory tsunami put in place after the crisis and targeted towards improving banks´ resilience (increasing their solvency and liquidity buffers) is rightly seen as the key element of success. But we risk being complacent. The shadow banking sector is expanding since the Global Financial Crisis and in the next decade its complexity will surely grow with the digital and ESG revolutions. If we want to preserve the stability of the financial sector in the post COVID world, regulating banks is not the sole answer anymore.

* Speech held by José María Roldán, Chairman and CEO of the Spanish Banking Association (AEB), at the Universidad Internacional Menéndez Pelayo on 24 June 2021.

Introduction: the risk of complacency in the post COVID world

When historians of 2050 look back and judge the years 2020 and 2021, the coronavirus pandemic and the digital and environmental revolutions will be the predominant themes in their analysis.

However, behind this great headline, there are a multitude of lesser, albeit interesting, developments. For instance, the tendencies towards the renationalization of politics, economics and finances that are already being observed and which will form part of the post-COVID new normal. Just as antigens and antibodies fight in our bodies, these opposing trends will also fight for ultimate hegemony, in this case, the struggle is between a global response to the challenges of sustainability versus the tendencies towards isolation and the (futile?) search for national solutions.

One of those less relevant (when compared to the brutal cost of the pandemic), is that of shadow banking, or to use the current nomenclature that the Financial Stability Board gives to this phenomenon, "non-bank financial intermediation".

This is an issue that I have been concerned with since a decade ago. The reason is none other than the flagrant unawareness, increased over the years, of the harmful role that this type of financial activities played in the Global Financial Crisis of 2007/2012. Indeed, all the attention was and still is focused on the role played by banks, but the crucial role of other non-bank structures present in the originate-to-distribute model is completely ignored. I am referring to the essential role that non-bank operators (insurance companies such as AIG, stock dealers such as Lehman Brothers, money market funds, SIVs, or monolines) played in fuelling the crisis. Of course, we also had a banking crisis: banks are at the heart of the financial system and, when turbulences hit the financial system, it ends up affecting the banks.

The regulatory efforts made after the Great Recession have been more successful in strengthening the resilience of the banks, than in strengthening the rest of the non-bank financial system. And while the COVID crisis has demonstrated the resilience of the banking sector, there are serious doubts that financial stability can be assured strengthening the banking sector but leaving the periphery of the financial system completely out of control.

Moreover, developments around digitalization and sustainability are increasing the complexity of this shadow banking ecosystem (Bigtechs, fintechs, and family offices) with the potential to generate new fragilities. Is this a baseless concern? Not at all, we have very recent examples of the fragility of these new players: Wirecard, Greensill, Archegos. Beyond the new players, we are also witnessing an increase in cyber risk and electronic fraud on smaller scales. Far from reflecting an orderly trade, the financial system seems to be entering into a new phase of anarchy and disorder.

If we pay attention to the press headlines relating to these cases, many of them focus on the losses they have caused to banks, sometimes through peculiar transmission mechanisms. For example, the collapse of a British firm, Greensill, has led to the liquidation of a small bank in Italy. And there is no doubt that errors in counterparty risk management have played a role in the size of losses suffered by the banks involved. But the key issue is whether these developments are anecdotal or whether they reveal a problem of design in the regulation and supervision of the international financial system. In my opinion, the answer to this second question is affirmative.

In the next few minutes, I will explain why I think we need to think deeply about the regulatory architecture emerging from the Global Financial Crisis (GFC).

1. Some preliminary considerations

Two very powerful forces coexist in any financial system. On the one hand, innovation and, on the other, regulatory arbitrage. Innovation drives the emergence of new financial instruments and intermediaries. Think of the recent development of Exchange Traded Funds (ETFs) or the recent Special Purpose Acquisition Companies (SPACs), but also of new payment companies (some very successful, such as Ayrden) and others whose fraudulent collapse is a cause for concern (such as Wirecard), or of new categories of financial instruments (cryptocurrencies). And going beyond digital, we have the Environmental, Social and Governance (ESG) territory, where the volume of innovations in the form of instruments or new players is considerable. Many of these innovations generate added value, and some others are created for spurious reasons. They introduce far reaching changes in the financial system, creating new interrelations and fresh potential fragilities.

Among these forces of transformation and innovation, the most powerful and pernicious one is regulatory arbitrage. All regulations have weaknesses that make them susceptible to being dodged by financial agents operating outside the regulated sector. Take, for example, the newly emerging SPACs. They have positive aspects, such as improving the financing of unlisted companies, but they also represent an arbitrage of the rules governing the IPO of start-ups.

Finally, we cannot ignore supervisory arbitrage: any regulation is only as helpful and useful as the supervision that verifies its compliance. In the financial field we are told that operators in the shadow financial system are subject to the same regulation as operators in the regulated system. But the key question is who oversees the application of that regulation when, for example, a bigtech is engaged in providing financial services. Regulation without oversight is useless.

In other words, rigorous and detailed regulations and a strong supervision of the banking sector may not be enough if the activity of shadow banking players, now exceeding the activity of regulated banking intermediation, remains unchecked due to fewer regulatory requirements and lighter supervision.

Another key aspect is the new interrelations that may emerge from financial innovation, either in the form of new instruments or in the form of new operators. Understanding how these interrelationships impact the hard core of the financial sector, the banking sector, is critical to safeguard financial stability. Indeed, we already saw this in 2007/2012, when problems in the shadow banking sector impacted violently on the banking sector.

2. The shadow financial system

Shadow banking or, according to the nomenclature of the Financial Stability Board (FSB), non-bank financial intermediation (NBFI), is defined as financial activity carried out by non-bank agents (insurance companies, hedge funds, real estate funds, money market funds and investment vehicles, among others), but which has characteristics typical of banking operations: leverage (heavy use of debt, i.e., few equity at risk), assumption of credit risk and maturity transformation (financing long-term assets with short-term liabilities). As long as they do not take deposits, they remain outside banking regulations, despite their risks being similar in nature to the banks.

Using the latest FSB data, banks are the institutions with the greatest share in the global financial system. They nevertheless represent less than 50% of the total (only 38.5%) and trending downward. On the contrary, the growth of the most fragile part of this shadow banking system has outpaced the growth observed in banks (in 2019 and 2020 by 8.9% and 5.9%, compared to 5.1 % and 3.8% observed in banks).

If measurement is a challenge being resolved by the FSB analysis, mapping the interrelationships is simply mission impossible. We can make a static description of the new players, whether they are instruments such as SPACs or family offices such as Archegos. But knowing the interrelationships, the flows, is practically impossible. I always mention the anecdote of a study carried out by the New York Fed, the only one I know of, on a static description of these interrelationships. The graph describing these interdependencies is so detailed that it would require a printer capable of printing canvases the size of a dining room table to see the details.

3. The problem of competitive equilibrium among operators

The competitive equilibrium between operators performing similar functions with a diverse charter (bank, insurance, SPVs, private equity, MMFs, etc.) cannot be taken for granted. If regulatory arbitrage is such a powerful force, it is precisely because financial regulation and supervision are as necessary as they are onerous.

Make no mistake about it. In this new financial world, the banking sector will be the underdog. As an example, in the EU, banks must share their customers with the new payment operators (the famous third-party services providers), but bigtechs are not obliged to share their data.

The regulatory architecture does not help either. We have a combination of activity-based regulation, but al so entity-based regulation and, to complicate things, a combination of both approaches. For example, deposit-taking is an activity reserved for banks, for institutions subject to banking regulation. But there are quasi-bank financial institutions, not regulated as banks, but highly leveraged, that take quasi-deposits and engage in maturity transformation. In short, they are susceptible to runs but are not subject to the same rules as banks.

Regulatory reform following the Global Financial Crisis has increased banks' capital requirements threefold (and up to tenfold for certain portfolios). Therefore, the incentive for regulatory arbitrage has been multiplied by three: whatever the cost of capital for banks, the potential gain of being outside the regulatory perimeter is proportional to the increase in regulatory capital.

Other regulations beyond capital, such as investor protection or anti-money laundering rules also involve high compliance costs. The incentives to escape from them are equally powerful, though more difficult to gauge. If we add to all this the cost of supervision, it becomes clear that evading banking regulations increase profits, although to an extent that is also difficult to quantify.

However, the biggest problem is not the unfair competition for regulated banks, but the impact the arbitrage may have on the stability of the financial system. Perhaps we banks have been annoyed by this type of unfair competition and we have expressed our complaints. It is understandable that any company operating in the marketplace expects public authorities to deliver a level playing field, to ensure that it is the best player, and not the most protected one, who wins.

But the level playing field issue is not the vital one. The fundamental question is: what is the point of having made banks safer from the point of view of solvency and liquidity, better managed from a risk perspective, with better corporate governance and more intensely supervised, if we are shifting risks to a part of the financial system that is less well-known, lightly regulated and supervised, and with players or products with a poor track record?

My message is clear: the shift of activity from banks to the shadow financial system may be increasing the risks of financial instability, including the likelihood of another systemic crisis due to the presence of pseudo-banks outside the regulatory perimeter. And given the complexity of the shadow financial system and the still rather primitive knowledge we have on it, these risks are difficult to assess.

What can be done? The banking industry has summed up its proposals in one sentence: same activity and risks, same regulation and supervision. This phrase has emphasized the problems of regulatory arbitrage and has been very effective in alerting the authorities of the need to abandon the laissez faire policy towards large technology operators. But it also has limits as a practical proposition. It may not be desirable in all situations, or it may be impossible to undertake in practice, even if it were desirable to do so.

Achieving such regulatory equality would be highly desirable in the case of quasi-bank entities, i.e., those that manage credit risk, have few equity (they are highly leveraged), and finance long-term assets with short-term, even instantly repayable liabilities, such as money market funds. For this subgroup, which meets the narrow definition of non-bank financial intermediation, there is no solution but to subject them to the regulatory capital and liquidity requirements of banks, and mainly for financial stability reasons.

But perhaps this segment of shadow banking is not so relevant. The more complex cases of competition in specific segments, such as means of payment or consumer finance or investment in redeemable instruments close to, but not equivalent to, bank deposits are more significant. Since they are subject to lighter regulation and supervision than banking players performing similar activities, they may well end up driving banks out of the market. And if this happens, the financial system will display a weaker regulation and supervision, and citizens and companies will become less protected.

If the price advantage of these new entrants is not based on lower costs derived from the use of technology, but on lower regulatory compliance costs, it will not only be unfair for incumbents, but potentially dangerous as well. By the time the digital challengers oust the incumbents and dominate these markets, consumer protection conditions may have been degraded forever.

In short, it seems inevitable that the authorities should take a more dynamic view, taking into account the incentives for arbitrage that regulation and supervision create, and react in advance to potential problems arising from such arbitrage. Perhaps we should rephrase that sentence to say that similar activities entailing similar risks should be subject to regulation and supervision that ultimately ensure equivalent outcomes in terms of preserving financial stability and minimizing long-term supervisory risk.

4. The new forms of Shadow Banking: digital and sustainable

The digital revolution and the emergence of a booming financial technology industry, which are driving the disappearance of boundaries between countries and sectors, will accentuate the challenges associated with the shadow financial system. If we have seen capital arbitrage in the years prior to the 2007 crisis, the emergence of the digital world will undoubtedly increase it.

In fact, the emergence of sustainability as one of the desired characteristics of the new post-COVID normal adds another layer of complexity to this problem. Indeed, we are already witnessing an increase in both operators and instruments. And we must not ignore that the combination of the digital revolution and sustainability creates dynamic forces that reinforce each other: we are talking about fintechs, but also about greentechs.

Innovation plays a central role in the digital and green revolutions. Without innovation in the use of technology applied to solve the problem of sustainability, we will not be able, as a society, country or planet, to successfully overcome the current challenge. I do not want my comments to be interpreted as digital or green luddism.

But if the shadow financial system was extremely complex before the 2007/2012 crisis, I fear it will become much more so in the coming decades. Perhaps the simplest example is that of bigtechs, characterized by their

network externalities, which allow them, on a truly global scale, to compete successfully with other smaller, specialized operators.

Existing bigtechs are formidable companies that have shown an enormous capacity for innovation and have defeated other challengers who did not have the vision or did not know how to put into practice the vision needed to succeed. They have changed the course of our economies and our consumer habits. But it is also true that their position of dominance is such that it is very difficult for new competitors to emerge. This is very different from what has been observed in areas such as cell phones, where leadership has always been temporary (think of Motorola, Nokia, Blackberry, etc.), and innovation and competition is still prevailing.

Of course, when a bigtech sells financial services, it is subject to regulation. But how many on-site inspections by the relevant supervisor are being carried out on this type of company? Because, as we have already indicated, regulation without supervision and compliance is a dead letter.

And we are not talking about something that may happen in the future: BIS data shows that, right now, a whopping 10% of bigtechs revenues comes from financial services. Authorities have little time to react.

The emergence of the green revolution, undoubtedly one of the great positive news of the post-pandemic world, threatens to further complicate the financial ecosystem. Think of sustainability in terms of new players, regulatory measures from different authorities, global initiatives or new wholesale and retail instruments (see Annex 1).

In short, the coming green tsunami, not only regulatory, will exponentially increase the complexity of the shadow financial system. Hence my repeated calls for us to replace the apostles of climate change with the plumbers of climate change without further delay, to bring order to this new world, to bring order to financial traffic and to limit, as far as possible, the complexity and confusion that tends to come with any economic revolution.

5. Closing remarks

A brief review of the headlines in the financial newspapers in recent months confirms a pattern seen before: problems in the shadow banking system that end up affecting the core of the financial system, i.e., the banks. But Wirecard, Greensill and Archegos are cases where activity on the periphery of the system ends up impacting the banking sector. Since not all banks are affected equally (some are better and some are worse at managing risk), and since no problems of viability have arisen so far in the banks, it would be tempting to say that the financial reform implemented in the wake of the Great Recession has worked properly. We could say that, by making banks more solvent and safer, the stability of the financial system has been preserved.

I sincerely believe that this is the wrong conclusion. The evolution of the shadow financial system points towards greater complexity and diversity. We have gone from Shadow Banking 1.0, the one prevalent before the Global Financial Crisis, to Shadow Banking 2.0, developed in recent times, with new and old players. With the digital and green revolution, we will witness the birth of version 3.0, without, I am afraid, the regulatory or supervisory architecture having been adapted.

Regulation and supervision must respond to this Brave New World and ensure a better competitive balance between banks and players in the shadow financial system. It is not a question of fair competition, but of safeguarding the stability of the financial system. We have made banks safer, but I fear that in the future this will not be enough to preserve our economies from future financial crises.

ANNEX 1: New Green Financial Ecosystem

- On the side of the new players, we have:
  - In the public sector, the European Commission (the High Level Expert Group, the Technical Expert Group, and the Finance Platform, the Sustainable Finance Action Plan, with the well-known taxonomy regulations and disclosure requirements for public companies), the EBA, but also IOSCO, the NGFS, the Basel Committee at the supra-European level or the Climate Change Office in Spain and the various ministries involved in the issue, with special emphasis on the Vice-Presidency for Ecological Transition.
  - In the private sector, the ecosystem includes a set of new suppliers: external verifiers, certifiers, ESG ratings providers, carbon footprint measurement companies, specialists in providing market information on all ESG-related issues, specialists in green financial risk measurement, and specialists in standardization (benchmarks), with a mix of incumbents and challengers in each of these areas.

- In terms of regulatory measures and standards, sustainability initiatives now number around 1,000, rising to 5,500 if we consider broader aspects such as reporting, supervisory policies, stress tests, etc. We can highlight the following:
  - The Ecuador Principles
  - Global Reporting Initiative (GRI)
  - Principles of Responsible Investment
  - Ceres, the United Nations Environment Programme Finance Initiative (UNEP FI)
  - The Institutional lnvestor Group on Climate Change (IIGCC)
  - Task Force on Climate-related Financial Disclosure (TCFD)
  - Task Force on Nature-related Financial Disclosure (TNFD)
  - Sustainability Accounting Standards Board (SASB)
  - Climate Disclosure Standard Boards (CDSB)
  - United Nation Environmental Program – Financial Initiatives
  - Sustainable Stock Market Principles
  - Principles of Sustainable Insurance
  - Principles of Responsible Banking
  - Collaborative Commitment to Climate Action (CCCA)
  - Net Zero Global Alliance (which includes banks, insurance companies and Securities Markets entities and operators).

- In the field of instruments, we have:
  - Green, social and sustainable bonds and loans, which are governed by the Green Loan Principles of the International Capital Market Association (lCMA) and The Climate Bond Initiative (CBI) and henceforth will also be influenced by the EU Taxonomy Regulation.
  - The Green Climate Fund, leveraged on the Paris Agreement.
  - Impact bonds and loans.
  - Green covered bonds, from which a multitude of products are derived, such as, for example, renewable energy bonds, green mortgage securitizations for housing rehabilitation (PACE), among others.
  - Derivatives for hedging climate change risks.
  - In retail financing, deposits, mortgages, cards and "green" or sustainable credit and the European Green Label, sustainable collective investment vehicles, among many others.

About the author

José María Roldán *is Chairman and CEO of the Spanish Banking Association (AEB) since April 2014, after 13 years as Director-General at the Banking Regulation and Financial Stability department of the Bank of Spain and member of its Executive Board. From May 2015 to June 2019, he was also Vice-President to the European Banking Federation (EBF). During his tenure in office as Director-General he was part of the Basel Committee on Banking Supervision (BCBS), and chaired both the Standards Implementation Group (SIG) of the BCBS and the Joint Forum during the tenure of the BCBS. He founded and was the first Chairman of the Committee of European Banking Supervisors (CEBS); the forerunner of the European Banking Authority (EBA), after being President of the Financial Action Task Force on Money Laundering (FATF) and chaired the extinct Banking Advisory Committee (BAC) of the EU. Mr. Roldán joined the Bank of Spain as Senior Economist of the Research Department in 1989, but in 1994 he took up a post at the European Monetary Institute (the forerunner of the European Central Bank) in Frankfurt.*

SUERF Publications

Find more **SUERF Policy Briefs** and **Policy Notes** at www.suerf.org/policynotes

SUERF is a network association of central bankers and regulators, academics, and practitioners in the financial sector. The focus of the association is on the analysis, discussion and understanding of financial markets and institutions, the monetary economy, the conduct of regulation, supervision and monetary policy.

SUERF's events and publications provide a unique European network for the analysis and discussion of these and related issues.

SUERF Policy Briefs (SPBs) serve to promote SUERF Members' economic views and research findings as well as economic policy-oriented analyses. They address topical issues and propose solutions to current economic and financial challenges. SPBs serve to increase the international visibility of SUERF Members' analyses and research.

The views expressed are those of the author(s) and not necessarily those of the institution(s) the author(s) is/are affiliated with.

All rights reserved.

Editorial Board
Ernest Gnan
Frank Lierman
David T. Llewellyn
Donato Masciandaro
Natacha Valla

SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at