Centre for Market and
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Regulatory Challenges in the Financial Sector

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Paul A. Grout
Professor of Political Economy
University of Bristol

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

University of BRISTOL

Briefly talk about three interrelated things:

- Banking regulation
- Consumer switching
- Digital future (present?)

Features of banks:

- Short term supply/long term demand for funds – multiple equilibrium
- Leverage ratios
- Systemic risk
- Payment systems – large interconnectivity
- Asymmetry of information (particularly smaller depositors)

Significant externalities (divergence between social and private incentives) - potentially too much risk, too big to fail, etc.

Requires sector specific regulation

Capital and Leverage Framework

Basel II

Pillar 1 - capital requirements

Pillar 2 - supervisory

Pillar 3 - market discipline

Basel III

New capital, leverage and liquidity requirements

Capital Requirements Directive IV (max harm)

- Capital Adequacy Ratio (risk weighted)
- Leverage Ratio

Bank Recovery and Resolution Directive

Financial Institutions must be able to fail and restructure in orderly fashion – removing barriers to exit - proportionate

Stabilisation tools:

- private sector purchaser
- bridge bank
- bail-in

Features

- MREL (minimum requirements for loss-absorbing capacity)
- ‘No creditor worse off’ safeguard

Structural Reform

Ring fenced banks requirement of Financial Services (Banking Reform) Act

In force 2019

Aims to minimize impact of failure – makes banks more resolvable

Separates core activities from trading

Applies to big banks - £25bn +

Structural reform elsewhere:

EU (under negotiation) and US (Dodd Frank Act)

Regulatory Challenges

1. Stability v Entry

    Competitors or bedfellows?

- Weak regulation: TBTF can be an equilibrium solution
- Competition objectives
- Better regulation provides confidence with regard to quality of entrant

2. Perception is important issue

- insufficient attention in the literature

- Understanding of protections and resolution systems for specific banks
- Understanding of specific and general shocks (matters for systemic risk)
- Scale or market power?

Consumer Switching:

- Low levels of consumer switching a feature of both markets (energy and retail banking) currently the subject of MIRs.
- Makes disruptive entry difficult
- Problem partly to do with cost and confidence but also behavioural causes.
- Hyperbolic discounting (bias for present)

- Consumers plan to make informed decision about switching but prefer to postpone it to next period.
- Also there is recognition that a better decision will be made by delaying.

What form of regulation can improve things?

- Quicker, easier switching with greater confidence can clearly help
- Increasing the knowledge of the size of gain from switching can make things worse:
    - bigger decision
    - better balance in next period
    - option value of waiting

Digital Future

Digital impact in three overlapping areas:

- Digital banks (access to accounts, etc.)
- ‘New’ digital payment systems
- New models: digital currencies, crowd funding, etc.

Open data and APIs

Digital banks

- Often standard banking products but no branches (telephone support but no telephone transactions) – aimed at millennials.

- Parallel banks

- Flexible IT systems

- Cost to income ratio for digital bank of 30% compared to 50% for branch based model (Anthony Thompson (Atom)).

- Large banks rapidly moving transactions away from branches.

Large scale innovation in payment systems from non-banks:

- Wrappers

  Potentially large scale impact - Google Wallet, Apple Pay, Paypal – essentially uses existing infrastructure

- Mobile money

  M-Pesa (Kenya)

Digital currencies - Distributed ledger technology

Crowd funding, etc.

Regulatory issues:

- Will this bring disruptive competition and innovation?
- How much difference will this make to the 'standard' model of regulation in the near medium term?
- IT quality is critical – does this raise concerns and, if so, what should be done?
- Impact on innovation and entry (culture differences?)
- How does regulation develop over time as parties grow?