



Five years on,
uncertainty is
the new normal

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Bank Governance Leadership Network ViewPoints

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Five years on, uncertainty is the new normal

On October 9–10, participants in the Bank Governance Leadership Network (BGLN) gathered in New York for the fifth Bank Directors Summit, the BGLN's 30th meeting since its inception in 2009. Directors representing 12 banks from six countries met with five regulators or supervisors from four countries and were joined on day two by James Gorman, chairman and CEO of Morgan Stanley.

Five years on from the beginning of the global financial crisis, discussion focused on the state of regulatory and internal reforms. The enclosed issues of *ViewPoints* capture the spirit of the summit discussion and are enriched by insights from five additional BGLN meetings and more than 160 discussions with BGLN participants over the course of 2013:

- **Much more prudential reform to come.** Banks are subject to much tougher capital, liquidity, and other prudential regulations as a result of a reform agenda aimed at protecting taxpayers from future bailouts. Despite the progress these reforms have achieved, banks and regulators are only just getting to the most difficult issues – how to ensure minimum capital and liquidity levels are truly consistent across borders and how, pragmatically speaking, to resolve cross-border institutions in the case of failure. There is significant work ahead on both fronts, particularly on resolution. It is clear that intensive supervision will be an ongoing feature of the regulatory environment. Overall, summit participants concluded we are not even halfway through prudential reform, so banks should expect regulatory uncertainty for many years to come. (*Pages 4–13*)
- **A new standard for effective board governance.** Summit participants acknowledged that the elevated level of engagement demanded of board directors after the crisis is here to stay, and that for the board to be effective, compliance activity must not be allowed to crowd out important strategic and talent discussions. Participants concluded that despite the importance of capital, liquidity, and other improvements, good management is a firm's best safeguard. Therefore, boards should emphasize senior management's accountability for the firm's performance and controls, give more attention to succession planning, and support management in the face of regulatory pressure. Additionally, because compensation remains a continuing source of controversy, it requires ongoing board consideration. Lastly, participants stressed that continuous board-supervisor engagement is essential in today's world of regulatory uncertainty. (*Pages 15–20*)
- **Heightened expectations for risk management and controls.** Banks' risk agendas remain full, as directors and executives are still grappling with how to implement risk appetite frameworks and better measure and mitigate operational risks. Improving the depth and breadth of talent in the risk and control functions is a challenge, as is improving risk data aggregation and internal and external risk information. Supervisors and directors agree that the ultimate objective is instilling and monitoring a desirable risk culture.

Beyond risk, other control improvements are required in light of the staggering fines and settlements that have recently been imposed in cases of control failures. Supervisors are pressing banks for enhancements to internal audit, the oversight of third-party vendors and outsourcing, and information

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technology (IT) system capabilities and controls. Because consumer protection – or conduct risk – creates such potentially significant business model and control challenges, many directors view it as the largest regulatory risk, going forward. (Pages 22–28)

- **The need for strategies that fit today’s reality.** In considering future business models, participants stressed the need for unambiguous strategies that can accommodate the new norm of continued regulatory uncertainty. At the base should be a solid, stable earnings engine that balances stakeholders’ varying demands. Four strategic issues that need to be addressed are the institution’s geographic footprint, physical versus online delivery, strategic investments in IT, and how best to address emerging non-bank competitors. (Pages 30–35)
- **Addressing systemic regulation and macroprudential supervision.** Regulators acknowledged that their reform agenda has not yet reached much beyond traditional banking, other than reforms linked to short-term funding. Macroprudential and systemic supervision are missing in action, in part because such supervision is highly political when applied. Summit participants were surprised to hear that systemic regulators have done little beyond data collection, even though, in participants’ view, systemic risks continue to grow in the financial system. Moreover, regulators are only just beginning to address regulatory reform of the shadow banking system and emerging non-bank competitors. Additionally, little has been done to ensure that central counterparties, which have emerged as a new, regulatory-driven systemic risk, are sufficiently robust. (Pages 37–42)

Banks and regulators realize that not only are they sailing uncertain seas, but they will be doing so for the foreseeable future. As yet, there is no distant shore in sight, but all constituents are committed to the journey. We encourage you to share these *ViewPoints* with your colleagues as a catalyst for discussion and to help your institution chart its course in these unfamiliar waters.

We look forward to continuing the discussion in the BGLN.

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Chapter 1

Much more prudential
reform to come

After the global financial crisis began, regulators and supervisors embarked on the most comprehensive set of prudential reforms in generations, most notably in capital and liquidity requirements, resolution, and ring-fencing. These reforms have been central to BGLN¹ dialogues since the network's inception, and they continue to garner much debate. While the general direction and intention of prudential regulatory reform are clear, many participants seek more clarity regarding the reforms' ultimate goal.

Supervision has grown more intensive, as well. Boards are feeling continued pressure to oversee management more actively and to hold them more to account. The regulatory pressure to improve risk oversight and risk management, and the control framework more broadly, continues unabated, in part in response to the litany of failures the industry has suffered in the last 18 months. See ["A new standard for effective board governance"](#) and ["Heightened expectations for risk management and controls"](#) on pages 15 and 22, respectively.

The salient questions then become: how far have the reforms gone, how well are the original reform objectives being met in practice, and how much more change lies ahead? At the summit, several regulators said much had been achieved. One remarked, *"Five years is a long time ... but we have made a lot of progress in putting in the broad regulatory framework. The overall shape is relatively clear."* However, participants also heard that *"the impact on individual institutions is still very much to be determined."*

"The implementation process is getting very messy." – Participant

Regulators suggested that overall, the industry is only *"midway through the [prudential regulatory reform] journey,"* and that in some areas *"we have only just gotten to the most difficult questions."*

One participant framed the prudential agenda well, saying:

There's three parts to the approach: at the front end, there's the things that help us avoid disaster – capital, liquidity, [lower] leverage. At the back end, if a disaster happens, we have resolution efforts to help contain the problem – this is still very much work in progress. And, in the middle, you have the CCAR [Comprehensive Capital Analysis and Review] process – the annual health check-up.² It is another layer of governance, and an independent check from the regulator.

Within this context, the summit dialogue centered on four broad themes:

- Expect more capital, greater liquidity – and lower leverage
- Developing workable recovery and resolution plans is critical
- Stress testing will become banks' annual health check
- Despite progress, uncertainty and challenges will persist

Expect more capital, greater liquidity – and lower leverage

While most major economies have committed to adopting Basel III, it has become increasingly clear that this will not be a consistent global standard, but rather, the accords will serve as a floor, with significant variation in country-by-country requirements. Therefore, the focus of coordination is moving to greater consistency in risk-based capital requirements and the calculation of risk-weighted assets (RWAs), including the relative merits of relying on banks' internal models against imposing standardized measures that are defined by regulators. Additionally, there is debate on the relationship and interaction between the RWA framework and the leverage ratio, and whether the leverage ratio should

serve as a backstop or binding constraint. More broadly, a regulator acknowledged the continuing debate – in the press and academia – over the trade-offs between simplicity and risk-based measures, and the balance between higher capital requirements and the potential impact on bank lending.

“How much [capital] is enough?”
– Regulator

Capital and liquidity have increased, but remain far from consistent

In response to the perceived failures of Basel II and insufficient capital buffers at banks in the run-up to the financial crisis, the Basel Committee on Banking Supervision (BCBS) created new regulatory standards for capital requirements and liquidity in 2011. Under the new Basel III rules, minimum common equity requirements have increased by a factor of 5–7 times as compared to the Basel II regime, when accounting for tightening in the quality of capital. Moreover, banks designated as global systemically important financial institutions (G-SIFIs) – the largest, most interconnected, and complex banks – have to hold additional equity capital buffers and meet minimum “bail-inable” debt requirements. One regulator remarked, *“We have made significant progress on capital and liquidity. Precrisis, banks slipped one standard deviation from the 20-year average. Today, on capital, we are more than one standard deviation above that average, and for liquidity nearly two standard deviations above.”*

Industry critics argue that progress has not been as significant; they point to softening of the draft liquidity coverage ratio (LCR) – a requirement for banks to hold enough liquid assets to sustain their operations for 30 days in case of another freeze in the funding markets – as a sign that regulators are buckling under pressure from banks. Certainly, draft rules have been watered down. In January 2013, with warnings that the requirements would expose \$1.5 trillion in liquidity shortfalls in

European financial institutions, which would discourage lending, the BCBS revised the rules to expand qualifying assets and extended the compliance deadline from 2015 to 2019.³ However, the revised LCR is still quite constraining. Regarding the liquidity situation, a participant stated, *“We have much more liquidity than ever, which should prevent a run on the bank. Politicians struggle with this concept. It would take an awfully long time for our liquidity to run out – a year, maybe.”*

A leverage ratio is coming, but as a backstop or a binding requirement?

More than capital or liquidity, the leverage ratio has stimulated vigorous debate among banks and regulators, and between banks themselves. While participants expect a leverage requirement will be adopted, they disagree over whether it should be a backstop or if it should be more binding relative to RWAs. Some participants argue that it is better to ensure banks use common risk weights in determining their capital levels, rather than have an additional leverage ratio as the way to force harmonization.

However, arguing against a leverage ratio may be misreading the state of debate, with one regulator commenting before the summit, *“There is more and more consensus that we need to have risk-weighted capital and leverage ratios ... I don’t think we can do without RWAs, but the leverage ratio is a good backstop.”* Another participant noted that, in effect, supervisors in some countries are already applying a leverage ratio. This participant offered the example of the UK Prudential Regulation Authority (PRA), which in June forced several institutions to raise capital because of their stressed leverage ratio.

If a leverage ratio is adopted, the question then becomes one of calibration, specifically, at what level will the leverage ratio be set and how will its denominator be defined in terms of risk coverage? While it appears likely that there will be different leverage ratio requirements across jurisdictions in

excess of the 3% minimum proposed by the BCBS (as suggested by the recent US proposal for systemic institutions), the key issue is to ensure a common definition of the leverage across jurisdictions, with one participant saying, *“the challenge will be having a common measure in the EU and US [United States].”*

The RWA debate relates to simplicity vs. complexity

At the core of the debate on the leverage ratio is the relative value of risk-weighting assets and the accuracy of banks’ complex internal models. A regulator at the summit addressed this challenge, saying:

One of the biggest dilemmas we face is models versus simple leverage rules. There was – and is – logic to relying on models, particularly if the models are about how you manage your business, not merely how regulators ask for information. Basel II was not implemented properly, including in Europe. It opened up the gate [to capital arbitrage] for everyone. The question is can we do Basel III properly? What is “properly”?

Understandably, the industry is frustrated by the changing preferences of regulators and supervisors, with one participant saying, *“It’s very damaging to just say you [the regulators] now don’t trust the models.”* Complicating the issue of internal models is the fact that there is wide variation in model output between banks and across borders. One regulator said, *“The challenge is the 20% variability in models across banks could mean 1%–2% difference in the amount of capital being held [at banks].”* Another regulator added:

RWA variability is a major issue. There is a real lack of comparability, and we worry about the differences. We may need a Basel IV ... this is the next big thing [to address]. We have three policy choices: we find the sources of variability and [try to develop

responses to] narrow the range of variance; we look at standardized risk weights; or we look into a higher leverage ratio, and use it as a backstop to the risk-based capital approach.

Each of the approaches outlined above have inherent trade-offs and challenges, which will have to be weighed as regulators seek to find a better balance between risk sensitivity, comparability, and the simplicity of the capital framework.

There is pressure to rely even less on short-term funding

Regulators have given increased attention to liquidity and short-term funding, with some viewing bank dependency on short-term wholesale funding as a source of systemic risk. A regulator remarked, *“We have not seen much reform on the reliance on short-term wholesale funding. [That reliance] creates macro- and micro-risks that need to be addressed.”* A recent statement by Daniel Tarullo shows that the Board of Governors of the Federal Reserve views this reform as a priority: *“We need to consider carefully possible additional steps in areas such as securities financing transactions to address the potential for runs in short-term funding regardless of whether the borrower is a large, regulated institution.”*⁴ While a range of responses have been discussed by the likes of Governor Tarullo and the Federal Reserve Bank of New York President William Dudley, there appears to be a preference for requiring large banks reliant on such funding to hold additional capital.⁵ In the view of regulators, this would force those institutions to internalize broader systemic risks such as fire-sale and run-risk. Some participants viewed the regulatory effort to contain short-term wholesale funding as a backdoor approach to addressing the issue of institutions being too big to fail, with one saying *“[Governor] Tarullo has said he doesn’t want to break up large banks, but he and others do think that banks are just too big, so they are using other ways to make us smaller. [It’s] sleight of hand.”*

Trapped capital and liquidity are a new reality for banks

It is becoming increasingly evident that national differences in capital requirements and ring-fencing proposals will lead to new reality of trapped capital and liquidity for banks. Varying proposals on ring-fencing – financially separating some parts of banks from others, either by business or geography – are at different stages in the United Kingdom, continental Europe, and the United States, ranging from hotly debated to nearly dormant. Beneath the differences lies a shared intent: to ring-fence capital and liquidity by jurisdiction and to require national-level governance structures. In the United States, under the Federal Reserve’s new proposals, “Foreign banks will have to ring-fence their American operations into separately capitalised and regulated subsidiaries; they may also have to be separately funded.”⁶ One regulator at the summit stated, “Regardless of the efforts to reach common global standards, local requirements will continue to be a major focus for national regulatory authorities, resulting in subsidiarization, trapped capital and liquidity, and local governance requirements.”

There has been a growing focus on separating retail and investment banking in several major financial markets. The UK Independent Commission on Banking (whose findings are known as the “Vickers Report”), for example, recommended ring-fencing local lending retail arms that will require operational and financial independence.⁷ In Europe, the European Commission is still considering the recommendations of the Liikanen Report to ring-fence trading activities. One participant at the summit said, “There are still a lot of decisions to be made. Take Vickers: there are still some important questions about what is inside the retail bank.”

Nationalistic approaches to ring-fencing capital within borders have been a source of great

consternation for participants. Prior to the summit, a director outlined the impact this approach would have, saying:

Capital is defined by national boundaries and being trapped because it’s measured by each country. Banks are now having trouble doing business outside their borders because capital is no longer fungible.

“Without a [harmonized capital] agreement, we’re seeing a disappearance, or downgrading, of international banking.” – Director

Another participant stated, “The structural changes will be years in the making, with ring-fencing at the heart.” However, one regulator at the summit disagreed with the notion that the industry is only now starting to have different structural rules by country: “Banks overstate concerns about structural reform. Yes, we have Volcker, Vickers, Liikanen, but we have always had different restrictions [on structure] in place across borders, such as Glass-Steagall [in the United States].”⁸

Developing workable recovery and resolution plans is critical

How to resolve the issue of too-big-to-fail institutions has been at the center of the political debate around regulatory reform since the bailout of many banks during the financial crisis. While prudential reform has focused largely on making banks less likely to fail, it has also addressed the issue of resolution, should failure occur, through recovery and resolution plans (RRPs) or “living wills.” While participants believe that developing workable RRPs is critical, there was also consensus that significant work remains to be done in what would be a multi-year process.

Banks and supervisors have gotten value from the RRP process

Both international and domestic policymakers and regulators have been active in this area. In 2010, the Financial Stability Board (FSB) proposed that banks write RRPs to increase the likelihood that governments would be able to resolve a large financial institution and the market would be able to avoid broad disruption without resorting to taxpayer support. In the 2012 summit *ViewPoints*, a supervisor emphasized the importance of effective resolution mechanisms saying, “We must address resolution, otherwise we are pinning the badge of too big to fail on [SIFIs (systemically important financial institutions)], and we must live with the consequences.”⁹ Indeed, a number of participants have noted that SIFI designation could actually provide these institutions an unfair competitive advantage relative to non-SIFIs if markets believe they enjoy an implicit government guarantee (see call-out box below). Accordingly, development and approval of RRPs has proceeded at varying speeds in the United States, United Kingdom, and

Europe, and to encourage faster adoption, the FSB has released multiple reports providing guidance.

One regulator at the summit stated, “*Resolutions and recovery plans are very incomplete. It’s like developing a will: it’s hard for the family to do, and it’s no fun, but they are important.*” Despite the challenges already encountered, banks and regulators have derived at least some value out of the process. Some industry participants acknowledged that developing RRPs has encouraged banks to simplify legal-entity structures and has led to rationalization. Prior to the summit, a participant commented that RRPs have “*helped management think differently about their firms.*” Benefits have also accrued to regulators, with one recently stating:

What we learned from the crisis is how complex financial institutions are. The RRP is an important exercise in this context. It helps us understand the institutions ... No matter how complex resolution will be in practice, it is very important that [regulators] understand the options we have and the important connections in the organization.

SIFI status raises many questions that have yet to be resolved

In 2011, the Basel Committee published its assessment methodology for identifying global systemically important banks (G-SIBs), so named because of their size, complexity, interconnectedness, and lack of substitutes.¹⁰ The committee said it was necessary to establish this designation, and regulations for such entities, because of “negative externalities created by systemically important banks, which current regulatory policies do not fully address.”¹¹

However, many market participants question the possible unintended consequences of the G-SIB and SIFI labels. For example, will applying the label of SIFI to an institution imply that it cannot be allowed to fail? Will all SIFIs receive government support? Will SIFI designations limit cross-border merger and acquisition activities? Will firms designated as SIFIs accrue more advantages, such as improved client or customer retention, as well as easier and cheaper access to funding? And finally, will higher capital requirements, tougher resolvability standards, and more intensive supervision ultimately outweigh the benefits of SIFI status?

But the challenges ahead are immense

However, as banks have developed RRP and worked with their regulators, it has become clear that they are only at the beginning of what will be an iterative process. The RRP will continue to need adjustment as the sector moves toward the development of a credible global resolution regime.

“We have only just got to the difficult questions on resolvability. The challenge is the politicians are impatient and want it completed.”
 – Regulator

Participants discussed several challenges that banks and regulators will face on RRP, including:

- **Building additional bail-in capacity.** Securing adequate trust among regulators and key stakeholders will depend greatly on banks having sufficient top-of-the-house (e.g., holding companies in the United States) bail-in debt that can be used to recapitalize distressed subsidiaries. A key determinant of investor appetite for bail-in debt will be the degree of transparency regarding how the bail-in decisions are made and where investors stand in the hierarchy of liabilities. Some participants noted that the investors for certain bail-in instruments, such as convertible debt, are likely to be institutional investors and pension funds, prompting one to question whether we solve the problem of trying to avoid *“using public money by using the public’s money.”*
- **Managing structural change.** One regulator warned that as plans are refined, regulators will likely ask banks to make more difficult changes: *“The changes [that have taken place due to RRP] so far have been [in banks’ self-interest], mainly to improve*

efficiencies. But banks have not yet been told to do the expensive things to make themselves resolvable yet. We have not gotten to the much more costly [structural] changes that [regulators] will ask of the banks, and [those] could be significant.” How far regulators plan to go in this direction remains unclear, but the regulator’s comments imply yet more significant organizational changes ahead.

- **Using single or multiple points of entry.** Ultimately, regulators have to determine how they manage the resolution of a major bank. FSB guidance in July put forward two resolution mechanisms: a single point of entry (SPE) approach, applying resolution powers at the parent company level by a single authority for banks that operate as an integrated group, or a multiple point of entry (MPE), applying resolution powers to multiple parts of the group by multiple resolution authorities for banks that operate as locally capitalized subsidiaries.¹² Before the summit, one BGLN participant noted that, for the SPE approach to work, *“there needs to be a high degree of trust among the regulators.”* At the summit, one regulator remarked, *“SPE is impossible. MPE is the approach we will take.”* Another participant commented that *“the SPE approach will only work in mainly domestic institutions.”*
- **Clarifying how RRP will work in crisis.** Most participants believe that in times of crisis, national self-interest will ultimately supersede other considerations and that regulators will first look to protect local taxpayers and depositors. Broadly speaking, markets also remain skeptical that governments will allow their largest banks to fail or risk systemic contagion. One participant added, *“The dependence on resolution is worrying. It ... assumes you can sell assets at the preplanned price, and that you can find a buyer.”* Participants noted that not only will the market be unpredictable, but investors and

counterparties may not assume that any individual resolution action is idiosyncratic, and fear of contagion could impact other institutions, as was the case in the last crisis.

- **Limiting trapped capital.** Several participants feared that a lack of trust in cross-border resolution could further exacerbate trapped capital within borders. Speaking before the summit, a participant said, “[Resolution planning is] a very important issue, and we all agree that it’s been a useful exercise, but if people don’t believe in cross-border resolution, then it will lead to balkanization and trapped capital. You’ll get what we’re seeing already, which is an intensely nationalistic focus.” The global effort to address cross-border issues is proceeding very slowly, and in the meantime, national authorities are moving quickly to protect their local interests.
- **Dealing with distrust among regulators.** Regulators acknowledged that trust among them remains low and that there is limited progression developing the necessary protocols for working together in crisis, but they also recognize that it is essential to make cross-border resolution plans workable. One participant at the summit lamented, “We are so far apart on regulators trusting one another.” Another said that if the resolution is viewed as a firm-specific event, coordination could be manageable, but if it is viewed as systemic, “it will be every country for itself.”

Though progress has been made, many summit participants were surprised by the many challenges still ahead in resolution. Additionally, some thought that the emphasis being placed on resolution is misguided, with one saying, “Some regulators still seem to think the silver bullet is resolution. But we’re never going to get there. It is an odd concept: start with resolution and work back from there in terms of necessary reforms.” Despite these remaining challenges, most

participants acknowledge the importance of making institutions more resolvable and increasing the probability that future crises can be better managed than in the past.

Stress testing will become banks’ annual health check

Summit participants agreed that stress testing – evaluating a bank’s capital levels in the context of certain adverse conditions – is likely to become common regulatory practice globally – what one person called the annual health check for the banks and the system at large.

Stress testing became a prominent supervisory tool for many major regulatory agencies, notably in the United States, after the onset of the financial crisis. Many participants said that, initial complaints about cost aside, the tests have become a valuable tool for supervisors (and banks) to understand both individual and systemic risks, and they have increased confidence in the financial system, at least in the United States. One participant said, “It is expensive and time consuming, but the concept of stress testing the balance sheet and future earnings capability is useful, and I expect, based on what we hear from regulators globally, that it will come to the rest of the world.” Several participants acknowledged the benefits of the Federal Reserve’s CCAR and that it is a tool that should be exported. In Europe, many view the Asset Quality Review (AQR) being conducted by the European Central Bank (ECB) as precursor to a more robust and transparent stress test framework. The United Kingdom’s recent proposal for a sectorwide stress-testing framework provides another example.

However, some participants expressed concerns about stress testing. Notably, some thought the process had become too rigid, with one director warning of the dangers of moving “too far towards standardized models so everyone thinks the same.” The fear is that if regulators compel banks to replace their unique internal approaches

with standardized stress test models, they may create new forms of systemic risk based on model uniformity. Other concerns focus on the degree of transparency in the process, with some participants believing that the public nature of the stress test results without accompanying disclosure of the process and assumptions behind the stress tests might exacerbate, rather than relieve, market concerns. Capital stress-testing exercises have also engendered political interventions, notably in Europe. The most contentious aspect in Europe was the effective risk-free weightings applied to government debt – many believe that political pressure, prompted by fear of runs on the debt and the challenges that governments would face in recapitalizing the banks, led to that decision. The ECB is now under immense pressure to ensure that the upcoming AQR and stress test are transparent and credible.

Despite progress, uncertainty and challenges persist

Summit participants were alarmed at the thought that, if anything, the industry is only halfway through the reform agenda. While welcoming the progress in banks' soundness and the benefits accruing from more capital, stronger liquidity, stress-testing, and resolution processes, they concluded that getting consistent standards for capital, liquidity, and leverage will take years – if consistency is ever achieved – and they fear an effective resolution process may take longer. Participants shared ongoing concerns about the approach to implementing reforms and the degree of uncertainty this will create for at least the medium term.

Balkanization of regulation continues to get worse

The divergence between the stated aim of increasing international coordination and the actual focus of national regulators on protecting local interests continues to concern participants. For the past several years, participants have

highlighted the fragmentation of the reform agenda, with one observing, *“There is an increasing volume of regulation coming from various international regulators at the same time as we are seeing increasing nationalism of domestic regulators.”* Despite the efforts of the Group of Twenty (G20), FSB, and BCBS, among others, participants believe that it will take many years to resolve cross-border issues. A regulator acknowledged that *“progress on cross-border issues is unclear,”* and said that although regulators are working at building trust, *“the default is balkanized approaches.”* Acknowledging the consequences of balkanization, one regulator said, *“addressing [balkanization] is crucial to the future of wholesale banking – we are damaging the free movement of capital.”*

“The balkanization of regulation and trapped capital is a real challenge to global banking.” – Regulator

Many bank and regulatory leaders still hope more global coordination is possible. One BGLN participant said before the summit, *“I think the whole coordination issue needs to be addressed – I know politically that may be impossible, but a lot of the problems come from being told to march left and right at the same time by different regulators.”* At the summit, another participant added, *“We need to ensure a degree of consistency in global regulations,”* and a third said simply, *“We need global coordination.”*

Rules continue to change, with no clear final goal

The degree of change and uncertainty as a result of banking regulation is unprecedented in recent history, with many participants finding it prohibitively challenging. Speaking about the rapidity of change, one participant said, *“The constant changes to expected rules are damaging.”*

Banks react to the rules by making changes. Then the rules are changed again.” Many participants also felt that regulation is becoming far too complex and is placing too heavy a burden on directors and management – resulting, paradoxically, in a potentially less safe financial system. One participant said, *“The rules are just too complicated, and that means it will take even longer to apply them.”* The sense that there was not a clear final goal for regulation concerned many participants, with one observing, *“The uncertainty feeds into a sense that the regulations are not complete. The narrative is that nothing has gotten done. Without a declaration of victory, it leaves the view that [the reform agenda] is not completed. It has to be done at some point; it cannot remain unfinished business.”* Some attribute the ongoing rule changes and uncertainty to the political context. One participant remarked, *“The whole reform has become too politicized and changes dynamically [from each] political intervention.”*

However, the reality is regulators don’t necessarily have a clear endgame in mind as they design new regulation, and even if they do within a jurisdiction, differences are clear across borders. Many participants felt that regulators need to clarify their future vision and expectations on reform.

“What are the key objectives and priorities of regulatory reform?”
– Participant

One participant said, *“I still don’t know what problems we are trying to solve. What is the endgame?”*

Regulators acknowledged that they need to better clarify a destination. One regulator commented, *“We still need to define the end point, not an incremental path to somewhere.”* Another admitted, *“There is still a debate about the end*

point. Have we gone far enough?” Regarding capital, one regulator said candidly, *“We do not have collective view on how much [capital] is enough. The vision for where we are going is fuzzy ... The costs are unclear, and the effects distorted.”* Another agreed, saying more broadly about the direction of policy, *“There is an uneven perspective among regulators.”*

Analysis of the costs and impact on growth is insufficient

Several summit participants thought that regulators’ analysis of how reforms will impact the ultimate safety of the financial system and the industry’s ability to support new global economic growth was insufficient. One participant remarked, *“The question we should all have about the new regulations is will they work, and at what cost?”* While some consequences of the reform agenda are intended – smaller, simpler, less risky banks – other, unintended consequences remain unstudied and unclear.

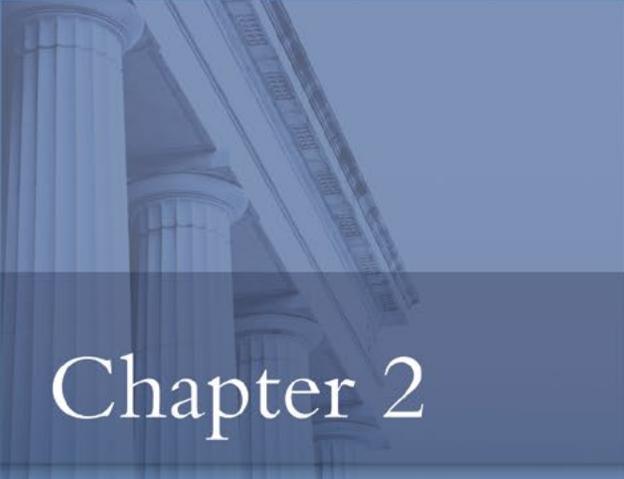
Some participants called for a pause to take account of changes under way before moving forward with additional reforms, whose costs and benefits are less clear. Said one regulator, *“We need to step back and assess what we have done and where we going. We know that [more] complexity doesn’t work [as a solution].”* Countering that sentiment, another regulator said, *“Where are we today? We have done a lot, but we have very incomplete implementation. It is very hard to assess the costs and benefits until we conclude the reforms.”*

Directors and executives are most concerned about the overall impact of regulatory reform on economic growth. One criticized regulators, saying, *“Regulators don’t seem concerned about growth.”* But another had a more optimistic view: *“The political pressures are making it hard to call a halt to reforms to focus on growth, but there are welcome signs that politicians and regulators are becoming uneasy about the impact on growth.”*

Conclusion

In reality, the mind-set of banking leaders has greatly changed over the last 12 months. Those waiting for the regulatory pendulum to swing back, or at least for clarity about where the pendulum will stop, have been forced to accept that regulatory uncertainty is the new norm, and that it's not going away anytime soon. One director said, *"The industry is making progress and working through the stages of grief. First, we had denial. Then we had anger – it wasn't just our fault ... Then some bargained, hoping for the clock to roll back ... Then there is despair, and some are still there. But then there's acceptance, and slowly we are getting there."* More and more bank leaders now acknowledge banks' position in the middle of a long journey.

*"We are nowhere closer to the end.
We have to live with it. We are a
long way from business as usual."
– Director*



Chapter 2

A new standard for effective
board governance

Investors, regulators, and board leaders themselves called for enhancements to governance at large banks following perceived failures of governance leading up to the financial crisis. Supervisors, too, have enhanced their approaches and have heightened expectations on bank governance, although more work is needed to translate these expectations into clear supervisory guidance. For many boards, this has meant changes in personnel and processes as new directors came onto boards and new committees were formed to improve risk oversight, especially risk committees where they had not previously existed. Some boards have added committees including technology committees, committees focused on integrity and reputation, and in at least one case, a financial system vulnerabilities committee. Directors are spending significantly more time on their role and the level of detail of board oversight across a range of business and risk issues has increased.

The engagement required from bank directors will remain high

At the first Bank Directors Summit in 2009, a director remarked that the expectations on directors of large banks had increased substantially and would not get any easier in the near term. At this year's summit, one director asked, *"What is the limit to the expanded expectations for NED [non-executive director] engagement? We went from too light touch to a 50 percent (time commitment) job. What is the business as usual expectation?"* Depending on the level and nature of their engagement before the crisis, some NEDs estimate the increase in time devoted to their role as ranging anywhere from 50 to 300 percent. A director said that at least one day of preparation is required for each board meeting, and they review press about the bank and analysts' reports almost daily. In addition, directors are finding time to get to know key people in the organization outside of formal meeting interactions. This includes senior executives, but also employees one or two levels down from the C-suite in the businesses and key

risk and control people. Increasingly, they are also meeting regularly with supervisors.

"Increased engagement was not a temporary matter – it hasn't been a spike, but a permanent change."

– Director

At the summit, regulators made clear that their expectations for the time directors spend have increased – one regulator suggested that the typical NED should spend 100 days a year on the role. The regulator stressed that *"there is a difference between a director at a regulated financial institution as compared to other industrial companies,"* and the commitment is greater. One participant drew a parallel to historical commitments of boards, asking, *"What was the job of a bank board in the 19th century? It was more involved than what we saw in the decade leading up to the financial crisis ... We need directors to understand the business – why are we in the businesses we are in and where we are in them?"*

These enhanced expectations raise a number of fundamental questions regarding the role of boards. Prior to the summit, one director questioned whether the changes to board governance have been sufficient to address the challenges of the modern business environment: *"Boards, especially at financial institutions, are at the apex of the capitalist pyramid, but business changes, globalization, have moved on so quickly, that boards and governance have probably not adapted enough ... We need a new playbook."* During the summit discussions a regulator posed a related question about the current expectations for bank governance: *"The dilemma we have is, is the model we have moved to sustainable? And if it's not, what is the alternative? It is not hard to conclude the approach pre-crisis was not working."*

Among the challenges facing boards discussed at the summit:

- **Compliance continues to dominate board agendas.** A director articulated the concern of several participants about the time commitment expected of bank directors: *“It is not so much that the board is being asked to spend too much time. It is the question of the balance of how the time is spent.”* In particular, many directors question the value of boards spending more time ensuring that the bank complies with regulations and delving into greater detail than may be valuable. A director protested, *“The focus on compliance is drowning out our ability to discuss strategy and talent.”* The result, according to some participants, is that regulators are increasingly the primary stakeholders in banks, which may crowd out the board’s ability to focus on strategy, business models, and building profitable institutions for their other key stakeholders: shareholders and customers. It may also actually have the opposite of the desired effect, by distracting directors away from managing the actual risk of the firm.

With board books reaching as much as a thousand pages, regulators are conscious of the potential to overload directors. As in past discussions, some participants suggested that greater clarity in regulatory guidance about board expectations could be helpful. The words ‘review and approve’ often cause confusion about the role of the board. A regulator said, *“We are not looking to blur the lines between the board and management.”*

- **Attracting the best directors could be difficult.** Many boards have added directors in the years since the start of the financial crisis, with a particular focus on bringing in directors with financial services and risk management experience. While participants agree that doing so has been beneficial, they continue to caution against moving too far in specialized

roles. One noted, *“There is a danger we become a group of ‘experts,’ where everyone defers to the director with the most expertise on a given issue.”* They insist that a broad mix of experience is best, allowing directors to apply business judgment, rather than making the board role too technical. The challenge, according to one director, is that *“it is harder finding the right mix of board members: the risk is higher but the reward hasn’t changed.”* The time commitment is also making it particularly difficult for sitting executives to serve on bank boards. One participant stated, *“The current expectations mean it is very hard to attract sitting CEOs, or even senior executives. That is a loss. CEOs are more able to push back on CEOs.”*

Management can be the best safeguard or the biggest risk

Participants emphasized the need to keep focused on arguably the most important job for directors: ensuring that the right management team is in place and is executing effectively. This is not just about effective execution of the strategy – in the view of some participants it is the most essential safeguard against failure, trumping all of the prudential reforms. A director observed, *“We keep talking about capital, liquidity, etc., but the word ‘management’ wasn’t mentioned once. There is this notion that if you have capital and liquidity you don’t need to worry anymore. That just isn’t true. Management needs to be focused, because if things go wrong, that will be the only thing that matters.”* Another participant went a step further, stating, *“The causes of the crisis in the banks that had the most difficulties were in many ways managerial. Don’t underestimate management’s ability to screw up. So, succession planning and governance structures need to get more attention in the stability, reform discussion.”*

“Management’s ability to wipe out capital is often underestimated.”

– Participant

Participants discussed the role of the board in ensuring they have the right management team in place for the current environment. They concluded that boards should:

- **Hold senior management accountable.** A regulator observed, *“What is the role of the board? To hold the CEO to account. So how well does that work? Not always very well.”* Another participant added, *“History has shown that CEO performance is patchy.”* According to a participant, boards need to ensure that management is striking the appropriate balance: *“The seminal question for governance is the culture around bank leadership’s view of its role: how much of their reason to be is to drive the business as opposed to manage the business? Driving the business can cause risk to go in one direction, causing it to tip over, whereas management should be trying to keep the boat steady, a bias toward stability and diversity.”*
- **Focus more on succession planning.** Given the environment in which banks are currently operating – and anticipating the shape of the world in which they will operate in the foreseeable future – a participant said that boards need to consider the following: *“What does leadership really do? How do they actually spend their time and with whom? It will help you understand what skills you need in your leadership team – do we have the skill sets? Are there deficits in potentially dangerous areas? You may need different skills now than what got you to where you are. You should be looking at succession a level or two down below the C-suite.”*

- **Support management under regulatory pressure.** Management is under added stress and fatigue from the reform agenda. A chief risk officer said after the summit that two of their top risks are execution risk and people risk, *“given the huge amount of initiatives underway.”* A key element of management’s role has shifted to engaging with regulators and policymakers. A summit participant commented, *“Washington is becoming the home away from home for bank leaders ... Building personal relationships with regulators is very important. We need to make them part of the collective solution. We are in this together. If you have that constructive relationship, you will have more credibility in pointing out differences. Regulators are tired too.”*

The importance of management has led to more supervisory engagement in the selection of key executives in banks. Supervisors have insight into the relative quality of executives across the banks they supervise. Therefore, a director said, *“Benchmarking from supervisors is of great value. Even force-ranking senior executives relative to others in the industry ... Or providing insight into how domestic banks compare to global banks using some simple measures.”* But participants were clear that the board is best qualified to make the ultimate hiring decisions about management, and that responsibility, even in the form of approvals, should not be left to supervisors. While supervisors should have a view, and be willing to express it to the board, they should not select management.

Compensation: an unresolved source of controversy

Compensation levels in banks are one of the most publicly sensitive and politically charged issues for banks and their reputations. As a result, regulators and supervisors have been exerting influence over compensation, though in quite different ways across markets, sometimes through rules and

sometimes through supervisory influence. A director described the impact: *“There is complete fragmentation on an international basis, and for a multinational company, it makes life complicated. [One regulator] just said, ‘We don’t think you should pay that person so much.’”* In the summit discussion, a regulator stated, *“One thing I think is still to be done is addressing compensation.”*

Prior to the summit, a director noted the importance of addressing total compensation, not just making adjustments to incentive structures, saying, *“We’ve looked at rebalancing fixed compensation relative to bonuses ... but no one has looked at total compensation. It’s extraordinary that a business that hasn’t washed its face on its cost of capital is still paying the salaries it does.”* At the summit, a director noted the importance of compensation in reducing costs, which can account for as much as 40 to 50 percent of adjusted revenue in banks.

While most banks have made significant changes to incentive structures – increasing the use of clawbacks and adjusting incentives to focus on longer term objectives and in some cases, reducing absolute compensation levels significantly – some directors and regulators see their work as incomplete. Participants concluded the following at the summit:

- **High compensation equates to risk.** One participant said, *“We identified material risk takers, but it is hard to define and difficult to get agreement on. It is too ambiguous. We should just base it on average pay – those with high pay are taking risk by definition.”* Another agreed with a simplified approach: *“If you really want to understand where risk is taken, look at the top 100 people by compensation, by title. If you see a title that doesn’t intuitively fit, that’s a good place to probe.”*
- **Deferrals and clawbacks are better than caps.** Summit participants generally do not see attempts to cap incentive compensation

through regulation as an effective way forward. One stated bluntly that the provisions aimed at capping bonuses in the EU’s Capital Requirements Directive IV are *“absurd,”* and will simply drive up base salaries. However, all participants broadly agreed about the importance of increasing deferred pay. Some banks have increased vesting periods for cash payments to as much as five years. A participant asserted, *“Real clawbacks are important. People ask why more people have not gone to jail after the financial crisis, and the answer is few did anything illegal. But one of the big regrets from the financial crisis is that more of the problem children who were making a lot of money didn’t lose their compensation. There is nothing like money to capture people’s attention.”* Another said, *“Pay should be 50 to 60 percent deferred. That should be a fact of life.”*

- **Major reductions in pay now could be demotivating.** Making material changes to compensation in a very demanding environment, where, as one participant said, *“the risk of burnout is quite high given this reform agenda,”* means that *“changes in compensation could be demotivating given the timing.”* Still, some directors suggest that the risk of losing people may be overstated, with one commenting, *“Do you really want ‘mercenaries,’ working for the highest bidder? I don’t think so.”* Similarly, some see the differences across jurisdictions that are already coming into play as evidence that mass defections are unlikely.

One challenge put to boards by a summit participant, which could reduce excessive compensation, is determining *“whether success is the result of the market or the individual. People should get paid well in a very difficult and demanding business, but it should be because of what they did, not because of the franchise or the market.”*

Continuous board–supervisor engagement is essential

In general, supervision has become more intensive, and some would say more intrusive, as supervisors have delved into a range of issues traditionally left to the board and management. Supervisors, as part of their evolving supervisory models, are increasing their engagement with boards, particularly with chairmen, lead or senior independent directors, and members of key committees and committee chairs.

The Financial Stability Board’s Supervisory Intensity and Effectiveness (SIE) Progress report on implementing the recommendations on enhanced supervision noted that prior to the crisis, “Supervisory work was often not geared toward ‘outcomes’ but more focused on process,” and “supervisory expectations for SIFIs in particular needed to increase.”¹³ As a result, supervisors globally have enhanced their focus on core strategic and business model issues, and conducting more comprehensive reviews of governance and risk management in the largest banks. Many regulators have stated their intentions to intervene more readily in management and board decisions if they deem it necessary.

At the summit, a director noted, *“Regulators veto management decisions in many countries. How far does that go?”* A regulator stated, *“The fact is we have moved to judgment-based, forward-looking supervision, and that makes us more interventionist.”* While the level of interventionism varies by country, most supervisors have become more proactive in sharing their views and intervening when necessary. As a result, some directors feel that regulators have become a primary stakeholder for banks, limiting the board and executives’ decision-making in a way that calls into question the very role of the board, what one participant described as *“micromanagement.”* One director even questioned, *“Why do we need boards anymore?”* But another asserted, *“Regulators are not qualified*

to do the job of the board. But this period of interventionism is a necessary stage in the rebirth of the industry.”

All participants agree that it is essential in this environment that boards and supervisors communicate openly and often. As discussed over the course of a number of BGLN sessions, building a trusting relationship through ongoing engagement is a goal of supervisors and boards alike. Even those who question the level of intrusiveness of supervision acknowledge that supervisors should have a view on key board and management decisions and should share it with the board, including via benchmarking. Then, a regulator said, *“we should be clear about when we are talking about standards and guidelines and when we are offering supervisory judgment regarding what isn’t working.”*

“There are real questions about whether supervisors will be effective.” – Regulator

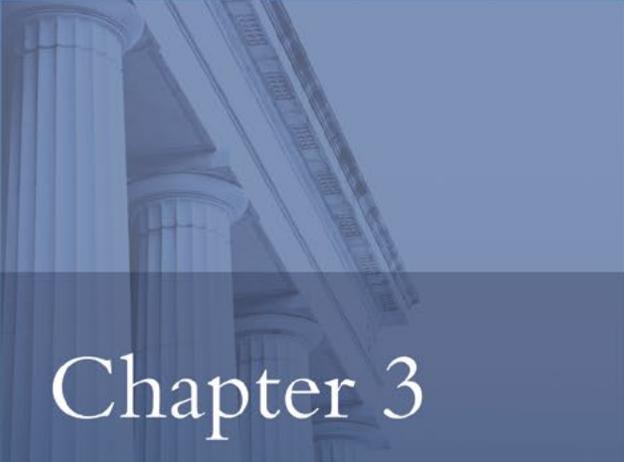
BGLN discussions throughout 2010 and 2011 brought supervisors and directors together to focus on how to make this engagement effective, and outlined the challenges for supervisors in their efforts to assess governance effectiveness.¹⁴ A supervisor acknowledged in late 2012 that “It is very new and a work in progress,” while another said, “We have a ways to go yet.”¹⁵ At the summit, a regulator said that their agency now requires lead supervisors to meet at least once a year with the risk committee, audit committee, and full board. Others are requesting meetings with directors much more frequently, and some directors have proactively scheduled meetings with key regulators as often as quarterly.

There is a range of benefits to this increased engagement.¹⁶ One is improved insight into governance effectiveness for supervisors. As one director said, *“The board evaluation forms tell you almost nothing.”* Regulators said they are still

looking for credible challenge from boards, in particular regarding *“acquisitions, new product approvals and business modifications – we want to see what kind of interaction there is between the board and the executives, how strong the personality of the CEO is,”* according to a regulator at the summit. So, a director asked, *“How do supervisors know it’s not working?”* A regulator said that they would develop a sense over time, based on *“a series of problems, attitudes and tone at the top, or if there is not enough challenge from the board.”*

Conclusion

Prior to the summit, a regulator acknowledged the BGLN’s *“contribution to the global discussion about governance over these past few years,”* noting, *“It is clear that the conversation is moving forward, perhaps not at breakneck speed, but forward.”* The summit discussions clarified for some that, indeed, the role of large banks in the economy and the heightened risk of failure mean that the expectations on bank directors will remain elevated relative to those of other companies.



Chapter 3

Heightened expectations
for risk management
and controls

Since 2008, a number of initiatives and reports have focused on the failings of risk management that exacerbated the financial crisis, notably the Senior Supervisors Group report, *Risk Management Lessons from the Global Banking Crisis of 2008*, which outlined a number of “deficiencies in the governance, firm management, and internal control programs.”¹⁷ The pressure on risk, controls, and compliance has intensified over the past five years, and it looks set to continue.

Following a number of reports from officials and industry groups on needed risk management and governance improvements, the FSB’s SIE Group has issued a number of reports, including one on a thematic review of risk governance issued in February 2013, which acknowledged improvements to risk management and governance in banks but also noted, “Although many surveyed firms have made progress in the last few years, significant gaps remain, relative to the criteria developed, particularly in risk management.”¹⁸

Most directors report real benefits from the efforts their banks have made to improve risk management and governance. But a range of losses and operational risk and compliance issues continue to challenge risk governance. As many risk executives and directors will note, improving risk management and governance is an ongoing challenge, with the goal of achieving a better balance between strategic business decisions and an understanding of the associated risks in order to get a better risk-return outcome.

Regulators continue to look for improvements across a number of areas, including:

- **Implementing risk appetite frameworks (RAFTs).** Banks and supervisors have continued to focus on how group-level risk appetite statements can be disseminated to the organization through effective implementation of broader RAFTs. As supervisors increasingly

try to determine whether RAFTs are effective, BGLN discussions on the topic have highlighted a lack of clarity regarding what is included in the framework and the expectations for it relative to broader risk management processes, making for some challenging discussions between supervisors and banks. This subject was a focus for supervisors, including the FSB, which published a consultative document, *Principles for an Effective Risk Appetite Framework*, in July.¹⁹ A regulator said their objective is developing a “*common terminology, clarifying risk appetite objectives, ensuring risk appetite frameworks include quantitative and qualitative metrics, describing the elements of the RAFT, and outlining roles and responsibilities.*”

Discussion at the summit focused on integrating qualitative statements and metrics and embedding the risk appetite across the range of business decisions. One regulator said, “*An ongoing challenge is finding the right balance between quantitative and qualitative measures ... and the search for a universal or global measure of risk appetite that can be allocated to the businesses, e.g., capital or earnings at risk.*” A director acknowledged, “*Because we are financial companies, we tend to focus on the quantifiable, those things that can be calculated at 95 percent probability,*” observing that now, “*operational risk is the biggest.*” To determine whether the risk appetite is embedded, a regulator said it must have “*a forward-looking component beyond the one- to two-year plans and be linked to performance and compensation ... We want transparency around how risk appetite is embedded in decision making.*”

“The use test is whether risk appetite is used in strategic, capital, and business plans.” – Regulator

▪ **Measuring and mitigating operational risks.** The big question is how to quantify and include in the RAF more difficult-to-measure risks like operational, consumer protection, and reputational risk, which do not lend themselves to the type of quantitative measurement models used for market and credit risk, but which can produce major losses and associated hits to capital. Inevitably, metrics remain relatively crude, and in many cases have been ineffective. The proper approach to predicting necessary capital cushions for such risks is also a matter of debate and discussion. For example, some of the Basel III calculations for operational risk are based on historical data, resulting in disproportionately greater future capital requirements because of these unprecedented past legal costs. A summit participant said banks and regulators would prefer to “*wrap all of this stuff up into a big capital number, throw money at it and get ahead of it.*”

▪ **Improving the depth and breadth of talent in the risk and control functions.** Along with the elevation of strong risk management come questions about the depth of the risk team and succession planning. Because the risk function has to be seen as an enabler of effective risk taking, and not simply part of compliance, the levels and types of experience needed in the staff may expand. Many in the risk function tend to have specialized technical expertise, but broader management and communication skills are also increasingly important. Attracting the right talent to the risk function involves it being viewed as an attractive career opportunity for bankers and others.

Regulators at the summit expressed support for greater mobility into and back out of risk and control functions. Some participants noted that those jobs should have improved compensation and career trajectories associated with them. One participant said, “*Developing*

leaders and giving them risk management exposure is important ... Instead, we have this tribe of people called ‘risk specialists.’” However, “*There are different skills you are looking for in different roles. Mobility is more the exception.*” Another director suggested alternative approaches: “*You can get risk management exposure without being a risk manager. We have management committees, etc., focused on risk.*”

▪ **Improving risk data aggregation and reporting.** Ideally, banks have IT systems that can gather risk information quickly and comprehensively, but few are satisfied that they have a fully automated process to do so. In January 2013, the BCBS issued its report, *Principles for Effective Risk Data Aggregation and Risk Reporting*, which states that “making improvements in risk data aggregation capabilities and risk reporting practices remains a challenge for banks, and supervisors would like to see more progress, in particular, at [Global Systemically Important Banks (G-SIB)].”²⁰ Regulators remain critical of banks’ IT systems – a recent analysis of large US banks’ capital planning processes by the Federal Reserve concluded the banks have systems that are “antiquated and/or siloed and not fully compatible, requiring substantial human intervention to reconcile across systems.”²¹

Despite progress, some directors still believe that internal risk reporting could be improved. Said one director, “*We get a voluminous risk report. It is still a major project to get better information, to understand what is important, to help the risk committee understand how the organization really works, e.g., how products are approved.*” At the summit, a regulator shared a related worry: “*My concern is that management information system [MIS] is often focused on the data requested by supervisors ... Banks need their own data to use within the risk department. You should be having a discussion about what is necessary for the board*

as opposed to supervisors.” These questions go well beyond IT, as they include issues related to the use of a common taxonomy, the need to validate the quality and reliability of information, and to report accurately on the risk profile in a timely manner in both normal and stressed conditions.

- **Improving risk disclosures.** Recent BGLN dialogues have included discussion with representatives of the investor community about the information asymmetry between banks and their investors and the challenges of understanding the complexity of bank balance sheets, performance prospects, and their key risks. In addition, differences among banks and across regulatory regimes, regarding risk weights, for example, makes comparison across banks and markets difficult. The FSB’s Enhanced Disclosure Task Force issued a report in 2012 identifying fundamental principles that “provide a firm foundation for developing high-quality, transparent disclosures that clearly communicate banks’ business models and the key risks that arise from them.”²² Some have suggested that the current lack of transparency results in higher than necessary funding costs. As one participant said, “*More disclosure is needed.*”

Several summit participants recommended that banks take lessons from other industries in redesigning their risk approach. Supervisors are looking to “safety industries” such as nuclear energy and oil companies for examples of how they instill risk cultures, and they are studying the related literature. A regulator said, “*We had the oil industry come in and discuss this with us. Exxon reinvented themselves after the Valdez spill in Alaska. It gave them a burning platform, a sense of urgency, and an obsessive focus.*” In the same spirit, a regulator said, “*We see great value in post-mortems, trying to determine what went wrong.*”

The ultimate objective: instilling and monitoring a desirable risk culture

At the core of effective risk management is a strong risk culture. As discussed at last year’s summit, shaping culture is a long-term challenge²³ and one that will be unique to each institution. Boards first need an understanding of the culture as it is, then need to articulate what kind of culture they want and promulgate and embed that through a range of mechanisms. This is not a simple task – one director noted that when we talk about culture, we are really talking about the “*behaviors of about 1,000 senior managers throughout the firm. If you can get them to change behavior, you change the culture of the firm.*”

Boards and supervisors are working on identifying metrics and tools for monitoring culture and indicators regarding culture and changes over time. This topic has been a growing area of focus among regulators and the FSB, which is proposing to develop assessment criteria by the end of this year. Ultimately, no risk appetite or control framework is bulletproof, nor can they accommodate every situation. A bank must therefore rely on its culture and ensuring that it is aligned with its risk appetite.

Supervisors are increasingly focused on risk culture. Observed one, “*The work supervisors are doing, including the report from the Supervisory Intensity and Effectiveness group, is very simple and will sound like common sense, but trying to assess risk culture is important because everyone can make huge improvements in some areas.*”

Another regulator shared some insight into how the SIE is approaching the issue:

We are looking at risk culture across four dimensions: 1. Tone at the top and tone in the middle, 2. Accountability – ownership of risk, consequences, openness to dissent

and encouragement of escalation and enforcement, 3. Effective challenge, e.g., the stature of the risk management function, 4. Incentives – performance and talent management and looking for mobility between the three lines of defense.

While supervisors will look for indicators regarding risk culture, this regulator said they are not planning to introduce a new risk culture audit process to supervision, or “*come in and ask for your risk culture binder,*” but instead, “*it is about applying the culture lens to any interaction that we have. The softer ‘so whats’ that we need to draw out consciously – what are the lessons from a culture perspective?*” This regulator also acknowledged, “*Risk culture is not binary good or bad – there are important considerations that relate to the bank’s business model.*” And regulators accept that this is a challenging area for supervisory intervention. As one said, “*[We] realize that it is a difficult discussion when we get into culture and behaviors and we have some real questions about when supervisors should intervene.*”

Supervisors are still questioning whether the frontlines in the businesses are really embracing a risk approach. A regulator observed, “*Is the risk appetite framework embedded in the culture? It is not always clear.*” And a director noted, “*It is difficult for boards to get insight into how embedded it really is deeper in the organization.*” A supervisor was skeptical that the work on risk appetite at the top of the house had really influenced decisions lower in the banks: “*I am not sure things have changed at the desk level. Young people may not understand the risk culture in their businesses.*” As a result, a participant said success will come over time: “*It is about consistent communications about why this really matters in understandable language.*”

“We have realized that we have arrived at the target at the end, which is risk culture.” – Regulator

“Risk culture is part of a broader cultural journey,” as one director said, and is therefore not something banks can simply address through development of another framework, set of controls, or new processes or systems. Doing so is challenging and takes time: a director said, “*Raising the standards for the way an institution behaves is about more than controls, and it is very difficult. It is being asked of banking, and it is a very hard road.*” And while regulators may be primarily concerned with banks engendering safety cultures, directors emphasize the need to find the right balance – to insert additional discipline that enables effective risk-taking, not produce a risk-averse culture that will hamper growth, innovation, and earnings.

“The danger,” another director said, “*is that risk culture can transfer to risk aversion. Some regulators are passing on the message as risk reduction, not risk management.*” A regulator countered, “*It is not about avoiding losses from risk taking. But banks had risks that were not correctly understood or monitored. We want to be confident that firms are able to run their business.*” The key, according to another director, is clear and consistent support from the board: “*There is nothing soft about it from the board perspective. When something goes wrong, fix it and ask the questions, ‘Do we need systems, people changes, etc.?’ That culture being reinforced by the board is key.*”

There are practical challenges to overcome as well. For example, banks operating in different businesses across different markets have multiple cultures. One director maintained, “*Trying to get a common culture across a global bank is quite*

difficult, and maybe not even what we should be aiming for. There are cultural differences in different countries; e.g., in some places, whistleblower lines don't work. So trying to define a universal culture when cultural norms are different is not easy." Still, there should be a range of core values and a shared risk appetite that cut across business lines and geographies.

Controls are still falling short

Since the start of the financial crisis, the industry has amassed a staggering amount of fines and settlements, some \$100 billion, with little end in sight.²⁴ To this one might also add headline-grabbing risk management failures, notably JPMorgan's "London Whale" trading loss, which scaled up quickly to over \$6 billion from initial estimates of \$2 billion, and UBS's \$2.3 billion loss incurred by a rogue trader. As one executive within the BGLN said, 2012 will go down as perhaps the first year that the industry's legal and operational losses outstripped market and credit losses. To many, the industry's woes are largely self-inflicted. For example, as one executive said in a recent Tapestry report, *"We have been shooting ourselves in the foot with these robo-signings and this poor mortgage lending. That was the fault of the industry."*²⁵

Some in the industry have grave concerns about the settlements. Past errors need to be corrected and compensation paid – and indeed, a summit participant emphasized, past wrongdoing acknowledged – but, as one director said before the summit, the authorities' zeal to "outcompete" each other has *"made it difficult to move on, and focus on building a stronger system."* Some argue that political grandstanding has made matters worse.

Yet discussion at the summit suggested that zeal for enforcement was unlikely to wane. One participant questioned whether we could achieve a better balance between the use of large fines, the quantum of which are taking billions in capital out

of the system, and potential alternative sanctions to hold banks accountable. A participant predicted, *"The fines will continue and there will be pile-ons and continuing litigation."*

Whichever view one takes, it is clear that the fines and settlements will have an ongoing effect on the industry and will create practical challenges for all banks, including the ongoing costs. One participant said of the costs, *"The pig isn't even halfway through the anaconda."* The settlement negotiations are also a major drain on senior management time, and the settlements contribute to a continuing *"one-sided narrative"* that suggests banks are not addressing their failings.

Supervisors will press banks for control improvements

The failures outlined highlight the ongoing need to strengthen controls within banks. Banks have had to make significant investments in their compliance, legal, and internal audit efforts in recent years to reduce the likelihood of future problems and to meet heightened supervisory expectations. A regulator said that they expect boards to step up their oversight and demand more of their banks. Said one regulator, *"After control failures, we are expecting the board to assess what went wrong and address issues. If corrective plans are not implemented on time, the board should ask why. And if the problem reoccurs the board has to do a lot more ... The board has to be accountable for the full system of controls."*

"We do expect more of the three lines of defense." – Regulator

Participants discussed the following areas for improvement:

- **Strengthening internal audit.** A regulator said, *"Internal audit has been neglected, but now we expect much of it, for example, evaluating the governance process and risk*

management. It has to have a stronger voice.” New standards for internal audit are appearing, such as in the UK and in the SIE’s reports.²⁶ Another participant noted the importance of internal audit in managing operational and compliance risks: *“The risk department tends to only focus on the business risk. But operational risk is upfront in the audit.”* However, expanding the role and expectations of internal audit means that boards should be assessing their skills, capacity, and stature within the organization. One regulator said, *“Internal audit can validate the processes for monitoring adherence to the risk appetite. But do they have the skills? Can they conduct model analytics? Can they review processes related to a broad range of risks? How are businesses responding to audit feedback? What is the reception to that?”*

- **Improving third-party vendor management and outsourcing.** The control agenda now goes well beyond the traditional internal issues to matters of controls over banks’ third parties. Some bank executives expect a future major supervisory focus to be outsourcing and off-shoring, which are prevalent in the industry. A regulator said, *“We see a lack of proper oversight of vendors. One CEO called in virtually all of their vendors for a vendor day and basically said, ‘The world has changed, we are renegotiating all of our [service level agreements].’”*
- **Upgrading IT and systems capabilities and controls.** A regulator said, *“A lot of this depends on systems and the ability to track and aggregate data ... Unless you’ve got the MIS and controls that allow management to see how people are behaving, you are lost.”* Controls related to cybersecurity and data security are increasingly a cause for concern. Said one regulator, *“The Rumsfeldian ‘known unknowns, and unknown unknowns’ are a continuing concern for risk management.*

What don’t we know? For example, technology risk and cybersecurity – these things will challenge supervisors and banks.”

“If every employee knows that part of their responsibility is protection of the franchise, it covers virtually every risk.” – Director

Consumer protection creates business model and control challenges

One additional challenge for banks in the area of controls and compliance has been dealing with the heightened regulatory and political focus on consumer protection, or conduct risk as it is known in some countries. Tougher consumer protection is likely to become a global phenomenon, with the most striking changes taking place in the UK and United States.

In the UK, the Financial Conduct Authority (FCA) intends to fulfill the objective of “delivering good market conduct” by “look[ing] at a wider range of behavior which damages trust in the integrity of markets or threatens consumer protection” through “a renewed focus on wholesale conduct.”²⁷ The FCA has indicated that there will be aggressive reviews of strategies, business models, and products with a view to consumer detriment, preemptive supervision, and heightened expectations on banks. In the United States, the Consumer Financial Protection Bureau (CFPB) has now completed its specific Dodd-Frank mandates,²⁸ and with the confirmation of Richard Cordray, its embattled director, it looks set to make a splash. As one participant noted on the CFPB’s potential, *“They are now freed from some of the procedural shackles ... and will have wide latitude to focus on other areas of consumer finance.”*

With new regulators and expanded mandates, it is not surprising that many directors and executives

consider consumer protection regulation to be the most significant regulatory challenge ahead. While bank leaders believe that rules like the Volcker Rule are difficult to implement, consumer protection is even more challenging. Regulators have not been very clear on the principles they are using to drive their thinking, so banks are finding it hard to address supervisors' concerns preemptively.

“We are moving from caveat emptor to caveat vendor.” – Participant

Standard industry practices such as bundling, cross-subsidization, and cross-selling may come under more intense scrutiny. Specific products may also be banned or greatly constrained; for example, in the United States, authorities are pressing large banks to stop offering deposit advances (otherwise known as payday loans). Regulators also have shown a willingness to use long look-back time frames, creating large potential liabilities for the industry. Said one director at the summit, *“The regulatory and legal side is always backward looking, and then we hear, ‘You should have caught it.’ But standards also change over time.”* In response, another said his bank is now *“looking over a 20-, 30-, 40-year lifetime to measure and manage the [conduct] risk ... because standards will get tougher over time.”*

After the summit, one regulator warned banks not to misread the regulatory direction: *“Stronger controls and compliance are necessary, of course. But that’s not the real message. It’s that strategies and business models need to take the customer into account. That’s much more difficult.”* This regulator said that without addressing these broader issues, including the overuse of *“financial targets,”* the *“front line [business people] will rely too heavily on the second line [of risk managers] and problems will reoccur.”* Such regulatory thinking suggests major change is ahead – a much more proactive, judgment-based approach.

Conclusion

A director summarized, *“There is a challenge that we are all like the frog in the pot of water – as the water starts heating up over time, we’ll be back to taking risks we may not want. Do we have the early warning systems to determine when risk appetite and risk culture are moving too far in one direction?”* In the end, the objective of the work to improve risk management, oversight, and controls is about providing discipline through the cycle and improving oversight to allow effective risk taking that finds the balance between risk and stability.



Chapter 4

The need for strategies that
fit today's reality

The last five years have seen banks make significant strategic changes, both in the midst of the financial crisis and in its aftermath. For some banks, the process has included major business or asset sales. For others, it has enabled market consolidation or broadened their business or geographic portfolios. The landscape of leading banks, along with their respective portfolios, has fundamentally changed.

However, recent BGLN dialogues on evolving business models suggest more change is in the offing. Changes to date have been more the result of initial tactical responses to regulatory changes or macroeconomic pressures, or in some cases the result of government action in those banks that became or remain partly state owned. Future changes will be driven by firms' perspectives on what constitutes a sustainable business model – given an evolving competitive landscape, more fundamental regulatory reforms affecting structure, changing technology, and customer and client needs – and will be based on their unique set of strengths and weaknesses.

Discussions prior to and at the summit about future business models focused on the need to adopt unambiguous strategies that fit the new norm of continued regulatory change and uncertainty. This means building a platform of solid earnings that meets regulatory and credit rating agency expectations but also delivers value to debtholders, shareholders, and employees.

Four core questions came to light, which large banks will have to address: whether to be domestic or global; what will be the right balance between physical and virtual presence; what is the desirability of, or necessity for, a radical shakeup of technology; and whether to fight emerging non-bank competitors or co-opt them.

Clear strategies and solid earnings

Directors are very critical of the high degree of regulatory uncertainty. It creates the sense that progress has stalled. *"I worry the rules are creating*

an ongoing crisis," said one director. Beyond perceptions, though, directors worry that ongoing uncertainty prevents management decision making. *"The constant changes to rules are damaging,"* said a director.

A summit participant recommended that banks stop waiting for the uncertainty to clear, or for politicians or regulators to roll back five years of regulation. *"We need to see the world as it is, not as we would like it to be,"* he said. *"Now we have to make it work."* This view had a clarifying effect on the group. *"There is so much uncertainty that banks need to focus on the things they control, driving their strategies and business models, and living in the reality we have,"* concluded one director at the end of the summit.

It's time for clear, strategic thinking

"What will be the business models of the future?" asked one participant. *"Regulation has to change how banks run their business and the scale of their operations,"* said another. *"Banks have been tactical in their response to regulation thus far, but what will be the level of change in the future?"* The starting point is a clear strategic statement, said one participant. His firm has adopted a very brief statement on its strategy, which acts as a lodestar for new ideas. *"[The statement] is the test against which we apply all new ideas,"* the participant said. *"If it doesn't fit, we won't do it."*

Naturally, new strategies will take different forms across organizations. Before the summit, a director said, *"Every institution is different."* An executive agreed, stating *"There is no sustainable business model for the industry. The 'industry' doesn't exist. It's for individual firms, whose business models are quite different."* Indeed, at the summit several directors cautioned against the industry moving toward, as one put it, *"homogenous businesses"* – an outcome some fear could result from regulatory constraints and supervisory pressures as banks move into businesses with stable earnings profiles and less-risky capital.

Views differ about how quickly institutions should move. Some may prefer a wait-and-see approach, reasoning that it is important to keep strategic options open until it is clear what others are doing. Plus, as one director said before the summit, *“No bank has paid a price for moving second, but there are lots who have made the mistake of going first.”* In contrast, others say it is important to make strategic decisions now. Said another director, *“There is no doubt banks need to evolve to new business models ... the ones that will survive and generate an attractive return on equity will be those that get on with the strategic task sooner rather than later.”*

Build a solid, stable earnings engine first

Inevitably, in an environment where risk aversion is pronounced, banks are being pushed to develop more stable business portfolios. Indeed, at many previous BGLN events, participants have bemoaned pressure to become “utility banks.”

The summit discussion was more pragmatic. One participant said, *“The reality is we need more stable earnings, to meet the demands of rating agencies and regulators. We need strong, consistent earnings and a strong balance sheet. Once we have that, they will accept volatility elsewhere.”*

Initially, the trick, as one participant said, is *“building more ‘ballast,’ with an aim that the ballast creates the level of stable earnings the regulators want, so that any additional revenue is upside.”* Several directors wondered how banks can build their ballast in a way that doesn’t create homogeneity. A participant responded, *“How [banks] will achieve this will be different. The ballast might be wealth management. Branch-based deposits. Credit cards. Firms should grow the ballast in areas they are good at, and already in. Not in new areas or new geographies where they have no competence.”* Such a view highlights what many concluded from the financial crisis – that there were countless examples of banks acquiring businesses or moving into geographies

where they had little experience, and most paid the price, as did the system as a whole.

In building the ballast, one participant stated *“everybody has to trim their business of idiosyncratic exposures, which isn’t a bad thing.”* An example in the news is banks’ moves into the physical side of commodity or energy trading, where they own plants and ship oil. This presents regulatory challenges and potentially damaging reputational risks. One participant asked, *“What if we had a major oil spill? We have to recognize that, today, the arrangement must be an untenable position for the regulators, to be exposed to such a risk.”*

Of course, whether one likes it or not, there will be common approaches across the industry. A prime example is asset management. Said one participant, *“Asset management is very stable, so many firms will want to grow this business. It’s expensive. But banks will buy out asset managers.”* However, in line with the caution about knowing the core business well, a participant noted, *“[asset management] is a business where you need real scale. You get more money, you get more fees. But you need scale because of the expensive platforms. But you also need scale so you don’t suffer key-team risk. You need very diversified teams, so no one team becomes too important.”*

“Stick to what you are good at.”

– Participant

Balance stakeholder demands

All of the long-term strategic discussion takes place within a challenging economic environment. As one executive said before the summit, *“Every bank is operating with returns below its cost of capital. That’s not sustainable in the long term.”*

While regulators have an interest in ensuring stable earnings, a participant noted, *“They don’t care if*

we generate 10 percent return-on-equity or 11 percent. They consider us stable if we can consistently deliver x earnings; it is irrelevant to them if there is growth or what the capital denominator is."

While regulatory and credit-rating-agency demands are driving strategic and business portfolio decisions, other stakeholders' needs remain important. First, the capital providers' needs must be satisfied, given the ever-present dependence of banks on new capital. *"We need to reward our equity and debt holders with enough that we remain an attractive choice,"* said one participant, adding, *"Achieving that is quite difficult."*

Secondly, notwithstanding public and political concerns about compensation, employees have to be satisfied. *"There [have] to be rewards, and we are clear there [have] to be good returns to employees as well as shareholders,"* said a participant. *"We are a people business."*

Many directors and executives believe that a public debate about the role of banking in society and the need to appropriately balance stakeholder demands is now appropriate. Said one director, *"It is very positive that we are starting to focus on the sustainability and success of the financial system. We have to do it together. I worry we may all have different views on the concept of success. We need to bring the key stakeholders together to focus on what constitutes success."*

Four strategic questions for every bank

Beyond figuring out the correct new mix of stable and more volatile businesses, four strategic questions need to be addressed.

Domestic or global?

Economic conditions have greatly impaired international investments and cross-border

banking, and many banks have retreated to their home markets and core customer base. But because growth remains stagnant in Europe and unsteady in the United States, international banks will still have to look to developing and emerging markets for growth.

A greater tendency toward national banks

However, expanding internationally in the context of nationalistic policy solutions could now be harder for two additional reasons. First, national regulators may not be as keen as before the crisis to allow foreign banks to take over their major local banks, particularly those designated as domestically systemically important. More broadly, regulators and supervisors will likely apply more scrutiny to major acquisitions, even within existing geographies. As one regulator said at the summit, *"The ECB's approach will entail more scrutiny of acquisitions."* Second, host countries are becoming more demanding in their terms for foreign entrants in a world of RRP that explicitly state which assets will be sold in times of stress and imply the parent company's strength of commitment to specific markets.

The summit discussion suggested that, ultimately, banks will have to decide whether they are predominantly domestic or global. Said one participant, *"Where firms are large domestically, I'd expect that they will focus even more on their home market. Politicians will accept the size nationally, but then [they will] ask how are these firms supporting the nation's needs ... So, essentially, I see firms picking between being global or national."* Many participants agreed.

"We are going to move to a few global institutions and more national institutions." – Director

A challenge making global work, especially in wholesale

Banks wishing to remain or become global have perhaps the most difficult strategic questions to address. On the one hand, as mainly domestic institutions retrench and sell non-core assets, it will, according to one participant, “*create opportunities for those firms that are more global in nature.*” However, new regulatory requirements – trapped capital and liquidity, subsidiarization, and governance and risk structures – are hampering banks’ ability to operate globally. Said one participant, “*We are [all] being pushed to create mini-banks in each jurisdiction. It’s not a global banking model. Each unit will have separate liquidity and capital. It’s very parochial, but the smaller mini-banks are popping up all over the world in part because supervisors don’t trust each other. It adds a lot of expense.*”

The most daunting business- and operating-model challenge is in wholesale banking. As one regulator said at the summit, “*Balkanization is damaging the wholesale banking model ... There are two big political issues: 1. We want more competition, and 2. We don’t like large banks. But they support global capital flows.*” Everyone at the summit recognized that balkanization not only hurts the banking sector, but global growth and trade. Reversing the trends towards balkanization and higher local capital and liquidity requirements is heavily dependent on making resolution of G-SIFIs workable, which will likely take many years. Until then, host country efforts to protect local markets will prevail.

Physical or virtual presence?

Customer preferences are changing rapidly, and banks are responding to stay ahead of potential competitive threats from non-bank technology and retail companies. A director observed before the summit, “*The scale of adoption in [online] sales/transactional activity is massive. The customer’s relationship with the bank is*

transforming fundamentally and the number of touchpoints is dramatically changing how we deal with customers ... How do we bring through some of the thinking on where the world is heading?”

The evergreen question about brick-and-mortar retail branch strategies versus online or mobile banking options is reaching a generational turning point, as noted in recent BGLN discussions. As one trade association head said before the summit, “*The retail banking model is going to change significantly in the next decade or so.*”

Every bank has to address this issue, as was apparent at the summit. Core retail banks have a major strategic question to address. Said one director, “*Our bank will be increasingly a digital business where we need to make decisions about [the appropriate] physical footprint we really need. This will have profound implications for us and for regulation.*” Firms that have material wealth management business also have to address the question, but from a very different starting point. As one participant said, “*In wealth management, [several firms] are now among the top 10 deposit takers [in the United States]. But [they] don’t have branches, so the funds are harder to access. [They] have to find how to deliver value. [Their] thinking will have a radical impact on traditional banks and their branch approach.*”

“Digitization will be a major issue for banks.” – Director

A radical shakeup of technology?

A recent article in the *Economist* declared, “[T]echnology and the internet are about to change banking for good.”²⁹ Indeed, banks are among the largest users of technology for interfacing with customers, managing data, and improving efficiency of back-office operations. Before the summit, a director asserted, “*We are the largest information companies in the world.*”

Some bank executives and directors suggest that bank IT is due to experience a major change, with regulatory expectations and bank needs driving increasing investment as the focus moves from risk issues to IT infrastructure. Others are skeptical that major change will happen. One director asked before the summit, *“Does any bank have a uniform, consistent banking platform? Some have tried, but gave up because they have too many legacy systems. It might not be possible for big, complex banks.”*

Inevitably, as one summit participant put it, *“Technology is a continual journey”* for the industry. Some firms will make bold strategic investments in new IT systems. Others will remain laggards. But the strategic rationale for material IT change is growing. One participant asked, *“Is there a clever way, as online usage increases, to do something radical without bricks and mortar?”*

Many reasons to upgrade

The first rationale for a different approach to IT is cost. As one participant said at the May BGLN meeting, *“There are two sources of cost: one, capital; and two, banks are incredibly inefficient. We need to build a cost structure that is very different than the past.”*³⁰ Doing so would mean making effective allocation of technology investments a key priority for bank boards.

At the summit, one participant agreed, saying *“There are lots of parts of our business that do not need people anymore. When you take away prop trading, etc., a lot of basic client facilitation can be done with technology. Financial institutions will be much more people-lite in the future, which is cheaper to run and has the added benefit of decreasing our compensation costs.”*

Those saying the industry already invests enough in IT may be met with scorn; said another director at a summer BGLN meeting, *“The amount of money that needs to be invested is small relative to the enormous amounts of legal and infrastructure*

costs that burden current large banks.” Replacing the outdated mix of legacy systems that many banks have cobbled together over years of mergers would allow for faster and more accurate data aggregation and analysis, more efficient middle and back office activity, and a more effective way to meet changing customer needs. A key challenge will be how to balance near-term tactical solutions with longer-term strategic ones, and all this in an environment of continuous regulatory change and uncertainty.

New systems would be safer

Cybersecurity is increasingly highlighted as a key emerging risk for banks and has garnered greater attention from policymakers and banking groups following some high-profile attacks and publicity about the potential threat to the financial system. Denial-of-service-attacks and fraud garner much attention, as does the emergence of state-sponsored cyberterrorism. At the summit, a participant added another dimension: *“It’s less about fraud, which we can deal with. The real concern is data being destroyed. We wake up on Monday and find out we don’t know who is party to the contracts.”*

“Next to people, technology is the biggest spend.” – Director

Fight non-bank competition or co-opt them?

The role and impact of non-bank competitors is climbing up the agenda of large banks. In some areas, such as clearing, their effect is already becoming pronounced. As one BGLN participant said before the summit, *“The revenue stream from over-the-counter securities is going away”* with emergence of central counterparties (CCPs). In other areas, such as retail banking accounts and corporate loans, the ultimate role of non-bank competitors is less clear and could either remain muted or become significant. A key question will

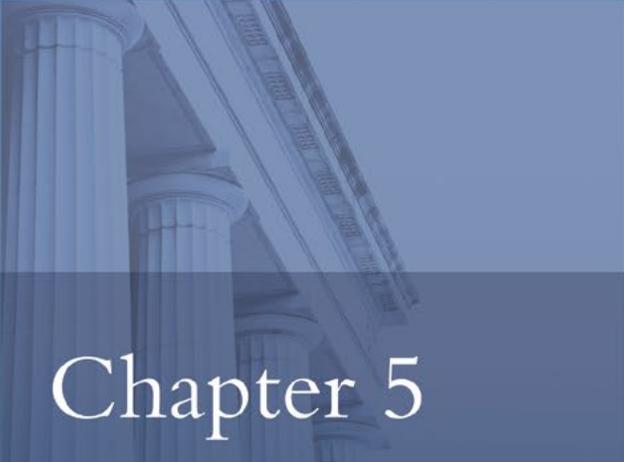
be the new competitors' strategic intent: to win major market share or to cherry pick the most profitable customers and business?

At the moment, it is not clear that bank management is sufficiently focused on the emerging long-term threat from non-bank competitors. As one director said before the summit, *“Management is concerned with the same competitors ... whenever you get into nontraditional competitors, that’s more of a distant dialogue and doesn’t attract the same attention.”* However, as banks start to refocus on strategy and the long-term competitive landscape, that situation will surely change.

What was apparent in the May and June BGLN meetings on non-bank competition is that as the situation changes and non-bank competitors become more important, boards and management teams may need to question conventional wisdom about the need to provide a full-service offering directly to customers and clients, and consider more strategic alliances with other institutions, even though the industry has a patchy record with alliances. Non-bank competitors are certainly open to such approaches.

Conclusion

The 2012 BGLN summit dialogue signaled that banks now have to intelligently confront the strategic questions that present themselves in the new regulatory and economic reality. This message was made even more forcibly this year, especially in light of everyone’s acceptance that regulatory uncertainty is here to stay. It is important that bank boards find time on their already packed agendas to engage management on the big strategic questions that they and their competitors now face.



Chapter 5

Addressing systemic
regulation and
macroprudential supervision

The success of the regulatory reform agenda will ultimately be evaluated by whether the system as a whole is more durable as a result of the changes that have been implemented, not simply by whether traditional banks are safer. After all, as one director said before the summit, *“If we don’t focus on the system, we will pay the price faster than we think, and no one wins if we have another crisis.”*

Summit participants were very concerned about the need for systemic oversight. One director summed up the concern well: *“In the current regulatory environment, everyone is derisking and deleveraging, and the risks are moving to the non-bank sector. Yet, we know it is the most risky activities that are moving. It is important we adapt the regulatory environment quickly.”*

There are signs that regulators are starting to focus on macroprudential and systemic issues. New systemic regulators are finally starting to act in an authoritative manner, and global policymakers have started addressing aspects of systemic risk – notably short-term funding – and developing a broad framework for oversight of shadow banking entities, and, in the future, central counterparties (CCPs). But the summit dialogue showed there is much more work to be done, and in key areas little or no progress.

The summit dialogue focused on three broad areas:

- Macroprudential and systemic supervision is missing in action
- Regulators are only just starting to address shadow banks and non-banks
- Central counterparties are the new systemic risk in town

Macroprudential and systemic supervision is missing in action

While few BGLN participants have objected to the concept of more systemic oversight, many

have noted that macroprudential supervision remains largely untested. One regulator at the summit agreed, saying, *“It is far from clear how macroprudential will work.”* The worry is, as one director at the summit put it, *“Macroprudential supervision is critical. Yet it seems to be the building block that is not being developed.”*

Macroprudential supervision is highly political

There are major conceptual challenges with macroprudential supervision. Many central banks, which have a broad mandate to contribute to financial stability, are being given a more prominent role in macroprudential supervision. Many have signaled their intent to more actively use macroprudential tools, such as countercyclical capital and liquidity buffers, system-wide stress tests, and limits on loan-to-value ratios, in order to reduce systemic risk. However, as one director with central banking experience observed before the summit, *“It is hard to find leading indicators for [central] banks to intervene early.”* There has also been limited thinking done on the interaction between monetary policy and macroprudential tools.

The real challenge is that macroprudential policy is extremely political, because in the end it comes down to stopping credit in areas where bubbles seem to be appearing. As one regulator said at the summit, *“We have to recognize the political economy within which macroprudential operates. It is much harder than monetary policy. The objectives are not as clear, and the levers are not easy to describe to people. By contrast, monetary policy has one or two relatively simple objectives.”* He continued, *“There are many competing policy objectives – inducing homeownership, promoting growth and ensuring the system is safe. The policy issues are deep and complicated.”* This statement accords with one director’s comment prior to the summit, that *“the objective function of a regulator is not that of a government or central bank.”*

Systemic regulators have done little so far

At the summit, one participant asked, *“If you step back and look at why crises happen, it is because there is excess liquidity, which moves to some asset class that everyone gets exuberant about. So, who is going to identify where the excess liquidity is going? How it is being leveraged and who is providing the leverage?”*

Certainly, the financial crisis revealed that both regulators and institutions lacked the capacity to develop a clear picture of risks building up in the financial system. As a result, new regulatory bodies were set up to better gather and analyze data, such as the Bank of England’s Financial Policy Committee (FPC), the European Systemic Risk Board (ESRB), and the Financial Stability Oversight Council (FSOC) in the United States.

Although these new bodies have an important function of looking at risk holistically, so far they have shown a limited range of action – mostly issuing reports and designating systemically important institutions. Even FSOC Chair Jack Lew is described in a 2013 US Government Accountability Office (GAO) report to Congress as “[not having] the authority to force agencies to coordinate, and neither he, nor FSOC as a whole, can force agencies to adopt compatible policies and procedures.”³¹ Furthermore, the GAO cautioned that while steps have been taken to “provide a systemwide view and identify potential threats before they create a disruption,”³² there remain unresolved risks, such as credit risk concentrations, with potential systemic implications.

At the summit, regulators admitted that systemic oversight is very much a work in progress. Said one, *“[Our new systemic regulator] has not really done macroprudential supervision yet.”* Another regulator said, *“The FSOC is still in start-up mode and depends on the staff of the [participating] agencies. It should be looking at the institutions that are beyond existing regulators’ remits.”* Another regulator agreed, saying, *“The FSOC is*

too often taking data from the existing institutions and rehashing the analysis that has already been evaluated. It should be looking at other key players – the specialist lenders, hedge funds – to look for other entities that are potentially creating systemic risk.” Of Europe, one participant noted, *“The ESRB, which is supposed to do macroprudential analysis in the EU [European Union], has done little, and may become irrelevant once the ECB [European Central Bank] has supervisory powers.”*

Regulators remain optimistic about the potential of systemic regulators. Said one at the summit, *“Increasingly, systemic regulators will look at leverage in the system and complex connectivity. We will have to look at the non-core firms and activities.”* In those few instances in which a systemic regulator has acted, it has caused tension. Said one director, *“The UK FPC has been bolder and more imaginative in trying to use its macroprudential tools [when asking for recapitalizations in several institutions]. But when they put out warnings and said the banks were undercapitalized, it appeared to many that those raising alarms were stirring the pot unnecessarily – the messages were too dark and created too much concern. And the FPC seemed to be second guessing the PRA [Prudential Regulation Authority], rather than looking at the gaps where the PRA isn’t looking.”* However, another participant acknowledged that the FPC’s conclusion was *“directionally correct.”*

Systemic risks are all around us

Summit participants did not view systemic oversight as simply nice to have; rather, it is critical. Several existing risks were highlighted. One regulator questioned, *“What would be the macroeconomic impact of a financial boom and bust outside of the regulated banking system?”* Said one director, *“The biggest systemic risk we face is monetary policy. We are leaning so hard on it – and central bank involvement [in the economy].”* Another director agreed, saying that

“the Fed’s balance sheet is a monstrous bubble. It will unwind in ways nobody has thought of.” A regulator commented, *“I am more worried by a disorderly unwind of compressed credit spreads than the movement in the level of interest rates. We don’t know how that will move through the system.”* The regulator continued, *“The US debt ceiling debate is worrying. What will be the effect on banks’ clients if they face stress? What if there are selective defaults, especially since US Treasuries are collateral in repos? Will counterparties demand more collateral? What are their contingency plans?”* Participants worry that major risks could be building up outside the banking sector, which could come to the surface when central banks begin to reverse quantitative easing.

A director stated that current regulatory reforms and the push toward common models, stress tests, and risk-management approaches causes additional concern: *“I worry that we are all managing risk in the same way, which creates systemic risk.”*

“There will be pockets of leverage out there and we need to assess the risk.” – Director

Regulators are only just starting to address shadow banks and non-banks

BGLN participants have long expressed concerns that as bank regulation increases, more activity and more risk will flow to the shadow banking system. As one noted before the summit, *“The risks will move out of the system to other places that are not regulated.”* Another said, *“There are non-bank forces of credit in the system because the needs don’t go away; the question is that we’re forcing these credit risks into possibly non-regulated entities and the answer last time was that’s not good.”*³³ During the summit, a director noted, *“Banks are exiting all sorts of high-risk*

activities, which are shifting to shadow banking and to entities that are not regulated.” Accordingly, regulators at the summit were asked what they are doing to oversee risks in shadow banking.

Initial reforms have focused on short-term funding

Policymakers and regulators have been more active than it first appears. Many leading advocates of reform, notably William Dudley, Bank of England Deputy Governor Paul Tucker, and Daniel Tarullo, have argued publicly that a major contributor to the financial crisis was shadow banking. Indeed, they highlight that much of the expansion of central banks’ balance sheets, particularly in the United States, was to address the collapse of credit intermediation that took place through the shadow banking sector, in areas such as securitizations and structured investment vehicles.

Accordingly, these regulators and others have committed support to the FSB’s work in this area. The European Commission (EC) has also stepped up its focus on shadow banking. As Michel Barnier, EC Internal Market and Services commissioner, has said, *“We have regulated banks and markets comprehensively. We now need to address the risks posed by the shadow banking system ... [and ensure that] markets are not diminished by the risks moving to less highly regulated sectors.”*³⁴

The most significant reforms have been in short-term funding. Changes in the area of triparty repos will over time greatly reduce the amount of intraday credit associated with this type of short-term funding. The FSOC’s money market fund (MMF) proposals would also be quite significant, if implemented. Building off their 2012 green paper on shadow banking, the EC proposed draft regulation on MMFs this past September and communicated possible further action in the area.

In addition, the regulatory agenda for shadow banking has encompassed securities financing (and the necessary margining requirements), securitization markets, and the link between banks and shadow banks.

A regulator at the summit stressed this initial focus: *“We are addressing money market funds and the run-risk they create. And, we are making triparty repos safer. The next big issue is excessive reliance on short-term wholesale funding.”* While addressing the risk associated with short-term wholesale funding is now at the top of the regulatory agenda, a consensus has yet to emerge about what should be the appropriate policy response. Options that have been discussed include additional liquidity requirements or capital surcharges. However, a key policy challenge is what the impact could be on the broader markets if the regulatory response is directed at just the traditional banking sector.

There is much more to be done on shadow banking regulation

Prior to the summit, one policymaker called shadow banking *“the last big regulatory challenge.”* The FSB has published an array of policy papers focused on aspects of shadow banking, some of which may eventually lead to major reform across the industry. But despite progress on funding, progress on shadow banking regulation has been limited to date. As Gary Gorton and Andrew Metrick of Yale University have noted, *“There are still large gaps where [the law and policy are] almost silent.”*³⁵

Part of the challenge is that the universe of potential activities and entities is so vast. By the FSB’s definition, shadow banking constitutes *“credit intermediation involving entities and activities (fully or partially) outside the regular banking system,”*³⁶ such as MMFs, credit investment funds, exchange-traded funds, credit hedge funds, some private equity funds, securities broker-dealers, securitization entities, credit insurance providers/financial guarantors, finance

companies, and trust companies.³⁷ The FSB conservatively estimates the worth of shadow banking assets at \$67 trillion, up from \$62 trillion in 2007 and \$26 trillion in 2002.³⁸

Several regulators at the summit admitted that the first step toward regulating shadow banking players more is gathering the necessary data on shadow banking entities. One regulator said, *“We are focused on data collecting, so we understand that risks are in the shadow banking sector.”* Said another, *“In terms of capturing data, it is important, but we are not there yet, especially in asset management and hedge funds. They [regulators] are trying to collect the data, but there remains a lack of sufficient visibility into what is going on from a regulatory perspective and where the risks are [in the system].”*

These statements left many directors thinking as one summit participant did: *“[Thus far] there seems to be no [enough] regulatory response to shadow banking.”* Yet, overall, summit participants believed that, while *“off-balance sheet structures have disappeared,”* other forms of credit and liquidity transformation are likely to emerge, which, when combined with leverage, need to be addressed in the future. So a key concern is that the speed of growth of the shadow banking sector far outstrips the degree of the regulatory response, putting banks’ business models under even more pressure.

Regulation of non-banks is way down on the agenda

In recent BGLN dialogues, banks have increasingly acknowledged that non-bank competitors are emerging as the foremost threat to current business models – think Apple, eBay, BlackRock, Wal-Mart, Verizon, for example. These competitors will certainly affect bank economics. However, members of the regulatory and supervisory communities have also expressed the opinion that non-bank competitors are a blind spot for their colleagues, both because of their

potential to affect the economics of traditional banks (and thus safety and soundness) and to create systemic risks by being lightly or insufficiently regulated. As one former regulator remarked before the summit, *“It’s a real issue for regulators about how to manage this exposure. The investors have no lender of last resort, but as these things get bigger, some form of protection inevitably emerges.”*

But thus far, policymakers and regulators have not signaled an intention to consider what new regulation or oversight is required for these competitors. *“We’re so focused on the current regulatory agenda and haven’t had the time to focus on the more cutting-edge stuff,”* admitted one current regulator before the summit. Summit discussions offered no alternative conclusion.

Central counterparties are the new systemic risk in town

In 2009, G20 leaders agreed that “all standardised OTC [over-the-counter] derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and clear through central counterparties by end-2012 at the latest.”³⁹ The aim is to safeguard markets against systemic risk and create more standardized swaps processes through clearinghouses for nearly \$600 trillion of OTC products.

While many acknowledge the benefits of standardizing derivatives and of greater transparency, they worry that regulators are creating new systemic risks. One BGLN participant raised concerns before the summit that while CCPs may have reduced the probability of failure, they could substantially increase the severity of failure if it were to occur, likening it to *“moving from a lot of coal power plants to a few nuclear power plants.”* So, as CCPs become an increasingly important part of the global financial market infrastructure, there is a growing sense that they are the new systemic risk in town.

“CCPs are clearly a very significant, concentrated risk.” – Regulator

The issue then becomes how stable CCPs are, and how they operate. As one director said before the summit, *“Clearinghouses and CCPs – how is this going to work, what are the risks, what are the costs? It’s one of the subjects that people are coming to grips with at a practical level.”* At the summit, a regulator said the critical questions are, *“Do banking supervisors understand how CCPs tick? How they operate? The information asymmetry between participants and the CCPs?”*

Other issues discussed at the summit were:

- **The right business model.** Regulators discussed openly which business model is most suitable for CCPs, now that they have taken on systemic importance. *“There is a strong argument CCPs should operate – or even be – cooperatives, where they keep cash to act as a loss absorber,”* said one regulator. He continued, *“In a for-profit model, you need good risk management and transparency. The banks around the table are effectively offering a guarantee.”* Another regulator commented, *“In Europe, we need to settle the issue of whether we want CCPs to be utilities and competitors. The overall business model will affect behavior.”*
- **Strong risk management.** Said one regulator, *“They need to have effective risk management. Oversight should come from the banks and regulators, not just regulators.”* Said another, *“CCPs need the right checks and balances.”*
- **Counterparty risks.** According to the *Financial Times*, *“As trading volumes through the clearing houses ramp up, banks increasingly fear this new counterparty risk.”*⁴⁰ Banks are voicing concerns that there is insufficient transparency on collateral and relatively low

levels of capital reserves. Yet, at the summit, a regulator asked, *“Do banks really understand the risks?”*

- **Resolution.** It remains far from clear how such a CCP would be resolved in an orderly manner, if they experience significant stress, so regulators are now stating that CCPs need a resolution framework and living wills.⁴¹ As one regulator at the summit said, *“The recovery and resolution of non-bank SIFIs [systemically important financial institutions] is very important, but it’s very much a work in progress.”*

Overall, however, regulators admitted that they have only just started considering the issues that surround the durability and stability of CCPs.

Conclusion

There is broad agreement that the system as a whole needs to be monitored and supervised. The financial crisis showed that a narrow regulatory lens is dangerous. However, the major focus on prudential reforms of banks has greatly constrained the capacity of regulators – new and old – to develop a system-wide approach to reform. Core building blocks remain unbuilt or untested. Yet major risks have moved out of the core banking system, and new systemic risks have been created, notably CCPs. There is a growing sense of urgency about the need for coherent, coordinated systemic oversight, although there remain open questions about the appropriate type of regulation, supervision, and market transparency that should be extended to entities and activities outside the regulated banking system.

About the Bank Governance Leadership Network (BGLN)

The BGLN addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy banking institutions. The BGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the BGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multi-stakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable, and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the banking industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients and for its communities. EY supports the BGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

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Appendix: Summit participants

Tapestry Networks and EY have hosted seven BGLN meetings, including the fifth Bank Directors Summit, in 2013. Over the course of the year, we also had over 160 conversations with directors, executives, regulators, supervisors, policymakers, and thought leaders. Insights from these meetings and discussions helped shape the summit agenda and quotes from those discussions appear throughout the enclosed *ViewPoints* documents.

The following individuals attended the 2013 Bank Directors Summit:

Directors

- Gary F. Colter, Non-Executive Director, Corporate Governance Committee Chair, Audit Committee Member, CIBC
- Tony Di Iorio, Non-Executive Director, Audit Committee Member, Nominations Committee Member, Risk Committee Member, RBS
- Dina Dublon, Supervisory Board Member, Deutsche Bank
- Robert H. Herz, Non-Executive Director, Audit Committee Member, Morgan Stanley
- Laban P. Jackson, Jr., Audit Committee Chair, JPMorgan Chase & Co.
- Olivia F. Kirtley, Audit Committee Chair, Executive Committee Member, Governance Committee Member, U.S. Bancorp
- Suzanne Labarge, Supervisory Board Member, Risk Committee Member, Deutsche Bank
- Jean Lanier, Compensation Committee Chair, Audit Committee Member, Chairman's and Governance Committee Member, Credit Suisse
- Rachel Lomax, Non-Executive Director, Audit Committee Member, Risk Committee Member, HSBC
- Donald T. Nicolaisen, Audit Committee Chair, Operations and Technology Committee Chair, Compensation, Management, and Succession Committee Member, Morgan Stanley
- David L. Roberts, Deputy Chairman, Risk Committee Chair, Audit Committee Member, Nomination and Governance Committee Member, Remuneration Committee Member, Lloyds Banking Group
- Jackson Tai, Audit Committee Member, Connected Transactions Control Committee Member, Risk Policy Committee Member, Strategic Development Committee Member, Bank of China
- Diana L. Taylor, Nomination, Governance and Public Affairs Committee Chair, Executive Committee Member, Personnel and Compensation Committee Member, Citigroup
- Kathleen Taylor, Chair Designate, Corporate Director, Human Resources Committee Chair, Risk Committee Member, RBC

Executive

- James Gorman, Chairman and Chief Executive Officer, Morgan Stanley

Regulators and supervisors

- Andrew Bailey, Deputy Governor, Prudential Regulation, Bank of England and Chief Executive Officer, Prudential Regulation Authority
- Michael S. Gibson, Director, Division of Banking Supervision and Regulation, Federal Reserve System
- Ben Gully, Senior Director, Deposit-Taking Group, Conglomerate Banking, Office of the Superintendent of Financial Institutions
- Patrick Montagner, Director, Insurance Supervisory Department, Autorité de Contrôle Prudentiel et de Résolution
- Martin Pfinsgraff, Senior Deputy Comptroller, Large Bank Supervision, Office of the Comptroller of the Currency

EY

- Ian Baggs, Global Banking & Capital Markets, Deputy Leader, Financial Services
- Andy Baldwin, Sub-Area Managing Partner, EMEIA Financial Services
- Robert Cubbage, Partner and Banking & Capital Markets Leader, EMEIA Financial Services
- Stefan Walter, Principal, Global Bank Supervisory and Regulatory Policy Leader

Tapestry Networks

- Dennis Andrade, Principal
- Peter Fisher, Partner
- Mark Watson, Partner
- Charles Woolcott, Associate

Endnotes

- ¹ *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.
- ² The Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) ensure that an institution's capital planning processes have taken into account the institution's unique risks and that the institution will be able to remain operational even in times of economic and financial stress.
- ³ "Go With the Flow." *Economist*, January 12, 2013.
- ⁴ Michael Crittenden, "Fed's Tarullo Sees Broad Risks from Short-Term Funding Markets." *MoneyBeat* (blog), *Wall Street Journal*, July 11, 2013.
- ⁵ *Ibid.*
- ⁶ "The Great Unravelling." *Economist*, April 20, 2013.
- ⁷ Ernst & Young, "Time to Define Your Borders: UK Banking Reform Implications 2012." (London: Ernst & Young, 2012), 1.
- ⁸ One provision of the Glass-Steagall Act of 1933 mandated separation of commercial and investment banking. The law was repealed in 1999.
- ⁹ Bank Governance Leadership Network, "An Industry under Assault: A Defining Moment." *ViewPoints*, November 30, 2012, 18.
- ¹⁰ See Basel Committee on Banking Supervision, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement: Rules Text* (Basel: Bank for International Settlements, 2011).
- ¹¹ *Ibid.*, 1.
- ¹² See Financial Stability Board, *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies* (Basel: Financial Stability Board, 2013).
- ¹³ Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Progress Report on Implementing the Recommendations on Enhanced Supervision*, 1.
- ¹⁴ See for example, Bank Governance Leadership Network, "Understanding and Assessing Governance Effectiveness: A Challenge for Supervisors." *ViewPoints*, June 11, 2012.
- ¹⁵ Bank Governance Leadership Network, "Strengthening Board-Supervisor Relationships." *ViewPoints*, March 28, 2013.
- ¹⁶ *Ibid.*
- ¹⁷ Senior Supervisors Group, Financial Stability Board, *Risk Management Lessons from the Global Banking Crisis of 2008* (Basel: Bank for International Settlements, October 21, 2009).
- ¹⁸ Financial Stability Board, *Thematic Review on Risk Governance: Peer Review Report* (Basel: Financial Stability Board, February 12, 2013).
- ¹⁹ Financial Stability Board, *Principles for an Effective Risk Appetite Framework* (Basel: Financial Stability Board, July 17, 2013).
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- ²¹ Board of Governors of the Federal Reserve System, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice* (Washington, DC: Board of Governors of the Federal Reserve System, 2013), 9.
- ²² Enhanced Disclosure Task Force, *Enhancing the Risk Disclosure of Banks* (Basel: Financial Stability Board, 2012), introductory letter.
- ²³ Bank Governance Leadership Network, "Reforming Bank Culture: Transforming Values into Action." *ViewPoints*, December 13, 2012.
- ²⁴ Donal Griffin and Dakin Campbell, "U.S. Bank Legal Bills Exceed \$100 Billion." *Bloomberg*, August 28, 2013.
- ²⁵ Dennis Andrade, Peter Fisher, Liam Hurley, Mary Teague, and Mark Watson, *Corporate Directors' Views on US Banking: News the Industry Can Use* (Waltham, MA: Tapestry Networks, 2013).
- ²⁶ Chartered Institute of Financial Auditors, *Effective Internal Audit in the Financial Services Sector: Recommendations from the Committee on Internal Audit Guidance for Financial Services* (London: Chartered Institute of Financial Auditors, July 2013).
- ²⁷ Financial Services Authority, *Journey to the FCA* (London: Financial Services Authority, 2012).
- ²⁸ Karen Weise, "The Consumer Watchdog Is Having an Impact." *Businessweek*, January 10, 2013.
- ²⁹ "Revenge of the Nerds." *Economist*, August 3, 2013.
- ³⁰ Bank Governance Leadership Network, "Global Banks Now Need to Transition to Materially Different Business Models." *ViewPoints*, July 8, 2013.
- ³¹ Government Accountability Office, *Financial Regulatory Reform: Regulators Have Faced Challenges Finalizing Key Reforms and Unaddressed Areas Pose Potential Risks*, (Washington DC: Government Accountability Office, January 2013), 33.
- ³² *Ibid.*
- ³³ See Tapestry Networks, *Regulating Shadow Banking – a Policy Agenda of Systemic Proportions* (Waltham, MA: Tapestry Networks, 2013).
- ³⁴ European Commission, "Commission's Roadmap for Tackling the Risks Inherent in Shadow Banking." (press release) September 4, 2013.
- ³⁵ Gary Gorton and Andrew Metrick, "Regulating the Shadow Banking System." *Brookings Papers on Economic Activity* (Washington, DC: Brookings Institution, Fall 2010), 262.
- ³⁶ Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* (Basel: Financial Stability Board, 2012), ii.
- ³⁷ *Ibid.*, 1.
- ³⁸ Financial Stability Board, *Global Shadow Banking Monitoring Report 2012*.
- ³⁹ Financial Stability Board, *OTC Derivatives Market Reforms: Fourth Progress Report on Implementation* (Basel: Financial Stability Board, October 31, 2012).
- ⁴⁰ Patrick Jenkins, Phillip Stafford, and Tom Braithwaite, "Banks Warn of Risk at Clearing Houses." *Financial Times*, July 7, 2013.
- ⁴¹ Phillip Stafford, "BoE Calls for More Clearing House Powers." *Financial Times*, April 23, 2013.