OLIVER WYMAN

CIGI

Financial Regulatory Outlook Conference 2017

SHIFT FROM MULTILATERALISM TO NATIONALISM

CONFERENCE REPORT


FINANCIAL REGULATORY
OUTLOOK CONFERENCE

THANK YOU

Oliver Wyman was honored to welcome delegates to the fourth annual Financial Regulatory Outlook (FRO) Conference in November 2017, jointly organized by the Centre of International Governance Innovation (CIGI) and Oliver Wyman. We were also proud to introduce our guests to Oliver Wyman-SPP, a recently created internal unit that is devoted to serving central banks and financial sector authorities.

The annual FRO conferences are designed as instructive and informative forums, where representatives of both the private and public sectors connect year after year. They bring together leading policy makers, regulators and senior executives from across Europe, to exchange thoughts and perspectives on some of the most pressing issues for the financial services industry. We would like to thank our distinguished speakers and panelists for contributing their knowledge, enthusiasm and intellectual curiosity to the discussion.

The theme of the 2017 conference was the “Shift from Multilateralism to Nationalism”. The global shift in political sentiment is having a profound effect on the financial services industry and beyond. The panel discussions brought forth robust opinions and insights into some of the major themes influencing the financial services industry

This report highlights some of the points raised that Oliver Wyman believes will be pivotal to the success of tomorrow’s financial services industry.

INTRODUCTION

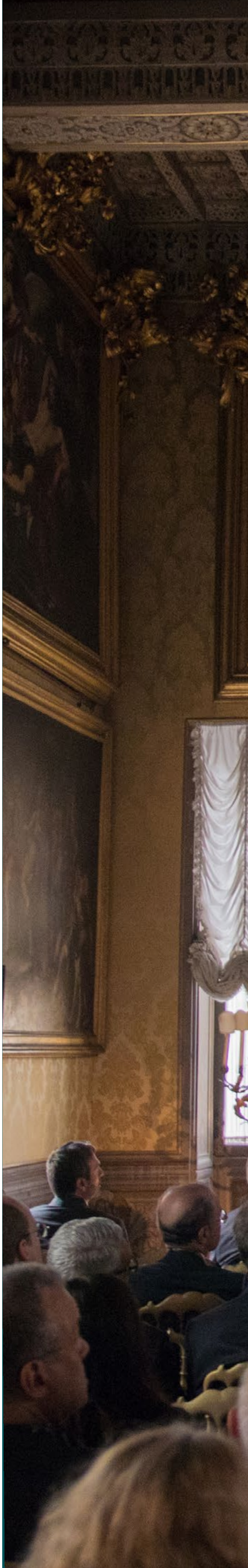
Global integration and cooperation were the key features of the second half of the last century, and despite financial crises and recessions, globalization has continued apace over the past two decades, boosted by new technology. Now this may be about to change as a growing number of governments begin to diverge from the policies and thinking of the past. Social, political and economic uncertainty is prompting a return to nationalism. Increasingly, globalization and international cooperation are no longer viewed as sources of prosperity, but as the main culprits behind unemployment and income inequality. In the worst case, a spiral of protectionist measures and counter-measures could unravel over the next few years.

Such an outcome will force a significant change in the modus operandi of corporations both locally and globally. Rises in tariffs, constraints on labor mobility, uncertainty around foreign investments and diverging local regulatory requirements would all dampen global trade and competitiveness.

The 2017 Financial Regulatory Outlook conference discussed the new regulatory and political equilibrium and how banks and multinationals should prepare for it. The panel discussions focused on the following topics:

- The new political equilibrium: What are its implications for banks and multinationals?
- Bank strategy in an era of rising nationalism
- What will the new regulatory equilibrium look like?

Both Brexit and regulatory reform in the United States are likely to affect global standards. It is crucial to understand their likely impact and the most-urgent regulatory implications. What is the best course of action as the world shifts from multilateralism to nationalism?




OLIVER WYMAN
CIGI
FINANCIAL REGULATORY OUTLOOK
CONFERENCE 2017
SHIFT FROM MULTILATERALISM TO NATIONALISM

CONSOLIDATION, FINTECH EXPECTED AS BANKS LOOK TO THE FUTURE – LONG POST-CRISIS CLEAN-UP FADES INTO THE PAST

Since the financial crisis, banks have had to repair their balance sheets, conform to a variety of new regulations, and exit structurally unprofitable businesses. That work is almost done. It is estimated that virtually all United States banks and two-thirds of European banks have moved beyond restructuring mode. But instead of a period of calm, the industry has to adapt to new political, regulatory and technological changes.

Regulatory milestones

MiFID II, the second version of the EU Markets in Financial Instruments Directive, is one of Europe's biggest changes in financial market regulation since the financial crisis. Implemented at the beginning of 2018, it requires prices of trades to be publicly reported, and restricts share trading in dark pools, among a range of other measures.

The General Data Protection Regulation, or GDPR, scheduled to take effect later in the year, gives consumers control over their data: They can demand they all be deleted, handed over, or transferred to another company. This will diminish the advantage of incumbents that have spent years amassing customer data for purposes such as marketing and development. IFRS 9, the latest version of the International Financial Reporting Standards, makes it less favorable for banks to keep non-performing loans on their balance sheets. Banks have been working towards its compliance deadline, also in 2018.

Technology-related changes include an increasing variety of sophisticated digital interfaces, businesses that operate solely through platforms, and new customer habits that both drive and respond to these innovations. Many of the new ideas come from the burgeoning fintech sector, so incumbent banks quickly need to figure out how to work with the new products, or how to compete with them.

How banks approach the new challenges will go a long way to deciding their chances of success, and of surviving a likely wave of consolidation. Skill at using digital tools will be important, but the crucial factor could well be to develop new ways of helping customers. "Banks have traditionally done a really good job on the asset and liability side of the services that clients need – providing credit and handling deposits," said Ted Moynihan, Global Head of Financial Services at Oliver Wyman. "But I think they would admit to doing not a very good job at helping their customers manage their P&L. How often has a bank come out and said: 'There are other ways of optimizing the way that you're saving and spending money'?"

The shift towards nationalism

The 2017 conference took place against the backdrop of firm economic growth in Europe after several stop-start recoveries that followed the financial crisis. But a decade of stagnant or declining incomes for large parts of the working and middle classes has led to widespread discontent in Europe and North America, and many people see globalization as the culprit.

So far, the forces of globalization and free trade remain very strong, essentially because they reduce the price of goods. However, persistent low growth makes Europe vulnerable to even relatively modest protectionist measures that slowed the movement of goods, services, and capital.

One problem with globalization is the relative mobility of capital compared to labor. The labor share over total income in advanced economies over the last 20 years has declined by 5 percentage points, said Carlo Cottarelli, Executive Director of the International Monetary Fund. While capital is getting more of the income, it is also more mobile and difficult to tax. As a result, government revenues have been in relative decline, making it harder to provide a public safety net for the losers of globalization. The squeeze in public funds also means that governments can't cut taxes for the middle classes to help make up for their declining share of total income.

A global tax system or other such moves might fix this, but it's not about to happen, Cottarelli said. "In the absence of these steps, the trends towards lower taxation on more mobile factors of production – less taxation on capital – will continue, and will fuel unhappiness among the middle class of advanced economies."

The backlash against globalization can be traced to before the crisis, said Mario Monti, Senator-for-life and former Prime Minister of Italy. Referenda in France and the Netherlands rejected the European constitution 2005 due to the specter of the "Polish plumber" arriving to take people's jobs away. "That was a very clear signal that many thought that integration had gone too far," he said.

The most dramatic consequences were the 2016 votes in the United Kingdom – for Brexit – and the US – for Donald Trump as President. "These two countries have, I hope temporarily, done their best to stop us from observing them with a sense of admiration and with a wish to imitation," Monti said.

Populism and nationalism could start to play a much larger role in advanced economies than they have in the last several decades, said Douglas Elliott, a partner at Oliver Wyman. As populism generally means the rejection of elites, national and international affairs could become increasingly politicized. Institutions such as central banks, which have been made independent, could be subject to more political direction. That could lead to institutional instability, and relatively predictable economic policies could be replaced by frequent economic experimentation. The result might be more-volatile markets, and less globalization and international cooperation.

"We've gotten used to – certainly in the US and UK, but even to some extent in continental Europe – governments that don't get involved in micromanaging business decisions," said Elliott. "They set up regulation. They may step in in certain cases. But mostly there's a division between business and government. And populists often do not respect that."

Regulatory reaction

One possible impact on financial regulation could be to the future clearing of euro-based derivatives. Depending on the results of Brexit negotiations, it may have to shift from London to locations in the 27 remaining EU member states. Though the problem was triggered by a populist vote in the UK, such an insistence by the 27 would also constitute a form of nationalism, according to Sandie O'Connor, Chief Regulatory Affairs Officer at JP Morgan Chase. The result could be that EU27 institutions would not be allowed to transact with institutions under UK jurisdiction, possibly halting clearing in euro-denominated derivatives markets. "What's the benefit of that?" she asked. "It's a choice, not a requirement."

A major goal of banking reform has been to make banks safer and break the link between banks and sovereign debt that threatened the fiscal sustainability of several European countries. To achieve this, the European Commission has made completion of the banking union a priority. But some banking union components are resisted by Germany and other countries that suspect they would be left on the hook for failures in other parts of the eurozone.

"I believe we need to recognize the fundamental tension between the banking union and resolution," said one participant. "The banking union is about going-concern banking groups, it's about removing borders. Resolution is about gone-concerns and legal entities, and there is a tension between the two of them because legal entities are indeed creating some borders. Allocating losses is an important issue if there is a crisis and we need to go to bankruptcy or resolution."

Some observers say that too much regulation is discouraging bank lending and weakening the economic environment – one of the very causes of populist anger. There is, therefore, a trade-off between making the banking system more resilient in the long term and facilitating economic growth in the short. And, while credit growth is picking up, this is from a very low level. "Here we are, nearly 10 years after the crisis, and it's not obvious to people that regulatory reform is actually providing the intended impetus to economic potential," said one participant. The result is "not so much reform fatigue as reform exhaustion."

However, Vítor Constâncio, Vice President of the European Central Bank, warned against any dilution of the Basel III reform package, arguing in particular that the ultimate definition of the leverage ratio should not be changed by excluding certain assets. "This weakening of the standard should be avoided, as it increases the probability of crisis and output losses," he said. "The mandatory leverage ratio applied to banks was one of the most important reforms introduced."

Opportunities for the future

Banks' real goal now should be to plan and invest for the future. European banks have a number of challenges. They have traditionally played a bigger role in financing businesses than US banks, but this is declining. The total consolidated assets of banks in the eurozone have shrunk 16 percent since 2007, while the total assets of investment funds have gone up from 13 percent of bank assets to 41 percent, said Constâncio.

"This transformation will continue, so banks are bound to have gradually a smaller role in the financial system and in the finance of our economies," he said. "As a result of this, of course we will see consolidation – hopefully gradually and in an orderly way, because we don't want disruptions that could create financial instability."

Moreover, European banks' profitability is low even when they are not troubled by non-performing loans, because they have high cost bases, said Gerd Häusler, Chairman of the Supervisory Board of Bayerische Landesbank and a Member of the G30. "None of us are currently earning the cost of capital and I don't see that changing anytime soon, quite frankly, due to the fragmented nature of banking and also an oversupply of banks. This all cries out for inorganic growth – or, in plain English, mergers."

However, Häusler does not consider the regulatory framework ready yet for cross-border mergers. "I don't see any action anytime soon because the impediments and the move towards national rules – and, more specifically, nationally devised applications of European rules – stand in the way."

Exceptions in Europe – both for their degree of consolidation and their cost-cutting – have been the Nordic banks, which went through crises in the early 1990s and then weathered the post-2008 problems relatively well. They have digitized operations to a high degree, helped in part by high levels of digital literacy in their countries, and some are even contemplating phasing out cash. "Branches have been severely reduced throughout those countries, and they have cost structures that are much, much lower than the rest of Europe," said Constâncio. "As a result, they have return on equity of 12 to 14 percent which, of course, you cannot find in the rest of Europe."

US banks have moved on from the financial crisis faster than their European counterparts. The authorities quickly recapitalized the weakest big banks, and US banks now have a relatively healthy rate of return on equity. Also, the US has been an easier market than Europe for banks. "Most of our US clients don't sit thinking, 'Wow, you know, the huge opportunity in Europe,' or even in Asia," said Moynihan. "They're really thinking, 'Actually, every dollar I put in the US gives me a higher return than a dollar I put anywhere else around the world.'"

Asia is a growing market because of the needs of the fast-growing middle class, as well as large-scale infrastructure projects, such as the One Belt One Road initiative to develop maritime and overland trade links between China and Europe.

Partly because Asian banks did not need to spend time recovering from the financial crisis, they have been more focused on the future, and Asia has become a hotspot for fintech. "They viewed the crisis as a European or a US issue," said Moynihan. "They have opted to be almost laissez faire, so the role in South East Asia and in China of some of the non-banking or insurance players in the financial system is huge. You think about Alibaba, Alipay, WeeChat, Lufax: These sorts of companies are major players in the financial system as of today."

The role of fintech

Fintech, the use of new technologies to develop and distribute financial products and services, is based on technologies such as blockchain, machine learning, and decision algorithms. It has clear potential to reduce transaction costs and foster greater financial inclusion around the world. Fintech-based services tend to be accessible to a larger segment of the population, in particular people who are underbanked or have not had access to banking services.

So far, fintech has penetrated mostly into payment systems, and one of its biggest potential areas of impact is cross-border payments. For example, blockchain technology could eliminate several intermediate steps in global transfers. One positive impact could be the extra competition they bring to the financial sector. "Fintech startups are, by definition of course, young companies that are going to be quite efficient," said one participant. "Therefore they act as a source of pressure on the traditional banking sector to become more efficient and more competitive. So, the regulator should not intervene by trying to stifle, hamper, or constrain the development of these innovative forces."

However, regulators will be on the lookout for new risks. For example, the use of artificial intelligence and machine learning by asset managers may contribute to further concentration in the sector. "New technologies generate new risks and do not necessarily eliminate the old ones which provide the rationale for financial regulation in the first place," said Constâncio. Asymmetries of information do not disappear with the introduction of new ways of supplying financial services. Fintech does not provide an excuse for less regulation."

CLOSING THOUGHTS

Most banks – including those in Europe – are now over the financial crisis. But it has taken them a long time, and they now face a race to restore their competitiveness against their US and Asian peers. That may come through a wave of mergers, and it may be boosted by new technology. However, their strategies and innovations will be complicated by the increasing encroachment of politics into regulation – a factor that may become even more significant in the future.

CONFERENCE SPEAKERS

SIR WIN BISCHOFF

Chairman of the Financial Reporting Council & Chairman of JP Morgan Securities plc

VÍTOR CONSTÂNCIO

Vice President, European Central Bank

CARLO COTTARELLI

Director of Fiscal Affairs, IMF

ANDREAS DOMBRET

Member of the Executive Board, Deutsche Bundesbank

DOUGLAS ELLIOTT

Partner, Financial Services, Oliver Wyman

ANDREA FEDERICO

Head of Public Policy, Oliver Wyman

DAME CLARA FURSE DBE

Chairman, HSBC UK

GERD HÄUSLER

Chairman, Supervisory Board, Bayerische Landesbank

MALCOLM D. KNIGHT

Distinguished Fellow, Centre for International Governance Innovation (CIGI)

SIR ANDREW LARGE

Chairman Oliver Wyman-SPP

DOMENICO LOMBARDI

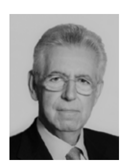
CEO, Banca di San Marino

SYLVIE MATHERAT

Chief Regulatory Officer, Member of the Management Board, Deutsche Bank AG

HEATHER MCNORGAN

Program Manager, Global Economy Program, CIGI



MARIO MONTI

Senator-for-life, EU Commissioner (1994–2004) and Prime Minister of Italy (2011–2013)

TED MOYNIHAN

Managing Partner, Global Head of Financial Services

SANDIE O'CONNOR

Managing Director, Chief Regulatory Affairs Officer, JPMorgan Chase & Co.

ALEXANDER PRIVITERA

Head of European Affairs at Commerzbank, Brussels

PIERRE WUNSCH

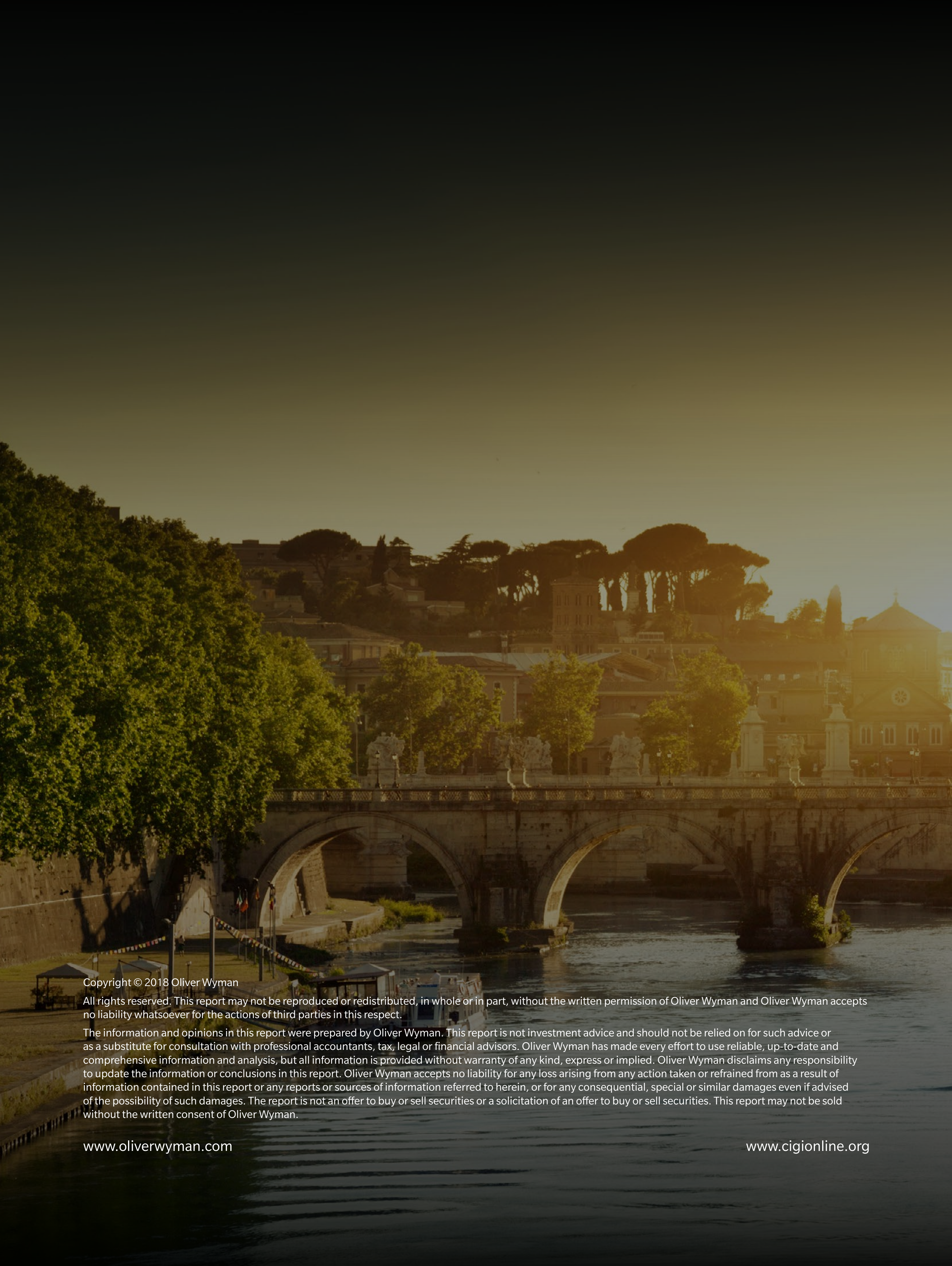
Deputy Governor, National Bank of Belgium

About CIGI

The Centre for International Governance Innovation (CIGI) is an independent, non-partisan think tank focused on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debates and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world. CIGI's research programs focus on: global economy, global security and politics and international law. The Global Economy Program addresses limitations in the way nations tackle shared economic challenges. In undertaking its research, the program leverages its comparative advantage in bridging the gap between economics and policy making.

About Oliver Wyman

Oliver Wyman is a global leader in management consulting. With offices in 50+ cities across nearly 30 countries, Oliver Wyman combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organisation transformation. The firm has about 4,500 professionals around the world who help clients optimize their business, improve their operations and risk profile, and accelerate their organisational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of Marsh & McLennan Companies [NYSE: MMC]. Oliver Wyman – SPP, the new alliance in which Oliver Wyman has joined forces with Systemic Policy Partnership (SPP), has been created in response to the increasingly challenging landscape faced by central banks. SPP has hands-on experience over the last ten years of high-level assistance focusing on fundamental issues of mandates, relationships with other authorities, decision making, and conflict resolution mechanisms.



www.oliverwyman.com

www.cigionline.org