SIFI Rules Are Recasting Global Banking

What is a SIFI?
Knowledge@Wharton: Welcome to Knowledge@Wharton for this discussion of a critical new area of global banking regulation — the new designation by the Financial Stability Board (FSB) for Systemically Important Financial Institutions (SIFIs). Today we have with us Itay Goldstein, a finance professor at Wharton, and also Bill Schlich, global banking and capital markets sector leader for Ernst & Young, and his colleague Donald Vangel, senior advisor for banking and regulatory matters at Ernst & Young. Thanks for joining us.

Knowledge@Wharton: Let’s start with a definition of SIFIs. Don, I think as an ex-regulator you’re probably best positioned to help.

Donald Vangel: The acronym stands for Systemically Important Financial Institutions. The concept defines financial institutions that are large enough, complex enough and interconnected enough with the rest of the financial system, that a demise of one of them would have negative externalities associated with it. It would have impact on other financial firms, impact on the financial system and potentially on the real economy.

Knowledge@Wharton: So, we want to focus on those institutions most likely to be involved in another financial meltdown?

Vangel: [The idea is that] if they are involved, the impact of their involvement would be most pronounced.

Schlich: And SIFI’s can differ from one another. So, there will be global SIFIs and then there will be SIFIs in each of the geographies.

Vangel: The Financial Stability Board is in the process of identifying global institutions deemed to be financially significant. However, each jurisdiction, depending on size, may have a different view as to what is a systemically significant presence within its borders. So, a firm might not be a global SIFI, but maybe a SIFI in a particular jurisdiction.

Who Identifies SIFIs and How Many Are There?
Knowledge@Wharton: At the global level, the Financial Stability Board includes global regulators, central bankers and what other kinds of representatives?

Vangel: Again, it’s central bankers and other senior policy makers. The Financial Stability Board used to be the Financial Stability Forum before the crisis. Today, it is the G20 body that oversees policy across the entire sector.

Knowledge@Wharton: You talked about 130 (significant) banks in the U.S. Globally how many are we looking at?

Vangel: Currently the Basel committee on banking supervision — which effectively reports to the Financial Stability Board — the Basel committee has tentatively identified 28 global banks [the G20 later identified 29] as GSIBs, Global Systemically Important Banks, as opposed to a broader array of financial institutions. But the FSB is in the process of doing a broader assessment of non-bank firms to determine how big that cadre should be in its entirety.

What Does SIFI Status Mean for Banks?
Knowledge@Wharton: So these are the biggest of the big banks. They are the usual suspects when you talk about the biggest banks in the world. What are the implications, from a bank point of view, to being designated a global SIFI?
Vangel: Most significantly would be enhanced prudential standards, the most prominent of which would be higher capital requirements. The Basel committee has a framework that would have these GSIBs hold more capital than other banks to account for their significance and to provide extra cushion against insolvency.

Knowledge@Wharton: Itay, from your point of view, what are some of the positive and negatives implications of all of this.

Itay Goldstein: From the regulator’s point of view we have to ask, what is the role of having this designation before a crisis even started? I think they see the chaos that we saw in the recent financial crisis, where a few financial firms basically brought the financial system to its knees. And this led to very quick government reaction, injecting capital into banks in the form of TARP, etcetera. So what they want to do is avoid future financial crises by identifying these institutions ahead of time and regulating them, asking them to hold more capital so that, first of all, you reduce the probability that they’re going to go into default; and second, if push comes to shove and there is a crisis, then the consequences will not be as severe. This is the logic behind being designating a SIFI for particular banks. But one thing that I think we should question is to what extent this is actually necessary. At the end of the day, we know which banks are big, which banks are interconnected, which banks are complex and which banks can bring the financial system to its knees. And should we really have this definition whereby if you hold more than $50 billion in capital, you have more than $50 billion in assets, you are designated a SIFI status and if you have below that you don’t get this status?

I’m not sure, because I think this definition is going to create a lot of complexities. For example, some banks may find it worthwhile to stay just below the threshold and not be called a SIFI. And as a result they will change their business structure, change their policies so that they’re not called a SIFI — officially. But then when there is a crisis and these banks do get into trouble, probably the regulators will face similar issues to what they did in the recent crisis. Even though these banks were not called SIFIs, they’re still systemically important and then we will need to inject capital into those banks once a crisis erupts.

Knowledge@Wharton: The Financial Stability Board is charged with looking at this from a global point of view. But how does their regulation actually get transmitted down to the banks?

Schlich: This is where it gets interesting because clearly there needs to be a global understanding on how we’re going to move forward and what the regulations should be. But then, when it gets implemented, it gets reviewed at a national level and that’s where the issues come in. So, will all the countries apply the regulation the same way and will all of them look the same? That’s where you begin to get concerned about regulatory overcharge and trying to take advantage of different regulators and the different ways in which it’s been implemented.

What Happens If the Regulatory ‘Playing Field’ Is Not Level?

Knowledge@Wharton: What could some of the results of that be — for banks or for consumers? Are there unintended consequences?

Schlich: You hear this question a lot from bankers: Is the playing field going to be level? And there are lots of concerns and it’s really interesting because, depending on what part of the world you’re in, everybody seems to think that it’s not a level playing field for them. So, in the U.K., they’re required to now ring-fence retail banking. Doing that is more costly, it requires more capital. And, therefore, the U.K. banks are saying, “Hey, that’s really impacting us and it’s really impacting our ability to compete.”

If you move to the U.S., they are not only going to apply the global rules, they’ve gone beyond that with Dodd Frank. You see, for example, the Volcker rules, and we have yet to figure out how that will impact the banking industry. So, each jurisdiction's trying to figure out how to implement their rules. The banks are trying to figure out strategically what they should do, what businesses do they want to be in, and most importantly, how they’re going to do the business and where?

Vangel: It’s a difficult problem. The Financial Stability Board doesn’t really have regulatory authority, so they really dictate what is done. The Basel community is undertaking a review of how regulatory capital standards are applied. These are difficult but they’re inherent in a world where we’re talking about globally significant institutions. But we have a regulatory apparatus that’s divided by nationality and unless that changes, there are always going to be these questions of balance and consistency.

Schlich: Banks grow globally and they die on a national basis. When they die is when the national interest becomes very important, and that’s when the rules that each different country imposes become very important.
How Will Additional Capital Controls Affect SIFIs?

Knowledge@Wharton: You talked about capital ratios and there is the core tier one capital ratio, which Basel is putting forth, and that is about 7% of your asset base. But then there is a second level required for SIFIs. Could you explain how that works?

Vangel: What Basel has put forward is up to two-and-a-half percentage points more of capital, depending upon a number of criteria: the extent to which there's substitutability for the services that are provided; and the extent of interconnectedness that the company has with the rest of the financial community. At the high end there could be a capital ratio in the area of 9%-9.5% for the larger institutions. And Basel even proposed a further one percentage point charge for an institution that becomes larger, more complex, more interconnected than any of the 28 institutions [the G20 later identified 29] that they have included in the first category – as a disincentive, to getting bigger and more complex.

Schlich: Don, regarding the 28 largest banks though, the basic assumption is they’re going to be at 9.5% — is right? Or will that number be sliding within the group?

Vangel: It’s sliding within the group.

Knowledge@Wharton: What does that mean for the bottom line of banks? Some banks are probably exceeding some of these levels already. Some will have to change their business. Can you generalize or is it, again, complicated by geography and position in the market already?

Schlich: It’s very complicated. What you’re seeing though, is that returns on equities are coming down and the expectations are coming down. Now on the positive side, you hope that being a GSIFI you have the additional capital, have the additional cushion, you’re viewed as a premier counter party and you’re viewed as being able to get cheaper funding. The downside: It’s going to be more costly to do your business. So what banks are doing today is looking strategically at what businesses are there in. And that becomes very difficult or challenging, given that not all the rules are yet written. So some key questions are: What businesses am I in today? Which ones are profitable? Which ones will be profitable in the future? How much capital do I have to have against those businesses, and most importantly, given the complex nature of the world today, where do I want to do that business?

Risk-weighted Assets – What Happens When Enforcement Differs by Region?

Knowledge@Wharton: Itay, there is another piece to the backstop that the regulators are trying to set up in addition to the capital ratios and that is risk-weighted assets. It is a less defined concept in a way because banks have some discretion in how they assign definitions to that.

Goldstein: The basic idea behind capital requirements is you want to hold a certain amount of capital against your assets. But then you would say, “well, different assets have different levels of risk.” For example, if I make a loan and this loan is backed by collateral, and this collateral is relatively safe and easy to value, then you can say that this loan is not very risky and there is less of a need to hold a lot of capital against it.

So the risk-weighted asset is really just a way to adjust assets based on the level of risk and to require capital on the basis of the risk-weighted assets, rather than just the assets per se. Now one of the problems here is that it is not that easy to define and there is a lot of judgment that goes into what is viewed as being more risky. In the U.S., for example, there are old criteria as to what level of risk is associated with different types of assets. But what banks can do is a certain type of regulatory arbitrage within a class of assets, they are going to hold the riskiest loans. And as a result of that, in this given class, they will need to hold less capital against it.

The dilemma for regulators is, to what extent you want to allow banks freedom and judgment in assigning different levels of risks to different assets, and to what extent you want to just control it on the basis of strict rules.

Schlich: There’s some tension today between the banks and in particular between different geographies, the U.S. and Europe as an example, where the question is, are they both risk-weighting assets in the same way? And you can see a true impact on the amount of capital you need. So there needs to be some ability on a global basis to review how you do your risk weighting. The Basel committee’s working on that, whether that’s peer reviews or reviews of different banks — or it may come up with a static portfolio and ask all of the banks to do risk weighting on it, and then compare the output so they can start to get a baseline.
That is going to be very important. You don’t want all the banks around the world suggesting that the risk weighting is different, because that would affect the amount of capital we have. And then you tend to lose the impact of the benefit you’re getting from the higher quality capital if you’re not comfortable with the weightings.

Vangel: There’s been a recognition by the Basel committee of some of the inherent uncertainties around the risk weighting of assets because the Basel II framework (which has yet to be fully implemented in the U.S. but it’s been implemented in a number of other jurisdictions) really relies very heavily on data and models that are developed internally by the institutions. So you could very easily get somewhat different results for what is almost an identical exposure.

What the Basel committee has proposed in part to deal with that, in addition to this assessment process to try and encourage consistency, is to establish a leverage ratio as well, which would require 3% of capital against assets on an off-balance sheet, irrespective of their risk weighting. It’s a backstop against some of the issues with risk weighting.

The Tension between ‘Too Big To Fail’ and Moral Hazard Continues

Knowledge@Wharton: Once you determine that these 28 [the G20 later identified 29] banks are the most important in the world, you set up all of these safeguards that hopefully prevent another meltdown. But at the same time, you’ve designated them as the most important banks in the world. Therefore, if one of these banks does get in trouble, is there a presumption in the market, that once again, everyone will pull out all of the stops to prop it up and prevent a single bank from causing another systemic blowout of some kind?

Goldstein: Yes. I think this is one of the problems with designating this SIFI status ahead of time. Essentially regulators took a stand and said, “You know, this bank is really important and we can’t let this bank fall.” So yes, they will regulate it more and require more capital. But on the other hand, there are other forms by which banks can take risks that are not easily detectable by regulators. And now that this bank knows that it is a SIFI, it is a systemically important financial institution, and it is essentially too big to fail, then maybe the bank will have a higher incentive to take risks. Now all of the counterparties doing business with the bank will know that, and as a result they will govern it less and require the lower cost of capital.

Knowledge@Wharton: What are a couple of those areas that you talked about that they might want to move into that would allow them to do it?

Goldstein: The problem with regulation is you are designing a set of rules that prevent the bank from doing certain things. But then banks can do things within these rules. So for example, for a long time certain institutions had to hold a certain fraction of AAA securities. But we saw from the recent crisis that there are certain types of AAA securities that are not really that safe.

Knowledge@Wharton: Not all AAAs are created equal.

Goldstein: Right, exactly. So now once you’ve designed these rules that you have to hold AAA securities, banks can find creative ways to take risks within those AAA securities.... Another example is the risk weighted assets that we just talked about. So you restrict the SIFI banks — you ask them to hold a certain amount of capital against the risk-weighted asset. However, they then have some judgment into what is the level of risk of any particular asset. And they can design it in a way that they will take more risks.

This is exactly the problem. On the one hand, you designated this SIFI status and as a result banks are restricted to a certain amount of actions. On the other hand, within this range they now have the incentive to take more risks, perhaps.

Vangel: I would agree with that. There are a number of things that policy makers are trying to do around the so called SIFI question. Capital liquidity and other requirements are really intended to increase the resiliency of those institutions to stress. The other important point is to try and internalize the costs associated with that enhanced status within the institutions themselves so that, in theory at least, if one of them were to fail, it wouldn’t be taxpayers who would be supporting it. Whether it’s contingent convertible securities that would trigger and convert to equity, or a so-called bail in, where if the firm were to fail, in theory the regulators could go up the debt stack and effectively convert more debt to bail out the company – it would not be with taxpayer funds but with investor funds.

Knowledge@Wharton: So, bondholders would take a haircut.
Vangel: Right. I think that gets a little bit at some of the moral hazard in terms of those investors who would be looking at some potential downside. In addition, they’re expecting these banks to have what are defined as credible resolution plans that would provide the regulators with information that could be used to resolve the firm in the event of its failure in a way that mitigated the externalities. That could be operating a bridge institution to maintain critically important functions, or breaking off and selling other parts, but not letting it be disruptive. That resolution piece is a challenge. These are across-border institutions, they’re very complex, they’re very interconnected.

So if you think of this in terms of likelihood and impact, the policy makers are trying to address both: Reduce the likelihood of a significant problem, and if there is a problem, mitigate the impact, particularly on the public — whether it’s on the economy or on the taxpayer. The difficulties with the latter make policy makers focus very heavily on reducing the likelihood of failure to as close to zero as you can get.

So you end up with these institutions — pending some clear end game for resolving one of those [meltdowns] being very heavily capitalized and very closely supervised in a way that could be viewed as reducing the probability of failure effectively to zero.

Knowledge@Wharton: In the best of all worlds, that is a very tough balancing act.

Schlich: It is. And I agree with what’s been said. I think very simply — and Don put it very well — they are trying to minimize the possibility of one of these banks going down, and then if you get to that situation, trying to get the softest landing possible. So I don’t think the regulators are viewing this as these banks are the ones that are going to somehow get bailed out by taxpayers. Rather, it is how do we minimize the possibility and then how do we make sure it’s as soft a landing as possible? And it’s incredibly difficult to do.

Vangel: Indeed, the policy objective is to avoid at all costs any need for taxpayer bailout. Getting there operationally is much more of a challenge than stating it as a matter of policy.

Will SIFI Designations Succeed?

Knowledge@Wharton: With the idea of too big to fail, do you think that when this process is done (and many of these rules won’t take effect for many years) it will be effective? Will it work? Or will there be too many unintended consequences?

Schlich: You have to look at everything in terms of moving forward and making progress, and this is progress towards minimizing the possibility of one [bank] going down and then providing for as soft a landing as possible. The problem is, we don’t know what the risks of the future are going to be. We don’t know how they’re going to impact the banks. It will certainly be an improvement over where we were four or five years ago. But to sit here today and say that we couldn’t have a bank go down and have a significant impact, that would be very difficult to do.

Vangel: I agree, particularly if you require these banks to have built suspenders and trusses to support themselves, if one of them still were to reach an extreme, that’s probably going to get a lot of reaction.

Schlich: I think it’s made much more difficult by the fact that there will be all of the different jurisdictions will be involved. So if you had to resolve one of these large institutions, you would like to think we could do that in a way that would get us to the softest landing or the least impact. However when you’re as interconnected globally as these banks are, it gets very difficult. That means that the governments have to work together, that means the regulators have to work together, that means there have to be agreements on how we’re going to settle across jurisdictions. That is very difficult to do.

We are not there today. There are some ideas of how to get there, the G20 has some expectations we’re going to get there. But as long as you still have national regulators and as long as you still have jurisdictions that are bound by countries — again, banks grow globally and they die on a very nationalist basis. So while we’ve made progress the concern is, trying to actually resolve one of these banks across borders is going to be very difficult to do.

Vangel: The thrust of regulatory reform broadly is going to have a pretty significant impact on global banks, business models, structure, their geographic footprint and how they use legal entities. And that’s already beginning to some degree, whether it’s capital requirements, resolution planning concerns, or in other constraints.
At some point you could get to an industry that allows for resolvability of these firms in a way that's not going to be disruptive. The real question is, over what trajectory? Who’s’ calling the shots? Does it happen indigenously within the industry? Is it dictated by regulators because they see impediments to resolution? Those are some of the real deep, unanswered questions I think.

Goldstein: To some extent we always react to the crisis in the past rather than think about what might happen in the future. And obviously it's much more difficult to think about all possible scenarios. So right now, the idea is that there were a few big financial institutions that caused too much risk to the whole system and going forward we need to reduce this. However, I think that there are also some advantages, potentially, in having large financial institutions, if you think about resolving a financial crisis, where you have many, many small financial institutions that are interconnected in all sorts of ways. And when you think about how to resolve such a financial crisis, that might even be more difficult. The fact that you had to deal with a few financial institutions could have alleviated the problem to some extent.

The point is, we’re taking all these measures to of prevent this idea of too big to fail. But as Don said, we are affecting the business model that these institutions use and their incentives. And now we’re going to have to deal with an industry that is going to look very different, and potentially has its own dangers in it.

The Business Impact and Cost of Resolution and Recovery Plans

Knowledge@Wharton: We talked about the recovery and resolution processes — banks must create living wills. In terms of the business impact, how deep are banks going to have to identify their areas of vulnerability, tactically speaking? How big of a burden is this going to be? What’s it going to cost and how tightly are regulators — it will vary by geography – going to hold their feet to the fire?

Schlich: When you talk about resolution or recovery plans, a number of the large institutions are fairly well along in the process. In the U.K. and the U.S. in particular, the top banks have put together plans and they've had them reviewed by the regulators. Resolution plans have not yet been developed. They’re working on them and they are very difficult to do. The interesting thing we’ve seen from the recovery plans is there's been a benefit to the company in doing them. Now, whether they’ll actually come out and admit it is another thing, because it’s very costly, it’s very time consuming, it involves a lot of people and you have to go very deep in your organization, you have to understand your legal entities everywhere, how you’re interconnected, and your service agreements. The level of detail you have to get to is great.

Knowledge@Wharton: How costly? Can you characterize that?

Vangel: Certainly in the $5 million to $10 million range

Schlich: I was going to say $10 million.

Schlich: But there has been some benefit. They now better understand their organizations. They understand how they’re situated around the world, which I’m not sure they had such a great understanding before. In the past, when you advised a company on how to set their operations up around the world, it was all about tax — what’s the tax jurisdiction and how do you do it to minimize tax? Today it’s a lot different – it has to be about tax, capital, liquidity, etcetera.

So the benefit for them has been to understand how their business operates around the world and they’ve learned a lot. I think that they would agree that there were either agreements in place or there were operations that worked certain ways that, they now look at and say, “You know what, we needed to make some changes.” And so there's been a benefit. It's been very costly. They’ll all say it’s a great burden. But I also think that for certain institutions, understanding what actions you take if you began to have a crisis, and then in the worst-possible scenario, how would you resolve it, is going to be important.

Knowledge@Wharton: Is it mostly a one-time cost to set up the systems and processes? Obviously there's ongoing [some] monitoring – But is a lot of the cost up front?

Schlich: A lot of that is up front. But you have to look at these, as I look at them: They are living, breathing documents that have to continue to be updated as your business changes or grows. If they are just put on a shelf then it’s a waste of the $10 million. If they are updated and reviewed and challenged, then there’s some longer-term benefit.
Goldstein: I think there is an additional cost, which is that in the process of writing these living wills you have to give away a lot of information about your organization to regulators. And the question is how regulators are going to use it and to what extent this information is then going to leak into the industry, to the press. And these things are probably holding banks back from wanting to go through this process.

Knowledge@Wharton: Is this about what level of confidentiality you can expect from the regulators when you turn this information over?

Goldstein: Yes.

Vangel: It’s a very big issue. U.S. regulators have issued final rules that deal with the confidentiality question – not to the full satisfaction of the industry. They have the ability to grant confidential treatment for information that's submitted to them, but they are subject in the U.S. to the freedom of information act, so it has to fit within particular exemptions. They've structured it in a way that firms have to explicitly request confidential treatment — in effect, submit two documents, a public version and a confidential version. And firms are very concerned that it's a request for confidential treatment. What will happen if someone challenges that? Will the information leak out? Will the regulators aggregate information and publish it in a way that's going to illuminate what firms are doing?

So there is a lot of concern about confidentiality and I can’t think of any information more sensitive from a competitive standpoint than how you would envision your firm reaching extreme situations and then resolving them.

Knowledge@Wharton: There’s always a worry about it leading to a self-fulfilling prophecy.

Vangel: Exactly.

Schlich: I also believe the banks, when they’re putting these together, have a balancing act. As you put together your recovery plan you certainly want to understand different scenarios. You certainly want to understand what your thought process would be. But you don’t want it to be so prescriptive that the regulator says, “Okay, well you said you were going to do this. Now sell that or move this.” It has to be fluid, because who knows what will come in the future? Who knows what the risks are? And so it’s a balancing act as to how detailed these plans are going to be. Are they going to be followed to the letter? Or is it a case where “here are the principles we’re going to follow, here’s the process we’re going to follow and here’s how we’re going to deal with recovery and then resolution.”

Vangel: This whole resolution planning initiative globally is going to be much more of a journey. It’s not a destination yet. What impediments to resolution will be identified? What ex-anti actions, preemptive actions will the regulators require to deal with some of those impediments? How much will that dictate changes in structure and operating models, the willingness of firms to make those changes? I’m not a corporate lawyer, but it would seem to me that if I have a fiduciary responsibility to my shareholders, spending a lot of resources planning for my own death is not a really good way to use corporate resources. How all that works out is going to be an iterative process over the next few years.

Knowledge@Wharton: Some of these regulations [banks] are not responsible for actually implementing 100% until 2019, some even out to 2024. So it’s a work in progress.

A New Category of Banks Goes Beyond SIFIs

Knowledge@Wharton: There’s another interesting area — a special category being talked about for the largest SIFIs — beyond the 28 [the G20 later identified 29 of the largest global banks] perhaps the top five — what some call the last-bucket category. The idea is to discourage further mergers and acquisitions so that we don’t get mega banks that are bigger than what we have, and that these institutions would be required to have an extra buffer of capital, about 3% percentage points of assets. And that’s seen as a poison pill.

Schlich: It’s interesting, when you think about it — the reason for having that category is quite simple. Regulators are basically saying banks are at a certain level today, and have a certain amount complexity. We want to put a disincentive in place so that people don’t get bigger or more complex, and if you do, we have the ability to then charge you additional capital. And so I think it’s pretty clear the supervisors around the world are not looking for more complex banks. They’re looking for less complex banks, less interconnected banks. And I think this is just another indication of how the rules are working in that direction.
Knowledge@Wharton: Does it effectively quash mergers and acquisitions for these larger banks? What happens down below is another story, but once you hit that level do you really want to get bigger? There’s a big price to pay.

Goldstein: Absolutely. And it’s related to everything we’ve talked about so far. So the idea is that the regulation will be kind of progressive. As you get bigger and bigger you will be required to hold more and more capital. And then there is a little bit of an extra punishment at the top of the scale so that if you get really big, then you will need to put aside capital that is really more than you want to. And yes, this is a clear incentive against doing that.

Schlich: You hope it doesn’t stop mergers and acquisitions. What you’ll see is that banks will have what will be the business that they’re focused on. So they may do a merger and acquisition and only keep certain parts of the business. So the future really could be about banks that are very focused — whether it be in retail banking or commercial banking — and not about becoming a universal bank. I hope it doesn’t stop mergers and acquisitions because I do think there still needs to be more mergers and acquisitions — we have too many banks in the world. It’s going to make banks be very selective. It’s going to make them think about their business model, and it’s going to make them think about what businesses they want to be in and where do they want to do it.

The Outlook for Mergers and Acquisitions

Knowledge@Wharton: I’d like your view about there being too many banks in the world and where any mergers and acquisitions should take place geographically.

Schlich: I do think that there is the possibility of additional mergers in the future. The problem right now is that there are a number of banks in the world that are still dealing with shoring up their capital, making sure they have enough liquidity, making sure they’re strong enough. Now the question is, are they mergers and acquisitions that occur in the normal course of business, meaning I want to take over Don [if Don were a bank], because Don’s a really good candidate? Or are decisions more supported by a push by the country’s supervisors? But I do think in general, if you look around the world, there probably are too many banks.

Vangel: To some degree the policy objectives are all anti-scale and complexity, and towards simplicity and smaller scale.

Particularly in a crisis, size can be really beneficial. Having large firms that can absorb somewhat smaller, but still significant, firms to work through a crisis is not an irrelevancy. That can be really useful and it certainly yielded some benefits in the U.S. situation. I have concerns about these arbitrary lines in the sand that. There are a lot of [perhaps better] mechanisms to govern expansion of regulated institutions....

Knowledge@Wharton: What are some of those mechanisms that you think would be more effective?

Vangel: In all jurisdictions expansion, other than organic expansion, requires prior approval of regulators. Regulators have a wide array of criteria that they can analyze proposals on. In the U.S., now, there are hearings going on about a pending merger that would create a $300 billion institution. One of the issues being debated is, will that create a systemically significant institution? And now, under Dodd Frank, the acquisition could be denied on those grounds. There are also limits in terms of how much more in assets the largest firms could acquire. I think those kinds of arbitrary constraints could create inflexibility in a time of crisis where that size could be really useful.

Do Non-regulated Institutions Have an Advantage?

Knowledge@Wharton: What about the idea of shadow banks, hedge funds and so forth that may be able to go right around a lot of this regulation. That doesn’t mean they’re not creating some systemic risks for the global financial system.

Goldstein: I think there is an attempt to address this going forward. This was clearly a problem in the recent crisis where there was regulation on banks. But because there was regulation of banks, then a lot of bank-type activities were taken by other institutions — like money market funds, hedge funds, insurance companies, and etcetera. And because the regulation structure was different, then they could do that without being subject to any of the rules.
I think going forward the crisis led us to understand that we need to think about this more carefully. And there is an attempt to designate the SIFI status to also some non-bank institutions and require them to hold capital just like banks. But I think that the problem is you will never be able to do it perfectly. And that's kind of the problem with regulation that I was trying to stress all along.

Regulation is, almost by design, not very flexible. You set some rules, and then there are very talented people out there in the banking industry and the financial industry in general who are always trying to do things within the rules, but still get the benefit. And you will probably need to have the next sort of crisis to understand this and change the rules accordingly. So even though there is an attempt to address the shadow banking issue, it's not going to be perfect and you will see that some of these activities are simply going to be shifted away from the regulated industry.

Knowledge@Wharton: Bill, what's your sense of that and is it putting banks at an unfair disadvantage?

Schlich: Shadow banking has always been around and it will always be around. The question is, how can you monitor it? And I think it will be working if all of the sudden as certain activities move out of banks, we see other institutions being designated as SIFIs or getting enhanced supervision. So hopefully it happens. Hopefully the process will be set up that the information on what's happening in the marketplace gets to supervisors and they can make decisions about who should continue to be SIFIs and where changes need to get made.

Is it putting the banks at a disadvantage? I guess it could. I don’t know that it is right now. The biggest change we’ve seen is really the prop [proprietary] traders moving out of the banks and moving into the hedge funds and creating — I call them trading firms, but they’re hedge funds. And my concern with that is that it is an additional risk. And the supervisors need to analyze that and decide, are there now hedge funds or these trading firms that need to be regulated in a more enhanced way? Do they need to be SIFIs? Clearly, Long Term Capital [a hedge fund that collapsed in 1998, causing great financial turmoil] taught us that there is interconnectedness and there are significant institutions out there that are not banks that are doing many of the things banks do.

The regulation is set up such that the attempt is to make sure they understand the shadow banking system and then to change their designations as they need to. Again, it will be the devil's-in-the-details and we’ll see what happens. But it's something that has to be watched and, you’re absolutely right, that was one of the issues in the crisis where all the subprime lending moved out of the banks.

Vangel: I think a challenge for the macro-prudential or systemic-risk bodies, you know, the Financial Stability Oversight Council in the U.S., the European systemic risk body, is to make sure that they’re gathering data from the broadest possible array of institutions to be able to gauge what's happening if business is moving out of the regulatory perimeter, outside of the regulatory perimeter. Is it creating systemic stresses? If you only gather information from within the perimeter, by definition you’re not going to see that until it’s probably too late.

Recommendations for CEOs of Global Banks

Knowledge@Wharton: If you were a global bank CEO right now and you had to weigh all of these issues, how do you think about it strategically? What do you need to act on quickly?

Goldstein: One thing you probably need to do quickly is figure out how you’re going to gather all the data internally that is going to be required by regulators. And this is whether you’re going to be designated as a SIFI or not. If you are going to be designated as a SIFI, then obviously very quickly you will be asked to provide a lot of information. If you are not, then it is possible that you will cross the threshold sometime in the future, and the threshold is going to change. So that's sort on the operational level, this is something they clearly need to do right away.

At the more strategic level there is a decision, and this is where this regulatory arbitrage gets into play, of whether you want to be designated as a SIFI or not. For some banks this is really not a decision to be made if you are really at the top of the scale in terms of size, then you are going to be a SIFI. And if you’re not that big, then you will not be one. But there are many banks that fall around a threshold and potentially can change their status. And I think following up on all the things that we said, I think this is really a complicated strategic issue and it has its pluses and minuses to be considered.

Schlich: It's incredibly challenging today to be the CEO of a bank to deal with all of the things that they’re dealing with. Obviously they need to be very focused on the regulatory environment and the changes, and they need to be compliant with them. And while some of them don’t come into play for a long time, there are a lot that do and so they need to be very focused on that.
I do think that the CEO thinking strategically today needs to consider a couple things. One, he's very focused on his customers, getting back to — who are my customers? What am I providing them? And what should I be providing them? Because that is really what they should be focused on, and on growth — where is it going to come from?

As it relates to the regulatory environment, the CEO that can get it right — where he can be nimble enough so that as these rules come into play, and as they get finalized, he can then change his business model effectively — is the one that's going to be most successful. So that would mean, as we move towards the full limitation of Dodd Frank, what are the implications for my businesses in the U.S.? Do I need to move them, change them? Do I need to get out of some businesses? The CEO has to be very, very focused on his businesses and his customers, but also on being nimble and understanding what the impact will be in the future on his business, and then being able to react to it.

Knowledge@Wharton: Sounds like another reason why there may be more acquisitions in the future, if people are getting out of some businesses.

Vangel: I would second what's been said. I think particularly things like capital and liquidity requirements are going to be very constraining on certain businesses. And different firms will determine where they feel they have a comparative advantage, what businesses they want to deploy that capital and liquidity on. Do they want to move more into businesses, say, in the asset management space, which is less demanding of capital and liquidity because it's “other people's money?” Those are important issues. One topic we haven't really talked about today, but that is relevant to this whole discussion, is the regulatory focus on incentive structures and how people are rewarded and incentivized to do work and take risk and manage risk in financial institutions. How will that impinge upon the ability to attract and retain the kind of people that you need to run certain businesses?

Bill alluded to the prop [proprietary] traders. Well, it became pretty clear when Dodd Frank was passed that prop desks were going to go away. And those people started to move pretty quickly. It wasn’t a matter of CEOs sitting there and saying, “We’ll plan how we’re going to move our prop desk.” So I agree there is a need to be agile and nothing can be off the table. And I agree with Itay that this question of data and infrastructure within the industry, particularly around risk data and being able to aggregate positions and understand exposures, is where I think the industry came up short in the wake of the crisis, and where the global regulators are very, very focused on ensuring that that infrastructure is enhanced.

They would say that the front office got most of the investment for the last 20 or 25 years and it's now time to really build the infrastructure. Well, it's very costly and you don’t want to do that in a way that's going to try to be all things to all people in the future.

Identifying Future Risks

Knowledge@Wharton: I said that was the last question but I do have one more. Don, you've already answered it because that was an important thing that we haven’t talked about. So I’d like to ask each of you what’s an important thing here, or two or three, that we haven’t discussed that maybe should be at least touched on?

Schlich: That's a good question. Well, I think the one thing we haven’t touched on, which, when you talk to the banks you and talk to the directors or you talk to the CFOs, the thing that they're very focused on – and while it’s nice to be focused on all these regulatory requirements and they have to — but how are they dealing with new and emerging risks? What's the process they go through to identify them and then to deal with them? And I think that's the right attitude to have. And I think it's like anything else, it's having the right people, the right process and the time to think about it. But how are they going to deal with evolving risks? Because all I know is the risk that caused the last crisis probably won't cause the next one. It'll be different. And I think we need to be very focused on how do we deal with that.

Knowledge@Wharton: What would you guess might be the future risk?

Schlich: That's a great question. I personally think it'll be around the IT space. As we get more technologically enhanced in terms of how we deal with our customers — it's going to be all about securing that information, it's going to be all about attacks and other things. I think that's one of the clear risks of the future.

Knowledge@Wharton: What's an important thing here that we haven't discussed?
Goldstein: Don mentioned the incentives inside the organization. There is really interesting recent research that shows that those banks that paid their executives more on the basis of the performance of equity ended up taking more risk. That is really striking because we always teach our students that you have to pay managers on the basis of the performance of equity so that they internalize shareholder volume, they try to maximize shareholder volume. But what we see here is that exactly those banks were those where you saw greater risks. And the reason is you have a double moral hazard problem here. You have the traditional moral hazard problem between managers and equity holders. But then you also have the moral hazard problem between equity holders and the government, the taxpayer. So I think this really calls for a change in our model for executive compensation. And perhaps you should not pay bank managers on the basis of equity. You should not give them an incentive just to maximize the value of equity, but rather more broadly to maximize the value that goes to all claimholders, including bond holders, equity holders, depositors and more generally taxpayers. And I think this is really a big reform in executive compensation.