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Banking Needs Entrepreneurship, but How Can Regulators Feel Comfortable?

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Entrepreneurship in banking is arguably not a popular concept in society. With the financial crisis still somewhere in our memory, predictability and stability are considered virtues. Not surprisingly, the last thing bank regulators and supervisors want is to face surprises. But the ICT (information and communication technology) *cum* fintech (financial technology) revolution is changing the world of finance, and banks need to respond or become obsolete. We are in a world with structural shifts; digitalization (the combination of ICT and fintech) lowers entry barriers and disaggregates value chains. How the future looks is up for grabs. The challenge is dealing with unknowns, or even "unknown unknowns" in the words of the former US defense secretary Don Rumsfeld. Entrepreneurship is needed, but how can this be reconciled with the concerns of regulators?

How can regulators and banks come together? Regulators and policymakers need to understand the dynamics of the industry. They should realize that they are facing a moving target. Banks need elbow room to deal with the dynamics—entrepreneurship is inevitable. But banks may hold an important key. Banks should make regulators feel comfortable. If they do not succeed, regulators will curtail the ability of banks to respond to the competitive challenges. See here *the* challenge for the financial-services industry. Regulators need to understand and feel comfortable with the dynamics, and banks should help them get to that level of comfort.

The task for regulators is not an easy one. How can they feel comfortable about the impact of ICT/fintech on the industry? Let's be clear, regulators have reason to be anxious. Big changes in the industry can undermine stability. The proliferation of financial markets, and particularly the rampant and sudden growth in securitization, did play a role in the financial crisis. Similarly, if fintech undermines the profitability of banks, stress may come about not just in individual banks but also in the financial system as a whole. Indeed, the perspective of regulators since the crisis has broadened: the system is important, not just individual institutions. Regulators, therefore, should try to understand how fintech could impact both,

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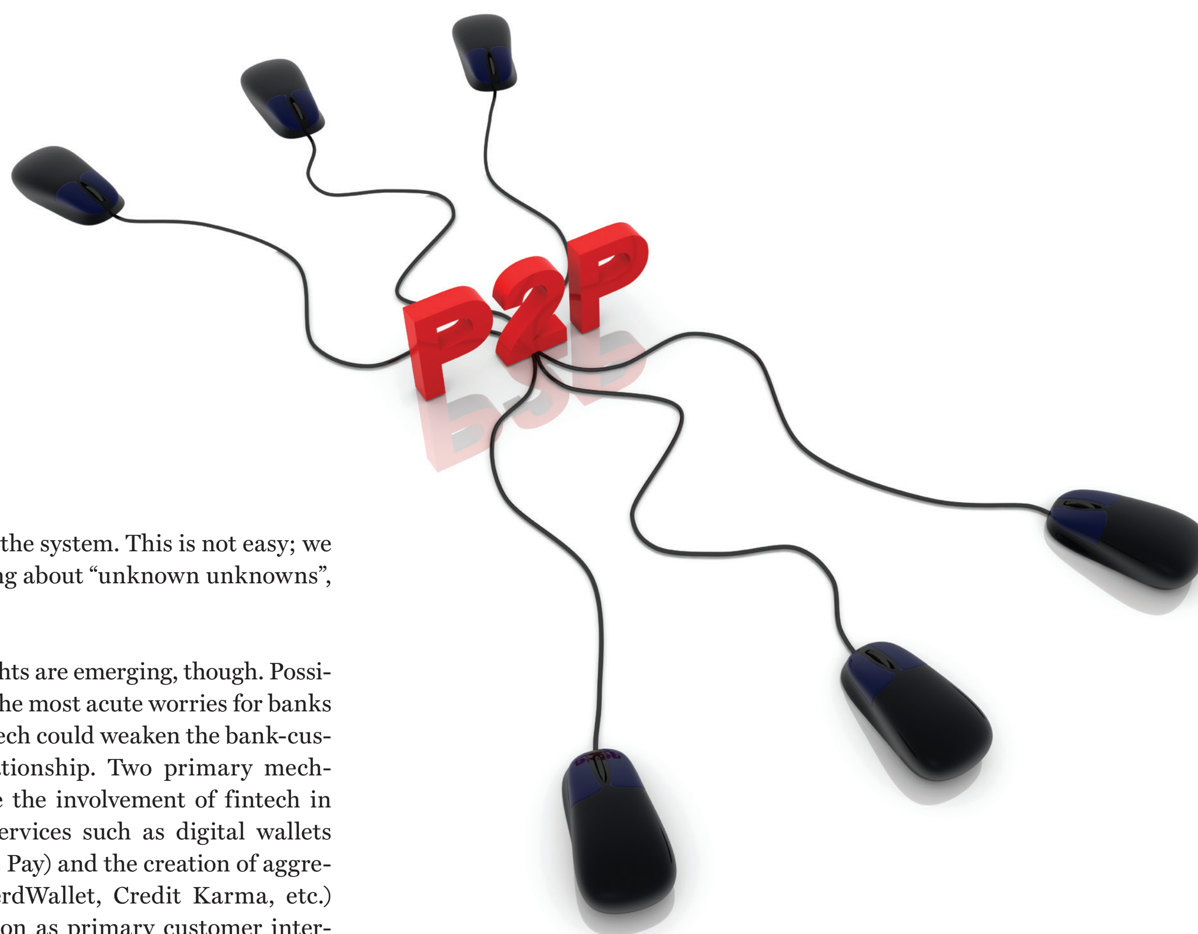

banks and the system. This is not easy; we were talking about "unknown unknowns", after all.

Some insights are emerging, though. Possibly one of the most acute worries for banks is that fintech could weaken the bank-customer relationship. Two primary mechanisms are the involvement of fintech in payment services such as digital wallets (e.g., Apple Pay) and the creation of aggregators (NerdWallet, Credit Karma, etc.) that function as primary customer interfaces and allow easy price comparison and switching between product providers. The fintechs involved in payment services may get access to sets of customer transaction data that previously were at the core of a bank's competitive advantage. Other well-known developments are platforms for lending (e.g., crowd funding, peer-to-peer lending), big data analytics and robo-advising. All these developments have elements of disintermediation, and, in the words of the consultancy McKinsey & Co, create "seamless or on-demand access to an added layer of service [*AB: compare Booking.com*] separate from the underlying provision of the service or product". Having said this, it is too easy to see this just as a threat to banks—banks themselves might become fintechs and expand in these areas as well. Increased competition and margin pressure are, however, likely.

The stress on banks could negatively affect the financial system as a whole. But fintechs may also help strengthen the stability of the financial system. If fintech, ultimately, leads to a more diverse, less homogenous financial landscape, resilience may go up. For example, several European countries are now overly dependent on a few large banks with very similar business models—the United Kingdom and the Netherlands are notable examples. In such systems, stress in one bank more or less automatically implies simultaneous stress in the others, and thus stress in the system: systemic risk. Fintech may help mitigate this. Another concern is the interconnectedness in the financial system, another determinant of systemic risk. Will fintech worsen this, or will it help by making more direct matching—as in PTP (peer-to-peer) lending—possible? Similarly, the decentralized nature of distributed ledgers, with blockchain as the most well-known example—will it add to resilience? At this stage, answers fall short, but progress is being made (the Bank of England is particularly at the forefront of this).

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Regulators and policymakers feel insecure and anxious in this uncertain environment. At the same time, banks seek elbow room to respond to these challenges, and this is where the need for entrepreneurship comes in. But how can regulators feel comfortable

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enough to grant banks leeway? As a start, banks and regulators should realize that the current intrusive regulatory design is not appropriate for the dynamic environment that banks face. The nitty gritty of the regulatory rule book does not fit the dynamics of the industry. It also provides only a false sense of security for regulators. It is the stability of the financial system as a whole, after all, that regulators should be particularly concerned about. A rapidly changing system with new players and existing ones on the run requires a helicopter view. Getting swamped in details should be prevented at all cost. This is not a Trumpian plea for deregulation and *laissez-faire*; to the contrary, stability concerns are real and need to be dealt with.

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The question is, how can regulators be convinced to become less intrusive? Here is where the need for substantial equity-capital cushions comes in. Recognizing the importance of entrepreneurship in conjunction with the desired financial stability makes equity capital of paramount importance—equity is what makes entrepreneurship possible. Banks first need to convince themselves of this. It is shocking to see how banks often try to stop regulatory initiatives to enforce substantial equity cushions. Extensive research in banking shows that being well-capitalized gives a distinct competitive advantage. Once banks have convinced themselves, they have some credibility in building up comfort for the regulator.

This perspective is at odds with the nitty gritty of risk-based capital requirements in combination with all kinds of supervisory requirements that characterize modern banking regulation. A particular eyesore is the overdependence on models in regulatory practice. The models that lie at the root of risk-based capital requirements might work in a world in which banking is predictable, in a steady state of sorts. But this is not the world in which we live. The world we have is one with structural shifts induced by ICT. In such a world, models fail (structural shifts are not in the model…) and provide only a false sense of security.

Making matters possibly even worse, regulators try to compensate for their lack of control with ever more intrusive requirements on banks to provide detailed data on each aspect of their operations. The new European supervisor—the Frankfurt-based “single supervisory mechanism” (part of the European Central Bank and the grand design of the banking union)—has become probably the world’s top data-storage facility. Massive amounts of data are provided daily by all of Europe’s key financial institutions. Insecurity of the regulator is masked by asking for ever more data. Rather than taking a helicopter view and trying to understand how that system works and evolves, details on institutions cloud the “mind” of this regulatory body. Indeed, the expression “can’t see the forest for the trees” would best describe the current status quo. Regulators need to go for the forest (a helicopter view), engage with the industry to try to grasp what is going on, and indeed become more realistic about the comfort that their intrusive micro-management—and models—can provide.

The financial architecture remains special. We need tools and measures to control the system. Adequate capital (and liquidity) at individual institutions do not fully mitigate the concerns about the financial system as a whole. The interconnectedness in the system is a concern, as is, for example, an excessive buildup of credit in the economy at large. Vigilance is needed to keep this in check. This is what in modern terminology is referred to as macro-prudential supervision: a view on the system as a whole. So, let’s not be dogmatic. There is something special about the financial sector that warrants government interference.

Fintech gives another reason to be vigilant. How it will impact the financial system is highly uncertain. Even basic questions such as what impact changes may have on systemic risk cannot be answered. Regulators will be stretched to guard the stability of the system. Banks need to find their way in this dynamic environment and be able to respond to competitive challenges. And, indeed, the new players also deserve a fair chance. Much can be gained if these competitive forces can play out, and the industry optimally adjusts to digitalized realities. But the rigidity and intrusiveness of the current regulatory approach fail to recognize the dynamics of the business and discourage entrepreneurship. Let’s help both the banks and the regulators by giving more freedom to individual institutions in return for sizable equity cushions. And with sizable equity cushions, regulators might feel more secure to take a helicopter view.

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