REBUILDING RESILIENCE, TRUST, CONFIDENCE AND GROWTH IN FINANCIAL MARKETS: WHAT BANKERS ACTUALLY DO

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It's been over three years since International Business and Diplomatic Exchange (IBDE) launched the international programme on responsible banking. Although we have seen a significant progress in terms of improvement in banking corporate governance, standards, conduct and culture, the tsunami regulatory initiatives that have been introduced or are on the way clearly show that there is still much to be done in the banking industry so as to rebuild its trust and confidence among politicians, regulators, customers, investors, the general public and the banks themselves. The huge penalties levied on banks for poor behaviour, failures in operational controls, regulatory breaches and illegal activities have fuelled the mistrust in the financial services industry in recent years.

The role of banks in causing the economic crisis and the banking policies that are required for economic recovery, have been very controversial since the crisis began some eight years ago. Although the financial crisis has had a global impact, the banking crisis itself was not actually a universal problem. We are talking about the United Kingdom, most parts of Europe and of course the United States. There are many other banks in parts of the world that have come out of the crises very strongly. Nonetheless, it is clear that in the west the banking industry has not only been involved, but actually been the cause, of the crisis as well as a break-down in trust.

That said one should note that the vast majority of the banking professionals are responsible people working very hard. So, other stakeholders including politicians and regulators do bear a significant burden for this break down of trust. Therefore, there needs to be continuing active and constructive engagement between the banking industry, regulators and politicians. And this is the focus of IBDE.

Has enough been done, and if not, what needs to be done to ensure that the costs of misconduct do not become an acceptable cost of doing business?

As a consequence of these significant failings in the banking industry we have witnessed an evolving regulatory landscape: with regulations like Dodd-Frank, EMIR, Basel II and III, being the highlights in the global regulatory agendas. A large part of this international regulatory agenda is being done to make the system safer with more capital, capturing derivatives and shadow banking activity in a tighter regulatory environment, coupled with greater transparency. At the same time everyone is observing everyone else to try and make sure there is a level playing field globally for fear of loss of competitiveness. This is an important issue given that in the end we need banks and the financial system to put money efficiently into the economy. Another important issue is the danger of regulatory divergence around the globe and the need for a coherent and coordinated response from regulators. The risk that the regulatory divergence poses is significant, but achieving a coordinated international regulatory response is not an easy task.

The IBDE's responsible banking programme, since its launch over three years ago, has examined some of the failings in banking standards and ethics, and I am happy to note that both the industry, policymakers and regulators seem to be determined to continue addressing these failings and improve the banking culture. Those that are deeply involved in this debate would have recognised that a genuine reforming spirit has been sweeping through the banking industry. In the UK significant changes have been introduced; i.e. changes in the supervisory authorities, reports and paving legislation for ring fencing, new rules on LIBOR, reports of the Parliamentary Committee on Banking Standards, and more recently, on 7 march 2016, the Senior Managers and Certification Regime came into effect, which aims to improve individual responsibility and accountability within banks.

We have seen a number of investigations into rigging and mis-selling have been centre stage these past few years which inevitably further damaged the already poor reputation that retail and especially investment banking suffered following the demise of the Lehman Brothers. Individual banks are investing time and resources to alter the way they are run. Most large banks have established new "strategic change" departments and have made significant investment in order to manage better their conduct risk and compliance. However, a lot still remains to be done. Bank boards and senior management teams, as a consequence, have an incredible amount of work to do to improve banking standards, and given the amount of regulation that has been already introduced and pieces of regulation that are in the pipeline, this will certainly increase the pressure on banks to aim to rebuild the lost trust in a relatively short space of time. This poses a significant challenge in ensuring that the priorities of those that manage the largest banks are set in the right order so as to introduce and implement the necessary new changes when it comes to behavior, competence and culture. So what needs to be done?

Firstly, restoring resilience is an essential component of restoring trust but it is not sufficient. Without confidence in the strength of banks' balance sheets there cannot be trust. But then trust, in terms of expectations of proper treatment of customers and high standards of market conduct, requires more than cast iron capital and liquidity.

Secondly, regulation (i.e. rules) is very important, but equally important is supervision (i.e. how the supervisors interpret and implement the rules). Stress testing is also important, with few if any rules, but has a material impact on the level of capital that banks are required to hold. Supervisors, especially in the UK and US, have a significant amount of discretion so it is crucial to know how they will decide to exercise their discretion.

Thirdly, although we're now eight years on from the start of crisis-induced re-regulation, the regulatory programme is by no means complete. There is significant implementation to come of what's already been agreed plus a new set of initiatives, revised standardised approaches and so on.

At the EU level, how much capacity is there for this unfinished business? The EU lawmakers' rhetoric suggests that "jobs and growth" will remain the top priority, with particular focus on the Capital Markets Union (CMU), meaning that first, we need to develop an efficient infrastructure to finance jobs and growth, and secondly, develop a financial system which can absorb shocks and operate efficiently across borders. As a consequence of the financial crisis, banks are shrinking and will find it difficult to fund the economy on their own; so we need to boost non-bank finance - i.e. shares, bonds and securitisations. This in turn will help corporates and the economy and also reduces the reliance on banks (around 70% of SME finance is in the form of bank debt in mainland Europe) thereby reducing the effect of a bank's failure.

Most of these changes have been welcomed by the industry, and in the long run they will play a crucial role in restoring resilience, trust and standards in the financial services industry, however, challenges still remain, given banks will still have a serious amount of work to do. Banks need to ensure they balance the safety of system against support of the so called "real economy". This is particularly important for the UK and European economies given the vast preponderance of business lending in the UK and the EU is through bank-lending (roughly 95% in UK and 80% in EU, in comparison with the United States being at 20%). Clearly, the retail and commercial banking still plays a key role in supporting the "real economy". But, investment banking, although hated by many, has an important role to play, too: investors, including pension funds, need to be financially connected to companies. So the intermediation by banks, creating and trading assets, is hugely important for allocating capital to the people, entrepreneurs and businesses that are likely to be profitable and beneficial to society.

Further, it is essential that credit is not withdrawn when a crisis occurs; therefore, the necessary preparations need to be made to allow for the fact that it can require a period of years following a crisis to sort out the problems. Capital must be maintained with due regard to ensuring that the real economy does not suffer.

Bank lending is cyclical and we need counter-cyclical sources of funding in place in time for the next downward cycle. As an attempt to fill the lending gap in the past two years we have been witnessing an increasing number of the so called "challenger" banks, peer-to-peer lending and crowdfunding as part of the alternative sources of finance. They have come to the market and are growing apace, but still from a small base. For alternative financing to succeed we need to focus as much on education of SMEs and cultural acceptance of alternative sources of finance, as we do the infrastructure. This is particularly key as, by the time the infrastructure is in place, we will be well into the next cycle of bank lending.

The fact that a variety of other actors from crowdfunding to private equity have entered the space partially vacated by the banks is good news. The sector could particularly play a key role in providing the much needed SME finance. The importance of SMEs to the Global Economy has been underlined many times. In the current constrained environment for bank lending, it is increasingly important for alternative financing solutions to come to the fore to complement the banking system, promote financial stability and diversify the sources of business funding for smaller and mid-market companies. There are a number of promising opportunities in the alternative financing field such as the development of private placement markets, the re-opening of SME loan securitisation markets as a mechanism to increase funding for smaller and mid-market companies.

Since the financial crisis, the debate about whether banks are lending enough to SMEs has become utterly sterile. The fact is that banks are lending differently and that is likely to remain the case. In addition, the alternative finance sector is now being properly regulated, and given they do not have the burden of mistrust as the big banks have, the prospect of alternative finance lending moving from an "early stage" to "scale-up" stage is becoming more realistic. Whether we are ready for this or not - that still remains to be seen. Particular attention should be paid when these funds become large companies and their aspiration for growth increases. This will lead to an increase in the appetite to take greater risks in lending which may lead to loss of confidence from their investors and customers should for instance investment turn sour.

In conclusion, restoring resilience, trust and growth in financial markets will remain one of the key priorities for boards in the next few years. Whilst some progress has been made in improving conduct and culture, banks' boards and senior management have an incredible amount of work to do in a relatively short space of time. That said, given the financial services industry plays a pivotal role to the global economic growth and prosperity, a better job should be done in explaining to customers, investors, the media and the general public what bankers actually do.

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