Regulation in the time of COVID: Are banks still too big to fail in 2021?

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While we've all been locked down at home, financial services regulation is continuing to move at pace. Gavin Stewart has been summarising regulatory updates on a daily basis.

Since lockdown began, I've been writing daily blogs on the impact of COVID-19, Brexit and digitisation on the financial services industry. I've compiled this week's updates into a digest form.

Are banks still too big too fail?

Last Thursday saw publication of the Financial Stability Board's (FSB) evaluation of the too-big-to-fail (TBTF) reforms that have been introduced since the financial crisis. From resolution plans to bail-in and total loss-absorbing capacity (TLAC) requirements, these were designed to prevent governments and taxpayers having to save banks in the future. The report is frank about caveating its conclusions - eg, almost all the analysis is based on pre-coronavirus data - but is by far the most serious attempt yet to judge the success of TBTF.

The conclusions are relatively positive but the remaining gaps it identifies are still significant - eg, there is still scope for systemically important banks (SIBs) to improve their risk data aggregation and reporting frameworks. There are also trade-offs, as ever, with the report noting that some risk has shifted to shadow banking, and that the resilience of central counterparties (CCPs) has become more important. Meanwhile, governments have continued to support failing banks, and although this has been for a range of reasons, it means TBTF arrangements remain essentially untested.

There hasn't been a bank failure in the UK since the financial crisis and the ring-fencing of large UK retail banks was designed to hive off higher risk-taking investment bank activities. On the other hand, the political mood around regulation is essentially for zero failures, while the government's use of banks to provide credit during coronavirus has intertwined public and private sector while strengthening the position of the largest. Overall therefore, despite the shifts noted in the FSB report, UK banks are probably still TBTF.

Archegos and post-financial crisis reforms

Last Wednesday, I suggested that regulators' focus post the collapse of Archegos would be, firstly, on whether it was a one off, and then on the risk management of the banks involved. Since then, the fallout has accelerated, and this twin regulatory focus is taking shape.

Down the line, regulators will renew their interest in shadow banking. Non-bank finance was generally given an easy ride by the post financial crisis reforms; partly it turned out not to have as strong a link to the causes of that crisis as many had anticipated, and there was also a general wish to diversify away from banking. Since then, the asset management sector has grown and consolidated, to the point where the FSB is again looking at whether it is systemic.

Meanwhile, the global body's recent evaluation of the TBTF reforms concluded that some risk had in fact moved from banking to shadow banking. Even it it is a one-off, Archegos shows some of the potential downside implications of this shift.

On the risk management side, the more information becomes public the deeper the problem appears to be. Back in 2009, the Walker Report on Corporate Governance made some clear recommendations (23-27, p19ff) on the governance of risk and the role of the Chief Risk Officer (CRO), which is also now (since 2016) a Senior Management Function in the UK. Both the Prudential Regulation Authority (PRA) and FCA will be therefore be interested in how the relevant banks' exposures to Archegos fitted with their risk appetite, the knowledge and scrutiny at board level, and the extent to which their CROs were aware of/involved in decision making.

Regulation and Big Tech

After a long period of inertia, the tectonic plates on this seem to be moving, if not yet entirely predictably or coherently.

It now seems that the Digital Markets Unit (DMU), being set up within the Competition and Markets Authority (CMA) to "rein in the power of big tech companies" won't have the weight of legislation behind it until 2022 - in the meantime, the new unit will operate in shadow form. Although not ideal, this may actually prove a catalyst for the CMA to experiment - necessity being the mother of invention - and so an opportunity for it to shape the eventual legislation.

The DMU - essentially intended as a competition regulator - will be significant for financial services regulation, not least as the big tech platforms continue to push into financial services, whether directly or, for example, as cloud providers. A more immediate concern, however, is their dominance of advertising. Post-London Capital & Finance Plc (LCF), the FCA's approach to financial promotions online clearly needs a major overhaul, but this will be ineffective without the active help of Google and others. At last month's TSC hearing, therefore, the regulator called for the inclusion of financial fraud in the Online Harms Bill, arguing persuasively that, even if reached, voluntary agreements aren't enough. Fraud's inclusion is also supported by the DWP Select Cttee and by the Bank of England.

The Online Harms Bill originates in the DCMS, with Ofcom as the intended regulator, and it's not clear how open Government is to broadening its scope. However momentum is building, with HM Treasury, the Home Office and the DWP also having an interest. And given the growing scale of the online fraud problem - £1.2bn in 2020 according to UK Finance figures, it would now be disappointing if this evident gap in regulation isn't quickly filled.

A regulatory success? Too soon to tell...

The role of regulation is critically affected by the state of the macro economy. When this is buoyant, firm and regulatory failings alike are often obscured; when it drops, all manner of problems are exposed as the tide goes out. This is a relatively simple argument, but the attractions of believing you are doing a good job are hard to resist when the most obvious measure of success is the absence of bad news, and they were a seductive factor behind the FSA's ill-fated 'Making a Real Difference' change programme in 2006.

As we (hopefully) start to emerge from coronavirus, there will be a temptation for the FCA, notwithstanding the continuing LCF fallout, to bask in the perceived success of its temporary regulations, and for the PRA to congratulate itself on its nuanced guidance last summer around the application of IFRS 9, its own form of forbearance. Both instincts might well prove right but it's too soon to tell, and regulatory problems often have a venomous time lag built into them.

The current economic picture is ambiguous and potentially contradictory, with strong recruitment figures sitting somewhat uncomfortably alongside evidence of how sharply divergent our K-shaped recovery is likely to be. As the FCA pushes on with its 'transformation' programme and the PRA starts to focus more on operational resilience and climate risk, it will be at least another year before we can start making a credible assessment of whether regulation performed well in the current circumstances.

Home working futures

Monday sees the next major step in re-opening the economy as the UK seeks to move out of lockdown. Almost since the first weeks of the first lockdown a year ago, when the shift to remote working proved more seamless than almost anyone expected, we have all been speculating about what a 'return to the office' would look like - when? how often? why? - and what sort of hybrid models might develop.

In the past few weeks, some of this thinking has begun to firm up, with proposals ranging across a wide spectrum from maximum flexibility for home working to an expectation of almost full return. For many firms cost will be a major factor, but this calculation will be as much about client expectations as real estate footprints. Less talked about is the increased choices that skilled workers will have, and whether flexibility and location will become important drivers of why people move employers.

Both the FCA, PRA and Bank of England (BoE) will have their own challenges in this regard, with the former still trying to build a corporate culture and the latter wary of diluting what it perceives as a strength. When they turn to regulated firms, they will inevitably be interested in how firms manage and monitor their staff, and its implications for everything from Senior Managers and Certification Regime (SMCR) to market abuse. But, increasingly, they are also likely to focus on broader risks, such as the potential weakening of corporate culture and the parallel creation of islands of cultural dissidence. Partly too, as this is new territory, they simply will watch firms' different approaches to see how they turn out.

To discuss these issues further, contact Gavin Stewart.