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Modern Banking Is a Global Enterprise

By Allan D. Grody and Peter J. Hughes
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Banking is not conducted locally. It is conducted globally, whether or not local branches serve a small rural community or operate in the City or on Wall Street, write Allan D. Grody and Peter J. Hughes.

The banker that James Stewart memorialized in "It's a Wonderful Life," the 1930s classic that depicted the small-town-lending and deposit-taking bank is gone, never to be resurrected. However, regulators are still trying to put the genie back in the bottle and return to our earlier model of banking.

Regulators cannot seem to understand that the changes effected by technological advances and modern risk management techniques have evolved banking practices and banking institutions into a new profession. Banking is not conducted locally. It is conducted globally, whether or not local branches serve a small rural community or operate in the City or on Wall Street.

Banking's traditional lending and deposit taking businesses are interrelated to global funding, syndication and intermediation. Banking must be placed in the context of a global financial industry of which it is but a part. Banking has evolved over a generation in which new technologies enabled the globalization of financial services and facilitated business consolidations through successive mergers and acquisitions.

A new category of financial institution, the systemically important financial institution has been recognized, formalized in regulations and placed at the apex of responsibility for facilitating regulatory implementations that will risk adjust the financial system. These banks are capital and contract markets participants as well as commercial and retail lenders and deposit takers. This complexity, overlaid on an increasingly technological infrastructure is a fundamental and foundational change in banking that must be considered when promulgating new regulations intended to separate "traditional" banking within the global financial system.

Whilst technological and infrastructure change was underway, the nature of banking was changing primarily due to declining credit spreads brought on by competition. Banks engaged increasingly in wholesale funding markets, in risk distribution syndications and securitizations, in risk management and in-balance-sheet leverage brought about by off-balance-sheet derivatives and special-purpose entities.

The dramatic change in the risk landscape characterized by burgeoning complexity of financial products, deregulation and escalating business consolidations occurred in little more than a generation and provided the backdrop to the most recent financial crisis. Such change occurred at a pace that did not allow regulators, accountants, auditors, risk managers and technologists time to design and implement sufficiently robust risk control, monitoring and reporting systems. This resulted in massive accumulations of exposures to risk in the global banking system that escaped timely identification and quantification.

The short-term regulatory response to the crisis, primarily driven by the Basel Committee and the Financial Stability Board was the mandate for banks to enhance the quantity and quality of their capital and liquidity reserves with the aim of increasing their capacity to buffer unexpected losses, and the introduction of mechanisms to counter model risk and measurement error in capital adequacy calculations. This was done primarily through the introduction of an accounting-based leverage ratio. The medium-term response placed emphasis on implementing more robust risk management frameworks and infrastructures. Five such mandates are worthy of particular mention:

- Principles for effective risk data aggregation and risk reporting (Basel)
- The regulatory framework: balancing risk sensitivity, simplicity and comparability (Basel)
- A Global Legal Entity Identifier for Financial Markets (FSB)
- Principles for an effective risk appetite framework (FSB)
- Supervisory interaction with financial institutions on risk culture (FSB)

We highlight these mandates as we believe they provide the cornerstone for a future global banking system that will provide the improved conditions in which the new profession of banker can evolve.

As a final observation we note that the above five initiatives are interdependent. For example, an effective risk appetite framework is dependent on the ability to aggregate risk data; the ability to aggregate data is dependent on defining participants in transactions consistently through common identification standards; the development of a positive risk culture is dependent on the implementation of an effective risk appetite framework; and none of this will be possible if we do not achieve a greater degree of simplicity and comparability in the regulatory framework.

Banking is a global enterprise. Its professional competency and credentialing should recognize the mobility of the profession and the multi-disciplined nature of the craft. The global banker in our future will be prepared to enter into a socially responsible global banking culture comporting to high standards of professional behavior.

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