SOME THOUGHTS AROUND OPERATIONAL RESILIENCE FROM A BANKING PERSPECTIVE

OPERATIONAL RESILIENCE OF BANKS

15th BCBS-FSI high-level meeting for Africa
Cape Town, January 30th, 2020

José María Roldán
Chairman & CEO, Spanish Banking Association

OPERATIONAL RESILIENCE IN CONTEXT (1/2)

- Operational resilience: how to prevent, adapt and respond to operational disruption.
- Not new… 9/11, Year 2000 effect (?).
- Not just financial sector: aviation, healthcare/pharma industry has been dealing with this for decades.

OPERATIONAL RESILIENCE IN CONTEXT (2/2)

- But environment/ecosystem has changed, dramatically! And poses difficult-to-answer questions:
  - Will operational disruptions be the main cause of bank failures in the XXI Century? Can a bank reputation recover from a massive and lengthy disruption affecting clients? How probable are these types of disruptions?
  - Will a main non-financial technological cloud services supplier failure be the cause of the next global financial crisis?

- ECB/ESRB: "**The General Board has also indentified cyber risk as a source of systemic risk to the financial system**. A critical point in assessing whether a cyber incident will develop into a systemic financial crisis is whether or not the incident escalates from an operational level to take on financial and confidence dimensions. The ESRB's analysis, which will be published in the coming months, illustrates how a cyber incident could, under certain circumstances, rapidly escalate from an operational outage to a liquidity crisis. In turn – and in common with historical financial crises – this liquidity crisis could, in certain circumstances, lead to a systemic crisis. The ESRB is continuing to work on cyber risk, focusing on how to mitigate the vulnerabilities identified and on the role of authorities in a systemic cyber crisis. This is particularly important in light of the likely speed and scale of such an event and the specific challenges they pose (in particular for communication and coordination strategies)" . (*Press release, 7 February 2020).*

- To sum up: we don't know yet.
  - Known unknown: It's gonna be different but we don't know practical implications of the new digital environment being different.

A NEW NORMAL?

The New Normal:

- **Digital revolution in banking**
  - New ways of conducting business: from branches to apps. From internal services to outsourcing.
  - New players: fintechs and bigtechs.
  - New ecosystem: cloud computing, Third Party Services Providers, increased concentration of services providers (cloud).
  - The importance of data access.
- **Demand has also changed**
  - From limited access to bank services (location and timing) to 24/7 banking.
    - Yet, the intolerance to any servicing failure is greater than ever before (last one, Lloyds Bank on New Year)!
  - No real ownership of data by consumers, so far, but this may change.

Externalilities abound in this new world:

- Not just between society as a whole and private firms.
- Also among private firms: weakest link problem.
- Cooperative solutions will be key.

SOME THOUGHTS ON REGULATION IN NEW NORMAL (1/2)

- **Stage I (Pre-crisis, pre-bubble):**
  - Relatively loose regulation.
  - Room for intrusive supervision.

- **Stage II (Bubble period):**
  - Irrational exuberance on the capacity of banks to manage and control risks.
    - Internal Models…
    - …although Basel II gave proper incentives to better risk management.
  - Supervision became more distracted.

- **Stage III (Post-crisis):**
  - Extremely detailed regulation: New Regulatory Paradigm.
  - Supervision, tougher but centred around compliance. More powerful but less discretionary than pre-bubble!

SOME THOUGHTS ON REGULATION IN NEW NORMAL (2/2)

- **Stage IV (Digital Revolution):**
  - The old regulatory scheme (any previous stage) does not work anymore and a new, more flexible, open-ended approach is needed.
  - Nitty-gritty regulations do not work anymore and can be even counterproductive.
    - Can you regulate operational resilience in a detailed way?
    - A detailed regulation may induce arbitrage by non banks.
    - A detailed regulation may create a false sense of security.
    - Regulation can result non-neutral from a technologial perspective.
    - Capital is useless for protecting banks from operational disruption.

A NEW DEAL FOR THE NEW NORMAL

In the Digital World a New Deal implies:

- New type of relationship between supervisors and supervised firms.
- The problem is not the known unknowns, but rather the unknown unknowns: new risks will surprise us in unexpected and unprecedented ways.
- The deal is basically a deal around cooperation: sitting around at the same table - to share “our ignorance”.
- The deal involves fewer rules and potentially more discretionary powers by supervisors.
- The deal involves reaching out to non-financial firms (cloud servicers, bigtechs, fintechs, etc.).

A NEW DEAL JUST FOR THE DIGITAL WORLD?

In fact, this *New Deal* between banks and supervisors should be applied to other areas:

- AML/KYC: information sharing among banks and between banks and FIUs.
- Climate Change.

RISK AND CHALLENGES AHEAD

- **Regulation faces two main risks of different nature:**
  - Regulatory capture.
  - Supervisors end up managing the banks.
- **Hybrid Model:**
  - Some regulators will not accept the new approach: difficult to switch from compliance mode in one area to cooperative mode in other areas.
- **Regulators reluctance:**
  - Philosophy.
  - Higher exposure/liabilities in the Hybrid Model.
- **Firms:**
  - How to ensure Board’s adecuate tension around these issues.
    - Shared responsabilities with regulators may generate the wrong incentives!

THE EUROPEAN BANKING SECTOR PERSPECTIVE (1/2)

The complex ecosystem of EU banks:

- Single Supervision:
  - SSM.
  - Hub and spokes: NCAs + ECB.
- Single payment area:
  - EU-wide Regulation.
  - Systems mostly domestic.
- EU Banks:
  - Global: Greater sophistication and IT budgets.
  - Pan EU.
  - Domestic: Limited budget capacity.
- Digital Revolution:
  - From branches to app.
  - Fintechs.
  - Bigtechs.
  - PSD2: regulation opening Payment System to greater competition.
- Separation of Supervision:
  - Conduct of business rules.
  - Solvency.
  - Resolution.

THE EUROPEAN BANKING SECTOR PERSPECTIVE (2/2)

Does it all matter?

- Probably European specificities do not matter so much.
- Cyber space risk and threats are global:
  - EU structure just adds another layer to global coordination, which will be key.
- Weakest link problem prevalent elsewhere.
- Central approach may help.
- But coordination challenges will emerge given the high number of sectors involved.

TO SUM UP

- New operational resilience framework requieres a new way of thinking, not only about risk management, but also about regulation/ supervision and how regulators and regulated entities interact.

- The new world implies new challenges. We may need a new regulatory deal.
    - ➢ But this new deal poses questions for which we have no clear answers: Perfection is not achievable in this new environment.

ASOCIACIÓN ESPAÑOLA DE BANCA