

Right of New Normality

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First of all, I would like to thank the International Bar Association and the other organizers of this great event for inviting me to deliver the keynote address. It is a very special occasion for me as I am a „sleeping agent“ of the Estonian Bar: my powers as an attorney at law have been temporarily stopped because of my service in the public sector. But I am with you, guys! ☺

Second, I would like to thank the Chairman of the Estonian Bar Association Mr. Hannes Vallikivi for helping to inspire this speech. It was 20 years ago or so when we worked together as young attorneys to advise billions of kroons worth of foreign investments that came to rebuild Estonia as a modern free market economy, based on the rule of law and democracy. While we were kept busy piling up the billable hours, back then we still found the chance to discuss many different topics, among them the role of law in financial markets.

In this speech I would like to share with you my thoughts on the role of banking in society, on the weaknesses of European banking, and on how the law and institutions can help to overcome these weaknesses.

The financial sector is a vehicle for redistributing wealth and risks across time and across space. As a general rule, this is done on a contractual basis. It is widely accepted that Europe, or at least continental Europe, is an economy that is largely built on a universal banking system. Our friends in Anglo-American jurisdictions have balanced that system more with capital markets.

The banking sector helps people to transfer money, or value, across space and time.

Across time,

- 1) by bringing the future to the present by granting credit to those who need extra resources to meet their needs and to bring their ideas to life, and who qualify for such credit;
- 2) by taking the present to the future by assuming deposits from those who do not need the extra resources they have right now for their needs and ideas.

And in space, by transferring funds almost at the speed of light from one country to another and between continents. This means the banking sector has an important role in intermediating money to facilitate the smooth operation of the free market economy and society as a whole.

The banking market in Europe varies a lot from place to place. We have markets that are dominated by a few large banking groups, like France, then markets where there are more credit institutions, like Germany. We see markets that are mainly populated by foreign institutions, like those in Eastern Europe, and ones with mainly domestic players, like in Western Europe. Unfortunately however, one thing seems to be common across Europe, which is that the current banking system is not in the best shape.

Yes, this could be an opportunity for newcomers, such as lending platforms and other fintech companies with clean balance sheets, newer technology, large databases, and hungrier risk-takers on board. An optimist would say this is good for competition and will let in a fresh breeze to the financial sector. A realist would argue that we should still not forget about the existing banking system, as it will remain the distributor of fuel for economies for some time.

What is the recipe for a stable banking system and strong banks? To put it in a nutshell, there are just a few key points:

- good people with the right values, with the moral hazard of bank managers sufficiently addressed;
- a transparent and flexible legal system;
- and strong, independent and professional public institutions.

Of course, the use of modern technology, reasonable processes for risk-taking and risk-management are also of value.

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A healthy bank is well capitalized with stable capital, and has properly dispersed financing, the right cost-income ratio, good asset-liability management, reasonable profitability, and low levels of non-performing loans. Let me give you some examples.

Capital adequacy shows how well the banks are capitalized. The higher the ratio, the better it is for stability and risk-taking. The average capital adequacy ratio in Estonian banking is well above 20%, while the Eurozone average is well below 20%. I have seen a bank reporting negative adequacy, which of course is clearly a breach of the law. And breach is not reporting it, but negative ratio, of course.

The efficiency of a business organization can be measured by its cost-income ratio. The lower it is, the more efficiently the business is organized. The cost-income ratio of our banking sector is below 50%, while the average in the European Union is 66%.

The return on assets of the Estonian banking sector was 1.8% in 2016, while the average in the European Union is 0.21%. All the credit institutions here are profitable, while we can see some struggle in the European market as a whole. Estonian banks have 1.7% NPLs to the total loan portfolio; the European average is 5.1%, while some regions tend to have around 10% or even more as a norm.

If a bank does not have sufficient capital to take risks, or when its balance sheet is packed with non-performing loans, it cannot adequately perform its function of redistributing funds in time to provide credit for the economy. There is a specific term of art for such banks – they are called “zombie banks”. They exist, but they are not alive. Now laws and institutions are among the keys for deciding whether, under what conditions, and how quickly economic agents can turn the page and have a new fresh start.

A legal norm is a universally binding rule or standard of conduct established by the appropriate authority in the prescribed manner, with compliance enforced by state power. Generally, the public associates such norms with laws and courts. In economics and finance, the law is associated with contracts, corporations, and bankruptcy. These are all children of the law, with regulations reflecting the prevailing values in society or the balance of values. Laws mainly deal with or ought to deal with market failures, distributing risks or opportunities to one or another individual or group.

Laws also prescribe how justice is carried out, how courts and judges operate and how judgements are enforced. In brief, procedural norms set out an algorithm by which truth is summoned, and set out the cost of how facts are found and fixed, which is necessary for legal norms to become alive.

"Time is money!" stated Benjamin Franklin, one of the founding fathers of the United States of America. I don't need to say that this crowd here knows very well the finesses of this phrase. I am afraid that not everyone in society fully recognizes the true meaning of time, money, and turning the page. Sometimes I even feel that the law is an instrument used to keep things static. No rushing, just clean fact finding, the fireworks of legal arguments, then steady analysis and judgement, which can be appealed several times. Checks and balances, they say.

The understanding people have of the cyclicity of the economy needs no further explanation. There are better and worse times. People tend to search for and find explanations for bad times: why they happened, what "mistakes" were made, and how it can all be avoided next time. Generally, a "guilty party" and answers will be found in economic policies and in human psychology. But this does not help in wiping out zombies from the past that exist, but are not fully alive. The law and institutions will do this, or they will not. An interesting fact: insolvency discharge periods in the Eurozone range from one to ten years across jurisdictions.

I like simple examples and equally simple solutions. There is solidity, precision and beauty in them. Let me give you an example to justify Benjamin Franklin's statement on time and money.

Let's take two countries: the Republic of Bureaucracy and the Kingdom of Simplistan. In Simplistan, assets can be acquired under an agreement reached by the seller and buyer. The state trusts its citizens, or does not care; your point of view depends on your value systems.

Before transferring property in Bureaucracy, the seller and buyer need to consult three state agencies, initiate a court case, and register the judgement in the public registry. Nobody remembers why this is done, but older annotations state that it is necessary to protect the rights of the contracting parties.

All other things being equal, it is clear that the transfer of property takes a bit more time in the Republic of Bureaucracy. E-solutions would help to speed things up, but even so, some additional cost will remain. We may believe that "rights are better protected" in this state, but this will only be clear afterwards, and it might not play out that way each time. In addition, there is no transparency about what the overall costs are for executing the consultations, processes, and registrations.

Simplistan allows quicker re-allocation of risks and opportunities. And thus a more sensitive search for new sources of ideas, and an increased likelihood of finding added value. Which in turn boosts the potential to make good earlier breaches, where these have occurred.

Now it is time to put the pieces together. To wrap up. To cut the long story short.

In regulating finance and enforcing respective norms, it is reasonable and welcome to consider the short and long-term incentives that any action will create, in addition to looking at arguments about protecting rights or protecting weaker parties. Would a particular regulation or the activities of an institution facilitate turning the page and opening up new opportunities and risks, or would it cement the status quo?

Why not swiftly resolve the weak banks in Europe to boost our economies so they are competitive at the global level? We have harmonized bank resolution rules for that. We have the EU institutions to enforce them and to guide the national authorities. If there is too much short-sighted incentives built into legal framework involved to keep current situation, let's change the framework!

Why not clean the balance sheets of NPLs to revitalize those credit institutions that have potential? Those banks could then grant credit to people and to potentially viable ideas. If there is a legal obstacle, let's change the law. Let's introduce out-of-court enforcement of collateral in the 10 Eurozone countries where it does not exist; let's digitalize court proceedings, like Estonia has, in the countries where insolvency takes 10 years to complete. Let's further simplify the procedural rules for debt collection to shorten the time it takes, as it can still take 5 years in certain member states even with consumer credit.

I am for a legal framework which incentivizes fast turnover, the search for new added value, and new normality. Regulations, at least in finance, should prioritize providing compensation for breaches rather than restitution in kind of the pre-existing situation.

I fully acknowledge that in real life there is no single one size fits all answer to all issues, as the circumstances of each case tend to be unique. This, however, does not overrule Benjamin Franklin's wise conclusion that time is money!