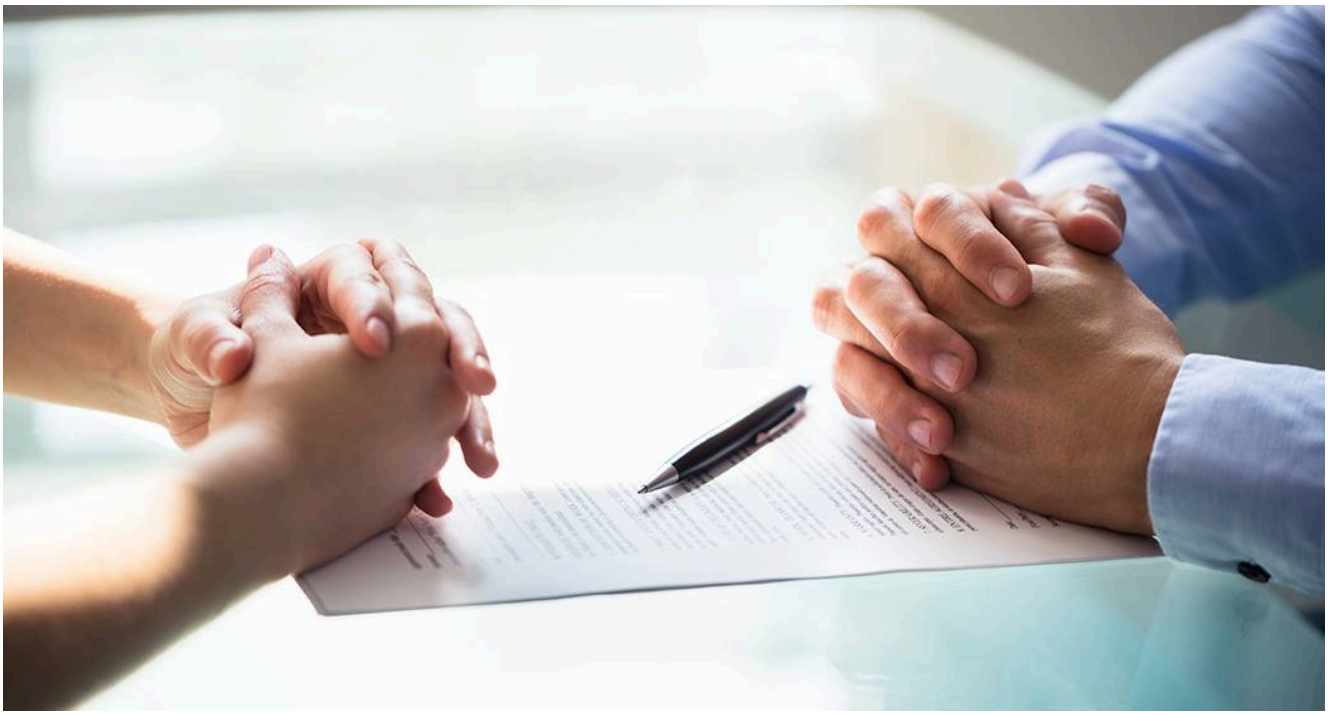
Is our banking system sound at last?

A new report assesses the achievements and outstanding business of a decade of financial regulation. IESE's Xavier Vives and co-authors look at the past to better prepare for the future of banking.



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What has changed since the **global financial crisis**? What remains to be done?

While there have been improvements in financial regulation and supervision over the past decade, there is still no framework for dealing with shadow banking and new digital competitors who remain outside the perimeter of regulation. What's more, new regulations and high compliance costs make entry difficult, and they have increased the tendency for

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market concentration, potentially aggravating the problem of banks that are "too big to fail."

These are among the conclusions of "Sound at Last? Assessing a Decade of Financial Regulation", the first report in a new series — *The Future of Banking* — from IESE Business School and the Centre for Economic Policy Research (CEPR) with the support of Citi.

Co-authored by four leading economists and CEPR researchers — including IESE's Xavier Vives — the report notes that the legacy of the crisis is stronger and better capitalized banks, as well as regulators and supervisors with increased clout who pay more attention to systemic risk.

But the crisis has also left a legacy of high leverage in advanced economies, especially in terms of ratios of sovereign debt to GDP. At the same time, interest rates are at very low levels. All of this, together with the digital disruption of the sector, poses formidable challenges for the banking industry.

Among the report's **key messages** are the following:

- Prudential regulation should take a holistic approach, considering and setting requirements for capital, liquidity and disclosure together and taking account of their potential interactions, together with the competitive conditions of the industry.
- Stress tests are very useful if well designed. A main lesson from the euro area is that effective stress tests can only be implemented when there is a backstop for the banking system. To remain effective, the tests must be severe, flexible and not overly transparent.
- Regulation inevitably leads to innovation aimed at escaping the new rigorous oversight. To ensure that an ever-changing financial system remains resilient, authorities need a framework to monitor, assess, designate, regulate and supervise entities outside the perimeter of regulation.
- Central banks have to recover their traditional financial stability remit, and these more powerful central banks need strengthened accountability and democratic legitimacy.

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