WHERE IS REGULATION REALLY GOING?

HERE WE GO AGAIN. EVERYONE APPEARS TO BE POSTURING BASED ON THE THINGS WE THINK HAVE HAPPENED AND SO WE NEED NEW REGULATIONS. NEW REGULATIONS FOR OFFSHORE FINANCIAL CENTRES. NEW REGULATIONS FOR LIQUIDITY AND STRESS TESTING. NEW REGULATIONS FOR CAPITAL CALCULATION, BONUSES AND THE PRICE OF A CUP OF TEA….

Regulation always makes the same mistake – it looks at what has happened and designs a regulatory structure to stop it happening again. Of course there are two main problems with this approach:

1. What happened last time will not happen next time; and

2. Most of the politicians, regulators and reporters really have very little idea about what happened last time anyway.

Hearing a prominent reporter from a so-called reputable newspaper referring to the crisis starting in 2008, for example, is all part of the problem. Of course the crisis did not start with a credit crisis, but with a liquidity crisis, and this commenced in 2004. If you look at responses from 2008 you are looking at symptoms not causes, and acting on symptoms may actually make matters worse.

Put at its simplest we need more regulation like a whale needs a hole in the head.

International Regulation

In the US there are 47 main regulators and probably a load of other minor ones. In the UK we have a single regulator for almost everything. Which is better? The answer is that they both have advantages and disadvantages. You clearly cannot regulate a major business by looking at a part that only represents perhaps 5% of the total. The risk of multiple regulators is that something gets missed. But the single regulator may not have sufficient skills to get into all of the issues of a specialist area. So what is best?

If we move towards international regulators for international firms, that is taking a view that they will somehow do a better job that is currently the case. The international regulators will not be based in any one country and will take a high level view of matters. They are less likely to understand the role a firm plays in a local market, or the legal jurisdictional rules that apply. In short they are likely to have their findings ignored since they would be inconsistent with those of other firms in the market – perhaps creating an even more uneven market.

For us the best system is the lead regulator structure, where the Head Office regulators take the lead and coordinate the activity of subsidiary regulators – with each regulator ensuring that the firm maintains sufficient capital and liquidity locally to protect the local market. These are the rules that have only just been put into place, so clearly should be allowed to work for a while. If we move towards a central international regulator, we can expect one of the next problems to be caused by exactly that change.

Capital for Stress

There is a lot of nonsense being written about the capital in the system. I remind you that we started with a liquidity crisis that caused a credit crisis. There is no suggestion that if Lehman Brothers had 50% more capital, then it would have survived. Put at its most basic, when the reputation of the firm has been impacted (rightly or wrongly), it is going to fail and no level of capital is likely to help it. If we allow the regulators to put capital charges onto the banks at a stress (or near stress) level this will be an unmitigated disaster for mankind.

The argument goes like this. The banks will need to have more capital and will

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therefore not be able to lend, since each loan increases the capital they need. The cost of borrowing will increase and the availability decrease. The increased rates on loans will cause more companies to fail, unemployment to increase and poverty to follow. It cannot work and must not be allowed to happen. What is capital for? If it is to guard a bank against a rainy day, then capital rules should be reduced now, not increased. A rainy day? It is pouring outside. Neither the reporters, politicians nor regulators appear to really understand why we have capital and what its role really is. Forcing banks to keep capital that they cannot use is like buying a painting and leaving it in storage. It does not achieve anything or add to the common good.

Stress Testing
As you will see later the Bank for International Settlements (and most other regulators) has mandated stress testing. They have not really said what should be done, or how much, or even how. They just want some. Actually they want rather a lot. So how could the US government stress test for unemployment be exceeded within three months? Do they really understand what stress testing is about? I am not sure that they do. The tool needs to be used carefully and not as a capital calculator. You do not want the stress event to happen. If you know that there is a tree in the road and if you crash into it you will die, will you just say "Oh Well, Never Mind" as you drive headlong into disaster? I would hope that you might at least brake, or change direction – avoiding hitting the tree. So you would not need capital for stress testing – you need thinking. More of this later.

More Regulation
There is a call for more regulation – almost anything so long as there is more of it. The regulators and politicians are forgetting the law of unintended consequences: Man that changes rules needs to rule the changes. As you make changes there is greater stress within the business caused by changing roles, processes, systems and controls. Some of these will be effective, but other will be ineffectual. Basically the uncertainty resulting from change inhibits the control structures, distorts historic results and trends and can actually mask true trends that need to be acted upon.

Worse than that, the last problem will not be the next one. Whatever the focus of the regulations are this time, will warn you what the problems will be next time. I would suggest that interest rate volatility, high interest rates and a default by a major Western country all would need to be factored into any new regulatory structure. If it cannot deal with that type of event then it will not provide the level of protection that we all require.

Salary and Bonus Caps
The greed culture is now working overtime. Is it true that some people were over remunerated for what they did? What about footballers or pop stars? Do you want to call up Wayne Rooney and tell him that he is only worth £200,000 a year? Banking is not unusual in paying large sums to so-called stars; and in those terms corporate CEOs are definitely stars. If you limit their remuneration in the banking sector some will pack up, others will go to places where they can earn more and a few will take the reduced remuneration and work just fine. What has that got to do with the crisis? Do you really think that the bonuses made any difference to the actions taken?

From experience we know that many people are actually not motivated by money, what they want is recognition and success. That means that even if they were not paid much they would probably have done exactly the same things. When you look at the new regulations see if they are driven by greed or malice, or whether they would really make a difference.

What do we need?
I would suggest a few changes are required:

1. We do not need a longer rule book; instead we need a better rule book. Too much regulation is almost worthless, really being little more than pointless motherhood statements. Other rules go to a level of detail which is nothing to do with risk. We need a risk based rule book that actually hits the big issues, rather than getting lost in massive amounts of detail.

2. We need better and more intelligent regulators who have actual experience of the areas that they are looking at. Too many junior staff have been relied upon to do work that experienced staff need to do.

3. We need enlightened debate that is not biased through ignorance, self interest, envy or blind prejudice. This area is too important for that and reporters in particular need to take heed.

4. The schools need to be part of the solution providing education into financial principles such that key issues will be better understood.

5. Risk based modelling should drive risk management, regulation, internal and external audit. It should be at the heart of regulation, rather than a sometime peripheral figure that is dragged out only when there is a problem.

6. The rules should encourage more thinking and less modelling. Spurious data sets that mask real problems inhibit the ability of Boards to achieve their objectives.

7. We need to enhance corporate governance, raising the standing of internal audit and non-executive directors. We would recommend that all non-executive directors should be required to attend courses to understand the business the are doing and in particular should be required to attend risk management courses. One non-executive director with risk management expertise should be appointed to the Board to provide the level of independent scrutiny that is really required.

8. The Lead regulator concept should be made to work effectively, requiring formal coordination between regulators.

9. We do not need more transparency and reporting, instead we need better regulation and understanding. A set of 400 page accounts in tiny print is not transparency; it is purely a hernia for the postman and the end of another forest of trees. Clear information that is short, concise and easily understandable is the requirement.

10. Fair value as it was introduced was a disaster. Fair value is not market value when the market is not fair – neither on the way up, not on the way down. There should be a rule based on intrinsic value, being represented by expected future cash flows to amend the current rules which clearly do not work effectively.