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GLOBAL riskupdate

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THE BRIBERY ACT 2010

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THE IMPACT OF GETTING REGULATION WRONG

The regulatory environment for banking and financial services is in a process of major change. And the market is responding to the financial challenges of the last few years. Whether the changes would have in any way prevented the crisis is open to significant doubt – indeed it might even be considered that the parts of the industry that performed best during the crisis are now being penalised in the solutions being implemented.

Regulation is generally developed in the wake of perceived problems that have occurred. It is not created in a vacuum; rather it is the actions of those seen as being responsible for regulation taken in the light of government or media pressure. Whether it is a secondary debt crisis, asset bubble or fraudulent activity each can have an impact on the regulatory structures that we face.

That it is often unaccountable bodies or groups that essentially develop such regulation is in itself a cause for concern. The global financial market is at the mercy of bodies such as the Bank for International Settlements and the International Accounting Standards Board which are unelected and unsupervised. Worse than that, they do not have the right set of objectives within their charters. If you look at the Bank for International Settlements in this area they focus on the development of best practice and capital rules which need to be implemented within local regulations to be effective. They are a committee of central bank governors although it is not the governors themselves that sit on the committees, rather it is their staff.

If you are a regulator in a particular country and have a great person working for you, do you think you would send them to Basel to work on designing best practice? Might you instead send someone who is worthy and technical but perhaps lacks the practical skills required to regulate your local industry? It certainly might be considered as being plausible.

The next question is what role do we want regulation to take since that should lead to the structure which is most appropriate for the global market to develop. Since the financial market is intrinsically linked to the main economy surely there needs to be regulation that delivers that which society requires. I would view society's aims as being:

- Economic growth
- Low unemployment
- Financial stability
- Financial crime reduction

Notice that I have neither included treating customers fairly or fiduciary responsibility. This is a deliberate decision since they can perhaps be better dealt with through other mechanisms, although these might certainly be considered as secondary objectives.

This leads to the obvious thought that the impact on the economy needs to be considered as the first magnitude in the development of any regulation. It would also suggest that the Grouping which should look to the development of global rules and

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regulations should include parties with responsibility for the areas set out and would include the following:

- Bankers
- Regulators
- Businessmen
- The Public Interest
- Enforcement agencies
- Infrastructure agencies
- Supranational bodies

This might lead to quite a different grouping making rules to the current BIS committees which essentially consist of regulators. Unless the impact of regulation is considered in the light of the expectations for the global economy it can hardly be surprising to be found wanting.

The Law of Unintended Consequences

We now have a wave of regulation washing across the financial community. Ranging from Basel 3 and Solvency 2 to central counterparties, collateral rules, operational and market risk rules, liquidity and credit rules it is hard to think of any part of the industry that is unlikely to be affected. But regulators should not wish for things that might actually happen. It appears that the intention of the regulators, following ill-informed media pressure is to develop a financial market where it is no longer plausible or acceptable for an institution to fail. The days of the central bank being the lender of last resort is essentially over since it is made clear that taxpayers will no longer be willing to pick up the tab for failure.

By developing a risk averse regulatory structure the regulators essentially are seeking to reduce risk taking. There are many types of risk taking within financial services which includes trading, lending and innovation. If the regulations are not correctly drafted innovation is stifled and risk taking, the lifeblood of the banking industry, suppressed. This results in a global financial crisis causes by a reduction in global GDP. The damage that poorly thought through regulation could cause must not be underestimated. In ensuring that institutions do not fail the reduction in global activity will ensure that governments and societies fail.

If you bias the rules towards the submerging countries of the G7 you impact the ability of the emerging countries to stimulate the growth that is required to service appalling government indebtedness. You also stifle the growth of small and medium sized companies which are the life blood of growth in times of stress. As we have indicated before this always leads to instability and unrest which can never be predicted and has itself negative impacts on the economy.

The ill thought through current set of regulatory change also has another impact. By suggesting a series of rules that will be implemented over a period in excess of 10 years you create a cost uncertainty which further constrains the ability of market participants to adequately price their products. If a firm cannot know for certain the capital requirements that will apply to a product over the life of the product, then they are forced into only offering short term products. This will also prevent companies from obtaining the long term financing that they require to stimulate growth.

If there is continual change there is also the risk that further mistakes will be made. Requiring firms to change the way they work globally and at the same time will also have a negative impact on the global economy – and will result in more problems. Which I suppose will result in more ill drafted regulation and even greater decline.

But the law of unintended consequences could actually come to the rescue. There are actually only a few things that are restricted to only being conducted by a bank. One of these is not lending and I certainly do expect lending to start to leave the banking industry. In trying to regulate the capital of the banking industry what the regulators may actually achieve is to move this risk from the banking industry to other market participants that operate under different or more benign regimes – for example venture capital and fund management businesses. Companies that have significant liquidity assets will be seeking return over the coming years and lending may well be one of the solutions identified.

Likewise forcing over the counter derivatives onto a central exchange does not mean that they will move there. Changing the regulatory structure enforces a change in behaviour leading to financial innovation. It is easy to design products which are not contracts for difference and achieve the same as the OTC derivatives that it is proposed move to the ETD markets. The cost of the transition based upon the necessity of designing margin requirements that ensure that the exchange will not fail will in most cases result in a lack of liquidity of the traded instruments which will them fail. New market participants will develop solutions which achieve the same as the current market. Again these will probably not be banks.

The Future of Banking?

It appears that the regulators envisage a time when banks really become funds transmissions and deposit taking entities, with little else left. Everything else might well be more profitably conducted in business that is not a bank. By over or inappropriately regulating the industry you actually result in the transference of risk to other areas of business where it will operate without regulation. Basically increasing regulation of the banking industry could reduce regulation of the financial community.

Of course designing urgent rules to be implemented over in excess of a ten year period highlights that even the regulators do not really expect much of this to be implemented. Of course regulations designed to optimise the minimisation of regulators risk when interest rates are falling become both dangerous and poorly calibrated if interest rates start to rise – which they will. So everything will need to change and perhaps that may be the siren call to try to get a bit more common sense into regulation. But common sense is not very common and nowhere is this clearer than in the design of banking regulation.

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