C L I F F O R D
C H A N C E

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Financial regulatory reform – avoiding the trap of over-regulating banks

The regulatory response to the financial crisis has been nothing if not voluminous. Its sheer quantity exceeds the capability of any single individual to comprehend it all. Clearly, the need to address the regulatory shortcomings in the financial system is vital. But, more than three years after the financial crisis first hit the headlines, there is a degree of opacity about the real purpose and value of all this regulation. What started as an attempt to stabilise the financial system and to address the weaknesses that had contributed to the financial crisis has, over time, become a political sledgehammer to beat banks.

Understandably, the regulatory response has come in for much criticism. Bankers point to the failure to ensure a level playing field and openly express fear at the unintended consequences of poorly-constructed and unevenly-applied rules. Meanwhile, Europe's policymakers vie with each other in their struggle to appease a still angry public even though their counterparts in the East show little inclination to follow suit. More worryingly, the UK authorities seem determined to gold-plate much of the EU reforms and are in danger of becoming an outlier. If the UK continues along this path, there may be significant implications for the City's future.

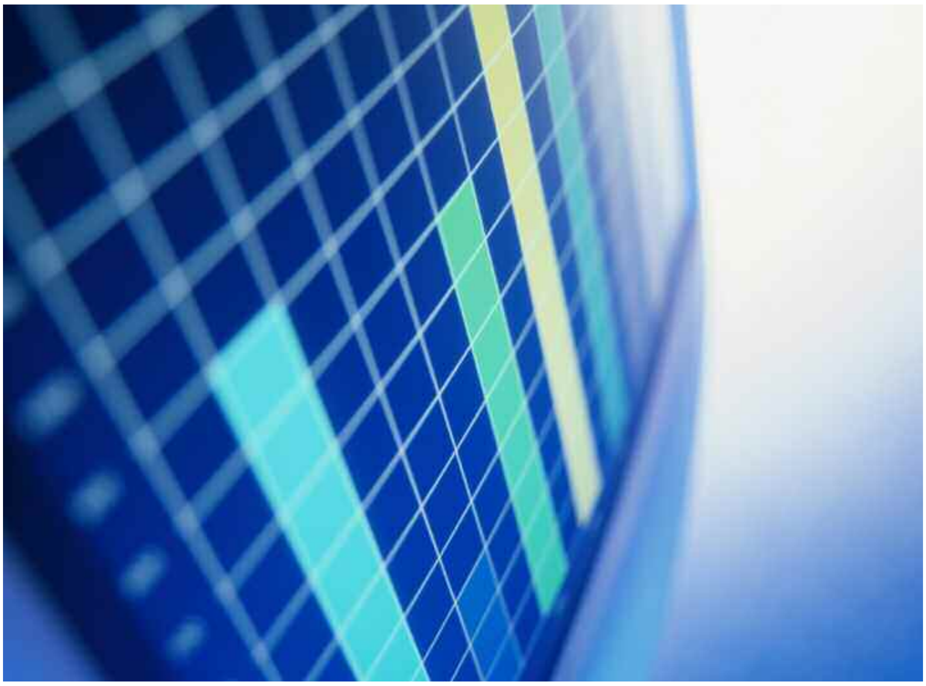
It really is time now to cut this Gordian Knot. And, with the publication of the interim report of the UK's Independent Banking Commission on 11 April, we are reaching a critical point and perhaps even the point of no return. Time is running out to find the right balance in regulation.

Essential elements of a good regulatory regime

Any successful regulatory regime must be built on foundations of strong governance and strong risk management systems. Regulation can encourage banks to achieve these aims but it is a self-directed cultural shift within these institutions that is crucial. Banks should be required to have sufficient capital and liquidity to absorb losses but they should not be obliged to hold so much that they refrain from prudent lending and risk-taking. Viable resolution plans are another essential element to allow banks that do get into trouble to be unwound in a way that minimises the risk of a systemic shock.

A more complex challenge facing a good regulatory regime is its ability to shine the light of transparency on interconnectedness. Regulation of the over-the-counter (OTC) derivatives market, including the requirements for central clearing to reduce counterparty risk, is also a fundamental part of this challenge.

But no amount of regulation can be deemed truly successful if it applies to just one jurisdiction. A global market requires a global approach to regulation. The regulatory vision will be rapidly undermined if the playing field is not level. To the extent that banks are precluded from taking on certain risks, it is inevitable that those risks will be pushed towards



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the unregulated or less regulated jurisdictions. If there is significant opportunity to arbitrage between different regulatory regimes, the value of the regulation will be undermined.

There are two other crucial components of any good regulatory regime. We need macro-prudential supervisors with the ability to foresee issues that might give rise to systemic risk and the authority to do something about it (even if their actions put them in direct conflict with democratically-elected policymakers). We also need highly-trained, well-resourced regulators to monitor and police the financial system.

To create such a regulatory regime for banks is no small undertaking. The challenges are great. But the risks of failure are greater. We have reached a crisis point in regulation. A failure to find the right balance may have calamitous consequences for the world economy.

Role of banks in the global economy

The fundamentals of a global economy have not changed. We need banks that are able to lend and to facilitate maturity transformation. We need banks that can facilitate the separation of risk from the underlying cash, and are able to hedge and distribute risk. In other words, we need banks that can take risk and innovate.

The key to all of this is to find the right balance between protecting the taxpayer and facilitating an efficient market. No-one doubts the need for regulatory reform, but this is about adopting a proportionate approach to creating regulation that has a clear aim in mind. We need policymakers and regulators who are tough enough to make the right choices, and then to justify those choices publicly, even though they may fall short of populist expectations.

Taking stock

If we were to take stock of where we are in the process today, some three years after the beginnings of the financial crisis, what would the scorecard look like? In summary, it is a mixture of the good, the not so good and the downright ugly.

Let's start with *the good*. If there was a collective intellectual failure to understand before the crisis the systemic risks inherent in the financial system, they are now well understood by bankers. There has been much activity within banks to overhaul their risk management systems and to give the chief risk officer the appropriate status and accountability to the board.

Banks are focused on what might destroy them. They are modifying their governance systems and are implementing many of the recommendations in Sir David Walker's report (*A review of corporate governance in UK banks and other financial industry entities*). In time, this process will lead to significant cultural change within banks that will exceed anything that can be achieved through the excessive and fragmented regulatory changes that politicians and regulators are seeking to impose.

Basel III is another positive development. The Basel Committee has, after much heated debate, endorsed the Basel III package of capital and liquidity reforms. These measures will be introduced over several years from 2013.

Basel III represents something of an international consensus and, while it is still the subject of much debate, banks can at least focus on a strategy to meet the anticipated costs of compliance.

However, Basel III is also an example of the *not so good*. One of the biggest problems with Basel III is the need for it to be implemented separately in each jurisdiction. This means that there will inevitably be scope for different interpretations in different jurisdictions. Even as banks are assessing the impact of Basel III on their business models, regulators are already applying pressure for an accelerated introduction of the rules. In the UK, regulators are openly talking up the need for higher capital ratios. And, in a sign of their mounting frustration with the Basel process, they are asking whether there is a need for more radical surgery on the structure of the banking sector. Complaints by senior bankers about the stifling impact of Basel III, once it is fully implemented, on bank lending appear to fall largely on deaf ears.

Looking beyond Basel III, there is little sign of significant progress. There is agreement on both sides of the Atlantic that OTC derivatives should be subject to regulation and a requirement for central clearing to reduce counterparty risk, but the detailed rules have yet to be drafted, and it may be years rather than months before they are implemented. There is a general consensus that recovery and resolution planning would protect the taxpayer in the event of a bank failure. But there is also a growing belief that the differences between the various insolvency regimes may make cross-border resolution planning impossible to achieve in the short term. In Europe this belief has caused the emphasis to shift to bail-ins as a means of protection against insolvency. There is agreement on the need for macro-prudential supervision and the shape of it has been more or less determined in both Europe and the USA. However, the detailed proposals have yet to be implemented.

Continuing uncertainty

Listing our achievements to date makes for bleak reading. We have not made enough progress and there is a very long way to go. The continuing uncertainty makes it very difficult for banks to assess

the likely costs of complying with the new regulatory framework and to make the strategic choices necessary to manage their businesses to an acceptable target return on equity. This issue, in itself, will delay a return of confidence to the international financial markets.

But there are greater risks ahead. The sheer volume of regulation tumbling out of Europe and the USA is simply staggering. Much of it has little to do with addressing the causes of the financial crisis or constructing a forward–looking regulatory regime which will provide a stable basis for dynamic and efficient financial markets. It is inevitable that there will be overlap in regulation, inconsistencies and contradictions. As these problems become more apparent, the law of unintended consequences will swing fully into play.

There are also policy differences between the USA and the EU in some areas. These differences are often prompted by a natural inclination in the EU to use regulation to shape the financial markets in a way which supports EU industrial policy. These differences are likely to add further confusion once the policies are converted into detailed regulation. Attitudes to short-selling and to uncovered credit default swaps are two examples of regulation that have been affected by a difference in approach between the USA and the EU.

Costs of compliance

The financial cost of building and policing the new regulatory infrastructure will be enormous and the costs of compliance will place a huge financial burden on the banks themselves that will influence their strategic decisions on where to locate (or re-locate). It remains to be seen whether, in a period of austerity, there will be a continuing willingness on the part of policymakers to provide adequate funding for regulators to do their job properly. There are already signs in the USA of funds being squeezed out of the regulators' budgets.

Perhaps the most worrying aspect of the present situation is that, in Europe, and particularly in the UK, the regulatory reform process continues to unfold against enormous ill-informed populist anger directed against banks and bankers. At a time when there is, in any event, a natural inclination for the epicentre of the financial market to follow the seismic shift of economic power eastward, this will, in time, become self-defeating if it is allowed to continue.

The Independent Banking Commission's dilemma

And so we come to the challenges facing the UK's Independent Banking Commission. It faces a stark choice that is emblematic of the challenge facing policymakers and regulators across the world. The Commission can take the easy road and opt for short-term, populist changes that are based on the "here and now" and without fully testing their long-term implications. Alternatively, it can take the hard road and opt for enlightened and potentially unpopular choices that are based on principle and will allow for the development of a well-regulated, robust banking sector that understands and manages risk and product innovation in a measured and intelligent way.

The debate over so-called narrow banking is a very good example of the choice facing the Commission. If a decision were to be taken to break up the so-called universal banks, where is the line to be drawn? If the net is drawn too tightly around the narrow bank to preserve its purity and immunity from unwanted risk, its funding options will be severely constrained, its lending restricted, and the cost of that lending will be very high. It would be an unexciting proposition for borrowers, depositors and owners. It would not a model for "our times".

On the other hand, if the net is drawn more loosely to allow more funding flexibility, the narrow bank will be at risk of being tainted by what happens outside the net – precisely the problem which beset Northern Rock.

The universal bank model developed as a natural consequence of our interconnected, international financial markets. Much of international banking is conducted through this model – in the USA, Europe and, increasingly, in Asia. While Northern Rock was most certainly a narrow bank, it is difficult to lay any blame for the financial crisis at the door of the universal banking model.

The final recommendations of the Independent Banking Commission, and any legislative changes made to implement them are likely to have far-reaching and lasting impact. There is a compelling need to get them right.

It should not be assumed that, if the UK elects to undertake radical surgery on the structure of our banking industry, others will follow. While London should be a leader in terms of implementing the international consensus on financial regulation, there is real danger in going beyond that aim by becoming an outlier at one extreme of a widening spectrum of views.

The inevitable consequence of such a move would be to drive away business from London and to re-enforce an emerging view that a level playing field is not really seen on either side of the Atlantic as a critical requirement. If such a view becomes widely-held, it will ultimately accelerate London's decline as a global financial centre.

If London is to pay such a heavy price for its part in the financial crisis, the arguments for such fundamental reform need to be compelling indeed.