

Think leadership

Regulatory reform: threat or opportunity?

'The biggest risk today is regulation'

Capco nights at the roundtable – a series of debates

In late Spring 2011, an eminent group of banking industry practitioners, including risk specialists, took part in a lively debate to round off the Capco/Cass Business School Risk Conference now in its fourth year. Chaired by Philip Best, Chief Risk Officer Threadneedle Asset Management, participants were invited to respond initially (although not exclusively) to the key questions of whether there is any real need for Basel III, and to what extent banks and regulators have diverged from their original intent while implementing Basel II.

The evening produced a wide-ranging and highly insightful set of contributions and reflections on major issues. The group consensus was that the regulatory horizon under discussion would be from the present as far out as 2018. Speculation any further into the future was seen as fruitless.

The key points captured in this paper include:

- External regulation will never be as effective as internal industry consensus
- Regulators must focus more on outcomes and less on rules
- Stakeholders need to decide what they want from regulation (and recognise that “too much certainty” can result in stagnation)
- Risk management can only work as a business-wide culture, supported from the very top
- Trading styles such as CCPs currently advocated by government are far from being “sovereign remedies”
- The first risk manager is the trader who picks up the phone

Complexity - overwhelming the capacity to control?

Even before the formal questions were put, the group was eager to share views. “The complexity of regulation has overwhelmed its capacity to control” - this was how one participant summarised his perspective on regulatory divergence with original intent. There is a plethora of rules but do these rules lead to actual regulation, in the sense of a true and coherent framework?

In the world of risk and regulation, do we see any coherence between principles, rules and real world outcomes?

The question above reflected another contributor's frustration with the gap between stated regulatory intent and what happens in reality. There was consensus on the need for regulators to make their minds up. Are they rules based or principles based? The shared feeling was that no strong direction has yet emerged. An even more important question was should regulators be outcomes based? Several participants believed that regulators must be judged by what actually happens in the markets; as opposed to how many rules they devise or what sort of principles they decide to apply. As one practitioner put it “what is the point of having regulation if nothing really changes, or if the changes are negative?”

Regulatory reform - risk or opportunity?

Then Philip Best, Chief Risk Officer Threadneedle Asset Management and Chairman for the evening, tabled the first core question: regulatory reform, threat or opportunity? There was agreement that the main opportunity represented by reform is to get core processes in order. The other, darker, “opportunity” is for institutions to shop around and “arbitrage” regulatory reform impact. They will do this by finding and operating in “kinder” regulatory environments. But, far from addressing risk effectively, this could well give rise to “moral hazard”.

The main “threat” represented by regulation was felt by many to be an “excessive emphasis” on liquidity. This threat was examined in greater detail through the evening.

Is there a need for Basel III?

After Philip Best raised the evening’s second formal question, the consensus was that application of existing regulations is already fraught enough! “We don’t need yet more regulation, we need existing regulation to work properly” was a common view.

The regulators - do they understand the subjects and/or the impacts of regulation?

Philip Best encouraged the audience to explore the issue of regulation “not working properly” by asking do regulators really understand what they are regulating and do they understand the real world impact of their regulations? In response, some made the interesting and perhaps unexpected argument for **increased** regulation. But this was emphatically not just a case of “more rules”. There needs to be “cleaner regulation” which is actually more prescriptive. Many financial institutions, it was felt by participants, would like the chance to say to regulators “tell us what to do and we will do it”. There is an appetite for “more codification and less interpretation”.

Are regulators focusing on the right things?

Philip Best’s next question prompted reflections on the role of regulation in any fundamental addressing of risk and risk factors. This role was questioned by more than one participant. The view was put that regulation is “just the fifth lock on the existing door”.

Access to accurate and timely data still key – and still an all too elusive goal for many...practitioner and regulator alike

Like today’s industry practitioners, regulators too continue to deal with the obstacles industry faced 20 years ago: lack of clean and timely data being one of the main issues. The real need is to get the basics mended; to develop an accurate and detailed picture of what is actually happening inside financial institutions...both for the institutions themselves, as well as for the regulators!

Do regulators approach their task in the best way?

In spite of the criticisms of the regulators from some quarters, it was felt in general by the group that “regulators are hitting in the right direction”. Their actual modes and methods of working were however felt to be more questionable, specifically in terms of the criteria they apply.

Some felt that, perhaps inevitably, the work of the regulators remains “superficial” – rather than really getting under the skin of understanding and controlling/preventing some of the big systemic issues. “Regulators are always aiming to arrive at a ‘big number’” remarked one practitioner. Another, picking up on the theme that this is a misguided direction, asked the question “how do you get to a “big number,” or any number that means anything, in markets that have only existed for the last five years”?

The current “moral landscape” inhabited by regulators was felt by many to be flawed. The flaws inherent in day-to-day regulatory approach include:

- Institutions are often treated as being “guilty until proven innocent”
- Populism and scape-goating are allowed to sway the decision process
- The regulators are excessively prone to allowing due process to be overridden by other considerations

In this negative and often adversarial situation a game of cat and mouse inevitably develops. As one contributor put it “if regulators are the mousetrap, bankers by instinct will always attempt to breed a smarter mouse”. The question was then raised “will the industry ever stop gaming the regulators”?

“De-sensationalising” the regulatory process

The “continuous audit” approach was cited as a source of “potential reassurance to regulators”. What is needed going forward is fewer “spot checks” and less of a culture of “catching people out”. Instead there is a need for “a sound and thorough approach, in order to de-sensationalize the regulatory process”.

You can’t audit everything

The operational reality of regulation was raised as an issue: “you just can’t audit everything”. This is where sampling theory and an intelligent, common sense and experience-led approach have a major role to play.

The risk function - trusted advisor and interlocutor

Can positive relations between banks and regulators ever be developed without negative implications (of “manipulations” and “fixing”) arising? Given the level of apparent mistrust, or even antagonism between banks and regulators, institutions’ internal risk functions should be seen in the role of “trusted advisor and interlocutor” between the business and the regulators. One contributor stated that the regulators’ “distrust” is often reserved for the business side of a financial institution - as opposed to its audit function. Regulators feel that the business will try to “game them” whereas at the audit level the institution will usually play straight.

Regulation reduces growth rather than risk

“They have gone overboard on liquidity”. A clear and present danger for many participants was the idea that excessive regulation will stifle growth and confidence. Day-to-day, it creates an expensive and illiquid market, with fewer players and less real competition. (Reverse stress testing was felt however to be a good approach.)

Operational insight and transparency need to be the focus (“reduce the fixation on liquidity”)

There was emphasis on the high value of steady, consistent and thorough auditing. One contributor cited an example from the automotive industry, in the aftermath of the recent events in Japan. The manufacturer’s bank actually had a better idea of their position with regard to parts availability than did the manufacturer itself. The bank knew that parts would run out in foreign plants, where the manufacturer is in reality no more than an assembler.

This degree of operational insight derived from intimate, audit-based knowledge of the manufacturer’s business. It was based on timely and accurate data, rather than assumptions. The same detailed, fact-driven approach needs to be applied in the financial sector itself. The lesson from the Japanese experience is that focus on “risk as an abstract” is ineffective. It was operational transparency that enabled knowledge of the manufacturer’s true situation with parts. “Keeping a lid on risk” is a limited and limiting idea. Making the business and its operations transparent should be the real objective.

Could today’s regulatory regime have prevented the crisis?

One contributor raised the question of whether regulators - in the form they have today and with their current powers - would have been able to prevent the 2008 crisis. The consensus was ‘probably not’. Then came the issue of whether regulators today will produce the outcomes desired of them for tomorrow. “Probably not” was the consensus again!

What does society want from regulation?

The theme of operational transparency led to a discussion of whether the regulatory framework could ever effectively address the boom and bust cycle. The question was raised “are we happy just to live with boom and bust”? In fact, “what does society really want from regulation?” This was a key context question posed by several participants before and during the main discussion.

Freedom to fail?

Society wants **safety** from regulation. But “regulation does not automatically equal reassurance” and “the biggest systemic risk is regulation itself” were two widely expressed viewpoints. Participants showed interest in the role of libertarianism versus regulation. Should, in 2008, Big Government simply have left Big Banks to Big Fail with Big Consequences? Some felt that the answer was “yes, they should”. By now, the system might well have resolved itself in more robust and credible ways, without government intervention/distortion. “What goes down comes back up” was suggested as a better mantra than “too big to fail” - more commercially realistic and a better foundation for the future.

Society wants **greater long term banking responsibility** from regulation. One contributor felt real stability and risk resilience will only happen in the market through a firm link between credit decisions and the lending process - “you lend money for 25 years, you keep the debt and you can't sell it on during that time”. Others reacted by saying that this approach would “gum up” the markets and that nobody would, for example, lend to SMEs on this basis. Unless the creditor can “shift the debt” at some point, there will be no appetite to lend in the first place. If people want to borrow they have to accept that their lenders will want to “trade the debt”.

Society wants **greater predictability** from regulation and an “end to the nightmare of boom and bust”. But one contributor felt that the reason regulation will never cope effectively with exaggerated cycles is that it has no real forward-facing function. It is always dealing with the data of the past. Being restricted to “reviewing reports in arrears” means its actions are inevitably too late.

Another of the group remarked that: “the bigger challenge is to prevent situations before we get to the cusp, but this won't happen any time soon!”. This observation led to wider debate around the question of whether regulators exist to smooth peaks and troughs. Some felt that too much regulatory control could lead to disproportionate influence on the performance of an essentially free market. This in turn could lead to “moral hazard”. The point at which regulators “should” intervene “in a free market” remains a moot one.

Does regulation encourage cyclical performance?

One practitioner pointed out that the current style of regulation is, paradoxically, **more conducive** to cyclical market performance, with exaggerated peaks and troughs. The relationship between regulator and bank behaviour means that an undesirable cycle is established: “we see regulation from the regulators, then push-back from the banks, then lack of actual meaningful implementation - it's just ‘pragmatic ways to be compliant’ - then more regulation, more push-back and so on it goes”.

The impact of this cycle was felt to be a major challenge to regulatory efficacy: “the bottom line is that regulation can and will never have an overnight and totally consistent impact”. And while this lack of real traction remains a reality, one practitioner believed that “the regulators are still even now failing to address bad lending practices”.

Do regulators have the skilled personnel to regulate effectively?

The group turned to the issue of **human capability** of regulators to function effectively. As one practitioner put it, there is a view widely held that: “regulators are sucking in junior people”. Regulatory personnel are not experienced bankers. The counter-argument advanced by others was that there are experienced people within regulatory bodies, but industry practitioners typically don't get enough “face time” with them. This is a loss on many levels, since the senior voices either side of the “divide” rarely have opportunities to talk or share perspectives. This would be useful in multiple situations, for example in discussion of the - seemingly inexorable - rise of CCPs.

The rise of CCPs - sovereign remedy or potential flaw line?

One practitioner raised the question “will regulatory insistence on more OTC clearing really work”? Another asked if the “rise of CCPs may be an empty hope as a measure to prevent systemic risk”. Contributors shared the fact that CCPs had generally been judged to work well during the 2008 crisis and beyond. Now, however, the G20 is upping the ante and encouraging a proliferation of CCPs. This was seen by some as carrying the footprint of political pressure and involvement: “now politicians are trying to regulate stuff they don’t understand”.

CCPs - a new “node of systemic risk”?

This “lack of understanding” was characterized by some as leading to a kind of blind faith in one way of working - “universal CCPs” - that was “assumed to be inherently better”. The big caveat on the rise of CCPs is that “they might end up creating a new node of systemic risk”. This possibility met with some support and acceptance, with one remark that “a ‘bad’ CCP could have very bad consequences”.

Others felt that the fortunes and performance of CCPs and their stability are not issues that can just be left to regulators. As one individual put it: “CCP users must now step up to the plate and make some difficult decisions”. It was felt to be very important to realise that CCPs, just by virtue of their existence, are not a “sovereign remedy”. Nor can they be expected to behave as quasi-regulators: “CCPs are actually competing on margin and they will go on undercutting each other”.

As far as the “survivability” of CCPs is concerned, the question was raised as to whether they have the skills needed to re-hypothecate assets. Some felt that yes, they did, but questioned whether CCPs should be doing so in the first place.

Given that regulatory frameworks cannot be “universally enforced” and that CCPs are not a “sovereign remedy on their own against future collapse” the issue was raised of whether “the next bubble is out there and we just don’t know about it yet”. Nobody present felt confident enough to state all major threats on the scale of 2008 had passed for good. But, equally, nobody said what they thought the

next specific threat to the stability of the financial system will actually be.

There were views to the effect that all CCPs are not equal and that “you pay your money and you take your choice”. But CCPs equally should “resist commoditisation”. They should be able to have a crisp idea at any one time of their VAR. And the market should never assume that “CCPs provide a **de facto** default system. This view is misguided”.

The question was raised about “what then happens to CCPs in a volatile market”? There was consensus with the view that “you must be able to trust a CCP in a crisis”. The reality was felt to be that “in a crisis with a CCP, government would have to step in once again”. This enforced intervention and support would actually create more “moral hazard”. Basically “if enough CCPs fell over, we would see a repeat of the government interventions of 2008/9 and more rescues”.

This argument was summed up by one practitioner, who asked “is regulatory encouragement of CCPs creating the next fault line”?

Are increased security / predictability / regulation compatible with market freedom?

The group discussed a number of potential avenues towards greater stability/predictability in the financial markets. Securitization was felt to be “an honourable idea”. But the big issue remains: how do you crack the conundrum of banks being politically pressured to lend increasing amounts, while at the same time being subject to punitive costs of capital in an increasingly illiquid market?

You can’t lend money that either isn’t available or is too expensive

Several individuals remarked that nobody has yet advanced a theory of how banks, in the real world of expensive capital, high lending risks and illiquid markets, can actually fulfill the “social utility function that government demands of them”. These demands relate, it was pointed out by many, to the earlier bail-outs and are part of the “price of government intervention”. But the practical issues have not been addressed.

Some contributors then tied the debate back in to the earlier point about regulators' lack of internal experience and expertise. They simply want to eliminate risk as an abstract pursuit and "taken to extremes, some regulators would simply shut down the markets if they could, rather than entertain the idea of any degree of risk!".

Over-regulation and the "shopping around factor"

The regulatory and taxation climate in which banks operate will become increasingly important. On the issue of the levy on banks, some believed that institutions will simply ask "where can we be safe from this?" and move operations to territories with less onerous regimes. International institutions will "arbitrage" the impacts of regulation, shopping around for, and then moving to, more favourable regulatory environments.

Regulation will lead, according to one practitioner, to a "land of unintended consequences" where there will be a "shadow banking industry pushed into dark corners". As another practitioner put it, no regulatory system can ever be truly ubiquitous: "how does the regulator get their arms around the whole financial system"?

One approach many felt should be avoided by regulators who want to be effective is micro-management. "Don't regulate the pipes" was the sentiment. "Regulate the right stuff".

Do the safeguards work?

A clear theme was emerging: many of the "safeguards" against future crisis are questionable in terms of their real effectiveness. The debate extends to ratings agencies, who are supposed to offer the market an objective and reliable series of "real value" benchmarks. As one contributor put it: "paying rating agencies to rate your issues will inevitably result in distortions". The counter-argument is that "somebody has to do it (rating / benchmarking) and would a government-backed 'official' agency really do any better"?

Ratings - reliable or junk?

The deficiencies of the ratings system were summed up for many in the fact that "Enron went from 'Triple A' to 'Junk' in one day"! There was no warning period from the ratings people and no consequences for them and their clear lack of judgement/insight. This view was countered by others, who asserted that "nobody care about ratings agencies, they all work in arrears, which means that anybody who wants insight into current status is inevitably going to get out-of-date information".

Others remarked on the "expectation gap" around ratings agencies' pronouncements: "with Enron, everyone **thought** the agencies were on the case and applying certain processes".

On the issue of whether viable alternatives to ratings agencies can exist, one contributor remarked that "Triple A-rated rubbish still abounds but, among others, it fits into government borrowing criteria". The counter-view to the idea of reliance on ratings agencies was the idea of a return to self-reliance: "when the market tanked, people still made money by going back to first principles and doing real research. Even reading the paper every day is preferable to relying solely on ratings".

What is debt *really* worth?

The debate led to the profound question of "how you decide where the real value of debt ought to be"? Deciding what debt "is really worth" is a major challenge to the market. One contributor felt however that allocating value to debt at the time of its acquisition was simply misplaced emphasis: "what you bought doesn't matter - market conditions when you sell are everything!".

Risk culture - influences and objectives

At this point the chairman, Philip Best raised the operational environment question: how can we make managers positively affect "risk culture"? One participant defined "culture" as the "combined behavioural aspects of senior management and those below them". An effective risk culture has to start with effective leadership, it was universally agreed. The question of how leaders themselves perceive and manage risk is fundamental.

The risk function - ineffective in isolation

Some contributors stressed that the risk function alone cannot effect change. The CEO “sets the day-to-day tone and the culture must come from the top”. An “idea of the right thing to do is coming now from the top. Senior management are starting to embrace standing by decisions, even if they go wrong - as opposed to looking for blame transference”.

The idea of the company culture as the only effective “breeding ground” for good risk management was widely echoed. One attendee put it like this: “Culture is at the centre of everything. A winning team will come down to culture - values, attitudes, norms and expectations”.

Shared positive outlook “more important than rules”

One practitioner stated that the whole sector’s aspiration should be “to deliver client expectations profitably in a socially acceptable way”. Having an innate and shared sense of where the industry should be going was regarded as ultimately more significant than regulation: “a shared belief and working to shared outcomes is more important than rules”. This sense of shared vision was placed by others in the wider context of a fast moving industry and its rapidly evolving challenges. They raised the question “with banking moving so fast, how do you build a culture in two years?”.

Alternatives to the ‘Gold Rule’ are emerging

One practitioner reported that in his international bank, real change had started to come from the top “in terms of willingness and ability to say no” (to ventures with the wrong risk profile). There is now “much more constructive conflict between the risk function and the business and its commercial issues”. This was echoed by others, who cited instances of a move away from the “gold rule”: he who makes the gold makes the rules. There is something of a shift away from the “inevitable dominance” of the business.

If risk as a concept is under debate, then so too is the profile and function of the Risk Manager. Defining who a Risk Manager should be and what they should do, one

practitioner made a plea that “they have to be more than good with spreadsheets from now on. This is not a statistician, but someone who really gets the situation. Somebody you can put in front of the board and who can articulate a rationale for what they are doing”. As another crisply put it “this is not about calculating VAR, this is about influencing senior management”.

Risk management - rising up the food chain

The good news is that post-crisis, “the risk management and valuations group does now have a seat at the top table”. This view was echoed by a risk professional’s assertion that “now risk functions that do their homework will have the ear of senior management”.

A neat summary was provided by the final contribution before the close of proceedings: “the business itself must be foremost in creating the culture. The first risk manager is really the trader who picks up the phone”.

About Capco

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