The Banking Regulation Review

Fourth Edition

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Jan Putnis

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THE BANKING REGULATION REVIEW

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EDITOR'S PREFACE

2012 may be remembered as the year when practical reality caught up with those who thought that the financial crisis that emerged in Western economies in 2007 would result in more effective cooperation between financial regulators across the world. By one measure – the number of new initiatives and proposals for reform – the amount of cross-border financial regulatory activism has never been higher. But by more useful measures – moves towards solutions to the 'too big to fail' problem through the development of effective cross-border resolution mechanisms for banking groups and international cooperation on reform of OTC derivatives regulation – the optimism of the past has faded a little.

Questions are increasingly asked about whether the obstacles to truly productive cross-border regulatory cooperation – political imperatives, different incentives and straightforward differences of view – will ever be surmounted in ways that make international banking groups fundamentally safer. Media speculation in January 2013 that US regulators might not allow banks to assume cross-border regulatory cooperation in the resolution plans that they prepare in 2013 would, if substantiated, highlight this trend.

These apparently negative developments have not made the period since the publication of the last edition of this book in April 2012 any less interesting. It is also worth noting that most of the challenges that we have seen – new law and regulation that creates difficult questions of cross-border consistency and extraterritoriality, differing regulatory philosophies between major financial jurisdictions and the sheer slowness and unpredictability of developments – have rational, if depressing, explanations. For example, fundamental differences between the insolvency law of major jurisdictions, coupled with cross-border recognition issues and disagreements over how to pay for resolution, are nothing if not formidable barriers to the development of workable group-wide resolution plans for banking groups.

However, the past 12 months have not been a period of complete failure of regulatory reform either. Progress has been made, for example, in the enactment of legislation regarding OTC derivatives, most notably the European Market Infrastructure

Regulation (EMIR) in the European Union. But, as noted above, cross-border cooperation in this area remains an issue: it seems that hardly a month goes by without the discovery of a previously unremarked-upon anomaly between the rules in this area in different countries.

Bank liquidity regulation has continued to be the subject of intense debate in 2012, culminating in the Basel Committee's announcement in January 2013 of its decision to relax and to recommend the gradual phasing in of the liquidity coverage ratio ('LCR') for banks. Taking into account the fundamental influence that the LCR will have on many banks' business models, this was a welcome sign of pragmatism and also a sign of the Basel Committee's willingness to move the debate on liquidity forward.

Despite the challenges that have arisen in bank resolution initiatives, legislation and rules are developing in this area in multiple jurisdictions, with, for example, the publication of the draft European Union Recovery and Resolution Directive ('the RRD') in June 2012.

The European Union is, at the time of writing, enjoying a period of respite from the problems that it faced from the eurozone crisis in 2012, but it would be very optimistic to say that those problems have been brought under control. The European Commission is placing much emphasis on finalising the legislation implementing Basel III (CRD IV) and the RRD as soon as possible in 2013, notwithstanding that each of these initiatives may ultimately be affected profoundly by the parallel 'banking union' proposals for the eurozone.

In the United States, the main rules implementing Basel III are also expected to be substantially finalised in 2013. The significance of the restructuring of the financial regulatory regime in the United States, principally under the rules that are emerging from the framework established by the Dodd-Frank Act, continues to unfold and looks set to dominate the careers of a generation of regulators, bankers and their advisers.

The realisation dawned on many banks in 2012 that regulatory reform will be a longer and more drawn-out process than had been anticipated. For this reason, 2012 may also be remembered as the year when the banking sector in Europe, the United States and some other parts of the world began to think seriously about structural change in the long term, accepting that restructuring will have to take place against a backdrop of continuing regulatory reform. We have begun to see more group reorganisations, disposals, and the severe downsizing or closure of some businesses in banking groups, as well as opportunistic acquisitions. Four principal factors have contributed to these developments:

a A little more certainty, or at least the perception of a little more certainty, about rule-making (or, at least, the direction of rule-making) when compared to the past.

b The continuing urgent need that many banking groups have for capital and liquidity, and the related need to ensure that capital is deployed in the most efficient and profitable ways.

c Some specific legal and regulatory initiatives driving structural change, such as the US Volcker Rule (although this rule has not yet been fully defined at the time of writing) and some emerging (though not yet in force) 'ring-fencing' proposals in parts of Europe (so far principally in the United Kingdom and France).

d Continuing regulatory attacks on complexity and actual or perceived barriers to resolution of banking groups.

Accordingly, many banks are refocusing their businesses (or are currently planning how to do so) on what they consider to be the areas that will yield the highest returns relative to cost in regulatory capital and liquidity terms. Consistent with that objective, we are seeing intense competition for capital allocation between different businesses within banking groups and a more widespread appreciation of the relative capital cost (or capital efficiency) of different activities.

2012 was of course also marked by further recrimination about past practices in parts of the banking sector. Allegations that LIBOR and other benchmarks have been manipulated (or subject to attempted manipulation), continuing losses from mis-selling and other past misconduct continue to affect the sector. Attention has turned more recently to the ways in which banking groups quantify and present these problems in their financial statements.

An increasingly orthodox view among senior management of banking groups in Europe and the United States is to conclude that the only way through these difficulties is to adopt a 'whiter than white' approach to compliance. This involves banks taking the initiative to present a new way forward on compliance matters and breaking away from the more reactive stance that some of them held in the past. Some commentators have asked where this will lead. Will it result in banking groups that are so hobbled and diminished by internal policies and rules that innovation, efficiency and, ultimately, service to the 'real' economy, is put at risk? Observation would suggest that this is a concern unless banks keep in mind four critical objectives when developing their compliance strategy and relationships with financial regulators:

Compliance

The first and most obvious objective is to ensure that banking groups are and remain compliant with their legal and regulatory obligations. In many countries this involves developing a good understanding of the purpose and spirit of those obligations in addition to (or, in some cases, instead of) their literal meaning.

Predictability

It is desirable to maximise the predictability of relationships with financial regulators. Good and constructive relationships with regulators generally make it more likely that banks will see what is coming around the corner sooner and will be better able to find positive ways to plan ahead.

Influence

Constructive influence of regulatory policy development in areas affecting banks is also desirable, even if a bank achieves no more than a small proportion of the change that it would like to see. For this purpose I would include within the meaning of 'influence' the conveying of cogent arguments even where regulators do not act in response to them. This is simply because the route to influence for a bank includes convincing regulators that it has thoughtful and coherent ideas, even where political or other imperatives have the result that the regulator does not address the bank's concerns.

Flexibility and pragmatism
Flexibility and pragmatism in the relationships between banks and their regulators is critical. Inflexibility can lead to inappropriate or overly formulaic regulatory approaches to unexpected developments. Flexibility is often difficult to achieve but is worth pursuing in the interests of both banks and regulators, through regular informal contacts and exchanges of views with senior staff at regulators in addition to formal interactions.

Obvious-looking these objectives may be, but serious problems in relationships between banks and their regulators can usually be traced back to a failure to achieve at least one of them.

This updated edition contains submissions by authors provided for the most part between mid-January and mid-February 2013, covering 56 countries (in addition to the chapters on International Initiatives and the European Union). As ever, comments on this book from banks, regulators and governments are welcome.

My thanks go to the contributors to this book, who have once again taken time out from advising on important matters affecting the banking sector to update their chapters – 'update' meaning a fundamental revision in many cases.

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