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Regulators in overdrive

When bankers hold meetings to discuss their internal regulations today, it is likely that someone will be at the table, silently making notes. He may not have a name badge or reveal his employer, but he will be treated with deference. For this will be the institution's regulator, quietly observing how the bank runs, its level of risk and professionalism. The regulator will expect to be copied in on internal memos and reports.

Regulators are more aggressive than they have ever been. They publish detailed requirements for banks, push through tougher laws and insist on intruding on what was once private space. The age of the Regulator has arrived. This is a global phenomenon, every country has its banking regulator and most countries are members of multi-national regulatory committees.

The men from the government are trying to bring bankers to book. The senior banker of a major financial institution says, 'across the world regulators feel they did not spot these problems coming. Therefore, probably rightly, they are now taking a much closer look at banks, and want to be much more involved and kept in the loop about decisions that the banks make about all sorts of things. So there is now a much more onerous regulatory oversight, which in large part is probably a good thing. We had quite close conversations with our regulator before the crisis, but now almost nothing happens in our organisation without the regulator being in the know.'

The regulators' demands are numerous and burdensome. One economist at a leading UK bank said, 'There are so many different reports for regulators it is difficult to say how often we do that! There are big annual exercises; it takes several months to do. And there other reports; I am probably not aware of half the reports the regulator mandates. Oversight by the regulators has massively increased since the crisis.' There is more. When the regulator receives the report, he is more than likely to request a meeting with the bank director responsible.

This banker noted, 'The regulators tend to sit and listen. They just observe how the bank operates, the kind of decision making processes we have, how we think about risk. One of the lessons of this crisis is that seemingly similar institutions behave quite differently, because of the way decision making works inside, and the way risk was or was not factored into decisions. It is appropriate that regulators have enforced higher standards for decision making and risk. But with some banks there is less need to do that than others.'

Banks learn to comply with this level of oversight, says the banker. 'Banks are now open to giving information to regulators, ensuring that we are compliant with new rules. But there has been a large increase in the cost of simply complying with all the new regulations that have come out since the crisis in terms of extra people you need, in the risk area, and also in the finance area and in separate businesses.'

Regulators have another stick to hit the banks with. This is the stress test. Bank economists are regularly required by regulators to take them through the economic assumptions which the bank is using to reach their conclusions both about the macro-economy and about the outlook for their own banks. The regulator goes further than that; he will pose a series of 'calamitous scenarios' - in the words of one economist -- and ask the economist how his bank would handle the events. Regulators that set these stress tests include the European Banking Authority (EBA), The UK's Financial Services

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Authority and the International Monetary Fund. The bank economist said, 'It is stress testing ad nauseam!'

This banker says that his institution provides the regulator with all the bank's economic assumptions about interest rates, inflations levels, insolvency, credit demand and explains how that will change over the next few years, admitting it is a hugely time-consuming exercise, both for the internal finance stream but also for the business stream. 'It is not just a modelling exercise; it is a very detailed bottom-up re-cutting of all the business plans for the bank, private businesses themselves. And the end result is to determine how strong our capital position is.'

The regulator is trained, indeed genetically programmed, to look for worst-case scenarios. So they also want to see that the bank has thought through how it will survive a crisis without precipitating the need for a government bailout. This is the 'living will' or 'recovery and resolution plan'.

An avalanche of new statutes, regulations, codes of practice and global and local standards accompany this regulatory blitz. Simon Gleeson of the accountants Clifford Chance says that companies have much to fear. 'There has been a tsunami of regulations.' These new rules and standards have been produced by the Basle Committee, the Vickers Independent Commission on Banking, the American Federal Reserve, the European Securities and Markets Authority, the Financial Policy Committee of the Bank of England and many more. On top that, companies with British links are now bound by the UK Bribery Act. One senior banker commented, 'the regulators were caught asleep at the wheel during the crisis. Now they have gone into overdrive.'

The names of the regulatory organisations tend to be reduced to a pea soup of initials, their individual policies and guidance can be equally confusing. Gleeson warns, 'some banks are well geared up for them; some are very worried about it. I think a lot are just too busy doing their daily business and really don't understand what is coming on down the track. But I think the really big banks are taking it quite seriously; they are into lobbying and have huge teams working on it. Everyone knows there is a tidal wave out there, but nobody quite knows how it is going to impact them. At times the fact that the policy maker is not interested in you is a positive benefit. But when your regulations are undergoing major changes, that is not one of those times!'

The regulations are less shocking for banks that do try to understand them, than the fact that they have to apply them and their competitors do not. The Basel Three regime for example, which requires banks to increase the amount of Tier One capital (high liquid instruments like common stock and reserves) they put aside to protect the bank for a rainy day is being adhered to by Western institutions but not by all Asian ones. One senior banker commented, 'there is no level playing field in applying Basel Three. It is not universally going to be adopted. The larger US banks are only just now signing up to a Basel II framework and there is still plenty of work to be done on the implementation of Dodd Frank. In addition whilst Singapore, Hong Kong and China are Basel Three members, they have less time constraints as they do not face the same negotiations the EU members do under the Capital Requirements Directive.'

Although the American Dodd-Frank rules came into force more than a year ago - President Obama signed the Bill into an Act in July 2010- bankers say that the key US regulators, the Securities and Exchange Commission, have failed to provide banks with the sort of guidance they need to implement many of its plethora of requirements. Details about the provisions needed for the orderly winding up of bankrupt institutions have been left particularly vague.

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This bumpy playing field can impact a bank's profitability. Because the amount of regulatory capital has to reflect the size and quality of the loan book, banks will either be dissuaded from lending at all or they will have to charge more for the loans they make to anything but the least risky company. This will put them at a competitive disadvantage to their peers based in non-compliant jurisdictions, says Jonathan Herbst of lawyers Norton Rose. 'Banks will seek to arbitrage the regulatory system. Large institutions are all out there desperately trying to look at every angle. They are very international. All you have to is move the desk to another jurisdiction and they get a regulatory benefit. They are all active in that.' This was confirmed by a spokesperson for the British Bankers Association who said, 'I have not seen hard evidence, but I am sure there must be some regulatory arbitrage.' The incentive for the largest banks to look for regulatory loopholes is all the greater as the Basle Three rules say that so called 'Systemically Important Financial Institutions' (SIFIs) whom regulators have deemed 'too big to fail' have additional capital requirements under the Basle Three regime.

Countries may also trim the regulations they impose on their own banks to enhance their competitiveness against banks of other jurisdictions. This has raised the possibility that rigorous peer reviews will need to be introduced to police the system. Lael Brainard, US assistant Treasury secretary, has been quoted as saying, "The calculation of risk weights is an important issue, so it is essential that we provide supervisors with visibility into implementation in other countries to ensure greater consistency across borders." One UK banker noted that Basel Three need not be fully implemented by 2019, leaving plenty of time for banks to mitigate the harshest effects of the new rules.

Yet regulators are inviting arbitrage by failing to co-ordinate their efforts, say lawyers. Herbst says that 'The Americans are going in one direction with Dodd-Frank, the Europeans are going in another with ESMA and the Financial Policy Committee. You do query what they are trying to achieve.'

Herbst points a finger at the British authorities, led by Sir John Vickers, the chairman of the Independent Commission on Banking which has just reported, who have taken the lead in advocating that the commercial part of universal banks should be separated from their investment banking arms. This is intended to protect domestic customers from banks engaged in proprietary and market trading. 'It is fine when you are a global power, to behave as if the rest of the world doesn't exist. But when you are medium sized country where your predominant role is by no means inevitable, you have to question whether this is a rational policy. Systemic bank failure is a perfectly important point. Of course something needs to be done about that. But then you say, what's the remedy? Unless there is a global approach, would it make any difference to a couple of UK banks, during a global crisis, if next week the US defaults?' The cost of the policy should also make governments think twice before they implement it, he says. 'The legal, administrative and pension structures required for completely separate banks are very complex.'

The British Bankers Association is aware of this problem, saying, 'the banks and the international regulators need to take action in concert, rather than some jurisdictions rushing ahead and other places lagging behind. That would create false surges, as money moves, and as staff moves from place to place. The UK has a tendency to go a bit quick, at more of gallop. And that has a negative consequence - particularly for London as an international financial centre.'

A lack of trained staff and resources to monitor regulations and compliance adds to the upsurge in regulatory fears. Herbst says, 'it may seem like a small thing, but where are the new resources to raise the regulators' game'. He cites the case of ESMA, which has been tasked with overseeing much

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of European banking regulation, but Herbst says its resources have not been increased. Pressures on ESMA are set to grow, says Gleeson, as the European Commission seeks to centralise European banking regulation. 'Brussels is now very, very keen on unifying the European rulebooks. So the proposed new generation of Brussels legislation will be in the form of regulation rather than directives. The key to that is that if the new banking rules come in the form of regulation, then national supervisors are not allowed to deviate from the terms of those rules.' Bankers question whether many of the regulations are serving more of a political than a regulatory purpose. One banker says, 'there is a risk that many of the rules will never be policed. Governments have decided that bankers are to take the blame for the crisis and the more noise they can create to serve their ends the better.'