Keynes’ ‘Animal Spirits’ in the financial markets

Also in this issue
- Black Swans Mean Business
- How Canadian Banks have Managed the Economic Crisis so well
- OTC Clearing Evaluation of the EMIR and Dodd-Frank Regulations and their Impact on IT
- International Financial Supervisory Convergence
The demand for international compliance and cross border supervision has been a long and complex debate driven mostly by responses to short term problems which in themselves develop into longer term difficulties. As we have developed through Basel 1 to Basel 3 or Solvency 1 to Solvency 2 one is left with the concerns as to what this all really means and is it good for society as a whole.

The key concern currently is to ensure that tax payers no longer pick up a liability for a failure of an institution. This essentially spells the end of the lender of last resort principle; which has underpinned the development of modern finance. The lender of last resort being the central bank of the country was able to provide finance to meet the demands of local difficulties. Essentially it provided a guarantee for the banks within country that enabled funding to be provided locally at a cost the borrower could afford. All of this has come to an end. The mantra of the central banker now appears to be that no bank liability should fall on the central bank and therefore to taxpayers. To achieve this we require increased capital standards and also higher levels of regulation leading to intervention.

The Role of Basel 2 and 3
The Basel 2 Accord sought to make the capital calculation underpinning bank regulation more risk sensitive. It did not seek to increase the level of capital in the system since it essentially left the capital ratios unchanged. Instead it tried to align the risk capital calculation with the management’s internal modelling approach. Of course there is little academic support for the original metric of 8% of risk weighted assets, so the revision essentially found a better way to calculate a number which really had limited intrinsic basis.

Basel 2 was of course not fully implemented when the next crisis hit, so we are unable to really assess whether it would have been effective in preventing such a crisis. What it did attempt to do was set a series of minimum standards for the management of internationally active banks through the implementation of a series...
“sound practice” papers, although these with regret are inconsistent in both depth and form.

Basel 2.5 sought to deal with an error in Basel 2 in terms of the way that market risk was calculated by including a new capital calculation which applied to a tail of an uncertain distribution. The illogicality of adding a tail distribution calculation to what is an inappropriate original capital calculation, providing a mathematically invalid yet globally used calculation, did not appear to provide anyone with any level of concern.

Basel 3 compounds these issues with a requirement for the banks that have survived the crisis to increase both the level and the quality of capital that they maintain. This might best be described as bayoneting the survivors since the banks that failed clearly will not need additional capital. This paper seeks to consider whether this does make sense and the drives to international regulation.

The Move to International Regulation

The basic principle adopted is that all banks need to be regulated identically to prevent regulatory arbitrage. The regulators who are set with drafting international rules at the Bank for International Settlements have taken this as an obvious truth. However the question is whether this is actually true and if so is it true throughout the industry?

We do have international banks that are often larger than the economies where they have their primary listing. This then potentially places on the home regulator a level of risk which is greater than that which might be considered as acceptable for the taxpayers of the individual country. What is therefore needed is a system which provides necessary protections to the local taxpayer of the home country whilst at the same time preventing contagion risks for systemic institutions. That this needs to be achieved without causing the local and international economies to fall into unnecessary recession is clearly one of the conundrums facing the international regulator?

While we do have regulatory colleges, there is always a lead regulator and this is generally the home regulator of the institution.

So the first real question to answer is to what extent will banking move to another jurisdiction to take advantage of so-called regulatory arbitrage, moving to the area where there is the lowest level of capital and regulation? I would argue that this has been overstated and that only limited areas of banking can move in such a way.

The Ability to Relocate Banking Activity

If you consider the activity of a local institution which does not have international presence then its ability to transfer assets or liabilities overseas is clearly limited. It takes deposits and accesses funding locally to support the activity it undertakes within its local area of influence. Such activity essentially local-to-local is unlikely to migrate to another jurisdiction. Local depositors would be concerned were their local funds to be routed out of the country to an area that they do not understand. They invest in the local institution specifically because it is both local and supporting local development. Such institutions do not require any form of international regulation and therefore the application of new and onerous rules which identify risks of limited relevance to such institutions resulting in enhanced capital levels will only serve to impact their ability to provide support to their local communities.

For the international bank where they are taking deposits from one jurisdiction, the question is to what extent is this used to fund business in another jurisdiction. From my experience this again is far more limited than you might be given to expect. Most institutions task the management of the individual unit to obtain their own funding to support their own activity. The international treasury banking centre provides additional access to the international funding markets, but generally does not recycle locally obtained retain deposits. This would suggest that there is limited evidence to support an assertion that either loans or deposits would be booked differently to take advantage of any form of regulatory arbitrage.

Of course it is made even worse by the Basel rules themselves in that whilst it is deposit taking that makes a bank a bank, it is loans, operations and trading book risk which leads to the capital calculation with credit risk dominating this calculation. Since for most banks 85% of their capital calculation under Pillar 1 is essentially based upon credit risk, that this is unlikely to move starts to make one consider the impact of these rules on the real economy.

So What Can Move?

The business that can easily relocate to another jurisdiction related to the treasury, trading and derivative activities of a bank. These, whether over the counter (OTC) based upon the International Swap Dealers Association (ISDA) master agreement of exchange traded (ETD) based upon a specific exchange, can be booked in any jurisdiction. If you consider the OTC market where transactions are currently negotiated between two discrete parties, they can be based in any jurisdiction. The transaction could be negotiated in the UK between a Japanese and a US bank. They could choose their subsidiaries to book the
transaction based on the capital impact of the individual transaction and its impact on their capital calculation. Of course this will be just one of a series of issues that will need to be considered which include the availability of credit lines, collateral requirements and the risks associated with the individual firm.

But such transactions can be booked wherever the firm considers appropriate. Is it then right that these jurisdictions should have differing capital regimes? If one in jurisdiction the central bank still operates as a lender of last resort and provides support to the local banking community then the level of capital that a bank requires in such a community is reduced. There is nothing to be achieved by forcing such firms to hold a level of capital that is inappropriate given the level of risk that they place upon the global community. Just as we have discussed for the local deposit taking and lending institution so this is also the case for the international bank when the capital distortion is due to real business reasons relating to the structure of the local market.

However if the transactions are purely being transferred to take advantage of benign regulation where this is not based upon a true assessment of the intrinsic risk that the firm poses to the local or international community then this could be a cause for concern.

The Other Roles of International Regulation

As I have suggested international capital regulatory arbitrage is in my opinion massively overstated. There is clearly a requirement for international cooperation in terms of banking regulation if the assessment of the single unit impacts a specific regulator’s judgement on another unit or the institution as a whole. However again let us investigate this assertion more clearly. If there is a fraud in a single unit of an international bank will this impact the regulatory judgement of a regulator of another business unit? This is unlikely to be the case if the fraud related to the actions of either an individual or a collection of individuals acting together. Such a case would be considered as isolated and so long as the capital requirements of the individual unit are still being achieved will have limited impact on the regulatory assessment.

However if there is a case where the central control units are implicated in the inappropriate conduct then this is likely to influence the regulatory judgement of both the local and home regulators. Of course most cases that have been found to date are essentially local problems rather than global problems for the firm. The failures of the local unit if they become critical to the capital requirement to the whole business clearly do still matter, but this is still a relatively small subset of the fraud industry. The cases are so few they are well known. Barings clearly was a fraud that resulted in failure. However none of Lehman Brothers, Northern Rock, Royal Bank of Scotland and Bear Stearns were fraud related failures. Other fraud failures such as Credit Suisse or Allfirst did not result in the failure of their institutions. So it is a subset of fraud related cases which result in failure and in most cases neither depositors nor tax payers were seriously impacted.

Strategic risk does lead to capital failure and that is a common message from the listed cases. Of course strategic risk is not a Basel based Pillar 1 capital charge although it is included within what is terms the Pillar 2 charge and is referred to within the ICAAAP documentation provided to the regulators to enable them to consider all the risks in a firm. Strategy can be the failure of the business model of a bank and the term “early intervention” is now prevalent indicating that regulators will increasingly seek to take action to prevent failure of a firm. Whether the regulators possess the skills necessary to either identify such cases or act appropriately may be open to concern. However I have no doubt that these new powers will be used to the detriment probably of both the banking industry and society.

The Needs of the Local Market

International regulation by its nature sets minimum standards. Even now we see a range of differing regulatory approaches operating in individual jurisdictions to meet specific local requirements. The impact of these can be severe. If you require a bank to hold a level of capital that is actually above that which society requires on a regular basis then this will result in sub-optimal economic performance. There is no free lunch here. The result on increasing capital requirements is to increases the funding costs of facilities. This will essentially reduce funds available for investment and increase unemployment globally. This self evident truth is obvious from any review of the current global economic malsease.

In a country with high unemployment and low growth there is a need to create energy within the local economy. Bank capital is the oil which enables the motor of growth to function effectively. In such times ideally you would want a bank to reduce its capital charge for new lending to encourage activity. However the regulations are essentially perverse in their application. At the times of difficulty the arrears within a banking book will increase requiring additional capital to be put aside. Such capital is required to support existing failing lending and is therefore not available to support growth or drive the economy forward. Essentially the rules as drafted will ensure that a reduction in local activity becomes a fully fledged slump. Given the inability of most firms to transfer to other markets to take advantage of benign regulatory environments the consequence is higher than necessary unemployment and a general absence of hope.

What under such circumstances is actually required is for flexibility to enable a market to have one set of capital rules for new lending and new business whilst protecting the bank from the vagaries of the past. This is the so-called good bank – bad bank conundrum where the central banker takes ownership of bad facilities to enable the bank to focus on good facilities. In such a growth environment maintaining capital at enhanced levels is neither desirable nor in the interest of taxpayers. The increased capital levels increase unemployment and loan arrears perversely increasing the risk to taxpayers.

Accordingly slavishly following international capital rules cannot be in the interests of the global economy.

The Need for Legitimacy and
International Financial Supervisory Convergence: How much should there be?

Accountability

Boards of banks are required under corporate governance principles to be responsible for their activities. Such a self-evident truth applies to all businesses not only banks and appears in every corporate governance statement. In the banking industry this has been extended within Basel 3 to include subsidiaries of banks. Accordingly all such subsidiaries (and indeed increasingly branches) must have a governing committee that is responsible for managing the risk of the firm and reporting to the relevant local regulator.

This accountability of the senior management deals with the majority of the risks since if each subsidiary is properly capitalised and managed then the group as a whole will also be adequately capitalised and managed. Indeed it will be overcapitalised since the advantages of portfolio diversity will have been subsumed under the greater banner of international regulation. So accountability is achieved. Likewise legitimacy is about the nature of the activity conducted and this will be reported to the local regulator through the ICAAP process and reported to the wider world through the Pillar 3 disclosure document.

So do we need International Convergence?

Too many arguments have been put out to suggest that we need such convergence to stop the process yet any analysis will lead to questions including those posed in this article. There is a need for transparency in international organisations to enable depositors, investors and competitors to better appreciate the risks that underpin any firm. The greatest risk to many firms is essentially the risk of a failure of another firm – yet this is a risk that is actually not easy to appreciate.

This data is held by the regulators but is neither shared with the banks not the general market, to the detriment of both.

In terms of derivative activity we are moving towards a market where there will be central clearing of many transactions in the interests of transparency. That post trade notification would have achieved the same benefits for a fraction of the wasted costs of the current development is also clear. Yes there is a need for more information to be available and sometimes for regulators to work effectively together. It is clearly also right that we should have a general set of best practice standards to drive the industry so that all banks achieve at least a minimum series of requirements. What is not required is a set of global standards which have the unfortunate consequence of significantly increasing unemployment.

Conclusion

I conclude that the arguments placed in favour of standardisation of international regulation have been overstated. The consequence of this will be higher than necessary unemployment and lower than necessary global activity. The approach of ensuring that each individual unit of a bank is properly managed and capitalised fails to take account of the diversification benefits that clearly exist and again result in charges for finance be unnecessarily increased. Whilst transparency is a good thing it can be achieved more effectively through post trade notification of those risks that are the greatest, with the greatest of all being interbank connectivity. The failure of the regulators to provide the industry with the data which they have calculated intemally to monitor this issue is to the detriment of the industry as a whole. So we have misdirected regulation impacting growth whereas properly thought through international regulation could stimulate the global economy a reduce pain and hunger. There are solutions to the problems that we face and these include the following:

1. Banks that are larger than their home market should be regulated at a global level through a global regulatory body. In each case the home regulator should make the decision that such a change is required.

2. Capital rules should be reduced at times of global financial stress and all regulators should have an unemployment and social impact objective within their requirements.

3. The liquidity rules proposed should be amended such that liquidity is maintained for reasonable expected shortfall and that plans exist for stress based shortfall.

4. All rules should be drafted for the banking industry including individuals responsible for ensuring that all regulations consider social and global economic and environmental impacts.

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