


The road to re-regulation

Views from the financial services industry

An aerial photograph of a winding asphalt road with yellow and white lane markings, curving through a dense forest. The trees are in various stages of autumn, showing shades of green, yellow, orange, and red. The road is the central focus, leading the eye from the top right towards the bottom left.

The Economist Intelligence Unit, on behalf of Ernst & Young, surveyed members of the financial services industry to assess their views on the emerging regulatory landscape.

About this research

This analysis is based on a survey conducted in October 2010 of 510 executives from the financial services industry. Respondents were from the UK, France, Germany, the Netherlands, Italy, Switzerland and the US, and represented a wide range of financial services sub-sectors. Over 40% of respondents were C-level executives, and about 60% from companies with at least \$500m in annual revenues.



After decades of deregulation on both sides of the Atlantic, the financial crisis has prompted a fundamental re-think of the rules and regulations that govern the financial services industry. Since the start of the crisis, dozens of regulatory interventions have been proposed, discussed and, in some cases, rejected. And although there remains considerable uncertainty over the exact scope of the future regulatory landscape, the dust is starting to settle, and a rough outline of the new framework is starting to emerge.

Perhaps the most significant change to financial regulation relates to capital adequacy. In September 2010, revised rules on banking capital under the new Basel III system were revealed. The capital reserves that banks must hold will need to be substantially higher and better quality. Although the new rules will be phased in over several years, this could force some banks to raise substantial amounts of new capital, or convert existing assets into those deemed safer by regulators.

In the US, the Dodd-Frank Act was signed in July. Among its proposals are the establishment of a new Consumer Financial Protection Bureau, the central clearing of over-the-counter derivatives, the requirement that large alternative asset managers register with the Securities and Exchange Commission and new measures to force the losses arising from banking collapses onto shareholders, creditors and competitors. The new law also contains a provision to ban proprietary trading by banks and limit the amount of funds institutions can allocate to private equity and hedge fund-style activities to 3% of capital. Other proposals, such as a bank levy, were shelved in negotiations. A huge amount of detailed rule-making will follow over the next two years.

In Europe, many proposals have been put forward and are being finalized. In addition, individual countries are announcing their own reforms, some of which go beyond the European standards. In September, the European Commission agreed a new financial supervision package that creates three pan-European watchdogs for banking, insurance and securities markets, and a new European Systemic Risk Board comprised of national central bank governors.

This highlights the most important problem with the new wave of financial regulation – building a consensus at an international level. Although the G20 has, on the surface, appeared united in its desire to develop a coordinated response, there are still very divergent views among member countries and the devil is in the detail. In June, the G20 dropped a plan to impose a global bank levy in the face of strong opposition from countries, such as Canada, which rightly pointed out that they had done little to cause the crisis. There is also disagreement over the Basel III standards, with a number of countries lobbying for exceptions and pointing to accounting differences that could skew the impact of the rules.

Key findings:

- ▶ **53% agree** that, in the long run, profits will be significantly lower as a result of increased regulation.
- ▶ **59% agree** that, in the long run, increased regulation will force them to fundamentally change their business model.
- ▶ **55% agree** that there will be a flight of talent to other locations if measures to restrict bonuses are instituted.
- ▶ **Just 14% agree** that the current approach to financial regulation at the global level is sufficient to make another global financial crisis much less likely.
- ▶ **79% agree** that regulation must be harmonized at the global level to prevent unfair advantages for certain markets.

Key findings of this survey include the following:

There is limited confidence in the ability of national regulators to prevent future crises

Despite all the rhetoric from governments and legislators insisting that next time will be different, just 35% of survey respondents agree that the current approach to financial regulation in their country is sufficient to make another financial crisis in their country much less likely. Among respondents from the UK and US – two of the countries that were most severely affected by the crisis – confidence levels are even lower. Among the former, just 26% agree that the current approach is sufficient and among the latter, a paltry 19% offer a similar assessment.

There are various reasons why the industry may lack confidence in its regulators including a lack of faith in ability of regulators to provide adequate supervision, but the main reason may be that it is still unclear whether their actions will address fundamental risks in the system. For example, there has been very limited progress on tackling the “too big to fail” problem. Poor communication and a lack of trust between the industry and regulators compound this problem. Only 31% of respondents think that regulators have listened to the concerns of the financial services industry when designing regulation.

Poor coordination at an international level is severely hampering the effectiveness of regulatory change

Two-thirds of survey respondents agree that national and global regulators have not done enough to coordinate proposed legislation. Among US respondents, this proportion rises to 75%.

This lack of coordination worries respondents – just 14% agree that the current approach to financial regulation at the global level is sufficient to make another global financial crisis much less likely. This figure drops to just 10% among US respondents, and 6% among Swiss participants.

World leaders pledged at the April 2009 G20 Summit in London to do everything in their power to repair the financial system and strengthen financial regulation. However, there is a divergence of views over how to tackle regulatory reform, which is slowing the pace of change and creating uncertainty for the industry, as well as the potential for regulatory arbitrage as some countries move more quickly than others in setting out new rules.

There is limited support for resolution regimes among survey respondents, with just 42% agreeing that such plans will allow financial companies to wind down more easily in the event of collapse.

Although there are common themes of change, there are significant differences between the approaches taken by major economies. Even international rules, such as Basel III, will need local implementation which is likely to take into account national interests on everything from the timetable for implementation to the nature of assets that can be treated as Tier 1 capital.

This lack of international coordination creates two significant problems. First, it gives rise to the opportunity for regulatory arbitrage, a concern for many survey respondents, with 79% agreeing that regulation must be harmonized at the global level to prevent unfair advantages for certain markets.

But more importantly, a lack of international coordination is entirely at odds with the global, highly interconnected nature of most banks' operations. The problem has highlighted the need for effective cross-border resolution regimes that allow troubled firms to be dismantled in an orderly way that distinguishes between creditors who should bear a loss and those who should not. Surprisingly, though, there is limited support for resolution regimes among survey respondents, with just 42% agreeing that such plans will allow financial companies to wind down more easily in the event of collapse.

Regulation will impose significant costs and may lead to a change in the business model for some financial institutions

Although the financial services industry broadly supports the need for regulatory reform, there are concerns about the heavy burden of additional compliance costs and reduced profitability.

Among survey respondents, 53% agree that, in the long run, profits will be significantly lower as a result of increased regulation. This proportion rises to 60% among the German respondents as the shift to Basel III is likely to have a particularly severe impact on the country's Landesbanken, which typically have lower capital ratios and use a form of hybrid capital that, under the new rules, will no longer count towards Tier 1 capital.

As well as potentially reducing profitability and shrinking assets on balance sheets, regulation also imposes additional costs on banks in terms of additional compliance and risk management obligations. Of survey respondents, 62% have increased their expenditure on compliance and 59% have increased their spend on risk management.

Just 40% agree that bonuses should be regulated and capped, although there are marked differences in opinion between countries.

The squeeze on both the top line and bottom line could force financial institutions to re-examine their entire way of doing business. Among survey respondents, 59% agree that, in the long run, increased regulation will force them to fundamentally change their business model. Already, there are signs that investment banks are seeking to focus on less capital-intensive activities, such as M&A advisory. Meanwhile, retail banks and insurance companies are turning their attention to fast-growing emerging markets.

The lack of overall consensus around the impact of the new regulatory environment is highly striking, and is a theme that runs strongly through the survey findings. Asked whether specific regulatory interventions, such as the Dodd-Frank law or the Volcker rule, would have a positive or negative impact on their business, a very high proportion of respondents – typically between 40% and 50% – said that they simply did not know. The fact is that these are uncharted waters for the industry, and the long-term cumulative impact of regulation on the financial health of the banking system against a backdrop of macroeconomic uncertainty remains unclear.

Efforts to curb bonuses will not work

Regulatory intervention on remuneration gathers fairly limited support among survey respondents. Just 40% agree that bonuses should be regulated and capped, although there are marked differences in opinion between countries. At one end of the spectrum, 63% of respondents from Italy and 60% from the Netherlands support the regulation and capping of bonuses, while at the other extreme, just 27% of respondents from the UK and 26% from the US hold a similar view.

Among the many issues swirling around the re-regulation of the financial services industry, remuneration is perhaps the most emotive and intractable. Politicians and regulators have become increasingly strident in their view that the bonus culture must be tackled both to ensure a more sustainable, risk-adjusted approach to remuneration and to rein in rising income inequality at a time of deep economic austerity. However, the financial services industry argues that no one firm can change the culture and there is a

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valid argument that curbs on pay, applied unilaterally, will lead to an exodus of talent and, in some cases, the migration of entire divisions or firms to jurisdictions with less stringent rules. This may become an issue for the European Union, as draft regulations from the Committee of European Banking Supervisors – now in consultation – may require banks to cap bonus payments at a multiple of annual salary and limit the cash component to 20%.

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Moreover, there is concern that regulatory interventions do not get to the heart of the problem. Almost two-thirds of respondents agree that bonus culture remains the same regardless of efforts to curb it. According to this view, bonus deferral and curbs on pay address some of the symptoms, but they do not cure the underlying problem of a culture that rewards high levels of risk-taking with correspondingly high rewards.

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