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FINANCIAL SERVICES

Moving on

The scope for better regulation

May 2013

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...The industry needs better regulation, more attuned to the needs of the wider economy, not 'more and more of everything'.

Executive summary

There has been a strong and understandable reaction from politicians and regulators to the financial crisis. But are we on the right track, or do we need to adjust the direction of travel?

Waves of regulatory reforms have been introduced to make financial institutions safer, to make the financial system more stable, and to shift the costs of failures from taxpayers to the creditors of failing institutions. These initiatives have ranged from tougher requirements on individual financial institutions to the 'macro-prudential' approach to financial stability, and from resolution regimes to more robust financial market infrastructure.

The growth agenda…

Additional regulation is not however a 'free good'. It increases the cost, reduces the availability and reduces innovation in financial services. It reduces the returns to investors in financial institutions. And it reduces economic growth. This has been seen most powerfully and immediately in the downward spiral of bank deleveraging and weak or negative economic growth in Europe. Further substantial costs are likely to arise from constraints on the ability of banks to provide credit, trade finance and risk management services to their customers.

A modest reduction in economic growth during normal times may be a reasonable price to pay to avoid financial crises. Post-crisis regulation was supposed to prevent future failures and financial instability, at a small cost in terms of foregone economic growth.

But the waves of regulatory reforms seem to have taken some countries and the global financial system beyond the 'tipping point' – the costs of ever more regulation have begun to exceed the benefits. In practice, regulatory reforms have exercised a substantial drag on economic growth, while their impact on the safety of the financial system remains uncertain.

Better regulation…

The industry needs better regulation, more attuned to the needs of the wider economy, not 'more and more of everything'. We need to strike a balance between regulation and its impact on the wider economy. We need to re-focus on the importance of credit, trade finance and the management of risk by corporates for economic growth, international trade and development.

Financial institutions, users of financial services, politicians and regulators all need to address this agenda. All stakeholders have a role to play in achieving a better outcome. This paper focuses on some of the issues that need to be addressed by the three key constituencies – financial institutions, investors and end-users and regulators and politicians.

Financial institutions…

Regulation is not constructed in a vacuum. It responds to the standards and behaviours of regulated entities. Financial institutions, and in particular banks, therefore have a strong incentive to behave more responsibly, not only to restore trust and confidence but also to enable regulators to ease back.

This requires financial institutions to make real and demonstrable progress in changing their cultures and behaviours; delivering much higher standards of governance, risk management and customer treatment; focusing more clearly on products and services that benefit the wider economy; making better disclosures of asset quality and risks; and not 'gaming' the regulatory system.

Investors and end-users…

Investors in financial institutions and the end-users of financial services also need to play their part in addressing the balance between regulation and economic growth. They need to be more realistic about what both financial institutions and regulation can achieve.

Investors need to recognise that the risk/reward landscape has changed and that return on equity expectations need to be adjusted accordingly. They also need to understand better the business models and risks of financial institutions, and put pressure on financial institutions to change these where necessary, in particular in a world where failures are more likely to result in the bailing-in of creditors than a bailing-out by taxpayers.

End-users of financial services need to remain alert to the impact of regulation on the cost and availability of products and services, and to enter regulatory debates with evidence on the implications of regulation for end-users.

Regulators and politicians…

Regulators should take proper account of the cumulative impact of their multiple reform initiatives, and of the uncertainty surrounding the many unfinished parts of the regulatory agenda. Regulators should also be more sensitive to the impact of regulation on the wider economy; recognise that banking is a risk business, and that future failures will occur; and focus more on the possible sources of the next crisis rather than plugging all the holes exposed by the last crisis.

Finally, many politicians should recognise the importance of finance as a contributor to and facilitator of economic growth, and to be more realistic about what regulation can achieve and its impact on the wider economy.

The growth agenda

Economic growth in Europe is at best weak, at worst negative. The US is growing more strongly, but fragilities and downside risks may blow this recovery off course. And the previously rapid growth rates in Asia Pacific have slowed – and may be difficult to restore.

In part, these weaknesses are the result of individuals and corporates seeking to reduce their borrowings, having become over-indebted in the run-up to the financial crisis. They may partly reflect the reversal of earlier unrealistic expectations about the sustainability of growth rates.

But weak, or weaker, economic growth across the world also reflects the higher price of – and constraints on the availability of – credit, trade finance and other financial services as a result of tougher regulatory requirements.

Significant capital, liquidity and bail-in liabilities are required to prevent failures and to enable the orderly resolution of a large bank. Capital is expensive and scarce, so it is hardly surprising that banks are less able to lend – and then only at more expensive rates. And other requirements that reduce the risk of failure and facilitate resolution – if a large bank does fail – also make it harder for the financial system to undertake the credit transformation needed to support the wider real economy.

Moreover, international banks face higher costs not only from meeting tougher international standards at group level but also from the increasing localisation of banking markets. National regulators have imposed their own capital, liquidity, governance and structural requirements on local entities within international groups. This constrains the ability of international banks to provide financial services efficiently to their international corporate customers.

Better regulation should recognise the negative impact of poorly designed regulation on economic growth and development.

In countries such as the UK, Ireland and Luxembourg there is also a need to recognise the importance of the contribution of financial services to national income, employment, tax revenue, the export of financial services, and trade with the rest of the world.

The trade-off between regulation and economic growth

The priority of many governments and regulators – particularly in the US and Europe – has been first and foremost making the financial system safe, and curbing what is seen by many commentators as socially useless aspects of investment banking.

Finance ministries and regulators understand the importance of banking and capital markets for the real economy, but many have been heavily influenced by their experiences in the financial crisis, where governments had to bail out banks and regulators were widely criticised for not doing their job properly. This has driven a risk-averse approach.

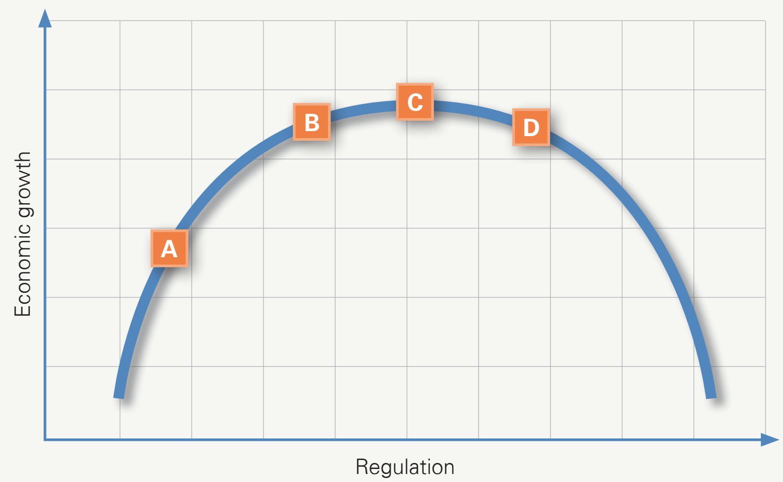
As a result, the flow of regulatory reform initiatives following the financial crisis has continued unabated, ranging from capital to collateral, from derivatives to deposit insurance, from liquidity to the Liikanen proposals, and from remuneration to resolution.

We may already be past the 'tipping point' at which the costs of regulatory reforms begin to exceed the benefits.

The relationship between regulation and economic growth may be illustrated by a simple chart, plotting these two variables. Up to a point, regulation promotes economic growth, not least because the negative impact of regulation on economic growth in normal times is more than offset by avoiding the severe costs of financial crises. But there is an inflexion point beyond which the negative impact of regulation on economic growth in normal times begins to exceed the benefits of regulation.

The really difficult question is establishing where the 'tipping point' lies. There is general agreement that before the financial crisis we were at point A, where too little regulation contributed to the costs of financial crises on economic growth. Official estimates of the Basel 3 capital and liquidity reforms moved regulation up to point B, leaving scope for additional regulatory reforms before reaching the 'optimal' point C. However, the evidence in Europe in particular suggests that we have moved beyond point C to point D, where excessive regulation is so damaging to the wider economy that the net impact of regulation on economic growth has become negative.

Regulation versus economic growth



All of these initiatives are designed to make the financial system safer, to improve investor and consumer protection, or to make it easier to deal with the failure of financial institutions. But they also impose costs on, and change the behaviour of, financial institutions. This has consequences for their customers and ultimately for the wider economy through their impact on the price and availability of lending and other financial products and services.

The record of the banking industry has also led many governments and regulators to view securitisations and derivatives as fundamentally flawed. Both are regarded by many as toxic and dangerous. But when used sensibly they can support and facilitate trade, the financing of the economy and risk management.

Even if each individual regulatory reform can be traced back to a problem that contributed in some way to the financial crisis, it does not follow from this that the sum of the regulatory parts is fully cohesive in covering the ground, or that all of these reforms add net value. Regulation has diminishing returns.

And in some cases the additional value of a reform may be limited because other reforms have already generated most of the available benefits, while the costs of the reform may be high.

The impact of regulation

The discussion two years ago between the official[1] and private[2] sectors of the costs and benefits of the Basel 3 package of capital and liquidity standards generated very different estimates of the impact of Basel 3 on the costs to banks of raising additional capital and liquidity; on the feed-through of these costs to bank lending margins; and on the impact of these higher loan rates on the wider economy.

But even while this somewhat academic debate was taking place, a very different picture was developing in the real world, where:

- Higher proposed minimum capital and liquidity requirements became binding constraints on banks much more rapidly than implied by the carefully transitioned glide path to 2019 set out in Basel 3. This was as a result of official stress tests based on the end game and the focus of investors and market analysts on whether banks were already meeting the full Basel 3 requirements.
- Although banks have raised new capital – and retained earnings through lower dividends and bonuses – they have also improved their capital ratios by reducing the size of their balance sheets, through the sale of non-core businesses, the sale of capital- and funding-intensive assets, and a reluctance to extend fresh credit to borrowers. New lending has been particularly weak in the commercial property and SME sectors. The IMF estimates that major European banks will reduce their assets by up to US$4 trillion between the middle of 2011 and the end of 2013[3]. These quantity adjustments have had a

1 *Assessment of the macroeconomic impact of higher loss absorbency for global systemically important banks,* Macroeconomic Assessment Group, Bank for International Settlements, 10 October 2011.

2 *The cumulative impact on the global economy of changes in the financial regulatory framework,* Institute of International Finance, 6 September 2011.

3 *Global Financial Stability Report,* International Monetary Fund, October 2012.

The cumulative costs of regulation may have been seriously underestimated; and the trade-off between regulation and economic growth may be much worse than estimated.

considerably larger negative impact on the wider economy than the price-driven transmission mechanism assumed in the cost-benefit analyses.

- In some countries – particularly in Europe – the rapid adjustment by banks has not only worsened the economic condition and outlook but also created a negative feedback loop back to the overall quality of bank loan portfolios.
- Even where banks already meet the tougher capital and liquidity requirements, these requirements may begin to bite over the medium-term, especially in countries where economic growth and banks' balance sheet growth are expected to remain relatively strong.
- While the academic studies focused primarily on the Basel 3 package of higher capital and liquidity requirements, banks and other financial institutions were adjusting to a much wider range of regulatory reforms.
- There remains considerable uncertainty in the implementation and development of many regulatory reforms, nearly six years since the start of the financial crisis. These uncertainties have caused banks and other financial institutions, investors and depositors to adopt a more cautious approach.

Overall, the cumulative costs of regulation may have been seriously underestimated; and the trade-off between regulation and economic growth may be much worse than estimated by the authorities two years ago. We need much better analysis of this trade-off, by all parties.

We may already be past the 'tipping point' at which the costs of regulatory reforms begin to exceed the benefits. If we travel beyond this point, society as a whole has to recognise the reality that a very safe financial sector can play only a very limited role in supporting economic growth and development.

Regulators should therefore move on by demonstrating greater realism. They need to pull back from 'more and more of everything' to a more nuanced approach to regulatory reform.

Moving on: Bank culture and behaviour

Many banks (and other financial institutions) are seeking to restore trust and confidence, not least by making significant and meaningful changes to their cultures and behaviours, and to their corporate and risk governance.

This is not only important in itself, but is a key element in enabling regulators to take a less intrusive and intensive approach. Improved culture, more responsible behaviour, and higher standards of corporate governance, risk management, customer treatment and disclosure by financial institutions will allow regulators to take a less heavy-handed approach and reduce the overall burden of regulation.

Currently, regulation is attempting to deliver cultural and behavioural change at one remove, by mitigating the adverse impacts of poor standards of culture and behaviour. Capital and liquidity measures are designed to increase the cost of risk-taking; structural separation measures to encourage banks to take different approaches to their retail and investment banking activities; resolution measures to reduce risk-taking by removing the prospect of government support if banks fail; governance measures to heighten the focus of Boards and senior management on risk; remuneration measures to reduce the incentives for inappropriate and excessive risk-taking; and conduct measures to increase the focus of financial institutions on the design and distribution of financial products and on the incentives of retail customer-facing sales and advice staff.

But regulation cannot do this alone. Banks and other financial institutions should seize control of their own destinies. Improvements in culture, behaviours and governance in financial institutions can also facilitate better regulation, by allowing regulators to rely more on regulated firms to deliver good outcomes. This in turn should deliver benefits for financial institutions themselves, for financial stability, and for economic growth and development.

This will require a massive shift by many banks – they will find it difficult to achieve the necessary shifts in culture and behaviour. Short-term profitability is not always closely aligned with the fair treatment of customers and good customer service, especially in markets – both retail and wholesale – where customers are unable or unwilling to engage on an informed basis. The old mantra of 'what is good for business must also be good for customers' has been shown to be seriously flawed, with too many cases of banks placing their own interests ahead of the interests of their customers.

Moreover, the industry has been slow to recognise and address these problems and to accept that the cultural and behavioural issues here cannot be solved simply by high-level statements about 'putting customers first' and by blunt adjustments to remuneration structures.

What banks should do

- Accept that the world has changed, and that their business, governance, culture and values need to change accordingly.
- Demonstrate their own commitment to a more constructive environment, by implementing significant cultural and behavioural change.
- Input actively and constructively to the debate on better regulation, while recognising that this is not simply about pushing back on all aspects of more regulation.
- Focus more on products and services that have a real benefit to the wider domestic and international economy, and demonstrate more effectively the value of these activities to politicians and regulators.
- Develop a positive response to regulatory and supervisory concerns on risk governance, and on the aggregation and reporting of risk data.
- Take a proactive approach to conduct risk, in both retail and wholesale markets.
- Make better disclosures of risk and asset quality.
- Take a more integrated approach to regulatory changes, and combine this with strategic responses to the economic environment, competition in the marketplace, and technological opportunities – as covered in more detail in KPMG's recent publication on *Evolving Banking Regulation*[4].

4 *Evolving Banking Regulation*, KPMG International, February 2013.

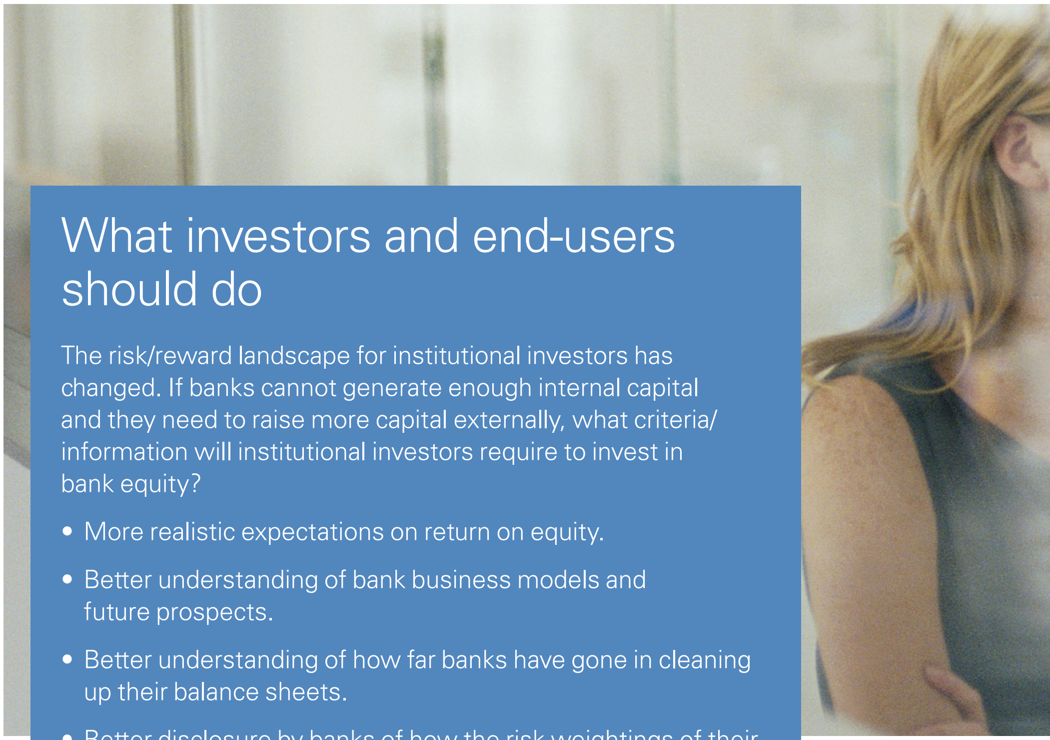
Moving on: Investors and end-users

Investors in, and customers of, banks also need to adjust to the waves of regulatory reforms.

First, they should take account of the impact on them of changes in the regulatory landscape and the responses of banks and other financial institutions to these changes. For investors this is likely to include a shift in the risk/reward profile of bank equity and the implications of the 'bail-in' resolution tool on the yields and riskiness of long-term debt issued by banks. Meanwhile, customers of banks are likely to face a higher cost and constrained availability of financial services, including lending, trade finance and risk management instruments such as derivatives; shifts in the returns on deposits as banks adjust to meet the new liquidity requirements; and changes to the terms of unsecured and uninsured deposits as a result of the potential bailing-in of a wide range of bank creditors.

Second, it is important that investors and end-users engage actively in the debate on regulation, not least in providing evidence on the actual and potential impact of regulation on the cost and availability of financial products and services, and the likely implications of this for the wider economy.

Finally, investors need to play their part in asserting market discipline on banks and other financial institutions, by understanding better the business models, behaviours and risks of these institutions; pressing for improved disclosure of risk exposures and how these correlate with capital and other resources; and seeking changes where institutions' strategies, risks and capital appear to be moving out of line.



What investors and end-users should do

The risk/reward landscape for institutional investors has changed. If banks cannot generate enough internal capital and they need to raise more capital externally, what criteria/information will institutional investors require to invest in bank equity?

- More realistic expectations on return on equity.
- Better understanding of bank business models and future prospects.
- Better understanding of how far banks have gone in cleaning up their balance sheets.
- Better disclosure by banks of how the risk weightings of their exposures correlates with the underlying risks.
- Clarity on the detail and impact of new and proposed regulatory reforms.
- Clarity on resolution and the bail-in of liabilities, at both national and international levels.

For the end-users of banks:

- Corporate customers need clarity on the extent to which they will be hit by additional costs as a result of new derivatives rules, new bank capital rules and the financial transactions tax.
- Corporate customers need to become more active in assessing the impact of regulation on the cost and availability of financial products and services, and enter more actively the debate on the impact of regulation on the wider economy.
- Depositors and bondholders need clarity on resolution and bail-in provisions, including the 'trigger points' at which a financial institution might be placed in resolution and the basis on which depositors and other creditors will be bailed-in.

It is important that investors and end-users engage actively in the debate on regulation.

Moving on: Regulation

At the beginning of 2013, the Basel Committee on Banking Supervision loosened the Liquidity Coverage Ratio (LCR) requirement that banks will have to meet as part of the Basel 3 package of capital and liquidity standards. The revisions included allowing a wider range of assets to count as high quality liquid assets; less stringent assumed 'run-off rates' for some types of deposits and committed facilities; and a phased introduction of the LCR requirement between 2015 and 2019.

Some commentators have portrayed this as a victory for the banks and a substantial climb-down by the Basel Committee. But this is better seen as a journey, with the end result still representing a major step forward from the absence of any internationally agreed quantitative liquidity standards ahead of the financial crisis.

Either way, the Basel Committee has taken a more realistic approach and has clearly considered the potential impact of the LCR requirement on the wider economy. The revisions represent modest encouragement for high quality mortgage securitisations; an easing of the additional funding costs on banks making loan commitments to, and taking short-term deposits from, non-financial corporates; and more generally a reduction of banks' funding costs.

In a similar vein, the final version of the EU's Capital Requirements Regulation, that implements Basel 3 in Europe, includes a 24 percent reduction in the capital required against lending by banks to small and medium sized enterprises.

And the European Union is now focusing on the linkages between financial regulation and long-term investment[5].

The table on pages eight and nine outlines a range of possibilities to rebalance the trade-off between financial stability and economic growth.

5 *Green Paper: Long-term financing of the European Economy*. European Commission, Brussels, 25 March 2013.

Policy suggestions for a better balanced regulatory approach

Where might better regulation be introduced? Although much regulatory reform has already been hard-wired into EU and national legislation, there remains scope for adjustment. The table below shows a range of possibilities to rebalance the trade-off between financial stability and economic growth, and to address the other trade-offs discussed in this paper.

Subject area	Current proposals
Capital: Domestic systemically important banks (D-SIBs)	National discretion to impose capital surcharges on D-SIBs, based on systemic importance to domestic economy (or region)
Capital: Use of macro-prudential tools	Wide range of tools available, few limits on the extent of their use National discretion in establishing macro-prudential authorities, and in the tools available to them
Capital: Trading book review	Basel Committee review in progress
Capital: Review of risk weighted assets	Basel Committee and European Banking Authority reviews in progress
Capital and liquidity: Mortgage securitisations	Tough capital treatment of all securitisations Limited scope to include mortgage-backed securities in high quality liquid assets to met the LCR
Liquidity: LCR	Basel Committee revisions to LCR published in January 2013
Liquidity: NSFR	Basel Committee has restated its commitment to implementing the Net Stable Funding Ratio (NSFR) from 2018
Resolution planning	FSB 'key attributes' for resolution, and proposed EU Recovery and Resolution Directive
Market infrastructure: Derivatives	Standardisation, exchange trading, central clearing and trade reporting of derivatives Various proposals on the amounts and quality of collateral (and margins) required to support derivatives transactions Capital requirements on non-centrally cleared derivatives
Shadow banking	FSB and EU formulating proposals, in particular on money market funds and on securities lending and repo transactions
Localisation	Geographic ring-fencing of capital, liquidity and other regulatory requirements US requirements on large foreign banking operations; UK liquidity requirements; pressures on foreign banks to operate in host countries through subsidiaries rather than branches
Governance	FSB statement of sound practice on risk governance Basel Committee principles on risk data aggregation and reporting More emphasis on corporate governance and remuneration in EU legislation
Conduct	Greater regulatory focus on retail and wholesale conduct issues – from the G20, the EU and national regulators

Potential scope for adjusting regulation

- Tighter criteria for designation as a D-SIB
- Limit on the size of capital surcharge (for example, the 0-2 percent range used in the EU capital requirements legislation)

- Narrow range of tools
- Greater predictability in how and when these tools can be used
- More checks and balances to ensure that use of tools is fully justified (similar to impact assessments and cost benefit analysis before regulatory rules are introduced), taking proper account of the potential impact of macro-prudential tools on the wider economy
- Protection of core lending (SMEs, corporate, unsecured personal loans) from macro-prudential requirements, except when there is a clear link between these types of lending and risks to financial stability
- Long transition periods between announcement and implementation, to reduce the extent to which banks have to hold permanent capital buffers against the possible use of these tools
- Clarity on the conditions under which tools will be lifted as systemic risks decline
- Limit the extent to which these tools become additive for banks, either among themselves or in conjunction with other capital requirements – avoid multiple capital requirements to address the same risk

- Greater focus on how any revisions correlate with the riskiness of exposures
- Avoid unjustified increases in capital requirements

- Promotion of lending and other financial services that contribute to economic growth
- Maintain the scope for genuinely risk-sensitive capital requirements
- Avoid moving to a reliance on standardised (only partially risk-sensitive) risk weightings
- Build on the Enhanced Disclosure Task Force recommendations that banks should explain and justify their model-based risk weightings through better disclosures

- More nuanced capital and liquidity treatment to encourage the securitisation of high quality mortgages and other high quality assets using simple securitisation techniques

- Avoid unjustified super-equivalence to the Basel Committee minimum requirements at national and regional level
- Allow national characteristics to be reflected

- Reduce the cost of funding for 'desirable' long-term lending, for example to SMEs and trade finance, by reducing the amount of stable funding required to support these types of lending. This would follow the path already taken by the Basel Committee for unencumbered residential mortgages (where the stable funding requirement was reduced from 100% to 65%)
- Greater weight on the value of retail funding, to reflect longer-term stability
- Replace the proposed NSFR with a simpler requirement directed at limiting the amount of short-term wholesale funding that a bank can raise

- Consistent and proportionate national actions to require legal entity and organisational restructuring in banks to make resolution more credible
- Greater clarity and certainty on when financial institutions would be put into resolution by the authorities, and on the basis on which depositors and other creditors would be bailed-in
- Limit the extent of requirements on banks to hold minimum amounts of long-term bail-in debt instruments – to avoid high funding costs and to recognise the scope to bail-in a wider range of liabilities, including through deposit guarantee schemes
- Recognition for the extent to which proposals for structural separation already constitute measures to enhance the resolvability of banking groups
- Greater consistency in structural separation requirements – avoid multiple over-lapping requirements

- Careful assessment of the impact of regulatory requirements on the use of derivatives for 'socially useful' purposes, by both financial institutions and non-financial corporates
- Avoid driving out hedging activities through prohibitive costs
- Greater international consistency and recognition of host country regimes

- Ensure that any regulatory requirements properly reflect the risks to financial stability
- Avoid simplistic application of bank-like regulations on non-bank financial institutions
- Recognise the value of non-bank alternative channels of intermediation, as well as the risks to financial stability

- Although the national pressures are understandable here, regulators also need to recognise the substantial impact of such measures on internationally active banks

- Regulators need to focus on outcomes, not procedures
- Banks and other financial institutions need to deliver more effective governance and improved culture and behaviours. If banks can demonstrate significant improvements in governance and culture, this should lead to a re-appraisal of other regulatory requirements

- Banks and other financial institutions need to deliver a more customer-focused approach – in putting customers first; in the design, development and distribution of products; and in staff training and incentive structures. Initiatives by financial institutions would lessen the need for ever more regulation in this area

Regulatory trade-offs

Multiple capital requirements…

There has been no shortage of additional capital requirements on banks. These include the higher Basel 3 minimum capital ratios; the minimum leverage ratio; the 'capital surcharges' for systemically important banks; the Basel 3 counter-cyclical capital buffer and various other macro-prudential capital tools (time-varying capital requirements for exposures to specific sectors and the use of permanent national 'systemic risk buffers' in response to structural systemic risks); and the continuing use of 'Pillar 2' capital add-ons.

Higher capital requirements will also arise from the continuing and prospective Basel Committee reviews of the capital requirements for banks' trading book exposures and for securitisations; of the risk weightings on assets and other exposures derived from banks' use of internal models; of standardised risk weightings; of the use of credit agency ratings; of the limits on large exposures; and of the finalisation of the level and specification of the minimum leverage ratio.

But should all of these requirements be purely additive, or is there some scope to view some of them as substitutes rather than complements? Some regulators are pausing for thought on how all the multiple capital requirements fit together. For example, the discussion in the European Union on the introduction of national discretion to impose a structural systemic risk buffer has surfaced clear differences of view on the desirability of additional capital requirements over and above the Basel 3 framework. The EU capital requirements legislation clarifies that capital requirements should not be additive where they address the same risks.

Multiple requirements to reduce the probability of failure…

There are also some important trade-offs within the wider range of reforms intended to prevent future financial crises.

At the broadest level, there ought to be trade-offs here across capital, liquidity, corporate governance and risk governance, recovery plans, structural separation, more intensive and challenging supervision, and other safeguards. There is a good case for tougher standards in all these areas, but many of these new standards have been developed in isolation from each other, so the sum of the (many) parts may not be fully optimal. As the details of national implementation emerge we may begin to see countries exercising their own choices on where and how these trade-offs should be delivered.

Examples of this are already emerging in the more relaxed approach across much of the Asia Pacific region to corporate and risk governance, recovery and resolution planning and structural separation, while at the same time some countries in the region are taking a tougher approach to liquidity to take account of local characteristics.

In Europe there is a debate on whether the Liikanen proposals on structural separation would add significant value (and would pass a cost benefit test) in addition to other regulatory reforms including the capital requirements legislation, recovery and resolution planning, and Banking Union.

A debate is also beginning on the interplay between capital and liquidity requirements. Some pre-crisis thinking may be re-emerging here, in the argument that – everything else being equal – if banks are well capitalised, are able to draw liquidity from central banks, at least under some circumstances, and are subject to effective resolution mechanisms, then it may be less important for them to have to meet tough liquidity requirements.

Even within liquidity requirements there is to some extent a choice between (a) limiting the extent to which banks can use short-term wholesale funding – as in the new Basel 3 liquidity ratios – and (b) supporting wholesale funding mechanisms through wider and more accommodative access (including access by some parts of the 'shadow banking' sector) to central bank liquidity[6].

Furthermore, many of these prevention initiatives focus too much on how the current financial crisis might have been prevented. They are less well directed towards the potential causes of the next crisis, be this from different threats to banks such as fraud, systems failures and cyber security, or from non-bank activities (for example, insurance or securities firms, or financial market infrastructure) within the financial sector.

6 William Dudley, President of the Federal Reserve Bank of New York, discussed this choice in his speech *Fixing wholesale funding to build a more stable financial system*, 1 February 2013.

Regulators need to re-focus on the impact of regulation on the wider economy. The taxpayer may suffer as much from lack of growth as from financial instability.

What regulators should do

- Remember that banking is not a zero-risk business; failures may occur from time to time.
- Re-focus on the impact of regulation on the wider economy. The taxpayer may suffer as much from lack of growth as from financial instability.
- Deliver a real focus on the most important issues.
- Recognise that the market will instantly analyse the position of a bank against new rules (for example Basel 3) so it may be of no use to phase in new rules over multiple years. If this is the wrong time in the cycle to push hard for more capital and liquidity, then the regulatory approach needs to be reconsidered.
- Reduce uncertainty in the implementation and development of regulatory reforms. Work on bail-in, risk weighting rules and other recent regulatory initiatives needs to be completed so that new expectations can be set for banks, investors and depositors.
- Decide whether cross-border resolution can be dealt with, or whether the difficulties here will further reinforce the trend towards greater 'localisation'.
- Avoid international fragmentation and inconsistency in regulatory requirements.
- Focus on the possible forms that the next big crisis might take, not the last one.

There is a better way forward, based on financial institutions delivering much higher standards of governance, risk management and customer treatment...

Prevention and resolution…

There is also a trade-off between prevention and resolution measures (resolution plans, bail-in liabilities, structural separation designed to ease resolution, central clearing of derivatives and other infrastructure improvements). Some regulators are – perhaps justifiably – ducking the 'trade-off' issues here by claiming that the potential impact and effectiveness of resolution initiatives are currently too uncertain to be relied on.

But at some point the question must be addressed as to whether the ability to resolve effectively a failing major financial institution (preserving its critical economic functions, while limiting the costs to the wider financial system, the real economy and taxpayers) means that the prevention of such failures becomes less important (or indeed that failures could then play a more positive role in the proper functioning of a healthy market).

Multiplicity of resolution requirements…

As with prevention tools, there are also trade-offs within the multiplicity of resolution initiatives. In particular, if bail-in liabilities provide scope for a more orderly and less time-critical resolution of a failing firm, this should reduce the need to use other resolution tools such as the rapid breaking up of a major financial group[7].

A similar debate is emerging on trade-offs among resolution tools in Europe, where there is some resistance to the implementation of the full set of proposed resolution initiatives – resolution planning, structural separation, the use of bail-in liabilities, a single pre-funded resolution fund, and a single pre-funded deposit guarantee scheme. Again, the availability and use of the bail-in tool should lessen the need for other resolution tools – for example the need for a pre-funded resolution fund.

Complexity and simplicity…

There is a growing debate among regulators on the trade-off between complexity and simplicity in regulation. Some regulators would prefer to focus on a smaller set of 'simpler' rules, based primarily on a tougher minimum leverage ratio, while removing other, more complex, regulatory requirements[8]. They – and many in the industry – would draw a connection here to the questionable benefits of the complexities of the Sarbanes Oxley legislation in the US, and of tax legislation in many countries.

A parallel debate – which again might lead to the imposition of a smaller number of more narrowly focused requirements – focuses on the development of a more clearly defined view of what society wants banks and the banking sector to do and look like. There are already some signs of this in the debates on limiting the overall size of banks; prohibiting banks from undertaking proprietary trading and some other trading activities; enforcing structural separation; and returning to 'basic', 'boring' and 'social utility' banking.

7 As discussed in *Bail-in liabilities: replacing public subsidy with private insurance*, KPMG International, 13 July 2012.

8 See for example the contrasting views of Andrew Haldane (*The dog and the Frisbee*, Bank of England, 31 August 2012) and Stefan Ingves (*From ideas to implementation*, Basel Committee, 24 January 2013).

Conclusion

Following the financial crisis, regulatory reform has frequently relied on a 'more and more everything' approach. This has enhanced the safety and stability of financial institutions and the financial system. But it has come at a substantial cost, seen most powerfully and immediately in the downward spiral of bank deleveraging and weak or negative economic growth in Europe. In the medium term further substantial costs are likely to become apparent, not least in the ability of international banks to provide trade finance, other credit and risk management services to their international customers.

There is a better way forward, based on financial institutions delivering much higher standards of governance, risk management and customer treatment; regulators taking proper account of the cumulative impact of their multiple reform initiatives, and of the uncertainty surrounding the many unfinished parts of the regulatory agenda; and politicians recognising the importance of finance as a contributor to and facilitator of economic growth.

Next steps

KPMG's global network of member firms have in-depth knowledge and expertise in risk, regulation and the financial sector; we can help clients to:

- Determine the possible impacts of individual and collective regulatory reforms on their strategy, business model, structure and operations;
- Integrate the impact of regulatory reforms with the effects of macro-economic, market competition, demographic and other pressures;
- Implement cultural and behavioural change, and improved standards of risk governance, and assess the extent to which these improvements offset the need for ever-increasing regulation; and
- Make the case for a better balanced regulatory approach, based on practical experience of the effects of regulation on the financial sector, on the users of financial services and products, and on the wider economy.

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Publication name: Moving on – The scope for better regulation

Publication number: 130232