CHAPTER 1

The Multiple Objectives of Financial Regulation[1]

"Globalization requires us to act in consistent ways. If we don't do that, we have fragmentation, we have regulatory arbitrage and in the worst cases a race to the bottom. We have just agreed . . . to look much more deeply at how we can coordinate our regulatory efforts on a global level."

—IOSCO Director General David Wright

The scope of this book is those regulatory issues that threaten the mere existence of financial institutions, and even more crucial, the areas where finance threatens the stability of the world economy. It does not look at all the aspects of regulation of financial institutions.

The number of legal disciplines and regulations that affect financial institutions creates a unique level of complexity. One can understand that, being at the center of the circulation, and even the creation, of money, their impact needs to be tempered and their activities have to be legitimate.

Laws and regulations that apply to financial institutions are structured to achieve many purposes, and that explains why they are sometimes perceived to be overreaching. The recent evolution has focused on the consequences of the financial crisis that developed in several parts of the world since 2008. In Europe, it additionally included the complex regulation issues raised by the sovereign crisis, making it even more complex.

However, in order to understand the dynamics of those regulations, it is important to look at some of the key objectives of regulation. At this stage,

COPYRIGHTED MATERIAL
http://www.pbookshop.com

let's look at the key elements of the financial regulation by focusing on the diversity of objectives pursued by the authorities.

In an article published by Professor Alan Binder of Princeton University, he summarized the key objectives of financial regulation:

I suggest the following four main reasons for (different kinds of) financial regulations, all of which play major roles in this paper:

1. ***Consumer protection:*** *To protect customers from anti-competitive behavior (and hence from excessively high prices), from fraud, from deceptive practices, and perhaps even—though this is far more controversial—from their own foolishness and gullibility.*
2. ***Taxpayer protection:*** *To limit the costs to taxpayers of the government's safety net for financial institutions. The huge bailout costs that taxpayers in many countries are now bearing are spectacular examples. Ex ante taxpayer protection often involves guarding against or limiting moral hazard. Ex post taxpayer protection involves, inter alia, such things as least-cost resolution.*
3. ***Financial stability:*** *To protect the financial system against various sorts of systemic risks that might be triggered by contagious runs, breakdowns of the "financial plumbing," or failures of large institutions that are either too big or too interconnected with others to fail—or, rather, to fail messily.*
4. ***Macroeconomic stability:*** *To limit the adverse spillover effects of financial shocks on the real economy and/or to limit the financial propagation and magnification of shocks that originate outside the financial sector—in short, to mitigate booms and busts.*[2]

http://www.pbookshop.com

STOP (AB)USING TAXPAYER MONEY

The main objective of the new banking regulation is to provide a resolution mechanism that provides for a recovery of financial institutions without using taxpayer money. The outrage created by the interventions of U.S. and European governments to rescue their banks during the subprime crisis led most of them to adopt policies that aim at resolving banking problems within the system (bail-in rather than bailout).

As President Obama put it in his State of the Union address in 2009:

I intend to hold these banks fully accountable for the assistance they receive, and this time they will have to clearly demonstrate how *taxpayer dollars result in more lending for the American taxpayer. This time, CEOs won't be able to use taxpayer money to pad their paychecks, or buy fancy drapes, or disappear on a private jet. Those days are over. . . . Our job is to govern with a sense of responsibility. I will not spend a single penny for the purpose of rewarding a single Wall Street executive, but I will do whatever it takes to help the small business that can't pay its workers or the family that has saved and still can't get a mortgage.*[3]

As noble as this objective is, regulation will not be sufficient to reach it. It will create the framework within which financiers will operate, and how to rescue financial institutions when they fail. Governments and central banks will have to take emergency measures if they have not been able to anticipate the imbalances that led to the collapse of the institution(s).

The Global Stability Report, published twice a year by the International Monetary Fund (IMF)[4] looks at the developments in this field and, among others, the stability of the financial markets. Its preface states that:

If these policy challenges are properly managed, and if reforms are implemented as promised, the transition toward greater financial stability should prove smooth and provide a more robust platform for financial sector activity and economic growth. But a failure to implement the reforms necessary to address the many policy challenges highlighted above could trigger profound spillovers across regions and potentially derail the smooth transition to greater stability.[5]

The Congressional Budget Office (CBO) released a report with what seemed like good news: the bailout of 2008, which fronted $700 billion in taxpayer funds to prop up the financial institutions that brought the economy to the brink, ended up with a profit. The estimated cost of the General Motors bailout to American taxpayers was $10 to $12 billion cheaper than expected. The price tag of the $700 billion TARP was revised down to $21 billion from $42 billion.[6]

PROTECT RETAIL AND SMALL INVESTORS AND DEPOSITORS

History tells us that unscrupulous financiers have always been trying to defraud retail and small investors. The objective of investor protection goes beyond shareholders who are inevitably the first victims of problems in financial institution bankruptcy. It first and foremost provides depositor

http://www.pbookshop.com

protection through the creation of some form of insurance for retail deposits. This objective, despite its own legislation, was clearly broken recently in Europe. In the case of the Cyprus rescue, the European Council publicly broke the sanctity of insured deposits and its own regulation by proposing a haircut on deposits below the 100,000 euros guarantee. They had to backtrack immediately in front of the uproar that such a precedent was raising.[7]

In the United States, regulation is aiming at protecting retail investors. Accredited investors are allowed to access other financial instruments. They include:

- A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person.
- A natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.[8]

The absence of an equivalent definition in Europe is the main reason why, for instance, the Lehman Brothers bankruptcy and the Madoff Ponzi scheme hit retail investors in Europe, while they did not in the United States.

There is no European equivalent to the U.S. rule on suitability of investments known as "know your customer":

> *FINRA's [Financial Industry Regulatory Authority] suitability rule states that firms and their associated persons "must have a reasonable basis to believe" that a transaction or investment strategy involving securities that they recommend is suitable for the customer. This reasonable belief must be based on the information obtained through the reasonable diligence of the firm or associated person to ascertain the customer's investment profile.*[9]

Not all assets can be sold legitimately to all investors. The need for a global suitability ruling, to be then defined at national or regional levels, would certainly make the unscrupulous sellers accountable for their abuse.

The Cyprus crisis has taught the European Union that it needs to respect the sanctity of insured deposits defined as up to 100,000 euros. However, everything else is pretty much up for grabs.

Deposits above this amount will be asked to accept a haircut to contribute to the bail-in of the bank under European rules. Europe has decided to sacrifice deposits and will create a handicap for the funding of

http://www.pbookshop.com

European banks. Large depositors will hesitate to deposit their money with European banks.

This in turn might make European banks more fragile and increase their market dependency. One of the many unintended consequences of its new resolution and recovery system might be to create a competitive disadvantage for European banks.

ENSURE TRANSPARENCY OF MARKETS AND INSTITUTIONS

The amplitude of the crises took the world by storm. It raises the question of the transparency and the availability of critical information that would allow markets and investors to act in time. Its objective should be to prevent some of the explosions that did transform into a systemic risk. The chair of the European Securities and Markets Authority (ESMA) articulates this argument:

> *Having said that transparency brings overall benefits to the market, improving its efficiency and good functioning and ultimately contributing to financial stability, we may argue that the market should have sufficient incentives to develop, adopt and implement measures to foster market transparency. However, opacity favours and benefits the individual positions of market players, allowing exploitation of information asymmetries. Therefore, this is a typical situation where decisions adopted in the general interest benefit all players, but, individually, there are not sufficient incentives to move ahead alone.*
>
> *Given the lack of sufficient and credible steps made by market led initiatives of a self-regulatory nature, transparency is an area where regulators had and have to intervene in the general public interest to restore conditions of adequate levels of transparency to reduce the information gaps and ensure good conditions of market functioning.*[10]

This objective is critical to market efficiency and investors' confidence. Capital market regulators or securities regulators have been fighting a constant battle to ensure proper information of the markets and its transparency. However, this is not unanimously shared around the world.[11]

Trust requires disclosure. An institution or a market cannot rely on investors' confidence if they hide substantial risks from them. Two of the tests will be both on securitization and on sovereign debt.

http://www.pbookshop.com

IMPLEMENT A TRULY RISK-ADJUSTED REMUNERATION SYSTEM

Remunerations had no limits or regulation before the financial crisis. The structure of remuneration in finance is a blend of several components that could affect the way risks are being taken. No incentive to increase the risk profile of the assets and trading positions can be tolerated. The Group of 20 (G20) launched this global initiative, and the Financial Stability Board (FSB) published its “Principles for Sound Compensation Practices” in April 2009, a few months after the Lehman crisis.

> *The Principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. They are not intended to prescribe particular designs or levels of individual compensation.*[12]

> Europe chose another way. The new rules are:

> *Upfront cash bonuses will be capped at 30 percent of the total bonus and to 20 percent for particularly large bonuses. In place of upfront cash between 40 and 60 percent of any bonus must be deferred and can be recovered if investments do not perform as expected. Moreover at least 50 percent of the total bonus would be paid as “contingent capital” (funds to be called upon first in case of bank difficulties).*
>
> *Bonuses will also have to be capped to salary. Each bank will have to establish limits on bonuses related to salaries, on the basis of E.U. wide guidelines, to help bring down the overall, disproportionate, role played by bonuses in the financial sector.*
>
> *Finally, bonus-like pensions will also be covered. Exceptional pension payments must be held back in instruments such as contingent capital that link their final value to the underlying strength of the bank. This will avoid situations, similar to those experienced recently, in which some bankers retired with substantial pensions unaffected by the crisis.*[13]

With the best intentions, those rules are unfortunately misguided. First, they focus on bonuses only: the reason is that the European authorities do not have the power to address salaries and, as a consequence, global compensation. As a result of these rules, if a firm believes it needs to pay a trader $1 million, it will be forced to pay this individual a higher salary, making its fixed costs higher.

http://www.pbookshop.com

> *While lawmakers hailed the vote as a major victory, many in Europe's finance sector questioned whether the new laws would lead to overall reductions in bankers' pay. Analysts warned that many firms would look to skirt the new restrictions by offering higher base salaries for their top earners, which would allow them to continue to receive multi-million dollar salaries despite the cap on bonuses.*[14]

Second, there is no attempt to correlate the remuneration packages with risks. A mergers-and-acquisitions (M&A) banker who uses no equity is treated the same way as an equity derivative trader who relies heavily on the bank's equity.

Unfortunately, the European Commission disregarded this approach. Unable to structure an adequate remuneration system and under the pressure of the Parliament, it chose a shortcut that disconnects its remuneration system from the risk considerations.

The web of regulation will certainly provide loopholes for bankers, as Edmond T. FitzGerald, partner and head of the Executive Compensation Group at Davis Polk & Wardwell, analyzes in the Harvard Law School blog.[15]

PROTECT DEPOSITS FROM TRADING

In order to avoid the contamination of risks that would in effect threaten the deposit base and consumer confidence, the European Commission tried to set up a European scale deposit guarantee system. While this objectively is unanimously shared, its definition is complex. Michel Barnier, the EU commissioner for the single market, asked a high group of experts to make extensive suggestions on this subject.

This report, known as the Liikanen Report, concluded that:

> *The central objectives of the separation are to make banking groups, especially their socially most vital parts (mainly deposit-making and providing financial services to the non-financial sectors in the economy) safer and less connected to high risk trading activities and to limit the implicit or explicit stake of taxpayer in the trading parts of banking groups. The Group's recommendations regarding separation concern businesses, which are considered to represent the riskiest parts of trading activities and where risk positions, can change most rapidly.*

It is at the core of the debate on separation of banking activities and the question whether some banks should not be allowed to conduct joint

http://www.pbookshop.com

activities since they have become too big to fail, manage, or regulate. We will further analyze this in Chapter 8, which is dedicated to the degrees of separation in financial institutions.

Eventually, the European deposit guarantee scheme was recast and capped at 55 billion euros. It was adopted on March 20, 2014.

NOTES

1. Financial regulation: laws and rules that govern what financial institutions such as banks, brokers, and investment companies can do. These rules are generally promulgated by government regulators or international groups to protect investors, maintain orderly markets, and promote financial stability. The range of regulatory activities can include setting minimum standards for capital and conduct, making regular inspections, and investigating and prosecuting misconduct. *Financial Times* lexicon, http://lexicon.ft.com/Term?term=financial-regulation.
2. Alan Binder, "It's Broke, Let's Fix It: Rethinking Financial Regulation," *International Journal of Central Banking*, December 2010. www.ijcb.org/journal/ijcb10q4a13.htm.
3. www.whitehouse.gov/the_press_office/Remarks-of-President-Barack-Obama-Address-to-Joint-Session-of-Congress.
4. International Monetary Fund, Global Stability Report, October 2013, Washington DC, 166 pages. www.imf.org/External/Pubs/FT/GFSR/2013/02/index.htm.
5. Ibid., p. xiii.
6. www.commondreams.org/view/2013/05/28-5.
7. This post I published on the website of Columbia Law School (the CLS *Blue Sky* blog) on March 21, 2013, when the news erupted, was denouncing the breach of the sanctity of insured deposits. The European Union was forced to amend its decision and agreed not to apply haircuts to insured deposits. http://clsbluesky.law.columbia.edu/2013/03/21/cyprus-what-happened-to-the-sanctity-of-insured-deposits/.
8. The SEC definition of accredited investors. www.sec.gov/answers/accred.htm.
9. The FINRA rule on suitability. www.finra.org/investors/protectyourself/beforeyouinvest/p197434.
10. Steven Maijoor, "Market Transparency: Does It Prevent Crisis?" FMA Supervision Conference, Vienna, September 29, 2011. www.esma.europa.eu/system/files/2011_322.pdf.

http://www.pbookshop.com

11. Robert J. Bloomfield and Maureen O'Hara, "Market Transparency: Who Wins and Who Loses?" *Review of Financial Studies* 12(1). Available at SSRN: http://ssrn.com/abstract=122708.

12. Financial Stability Forum, "Principles for Sound Compensation Practices," April 2009. www.financialstabilityboard.org/publications/r_0904b.pdf.

13. www.europarl.europa.eu/sides/getDoc.do?language=en&type=IM-PRESS&reference=20100630IPR77285.

14. Mark Scott and James Kanter, "Europe Votes to Curb Banker Bonuses," *New York Times*, Deal Book, April 16, 2013. http://dealbook.nytimes.com/2013/04/16/europe-votes-to-curb-banker-bonuses/.

15. Edmond T. FitzGerald, "Remuneration Regulation in the European Financial Services Industry," Harvard Law School blog, August 18, 2013. http://blogs.law.harvard.edu/corpgov/2013/08/18/remuneration-regulation-in-the-european-financial-services-industry/.

http://www.pbookshop.com

http://www.pbookshop.com