Assessing the Impact of Post-Financial Crisis Regulation

04 / 28 / 15

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The financial crisis of 2008 demonstrated that the then-existing financial regulatory system was in need of substantial repair. By any measure, the financial regulatory reform that has followed has been extensive. In areas such as capital and liquidity, derivatives, resolution planning and consumer protection, the change has been sweeping. In the United States, the Dodd-Frank Act itself mandated the regulatory agencies to write almost 400 rules. That number does not include the rules based on international agreements such as the Basel accords on capital and liquidity.

Regulators around the world have been working on completing these rules, coordinating and consulting not only with their domestic counterparts but also their international colleagues. The task has been challenging not only because of the volume of regulations, but also the complexity and novelty of the subject matter, not to mention the contentiousness of some of the issues. Even so, as the chairman of the Financial Stability Board (FSB) indicated in his November 2014 letter to the G-20 leaders, the work of correcting the "fault lines that led to the global financial crisis" is substantially complete. Although financial regulation should be ongoing and attuned to evolving risks and vulnerabilities, and while there is still work to be done to complete the post-crisis G-20 regulatory agenda, the regulators' achievement thus far is noteworthy.

The volume of regulation, the extensiveness of its ambit, the number of regulators working on the rules and the relative rapidity of their collective implementation all invite the question as to the aggregate or cumulative impact of these measures. As Stefan Ingves, chairman of the Basel Committee on Banking Supervision, said in a speech at the Federal Reserve Bank of Chicago in November 2014 — six years after the financial crisis, with substantial progress on the reform agenda — it is "a good time to take a step back and ask how the different bits and pieces of the regulatory framework fit together."

Discussion of the cumulative impact of regulation often has been in the context of regulatory cost/benefit analysis. One side of the debate states that the regulations have placed burdensome operational demands on financial institutions and have come at the expense of economic growth. The other side counters that any burdens imposed by the regulations are warranted because they will help avoid another financial crisis, and that any costs pale in comparison to the costs of the 2008 crisis. Aside from cost/benefit analysis, consideration of the overall interplay between regulations is important for another fundamental reason: understanding whether the regulations, as a whole, have coherence and whether they successfully advance essential policy objectives. For example, where financial stability is a principal goal, we must test our approach to macroprudential regulation by asking whether the increased resiliency of some of our financial institutions has also translated into increased resilience of the financial system as a whole.

The regulators have begun to take stock of the interplay among different regulations. In announcing its work program for 2015-16, for example, the Basel Committee stated: "Now that the major elements of the reform agenda have been agreed, the Committee will assess the interaction, coherence and overall calibration of the reform policies. The aim of the Committee's work on coherence is to consider how the various regulatory metrics interact and whether the calibration and design of the various elements of the framework are consistent with their intended objectives." The Basel Committee further explained that an important area to monitor will be the interplay among capital rules (*e.g.*, the leverage ratio, risk-weighting of assets), liquidity (the liquidity coverage and net stable funding ratios) and resolution (*e.g.*, loss-absorbing capacity requirements for resolution planning). The committee added that it "will further assess the potential interactions among these metrics, including the extent to which the various measures bind across different banks and drive bank behaviour."

The exercise is timely. Individual financial institutions (and individual subsidiaries within a financial institution group) often are supervised by multiple regulators, which are governed by differing missions and focus. As extensive as the consultation and coordination has been, the complexity of the subject matter warrants frequent review to determine whether regulatory and financial stability goals are being met.

As the Basel Committee notes, the capital rules are one area that merits such monitoring and review. Regulators depend on more than one capital standard because no one standard can definitively be relied upon to establish adequate capital levels. As the Basel Committee notes in its 2015-16 work program, the leverage ratio, which provides a ceiling on leverage, "by itself, could incentivize banks to increase their holdings of higher risk assets." Because of that risk, regulators also count on a risk-weighted capital regime to determine whether a bank is holding sufficient capital in light of its specific risk profile. Thus, reliance on multiple metrics for safety and soundness can provide both flexibility and a back-stop measurement to reassure supervisors.

But the interplay among alternative capital rules (and between capital rules and other rules) also highlights the importance of considering the rules' coherence with other regulations in promoting financial stability goals. For example, with increasing frequency, market participants (from both the buy side and sell side) and regulators comment that liquidity in markets is thin, particularly in fixed-income markets. As Jaime Caruana, general manager of the Bank for International Settlements, noted recently, "[M]arket liquidity has become more problematic." Sell-side firms, traditionally intermediaries that would put their balance sheet at risk to maintain liquidity in different asset classes, including during periods of stress, may no longer do so to the extent they had before. Although the reason for the pressures on liquidity is debated, many attribute it to the effects of some of the new capital rules. At the same time, alternative vehicles for enabling a market-based intermediation for these asset classes remains a work in progress.

The FSB announced that it intends to review liquidity risks in fixed-income markets. The announcement is significant, but it also is important for such reviews to more broadly consider the interplay among regulations. Fixed-income markets are not the only over-the-counter markets in which there are reports of dislocation; market participants also speak of liquidity pressure and fragmentation in the derivatives markets, particularly in connection with implementation of the trading mandate in the United States and Europe. Here, too, the regulators are showing appreciation of the issues. In a February 2015 testimony before the U.S. House Committee on Agriculture, Chairman Timothy Massad of the Commodity Futures Trading Commission (CFTC) stated with respect to swap execution facilities, "[o]ur rules are new, and as we gain experience with their application in the marketplace, we will see what works well and what doesn't, and we will make changes as appropriate." He added: "[A]s other jurisdictions develop their rules on trading, we will look to try to harmonize the rules as much as possible so as to minimize the risk of market fragmentation."

Thus, review of the interplay among regulations should have at least three elements. First, the analysis should be holistic. For example, because the institutional markets have been affected by regulations enacted by both prudential and market structure/conduct regulation, it is important to consider the effects of both.

Second, because markets are global, the review should involve the global regulatory community. Such an effort could properly fit within the FSB's ongoing efforts to identify emerging risks and vulnerabilities in the financial system. Third, the review should be rigorous and evidence-based. During this phase of regulatory review, regulators and financial institutions should compile data and experience derived from regulatory implementation.

The post-crisis financial reform agenda was both sweeping and necessary. Financial institutions are individually more resilient, and significant "de-risking" has taken place. However, we must continue to be attentive to how the financial system as a whole performs. During the post-crisis transitional period, we need to be vigilant as to whether the changes in market structure and introduction of new forms of intermediation in institutional markets can adequately address market demand for assets, and whether in times of distress, the market as a whole has the necessary resilience.