Editorial

Risks of regulation

Risk and regulation go hand in hand in the financial industry. The public wants its financial system and financial services delivered free of risk. Politicians propose ever more regulation, frequently shaded, if not outright painted, with as much political colour as risk management tint. This is not a new dynamic. The relationship between risk and regulation has been complex and evolutionary since the day of original risk was followed by the day of original regulation (assuming risk came first!). The present regulation of known risk reshapes risk, and current events conjure unexpected outcomes — new risks, then new regulations.

Should this mobile interaction of risk and regulation disturb us? For many, the answer would be 'no', so long as we get our proportions right. Obviously, we want to acknowledge and moderate risk, but we also must acknowledge the contributions of risk taking. Without risk taking, we would have inert economies, prone to their own … risks. Societally, we want to curb excesses of risk and to limit risk taking to that which is just right. We want regulation, but how much and of what kind? And how do we tell when enough has become too much? In Goldilocks' absence, we must consider our regulation in the round, looking for accompanying bellwether phenomena that may tell us that our regulatory risk control strategies have gone astray.

COST-BENEFIT ANALYSIS

Cost-benefit analysis, promising an advance read on the merits of regulatory change, sounds like what we are looking for. The words 'cost-benefit analysis' have a clarity and concreteness to them, however, that disguises our frequent inability to reckon in advance either the costs or the benefits of regulation. Clear data on either side of the comparative analysis are hard to come by. Although much of the US regulatory apparatus is subject to the requirement to show a favourable cost-benefit analysis before promulgating a new regulation, that requirement is honoured frequently through recitals of unalloyed and immeasurable good in the regulation set against surprisingly low assessments of cost. A frequent problem in the completion and ultimately the review of cost-benefit analyses in the financial industry is the inexperience of the regulator and a shortage of data provided by industry itself, whether out of concern for data confidentiality or simply because figures are hard to come by. So we find ourselves with unilluminating exercises like the recent remand of multiple Dodd–Frank regulations to the US Commodity Futures Trading Commission (CFTC) for additional cost-benefit analysis, yielding at least in the initial stages an agency statement of denial of the existence of unconsidered costs versus industry participant statements of substantial, but unquantified, unconsidered costs.[1] That we should come to this pass perhaps is unsurprising. Prominent economists themselves disagree as to the nature of the utility, if any, of current cost-benefit analyses,[2] leaving us in doubt as to the helpfulness of what otherwise tempts us to consider cost-benefit analysis as a primary predictor or verifier of regulatory value. Two articles published in the 14th January, 2016 electronic *Wall Street Journal* verify the ambiguities that can accompany the economics of regulation. One, entitled 'Not too big to fail. Too expensive to exist', declares that the 'operative question for the [US's] largest financial firms is increasingly whether the government has made it too expensive to be "big"'. The other article reported J.P. Morgan's second consecutive year of record annual earnings.[3]

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If cost-benefit is too complex a proposition, what are the other indicators that we can look to that may show regulation moving markets in unanticipated ways? Functionally, we may look to the appearance of market changes that may import new risk. Present examples of these in some markets include market participant attrition, increased concentration, market balkanisation, decreased liquidity, increased volatility, and movement of risk to other, less-regulated markets.

MARKET PARTICIPANT ATTRITION AND INCREASED CONCENTRATION

The US Financial Stability Oversight Council (FSOC), in its 2015 annual report, acknowledges that broker dealers are reducing their securities inventories and in some cases exiting markets, with consequent potential risk to liquidity.[4] Deutsche Bank has abandoned its cleared swaps customer business.[5] The Bank of New York Mellon closed its US derivatives clearing business 'due to market and regulatory factors that will limit our ability to grow the business. …'[6] The number of US-registered futures commission merchants or FCMs (brokers of futures and cleared swaps) has shrunk from 93 at the beginning of 2014 to 73 as of the most recent report on the CFTC website, a decrease accompanying increased regulatory demands on FCMs. In Europe, buy-side firms concerned by increased futures brokerage costs are looking to create direct relationships with clearing houses, disenfranchising brokers.[7] And of course, General Electric is selling off its financial services business just as Met Life has decided to separate itself from a large portion of its US life insurance business — in both cases to avoid costly regulation.

MARKET BALKANISATION

Research conducted by the International Swaps and Derivatives Association (ISDA) indicates a marked regionalisation of the Euro interest rate swap market in response to the implementation of mandatory facility trading rules by the US CFTC. ISDA observed a parallel, but more 'subtle' effect in the US dollar interest rate swap market.[8] Nomura is closing down its consolidated derivatives booking centre in London and opting for local booking instead of cross-border.[5] The Japanese Bankers Association, in its 8th May, 2015 response to the CFTC's request for comment on the Initial Response to District Court Remand Order, observed that Japanese banks are avoiding even US dollar denominated transactions with US financial institutions as a result of the CFTC's implementation of the Dodd–Frank regulations.[1] And, to avoid creating the impression that it is only US regulation of derivatives having a market-dividing effect, note that US hedge fund managers have been seen to be avoiding European capital raising, apparently as a result of the European Alternative Investment Fund Managers Directive.[9]

INCREASED VOLATILITY AND DIMINISHED LIQUIDITY

US Fed Chair Janet Yellen has recognised concerns that market liquidity may deteriorate during stressed conditions, due to new regulations among other things.[10] PIMCO's Douglas Hodge, writing in the *Financial Times* on 22nd July, 2015, observed that bank-oriented regulation, while reducing leverage, has had the effect of reducing liquidity in markets that have historically relied on banks to play a smoothing function in trading, leading to more volatility.[11]

GROWTH OF NON-REGULATED PROVIDERS

According to the Financial Stability Board (FSB), the 'shadow banking industry' has grown to a global US$36 trillion, equivalent to a huge 59 per cent of GDP of the 26 jurisdictions included in the FSB study.[12] Here we have new and less regulated providers of credit intermediation finding opportunities that regulated providers have foregone or have had to let slip. Should we be concerned? Well, we should have questions. First, what will the ultimate effect be on financial institution services availability if our 'sunlit' regulated institutions are so constrained

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as to forfeit the huge shadow market? Secondly, what unknown risks lie unregulated in shadow intermediaries that are growing in market importance, but remain opaque? And finally, are the fates of 'shadow' institutions really as disconnected from those of the regulated banks as regulators would hope? Although the FSB offers an ultimate goal of 'transforming shadow banking into resilient market-based financing', our uncertainties will no doubt remain for many years to come (p. 6)[12].

MARKETS AT RISK?

Does the preceding list of phenomena mean that at least in some markets we are seeing the ill-effects of over-regulation? Such a short list of examples cannot be conclusive, but arguably that is the case, whether these examples are un-, mis- or intended consequences of regulation. Interestingly, the Financial Stability Oversight Counsel (FSOC), without a trace of irony, includes new regulation in its list of causes of changes in market structure and activities migration that may be of new concern to regulators (pp. 2–3)[4]. But the FSOC offers no critique of new regulation. Not all regulators, however, are quiet about the negative effects of the current wave of regulations. CFTC Commissioner J. Christopher Giancarlo, a gifted critic of regulation, characterised the USA's massive Dodd–Frank Act as 'an oversized rear-view mirror covering almost the entire windshield' of an automobile full of US regulators speeding down a highway.[13] Nobuchika Mori, commissioner of Japan's Financial Services Agency, warned of the potential bank credit paralysing effects of the concurrent work of scores of poorly coordinated regulatory groups — 'factories manufacturing new regulations … still operating at their full capacity'.[14] Mori's view of the present global wave of financial regulation is that it might lead to stagnation similar to that Japan has experienced after its own, many, financial regulatory initiatives: 'Too much medicine might make the patient sicker.'[15] Such regulatory self-examination, colourfully phrased, gets headlines and is most welcome. Nonetheless, given the expertise of the readers of this journal, perhaps we have a particular responsibility to be vocal should we be confronted with the ill-effects of misguided or miscast new or proposed regulation. After all, dispassionate, reasoned and authoritative analysis should find its voice in what often are highly political discussions of new regulation.

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