Progressing Financial Markets

PFM03 - Regulation

With Michael Dawson, CEO of Promontory Financial Group (UK) Ltd

Mike O'Hara: [0:00] Voices In Business presents "Progressing Financial Markets", a podcast series sponsored by IBM.

Episode 3: Regulation. With Michael Dawson, CEO of Promontory Financial Group (UK) Ltd.

[intro music]

Mike: [0:20] Hello and welcome to this episode of "Progressing Financial Markets", a podcast series brought to you by Voices in Business and sponsored by IBM. My name is Mike O'Hara of Voices in Business and on today's show where I'm joined by Keith Saxton, Global Director of Financial Markets at IBM, we talk to Michael Dawson, CEO of Promontory Financial Group (UK) Ltd, the global financial services consulting firm, about regulation in the industry.

Well Michael, welcome to the show.

Michael Dawson: [0:48] Thank you.

Mike: It's good to have you here. Maybe we can start with you just giving us a little bit of background as to who you are and what you do at Promontory Financial.

Michael: [0:57] Well, thank you. Thank you for having me. My name is Michael Dawson, I work for the Promontory Financial Group. We're a group of former regulators. We advise financial institutions on risk management, sort of like "doctors for banks". I come from the Treasury but others in the group come from the FSA or the US Securities and Exchange Commission or the Federal Reserve System.

Mike: [1:19] Now, you've mentioned that you advise on regulatory issues. I think one of the things you've done recently is produce a paper: "The Road to International Regulatory Reform". Is that widely available for people to read?

Michael: [1:34] I think it's on our Internet site at www.promontory.com.

Mike: [1:39] OK, because what I'd like to talk about today in this discussion is: regulation. I'm sure you've got many thoughts on the topic. So, really, the first thing I'd like to ask you is, in the wake of the world financial crisis, just to get an idea of your view on the future of regulation in the international financial markets: do you foresee that there will be greater cooperation between regulatory bodies or is that a very difficult thing to achieve?

Michael: [2:07] Well, I think there has been a greater cooperation during the current crisis, especially as it unfolded and after the UK's government approach to the takeover of Northern Rock. In the wake of that there was increased international cooperation and I think that trend will continue. So I would expect to see increased international cooperation as a result of the current crisis.

Mike: [2:31] And Keith, you've been talking to a number of regulators recently, I believe. Is that what you've found as well?

Keith Saxton: [2:37] Yes, I think we're trying to assess really how we can help and how the industry can help itself moving forward. So, as a consequence of this cooperation there is clearly a drive towards greater transparency in the first instance and, coming out of that need for transparency, you really have to sort of look at the marketplace and try and get a picture of, well, how will that happen?

Michael: [3:02] I agree and if I could just elaborate on this concept of cooperation because it's talked about a lot in general and abstract terms -- international cooperation -- but rarely is really talked about in concrete terms, in terms of what that actually means.

I think Brown has done a good job of trying to articulate what that might mean with his vision of a college of supervisors that would look after the top 20 organizations but international cooperation could also mean other things like national governments really stepping up and submitting to the IMF's financial system assessment program rather than trying to delay their participation in that program.

I think one of the things that we saw come out of the G20 meeting over the weekend was a commitment to participate in those types of assessments more quickly and with less sort of dithering. So there are, in addition to the nice words about international cooperation, I think there are some concrete ideas on the table for what to actually do to make it happen.

Mike: [4:08] Those concrete ideas, do you think that they will be followed by all of the necessary regulatory bodies or are there challenges to specific regulatory bodies or specific countries in sticking to those kind of principles and agreements?

Michael: [4:23] Yeah, I think there are challenges first and foremost to the national governments to really agree to open themselves up to inspection by the international bodies. I think the international bodies, the IMF and others, are ready and willing to do it. It's just a question of the national government's willingness.

They also will need to be willing to do other things that are tough like expose their own national banks that are in some cases sort of national darlings or national champions to tough judgments by not only their home country's supervisors but international supervisors who say: "This bank is really growing too fast and taking on too much risk for its own good."

Mike: [5:06] Do you have any thoughts on that Keith?

Keith: [5:10] Yeah, I think so. So, what we're seeing is really potentially three cycles here that can help to improve some of this activity within the marketplace and all of these three are concurrent. So, first and foremost we see quite a lot of activity with utilities, if you will. So, very significant moves to create central clearing counterparties for credit default swaps. It's a very good example of that sort of activity.

We see other utilities being promoted. Those that currently exist around providing benchmarking market data I think will sort of grow. So, I think there's quite a lot of emphasis on exchange versus OTC although some OTC markets will of course continue, they're not all going to disappear, but a lot of focus on transparency within that scope.

The second stage, which we think is really also starting now, is really within the firms and the regulators themselves, where you could argue that perhaps the management information systems within regulators is not robust enough. Most firms we know have a significant problem providing really what we would say is the "golden copy" of the trade, so when you're looking at risk management horizontally rather than vertically, if you're looking at this across the system, very difficult to measure.

So, those two things are probably starting, we think the third element is potentially this creation of the "uber-regulator", which in a sense is really one or two organizations globally will be mandated, maybe it's the IMF, to really take a look at systemic risk. Of course providing the data for systemic risk is incredibly difficult, political, very difficult to collect not just because of the size but because that data doesn't currently exist in the format that you would be able to roll up very easily.

Mike: [7:05] Yeah, I'd like to come on to that maybe a little bit further down the line in the discussion, in terms of where things have gone wrong with regulations up till now, but one of the things that I wanted to get your idea on, Michael, is: are there dangers of individual nations or individual regulators adopting a kind of knee-jerk approach as opposed to a measured response to what's been happening over the last few months?

Michael: [7:29] Yeah, I'd say unquestionably yes and that danger is made worse, you know, it's exacerbated by the view that some have that we shouldn't take steps to fix the international financial regulatory system until after this crisis is behind us. So we hear people say: "You know, let's wait until this is over before we start to fix the rules."

The problem with that approach... There are many problems with it. But one of them is that politics abhors a vacuum. If the regulators wait, there are plenty of legislators and congressmen, senators, and members of parliament who are more than happy to step into that void and take some initiative and pass rules that they believe will help.

I think there is a danger. It is made worse by the view of...

Mike: [8:23] By the wait and see approach?

Michael: Yeah, exactly.

Mike: Have you actually seen, or can you talk about any of these kinds of knee jerk type reactions that have been taking place?

Michael: [8:31] You already have... Knee jerk can have a pejorative connotation. It is the job of a state attorney general, for example, to investigate market malfeasance where is he believes it exists. I would not necessarily characterize it as knee jerk.

You already see states' attorney generals getting into the action in other contexts. In the Spitzer investigations of research and conflicts of interest, these prosecutorial agreements ended up setting the rules for the industry going forward.

You already see these investigations underway. They could well result in agreements with the industry that essentially set new rules of conduct. So, yes.

Mike: [09:20] Going back to the previous point about where, potentially, regulations and, possibly, market supervision and that kind of thing have failed up until now... How much of the crisis that we have seen, over the last few months, has come down to ineffective or inefficient regulation do you think?

Michael: [09:42] I think it is hard to put a percentage on it. It is unquestionably part of the problem but not all of the problem. In large measure, more vigorous enforcement of the tools that already exist on the books could have done a lot to prevent the crisis or, at least, make it not as bad as it has turned out to be.

So I think that there are really two questions. One is: Do you have the right rules on the books and the right framework of international cooperation to apply them consistently? The second question is: Do you have the will--the political will--to stand up and say that you are growing too fast, taking on too much risk, and this bank needs to slow down.

Keith: [10:30] Yes, there is a certain amount of self-regulation, also. The market is supposed to be regulating itself, to some extent. I think you can look inside some of the firms themselves.

[There are differing aspects to it. Maybe they had the right risk measurements, and people chose to ignore that in the quest for growth.

I think one of the things that we really need to be careful of is: In articulating new measures and imposing those on the marketplace, you may compound the problems.

There is a balance here between imposing new regulations, which we all want to see for transparency, but which may actually double up on, effectively, the problems that people have right now.

But there is no doubt that it needs to be simpler. It needs to be safer, in a sense.

Mike: [11:17] Can we talk for a couple of minutes about Basel II? Some commentators have argued that Basel II, which requires banks to mark their assets to market on a daily basis, has resulted in inappropriately heavy write-downs and does not reflect the true value of a bank's assets, thus exacerbating crisis. Is that something you agree with? Do you agree that there are fundamental problems with that Basel II approach?

Michael: [11:45] Yes. I think I would agree. I think most people would agree that there aspects of Basel II. I will use the American pronunciation, just to...

[laughter]

Mike: ... Keep it balanced.

Michael: Keep it balanced... I think that some of these problems were recognized when Basel II was agreed. For example, I think it was recognized that the ratings based approach to securitizations was flawed from conception. But it was thought to be a reasonable compromise and better than the risk of not reaching an agreement on that particular issue. It is something that can, perhaps, be fixed, later.

There does seem to be a consensus, now, that mar to market accounting during times of extreme stress in the market and when there really isn't an effective or efficient market with which to derive a price can have a pro-cyclical impact that exacerbates the downward spiral.

I think that the communique that came out of the G-20 today really put pro-cyclicality up at the top of the agenda. To the extent which that impacts on mark to market accounting, I think there is a large consensus around the idea that, in times of stress, mark to market accounting may not be appropriate for measuring regulatory capital.

But, I think mar to market accounting, in my own view, is going to stay with us. You will, in a sense, never get away from mark to market accounting.

But it doesn't have to be the only measure that an institution or its regulators use to determine regulatory capital. If a regulator chooses, because of times of stress in the marketplace, to use an alternative measure, such as looking through the lifetime value of the asset, for example, then they could do that. They could not require the institution to raise additional capital at a time when it would be diluted.

Mike: [13:45] OK. Maybe we could talk for a few minutes about technology. How do you think technology, generally, can improve the regulatory landscape?

Michael: [13:57] It is essential. I think Keith did a good job of pointing out some of the data challenges that exist and the need for technology to help process this vast amount of data that is necessary to be processed in order to improve the modeling or to build effective models of liquidity risk. I think it is essential in the data modeling context.

It is also essential in other contexts in terms of managing some of the huge numbers of compliance obligations that a financial institution with 100,000 employees and operating in 90 countries are subject to.

I think technology is a vital program. It is part of the solution in terms of modeling data and also helping people do their jobs in a way that is compliant with the rules.

Keith: [14:47] I think that is right. Essentially data is the problem. The industry has been struggling with an explosion data over the past five, six, seven years as we have gone to electronification. A lot of the markets are trading that way.

So even before you look at regulatory issues, there are simply many, many problems with infrastructures, both market infrastructure and firms' existing infrastructures.

I think that has really called into question a number of things that you might do differently, looking forward. When you start to look at the regulatory regime and risk management, the fact is that this industry has been very siloed. It has some huge interconnectivities which, again, is a little bit like trading today.

If you are trading in the market electronically, today, there are things going on that the human brain, the human eye, cannot see.

It is the same in the regulatory regime. You have a lot of interconnectedness which you just don't see. Using technology I think... It is about where technology is going, perhaps, not where it has come from.

It is really important when we all sit down and think how we would rebuild all of these systems. We should be thinking about what we could do, two or three years out. That might be different to what we could do as of yesterday.

So, the art of the possible is there. And I think that's where technology can help in a slightly different way here.

Technology is the market. We know that. Technology underpins the market. Whereas, five years ago, perhaps you'd have said, well, OK, we could understand the mathematical aspects behind some of the things we needed to measure, but maybe it was just too big a job to pull that all together.

So it's a massive challenge; shouldn't sort of pretend it's anything otherwise. But it is one that actually can be undertaken. But it will require significant single-mindedness and direction, I think, from a very few global regulators working hand-in-hand with some major counterparties to achieve that objective.

Michael: [16:55] I think that technology is undoubtedly part of the solution, but it can also lead to a false sense of security, and it can also impede transparency and sometimes create some opacity. And it's important to have good risk management controls and governance around how this technology is used.

So, for example, as trading models are distributed across a trading desk, and technologists are literally sitting on the same trading desks with traders, we've got to have good controls around how changes are made to those models, to make sure that they ultimately are consistent with the risk tolerances that are set by the board and, ultimately, the shareholders.

So I think technology is crucial. But there needs to be a good control of the human dimension, the governance that goes around it, to make sure it doesn't cause more problems than it solves.

Keith: [17:49] I think you could even look at, from a regulatory point of view, what is the standard valuation they require from certain instruments. There's nothing to stop a firm working on their own models, from a competitive point of view. But part of the issue is, when it comes to the regulator, they're not really sure what model's been used and how that goes.

So, again, it's back to, perhaps, there will be a utility around that, a computational utility which is used by the regulators for benchmarking and all that. But you're right. I think the human point here is, again, it's back to almost a self-regulatory thing. There is a human, social responsibility here to sort of look after that.

Michael: [18:26] Just touching on this question of data again, because clearly the data is critical, and it may be the case that no one national regulator has all the right data to do the modeling well. And so, if that is the case, you either need to go to some new regulator that sits on top of it, or perhaps to some of these utilities that you were talking about earlier.

Keith: [18:52] I think that's right. I think the model is, ultimately, if you created this super-regulatory body tomorrow, you could go and find quite a lot of data, either sitting in national regulators, in utilities' firms themselves. But you don't have this very broad view of the whole aggregated data.

Now, there's been some attempt to do that before, I believe. I think BIS started something in the late '90s. Banque de France, I think, have been looking at something around measuring credit. But it is this imposition. So it's almost an extension of standards within the industry.

So we've got to sort of create. Anything forward looking has to have the right standards applied to it so that data is actually collectible. And then, as it drives up to this super-regulator, then you can write your models once you've got the data, but it's really the creation of some sort of utility that starts now to look at that.

I think that's the biggest challenge, really, in terms of we could set up an "uber-regulator", and I think the technology exists to be able to do that. But it's that collection and creation, aggregation of data, to make true sense of what's been going on.

Mike: [20:05] There's a cost involved in that as well, surely. Who would bear that cost?

Keith: [20:10] Well, there's a cost already to the industry, not least because we're writing off a significant amount of money here. But the industry already invests in a number of bodies that are a cost to them.

Now, of course, the governments are paying very heavily for this. The regulators are funded at the moment. There's clearly a need to do something slightly different. And it is an issue. But there is an opportunity--probably a once-in-a-lifetime opportunity--for the regulators to start to look at how they might benefit from scale.

So the industry owns SWIFT. It owns Euroclear. It owns CLS. It owns DTCC. It owns a number of very specific utilities, all of whom do a very admirable job. But in forcing the issue, we really need to look at how many infrastructures do we need duplicated? How many organizations could actually provide a piece of this very difficult jigsaw puzzle?

So I think it's an expensive thing to look at. It's an expensive thing to run. But this has been a very expensive couple of years, so I guess you have to put it in context with that.

Mike: [21:26] Maybe just finish off on the point, the subject of the series is progressing financial markets. Again, a very, very broad question. But how do you see financial markets progressing over the short, medium, and long term?

Michael: [21:43] Well, if I could take that question from the regulatory side, I think you'll see, first, just a general recognition that this is a complicated problem. And I say that, by way of preface, almost by way of apology for what is now a five-part answer. But I think, on the regulatory side, you will see action in five areas.

You'll see increased focus on the consumer and consumer protection and making sure that the consumer is educated to make informed decisions about mortgages or other investments they buy.

I think you'll see regulators expand the net and make sure that more financial institutions are brought within the ambit of regulation. So that's the second component.

And the third: you may see some changes at the top in terms of how regulators expect headquarters to calculate economic capital, or how regulators expect headquarters to set dividend policy or executive-compensation policy.

And then, just to continue this theme of this complicated problem, I think the fourth area is that you might see some change in the plumbing, some change in the regulatory structure itself--consolidation of regulatory agencies, particularly in the US.

And then, last, there's everything else, in terms of bankruptcy and administration law and procedures and the differences in how the Lehman workout is proceeding in the UK versus in the US. These sort of differences have surfaced, and will require attention if the UK is to preserve sort of a competitive par in that area with the US.

So you have these five areas, ranging from the consumer to sort of everything outside of financial regulation, including tax policy and bankruptcy law, that will need to be fixed.

Mike: [23:33] Great. Just before we finish off, can you give us your URL, again, of Promontory Financial's website?

Michael: It's www.promontory.com.

Mike: And on that website you have white papers and...

Michael: Yeah, white papers on risk management, congressional testimony of our consultants before Congress and the Senate Banking Committee, and other opinion pieces by Promontory professionals.

Mike: [24:00] Well, Michael, thank you very much for taking the time to speak to us this afternoon.

Michael: My pleasure.

Mike: We appreciate your thoughts. And Keith, thanks again for being with us.

Keith: Thank you.

Mike: And, until next time, thanks for listening.

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[24:29] [music]