



**Brendan Nelson**

# Major changes ahead

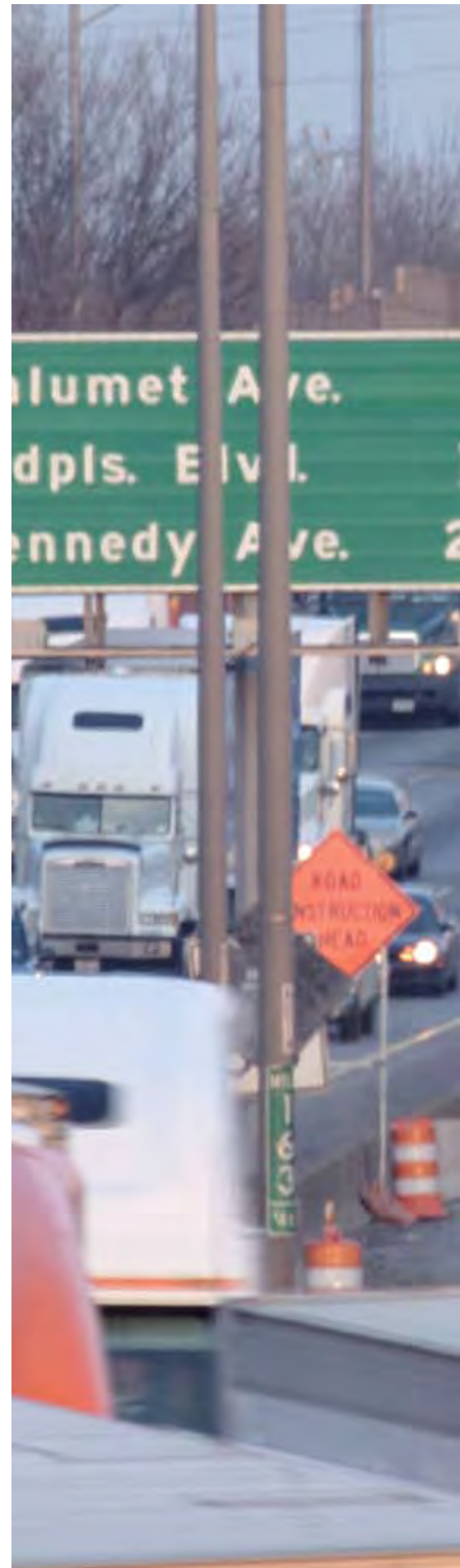
## Making sense of regulation

In some respects, the likely shape of the financial services industry after the crisis may remain unclear. But one thing seems certain: the nature, scope and purpose of regulation will change substantially. Politicians, regulators and treasury officials across the developed world are setting out proposals for a more robust and effective regulatory regime to improve protection against future crashes.

### **The failure of the authorities**

Responsibility for the crisis may reasonably be shared among a number of interests. Central bankers declined to assume responsibility for the growth of unsustainable asset bubbles; governments failed to tighten policy when public finances allowed and regulation failed in its key task of maintaining stability and confidence in markets and the financial system.

The dangers of systemic risk were ignored, and the need for macro-prudential oversight forgotten. As a consequence banks, especially, are now coming under huge pressure from regulators to significantly improve their capital and liquidity positions and demonstrate sound and prudent management. A major drive for regulatory reform is already under way.





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### Regulatory reform

In the US, Treasury Secretary Tim Geithner is calling for comprehensive regulatory reform: “not modest repairs at the margin, but new rules of the game”. The European Commission’s de Larosière report suggests the creation of a European Systemic Risk Council to oversee a new system of regulation and supervision. In the UK, the Turner Review calls for higher minimum capital requirements, counter-cyclical capital buffers and limits on gross leverage.

What is still unclear is how all of the proposals currently being formulated and discussed can be integrated into an effective global framework which also reflects individual national priorities. The dangers of confusion, incoherence and promotion of regulatory arbitrage are real.

At the G20 London Summit in April, world leaders pledged action to build a stronger, more globally consistent supervisory and regulatory framework for the future financial sector:

**‘Strengthened regulation and supervision must promote propriety, integrity and transparency; guard against risk across the financial system; dampen rather than amplify the financial and economic cycle; reduce reliance on inappropriately risky sources of financing; and discourage excessive risk-taking.’**

G20 Final Communiqué, April 2009

They announced that regulation and oversight would be extended to all ‘systemically important’ financial institutions, instruments and markets, including hedge funds.

While the principles of the G20 declaration are to be applauded, a great deal of detailed discussion and drafting

will be needed to ensure that an effective and unambiguous system emerges. The criterion of systemic importance, while intuitively clear, is merely the most high-profile concept over which fierce debate is inevitable. There is also a risk that the real progress made over the last 20 years towards harmonization of global standards will be undermined or thrown off course.

### Capital adequacy

The G20 proposals for a counter-cyclical capital adequacy regime are likely to be among the least contentious in principle, since they are consistent with current thinking from a number of sources. But they are likely to result in a more formulaic regime, which could constrain scope for flexibility at the same time as imposing more stringent overall capital requirements. It remains to be seen whether any new system will be truly balanced, or will simply be used to impose higher limits during the good times. Nor is it clear that it will be easy in practice to track the economic cycle with sufficient precision. The rate and extent to which capital requirements are tightened as we emerge from recession will be a particularly sensitive decision.

One of the more challenging commitments of the G20 Communiqué is that all G20 countries should progressively adopt the Basel II framework. However, no timetable for this has been agreed. One of the obvious major stumbling blocks is that the US has, to date, failed to make any commitment to Basel II at all. In addition, it is not obvious that imposing Basel II on all banks, whatever their size and degree of cross-border exposure, will turn out to be realistic.



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### Hedge funds

Political considerations and public anger are giving extra force to demands for tighter regulation. Although hedge funds have had only a minor role in causing the crisis, they are widely criticized – and misunderstood – and are going to be drawn more tightly into the new regulatory framework. Funds and their managers can expect to be registered and subject to new disclosure requirements. The adequacy of risk management systems will likely be probed. Institutions which have hedge funds as their counter-parties will likely need to develop mechanisms to monitor the funds' leverage and set limits for single counter-party exposures.

Once again, though, the detail will be critical. There is not yet even an agreed definition of what is, or is not, a hedge fund, let alone which criteria would identify one as systemically significant. In the UK, Lord Turner notes that hedge funds in general are not like banks; the implication is that they should not be regulated in the same way as banks. The UK's Hedge Fund Standards Board, while operating a voluntary framework, has established a sound foundation which global regulators could profitably build on.

### Remuneration

There is also widespread public concern – and anger – at the remuneration of those bankers perceived to have caused the crisis; some extension of regulation to include salaries and bonus arrangements is politically inevitable. The argument seems even more compelling in relation to those institutions which have been bailed out or taken into public ownership.

The argument that compensation arrangements should properly reflect risk and, in particular, match the time horizon of risks – so that payments

should not be finalized over short periods where risks are managed over long periods – is surely sound. Similarly, recent high-profile controversies have accentuated the need for non-executive directors and shareholders to be more fully involved in and appraised of remuneration arrangements before irrevocable awards are made.

However, it will be important that decisions in this area are fair, reasonable and proportionate, and do not succumb to 'bash the bankers' prejudice. The G20's proposal that supervisors should, where necessary intervene in compensation policies (with responses including increased capital requirements) could be seen as a veiled threat. The Turner Review concluded that remuneration structures played a less important role in contributing to the financial crisis than inadequate approaches to capital, accounting and liquidity.

### Overall

Nobody can argue that the current systems of regulation are sustainable. They have very dramatically failed to prevent one of the worst financial crises in many decades. Financial services institutions have to brace themselves for a much more muscular and interventionist regime in future. But what that regime ultimately looks like will depend on a great deal of argument and compromise, which is a process only just beginning. Moreover it is essential that it avoids giving the impression that all risk can be eliminated from financial markets.

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