Financial Market Conduct Risk and Financial Stability

Malcolm Kemp, Managing Director, Nematrian Limited and Adjunct Professor, Imperial College Business School

Presentation to RiskMinds Risk and Regulation Forum, Brussels

24 June 2015

Financial Market Conduct Risk and Financial Stability

- Recent regulatory change: FATCA, EMIR, Dodd-Frank etc.
- Conduct risk and financial stability
- Other drivers

Malcolm Kemp

- 2009-now:
  - Managing Director, Nematrian, actuarial function holder of Threadneedle Pensions and of Mobius Life
  - Adjunct Professor, Imperial College Business School (where he teaches Enterprise Risk Management) and member of the ESRB Advisory Scientific Committee
  - Author of books on Market Consistency (2009) and Extreme Events (2011)
- 1996-2009: Head of Quantitative Research, Threadneedle Asset Management
  - Responsible for Threadneedle's derivatives, investment risk management, performance measurement, LDI and other quantitative investment activities. Director of two of Threadneedle's hedge funds and of its insurance subsidiary
- Before 1996: Partner in investment consulting practice of Bacon & Woodrow

Financial Market Conduct Risk and Financial Stability

- Recent regulatory change: FATCA, EMIR, Dodd-Frank etc.
- Conduct risk and financial stability
- Other drivers

Foreign Account Tax Compliance Act (FATCA)

- A US federal law ostensibly aiming to detect the non-US financial accounts of US domestic taxpayers (rather than identifying non-resident US citizens)
- Also aims to address money laundering, offshore tax abuse etc., since:
  - FATCA data is used to cross-check a US person’s self-reported data at the Financial Crimes Enforcement Network
  - Non-US (‘Foreign’) Financial Institutions (including global financial institutions, investment entities and insurance companies) required to report asset and identify information related to suspected U.S. persons using their financial institutions
- Controversial (within the financial industry) because costs (to industry, globally) appear likely to exceed revenue (to US IRS)
  - C.f. other anti-money laundering (AML) and “know your customer” (KYC) rules

European Market Infrastructure Regulation (EMIR)

- An EU regulation implementing most of the 2009 G20 pledges on increasing transparency and reducing counterparty risk in the OTC derivatives market
  - Applies to any entity established in the EU that has entered into a derivatives contract
    - Financial counterparties (FC), including banks, insurers, investment firms and fund managers
    - Non-financial counterparties (NFC), i.e. everyone else (including NFC+)
  - Extensive reporting requirements
  - Promotes the use of central counterparties (CCPs) and imposes margin requirements on non-cleared trades
- Controversial (within the financial industry) because expensive to implement, has disrupted some business models and many in the industry doubt it will actually lead to a substantially safer financial system

Dodd-Frank

- Dodd–Frank Wall Street Reform and Consumer Protection Act is a US federal law which was passed in response to the 2007-09 Credit Crisis and which brings the most significant changes to US financial regulation since the Great Depression
  - Reasonably similar rules have been introduced in EU and elsewhere, but often via a wider range of legal instruments, e.g. in EU similar market-wide requirements are being introduced via EMIR, MiFID II / MiFIR, AIFMD, CRD and wider financial stability requirements via e.g. creation of ESRB
- Controversial, with some critics arguing that it is not enough to prevent another financial crisis (and more bailouts) and other critics arguing that it has gone too far

Themes

- All are controversial
  - But is this just a function of inevitable politics and lobbying?
- All have an underlying bias towards transparency
  - Achieving this transparency can be very IT / system intensive and hence potentially very costly (especially for firms with legacy systems)
- Most current regulatory change is formulated with the aim of promoting financial stability

Financial Market Conduct Risk and Financial Stability

- Recent regulatory change: FATCA, EMIR, Dodd-Frank etc.
- Conduct risk and financial stability
- Other drivers

Dodd-Frank Act: stated aim

- “*To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes*”
- Increases oversight of specific institutions deemed systemically important
  - Both banks and non-banks
  - And brings many more investment advisors, hedge funds and private equity funds more within the scope of financial services regulation
- Creates new institutions such as the Financial Stability Oversight Council, the Office of Financial Research and the Bureau of Consumer Financial Protections

Dodd-Frank Act: Titles

	Title	Comments (non-exhaustive)
I	**Financial Stability**	Overarching macro-prudential bias of the Act
II	**Orderly Liquidation Authority**	c.f. importance now placed on "resolvability"
III	**Transfer of Powers to the Comptroller, the FDIC, and the Fed**	Streamlining banking regulation
IV	**Regulation of Advisers to Hedge Funds and Others**	Catches entities who did not previously need to register as advisors
V	**Insurance**	Reflects view that insurance can also be 'systemically important'
VI	**Improvements to Regulation**	Limits bank proprietary trading
VII	**Wall Street Transparency and Accountability**	More regulation of derivatives markets, e.g. OTC swaps
VIII	**Payment, Clearing and Settlement Supervision**	Seeks to mitigate systemic risk in these areas
IX	**Investor Protections and Improvements to the Regulation of Securities**	Addresses e.g. powers and structure of SEC, regulation of credit rating organisations and client-broker interactions
X	**Bureau of Consumer Financial Protection**	Bureau will regulate consumer financial products and services
XI	**Federal Reserve System Provisions**	Introduces some changes to how Fed operates
XII	**Improving Access to Mainstream Financial Institutions**	Incentivises financial system participation for lower-income people
XIII	**Pay It Back Act**	Identifies how TARP etc. would be unwound
XIV	**Mortgage Reform and Anti-Predatory Lending Act**	E.g. imposes obligations on mortgage originators vs borrowers
XV	**Miscellaneous Provisions**	Miscellaneous
XVI	**Section 1256 Contracts**	Refers to tax treatment of some futures contracts

“Changing Financial Sector Interconnectivities”

- Paper (and presentation) to last year’s RiskMinds Forum proposed that current financial service regulatory developments have three main strands:

Systemic risk Places focus on macro-prudential tools, resolvability etc.	**Short and medium term** E.g. most of EMIR, Dodd-Frank, SIFIs, resolvability etc.
Interconnectivity and substitutability Highlights similarities between different sorts of financial institution	**Medium term** E.g. Classification of non-bank non-insurer (NBNI) SIFIs. International insurance capital standard (ICS)
A focus on societal ‘fairness’ Responds to changing societal norms and technological developments	**Short, medium and long term** E.g. Disintermediation by technology firms. Business model impact of proprietary trading bans, CCPs etc.

Interaction with Financial Conduct Risk

- UK Financial Conduct Authority Business Plan / Risk Outlook, Mar 2015
  - Seven forward-looking focus areas: 4 unchanged from 2014, 2 refined, 1 new

Technology may outstrip firms' investment, consumer capabilities and regulatory response

Poor culture and control continues to threaten market integrity, including conflicts of interest

Large back-books may lead firms to act against their existing customers' best interests

Pensions, retirement income products and distribution methods may deliver poor consumer outcomes

Poor culture and practice in consumer credit affordability assessments could result in unaffordable debt. This risk may increasingly affect younger people

The range of issues that need to be considered in unfair contract terms is given sharper focus by developments over the last year in legislation and legal precedents

The importance of firms' systems and controls in preventing financial crime

Key: Probably world-wide

Maybe more UK specific

Interaction with systemic risk and financial stability

FCA Theme	Analysis
1. Technological change may outstrip firm's investment etc.	IT involves 'systems' and experience indicates these can introduce vulnerabilities, although may not be the *same* systemic risk of the Financial Crisis?
2. Poor culture and control: threatens market integrity	Market integrity requires trust between market participants (and between firms and their customers)
3. Firms may act against (existing) customers' best interests	Customer trust strengthened when firms play "fair"
4. Pensions etc. may deliver poor consumer outcomes	Is the pensions system 'systemic'?
5. Poor culture and practice in consumer credit affordability	A specific example of 3?
6. Range of issues relating to unfair contract terms given sharper focus	A relatively time specific issue?
7. Firms' systems and controls important in preventing financial crime	Crime diminishes trust in financial system (and in social fabric more generally)

Regulator views, e.g. Haldane (2014)

- "*Macro-prudential policy is gaining ground every bit as quickly as central bank independence did in the 1990s. It has quite radical implications. Pre-crisis credit cycles were allowed to operate largely unconstrained. Macro-prudential policy overturns that orthodoxy, with policy instead leaning against the credit cycle to moderate its fluctuations, both during the upswing and the downswing.*"

- He is hopeful that the financial system and economy may become less prone to the low-frequency, high-cost banking crises seen in the past. However, he thinks that the financial system could "*exhibit a new strain of systemic risk – a greater number of higher-frequency, higher-amplitude cyclical fluctuations in asset prices and financial activity, now originating on the balance sheets of mutual funds, insurance companies and pension funds*" which could in turn be transmitted to, and mirrored, in greater cyclical instabilities in the wider economy.

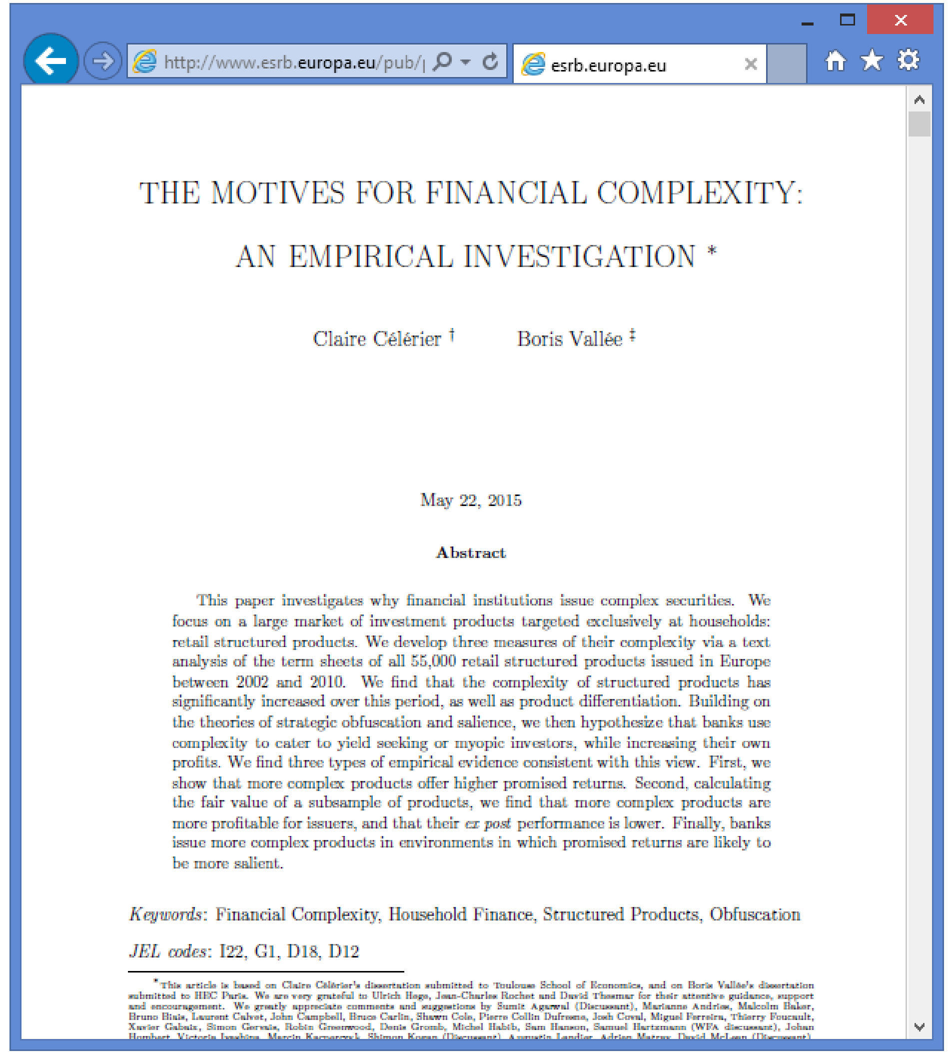
- He thinks it "*… likely that regulatory policy would need to be in a constant state of alert for risks emerging in the financial shadows, which could trip up regulators and the financial system. In other words, regulatory fine-tuning could become the rule, not the exception*"

Are pension “systems” vulnerable to systemic risk?

- Defined benefit
  - Occupational schemes are often underfunded on a discontinuance (wind-up) basis, not helped by low interest rate environment / quantitative easing
  - Hence dependent on sponsor support (the “sponsor covenant”)
  - Underpinned by industry-wide pension protection scheme (in UK, the PPF) which raises levies on solvent schemes to fund cost of sponsor defaults
  - Could sponsor defaults be so numerous (or affect so many large schemes) that a PPS runs into trouble and runs out of legal or practical levying powers?
- Defined contribution
  - Some trust-based occupational schemes, some insured arrangements
  - Underpins and protection arrangements more akin to those applicable to insurers
  - How robust are some insurers to low interest rates?

Does conduct risk create systemic vulnerabilities?

- E.g. ESRB 2015 [Ieke van den Burg Prize for Research on Systemic Risk]() won by a paper on "The motives for financial complexity: an empirical investigation"
  - Used textual analysis to show that more complex retail structured products tend to offer higher promised returns and higher profit margins for issuers
  - And issuance tends to be higher when investors place more credence on headline rates
- Perceived link between behavioural issues and systemic risk



Conduct risk costs

- According to UK's FCA Business Plan 2015/16, in 2014 UK's financial industry
  - Contributed £126.9bn gross value added to UK economy (8% of total)
  - Employed 1.1m people (3.4% of UK employment)
  - 97% of adults in Great Britain own a current account
- FT Article, 14 June 2015 (Jonathan Ford, "*Breaking up retail and investment banks is not so hard to do*") indicates UK's four biggest banks have racked up £34bn in fines and customer compensation over past 7 years
  - C.f. according to CCP Research Foundation, largest 16 (global) conduct costs by firm (bank) total:

GBP bn	Total costs 2010-14	Provisions 31 Dec 2014	Grand Total 2010-14	Grand Total 2009-2013	Grand Total 2008-2012
Top 16 globally	160	46	206	173	158

Source: CCP Website viewed 8 June 2015

Financial Market Conduct Risk and Financial Stability

- Recent regulatory change: FATCA, EMIR, Dodd-Frank etc.
- Conduct risk and financial stability
- Other drivers

Focus is changing

- E.g. plan to introduce an international insurance capital standard has gained momentum of its own, even if originally an outworking of SIFI classification

Systemic risk
Places focus on macro-prudential tools, resolvability etc.

Short and medium term
E.g. most of EMIR, Dodd-Frank, SIFIs, resolvability etc.

Interconnectivity and substitutability
Highlights similarities between different sorts of financial institution

Medium term
E.g. Classification of non-bank non-insurer (NBNI) SIFIs. International insurance capital standard (ICS)

A focus on societal 'fairness'
Responds to changing societal norms and technological developments

Short, medium and long term
E.g. Disintermediation by technology firms. Business model impact of proprietary trading bans, CCPs etc.

Impact of having some G-SIIs (i.e. insurance G-SIFIs)

Presumes that G-SII's will eventually be subject to higher capital requirements

↓

Requires an agreed common base against which to measure "higher"

↓

Requires a global capital framework (c.f. Basel III)

↓

Hence IAIS proposals for a global **Insurance Capital Standard** (ICS) by end 2016 and introduction of **Basic Capital Requirements** (BCR) during 2014

Longer term consequences

- Promotes longer term harmonisation of regulatory requirements across financial services industry
  - Now that more than one sector has G-SIFIs we presumably need to think harder about treatment of groups that span sectors (which some studies have suggested may be more important transmitters of systemic risk than single sector players)
  - FSB assessment methodologies for NBNI G-SIFIs are explicitly designed to have some consistency with those for other G-SIFIs
- G-SIFI classification may major on capital adequacy but note commonalities in UK's regulatory regime for senior managers in the banking and the insurance sectors
  - And planned extension of senior manager regime to other parts of the UK financial services industry including shadow banks

Is systemic risk focus for conduct risk issues lessening?

- E.g. UK's recently published Fair and Efficient Markets Review

Systemic risk Places focus on macro-prudential tools, resolvability etc.	**Short and medium term** E.g. most of EMIR, Dodd-Frank, SIFIs, resolvability etc.
Interconnectivity and substitutability Highlights similarities between different sorts of financial institution	**Medium term** E.g. Classification of non-bank non-insurer (NBNI) SIFIs. International insurance capital standard (ICS)
A focus on societal 'fairness' Responds to changing societal norms and technological developments	**Short, medium and long term** E.g. Disintermediation by technology firms. Business model impact of proprietary trading bans, CCPs etc.

Fair and Effective Markets Review (1)

- Review (which UK is hoping to export globally) published 10 June 2015 has involved a comprehensive and forward-looking assessment of the way in which wholesale financial markets operate

- 21 recommendations to:
  - Raise standards, professionalism and accountability of individuals
  - Improve the quality, clarity and market-wide understanding of Fixed Income, Currency and Commodities (FICC) trading practices.
  - Strengthen regulation of FICC markets in the United Kingdom.
  - Launch international action to raise standards in global FICC markets.
  - Promote fairer FICC market structures while also enhancing effectiveness.
  - Promote forward-looking conduct risk identification and mitigation.

Fair and Effective Markets Review (2)

- "Systemic" mentioned five times in Final Report:
  - Page 26: leverage ratio being introduced for G-SIBs
  - Page 42: systemic importance of Libor in financial markets
  - Page 62: recommendation not to extend Banking Reform Act offence of recklessly contributing to a bank failure to other institutions simply because they are active in the FICC markets, where their failure would not pose a system and prudential threat to public funds and the economy
  - Page 81: effective management of conduct risks, e.g. 'cherry-picking', viewed as having potential to become more systemically important if relative size of trading volumes and pay levels continues to shift towards buy-side
  - Page 96: planned future research to include analysis of impact of remuneration composition on systemic and conduct risk
- But is this relatively small number of mentions due to other links to systemic risk and financial stability being kept out of scope of this review?

Summary

- Subdivision into 3 key strands (and associated time-scales for regulatory change) seems as true of conduct risk as any other regulatory risk category
  - Systemic risk: Short and medium term
  - Interconnectivity and substitutability: Medium term
  - A focus on societal 'fairness': Short, medium and long term, but maybe the long term will be a long time coming
- Regulators increasingly view market participants as similar
  - And increasingly all capable of creating or at least transmitting systemic and conduct risk (with the definition of each of these risks then flexed to fit this view)
- Responding to these trends is likely to require improvements in
  - Culture, an obvious regulatory intervention area
  - Transparency, likely to create a significant IT burden

Important Information