

## Regulatory developments in disoriented markets

### **Keynote address by Daniel Zuberbühler, Senior Financial Consultant, KPMG Switzerland**

*Market perspective on regulatory developments – ICMA & SIX conference on MiFID II, MiFIR and CSD, Zurich, 10 July 2012*

#### **Unfriendly market environment**

- Hans-Jörg Rudloff, the Doyen of Swiss Banking, Chairman of Barclays Capital and former chairman of ICMA, in a speech, entitled “Financial markets in a new economic environment”, at the Business Club Berne on 5 July, gave a very bleak outlook, culminating in the diagnosis that the world economic order has lost its orientation. Europe and particularly the Euro-zone is the biggest wound which lets entire southern countries like Spain bleed out. Not only are bank deposits depleted at an alarming rate but also inhabitants driven out, especially young people who suffer from an appalling unemployment rate of 50%. Mr. Rudloff believes that the technical means to solve the financial problems do exist, but this would require EU politicians to act decisively now and pursue a real monetary union. He is less confident that this will happen, because nationalist movements in the north will attempt to stop the Euro train and refuse to shoulder the burden of solidarity.
- At the IIF spring membership meeting in Copenhagen on 7 June, I watched a panel on new challenges facing Europe and was surprised about the unanimity of all European panellists, whether academics, politicians or bankers: the only way forward is – more Europe, more integration and harmonisation, centralisation, mutualisation of debts and a fiscal and transfer union. This single-minded determination reminded me of a familiar scene in action films where a car drives into a dead-end street and accelerates to full speed in the hope of breaking through the wall. What about the other option of stopping and putting the car into reverse gear? Why not admit that a project might be over-ambitious and could do with some realistic downsizing? The standard answer to such questions is that European integration is like a cyclist who will fall over if he does not keep on moving forward. More concretely, everybody is understandably afraid of the consequences of a break-up of the monetary union. However, on my mountain bike I have found myself several times in a situation where I had to get off, turn around and find an alternative route or just go home.
- But admittedly, these are simplistic views of a Swiss peasant who looks sceptically at grand projects and gigantic supranational institutions. In any case, it is not for us Swiss to give advice to others from the outside, as long as we do not want to become a member of the EU, let alone join the monetary union. For the foreseeable future, such an option has no chance of being accepted by our people. Nevertheless, we are unfortunately closely affected by what happens in Europe. In a recent interview an economics professor compared Switzerland with a beautiful sailing boat which is chained to the Titanic. He was referring to the Swiss franc being pegged to the Euro at 1.20 and our strong interconnectedness with the EU economy and financial system. And our brave Swiss National Bank – as many central banks with their blown-up balance-sheets – looks more and more like a python that has swallowed an indigestible hippopotamus. So we do have a vital interest in Europe being able to solve its severe crisis.

#### **EU banking union**

- Where I do feel more competent to assess the European integration efforts is on the proposed EU banking union. In the year 2000 at the International Banking Supervisors Conference in Basel, we as Swiss hosts had to organise workshops and chose the futuristic title “The financial industry in the 21<sup>st</sup> century”. In a discussion paper I proposed a global supranational regulator for internationally active mega banks, which we nowadays call

global systemically important banks (G-SIBs). As this global supranational regulator I suggested the Bank for International Settlements (BIS) because it has a truly global scope, the necessary skills and as the bank of central banks also the deep pockets for rescue operations for failing too-big-to-fail banks. Not surprisingly, the participants at the workshop unanimously rejected this idea as being completely crazy. I had to make a coming out as the author of the paper, assuring my colleagues that I did not really believe in it myself, because the United States – G1 – would never agree to give up sovereignty on their own banks and because none of us national supervisors would want to be reduced to only looking after less exciting local institutions.

- The proposed EU banking union has many of the features of my old proposal and encompasses a completely harmonised regulation, a supranational supervisor – the Euro leaders favour the European Central Bank, a unified deposit protection scheme and a transnational resolution regime. But at the same time it has a much more limited geographical scope because it would be confined to banks in the Euro zone. The UK already stated that it does not intend to participate in this banking union, which leaves out by far the largest financial centre of the EU. In view of the important presence of internationally active Swiss banks and especially the investment banks of our two G-SIBs in London, a Euro-centric banking union is of little direct use for Switzerland. The limited scope will also create tensions for harmonisation and coherence within the EU, because it could divide the European banking landscape into two zones with varying degrees of regulatory and supervisory integration. Will the European Banking Authority have to bridge this gap and how will its competences be delineated from the ECB? More importantly, will the competence of the ECB – or another Euro-zone supranational supervisor – be limited to systemically important banks in the Euro-zone and is systemic relevance confined to cross border activities or does it also include purely domestic SIBs? The answer is not obvious because the Spanish example, which spurred the idea of a EU banking union in the first place, points in the opposite direction. The Spanish G-SIBs, BBVA and Santander, due to their global diversification are not the ones who need state aid and nobody claims that Banco de España did not supervise them well – on the contrary. The culprits were rather small and purely domestic savings banks – Cajas de Ahorro – and they might have become systemically important only after a series of forced mergers to protect them from their huge losses incurred in a domestic real estate bubble. Hence, if one wanted to reduce the risk of small domestic banks becoming a systemic risk for the whole Euro-zone, the supranational supervisor would have to cover thousands of banks, which frankly is an illusion. A supranational supervisor may be more independent from national political interference and less inclined to undue forbearance, but such a central institution would be far too remote to deal directly with a vast and diverse banking population. On the other hand, Europe should avoid a complex web of competing, overlaying supervisory authorities at the national and the pan-European level. The USA with their Himalaya of different state and federal authorities serve as a negative example, except for the supreme resolution capacity of the Federal Deposit Insurance Corporation.
- The Euro-zone leaders have set a deadline until the end of this year for more concrete proposals on the banking union. So it is too early to judge its validity. What makes one suspicious is the origin of this idea. It is a political compromise to get the German approval for the direct use of funds from the European Stability Mechanism to recapitalise failing banks without the intermediation and full financial liability of the member state concerned, thus avoiding a corresponding increase of a government's debt in the amount of the aid given to its banks. To break the vicious link between bank solvency and government solvency was the goal. And the Germans agreed under the condition that a common liability for bank debts also required a common responsibility for supervision and resolution of Euro-zone banks. It seems obvious that a banking union is a first step towards a more general mutualisation of debts in the Euro-zone, even if it is putting the cart in front of the

horse and if politicians promise that there will be no unlimited European liability for bank debts.

### Regulatory developments

Where do we stand in the regulatory developments which are the focus of today's conference?

- Michel Barnier, EU Commissioner for Internal Markets and Services, while fully recognizing the challenges which Europe faces, proudly mentioned in a speech at the afore-mentioned IIF meeting in Copenhagen, that the European Commission had just tabled the last of 29 texts translating the G20 commitments from London and Pittsburgh into European law, among them of course MiFID II, MiFIR and CDS-R. And he repeated that the goal of these efforts remains unchanged: no financial player, no financial product and no financial market should escape effective supervision. This is very ambitious indeed.
- Cynics could ask whether this impressive regulatory Tsunami is not tantamount to re-arranging the chairs on the deck of the Titanic. As an ex-regulator I would of course not share such a nihilistic attitude and see merits in many of the global regulatory reforms, especially with regard to bank capital and liquidity. It is crucial that the banking system becomes more resilient against shocks and that we make progress in solving the too big to fail problem. This comes at the price of de-leveraging and of simplifying complex banking giants: you can't make an omelette without breaking eggs, or literally translated from a Swiss-German proverb: you can't wash the fur without making it wet. The only question is whether the long implementation schedule for Basel III and the G-SIBs framework is not far too generous in view of the imminent threats mentioned before.
- Personally, I am less enthusiastic about MiFID II which pushes investor protection rather far into bureaucratic extremes. The Swiss problem is that we are not members of the European Economic Area but as a third country need EU recognition of regulatory equivalence to get access to the common market. This explains why FINMA's position paper on distribution rules of 24 February 2012 – apart from genuine customer protection objectives – attempts to mirror the conduct of business rules set out in MiFID. However, even if we did a copy – paste of all European regulations, there is still no guarantee for recognition and market access, as long as we have not resolved the overarching institutional framework for our bilateral relations with the EU. As former Swiss Ambassador Alexis Lautenberg pointed out, the EU will hardly be satisfied by the recent Swiss proposals which exclude a supranational, truly independent body to oversee the implementation of bilateral agreements. In addition, the question arises whether we really have to implement the full set of EU regulations for all financial intermediaries in Switzerland. I could well imagine a two-tiered system of Swiss financial regulation: a fully EU compatible framework for those market participants who need the European passport to get cross-border market access and a more simple, less burdensome framework for purely domestic smaller players. We did have such a menu approach in the Capital Adequacy Ordinance for the implementation of Basel II, where banks could choose between a historically grown, robust Swiss Standardised Approach ("Swiss finish") and a BIS-compatible international approach (Basel pure), with multipliers to bring the latter up to the generally higher requirements of the Swiss finish. But FINMA managed to get rid of the Swiss finish, albeit with a long grandfathering period until the end of 2018, in the course of the implementation of Basel III, mainly because it wanted to avoid having to maintain two parallel frameworks and in order to improve international transparency. Therefore I am not very optimistic that FINMA will have mercy with smaller firms when implementing customer protection rules. Unlike highly technical capital adequacy rules, a two-tiered regulatory system for investor protection would also be more of a challenge for the information of customers themselves: do they know which level of

protection they get (super league or challenge league?) and do they understand the difference?

With this I leave you to more fruitful technical discussions of practical relevance. I sincerely hope that the doomsday scenarios will not materialise, as we have already more than enough challenges with regulatory reforms and the implementation of a tax compliance strategy in this financial centre.