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Gaming the rules or ruling the game? – How to deal with regulatory arbitrage

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Introduction [1]

In 1986, Nobel laureate Merton Miller noted: "The major impulses to successful innovations over the past 20 years have come, I am saddened to have to say, from regulation and taxes."[2]

It is true that banks can be highly innovative when it comes to reducing the regulatory burden. They are always tempted to game the rules. They are tempted to exploit loopholes and seize on the fact that rules differ across countries and sectors.

Such regulatory arbitrage is, of course, a problem. Rules are put in place for a reason, and working around them defeats that purpose. As you all know, we have just emerged from the worst financial crisis since the Great Depression. That's why we have made these rules stronger: to make such crises less likely. Whenever a bank tries to get around the rules, it increases the risk of another crisis.

So regulatory arbitrage is a matter of great concern for regulators and supervisors. Let's take a closer look at how it works and what we can do about it.

[1] „2017 Marjolin Lecture" by Danièle Nouy, Chair of the Supervisory Board of the ECB, at the 33rd SUERF Colloquium and Bank of Finland Conference, Helsinki, 15 September 2017.

[2] Miller, M.H. (1986), "Financial innovation: The last twenty years and the next", *Journal of Financial and Quantitative Analysis*, Vol. 21(4), pp. 459-471.

Regulatory arbitrage – jumping fences and exploiting loopholes

What exactly do we mean by "regulatory arbitrage"? Well, we are referring to banks structuring their activities in a way that reduces the impact of regulation without a corresponding reduction in the underlying risk. The result, of course, is that the risk becomes insufficiently regulated. And that is not a good thing.

As you can imagine, such arbitrage can quickly become highly complex. The rules are complex in the first place, so regulatory arbitrage has to be even more so. In my speech today, I will try to spare you all the technical details and just focus on the essence of the problem.

In very general terms, regulatory arbitrage takes three forms. The first can be described as "cross-jurisdiction arbitrage". This exploits the fact that rules for banks differ from one country to another. Some rules, for example, might be less strict in country A, while others might be less strict in country B.

Banks might therefore be tempted to set up their operations in such a way that they are always subject to the most relaxed rules. They would constantly jump fences in order to be where the grass is greenest.

This could, for instance, involve adapting their booking models. A booking model determines how and where a bank books its transactions. For example, a European subsidiary of a US bank could choose to book its exposures back to back with its parent in the United States. Depending on the circumstances, this might enable the bank to get around local rules.

The effect of one bank doing this might not be that big. But if, over time, more and more business shifts to countries where the rules are less strict, this could easily become a threat to stability – not just in one country, but everywhere.

What is more, cross-jurisdiction arbitrage can also trigger a race to the bottom. Countries that lose business might be tempted to relax their rules as well in order to keep banks from jumping the fence. As a result, rules would become less strict around the world and crises would become more likely.

Here in Europe, cross-jurisdiction arbitrage has become even more of an issue since the United Kingdom decided to leave the EU. Post-Brexit, UK banks will need to set up entities in Europe, and most likely in the euro area, in order to retain access to the Single Market. In this context, we will need to keep a close eye on back-to-back booking, for instance.

And that's not all. While some UK banks might choose to set up subsidiaries in the euro area, others might set up branches. And such third-country branches would not be supervised by the ECB; they would be supervised by national authorities, with national rules being applied. A similar issue would arise if UK banks were to set up investment firms.

Thus, there is still room to arbitrage national rules within the euro area. The single European rulebook is not yet single enough.

However, jumping national fences is just one way to get around the rules. Banks can also jump sectoral fences. While the banking sector is highly regulated, other parts of the financial system are much less so. The shadow banking sector, for instance. This opens the door to what could be referred to as "cross-framework arbitrage".

Banks can pass through that door by moving business to the shadow banking sector. They can shift exposures to entities that are not consolidated for prudential purposes. Looking back at the run-up to the financial crisis, one of the more popular ways to do this was through special-purpose vehicles, or SPVs. The consequences of this are now well known.

However, banks don't need to turn to shadow banks. They also have other options when it comes to shifting business out of the prudential perimeter. These options often involve adjusting their legal structure. Under some accounting rules, for instance, joint ventures do not need to be fully consolidated. This allows risks to be kept out of regulators' reach.

The danger, of course, is that these risks could eventually spill back into the banking sector. Out of the shadows, banks could suddenly be hit by a flood of risks that have not been accounted for.

This is what happened during the financial crisis. In the build-up to the crisis, banks shifted assets to SPVs. When those SPVs got into trouble and lost access to market funding, the banks stepped in. In many cases, they were not legally obliged to do so, but they supported the SPVs to safeguard their own reputations.

If banks shift exposures to shadow banks, they become vulnerable to what is known as "step-in risk". And this kind of risk often remains hidden and unaccounted for. That's why the shadow banking sector is a concern for banking supervisors. It is intertwined with the banking sector, and risks could easily spill over.

And finally, there is also a third kind of regulatory arbitrage, where banks do not even have to jump national or sectoral fences to find a way around the rules. This can be termed "intra-framework arbitrage". In this case, rather than trying to exploit differences between two or more sets of rules, banks try to exploit loopholes within a single set of rules.

Banks' main objective in this regard is to "optimise" prudential indicators such as capital and liquidity ratios. To call a spade a spade, they seek to hold less capital and liquidity for a given level of risk. In order to achieve this goal, they have to structure transactions in such a way that the underlying risk profile remains unchanged, but the amount of capital or liquidity that needs to be held is reduced.

This affects the leverage ratio and the liquidity coverage ratio, for instance. Two things can be observed in this regard. First, although the rules do capture most off-balance-sheet exposures, they still leave some room for interpretation. So banks have an incentive to move exposures off their balance sheets to make use of this grey area.

Second, there is scope for banks to tweak the maturity of transactions – particularly where the contractual and economic maturities of a trade differ. As regards the leverage ratio, for instance, more capital needs to be held for longer-dated derivatives than for shorter-dated ones. At the same time, the liquidity coverage ratio only captures transactions with a residual maturity of 30 days. This might tempt banks to structure their transactions around certain maturity thresholds to save on capital and liquidity.

To sum up, banks have plenty of scope for getting around the rules. And this is a problem. Regulatory arbitrage undermines the basic idea of regulation, and it poses a threat to stability. So, the question is: what do we do about it?

The regulatory and supervisory response

Well, regulatory arbitrage often exploits differences between rulebooks. So, the first thing we can do is harmonise the rules. This is a powerful tool when it comes to preventing cross-jurisdiction arbitrage, for instance. If the rules were the same in all countries, banks would have less scope for getting around them. A lot of progress has been made in this regard. At the global level, we now have a common set of standards known as "Basel III", which will help to reduce the scope for regulatory arbitrage.

There are three caveats, though. First, Basel III has not yet been finalised, so that needs to be done as quickly as possible. Second, Basel III still needs to be transposed into national law, and that needs to be done in a coherent and consistent manner. And third, supervisors around the world will then need to apply those rules in the same way. Only then will cross-jurisdiction arbitrage be prevented effectively.

Here in Europe, we are in a similar situation. For some time now, we have had a single European rulebook for banks. However, parts of that rulebook still need to be transposed into national law. And this has, again, led to differences in rules across countries. As I said earlier, the single European rulebook is not yet single enough. There are still differences that banks can exploit – something that has gained even more relevance with Brexit on the horizon.

So, there is a clear case for further harmonising the European rulebook. To that end, we should rely less on EU directives and more on EU regulations, which are directly applicable in all Member States.

However, as I said earlier, it is not just about differences between countries. There is also the issue of cross-framework arbitrage and the shadow banking sector.

From my point of view, the first priority is to try to ensure that no risks spill over from the shadow banking sector to the banking sector. This means looking at the links between banks and shadow banks and addressing step-in risk.

Much has been done in this area since the crisis, but step-in risk has not yet been fully taken care of. With this in mind, the Basel Committee on Banking Supervision has made step-in risk part of its official work programme. It is currently working on guidelines for banks and supervisors. Those guidelines contain a number of criteria that will help to assess step-in risks for individual banks. And they propose measures aimed at helping banks to deal with such risks.

However, the aim is not to specify a single standardised approach. It is rather to encourage banks to adopt measures that are tailored to their individual needs. Thus, the guidelines will not contain automatic Pillar 1 capital or liquidity add-ons. Instead, they will provide a list of potential measures that leverage existing tools. It will be up to the banks to choose the most appropriate measures, while supervisors will check and challenge the choices banks make.

From a supervisor's point of view, it is important to tackle the links between banks and shadow banks. But shadow banking raises other, broader issues as well. Against that backdrop, I fully support the work being carried out by the G20 and the European Commission. The aim should be to address financial stability concerns and turn shadow banks into a resilient source of market-based funding.

This brings us to the third form of regulatory arbitrage: the one that happens within a single set of rules – intra-framework arbitrage. Here, we are more concerned with closing loopholes rather than harmonising rules and preventing the spillover of risks. This can be achieved using a variety of different tools.

One solution could be to change the rules in such a way that loopholes are closed. However, for this to be effective, regulators would first have to identify every loophole, which we all know is impossible. So it makes sense to also apply tools that have a broader and more preventive effect. And such measures are indeed being implemented.

In the wake of the financial crisis, the rulebook for banks has been revised with a view to shutting down intra-framework arbitrage. Before the crisis, the rules focused on just one dimension: risk-weighted capital. That was the only stringent constraint banks faced. Structuring transactions in a way that would "optimise" that single constraint was not too difficult.

Today, the rules focus on more than one dimension. Thanks to Basel III, banks around the world now face multiple constraints: the risk-weighted capital ratio has been supplemented by a leverage ratio and liquidity ratios. These constraints reinforce each other, which makes it much more difficult for banks to game them.

But tackling regulatory arbitrage is about more than just multidimensional rulebooks. It's also about flexibility. As former Deputy Governor of the Bank of England Paul Tucker writes: "A static rulebook is the meat and drink of regulatory arbitrage."[3] The more detailed the rules are, the more scope there is for getting around them. Rules should therefore be based on key principles. "Same business, same risk, same rules" is one of them. Shaping the rules in line with this principle would help to further limit opportunities for regulatory arbitrage.

[3] Tucker, P. (2014), *Regulatory Reform, Stability, and Central Banking*, Hutchins Center on Fiscal and Monetary Policy, Brookings Institution, Washington D.C.

To sum up, there are ways and means of dealing with regulatory arbitrage. These range from harmonising rules across countries to closing loopholes. But in spite of all that, regulatory arbitrage will remain an issue.

The financial crisis triggered an overhaul of banking regulation, and banks now face much tougher rules than ever before. This is good, of course. Still, it gives the banks even more incentive to game the rules. This is reinforced by the fact that competition among banks is very intense. They might therefore try to gain a competitive edge by getting around the rules and avoiding the associated costs.

Against that backdrop, supervisors need to keep a close eye on banks. Prudential banking supervision is fundamentally about ensuring sensible bankers set aside enough capital for the risks they choose to take. Supervisors do this in a number of ways but the end result should always be the same: well capitalised banks that take prudent risks. For euro area banking supervision, an important element of this is ensuring supervisors can have confidence in the internal models used by some banks to calculate risk and the level of capital they need to set against it. The ECB's ongoing targeted review of internal models at over 60 banks, including all nine of the globally significant banks supervised in the euro area, is an important part of this process.

Supervisors need to scrutinise what bankers do and examine individual transactions to see whether they might be an attempt to game the rules.

This obviously requires us to cooperate with supervisors around the world. Only by working together and sharing information will we be able to effectively address regulatory arbitrage. For that reason, the ECB is in very close contact with other supervisors, such as those in the United States and the United Kingdom.

Conclusion

Ladies and gentlemen,
I think we can all agree that an unregulated banking sector is not a good thing. Experience – some of it fairly recent – shows that banks need rules. Effective rules help to ensure that banks remain resilient and can reliably serve the economy.

It is true, of course, that rules also place a burden on banks. Complying with them is costly. As a result, banks are always tempted to work around rules, particularly in difficult times such as these.

Such behaviour may look optimal from the point of view of an individual bank. But from the perspective of society as a whole, it is not. Working around the rules undermines their purpose and might lead to another crisis. And we all know what such crises entail for the economy, for savers, for investors and for taxpayers.

So, regulators and supervisors are engaged in a game of catch-up with banks – a game that is sometimes referred to as "regulatory dialectic". Regulators set rules in order to ensure stability and prevent financial crises. Banks seek ways around these rules in order to lessen the associated burden. Regulators then adjust the rules; and banks find new ways to get around them. This game has probably been going on since the very first rule was designed – and not just in banking, either. And it will probably go on until the end of time.

So it is in everyone's interests for supervisors and regulators to have the edge in this game. They have to rule the game, in order to prevent banks from gaming the rules.

And this is the key question – do supervisors and regulators rule the game? Well, today's rules are far more harmonised than ever before – at both global and European levels. That leaves less scope for regulatory arbitrage. At the same time, we can also see more clearly what banks might be up to. Thanks to European banking supervision, we have a much better overview of their activities. We are now more able to detect regulatory arbitrage at an early stage and react quickly.

So, regulators and supervisors have made their latest move in the game of catch-up. We would now expect the banks to make theirs. In my view,

however, banks should reconsider their position on regulatory arbitrage. This is not a movie where a rogue hero happily flouts all the rules to save the world. This is about the stability of the banking sector, the prosperity of the economy and the wealth of society as a whole.

Thank you for your attention.

About the author

Danièle Nouy joined the European Central Bank in January 2014 as Chair of the Supervisory Board of the Single Supervisory Mechanism, following a 40-year career in banking supervision. She began her working life as a supervisor at the Banque de France. During the early years of her career Ms Nouy was posted to the United States as the Banque de France representative in New York returning to spend time as a policy expert in the Foreign Department. She returned to her supervisory roots to head the research department and policy group in 1987 and was appointed director of financial supervision in 1990. In 1993 she became the French member of the Basel Committee on Banking Supervision. She then served as Deputy Secretary General of the Basel Committee from 1996 to 1998. She was appointed Secretary General of the Basel Committee in 1998, a position which she held until 2003. Returning to France, she became the head of the French supervisory authority, which she held for the next ten years: first as Secretary General of the Commission Bancaire and, following its merger with the insurance supervisor, as Secretary General of the Autorité de Contrôle Prudentiel et de Résolution.

Ms Nouy holds a Degree in Political Science and Public Administration from the Institut d'Etudes Politiques, Paris, and a Post-graduate Certificate in Law. She authored numerous papers on international and European financial supervision and regulation.

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