

# INTERNATIONAL REGULATORY ARBITRAGE

Will Dodd-Frank export the U.S. banking industry?

## POINT OF VIEW

### Piecemeal Oversight

We have heard a lot about the importance of working together toward global financial stability and growth, but the action behind the talk stands in stark contrast. G-20 member countries are creating their regulations with only a passing focus on coordination, and the U.S., the U.K. and the EU are all heading in different directions<sup>i</sup>. What does this mean for financial companies that operate globally?

Many feel that passing Dodd-Frank was an ineffective way to introduce global regulation and many international players are none too excited about following in the footsteps of US financial leaders after the 2008 debt crisis. There are, however, looming questions. Are we prepared to put aside national tendencies for the interests of the global economy? Will national governments and businesses commit to a broader global process that will promote jobs on a global basis in a financial system where all of the most important firms are operating across borders? And if not, what happens?

### International Regulatory Arbitrage

Incoherent and inconsistent financial regulation across the globe is bound to create opportunities for Wall Street to disperse their risk and profit accordingly. Dodd-Frank naysayers love to talk about how the rest of the world is just sitting back, chuckling and waiting for the US to regulate so that they can sweep in and steal clients looking for a more appealing business environment that offers less costly ways to manage risk. This could result in trading like products internationally to capture a favorable spread created by regulatory mandates, or it could mean moving whole trading positions, even divisions, internationally to capitalize on favorable trading and business environments. Could Dodd-Frank create an environment so unfriendly to US businesses that components of the financial services industry are exported to other locales?

### Where Dodd-Frank Happens

How is Dodd-Frank affecting US businesses directly? Let's take the case of corporations subject to new requirements under Dodd-Frank. The day to day business of US corporations creates dispersed risk throughout an organization which is often hedged in the swaps markets. To allow for centralization of swaps execution and processing and to lower transaction fees, non-financial institutions often create trading affiliates. Here, risk and transactions

can be bundled together for better execution, or offsetting trades can be netted for lower transaction costs. The trading affiliate basically functions as a bank for their in-house clients<sup>ii</sup>.

Enter Dodd-Frank. Under the new regulations, the trading affiliate, which does not hold the actual risk, cannot be deemed an end-user for regulatory purposes nor can it qualify for the conventional clearing exemption. If the derivative that you are trading is not strictly a hedge for commercial activities, you are considered to be trading risk for profit, and based on size and activity levels, may be considered a major swap participant or a swap dealer. As a major player in the new swaps market, the trading affiliate could be subject to vastly more rigorous registration, reporting, clearing, capital and margin requirements. In addition, it would also be subject to strict limits on collateralized positions and the onus of real time record-keeping. Even if firms can escape branding as major swap participant or swap dealer under the new regime, participation in the swaps market will at a minimum bring requirements to comply with new rules of business conduct that can dictate organizational structure.

All in all this could prove a tough hill to climb for US businesses. So what can the corporation do? It can keep its risk dispersed across hundreds of silos throughout the organization, but that is likely an ineffective approach to risk management and a process and technology nightmare. Or it might choose to move its trading affiliate off-shore and capture a more favorable business environment, leaving the costly one behind, ergo, participating in regulatory arbitrage – as described by Sandeep Vishnu of Capco “identifying and positioning a firm under the most beneficial regulatory regime.” The perfect nesting bed for regulatory arbitrage to form is inconsistency<sup>iii</sup>.

“For instance, the Volcker Rule clearly prohibits proprietary trading desks at banks. These intuitions are already winding down these operations and in some cases might move proprietary desks overseas.”<sup>iv</sup> According to an October FT report, while most countries are still moving in the same regulatory directions, “cracks are starting to form.” Derivatives reform is going in somewhat different directions in the US and Europe, and most Asian countries have not done much at all.”<sup>v</sup>

## The Effects of Dodd-Frank

In the financial industry, where Dodd-Frank looms darkest, the biggest global banks are cutting jobs at the fastest rate since 2008. The 50 largest banks, including HSBC Holdings Plc (HSBA), Credit Suisse Group AG (CSGN) and Bank of America Corp. (BAC), disclosed plans for almost 60,000 reductions in 2011, and at this pace, banks are expected to cut more than 101,000 jobs in the coming years. Firms are reported to be seeking to pare costs in some countries while expanding in faster-growing economies, such as China, India and Brazil. As an example, HSBC announced it will cut 30,000 jobs in Western Countries and create 15,000 new jobs in Asia's emerging markets. Bankers will need to be extremely innovative to discover new revenue opportunities and manage risk, which may involve restructuring their business lines and looking for international solutions. In an already severe economic environment, substantially higher regulatory costs can only amplify US-based banks' need to streamline their operations. This means that, for some financial institutions, moving business elsewhere will not only make financial sense but also allow them to significantly reduce their regulatory burden. Some have speculated that if the banks move so will the industry and subsequent employment, and with corporations joining financial institutions seeking better business climate, it could lead to a mass financial migration to emerging markets.<sup>vi</sup>

While substantial portions of the new regulatory regime are yet to be completed, the picture that is emerging shows that the results of Dodd-Frank on Main Street will be significant and may be long-lasting. In a recent Wall Street Journal article<sup>vii</sup>, a medium sized bank stated that in the current environment it has 1.2 employees on compliance for every one employee focused on lending and bringing in business. That is not supportive of growth as evidenced by the fact that new business creation has fallen to a 17-year low<sup>viii</sup>. And worse yet, the cost of regulatory compliance as a share of operating expenses is two and a half times greater for small banks than for medium-sized banks<sup>ix</sup>. Commodity Futures Trading Commission Chairman Gary Gensler's admission recently, that he is concerned position limits and other financial reform rules could compel US market participants to flee for overseas markets, was a rather bold statement considering the White House has repeatedly denied this possibility<sup>x</sup>.

The House Financial Services Committee reported that the overall budget cost of Dodd-Frank through fiscal year 2012 will be more than \$1.2 billion, with an estimated 2,260,631 annual labor hours required to comply. And that's only ten percent of the red tape that's been issued so far<sup>xi</sup>.

Based on 2010 data, the average return on equity (ROE) – a key profitability benchmark for banks – was about 20 percent but with the introduction of tougher global bank capital and liquidity standards and other rules such as mandatory clearing of derivatives contracts that number will be slashed to 7. According to a recent study, 'rebuilding returns will involve a full menu of immediate actions in four areas: improving risk and capital models, raising the bar for data quality, improving financial and operational efficiencies<sup>xii</sup>. That's a lot of work, but impacted firms will be best served by addressing these challenges now. Anxiety levels over on-coming Dodd-Frank regulation, in addition to other mandates like Basel III, are mounting, as companies begin to consider the strategic and financial ramifications of international financial regulation. Let's hope the regulators - Wall Street and Main Street can come to an agreement about how much regulation is necessary and the potential economic effects of over-regulation. We cannot afford to export our trading community while saddling corporations with over-regulation. Dodd-Frank is still searching for the balance.

## The Satori Difference

Satori Consulting is positioned to work with investment managers and banks to effectively navigate the challenging regulatory environment. Our strong understanding of the financial and regulatory space, changing technology needs, and deep expertise in developing solutions and managing complex projects makes us an ideal partner to drive and support required transformational change. We approach every project with our client's broader strategic needs in mind and assess the organization within the confines of current regulatory expectations. We partner with our clients to define and execute change programs that will ensure a seamless and coordinated transition to regulatory compliance.

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<sup>i</sup> [http://www.google.com/search?sourceid=navclient&aq=1h&oq=&ie=UTF-8&rlz=1T4ADFA\\_enUS425US429&q=http%3a%2f%2fwww.bankinvestmentconsultant.com%2fnews%2ffinancial-services-international-regulations-2674501-1.html](http://www.google.com/search?sourceid=navclient&aq=1h&oq=&ie=UTF-8&rlz=1T4ADFA_enUS425US429&q=http%3a%2f%2fwww.bankinvestmentconsultant.com%2fnews%2ffinancial-services-international-regulations-2674501-1.html)

<sup>ii</sup> <http://www.ft.com/intl/cms/s/0/096e492e-bc54-11e0-acb6-00144feabdc0.html-axzz1UA5L1ruD>

<sup>iii</sup> <http://www.fow.com/Article/2871244/Regulatory-arbitrage-is-Dodd-Frank-going-to-far.html?ArticleID=2871244>

<sup>iv</sup> <http://bigfatfinanceblog.com/2011/04/18/risk-chat-what-is-regulatory-arbitrage/>

<sup>v</sup> <http://www.ft.com/intl/cms/s/2/acabf590-e829-11e0-9fc7-00144feab49a.html#axzz1aKrGgCJz>

<sup>vi</sup> [http://online.wsj.com/article/SB10001424053111904875404576532871460271158.html?mod=googlene\\_ws\\_wsjinovantas.com/news\\_article.php?id=292](http://online.wsj.com/article/SB10001424053111904875404576532871460271158.html?mod=googlene_ws_wsjinovantas.com/news_article.php?id=292)

<sup>vii</sup> [http://online.wsj.com/article/SB10001424053111904875404576532871460271158.html?mod=googlene\\_ws\\_ws](http://online.wsj.com/article/SB10001424053111904875404576532871460271158.html?mod=googlene_ws_ws)

<sup>viii</sup> <http://www.ft.com/intl/cms/s/0/096e492e-bc54-11e0-acb6-00144feabdc0.html#axzz1Vn4ByOr5>

<sup>ix</sup> [http://online.wsj.com/article/SB10001424053111904875404576532871460271158.html?mod=googlene\\_ws\\_ws](http://online.wsj.com/article/SB10001424053111904875404576532871460271158.html?mod=googlene_ws_ws)

<sup>x</sup> [http://www.platts.com/weblog/oilblog/2011/04/14/in\\_terms\\_of\\_rev.htm](http://www.platts.com/weblog/oilblog/2011/04/14/in_terms_of_rev.htm)

<sup>xi</sup> <http://www.ft.com/intl/cms/s/0/096e492e-bc54-11e0-acb6-00144feabdc0.html#axzz1Vn4ByOr5>

<sup>xii</sup> <http://www.reuters.com/article/2011/08/30/mckinsey-banks-idUSL5E7JU26Y20110830>

*At Satori Consulting, our mission is simple—to work side-by-side with clients to discover opportunities and solve problems. We strive to provide both comprehensive and expert service, mindful of every client’s unique needs. Our team of highly-skilled management consultants brings a wealth of industry and functional experience to provide wide-ranging services in project and program management, risk management, change management, organizational effectiveness, strategy and advisory, business process engineering, performance management, and infrastructure and technology.*