RIDING THE WAVE

The financial services sector has been drowning in regulation since the financial crisis struck. Are corporate treasurers staying afloat? Sally Percy reports

ILLUSTRATION BY STEVE SCOTT/JELLY

If the global financial crisis of 2007/8 was the earthquake that shook the world, then regulation of the financial services sector has surely been the tsunami that followed it.

Since the crisis struck, a string of hard-hitting regulations has been unleashed on the financial industry, and these have inevitably had repercussions – some intended, others unintended – for their corporate clients.

Basel III, the global standard on bank capital adequacy, stress testing and market liquidity risk, is transforming the financial services landscape. The standard, which is being implemented in Europe as Capital Requirements Directive IV, is "changing the attractiveness of most things to banks", according to ACT policy and technical director John Grout. "For example, it means that the attractiveness of a particular asset to a bank goes up and down according to which of the boxes for treatment, valuation and capital that it falls under."

The pressure on banks to bolster their liquidity with 'stable' liabilities that have a low risk of flight during a period of stress means they are primarily interested in holding corporate operating account balances or deposits for three months or longer. They view deposits for less than 30 days as extremely unappealing. "You see this especially at month end when banks report liquidity to their supervisors," observes Grout. "In addition, other controls, including leverage rules coming in and bank levy calculations that are done annually in certain countries such the UK, mean that overnight and short corporate deposits become very unattractive to banks at month, quarter and year ends."

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It is not only in the deposit business that banks' behaviour is changing. They are also much more discerning about who they lend money to than they have been in the past. Therefore, they are falling over themselves to lend money to 'safe bets', such as large corporates with good credit ratings – hence, the competitive funding rates that are available to these companies – but borrowers that fall outside this category can still find it hard to finance themselves with bank loans. While politicians like to make much of the 'alternative funding options' that are available to SMEs, most still see banks as their default lending option. So, in the long term, it is they who are likely to end up picking up the hefty tab for financial services regulation. The scale of the bill is evident from a study by policy-analysis firm Federal Financial Analytics, which found that regulation following the crisis had cost the six largest US banks a staggering $70.2bn by the end of last year.

Paying the price

"The more you regulate and make lending more expensive for banks, the more those who are pretty much reliant on them are going to pay the price," observes Stephen Pugh, FD of UK brewer Adnams. "The result is that SMEs may end up paying a disproportionate share of making the financial markets safer because they don't have the array of other funding options open to them that larger companies have."

He continues: "Regulation is squeezing the banks' ability to provide finance on the basis that others would do so and the banks would be disintermediated. That's fine if you are able to make use of that disintermediation. It's not so fine if your funding requirements are relatively small and therefore you haven't got a lot of options outside banks. There are some other options, but they are not so easily accessible or that cheap, either."

And while large corporates may not be feeling the true pinch of regulation in the funding market, they are feeling it in other ways. "Financial regulation affects us quite a lot," says Pedro Madeira, assistant treasurer at Heathrow Airports. "It affects us both directly through the European Market Infrastructure Regulation [EMIR] and Dodd-Frank, and indirectly because it impacts our counterparts, which drives up our costs."

Heathrow Airports has a £11.5bn derivatives portfolio for hedging currency risk as well as interest and inflation rates. So it was significantly affected by the requirement to report derivative transactions to trade repositories, which was brought in under EMIR. The financial services industry was unprepared for EMIR, Madeira says, and he criticises the regulation for being "rushed through" and not properly thought out. Trade repositories were not set up on time and regulators refused to budge on the implementation dates because the deadlines had already slipped.

"We had to get in additional resources just to report our whole backlog," Madeira explains. "Going forward, we have extra workload in terms of reporting all the trades we have."

Meanwhile, Madeira also notes that Heathrow Airports is finding it harder to secure long-term hedging now, which impacts on its financial strategy. "Regulation weighs as much on the price of our derivatives as anything else," he says. "It affects the pricing and availability of long-dated derivatives. I find it hard doing anything over 10 years, and anything above seven years tends to be quite expensive. We have to adapt and recognise that most of our long-term funding will have to come from sterling."

Quest for information

The political environment is also weighing heavily on the financial services industry, especially given the conflict in Ukraine and the actions of Middle Eastern terrorist group Isis. As a result of the imposition of sanctions on Russia, along with other nations and groups, banks have had to embark on an exhaustive search for information about the parties they do business with. For example, the large Russian banks and state oil companies are subject to a string of capital market sanctions (see page 10), while the UN Security Council has blacklisted Isis, which has been funding itself by selling oil from captured oil fields.

Intense political scrutiny means there are heavy penalties for those banks that breach sanctions or facilitate money laundering or tax evasion. This year, BNP Paribas was fined $8.9bn by the US Department of Justice for failings in these areas, while Credit Suisse was charged €2.6bn. Meanwhile, in August, Standard Chartered agreed to pay out $300m over lapses in its anti-money-laundering procedures just two years after it incurred a $340m fine for breaching sanctions on Iran and some other nations.

Given the sums at stake and what appears to be a trend towards 'fine inflation' from regulators, it's not surprising that banks are interrogating their customers closely. But responding to information requests from banks is difficult and time-consuming for companies. "The banks are asking their corporate clients to assure them that none of their suppliers or customers are on any of these blacklists," says Grout. "But often those are not the kind of questions that companies are in a position to answer. A lot of those questions would be very difficult for a developed country's national security service to answer, never mind a mid-sized company that has a business making widgets."

Not only are banks asking questions that corporates can't answer, they are also increasingly unwilling to carry out certain transactions, such as making payments to, or receiving payments from, certain sources. And they are scrutinising their correspondent banking networks closely, which compounds the problem that small, regional banks already have in maintaining correspondent banking networks in an era when the in-built costs of bank relationships are rising all the time. "Service levels are falling," observes Grout. "Companies are beginning to see that."

Chris King, group treasurer of private-equity backed foam manufacturer the Vita Group, concurs that banks'

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A SAFER PLACE?

Ultimately, the objective of regulators is to make the financial system safer. So is that what is happening in practice?

Heathrow Airports' Pedro Madeira does concede that EMIR has helped to tidy up the derivative trading environment through more regular portfolio matching and exchanging confirmations. But that doesn't stop him querying the usefulness of universal derivative reporting or other forms of regulation. "Regulation is trying to make the financial environment safer," he notes, "but it is making certain kinds of hedging so complex and unaffordable that some corporates just end up taking more unhedged risks. Then regulation has the perverse effect of increasing, rather than decreasing, risk." He is also unsure as to whether regulation is really making the global capital markets a safer environment in which to do business. "Do we feel much safer just because we are reporting all of our hedging? Not at all."

"The upside of regulation is that we are supposed to have a more stable financial services industry," says the ACT's John Grout. "But if you want stability, you pour everything into liquid concrete and let the concrete set. That's very stable, but pretty useless, and that's the risk we have. The risk is, we end up with a safe but useless banking system. But non-financial companies need a safe but useful banking system. The idea that everything needs regulating is pervasive, but it's not helpful."

know-your-customer (KYC) due diligence processes can be lengthy. "KYC is really the main headache for us, given our shareholder base," he says. "It took five months to set up a single bank account in Serbia, just purely from a KYC process. It was the most painstaking process I've ever been through."

Uncoordinated approach

In his September column in *The Treasurer* (see September issue, page 15), Thomas C Deas Jr, chairman of the International Group of Treasury Associations, observed that treasurers are being swamped with waves of often contradictory rules. He highlighted the asymmetries that exist between the US and Europe on reporting requirements for derivative transactions to authorities and trade repositories. For example, under the Dodd-Frank Act, the onus is on swap dealers to submit the necessary derivative trade reports to the repositories for trades with end-user treasury departments. But under EMIR, the reporting requirements are more onerous, since both parties must report separately to a trade repository.

Bank ring-fencing is another example of where regulators do not appear to be on the same page. At the ACT Regulation Breakfast in September, which was held under the Chatham House Rule, a speaker queried the logic of why the UK was adopting a different approach from the rest of the world with regard to ring-fencing. In the UK, it is the 'safe' retail, deposit-taking parts of a bank that will be ring-fenced, whereas other jurisdictions will be ring-fencing the riskier securities and dealing activities of banks.

This lack of coordination exacerbates the wider uncertainty that exists over ring-fencing. In future, companies will need to pay close attention to which arm of a bank they are doing business with in order to manage their risks effectively. Furthermore, ring-fencing is likely to come at a price. "We worry about how that is going to impact the cost of hedging," Madeira says. "We can only deal with counterparties that have a certain credit rating and we don't know which bank will be better rated – the ring-fenced bank or the other bank. But it's clear that the ring-fenced bank won't be able to do any complex derivatives."

A DRIVER OF INNOVATION

Regulation has been a major driver of innovation over the past six years and it has played an important role in developments such as the UK's Faster Payments Service. In September, the UK's Financial Conduct Authority (FCA) launched Project Innovate to support technological endeavours that will improve the lives of users of financial services.

In a speech, FCA CEO Martin Wheatley said the opportunities that could be explored included "more direct interaction for consumers with products and services, customised offerings, greater efficiency, better information and, of course, the possibility of increased convenience". The aim of Project Innovate is to help both start-ups and more established businesses to bring innovative ideas to the financial services industry.

UK Financial Conduct Authority CEO Martin Wheatley

GETTY IMAGES

Looking ahead

Without doubt, the financial services landscape has been permanently transformed since 2007. But while the banks have been adjusting to the new world order, the real economy probably hasn't yet felt the full force of the regulatory tidal wave as yet. Indeed, parts of the real economy probably don't know what is about to hit them.

"The SME market doesn't have much say in these regulations because we're not geared up with lots of technical staff who can get involved with lobbying and assessing regulations as they are being developed," says Pugh. "So regulations arrive and start affecting businesses without them having had any notification at all because they haven't been able to devote time and resources to following them."

But can we assume, at least, that the worst of the regulatory tidal wave is now over? Grout, for one, is not convinced. "There are still speeches being made by politicians, who have no love for the financial services industry, about what remains to be done," he says. "A lot of the stuff that was done is subject to review after three years. You've got the bedding down of the existing regulations and we only really find out what chaos regulations cause when we try to implement them. Plus, we don't know how the combined effect of all these changes is really going to work – whether this regulation steps on the toes of that regulation or whether doing both is going to be hugely difficult, whereas it didn't look too bad on its own."

For now, then, it seems too early to say whether the real economy is going to sink or swim amid the tsunami of regulation. But one thing's for sure – from a corporate treasurer's perspective, the waters will look choppy for a little while yet.

For an interview with Chris King of the Vita Group, see page 22

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