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No more Mr Nice Guy!

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As the beginning of 2010 seems to show the first green shoots of recovery, the political backlash following the global financial crisis shows no signs of abating – if anything, it is becoming more radicalised.

Last year, a number of considered reports analysed many of the root causes of the problems. Most recognised the elements of interdependence between national financial systems and the need to better co-ordinate regulation, control and supervision globally.

More recently and perhaps goaded by the rapid return to profit of some banks and the reappearance of large bonus payments, politicians around the world have returned to the front foot and demanded more sweeping changes. Some of this is undoubtedly playing to the gallery of upcoming important elections; however few doubt that the underlying trends will be towards more restrictions, regulation and supervision. What are the implications this year for compliance and risk managers, particularly for monitoring and surveillance?

We simply cannot return to business as usual

President **Barack Obama ha**s been signaling his intentions to take on the Banking sector, announcing plans for stringent new constraints (the so-called 'Volcker' rule and others) that have prompted comparison the Glass-Steagall Act introduced after the Great Depression some 80 years ago. The US president proposes new limits on size and trading practices of big deposit-taking banks, so that they will not be allowed to use their own money to take bets on markets, run hedge funds or make private equity investments.

"We simply cannot return to business as usual," said Obama "Even as we dig our way out this deep hole, it is important we do not lose sight of what got us in this hole in the first place. While the financial system is far stronger today than it was one year ago, it is still operating under the exact same rules that led to its near collapse."

The US is not completely alone in taking this stance. Michel Barnier, EU commissioner for internal markets, said "We need to turn the page on an era of irresponsibility. We need to put transparency, responsibility and ethics at the heart of the financial system," he said. "It is in the interest of the European financial sector and of the British financial sector to be regulated properly and effectively. We have to learn the lessons from the crisis and we will do so. No market, no financial player and no product should be allowed to escape anymore"

There is concern about over-reaction, especially in the UK. The idea of a kind of more powerful European über-regulator has been proposed, but is not universally popular and there is some recognition that it is unlikely to be effective. However, the direction of the tide is clear, a movement away from light touch, principles-based and the so-called Anglo-Saxon model and towards a more regulated environment with an emphasis on appropriate behaviour and responsibility.

A major part of what is likely to emerge will be demands for greater capital adequacy to properly support the business the banks are undertaking, more restrictions on highly speculative trading, together with a much more transparent, detailed and accurate view of what that business actually is and how the risks are being measured and monitored.

Bankers are on the run

The global think-tank that takes place at Davos every year could be expected to offer more considered thoughts, however feelings were riding even there this year.

The contrast between the billions of public money spend on bailing out the financial system, the billions set aside for bonus pools, yet the continuing short supply of credit for commercial purposes in the underlying economy proved as unpalatable at Davos as it does on 'Main Street, USA'. Unsurprisingly, there was a very strong sentiment that executive compensation, especially for bankers and others perceived to be responsible for the crisis, was exorbitant and needs to be restrained. This view goes further than just compensation; indeed for some it heralds a critical re-evaluation of market capitalism itself. As even the Wall St Journal noted "Bankers are on the run."

From the perspective of Financial Services, some of these views may lead to damaging and unintended consequences and fail to recognise the real demands in the system. Excessive constraints, particularly if applied unequally to the US and the UK, may simply drive the same old behaviors to new locations, rather than rehabilitating or eradicating them. Tax burdens have already caused many firms to look at the implications of relocating or rebasing in more beneficial fiscal climates. Meanwhile, with a pressing need for more profitable returns amongst investors, banks around the world are pressing clients old and new to rediscover riskier investments such as convertible bonds and derivatives, especially in the Asia Pacific region.

"The lack of trend and the falling volatility among all asset classes is incentivizing investors to take more risk to generate return, as they don't expect large upside movement nor large downside movement in the current context," said Marc Saffon, head of financial engineering at Société Générale.

Rethink, rebuild, redesign

The financial crisis and the resultant recession are being viewed by some commentators as potentially symptoms of rather deeper and long term failures of institutions and systems.

This has given rise to a feeling that organisations and processes that have served us well for decades, may no longer be fit for purpose in a globalised economy.

Up to now, we haven't got a great track record on global collaboration in the face of this type of challenge. For example, the recent Copenhagen conference on global warming is generally viewed as a failure. The initial response to the Haiti earthquake disaster has been criticised as too slow and un-coordinated. Both however, are examples of *attempting* greater global co-operation in the face of challenges of a more massive scale, extending beyond what individual nations and organisations have managed to do so far. Similarly in financial markets, the actual success of global collaboration and common regulation may turn out to be less than hoped for, but that won't stop them trying.

Despite some apparently highly contradictory viewpoints, there is a general realisation that we need to build a working global financial system, not just destroy it. Hence, the theme of Davos emerged as Rethink, redesign, rebuild.

Themes for 2010

The public proclamations of politicians and the high-altitude musing of the great and good at Davos may seem somewhat distant from the practical issues of compliance and risk monitoring today – but the emerging themes are very relevant.

Political and regulatory

Analysis in the aftermath of the financial crisis clearly highlighted a lack of visibility and control at every level from the individual firm, through exchanges to supervisors. This will be a priority for all market participants to address, in every geography.

The way markets and banks are run, the way risks are measured and the way monitoring and control is exercised, is in the political and regulatory spotlight. This will inevitably result in more rules and restrictions – the only question is how much more. Key targets are likely to include:

- Tighter correlation between some risk types and capital,
- Over the counter (OTC) trading, where the lack of transparency is a major concern
- Speculative trading in many forms from proprietary desks through hedge funds to short-selling.

Political pressure in the USA appears to position that market as being likely to have the most draconian restrictions imposed on it. In the UK, there are voices such as Hector Sants (Chief Executive of the FSA) preaching a more measured reaction, although his recent resignation may signal the fact that, even in the UK, the hawks are gaining ascendancy over the doves in this debate.

'Intensive supervision' and 'credible deterrence'

"We remain, and must remain, evidence- and risk-based but the phrase 'principles-based' has, I think, been misunderstood. To suggest that we can operate on principles alone is illusory particularly because the policy-making framework does not allow it. Europe, in particular, has a particular penchant for rules and in any case in a number of key areas such as prudential they are indeed necessary.

Furthermore, the limitations of a pure principles-based regime have to be recognised. I continue to believe the majority of market participants are decent people; however, a principles-based approach does not work with individuals who have no principles.

The delivery of supervision has to be done in partnership with responsible firms, shareholders and auditors. The supervisors cannot operate alone. All involved in oversight must ensure the right business strategies and behaviors are being pursued. This will require greater engagement by all of us" – Hector Sants, Chief Executive of the UK FSA.

The analysts' views - GORC

Joining the ever growing list of entertaining new acronyms is the term GORC, otherwise known as Governance, Operation Risk and Compliance. According to the Boston-based analysts Celent, global IT spending associated with GORC activities is expected to increase from $1.4 billion in 2008 to $1.7 billion in 2011, a growth rate (CAGR) of 6.6% overall. A particular focus will be banks looking to replace or consolidate in-house tools, particularly with third party suppliers who can provide an "out of the box" approach.

The uplift in spending will benefit those given all of the activity we anticipate occurring in 2010; Aite Group believe the key points to consider for asset managers, brokers, banks, exchanges, regulators, and technologists in capital markets include the following:

- Advanced trading tools and strategies continue to migrate into new markets; the importance of having a global presence will remain one of the key issues for large sell-side and buy-side firms.
- Regulatory changes will finally come in 2010, but the ultimate goal of bringing transparency to the OTC markets will fail short due to end-user exemptions and the lack of mandates for customized products.
- Transparency will continue to be a mantra in the post-credit crisis world. Even alternative investment funds, which historically operated away from prying eyes, will need to come to terms with this reality.

Implications for Compliance and Risk Management

Expectation
It is clear that there is an expectation in all quarters that compliance and risk monitoring will become more extensive and important. There is also an understanding that what was being done before was probably inadequate and there is certainly now a demand for you to have much better visibility over activity, meaningful and up to date information and effective compliance and risk controls

Responsibility
The need to improve the culture of individual responsibility has become widely accepted and underpins a number of recommendations – many of these strengthen the power and independence of the internal risk and compliance officers

Flexibility
The sound of new regulation being formed is already audible. Given the political climate, there will be demands for things to be done and done quickly. The implication is that to survive, you will have to be flexible and agile enough to change with them. Speed of change will be as important as change itself.

Investment
The good news is that, if the analysts' predictions are correct, compliance and risk budgets are being significantly increased, including the provision for staff, training and the investment in appropriate technology to provide the necessary monitoring and controls. Interestingly, the Aite survey noted that risk management and compliance were the top systems in terms of number of CIO responses and that risk management and compliance personnel have the most momentum as technology influencers.

Preventing problems before they ever emerge

Perhaps we can leave the last words to Mary L. Schapiro, chairman of the SEC, with this extract from a speech to an audience of compliance managers recently:

"The work of chief compliance officers like yourselves should have the most meaningful impact. For it is you who are on the front lines making sure your firms are complying with the law, the rules and the guidance we offer. It is you who are on the ground alerting colleagues to avoid conflicts of interest, and ensuring that your firms are providing clear, simple and meaningful disclosure. And, it is you who can prevent problems before they ever emerge."

So Mr Nice Guy - there may be no time better than now to start flexing your muscles.

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