Bloomberg BRIEF

Financial Regulation

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QUOTE OF THE WEEK

"The SEC's saying, 'If you want to play in our sandbox, you have to follow our rules.'"

– Drew Bernstein, co-managing partner at Marcum Bernstein & Pinchuk, on the recent accounting scandals involving Chinese firms listed in the U.S. See page 6.

REGULATION WATCH

Consultation on Finra's Broker Bonus Disclosure Plan Ends. Comments are due March 5 on the proposal, which would require brokers to disclose bonuses of $50,000 or more that they receive to switch firms. See page 8.

INSIDE

Q&A

Robert Priester, executive director at the European Banking Federation, calls for more uniformity on capital levels for cross-border banks.

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EU Stress Tests Don't Reflect Sovereign Debt Risks

BY DANA WILKIE

European Union stress test models haven't fully reflected the riskiness of European sovereign debt, New York University economists have found.

The economists – who run market-data-based "stress tests" that differ from regulation-required stress tests in the U.S. and EU – have found their reviews generally mirror the **Federal Reserve**'s list of systemically risky financial institutions, said **Viral Acharya**, a professor of economics at NYU.

"The macroeconomic scenario the Fed has used has – by and large – been more severe than the scenario that European stress tests have been considering," said Acharya. "And in Europe, the stress tests continued to assume that sovereign debt was risk-free, so those tests came out very rosy."

Viral Acharya. Photographer: Jin Lee/Bloomberg

The Fed, mandated by the Dodd-Frank Act, now conducts a yearly stress test of bank holding companies with total consolidated assets of $50 billion or more, and nonbank financial company firms that the Fed designates. It is slated to release results for the most recent round of tests on March 7. The tests evaluate whether a company has sufficient capital to absorb losses under adverse economic conditions. In 2012, an "adverse" scenario was defined as an economy with 13 percent unem-

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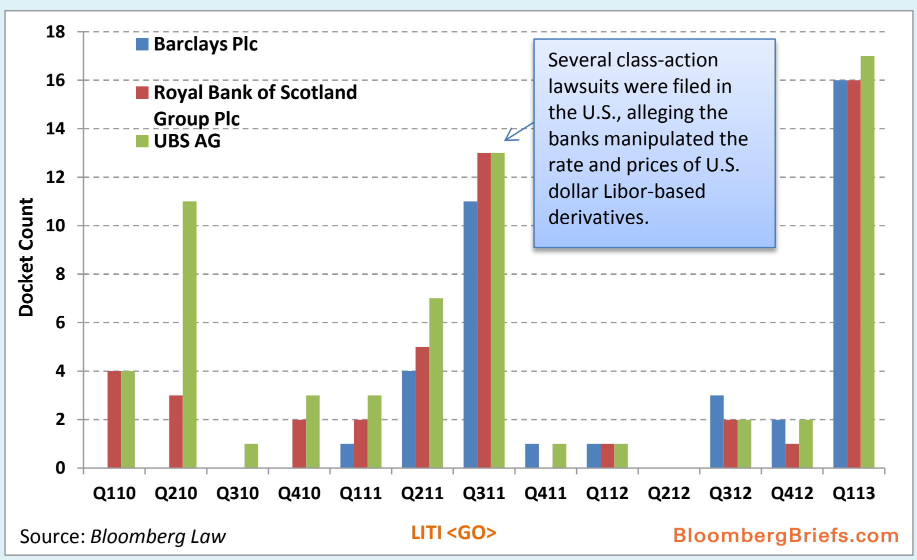
Antitrust Case Filings Rise After Libor Settlements



Antitrust case filings, which include Libor civil suits, against UBS, RBS and Barclays rose this year to their highest levels so far, following bank settlements with regulators on Libor-rigging.

EU STRESS TESTS...
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ployment, a 50 percent drop in equity prices and a 21 percent decline in housing prices.

The **European Banking Authority**, which is responsible for European Union-wide stress testing, in 2011 reviewed how 90 lenders would handle a 0.5 percent economic contraction in the euro area, a 15 percent drop in European equity markets and trading losses on sovereign debt not held to maturity. The EBA was widely criticized for the 2011 results for excluding a Greek default. It is slated to hold a joint stress test this year with the **European Central Bank** before the central bank takes over supervision in order to gauge banks' progress in meeting Basel III capital rules.

Economists at New York University's Stern School of Business have created their own list of "systemically important" firms using a model that starts with a financial firm's stock price as a proxy for its capital – the money it has to make loans, buy bonds, or absorb loses. The economists regularly subject each company to a stress test – in which the stock market declines 40 percent – to learn how much capital a firm would need to continue holding the same amount of loans and bonds.

The university model only works for publicly traded companies, because these are the ones for which market data are available.

"Clearly we know less than regulators do because we don't see bank balance sheets in the detail regulators do," Acharya said. "We are capturing risk using market data, which is not something based on some formula that regulators have said we should use, because those assumptions may no longer be valid in current market conditions."

Acharya said the university launched its stress-test model because many banks that failed during the financial crisis appeared to be well capitalized under regulatory standards, "but the market wasn't willing to provide them any funding. That means regulatory assessments are out of sync with the market assessments of capital funding."

Anat Admati, a finance professor at Stanford University, said she objects to trusting stress tests as a way to tell if banks have "enough" equity because they involve projections and don't consider all of the possible risks.

"Even interest-rate changes are not considered particularly by these models," said Admati, whose book "The Bankers' New Clothes" was published this month. "It's a very stylized exercise. They are really trusted to assure us on things they are not good enough for."

Fed spokeswoman Barbara Hagenbaugh declined to comment on the NYU stress tests. She noted that the Fed last year created of a council of outside experts to review its stress-test models, held a symposium on its models and asked for public comments on developing stress-test scenarios.

The Fed's stress test results last year for 19 financial groups showed that all but four demonstrated that their core tier one capital ratios would remain above the required 5 percent of risk-weighted assets in the stress scenario. Eight of the 90 banks tested in the EU failed in 2011 and about 16 needed to boost capital, the EBA said.

Romain Sadet, an EBA spokesman, declined to comment.

–With assistance from Melissa Karsh

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ENFORCEMENT

■ **The Libyan Investment Authority**, the nation's sovereign wealth fund, is cooperating with the U.S. **Securities and Exchange Commission** on its probe into the fund's dealings with **Goldman Sachs Group Inc.** The LIA is also considering legal action against Goldman Sachs to recover losses on its investments, the fund said in an e-mailed statement yesterday. The SEC is investigating possible violations of U.S. anti-corruption laws by Goldman Sachs, the Wall Street Journal reported yesterday. SEC spokesman John Nester and Goldman spokesman Michael DuVally declined to comment when contacted by Bloomberg News yesterday. Under Muammar Qaddafi, the sovereign wealth fund had assets of about $60 billion and turned to financial firms to achieve its goal.

■ **Carl Esprey**, who has worked as a portfolio manager at **GLG Partners Inc.**, was one of the three men arrested Feb. 27 in London on suspicion of insider trading, a person with knowledge of the matter said. Esprey was detained and questioned about trades he made through a private account, said the person. He joined **Man Group Plc**'s GLG unit in January 2008 as a portfolio manager for its European Long-Short Fund, according to a July 2012 company press release. The investigation is part of the **Fi-**

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STRUCTURED NOTES

Deutsche, UBS Move Note Issuance to SPVs as Basel Looms

Deutsche Bank AG and **UBS AG** are among banks pushing sales of structured notes onto off-balance-sheet entities as they prepare to meet stricter capital rules.

So-called special purpose vehicles have issued as much as eight times more notes than their sponsor banks this year, according to data compiled by Bloomberg that exclude securities where the amount of principal returned can vary. Deutsche Bank has sold $130.4 million of notes, down 81 percent from a year earlier, while two affiliated SPVs raised more than five times as much. UBS issued $28.1 million of the securities this year, compared with $227 million for entities sponsored by the bank.

Lenders are preparing for new regulations by trimming their balance sheets and retreating from capital-intensive businesses to become leaner and less leveraged. New standards from the **Basel Committee on Banking Supervision**, known as Basel III and scheduled to phase in from next year through 2019, more than triple the core capital they must hold.

UBS is partly redirecting issuance off its balance sheet because of its "strong funding position," said Paul Bajer, a fixed-income structurer at the bank in London. "Our appetite for issuance is limited and accordingly we have adjusted our offering so that third-party issuers feature more prominently."

Chief Executive Officer **Sergio Ermotti** is cutting 10,000 jobs over three years, shedding assets and shrinking UBS's balance sheet as regulators pressure the lender to boost capital and scale back trading and investment-banking operations. Reducing the balance sheet is expected to cut its funding requirements by 30 percent, the bank said in October.

UBS, the third-largest issuer of structured notes outside the U.S. in 2012, sold the least notes since 1999 this year, Bloomberg data show. Meanwhile, Switzerland's biggest bank arranged $105.2 million of securities for Luxembourg-incorporated VIS Finance SA and $121.8 million for Amsterdam-based Elm BV.

Deutsche Bank, which is also restructuring operations, reducing pay and eliminating almost 2,000 jobs, had the worst start to the year for issuance from its own debt program since 2001, Bloomberg data show. At the same time, Germany's biggest bank underwrote $691.7 million of sales for SPVs Palladium Securities 1SA and DB Investor Solutions, Bloomberg data show.

Sebastian Howell, a spokesman for Deutsche Bank in London, declined to comment on the bank's SPVs.

Shrinking the balance sheet can make a bank more attractive when it tries to sell stock to raise money to help satisfy the Basel III requirements, said **Jeremy Jennings-Mares**, a London-based partner at securities law firm **Morrison & Foerster LLP**.

"An over-indebted balance sheet is not what you want when you are trying to raise equity and finding it hard," he said.

Azusa Ltd., a Cayman Islands-incorporated SPV, raised $111.2 million from selling 10 notes this year, more than double the issuance of Bank of America Corp., its sponsor, Bloomberg data that exclude U.S. notes show. Alexandra Parry, a spokeswoman for the bank in London, declined to comment.

Investors generally pay greater costs when buying notes from SPVs rather than banks, such as for administrative and custodian fees. They should be insulated from the worst of the fallout if the sponsoring bank defaults, as long as the SPV is set up so that it doesn't become part of the lender's bankruptcy estate.

Typically an SPV will use the money raised from selling the securities to purchase collateral, which can be highly rated government bonds, as well as bonds of investment-grade European or U.S. banks.

"SPVs can take bank credit risk right off the table," said **Moritz Seibert**, a Munich-based partner at asset-management firm **Aquantum AG** and the former U.S. head of equity-derivatives structuring at **RBS** in Stamford, Connecticut.

– Alastair Marsh

ENFORCEMENT...
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nancial Services Authority's push to crack down on insider trading by employees at London's biggest financial firms. Esprey didn't respond to e-mails sent to his GLG address and he couldn't be reached on his mobile phone. FSA spokesman Joseph Eyre declined to comment on the identity of the three people arrested. Man Group Chief Executive **Emmanuel Roman** also declined to comment, when asked about the investigation of the employee on a conference call with reporters. Man Group confirmed that one of its employees had been arrested by the FSA in an e-mail. The investigation regards the person's "actions as a private individual and not as an employee of Man Group or GLG," it said. Man Group said it suspended the employee and had cooperated with the FSA's probe. The other two men arrested by the FSA don't work for GLG and haven't been identified.

■ **Rabobank Groep** faces a fine of more than $440 million for Libor rigging and is next in line to reach a settlement with the U.S. **Commodity Futures Trading Commission**, the **Department of Justice** and the U.K. **Financial Services Authority**, said four people with knowledge of the probe. The penalty, which may come as soon as May, is likely to be between the 290 million pounds ($440 million) **Barclays Plc** paid in June and the $612 million **Royal Bank of Scotland Group** paid this month, one of the people said. "It's likely that an assessment of the facts and circumstances will lead to a settlement," Rabobank said. "The amount of such a settlement cannot be estimated reliably at this time," nor can the timing of any announcement. DOJ spokeswoman Rebekah Carmichael and CFTC spokesman Steven Adamske declined to comment as did an FSA spokesman.

– Elisa Martinuzzi, Lindsay Fortado, Maud van Gaal, Greg Farrell

THE WEEK IN REVIEW

Europe's Bonus Restriction Plan, CSRC Issues Capital Rules, U.S. SEC Fraud Actions Lag

Regulation

European plans to levy the world's toughest bonus restrictions on bankers drew condemnation in London as the industry warned it may backfire as firms raise fixed pay instead. The agreement of European Parliament lawmakers and government officials in Brussels yesterday to ban bonuses that are more than twice bankers' fixed pay starting Jan. 1, if ratified by EU countries and the full Parliament, will be a blow to banks in the 27-member states, pay consultants and the U.K. government said.

– Ambereen Choudhury and Jim Brunsden

Poland's financial watchdog is seeking to help banks fund lending more cheaply by developing the asset-backed securities market as the nation faces its worst economic slowdown in more than a decade. The Financial Services Authority is studying the ABS market and will propose regulatory changes, Wojciech Kwasniak, the FSA's deputy chairman, said in an e-mail Feb. 27.

– Konrad Krasuski and Esteban Duarte

Leaders of the Senate Banking Committee promised a bipartisan bill to restructure the Federal Housing Administration as it faces its first shortfall since it was founded in the 1930s. The pledge by Senator Tim Johnson, a South Dakota Democrat and chair of the panel, and ranking member Michael Crapo, an Idaho Republican, contrasts with partisan divisions over the FHA's future in the House of Representatives.

– Cheyenne Hopkins and Clea Benson

The U.K. Financial Services Authority doesn't need the power to prosecute executives at banks that fail or take bailouts because such matters are unlikely to be criminal, the agency told lawmakers.

– Lindsay Fortado

The U.S. Commodity Futures Trading Commission, in consultation with European regulators, probably will "take up" final margin rules for uncleared swaps and related rules on capital in the year's second half, Chairman Gary Gensler said. Separately, the CFTC will seek public comment by May 1 on reauthorization, Senator Debbie Stabenow said.

– Silla Brush and Kim Chipman

The China Securities Regulatory Commission will lower the capital reserve requirement ratio for futures companies to 4 percent from 6 percent, the regulator said in a statement. Futures companies should meet the requirements from July 1, the statement said.

– Bloomberg News

A bill requiring high-frequency trading firms to register with banking authorities passed the German Parliament's lower house this week. The bill would require firms that use computer-driven strategies to register with banking authorities.

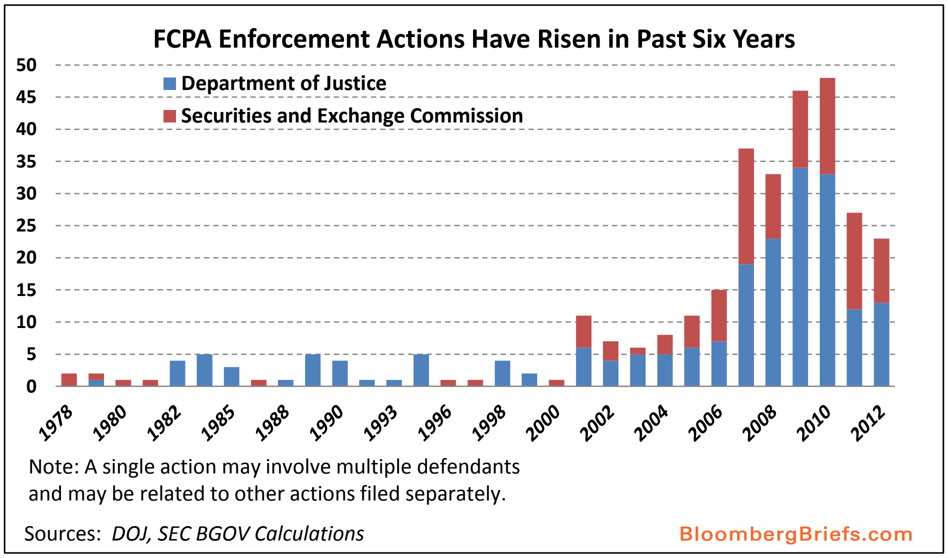
– Patrick Donahue and Jonathan Morgan

The Consumer Financial Protection Bureau, which last year began exploring whether to tighten rules on checking overdraft fees, has decided against quick action after hearing from smaller U.S. banks that rely on the revenue.

– Carter Dougherty

South Africa relaxed foreign-exchange controls to make it easier for companies to invest more of their assets offshore. Companies trading on Johannesburg's stock exchange will be allowed to set up one holding company to house their offshore assets that will not be subject to foreign-exchange restrictions, the National Treasury said. Separately, South Africa will introduce laws to regulate the retirement industry later this year.

– Mike Cohen



More than 67 percent of enforcement actions in the 35-year history of the Foreign Corrupt Practices Act have been brought in the past six years, according to a Bloomberg Government analysis.

– Sanford Reback, Director of Global Business, and Miguel Garrido, Quantitative Analyst, at BGOV

Compliance

The European Banking Authority found "material differences" in the way lenders calculate how much capital to hold on their balance sheets against potential losses in asset value. The agency must conduct an in-depth investigation to ensure lenders' calculations of risk-weighted assets are reliable, consistent across banks and reflect their true risk profile, the EBA said in a report.

– Ben Moshinsky

Goldman Sachs Group Inc. lowered its estimate for potential losses from

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legal claims by $100 million. "Reasonably possible" legal costs are as much as $3.5 billion, the firm said today in a report on the quarter that ended Dec. 31. That compares with $3.6 billion three months earlier and $3.4 billion at the end of June.

– Christine Harper and Ambereen Choudhury

Regulators have a new ally in their campaign to prevent banks from disguising their capital needs: holders of contingent capital notes, a type of debt banks have started selling to bolster their balance sheets. "They'll be watching like hawks," said Georg Grodzki, head of credit research at Legal & General Investment Management. "They have to be pretty mesmerized by capital ratios if they're holding something with capital triggers."

– John Glover

Global regulators plan to complete by the summer the first step in overhauling financial benchmarks after three banks paid more than $2.5 billion in fines to settle interest rate-rigging charges. An International Organization of Securities Commissions task force on financial benchmarks plans to publish a final document in late spring or summer, the CFTC's Jacqueline Mesa said.

– Silla Brush

About 4.2 million borrowers who went through foreclosures will hear from Rust Consulting Inc. within 31 days to outline their compensation under a settlement with 13 servicers, according to U.S. bank regulators. The final details of an agreement with the largest U.S. mortgage servicers were released this week by the Federal Reserve and OCC, which said that Rust was hired as the agent tasked with giving out $3.6 billion in cash payments.

– Jesse Hamilton

The Hong Kong Securities and Futures Commission is set to review dark pool traders licensing to unify the standards in accordance with international regulations, the Oriental Daily reported. The review doesn't necessarily mean the SFC will tighten the rules, the paper said.

– Fion Li

Royal Bank of Scotland Group Plc posted a wider full-year loss after it set aside an additional 1.1 billion pounds ($1.6 billion) to compensate clients wrongly sold insurance and interest-rate hedging products. The net loss swelled to 5.97 billion pounds from 2 billion pounds in the year-earlier period, RBS said.

– Gavin Finch and Howard Mustoe

The Securities and Exchange Commission must move more quickly in pressing some fraud lawsuits, the U.S. Supreme Court ruled in a decision that may affect agencies across the government. The justices ruled in favor of two Gabelli Funds LLC officials seeking to block SEC claims that they improperly let a client engage in market timing, contending that the SEC sued after the five-year window for seeking penalties had expired.

– Greg Stohr

The European Union's top banking and markets regulators warned inexperienced investors that they may lose more money than they expect when trading contracts for difference. Volatile markets, combined with extra leverage, "can result in rapid changes to your overall investment position," the European Banking Authority and European Securities and Markets Authority said in a statement.

– Ben Moshinsky

Blackstone Group LP has devised a way to profit from regulation: It's helping banks meet tougher capital rules without the pain of selling assets or raising equity. The firm last year insured Citigroup Inc. against any initial losses on a $1.2 billion pool of shipping loans, said two people familiar. The regulatory capital trade, will let Citigroup cut how much it sets aside to cover defaults by as much as 96 percent, while keeping the loans on its balance sheet. For banks, the transactions offer a way to redeploy capital more profitably while meeting stiffer Basel requirements.

– Michelle Wiese Bockmann, Liam Vaughan and Ben Moshinsky

India's stock market regulator said it is probing a crash in shares of some small and medium-sized companies that has erased as much as 76 percent of their value this week.

– Santanu Chakraborty and Rajhkumar K. Shaaw

IN BRIEF

- The **Office of the Comptroller of the Currency** celebrated its 150th anniversary on Feb. 25. It was created as a bureau of the U.S. Department of the Treasury by the National Currency Act in 1863.
- Compliance officer ranked as the fourth-best business job for 2013, according to U.S. News & World Report in its annual rankings. The magazine reported that employers in finance, oil and gas and the postal service pay the highest salaries for compliance officers and that the **Bureau of Labor Statistics** forecasts 15 percent employment growth between 2010 and 2020.
- **Andrew Haldane**, executive director for financial stability at the **Bank of England**, has been reappointed to the interim Financial Policy Committee and appointed to the statutory Financial Policy Committee for three years through April 1, 2016, a statement said. His current term on the interim committee expired Feb. 28.
- The U.S. Senate Banking Committee is aiming to hold a hearing on the nomination of **Mary Jo White** to lead the **Securities and Exchange Commission** during the week of March 11, a Senate aide said. President Obama nominated the former U.S. prosecutor, who is retiring as a partner at **Debevoise & Plimpton**, on Jan. 24.
- The U.K. government started the search for a replacement group to oversee Libor. A seven-member panel including **Sarah Hogg**, chairman of the **Financial Reporting Council**, the **Financial Services Authority**'s **Martin Wheatley**, and the **Bank of England**'s **Paul Fisher** will recommend a new administrator this year, the Treasury said in a statement.

– Melissa Karsh, Charles Daly, Cheyenne Hopkins, Liam Vaughan

FOR THE RECORD

Gary Gensler, chairman of the U.S. **Commodity Futures Trading Commission**, said efforts to reform the London interbank offered rate (Libor) and other benchmark rates come "at a critical juncture," because the rates have been "readily and pervasively rigged." Gensler made his comments Tuesday at a roundtable designed to get feedback on how to improve benchmark-rate oversight. Other participants included representatives of CME Group Inc., Intercontinental Exchange Inc., NYSE Euronext and Pacific Investment Management Co. "I don't choose those words lightly," Gensler said during the joint roundtable, sponsored by the CFTC and International Organization of Securities Commissions, which on Jan. 11 published a consultative paper on benchmark rates. "But how else can we describe what we've seen in these cases? The misconduct spanned many years. It took place in offices in several cities around the globe. It included numerous people – in one case it was at least three dozen. It included management and involved multiple benchmarks. And in each case, there was evidence of collusion." Gensler has questioned the long-term viability of Libor and other benchmark rates, saying the underlying markets must be based on transactions and not estimates from banks.

Gary Gensler

– Dana Wilkie

Germany's financial markets regulator said a U.S. plan requiring local units of foreign banks to be separately capitalized hampers global regulators in their efforts to coordinate policy. "It's a step backward," **Elke Koenig**, **Bafin**'s president, said yesterday on the sidelines of a conference in Frankfurt. "Basel III is a consolidated system and such a unilateral decision goes in the wrong direction," she said referring to capital rules from the Basel Committee on Banking Supervision. In November, Federal Reserve Governor Daniel Tarullo proposed ordering 23 foreign banks to adhere to stricter capital requirements to reduce risks to the financial system. Koenig also said that the U.S. calling on banks to prepare for a lack of coordination between regulators in the event of defaults under so-called living wills "went in the wrong direction." Bafin and global peers should cooperate on making the finance industry more stable, she said.

– Nicholas Comfort

Sheila Bair, former chairman of the **Federal Deposit Insurance Corp.**, said U.S. regulators lack the nerve to designate non-bank financial companies systemically important and aren't doing their job. "It's lack of will, it's lack of courage, it's lack of spine," Bair said in a telephone interview yesterday. "You can quote me on that and they'll be angry with me, but I don't care. This is outrageous." The Financial Stability Oversight Council, led by new Treasury Secretary Jacob J. Lew, met yesterday in Washington and discussed companies it is considering designating for Federal Reserve oversight. American International Group Inc., Prudential Financial Inc. and General Electric Co.'s finance unit are in the final stage of review by the council. "What's frustrating is the ones that we said were systemic during the crisis, like AIG and GE Capital, they can't even say that they're systemic," said Bair, who is now a senior adviser to the Pew Charitable Trusts and heads the Systemic Risk Council, a private watchdog group focused on regulatory issues. "We seem to be able to decide in a nanosecond if it involves shoveling taxpayer money out the door to keep these guys afloat." Anthony Coley, a Treasury spokesman, referred to testimony by Mary Miller, the Treasury's undersecretary for domestic finance. On Feb. 14, Miller told the Senate Banking Committee that the council has taken "significant steps to designate and increase oversight of financial companies whose failure or distress" could hurt financial stability.

Sheila Bair

– Ian Katz

SEC Ban Would Challenge Auditors' Chinese Arms

Drew Bernstein, co-managing partner of U.S.- and China-focused accounting firm **Marcum Bernstein & Pinchuk**, said in an interview that Chinese companies face reputational challenges in the wake of the recent accounting scandals involving firms listed in the U.S.

"The situation you have right now is explosive because you have the SEC and the Chinese government on two complete opposite sides of the fence," Bernstein said. "The SEC's saying, 'If you want to play in our sandbox, you have to follow our rules,' and the Chinese government is coming from an angle of sovereignty – they don't want to give foreign powers the ability to come in and inspect their accounting firms. The SEC has its finger on the trigger of the nuclear option: it could take away the privileges of the big four in China to practice because they're not inspected and they don't want to turn over audit papers."

Bernstein said there would be "terrible" ramifications to both China and the U.S. "From the Chinese side, a lot of large companies would have to de-list because they wouldn't be able to have audited financial statements and industries such as the tech sector would lose an important source of funds," he said. "It wouldn't be very good for the U.S. either, because you would have to write off billions of dollars' worth of shareholder equity and you'd also be precluding yourself from participating in the world's second-largest economy."

The responsibility for the current situation doesn't just rest with Chinese companies, said Bernstein. "Closer to the truth is that the responsibility for what happened is a little bit broader," he said. "It rests with the whole system that dealt with them."

U.S. Securities and Exchange Commission spokesman John Nester declined to comment.

– Susannah Birkwood