

## **Give us a Break – Stop Legislating**

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### **Foreword**

*This paper aims to provide an illustration of how a complex process of excessive legislating has significant impacts on the banking and financial sector. We all know that following the 2008 financial crisis, the banking and financial sector is now among the most heavily regulated industries. The 2008 financial crisis may have been caused by deregulation in the financial industry, but what about now? We have witnessed an onslaught of legislation, as if this could be the answer to catching any flaws in the financial system.*

*With this paper, we seek to provide different perspectives on how excess regulation can have a negative impact on the banking and financial sector's business, on its ability to rapidly adapt its technologies to new developments and on financial stability as a whole. We also question how small banks, such as national or even international banks, which lack human resources and strive to reduce employee costs, will manage to survive the hurricane of legislation and comply with all its requirements. In view of increasingly demanding regulatory reporting requirements, their alignment with national and local specifications and interpretations must also be considered. National authorities and local governments are always tempted to add a little more "spice", further complicating the transposition processes and causing the non-uniformization of requirements between countries, what we may call "the big mess". For international banks with a global presence, this represents a big challenge, particularly when a horizontal transposition of a given requirement is demanded in the countries where they operate.*

*The three "visionaries" whose views are presented here come from three different fields of work, one is a general in-house counsel at an international bank, the other a partner at a law firm and the third a private banker with more than 24 years of experience in the banking industry.*

Banking regulation has always played a very important role in the markets and in society in general. The article "The Future of International Banking and Financial Law and Lawyers" published in *The Singapore Journal of Legal Studies*, in 2014, concluded that laws have a hierarchy according to their importance in society and attributed a central role to money, banks and corporations in promoting prosperity in modern societies; however, it also claims that "good law improves us all and bad or excessive law prejudices us all". This article sought to understand the growth of law from 500 BC to 2010 AD, relating it to the growth in population and wealth, while concluding that the growth of law had been exponential since 1830, most likely due to the global population explosion and resulting increase in wealth.

Another point of view argues that the appearance of new legislation is often related to periods of crisis. At the time of writing, the World Bank estimates negative world economic growth (GDP) in 2020 of around -4,3% as a result of the global health crisis caused by the Covid-19 pandemic. Previous crises have shown us that the flood of legislation usually arrives shortly after, as happened following the 2008 financial crisis.

In order to stabilise the global financial system, US authorities took several emergency actions, creating a “perfect storm” for new financial regulation. One of the most important measures in 2010, taken by the Obama administration, was the Dodd-Frank Act (also known as “The Act”), the most extensive revision of US financial regulation since the 1930s, which covered five main areas: consumer protection, the resolution authority, systemic risk regulation, the Volcker rule, and derivatives. In 2012, Standard & Poor’s estimated that Dodd-Frank could have reduced from 22 to 34 billion USD annually from the eight largest US banks and the private sector spent 24 million hours each year complying with the first 224 (out of 400) rules established by The Act. A 2018 survey, carried out in partnership with the OECD, of banks, insurance companies, asset management firms and capital markets executives concluded that institutions spend up to 10 percent of their annual revenue dealing with divergent regulations, most of which have been introduced since the financial crisis, with smaller companies facing disproportionate costs to keep up. This cost can reach 780bn USD across the world and could increase further now that the UK has left the EU, potentially resulting in greater regulatory divergence.

Another good example of increasing legislation in the financial world and its tremendous impact is the Basel Accord. After the 2008 crisis, the third version took immediate action and placed demands on banks’ capital and liquidity. This increased the cost of capital for banks and made borrowing more expensive and less accessible. The world saw banks increase their lending spreads, reducing lending growth and impacting on the economy. A few studies have shown us that regulators need to be mindful when implementing new regulation, seeing as there are negative effects on economies’ lending growth.

Economic theory tells us that when credit is cheap, companies tend to resort to larger lines of credit and to make larger investments, creating an effect of economic expansion. In contrast, if the cost of credit is higher, with the impacts of increased legislation mentioned above, we will have the opposite effect.

Legislation enactment is a complex process as there is a great number of steps involved and entities are called to opine on the matter. Even if the approval of a new piece of legislation is usually preceded by a public consultation process, the banking and financial sector still struggles to implement the hurricane of legislation and regulation from European Authorities and local governments. Local authorities also struggle to monitor and control the implementation of this legislation and to apply more enforcement actions than expected. Why is this happening? Could it be because we are in the middle of a transposition and another directive or regulation applicable to the same matter is already in the pipeline to be released for implementation? More importantly, how can regulators and governments adequately assess the changes in the regulatory environment caused by previous implementations when these regulations have not yet had time to solidify their foundations and reveal their effectiveness and level of compliance by all participants?

The market needs stability to assess the impact of legal measures and whether they achieved their intended goal before any further implementations are considered. The complexity in the transposition of directives has caused gaps between countries, sometimes creating markets business disruptions. Certain jurisdictions may become less attractive due to their intricate and highly complex regulatory requirements. This has led to the so-called “jurisdiction cherry picking” phenomenon, where market players work through local requirements to ascertain which jurisdiction is less burdensome in regulatory terms. A

proven example of this is the very recent Digital Finance Package published by the European Commission with the aim of ensuring consistent approaches among Member States.

Regulatory compliance has become one of the most significant banking industry challenges, as a direct result of the dramatic increase in implementation costs. Non-compliance may result in severe consequences for banks, with reputational and additional costs and risks. Credit institutions are now fostering an internal culture of compliance, implementing compliance structures and systems, and making investments in technology, to ensure that they are fully compliant with all present and future requirements. It is a non-stop investment and run against time to always remain on top of all regulatory requirements, since “*Speedy Legislation Gonzalez*” is just around the next corner. It seems that business is no longer the priority.

Another perspective on the effects of excessive legislation is that of an in-house legal counsel. Regulatory changes are the external factor that has most impacted the banking business, requiring constant overseeing of new requirements in order to secure business results, resilience and endurance. The contribution of value is ensured by the successful outcome of projects, strong advice in business transactions and other key organisational matters. The legal implementation of these rules is a complex process, involving different support functions and businesses, but regulatory compliance is crucial and a top priority for all organisations working in financial services, where legal plays a key role.

Every day, in-house counsels are faced with the challenge of providing feedback on an avalanche of internal requests while also keeping up with the applicable legal framework. It should come as no surprise that an in-house legal team is continuously required to validate solutions and sort out the factual matters faced by every bank as a matter of operation.

While this is true for the legal team, the same can be said for other core areas of a bank, including its compliance and IT teams. Banks, notably when compared with fintech and start-up entities, which are new to the market and usually benefit from less burdensome commitments when it comes to human staffing and available resources, will face more stringent demands every time new legislation and regulation is adopted. In order to comply with new legislation, they will need to adapt processes and internal procedures. When it comes to regulation imposing new reporting obligations towards any given regulatory entity, the challenge may be even greater, triggering all sorts of communication channels and levels of compliance that are not achievable from one day to the next.

All this comes at a very high cost. A cost which translates into hours spent on assessments, system adaptations and investments in new IT tools, rather than devoted to what banks should really be focusing on – providing credit and assisting customers in accessing such credit.

The struggle is that of creating mechanics to ensure that the legal and regulatory environment, and associated hurricane of obligations, does not put at stake banks’ core business.

The impact of excessive legislation on the financial sector is ultimately that of making access to capital more costly, as a result of the costs of compliance with the obligations arising from this excess.

Just think of the amount of legal fees incurred when a more complex financing structure is being put in place; the issuance of rated instruments is a straightforward example of this. To draft a prospectus including all legally required information and then also ensure that all investor-related documents are ticking all the required legal boxes certainly demands a huge amount of time and human resources, which obviously comes at a cost. This is particularly ironic considering that, in the end, those who actually read all the

documentation prepared are “only” the legal teams involved and judges – if the case ends up in court upon default.

At the same time, there is a real risk of financial market players “missing” pieces of relevant legislation and regulation and suffering adverse consequences as a result. Diplomas preceded by highly scrutinised public consultation processes may be more easily identified by the industry, but a great deal of regulation can go by unnoticed and be enacted without the awareness of market players. This is especially difficult when it comes to reporting obligations, which usually have demanding deadlines and limited transitional periods before their entry into force.

Then there is also the timing perspective. It is not uncommon for a diploma to enter into force and, immediately thereafter or simultaneously therewith, a new consultation process being launched for its amendment or replacement. It is hard to understand the real benefits of this. Should the addressees of such diploma tackle the one that has just entered into force or immediately start preparing for its new version? While this may not be the legislator’s fault, mechanisms need to be put in place to guarantee that we do not enter a massive vortex of legislation that ultimately renders all compliance programmes outdated at their core.

A real-life example of this is fintech related areas where start-up players are naturally faster in finding solutions beyond the existing legal framework. The principle that legislators should take a neutral approach towards technology is certainly welcomed, but it may not work when such technology creates products and solutions lacking the legal framework to guide interpretation. A very recent example is the European Commission proposal for a Regulation on Markets in Crypto-Assets, where players will now be left to deal with a number of new legal definitions not found in legal textbooks. This Regulation also cross-references to other EU Directives, creating a bundle of diplomas that need to be read together and require additional interpretation efforts which may be hard to fit into the daily life of an in-house lawyer.

This paper could also be read as a call for solutions that can assist legal teams in dealing with this legislative hurricane. Such solutions could be built on top of the current legal tech trend which is designing solutions that could also help tackle this issue. In our view, in-house lawyers would greatly benefit from any solutions providing continuous access to and assistance on the legislative framework in place at any given moment. For instance, a user-friendly database providing legal teams with updated information on the applicable legal and regulatory framework, would prove extremely useful. A research mechanism that could accurately provide the diplomas in force at any given time would also help save costs and time.

While there are already solutions similar to those described, they are still not sophisticated enough and struggle to process and identify the diplomas enacted and in place at any given moment.

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*Disclaimer: Our opinion is independent and shall not be linked to any statements or opinions of our entities.*

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