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"ESG: Everything Starts (with) Governance..."

Inverse relationships in financial services (FS)

Headlines

- The crisis at Silicon Valley Bank ("SVB") highlights the inverse relationship between interest rates and bond prices, and the effects of exposures to movements in bond prices.
- Does the crisis also illustrate an inverse or direct relationship between the prescriptive regulation of FS business and the likelihood of its growth, continuity or failure?

Key background

- A bond is an instrument with attributes relating to the security of capital / repayment and income streams. A bond holder will often receive a fixed annual sum ('coupon') but the saleable price of the bond will be determined by market conditions.
  - Where interest rates exceed the percentage value of the coupon on, say, 'Bond A', and other bonds are available with a coupon closer to that interest rate, the holder of Bond A may prefer or need to sell Bond A for another bond, but will need to discount Bond A's price to make it attractive to a purchaser.
- "... risk goes up when rules are relaxed ..."
  - This phrase (below, the "Edinburgh Maxim") was originally reported as part of insurance industry leaders' response to the UK government's 'Edinburgh Reforms' speech (see eg Financial Times ,18.12.22): "*of course risk goes up when rules are relaxed ... all of us in financial services and beyond should identify and manage those risks all the time ... The way to address risk is to understand ... and manage it, not necessarily to try and freeze it with immovable laws ...*"
  - The Edinburgh Maxim was cited in a Bank of England speech, 20.02.23 in the context of the Bank's recognition that Parliament may overrule its concerns about certain proposed insurance prudential de-regulation.

The direction of travel?

Given UK FS regulators' cautious approach to prudential risk, it is worth considering their view of the Edinburgh Maxim, not least as SVB's collapse has been linked to broader questions of governance. This is not to say that SVB's issues can also be found in UK FS firms, but regulators might seek to argue that certain common factors could be present – eg by following the analysis by the Global Association of Risk Professionals (GARP) in its article of 14.03.23:

- "... ***a disconnect between what*** **[SVB's management]** ***said on paper and their actions*** *...*

... an apparent lack of risk management oversight by the board and the risk team ... [despite] *a risk committee charter documenting all the components of risk management that should be in place ..."*

- *" ...* ***lack of risk expertise represented on*** *...* ***boards*** *...*

... Only one of the seven board members assigned to SVB's risk committee ... had any background remotely related to risk management ... [and] *none of the committee members ever held a senior risk management role, such as [chief risk officer -] CRO ...*

"... SVB was without [a CRO] *for about eight months in 2022* [until] ... *January* [2023] ..."

Why is this significant?

UK government policy is increasingly geared towards 'liberalising' FS regulation on the basis of an argument along the lines that regulations constitute, at least in part, red tape suppressing growth and competitiveness. Many in the FS markets support the government's aims.

Putting to one side the concept that any regulation might properly be described as an 'immovable law', it is notable that some in the insurance industry have highlighted how the existing framework of insurance prudential regulation has protected policyholders (see eg Why insurers weathered the gilt yields ... crisis ... | ABI).

SVB's collapse seems unlikely to assist arguments for de-regulation, and the policy-making tension between one person's 'red tape' and another's "rules-based regime contributes to ensuring ... safety and soundness even in stressed market conditions" seems likely to continue.

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