For some people in the financial industry, arbitrage is a label put on products to attract buyers. Especially in the credit market, so-called ‘regulatory arbitrage strategies’ seem to attract attention even before the characteristics of the strategy are known. For some other people, regulatory arbitrage is associated with a legalistic approach to regulation: exploiting loopholes in the law. And then there are people who contend that there’s arbitrage wherever they observe differences in regulatory treatment.

We think none of the abovementioned is a correct approach.

WHAT IS REGULATORY ARBITRAGE?
When we talk about regulatory arbitrage, we mean the structuring of a financial product in such a way that it brings about the lowest regulatory burden, both in terms of capital requirements and in terms of administrative burden, or that it even evades a regulatory regime. By focussing on the structuring of a financial product, we intend to stress the economic function of a specific transaction. E.g., both a credit insurance contract and a credit default swap (CDS) protect the buyer against losses due to the default of the counter-party; they perform the same economic function, although they are subject to different regulatory regimes. Taking out either the one or the other product for protection purposes is an exemplary case of regulatory arbitrage.

For the purpose of this article we will refrain from any considerations other than regulatory.

WHAT IS NOT REGULATORY ARBITRAGE?
Transferring assets within a financial conglomerate from the banking subsidiary to the insurance subsidiary is not regulatory arbitrage, because the assets have different purposes within different economic contexts. Take for example a corporate loan with a maturity of ten years that is transferred from the banking balance sheet to the life insurer’s balance sheet. The loan will receive a different regulatory treatment on each balance sheet driven by economic logic. On the bank’s balance sheet, the loan can be considered risky relative to the typically short-term liabilities of the bank. On the insurer’s balance sheet, the maturity of the loan comes close to the duration of the life insurance liabilities, so it will be relatively less risky in terms of interest rate risk.

INNOVATIONS DRIVEN BY REGULATORY ARBITRAGE
Arbitrage options provide a natural space for innovations to germinate. Merton Miller (1986) is often cited on this point: “The major impulses to successful innovations over the past twenty years have come, I am saddened to have to say, from regulation and taxes.” To this end we can distinguish between the following forms of arbitrage:
- evading a regulatory requirement within the same regime;
- shifting to another regulatory regime; and
- flying beneath the regulatory radar.

Below we will show examples of each form of arbitrage. Some of these are true examples of innovation.

EVADING A REGULATORY REQUIREMENT
The more rule-based regulation is, the more it is prone to loopholes. It will therefore come as no surprise that the Basel II capital requirements regime, which is essentially a rulebook which prescribes the capital requirement for each subcategory of assets, contains many loopholes. For example: as the capital requirements for loans are added up without taking into account risk diversification across loans, a bank will generally get a lower capital requirement if it transfers the portfolio of loans to a special purpose vehicle (SPV) and accommodates the SPV with a loan.

In insurance, regulatory arbitrage can be categorised in the following items:
- capital requirement for underwriting risk;
- absorb risks outside the lines of business;
- take away financial inefficiencies arising from regulatory standards.

Firstly, in insurance regulation, there are loopholes with regard to underwriting risk. An insurer is obliged to have adequate provisioning for underwriting risk, and must hold capital on top of the technical provisions. For example, if the insurer invests in a catastrophe bond instead of insuring the catastrophe risk via an insurance policy, there’s no capital requirement attached to it.

Secondly, financial instruments can also be used by life insurers and non-life insurers to evade the prohibition to sell insurance policies outside their own lines of business. For example, a non-life insurer may invest in securitised life insurance liabilities and thus will be exposed to life insurance risk.
Thirdly, financial instruments can take away financial inefficiencies for the insurer arising from regulatory standards. Two types of inefficiencies can be identified:
- conservative statutory reserve requirements;
- currently unrecognised balance sheet items.

Typical examples that take advantage of financial inefficiencies are triple X securitisation and VIF monetisation; see text box 1 and 2.

**TEXT BOX 1**
**TRIPLE X SECURITISATION**

In the USA, the Regulation XXX, effective from 2000 onwards, defines conservative statutory reserve requirements for term life insurance. Consequently the statutory reserves held for underwritten term life insurance are above the economic value of the underlying risk. This has led initially to off-shore re-insurance of these books on a large scale. More recently capital market structures have proven to be efficient. In these structures the excess liabilities above the economic value of the underlying risk are transferred to investors by means of an SPV thus releasing the excess reserves to the insurer at the cost of an interest charge.

**TEXT BOX 2**
**VIF MONETISATION**

Under current EU regulation, the 3rd Life Directive, VIF is not taken into account as a foreseeable asset and therefore the future profits (VIF) are valued as nil under current solvency regulation. As a consequence, VIF is not considered a part of the available capital for solvency purposes. However, in case of a VIF monetisation the assets increase by the amount of cash received from investors. If the repayment obligation of the insurer (be it a loan or reinsurance agreement) is agreed to be non-recourse and contingent only on regulatory surplus arising from the defined book, the repayment obligations are valued as nil under the regulatory regime. In this way the proceeds from VIF monetisation increase regulatory equity capital of the insurance company. Thus VIF as an off-balance sheet item, is transformed into full regulatory equity. A new type of, relatively simple, financial instrument creates a tangible asset for the insurer at capital market costs. The structure creates a floor for future profitability for a defined period (guaranteed by investors), the interest is tax deductible and any profit above principal and interest is retained by the insurer. It is therefore also referred to as tax-deductible Tier-1 capital.

**REGULATORY REGIME SHIFTING**

With the examples given above, we also have shown opportunities for regime shifting. The existing cases of regulatory arbitrage most commonly known, however, are not across sectors, but across jurisdictions, and are often caused by differences in tax treatment. Favourable tax regulation in Luxemburg and Ireland has attracted a lot of financial business to these places. Corporate governance regulation may also be a reason for regime switching. The state of Delaware in the U.S.A. is a famous domicile for companies that are not very fond of shareholder protection. We would expect that regulatory regimes that are open minded and have a good understanding of the business that is being regulated, would attract relatively more business.

Although there is a trend towards regulatory convergence, even the latest EU directives do not provide a 100% level playing field amongst the EU member states. The new banking directives, based on the Basel II framework, leave room for many national discretions. Also with respect to the pensions directive, different implementations in the member states of the EU leave room for competitive advantages; see text box 3.

**TEXT BOX 3**
**THE BELGIUM ROUTE FOR PENSION SCHEMES**

The implementation of the pensions directive in Belgium has attracted quite some attention in the Netherlands, because the Dutch government has not implemented the full range of possibilities of the directive and thereby left room for Belgium to create a competitive advantage. The EU pensions directive defines a common regulatory regime for IORPs, i.e. institutions for occupational retirement provision. In the Netherlands, the legal entity known as pension fund has some additional requirements and legal restrictions attached to it, compared to the IORP as defined in the EU directive. Dutch pension funds are prohibited from carrying out multi-employer schemes featuring ring fencing of the different pension schemes, whereas IORPs are allowed to do so, which make IORPs especially attractive for multinational companies. Dutch pension funds bear a heavier burden with respect to corporate governance requirements than IORPs do.

**FLYING BENEATH THE REGULATORY RADAR**

The last form of regulatory arbitrage is evading any regulatory regime. The hedge fund industry is a typical example of a non-regulated industry. There’s another side to the coin, however. The absence of regulation may lead to morally questionable practices. Sophisticated
investors understand that flying beneath the regulatory radar gives fund managers the freedom to maximise returns by exercising options which are unavailable to regulated businesses. However, freedom from strict reporting requirements presupposes a high degree of trust between fund managers and investors. The disadvantage of doing business with non-regulated entities is that the need for due diligence incurs higher information costs, next to the advantage of not incurring regulatory expenses. Reinsurance is another example of an industry that historically has not been regulated in a number of jurisdictions. Those jurisdictions apply the economic logic that the buyers and sellers of reinsurance are professional parties, hence they could do without the concern of a regulator.

ARBITRAGE PUT INTO PRACTICE

Now, what does it all mean in practice when we combine these regulatory arbitrage opportunities? Let’s assume a corporate entity wants to hedge its position against counterparty credit risk. In order to hedge the counterparty credit risk, the corporate entity can choose for instance to:
1. buy credit insurance from an insurance company; or
2. buy a CDS from a third party; or
3. securitise the credit risk by transferring it to an SPV for which third parties provide the capital in the form of securities (notes structured for different levels of risk).

The cost of the transaction is partly determined by the regulatory required capital. Under the current EU solvency regime this will be as follows for insurers and banks.
1. Credit insurance: the required solvency is at most 18% of the insurance premium. So if the premium equals 1% of the sum insured, e.g. for a BBB rated counterparty, the required capital is 0.18% of the sum insured.
2. CDS: the transaction does not incur a regulatory capital requirement if the CDS were sold by an insurer, as the CDS will show up in the investment portfolio and not in the technical provisions. A bank, however, would have to hold capital equal to 8% of the nominal reference value of the CDS, which is many times the insurer’s capital requirement.
3. Securitisation: an insurer buys securities from the SPV, for which no regulatory capital is required. The securities can be held as investments covering technical provisions.

CONSIDERATIONS

Does one need to worry about regulatory arbitrage? Let’s have a look at some pros and cons.

PROS ARE:
– regulatory arbitrage activities of market participants contribute to an efficient allocation of capital and thus to an efficient financial services industry;
– regulatory arbitrage may mitigate or eliminate the impact of market distorting regulation;
– it keeps regulators watchful with respect to achieving and maintaining a level playing field;
– it provides consumers with ample choice on the riskreturn continuum of financial products and services.

CONS ARE:
– regulatory arbitrage may undermine adequate capital coverage in financial markets;
– it may increase information a-symmetries which may frustrate market competition;
– the leaking of transactions to less regulated or unregulated markets may dry up market liquidity in regulated markets.

We think that regulatory arbitrage is linked to regulation as Siamese twins are to each other. It carries forward the spirit of innovation with it, and pushes financial markets to new boundaries of efficiency and product differentiation. At the same time regulators will strive to optimise the level of regulatory arbitrage in order to avoid moral hazard and systemic risk transfer to less regulated or unregulated markets.