

Global Trends In Financial Supervision and Regulation

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Introduction

Why discuss international trends in financial regulation and supervision?

All forces that affect regulation and supervision at an international level have an inevitable effect upon national economies.

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The Transition of Financial Markets – *Then and Now*

- Traditionally all types of financial transactions ranging from banking to securities trading involved face-to-face interaction between traders, within the physical confines of an institution such as the trading floor of a stock exchange.
- Financial transactions involved the exchange of paper stating the legal transfer of ownership between the parties concerned.
- These two activities coupled together meant a slow system and inefficient system with limited scope for financial market development..
- Regulation was moulded around these circumstances.
- Initially, regulators were merely observers of the trading floor. Monitoring traders was carried out with relative ease because participation was limited to certain individuals and because all transactions were limited to the trading floor, within allocated time durations.

- Developments in information technology during the second half of the last century however, opened the floodgates to a vast array of highly innovative financial products. The velocity of the fusion between markets and technology has revolutionized the structure and function of financial markets and continues to do so at present.
- These developments have led to a diversion in regulation, with the focus of regulation moving from individual traders to the financial institutions that governed their behaviour.
- Regulation has categorized financial markets into insurance, banking, retirement fund management, collective investment schemes and exchanges. This was achieved mainly through legislation and through the creation of separate regulatory authorities with jurisdiction over various groups of financial institutions.

This all seems in order. What is wrong with this system one may ask?

The glaring weakness with this system is that while it focuses on the institutional infrastructure of markets it ignores the technological infrastructure that underlies the financial systems of today.

Technology has created numerous dimensions to the way in which financial systems operate. In order to foster an efficient and resilient system of financial regulation, it is crucial to set the energy and innovative capacity of the financial sector within a framework of prudential oversight that ensures stable operation. It is also necessary to realize that regulation should respond to the realities of the financial market and not vice versa.the other way around.

Innovation and Deregulation

•Consequences for the financial sector.

The increasing pace of technological innovation (especially data processing and communication) and the growing acceptance of market processes as a basic determinant of resource allocation, are factors that affect the macro-economy. These factors have knock-on effects in the financial industry for two reasons.

Firstly, the financial sector is highly informative (prime innovations in recent years involve processing and transmission of information). Secondly, due to heavy regulation of the financial sector in the form of extensive price controls, high barriers to entry, competitive practices and inflexible portfolio composition.

The financial sector has undergone profound changes due to deregulation and innovation. As a result there are five key trends that are central to Regulation and Supervision. These are: Globalization and market integration, Securitization, increasing complexity of financial instruments, intensified competition and consolidation.

•Globalization

This is the increase in the level of financial transactions that take place between countries due to the lowering of barriers to entry between financial markets of different economies the world over.

Globalization ensures that capital flows to where it will be utilized best. When local institutions gain access to foreign markets it leads to a blurring of financial institution demarcations as they begin to deliver various forms of financial services distinct from their initial specializations.

Financial services are increasingly integrated and therefore, global. Prudential supervision should take account of these significant changes.

- **Securitization**

Securitization has two dimensions to it. The supply-side of securitization involves credit originating institutions such as banks parceling off chunks of their portfolio to ensure sufficient capital resources as a buffer against further lending activity.

On the demand-side of securitization, institutions such as pension funds and insurance companies receive continuous flows of funds in order to ensure that assets will be made marketable.

- **The increasing complexity of financial instruments**

This factor too, is driven by supply and demand. For instance, technological advancements in the processing of information, such as the development of the option pricing theory, have facilitated independent pricing of risk factors that were previously inseparable within the same instrument. Simultaneously, intensification of financial intermediation has given rise to an explosion in the demand for hedging (and position taking) instruments.

The introduction of new financial instruments have led to tremendous improvements in risk-management techniques. As a result, financial institutions can at present facilitate much greater levels of real and financial investment.

However, these instruments must be used with caution for they have the potential to cause significant losses if used with the lack of sufficient knowledge or if used as a deliberate leveraged bet.

- **Enhanced competition**

Deregulation and privatization are the prime means through which competition within the financial industry is enhanced. In addition to these factors, alternative factors such as the need for increased shareholder wealth have led to financial institutions such as banks becoming more stringent on risk-adjusted rate of return on equity.

The benefits of this type of activity are the more resourceful use of capital funds and the availability of cheaper financial services to end-users.

The downside of this is that there is less of a cushion against bad luck or bad judgement. Franchise values are much smaller and so the erosion of capital can lead to liquidation much faster than before. As a result, financial institutions are now more inclined to accept unwarranted risks in order to survive.

- **Consolidation**

Though consolidation has been occurring within national markets and within particular market sectors, we could expect to see increasing levels of cross-border mergers and alliances, as well as the formation of groups spanning different financial activities.

Examples of such activities may be commercial banking, fund management, insurance and investment banking.

It is not yet apparent however, whether this trend toward consolidation will be uniform for there is still much scope for specialist service providers.

•Regulatory and supervisory implications

The trends discussed above determine the level of focus of supervision and the ways of allocating supervisory responsibilities. Some of the implications are as follows:

1. The allocation of supervisory responsibilities.
2. The quest for greater risk-sensitivity.
3. The increased use of supervisory oversight and market discipline.
4. The importance of financial infrastructure.
5. The need for a level playing field.
6. Marrying the micro- and macro- perspectives in regulation and supervision.

The allocation of supervisory responsibilities

The question of where the authority for the supervision of financial institutions should reside is now the subject of intense debate. Until recently, in most countries, it was the central bank that was held responsible for supervision. However, countries such as the UK and Japan are seen to be diverting from this model by forming a single financial regulator that is independent from the central bank and political influence.

This model of financial market supervision was adopted due to two reasons. Firstly, since there is an increasing demarcation between the different types of financial institutions, it is more practical to integrate the supervision of all financial institutions in a single agency. Secondly, forming a separate financial regulator avoids the presumption of extending lender-of-last resort privileges. This in turn allows central banks to focus upon the objective of price stability.

Simultaneously, it is desirable for monetary and prudential regulation to work together particularly during times of financial market distress. For economies with resources in short supply, the skills, experience and status of the central bank can be a valuable asset in assuming independent and rigorous supervision.

The quest for greater risk-sensitivity

Management of risk in financial institutions consists of three elements:

- Accurate measurement and monitoring of risk.
- Controlling and pricing exposures.
- Accumulation of adequate capital and reserves to meet unexpected losses.

Supervision over recent years has concentrated on these aspects.

Numerous papers have been published by the Basel committee to provide guidance on how to best practice the management of various risks such as credit risk, interest rate risk, market risk etc that financial institutions face. Supervisors are also refining the measurements on retaining adequate levels of capital to act as a buffer against these risks.

Two further Improvements have been made to the 1988 Basel Accord. Firstly, the measurement of risk weights has been refined in order to be more reflective of the actual level of risk. Secondly, the new accord introduces two additional 'pillars' concerning capital adequacy, supervisory review and market discipline.

The increased use of supervisory oversight and market discipline.

Contrary to the title of the presentation, a significant trend in recent times, is the move away from regulation and move towards supervision. i.e. this involves an assessment of whether the management of financial firms' undertakes prudent business activity.

There is also a need for financial disclosure as a means of allowing markets and counterparties to better control excessive risk acceptance. Supervisors are required to be knowledgeable on all aspects of the business activity of financial institutions and to foresee the multiple sources of risk they are likely to encounter. Present day supervisors are required to understand the business of financial institutions and to draw the attention of management to under-appreciated sources of risks.

The importance of financial infrastructure.

Efficiency and stability of the financial sector depends both on prudential standards and on the robustness of the financial infrastructure that underpins financial transactions. Examples of the latter would be accounting standards used to value financial assets, payment and settlement system, etc.

Even the most stringent supervision can become useless if operated under faulty financial infrastructure. With regard to insolvency arrangements for instance, all contracts should foresee the possibility that one party is unable to perform under the contract and that this gives the other party a predictable and timely recourse.

The need for a level playing field

Globalization of financial activity makes a global approach to financial supervision essential. Absence of global supervision leads to dangers of competition in laxity and regulatory arbitrage.

Competition in laxity occurs as a result of jurisdictions consciously lowering regulatory requirements in order to attract businesses. Regulatory arbitrage occurs when financial institutions seek jurisdictions that carry the lightest levels of regulation.

One solution would be to set up a world financial authority that is delegated the power to set and enforce regulations on a global scale. However, there is much doubt as to whether such an approach is feasible and desirable. The approach also becomes unworkable since there is only a limited chance of sovereign legislatures ceding powers in the regulatory area to a supranational body.

The Basel Committee's proposals on banking supervision outline standards that can be followed by supervisors in most advanced jurisdictions. Adherence is triggered through peer pressure and market forces. Considering the fact that the Basel committee is neither backed by a formal legislation, nor has a legal existence it is remarkable that the Basel proposals carry such weight.

Marrying the micro- and macro- perspectives of regulation and supervision.

Monetary authorities are seen to be responsible for Macro-economic stability while prudential regulation is seen to be responsible for the micro-economic stability of the financial sector. These policies are complex and intertwined and thus cannot be considered in isolation.

Financial instability is generally the result of macroeconomic factors. Systemic risk occurs due to banks being jointly exposed to macroeconomic shocks which are linked to the financial cycle. Thus supervisors concentrate on developing techniques that make banks resilient to the financial cycle.

Banks must accumulate capital during profitable times in order to ensure protection against lending during times of un-favourable economic conditions. Such prudent conduct makes

banks resistant to loan losses and thus reduces the risk of financial distress. Examples of such techniques include stress-testing, pre-provisioning, etc. Pillar two of Basle Committee deals with the strengthening of the supervisory review process and is expected to enhance these practices.

Monetary authorities are expected to recognize the two-way relationship between monetary and financial stability. Excessive credit expansion causes future financial instability through increased gearing. High gearing exposes the institution to risk of large losses at an economic downturn. Monetary policy must mitigate the risk of accumulating excessive credit expansion and the resulting unsustainable rise in asset prices..

New Approaches To Regulate Financial Markets And Participants.

Sarbanes-Oxley Act

- This is probably the single most important piece of legislation affecting corporate governance, financial disclosure and the practice of public accounting since the U.S. securities laws of the early 1930's.
- Sarbanes-Oxley contains many advances for corporate governance, although it also represents what formerly would have been an unimaginable immersion of the U.S. Federal government into the corporate governance arena.
- Fundamentally, the Act acknowledges the importance of stockholder value, strengthens the role of directors as representatives of stockholders and reinforces the role of management as stewards of the stockholders' interest.
- A lesson from the recent corporate failures in the USA is the importance of corporate culture and a CEO's tolerance or lack of tolerance for ethical misdeeds. The CEO's business philosophy conveys a great deal throughout the organization.
- One of the most significant aspects of this Act is the expanding role and responsibilities of audit committees. The audit committee must be responsible for the outside auditor relationship and must be 'independent' from company management.

IAS 39

IAS 39 applies to financial instruments and discusses the recognition and measurement of such instruments in order to ensure fair value reporting.

Requires financial assets to be classified in one of the following categories:

- Financial assets at fair value through P& L
- Available for sale financial assets
- Loans and receivables
- Held to maturity investments

Recognizes two classes of financial liabilities:

- Financial liabilities at fair value through P&L
- Other financial liabilities measured at amortized cost using the effective interest method.

Impairment is discussed and measured as the difference between the assets' carrying amount and the present value of estimated cash flows discounted at the financial assets' original effective interest rate.

Basel II

- **Enhances** the 1988 Accord by providing greater risk sensitivity and using internal credit ratings.
- **Reform** was necessary due to crude credit risk measures in the 1988 Accord (eg, loans to AAA-rated US corporates require more capital than loans to BB-rated foreign banks).
- The primary **impact** will be on Credit Risk RAP assets. Under the **A-IRB** (Advanced Internal Ratings Based) approach, banking organizations will be allowed to use internal models for key statistical data: credit ratings (“probability of default” or **PD**); “loss given default” (**LGD**) to reflect recoveries, collateral, etc.; and “exposure at default” for un-drawn commitments, etc. (**EAD**). This A-IRB approach will be mandatory for top-tier **US banks**. Bank Supervisors must approve the internal models.
- However, the actual **capital required** will still be set by Basel. Mandated formulas will use internally-generated data (PD, LGD, EAD) as inputs.
- The goal is to more closely align the banks’ regulatory capital with banks’ actual risk exposure and to provide incentives for adopting more advanced risk management practices and technologies, including those used for (internal) **economic capital**.

Basel II – new requirements

Establishes three formal “pillars” of supervision for internationally active banks.

- Pillar One - Minimum capital requirements similar to that of Basel I except that the credit risk calculation will be reformed and a new charge for Operational Risk will be added. (Generally, banks expect that the reduction for credit risk will offset the increase for Op Risk. Fed statistics show 2% average net drop in required capital, but with wide dispersal.)
- Pillar Two - Establish formal bank supervision standards (ie, more rigorous). Addresses credit concentrations, interest rate risk (banking book) and business cycle effects in addition to compliance with Pillar 1.
- Pillar Three - Public disclosures to enhance market transparency. Specific list includes composition of loan/credit portfolios by risk rating and detailed risk parameters for each risk-rating category.

Conclusion

Prudential regulation is increasingly more complex, demanding and innovative. It combines multiple disciplines in an attempt to harness market forces and thus enhance market stability.

The New Basel Capital Accord is one manifestation of this evolving approach. It encompasses greater risk sensitivity, flexible supervision and more resilience to market disciplines. It contributes to the objective of an increasingly efficient and resilient financial system that benefits all.