



# Global Trends In Financial Supervision & 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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### Order of Topics Covered

- I. The Transition of Financial Markets – *Then and Now*.
- II. Innovation & Deregulation
  - Consequences for the Financial Sector
  - Globalisation
  - The increasing complexity of financial instruments
  - Enhanced competition
  - Consolidation
  - Regulatory and supervisory implications
- III. The allocation of supervisory responsibilities.
- IV. The quest for greater risk-sensitivity.
- V. The increased use of supervisory oversight and market discipline.
- VI. The importance of financial infrastructure.
- VII. Marrying the micro- and macro- perspectives in regulation and supervision.
- VIII. New approaches to regulate financial markets and participants.
- IX. Conclusion

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### The Transition of Financial Markets – Then and Now

- Traditionally all types of financial transactions involved face-to-face interaction between traders within physical confines of an institution such as the trading floor of a stock exchange.
- The financial market activities were slow and inefficient with limited scope for development of financial markets.
- Regulation was moulded around these circumstances.
- Initially regulators were observers of the trading floor.
- Monitoring of traders was done with relative ease since participation was limited and transactions took place on the trading floor within allocated time durations.

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### The Transition of Financial Markets – Then and Now contd...

- Developments in information technology opened floodgates to a vast array of highly innovative financial instruments.
- The fusion between markets and technology over the years revolutionized the structure and functioning of financial markets.
- These developments lead to a diversion of regulation from individual traders to regulation of financial institutions.
- Regulation categorized financial markets into insurance, banking, retirement fund management, collective investment schemes and exchanges.
- This was primarily achieved through legislation and creation of separate regulatory authorities with jurisdiction over various groups of financial institutions.

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

- The weakness is that focus on institutional infrastructure of markets ignores the technological infrastructures that underlies the financial systems of today.
- Technology has created numerous dimensions to ways in which financial systems operate.
- In order to foster an efficient, resilient and stable system of financial regulation it is crucial to set the energy and innovative capacity of the financial sector within a framework of prudential oversight.
- Realization that regulation should respond to the realities of the financial market and not the other way around, has been a significant trend being encouraged to ensure an efficient and resilient system of financial institutions.

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## Innovation and deregulation

### Consequences for the financial sector

- The financial sector has undergone profound changes due to deregulation and innovation.
- Five such key trends that are central to Regulation and Supervision are: Globalisation and market integration, Increasing complexity of financial instruments, Intensified competition and consolidation.

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### Globalisation

- It is the increased level of financial transactions that take place between countries in a global scale due to lowering of barriers to entry between financial markets of different economies.
- Globalisation ensures capital flows to where it will be best utilised.
- Thus local institutions will gain access to foreign markets and lead to a blurring of financial institution demarcations as they begin to deliver various forms of financial services distinct from their initial specialisations.
- Financial services is increasingly integrated and therefore global. Prudential supervision should therefore account for these significant changes.

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### The increasing complexity of financial instruments

- Intensification of financial intermediation has given rise to an explosion in demand for derivatives.
- Globally, we have seen an improvement in risk-management techniques of derivatives in the past few years.
- Thus financial institutions can at present facilitate much greater levels of derivatives and position taking.
- These instruments must be used with caution since use of such instruments with lack of sufficient knowledge or as a deliberate leveraged bet, has the potential for causing significant losses.

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### Enhanced competition

- Deregulation and privatization are the prime means aimed at enhancing competition within the financial industry.
- In addition, factors such as the need for increased shareholder wealth have caused financial institutions to be more stringent on risk-adjusted rate of return on equity.
- The benefits flowing from such activity are, more resourceful use of capital funds and cheaper financial services to end-users.
- The disadvantage is that there is now less of a cushion against bad luck or bad judgement.
- Thus financial institutions are now more inclined to accept unwarranted risks in order to survive.

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### Consolidation

- In the future we could expect to see increasing levels of cross-border mergers and alliances, as well as the formation of groups spanning across different financial activities.
- Examples of such activities may be commercial banking, fund management, insurance and investment banking.
- However it is not yet apparent whether the trend toward consolidation would be uniform.

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### Regulatory and Supervisory Implications

- The trends that were discussed above determines the level of focus of supervision and ways of allocating supervisory responsibilities.
- Six of such 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. Marrying the micro- and macro- perspectives in regulation and supervision.

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### The Allocation of Supervisory Responsibilities

- The question of where authority for supervision over financial institutions should reside is now the subject of intense debate.
- In most countries, it was the central bank that was held responsible for supervision. Yet countries such as UK and Japan have diverted from this model by forming a single, independent, financial regulator.
- This form of model was adopted due to two reasons.
  - Since there is increasing demarcation between different types of financial institutions it is more practical to integrate the supervision of all financial institutions in a single agency.
  - Forming a separate financial regulator avoids the presumption of lender-of-last resort privileges being extended. Thus allowing central banks to focus upon the objective of price stability.
- Simultaneously, it is desirable for monetary and prudential regulation to work together particularly at times of financial market distress.
- For economies with resources in short supply, 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 consist 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.
- The Basel Committee has made numerous publications providing guidance to best practice in management of various risks faced by financial institutions such as credit risk, interest rate risk, market risk, etc.
- Supervisors are also refining 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:
  - **The measurement of risk weights is refined to be more reflective of the actual level of risk.**
  - **The new accord introduces two additional 'pillars' concerning capital adequacy, supervisory review and market discipline.**

### The Increased Use of Supervisory Oversight and Market Discipline

- A significant recent trend is the move away from regulation and 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 increased financial disclosure.
- Supervisors are required to be knowledgeable on all aspects of business activity of financial institutions and to foresee 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 upon both prudential standards and robustness of financial infrastructure that underpins financial transactions.
- Examples of the later 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.

### Marrying the Micro- and Macro- Perspectives in Regulation and Supervision

- Monetary authorities are seen to be responsible for Macro-economic stability while prudential regulation is seen to be responsible for micro-economic stability in financial sector.
- These policies are complex and intertwined thus cannot be considered in isolation.
- Financial instability generally is a cause of macroeconomic factors.

### Marrying the Micro- and Macro- Perspectives in Regulation and Supervision contd...

- Banks must accumulate capital at profitable times to ensure protection against lending at unfavorable economic conditions. Such prudent conduct makes banks resistant to loan losses and reduces the risk of financial distress.
- Examples of such techniques include stress-testing, pre-provisioning, etc. Pillar two of Basle Committee on strengthening of the supervisory review process 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 risk of accumulating excessive credit expansion and the resulting unsustainable rise in asset prices that follows.

**New approaches to regulate financial markets and participants.**  
**Sarbanes-Oxley Act**

- Affects 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 immersion of the U.S. Federal government into the corporate governance arena.
- Fundamentally, the Act acknowledges the importance of stockholder value and 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 of ethical misdeeds. The CEO's philosophy of business conveys a great deal throughout the organization.
- One of the most significant aspects of this Act is expanding the role and responsibilities of audit committees. The audit committee must be responsible for the outside auditor relationship and must be 'independent' from company management.
- Section 404 of the Act requires a management assessment of internal controls with specific action plans to cover gaps if any.

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**IAS 39**

- IAS 39 applies to financial instruments and discusses its recognition and measurement 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 cashflows discounted at the financial assets' original effective interest rate.

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**Basel II**

- Enhances the 1988 Accord by providing greater risk sensitivity and uses internal credit ratings.
- Reform is 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 undrawn 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 closer alignment of bank 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.

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**Basel II – new requirements**

- Establishes three formal "pillars" of supervision for internationally active banks.
- Pillar One - Minimum capital requirements similar to 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.

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**Conclusion**

- The concern about safety and soundness of the financial system has made prudential regulation increasingly more complex, demanding and more innovative.
- Developments in information technology, the proliferation of financial markets, the blurring distinction between financial institutions and the continuous barrage of new product innovations have placed financial services in a state of perpetual flux.
- This more competitive and dynamic environment may not be compatible with traditional regulatory structures, including deposit insurance, limits on permissible activities and controls such as intrusive capital and liquidity reserve requirements.
- Though traditionally bankers and regulators worked in concert to safeguard the financial services sector, at present, role of regulators and supervisors are generally limited to only setting and verifying compliance with the certification requirements.
- Timely intervention in the case of non-compliance should be the primary objective of supervision.

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**Conclusion conti...**

- Much publicized internal control failures in recent years clearly point at the importance of internal supervision.
- The common feature for the regulation of transition and other emerging economies should be increased disclosure and transparency, and strengthened incentives (through personal liability, for instance) of the owners and managers.
- 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.

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