REVISITING REGULATORY REGIME FOR THE FINANCIAL INDUSTRY

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Why change the Regulatory Regime?

- US and European Financial Systems were badly affected by the recent Global financial crisis and trillions of public tax dollars had to be poured into the system to avert a complete collapse.

- The banks in Europe particularly in Spain, Greece, Ireland and Portugal are still not out of woods despite generous support from the European Central Bank in the recent months.

Why change the Regulatory Regime?

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- Financial systems in Canada, Australia and New Zealand were least affected despite their close integration into the global system.

- Emerging and Developing Economies (EDEs) particularly China, India, Turkey, Indonesia, Brazil, Pakistan survived the onslaught and their economies rebounced fairly quickly. Although, Eastern European Economies did suffer

Salient Features and Lessons Learnt

- The question therefore arises as to what were the salient features that distinguished the US and European systems from those in Canada, Australia and New Zealand and the EDEs and what are the lessons learnt?

- First, Bank lending forms the bulk of financial sector lending in EDEs and Capital markets are not so well developed unlike the US and Europe. The contagion risk and transmission effect of an interconnected world capital markets in the EDEs remained muted.

Salient Features and Lessons Learnt

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- Second, Asian countries had learnt the hard way from the crisis they faced in 1997-98. Prudent macroeconomic management, credibility of policy makers, open trading and investment regimes, accumulation of sufficient foreign exchange reserves combined together to maintain an enabling environment for growth and stability.

Salient Features and Lessons Learnt

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- Third, the banks in EDEs relied upon low cost and stable deposits for financing their assets rather than wholesale funding that was volatile and expensive. This permitted maturity transformation, ample liquidity to the system and preserved confidence among investors. In the US and Europe, abrupt withdrawal of wholesale funds led to a vicious cycle of distressed sales of assets, falling asset values, shortages in capital adequacy and difficulties in raising fresh capital from the private sources.

Salient Features and Lessons Learnt

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- Fourth, the Central banks in EDEs had developed the capacity to draw the rules of the game and enforce them in a way that was orderly and least disruptive. The quality of banks' portfolio had improved as a result of the Central banks vigilance and continuous watchdog monitoring. Mark-to-Market accounting, loan-loss provisioning and capital infusion helped the strengthening of the banks.

Salient Features and Lessons Learnt

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- Fifth, the bank lending in EFEs avoided exotic products such as derivatives, loans to hedge funds, private equity, credit default swaps. Capital infusion from time to time helped strengthen the balance sheets.

- Sixth, partial capital controls and lack of full capital convertibility in China, India, Pakistan, did not allow large exposure to foreign currency denominated assets. The market share of the large financial conglomerates was kept limited by design and therefore direct exposure of the significantly important financial institutions was quite low.

Salient Features and Lessons Learnt

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- Seventh, as the markets in EDEs are generally considered imperfect or incomplete and market failures loom large on the horizon the intellectual foundation of contemporary financial theory – efficient market hypothesis – did not assume a pivotal role as in the developed markets and therefore, did not lead to the widespread belief and practice that Market is self correcting and therefore, a hands-off approach is required by the regulators.

The Role of Regulatory Failure

- There are multiple factors that have been used to explain the genesis of Global financial crisis but influential researchers have attributed the major cause to regulatory and governance failure.

- Ross Levine has argued that there was a fatal inconsistency between a dynamic financial sector and a regulatory system that failed to adapt appropriately to financial innovations such as securitization, collateralized debt obligations and credit default swaps. "The inability or unwillingness of the governance, apparatus overseeing financial regulation to adapt to changing conditions allowed these financial innovations to metastasize and ruin the financial system".

Principles underlying Regulation

- Financial Regulations in a country have to be embedded in the overall macroeconomic environment, market structure, depth of financial sector, strength of financial institutions, and the nature of financial structure.

- The regulatory framework has to be designed keeping the above considerations in mind. At the same time the framework has to be forward looking providing ample room and scope for regulating financial innovations in form of new products, processes, services or technological solutions.

Principles Underlying Regulation

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- The test of an adequate and satisfactory regulatory framework is that is can ensure financial stability by reducing the probability of bank failures and the costs of those that occur. It should be primarily aimed at altering the behavior of regulated institutions because unconstrained market behavior tends to produce socially sub-optimal outcomes.

Strategy for Revisiting Regulation

- In addition to the Capital adequacy and liquidity requirements recommended under Basle III the integrity of regulatory mechanism has to be preserved. Multiple and overlapping jurisdictions with varying objectives and mandates dilute and diffuse the effectiveness and efficacy of regulation and promote regulatory arbitrage. Joint inspections and supervisions by multiple agencies have usually not been able to produce the desired results despite well intentioned efforts. The lessons from U.K. consolidating financial sector regulation and supervision under FSA and then reverting to the Bank of England should prove useful.

Strategy for Revisiting Regulation
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- 'Shadow Banking System' that was loosely regulated in the U.S. and other countries was responsible for damage to the financial system should be brought under a strong and effective regulatory framework.

- European Central Bank and other Europe-wide regulatory institutions have to work together to achieve union-wide financial stability. The current fragmentation in the approach by national and EU regulatory agencies has to be replaced by a consolidated approach along with better enforcement.

Strategy for Revisiting Regulation

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- Volcker Rule that strips off Proprietary Trading from Trading on behalf of clients in the portfolio of Commercial banks should be used as a good practice by other national regulators.

- The competitiveness of the financial markets particularly the banking system can be enhanced by lowering entry barriers, abolishing interest rate ceilings, privatizing government owned banks, promoting mergers and acquisitions that weed out weak banks, enlarging the economies of scope for banks, liberalizing bank branch policy and removing directed credit allocations.

Strategy for Revisiting Regulation

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- In the realm of strengthening financial institutions, incentive structure is to be realigned so that the bank owners stand to make substantial losses in the event of partial or complete insolvency arising from excessive risk taking. Limiting bank holding of highly risky assets, preventing lending to related parties, requiring diversification and making sure the banks have appropriate credit appraisals, evaluation and monitoring procedures in places.

Strategy for Revisiting Regulation

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- A mechanistic and automatic adoption of the credit rating agencies' evaluation of the Financial institutions' creditworthiness and strength should be given up by the regulators. The SEC requirement that credit risk assessment of these agencies should be used in establishing capital requirements should be dispensed with. Multiple indicators including frequent stress-testing results should be used in forming the judgment about a financial institution.

Strategy for Revisiting Regulation

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- The crisis revealed that the models used by the banks and financial institutions to capture the real systemic risks were either flawed or inadequate. The behavioral relationship based on the past observed data proved to be unstable or invalid under the pressure points triggered by the crisis. Risk management practices have to be rethought through and revamped to avoid the pitfalls faced in 2008-09

Strategy for Revisiting Regulation

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- Corporate governance code and best practices have to be implemented by the financial institution under regulatory vigilance. Adverse selection in bank entry should be avoided and the individuals or groups likely to misuse bank are not granted bank licenses. Fit and proper criteria and character antecedents, financial back-up and past track record have to be scrutinized carefully in respect to the strategic investors, controlling shareholders, directors of the Boards, Chief Executives and Senior Management of the banks.