# Designing an effective financial regulatory architecture for the future

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It is well accepted that a period of deregulation and inherent weaknesses in the financial regulatory system, contributed in no small way to the current global financial and economic crisis. Dating back from 1971 when the Bretton Woods system of fixed exchange rates was dismantled, effectively allowing capital to flow freely from one country to another, to the abolition in 1999 of the Glass-Steagall Act, which effectively allowed the more risky investment banking to mix with the more conservative commercial banking, deregulation and or the lack of a strong regulatory framework allowed a build up of risk and asset bubbles in the world's financial system, paving the way for the crisis we are experiencing today.

In the last decade there was the largely unregulated growth of the market for securitised instruments, derivatives and credit default swaps. A common characteristic of these instruments is that a small initial position could easily lead to a much larger exposure, making it difficult for regulators and risk managers to keep track of a firm's true exposure. By no means is this to suggest that deregulation/weak regulation was the only suspect in the crisis. Indeed, the availability of cheap money, heavy savings in Asia, complacent and at times negligent rating agencies all had their part to play, not to mention the overzealous bankers, less-than-honest borrowers and selfish politicians.

Without a doubt, financial markets have become more global, complex and interdependent in the last few years. Laws and regulations therefore must change in tandem and indeed what is needed going forward is a new global financial regulatory architecture. The recent failures of a couple of large financial conglomerates in the Caribbean have put the spotlight on our own need to accelerate our regulatory reform in the region. As each country in the region goes about doing this, it is important to remain plugged in to the evolution of the global architecture that is taking place, so as to ensure our efforts are well coordinated and directed and consistent with the general direction of the rest of the world.

## Evolution of reforms

In direct response to the global crisis, several regulatory reform proposals were advanced, including:

- Limit the use of leverage
- Curb innovations in new instruments
- Require securitisers to retain exposure to the instruments they create
- Require more balance sheet disclosure of derivatives and risk positions so lenders can more easily identify weak borrowers
- Give regulators more discretion to prevent banks from pursuing business models that pose systemic risk

- Consolidate off-balance-sheet activities
- Prevent banks from certain off-balance sheet entities
- Raise capital requirements in general and adjust prudential reserves as needed to rein in rapid loan growth
- Require banks to put away billions in "generic provisions" in good times to prepare for bad

The list goes on but many of the measures proposed were of a heavily prescriptive nature and ran the risk of stymieing future growth, innovation and competitiveness. Other proposals insisted that we maintain the market discipline approach of principles-based regulation rather than rigid rules. The strict reliance on market discipline however has been proven flawed over the years. **As a fundamental design principle therefore going forward, what is needed is an approach that provides the right balance between the strict prescriptive rules-based approach and the overly vague principles-based approach.** This no doubt is easier said than done and makes the task more an art than a science.

**Global Regulator**

After the crisis hit, there were also calls for a global regulator. This idea was quickly abandoned after China and the US objected that a global enforcer would infringe on national sovereignty. Other proposals were then considered, a key one being better coordination between the IMF, the Financial Stability Forum (FSF), an international organisation established in 1999 and composed of senior representatives of national financial authorities, and the G20 to provide an early warning system of threats to the stability of world markets. But this quickly became a Catch 22 because without a global enforcer, warnings could go unheeded if individual countries decide that an activity that happens to increase systemic risk is in their best interest.

**International Harmonisation**

International harmonisation of national regulation was also a popular topic. Indeed in April 2008, the FSF made 67 recommendations for rendering regulatory frameworks more consistent among countries with respect to prudential oversight, use of credit ratings, and responses to stress in the financial system. Harmonisation, however, is not easy to achieve in practice and can never produce complete uniformity in rules, because local conditions vary and individual countries have differing capacities for implementation. Without some form of uniformity, regulatory arbitrage can easily occur. All that is required is for aggressive firms, when faced with new regulation, to simply move their registrations to less restrictive jurisdictions, and potential threats to world financial stability will remain.

The communiqué from the November 2008 G20 summit called for greater and more formalised collaboration between regulators in different countries regarding the health of internationally active financial institutions. This "College of Supervisors" idea is a good

one but not a new one as it has already been used for example in the Basel 2 framework and in the European Union.

**Systemic Risk Regulator**

But perhaps the most significant development came at April 2009 meeting of the G20 – the decision to regulate risk at the systemic level. The thinking here is to take an integrated approach for banking, insurance, securities, derivatives, hedge funds, and beyond, to identify and manage risk systemically. A systemic risk regulator would register and approve new products, supervise prudential ratios, mandate public reporting of newly important institutions and instruments and basically be charged with the responsibility of deflating asset bubbles early in the game. While this approach on the surface makes a lot of sense, it too is not without its share of challenges – ability to precisely define and accurately measure systemic risk. Any definition will have to include leverage, liquidity, risk, concentrations, and sensitivities to market prices and economic conditions. Measuring systemic risk will require the collection of more data from a wider range of institutions ranging from insurance companies to off-balance sheet SIVs (special investment vehicles). As it is now many large institutions have a problem keeping up with timely compilations of their risk positions, counterparty exposures and liquidity information. Regulating systemic risk is therefore a move in the right direction but it will be fraught with data challenges.

**Increased Regulation of Credit Rating Agencies**

The G20 in April 2009 also agreed to replace the FSF with a Financial Stability Board with a strengthened mandate, and recommended robust regulation of credit rating agencies. Under the new regime, all credit rating agencies whose ratings are used for regulatory purposes should be subject to regulation, including registration. The regulatory oversight regime should be consistent with the IOSCO Code of Conduct. In particular, rating agencies should differentiate ratings for structured products and provide full disclosure of their ratings track record and the information and assumptions that underpin the ratings process. The G20 also called on the accounting standard setters to improve standards for valuation and provisioning and endorsed major changes in executive compensation, calling for regulation to ensure that compensation structures are consistent with firms' long-term goals and prudent risk taking.

**Conclusion**

As seen above, a new framework for global financial regulatory reform is evolving and measures put forward are targeted at addressing systemic risk, providing greater protection for consumers and investors, eliminating gaps in the regulatory structure and fostering international coordination. Fundamental design criteria going forward for any new regulatory architecture should speak to:

- Safety and soundness of financial markets with greater emphasis on liquidity risk management

- Business conduct based on transparency and fair dealing
- Efficiency and cost-effectiveness by aligning responsibilities among different participants across the marketplace
- Consistency of regulation across similar businesses
- Internationally consistent standards and coordinated enforcements
- Promotion of credit ratings that are analytically sound, independent and unbiased

Further, given the rate at which market players develop new products, or wrap existing products in new packaging, two key features that cannot be overlooked in any modern design are adaptability and flexibility. As such, to complete the design criteria, I would add:

- Adaptability to accommodate future innovations and changes in market structure
- Flexibility to foster fair competition to benefit investors

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