REREGULATION, OPPORTUNITIES FOR INTEGRATION OF REGULATION IN THE BANKING AND FINANCIAL SECTOR

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Way forward for regulation. Is it deregulation,. re-regulation, integration or all ?

Background

Bank regulation and regulators are a much maligned lot in the current global financial scenario. The financial crisis for the most part in the world is blamed on regulators, regulations and the regulated institutions. In this context findings reveal that regulation is fragmented, inconsistent, uncoordinated and as a result ineffective. This article seeks to ascertain the inherent weaknesses in regulatory systems and examine the scope for re-regulation.

Regulation refers to controlling human or societal behaviour by rules or restrictions. Regulation can take many forms: legal restrictions promulgated by a government authority, self-regulation, social regulation (e.g. norms), co-regulation and market regulation. The economics of imposing or removing regulations relating to markets is analysed in regulatory economics. Re-regulation refers to amendments in regulation or re-enforcement of regulation.

Role of regulation in the financial markets crisis

Objectives of bank regulation

The objectives of bank regulation and the emphasis, vary between jurisdictions. The most common objectives are:

1. Prudential
   To reduce the level of risk, bank creditors are exposed to (i.e. to protect depositors)

2. Systemic risk reduction
   To reduce the risk of disruption, resulting from adverse trading conditions for financial institutions causing multiple or major financial institution failures

3. Avoid misuse of banks

To reduce the risk of banks being used for criminal purposes, e.g. laundering the proceeds of crime

4. To protect banking confidentiality

5. Credit allocation — to direct credit to favoured sectors

Regulation should facilitate risk taking rather than curbing such activities, as it is risk taking which drives towards the market and the economy.

Regulation and the Financial Crisis

In analysing the financial crisis to assess if regulation was a failure which triggered the collapse the findings indicate that rather than individual regulations it is a host of other reasons.

a) The inadequacy of enforcement of regulations by supervisory authorities

b) Lack of a supervisory framework to supervise cross border transactions

c) Lack of supervisory resources

Ironically, it transpires that the regulators had not always kept pace with the market when it was at it's best performing level and where financial engineers were introducing products which were changing much faster than the regulators expected. Further, the markets were producing profits and economic prosperity seemingly rewarding entrepreneurship in financial markets when regulators appeared very simply as ineffective and an impediment to the further, growth of the market. When markets are performing at its best and financial engineering is at it's, peak risks involved are also at it's highest level.

d) Public sector salaries which lag behind the market

In times of crisis it is the tax payer's money which go towards bailing out of the financial system, which is by no means insignificant. It is strongly felt that the expense on higher salaries and training would be only a fraction of the cost of a financial crisis. Understandably, public sector salaries are influenced by pay parities and relativities which need to be overcome.

e) Lack of life skills on the part of the investing public on the management of personal finances.

This results in mis-selling and leads to large scale investments without understanding the risks involved. Education is the only long term solution as one cannot regulate the individual investor.

f) Heavy influence on regulations by the sell-side of the market

In the implementation of any proposed or new regulation it is the sell-side of the market which engages in the strongest form of lobbying which has a major impact on the regulation which at times is changed beyond it's original objective. The cause for this is the lack of organisation in lobbying on the part of the buy- side which would have added balance to the process. A financial regulation needs to be clear- cut and impenetrable with respect to the achievement of it's objective without being an impediment. With excessive lobbying, it would not be impenetrable. Balanced regulation should seek views of the buy- side as much as the sell- side.

A regulation should be designed to protect the saver, based on his business model. Obviously the small time saver merits a higher level of protection as opposed to the institutional investor, whose business model may be different and the risk appetite much higher.

Changes in the Financial Services Industry

An efficient financial market would deliver economic prosperity to a country through optimum financial capital allocation. Broadly, regulators are needed for three reasons;

1. To ensure that excessive risk taking is prevented.
2. To ensure that investors are correctly informed, protected and prevent institutions from behaving in a manner which promotes corruption and opportunities for fraud.
3. To promote financial stability by ensuring that problems of one financial institution does not affect another and create on impact on the systemic stability of a country.

Current scenario

Models of regulation

Interestingly in developed markets such as the United States, regulation is at a functional level which means the regulator regulates the transaction and not the entity while an entity would be regulated by an entity specific regulator at holding company level. This move effectively promoted specialists in regulatory agencies and the need to develop skills and expertise in wider areas of transactions was not considered important. This is a clear move against integration of regulation.

In countries like Sri Lanka and India, there is a clear disconnect between regulatory agencies. The regulators regulate the organisations both at holding company and subsidiary level and not based on transactions. Therefore an entity, be it a subsidiary or a holding company would be regulated for its legal incorporation status and not for all it's transactions. This is what led to certain financial institutions, although regulated by the Central Bank for the manner in which their incorporation was entered into, collapsing when transactions on their books ended up in losses. Such transactions did not come within the purview of the entity regulator.

Risk transfer

Initially, risk transfer appeared to be a magical solution for organisations willing to take more risk and organisations willing to take on risks analysed by credible institutions. Further the diversification of markets and exposures only contributed to a perceived mitigation of concentration and other risks. However, this phenomenon served to increase the complexity of financial instruments and wide spread ownership which posed limitless systemic risks that were not apparent, due to the opaque structure of such products.

Existing Regulation in key countries of the world

Except for the USA certain developed countries such as Japan, UK, Germany and Australia; all have a higher level of integration among regulators with their respective Central Banks joining to regulate the banking institutions. In such markets the economies are smaller than the US economy, as well as instruments less diverse. Further, no single agency has the responsibility for analysing the risks to the financial system as a whole or planning strategically to address those risks and problems that may develop in the future. There also is no mechanism for agencies to cooperate effectively to perform these tasks. Some characteristics of the U.S. regulatory structure, specialization and competition among the agencies, facilitate the attainment of some regulatory objectives and impede the attainment of others.

Australia and the Netherlands have consolidated their regulatory structures into two agencies that have responsibility for a single regulatory objective. In each country, one agency is responsible for prudential regulation of all financial institutions and the other for ensuring that financial firms and markets conduct their businesses properly.

Harmonization of domestic regulatory mechanisms and supporting institutional strengthening could promote increased investments in infrastructure, in industrial goods and services and also in banking and capital markets. In addition, harmonization of national investment laws through an internationally best practice regional code could further enhance investor confidence in the region, whilst avoiding the costly “race to the bottom” that countries engage in, when awarding investment incentives. (provided incentives are also harmonized).

Country	Regulators	Level of integration in regulation
Australia	**Reserve Bank of Australia (RBA)** Deals with Monetary policy and systemic stability with the Payments System Board considering payments systems regulation; **Australian Prudential Regulation Commission (APRA)** Deals with prudential regulation of: Authorised deposit-taking institutions (ADI's) Life and general insurance Superannuation (including Industry superannuation) **Corporations and Financial Services Commission** Renamed and expanded version of Australian Securities & Investments Commission (ASIC) to deal with: Market integrity Consumer protection Corporations. It is Australia's corporate regulator	APRA is a statutory authority, and the prudential regulator of the Australian financial services industry, established on 01st July 1988. Prior to this Australian financial markets were regulated only by, · The Insurance and Superannuation Commission (ISC); · The Reserve Bank of Australia · The Australian Financial Institutions Commission (AFIC). This depicts high level of integration

Germany		Banks own large holdings of industrial corporations.High level of integration
United Kingdom	Financial Services Authority (FSA) Bank of England	Relatively light regulation of banks by the government. Nine regulatory bodies, including self regulatory organizations (SRO), were merged into to a single agency, the Financial Services Authority (UK-FSA)
Iceland		Relatively light regulation of banks by the government.
China		Heavier regulation of banks by the government. Reasonable integration.
Canada	Investment Industry Regulatory Organization of Canada (IIROC) Set and enforce high quality regulatory and investment Investment Industry Regulatory Organization of Canada (IIROC) sets and enforces high quality regulatory and investment industry standards, to protect investors and strengthen market integrity whilst maintaining efficient and competitive capital markets. Canadian Securities Administrators, (CSA). The CSA is primarily responsible for developing a harmonized approach among securities	High level of integration

	regulations across the country. Mutual Fund Dealers Association (MFDA)	
USA	Federal Reserve System Office of the Comptroller of the currency National Credit Union Administration Office of Thrift Supervision Federal Deposit Insurance Corporation Commodity Futures Trading Commission Securities and Exchange Commission Financial Industry Regulatory Authority	Upto and including the federal Deposit Insurance Corporation the agencies are bank regulators. They generally focus on the safety and soundness of banks. The Securities and Exchange Commission is the primary regulator for securities markets whilst The Commodity Futures Trading Commission is for the regulation of the future markets. Their main objective is to maintain market integrity and investor protection. Relatively light regulation of banks by the government Light level of integration

New developments

Europe

1. Proposed Regulation for Derivatives/Alternative Investments Fund Managers
2. Bank regulation to rely less on pro-cyclical methods. For example banks to be encouraged to make bigger slices of provisions for bad debts in good times.

United States of America

1. Establishment of a Systemic Risk Regulator -Responsibility for oversight in the area of system-wide leverage which will seek to improve the regulatory approaches to restrict leveraging in regulated financial institutions

Basle II

Basle II under it's first pillar of Minimum Capital Requirements, permits regulated financial institutions (banks) to maintain regulatory capital, based on risk assessment models. The objective was to ensure that banks maintained adequate capital to absorb losses which would be greater than under Basle I. However, in reality banks maintained less capital than the risks their balance sheets took based on Advanced Measurement Approaches. In formulating a new approach to risk management, subsequent to the financial crisis, an integrated approach is strongly recommended.

Objectives and advantages of integration in regulation

Consolidation of the regulatory structure would lead to;

(1) Better control of the risks posed by large, complex firms and their consolidated risk management approaches.

Under Basle II accord Risk Management requirements, the prudential regulator is tasked with wider responsibilities. Information sharing would be a significant development of integration in regulation. In the case of Sri Lanka large conglomerates which have diversified holdings carry many risks which go unregulated due to the non-regulation of certain transactions.

(2) Promoting competition domestically and internationally

(3) Containment of systemic risk.

Integration will seek to address causes of financial market inefficiencies rather than symptoms such as high margins which cannot be corrected despite reforms.

Disadvantages in integration in regulation

However, larger regulatory agencies could be less accountable to consumers or the industry, possibly damaging the diversity that enriches economies or could lose expertise critical to overseeing certain aspects of the industry. In addition, change itself has certain costs, such as the costs of rewriting the various laws that support the current regulatory structure and any unintended consequences that could result during the transitions from the current structure to a new structure.

Integrated regulations in Asia

The Asian countries were mostly spared from the immediate fallout of the financial crisis due to their insignificant exposure to toxic assets and the fact that most South Asian countries still has underdeveloped financial sectors which leads to resilience from external shocks. The example of India can be cited which successfully implemented capital controls that had reduced the incentives for domestic banks to accumulate toxic assets in their portfolios. However in going forward to capital controls may always not be the answer as it can be interpreted as an impediment economic growth. As a result the Asian regulators are credited with averting the fallout of the financial crisis. However the danger is that this may lead to a tightening of controls rather than integration and harmonisation and skill development of regulators.

The lessons for Integrated Regulation should be drawn in the aftermath of the international crisis which is perhaps the best time for Asia to look at Integrated Regulation for the region.

Post crisis regulatory initiatives by ASEAN region

The Sri Lankan scenario

Regulatory authorities in Sri Lanka are represented by the following;

- Central Bank of Sri Lanka which includes the Public Debt Department and the Exchange Controller
- Securities and Exchange Commission of Sri Lanka
- Colombo Stock Exchange
- Insurance Board of Sri Lanka
- Department of Inland Revenue
- Ministry of Finance
- Credit Rating Agencies
- Registrar of Companies
- Board of Investment
- Sri Lanka Accounting and Audit Standards Monitoring Board

In an environment where capital controls are relaxed in a gradual manner in Sri Lanka for both equity and debt markets integration has never been more important. Sri Lanka has opened her domestic debt markets to foreigners in a limited capacity whilst the country has also issued international bonds. Accordingly, the phenomenon of capital flow volatility and reverse flows is a reality. Therefore the close liaision and integration between the Central Bank, Securities and Exchange Commission and the Colombo Stock Exchange is key. There is at times a disconnect between the above mentioned regulatory agencies in terms of the regulations itself and thelack of coordination which result in violations of regulations and discouragement of investors. Lack of integration also results in contrasting regulatory objectives being communicated through regulations issued by various agencies.

There would be significant clarity if the Inland Revenue authorities, Securities and Exchange Commission and the Central Bank coordinated in drafting regulations where banks and other financial intermediaries would issue capital market instruments and investor would invest in them and trade in them in the secondary market.

The regulations governing insurance companies pertain to the security of the insurance funds which are rigid and directly in contrast to the rules and regulations of the Securities and Exchange Commission and the Stock Exchange is of paramount importance for the development of capital markets.

The Accounting standards stipulated by the Sri Lanka Accounting and Auditing Standards Monitoring Board and the directions issued by Central Bank on the presentation and valuation of certain transactions also contradict one another.

It is a prerequisite to draft regulations in financial markets in coordination with each other. This coordination is currently absent in drafting tax, banking and market regulations. Banks constitute the major component of financial markets in Sri Lanka. The banks are active in virtually all aspects of financial services, with most having subsidiaries or affiliates engaged in insurance and capital markets activities. Unlike in developed markets , organisations are regulated at holding company and subsidiary level, irrespective of the nature of their transactions. Accordingly, bank regulations have attracted considerable attention of regulations while certain other sectors are not regulated so effectively in Sri Lanka. Currently bank regulation does not have any linkages to capital markets regulation or non –bank institution regulation, which create pockets of unregulated activity. Exchange control regulations which stipulate foreign exchange transactions have not kept pace with developments in the capital markets.

In going forward, Inter Regulatory Council has been set up to explore the possibilities of integrating the functions of the different regulators in the country as well as establish better coordination among the agencies. The process of issuing new regulations or amendments must ensure that such issuance /amendment does not amend/contravene any existing regulation and create confusion and ambiguities in the market place.