In the midst of the current financial crisis, the needs for major reform of the global financial system and global financial stability framework have been increasingly recognized. Policymakers and international organizations have made substantial efforts to improve the international financial system including financial regulation and supervision. Various proposals have come forward on priority areas such as redefining the scope and boundaries of financial regulation and supervision, tackling issues of pro-cyclicality in the system, retooling capital and provisioning requirements as well as refining valuation and accounting rules, and some consensus has been reached. Among others, the Group of Thirty has published a Financial Reform report, and FSF and BCBS have undertaken some work on various aspects of financial regulation and Basel II framework. A number of regulators and the financial industry have initiated a centralized clearing and central counter-party mechanisms for OTC derivatives including credit default swaps (CDS). All these efforts will help to fend current crisis and future risks. However, we also note that several issues with respect to the financial regulatory framework have not received adequate attentions. In this note, we would like to explore these issues and provide relevant suggestions.

1. Problems of financial regulation exposed by the financial crisis

The current financial crisis originated from the U.S. subprime crisis, and rapidly spread onto the rest of the world through financial products, financial institutions and markets. The rampant spread of the current crisis demonstrates that issues in the philosophy, effectiveness and international cooperation of financial regulation need to be resolved as effective regulation and supervision is the most powerful external force for containing financial sector risks.

(1) Regulatory philosophy over-confident in self-restraint of market players
In terms of financial regulation philosophy, some developed countries have been heavily reliant on self-regulation of the marketplace, believing in “minimal regulation is the best regulation”. In fact, the financial institutions implicated in the Enron and WorldCom debacles and the liquidity crisis troubling some financial institutions in the early stage of the current crisis should have impelled regulators to upgrade supervisions. However, authorities have failed to take much-needed systematic actions. One of the most important reasons for this omission is the conviction that market can correct itself, which led to the overlook of financial sector vulnerabilities posed by the profit-seeking nature of financial institutions. The evolution of the crisis demonstrated that due to the profit-driven nature of market players, market forces, if unchecked, will lead to asset bubbles and ultimately a disastrous market clearing in the form of a financial crisis like the current one, hence wreaking great havoc to global finance and world economy.

(2) Regulatory system need to upgrade timely to avoid lagging behind financial innovations

The developments of the financial crisis have proven that financial innovations have created new sources of systemic risks, such as OTC products and near-bank entities including investment banks, hedge funds and special purpose vehicles (SPVs). These entities, saddled with internal problems and intertwined with traditional financial institutions, are prone to trigger systemic risks. In addition, most financial conglomerates were engaged in non-conventional financial products and businesses to circumvent regulations, which created another source of systemic risks.

The current crisis has clearly shown that the prevailing model of financial regulation lagged behind financial innovation activities. Under the current regulatory model, only deposit-taking financial institutions and conventional financial products with obvious externalities are regulated, while near-bank entities and OTC products are subject to little, if any, supervision. Moreover, financial institutions of different types or domiciled in different jurisdictions, and different products are subject to different regulatory rules and systems. Moreover, the lack of coordination among regulatory authorities has also fostered regulatory arbitrage possibilities. As a result, financial institutions are able to circumvent rigorous regulations and maximize abnormal returns. Different types of arbitrage have hastened the rapid development of near-bank entities and OTC products, and let hedge funds enjoy the treatments from offshore financial centers.

The swift development of financial market and real economy over the last decade had led policymakers in some major economies believe that the existing regulatory structure was effective. Few measures were taken to enhance the regulatory framework to keep pace with the
emergence of new products, new institutions and new markets. Since the breakout of the crisis, cases have proved that due to the lack of coordination among regulatory agencies and communications between regulators and central banks and finance ministries in some advanced countries, efforts to rescue financial institutions and stabilizing markets were hampered.

(3) Effective international regulatory cooperation yet to be in place

Due to the lack of consistent regulatory standards and a platform for effective information exchange, regulators do not have a good understanding of the cross-border activities of internationally active financial institutions. In particular, there is a lack of understanding of international capital flows. Relevant international organizations were pre-occupied with macroeconomic surveillance, especially with respect to the exchange rate regimes of emerging economies. Its work on monitoring international capital flows is insufficient. So far, we still do not have a good understanding of the channels and mechanisms of cross-border fund flows, especially flows to and from the emerging market economies, and how these flows reverse in unfavorable times.

To enhance international cooperation in financial regulation, the Financial Stability Forum has identified 30 large internationally active financial institutions for which supervisory colleges have been established. In due course, we should assess how effective and sufficient these colleges are in strengthening international supervision of cross-border financial institutions. And IMF should also include regulation and surveillance of international capital flows as an important part of its early warning system.

2. Issues meriting special attentions in reforming the financial regulatory system

(1) Reform begins with self-criticism

One ancient Chinese philosopher once said, “(w)e should self-examine ourselves three times daily.” This epitomizes the oriental philosophy on the importance of self-criticism in improving oneself. In analyzing the root causes of and drawing lessons from the current crisis, such spirit is sorely needed. Only by looking inward with this spirit, can we draw the right lessons and avoid being blindsided. Only with the right lessons learned, can far-reaching reforms begin. Recently, there have been some blaming games, which intend to hold others responsible for the on-going difficulties. Such lack of remorse does not help in examining the flaws in the existing financial
regulatory system.

In fact, lack of remorse is one key factor leading to the current crisis. Before the crisis, there was a prevalent complacency. Although the US regulatory structure was a complex patchwork of fragmented agencies and jurisdictions, some believed that it worked quite well. Though some made efforts to address issues, most are reluctant to take a serious crack at the problems with an excuse of “(i)f it ain’t broke, don’t fix it.” The cost of waiting for the system to break has turned out to be tremendous. Against this backdrop, we should begin with an attitude of self-criticism while addressing the challenges of financial regulatory reform.

(2) Introduce counter-cyclical multipliers to strengthen counter-cyclical mechanism

Effectively addressing the pro-cyclicality elements in the existing capital requirement framework and improving quality of capital is essential for preventing serious financial crisis. The ongoing crisis has exposed vulnerabilities in capital adequacy requirements of banks in the following areas: (a) the Basel II framework does not adequate capture risks of complex credit products; (b) the minimum capital requirement and the quality of capital have not provided adequate buffer during the crisis; (c) the pro-cyclicality of capital adequacy has amplified volatilities; (d) there exists the differences in capital requirements among different types of financial institutions.

Currently, efforts are being made in some countries and by some international organizations to expand the coverage of capital requirements, including setting requirements on asset-backed securities, off-balance sheet risk exposures and trading account activities, improving the quality of tier 1 asset, and enhancing the global consistency of minimum capital requirements. In addition, as a complement to capital adequacy ratio requirement, a properly constructed leverage ratio indicator will play a role in the macro prudential regulation framework as the new indicator can both measure potential excessive risk-taking and dampen the cyclical fluctuations.

In addressing the vulnerability of the exist capital adequacy ratio framework, particularly the cyclicality of capital buffer, authorities responsible for the overall financial stability need to develop counter-cyclical multipliers in an effort to contain pro-cyclical elements. If an economy experiences an unusual change or economic system needs an unusual counter-cyclical adjustment and specific stabilization measures, the authorities may consider issuing quarterly indexes of prosperity and stability. These indexes may then be used by financial institutions and supervisors to multiply into risk weights in calculating capital adequacy ratio. In this way, the risk weighted capital
adequacy requirement and other criteria, like IRB, can better reflect counter-cyclicality requirements for financial stability.

Specifically, with a set of prosperity indices in place, counter-cyclical multipliers can be derived. Many existing indicators linking to business cycles, investor and consumer sentiments can serve as a base for such prosperity indexes. During the boom period, asset prices increase, market exuberance prevails, and prosperity indexes are high; and vice versa during economic downturn. In deriving counter-cyclical multipliers from prosperity indexes, we should take into consideration of factors such as product type, industry and country of risk exposures. Then, the multipliers can be applied to contain the pro-cyclical factors including risk-weights, default probabilities for credit rating purposes and discount (haircut) percentages for various collaterals used in financial transactions, as well as other pro-cyclical factors. This will not only help to mitigate the pro-cyclicality elements, but also improve quality of capital by improving management of collaterals and by using multipliers-adjusted default probabilities to manage risks in complex credit products.

(3) Regulatory agencies should be adequately staffed with people with market experiences

Some regulatory agencies do not have enough professionals with practitioners’ experience and hence are lack of sufficient understanding of the market developments, especially the systemic impacts of financial innovations. As a result, some supervisors turned a blind eye and were not sensitive to problems in structured products such as CDOs and derivatives such as CDS, and the shadow banking system reflected in the off-balance activities, including the critical rating methodologies for structured products. To enhance capacity, regulatory agencies should conduct systematic and frequent staff exchanges with the industry, which will enable regulatory agencies to become attentive to and keep abreast of developments of the industry and do a better job in supervisory oversight.

(4) Strengthen supervision on the use of credit rating services and on rating agencies

Credit ratings from the major rating agencies have become international financial services products. In many countries, various rules have required investment management decisions and risk management practices to be benchmarked on financial instruments attaining certain ratings by major credit rating agencies. Once these ratings were given, the financial institutions do not need to worry about the inherent risks of the products. However, the ratings are no more than indicators of default probabilities based on historic data, which never meant to be guarantees for the future. The business model of issuer-paying for services has rendered the rating process with
conflicts of interest and the major rating agencies irresponsibly gave many structured products high ratings before the crisis. During the crisis, the reversal of market conditions have forced the rating agencies to lower the ratings of many financial products, which led to massive asset markdowns and exacerbated the severity of the crisis.

Our view is that the financial institutions should conduct independent examination of risks, not simply delegate the duty to the rating agencies. To the extent external ratings are needed, internal and independent judgment has to be deployed as a complement. Regulators should encourage financial institutions to enhance internal rating capability to reduce their reliance on external ratings. Moreover, central banks and regulators should limit the use of external ratings within 50 percent of business volume, at least for those systemically important financial institutions. Meanwhile, these institutions should upgrade their internal rating capabilities to exercise independent judgment on credit risks.

The current crisis has also shown that national regulation of rating agencies is insufficient, and concerted international cooperation is required to tackle the problem of international regulation of credit rating activities. It makes sense for the International Organizations of Securities Commissions (IOSCO), Bank for International Settlements (BIS) and Financial Stability Forum (FSF) to coordinate in setting standards and in enforcing them. An entity should be designated to take regular responsibilities in implementing the rules. The focus should aim to identify problems in the rating industry, to identify the conflicts of interest between the raters and the issuers and to improve the independence, fairness and transparency of rating activities. Such a body should review the track record of the major rating agencies on a periodic basis and assess the default and loss statistics of different ratings. In particular, reviews should also be made in the area of sovereign ratings of emerging economies. Results of such regular reviews should be made public so that market participants can form their own opinions and make better use of the credit ratings. In cases severe problems are identified, the designated implementing entity should take remedial actions including, among others, imposing corrective actions on the problem agencies, publicizing problem areas, private censures and public reprimands. Based on the findings of the entity, national regulators can also impose punitive measures including banning from the industry on the problem agencies.

(5) Promote higher corporate governance standards

Evidence abounds that boards of directors at some systemically important financial firms in the US were rendered as a “gentlemen’s
club”, which rubber-stamp all major decisions sponsored by the management. Often times, the independent non-executive directors (INEDs) did not have meaningful expertise or training in financial services sector. As a result, the board is unable to provide strategic direction for the firm’s operations and effective guidance and backing for risk management and internal control. Cases also reveal that at some too-big-to-fail institutions, the risk management professionals were beholden to business people. This has led to lack of effective check and balance mechanism, which tolerated excessive risk-taking in pursuit of short-term rewards.

Management was motivated by short-term barometers such as quarterly results and year-end bonus. The pro-cyclical compensation structure, which rewards short-term results, doesn’t help in restraining aggressive risk-taking. In addition, decisions for succession planning and appointment of Chairman/CEO was sometimes made not on candidates’ well-rounded qualifications and merits but on factors not consistent with the interests of the shareholders and the firm’s long-term viability.

Regulators should impose higher governance standards on systemically important and internationally active financial institutions. At the minimum, the majority of their INEDs should be financially literate and can provide the management with substantive guidance in areas of the firm’s strategic positioning in the market place, balance between business expansion and quality of growth, financial innovations, succession planning and etc. The annual report of such firms should disclose how active the INEDs are with respect to the firm’s issues in and out of the boardrooms, so that investors can judge the effectiveness of the board in discharging its fiduciary duties. In some countries, it may also help to abolish the practice of the same person holding both positions of chairman and CEO, especially in those financial institutions of systemic importance.