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Discussion: Standardization or Convergence of International Best Practices

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Executive Summary

Two themes arising out of recent events that merit focus:

- **Impairment of reputational and control intermediaries**

There has been a significant impairment of control elements in financial businesses which has led to sharply higher risk profile and destruction of value on a massive scale. This impairment has occurred both at control elements internal to firms as well external control elements which operate on an agency basis such as auditors, credit rating agencies, and regulatory bodies.

- **Rapid financial innovation and product development**

The global financial markets have witnessed rapid and widespread financial innovation over the past few years, engendering an avalanche of new products, concepts and markets. These developments have intensified the level of complexity in financial markets, contributing to the current pandemic instability and associated serious systemic issues. This rapid development, across jurisdictions has left Boards, risk managers, auditors and regulators in its wake, and has made a viable control environment almost impossible.

Issues that arise for discussion from these two themes include the following;

- **Market early warning systems & review of new products /trends:** Markets should be monitored to identify the emergence of new trends in products or markets which are significant enough to alter the prevalent risk-return paradigm or exacerbate the risk profile. This should be implemented on a multi-lateral level with a detailed set of criteria that will alert regulators to potential risks at an early stage.

- **Widening regulatory oversight.** It is imperative that all systemically important components of the financial system have the adequate regulatory oversight, irrespective of the type of investor being served. This will enable better monitoring of financial risks assumed by entities which are capable of a systemic impact.

- **Education and culture.** Reputational intermediaries need to enhanced and retooled so that they are adequately equipped to better understand new financial products and their risk implications. In addition, the culture transformation needs to occur that reinforces the importance of controls, restore the balance of control elements vis-à-vis business drivers in financial entities and the justification of resource allocation to that area.

- **Regulatory co-operation.** Regulators need to act across borders and they need to this in seeking to address issues around product development. This will need co-ordination, allocation of responsibilities and actionable abilities.

- **Transparency.** More disclosure will help but there is a need for caution; there is a tipping point as to the usefulness of transparency beyond which it is arguable that it actually becomes detrimental to the market. (IFRS standards)

Two proposals for discussion in addressing these issues

- A global task force is created and permanently put in place to provide timely analysis of market developments and identification of actions that need to be taken

- The ongoing education of Board members and regulators becomes a statutory requirement.

Key issues for discussion

The main causes for the devastation witnessed in the global markets over the last six months can be traced to the concepts which form the topic of this session. The adverse impact of the risks spawned by unregulated entities, products and markets has been aggravated by the sharp growth experienced by them over the recent past. The overall trend of deregulation and the failure of regulators to keep pace with financial innovation over the past decade have led to a host of entities, products and markets which are not regulated or lightly regulated. An intensive analysis of the events in global financial markets reveals critical and recurrent themes which merit focus:

- Impairment of reputational & control intermediaries

There has been a significant impairment of control elements in financial businesses which has led to sharply higher risk profile and destruction of value on a massive scale. This impairment has occurred both at control elements internal to firms as well external control elements which operate on an agency basis such as auditors, credit rating agencies, and regulatory bodies.

- Rapid product development

The global financial markets have witnessed rapid and widespread financial innovation over the past few years, engendering an avalanche of new products, concepts and markets. These developments have intensified the level of complexity in financial markets, contributing to the current pandemic instability and associated serious systemic issues. This rapid development, across jurisdictions has left Boards, risk managers, auditors and regulators in its wake, and has made a viable control environment almost impossible.

Policy makers at the national and supra-national levels are currently considering proposals for addressing the issues related to unregulated aspects of the global financial system. Attempts to outline potential remedial plans to address the issues referred above can be based on the approaches taken by individual firms or by regulators in other segments of international financial system.

Unregulated entities

In the past, the focus has been predominantly on hedge fund managers and to a lesser degree on private equity investors. Absence of adequate information on unregulated entities has hindered the ability of other market participants and regulators to effectively assess the risk profile of such entities. Because of the rapid growth in their share of the overall market activity, lack of information has also severely limited the overall view on risks in the market place. Excessive use of leverage and widespread use of CDS by various types of market participants, many of whom were unregulated, could not be monitored for lack of credible data. Eventually these trends contributed significantly to the financial instability and manifestation of various stresses in the system.

Previously, many of these entities have enjoyed the relief from “light-touch” regulatory oversight on the basis that they catered to a set of qualified investors capable of taking decisions on their own with little or no need for protection. However, the current financial crisis has exposed a floor in this approach; i.e. that the market impact of such operations merits proper regulatory oversight.

Unregulated products or markets

Currently, the focus of the debate is OTC products, particularly OTC derivatives. The level of complexity in the OTC derivatives being traded has increased rapidly driven by financial innovation. However, inadequate comprehension of the nature and structure of these OTC derivatives has led to uncertainty about their market impact and inadequate assessment of risks related to these products.

Having considered the nature and the characteristics of unregulated entities, products and markets, the following initiatives are being proposed to address the risks identified.

New Product review Process on a global basis

To address risks or issues related to financial innovation and the resulting new products, it is imperative that products are subject to an effective review process. Such a review process would provide an opportunity for the relevant market participants and regulators to critically analyse the product or market, identify the risks and consider potential means of mitigating such risks. This would also impose a greater level of responsibility and increased scope for reputational intermediaries to reflect upon the new product being reviewed and to raise potential issues or concerns at an early stage.

The key question would be to ascertain the point at which a new product would necessitate such a review. Considering past history and the importance of the market impact, the threshold for determining the need for such a review should be based on a test of whether a new product or market has started to materially impact the risk-reward paradigm existing in the overall market. This implies the point at which a new product starts having the kind of volumes and participation by various market players that it changes the overall risk-return standards in the market and extant business models.

The proposed review process should be based on a standard framework and carried out on a global scale, probably by supra-national regulatory entities or other multilateral bodies which are mandated to ensure financial stability and market integrity on a global level. The standard framework should aim to review and understand risks involved in new products or financial innovations using a framework based on broader criteria rather than one focused on specific detailed criteria.

The proposed review process should be aimed more at uncovering the risks and operational issues as well as potential market impact. The results of such an exercise would provide the basis for addressing potential risks associated with future growth of the new product. It is expected that this approach would address the risks arising from innovation and ensure orderly development of new products and new markets.

Products or markets exempt from regulation

As referred to above, many entities or products which were exempt from regulation or experienced a light-touch regulation have contributed to the instability of markets, mis-pricing of assets, exaggerated leveraging and other causes for the current crisis.

The application of such exemptions from regulatory oversight need to be critically challenged, particularly if such entities are capable of having a material impact on market integrity or overall risk levels in markets or economies. The past decade has many examples of such light touch products or markets in the growth of CDS markets, hedge funds, OTC derivative markets and Multi-lateral Trading Facilities. Although some of these could have delivered positive benefits to the intended customers, the absence of adequate regulation might have led to the risks that have crystallised in these areas. All market segments or products which could impact integrity of the markets need to be brought under proper levels of regulation.

Regimes like exempt funds or light touch regimes for collective investment schemes can have a significant impact on markets and investors as fully regulated funds, irrespective of the fact that they are targeted at so-called qualified investors. Investments into such vehicles are often tiered and the ultimate investor may not have the risk tolerance which the qualified investor is assumed to possess.

In the past, it has been observed that losses incurred by qualified investors lead to changes in their investment behaviour and adversely affect the overall market sentiment indirectly. This is corroborated by the massive redemptions experienced by hedge funds over the past six months which have contributed to significant market declines and instability.

Bringing such unregulated products or entities under regulatory oversight would impose higher levels of transparency, leading to better assessment of their operations and their impact on systemic risk levels. Regulation of such products cannot be left to voluntary codes of conduct, which are not geared to addressing market stability risks.

There is also a need to move towards convergence of broad regulatory approaches for the regulation of products with similar risk profiles. The regulatory approaches should be consistent with reference to the market place in which such products are traded, irrespective of the type of investors investing in such products.

Need for regulators to understand and monitor the financial risks involved in investment products

In the past, regulators of securities markets have mostly confined their activity to conduct issues and have not focused on financial risks (credit, market and liquidity risks) carried by securities under their purview, in particular collective investment funds. The regulations currently in force are aimed at disclosure, governance and conduct of business issues. This approach could possibly have been based on the philosophy that the investors in securities markets are wilfully assuming risks and are not being offered any assurance on return of capital, whether implicit or explicit.

This philosophy is weakened in the current scenario wherein the indirect impact of the losses in securities markets have significantly altered the overall pricing of risk and investment behaviour of investors. In addition, the market movements have increasingly affected the banking system and consequently the broad economic system, given the increasing levels of participation of banks in securities markets either directly or indirectly.

Therefore, there is a need to understand and monitor the financial risks carried by similar products, though there is no liability or public policy impact as in the case of deposits offered by a bank. The financial risks of all investment products including those targeted at wholesale or qualified investors need to be understood and monitored as such investors are significant players in many markets and their behaviour could have material impact on the overall risk in such markets.

Monitoring financial risks in all product segments including those like OTC derivatives and hedge funds in the same way as risks in the books of banks are monitored would enable regulators across jurisdictions to get a bigger picture of overall risk levels and emerging trends in risks.

Money flow analysis

An analysis of the overall flow of funds across markets and across asset classes could be useful in identifying emerging trends in risks, particularly when seen in the light of emergence of new products and business segments. There is a need for regulators to monitor changes in risk-return profiles of significant market segments over medium and long term time horizons to identify any change in the overall risk-reward paradigms. Such changes have to be challenged and the underlying reasons for such changes have to be fully understood, if the attendant risks are to be identified and managed. Such monitoring along with the changes in the market activity may provide significant clues on emerging risk trends.

Transparency and Disclosure

As in the case of exemption from regulatory oversight discussed above, significant segment of markets and market players have not faced any disclosure requirements. The development and implementation of a global disclosure framework similar to pillar 3 of Basel II for securities and other investment products, which can be adapted for every jurisdiction and product segment, can be attempted. Such a framework would lead to a more uniform disclosure pattern, which is credible and comprehensible across jurisdictions. The impact of investment entities and collective investment vehicles of all sorts on the broader markets and economic systems is as critical as banks. Therefore, they must be persuaded to share information on risks involved or emerging from their operations, with a view to informing the market in general apart from potential counterparties and investors.

The need for a rational approach towards disclosure is emphasised as often disclosures can move beyond the balance at which the costs of further disclosure cannot be justified by resultant benefits. The emphasis here should be on the consistency and coverage of risks involved rather than on the quantum of information to be provided. The focus should be on risk disclosures and performance presentation standards, consistent with the type of product or business, rather than on the type of investors targeted. This approach implies that there would not much of exemptions from disclosure just because the entity involved targets sophisticated investors.