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Financial Regulation Reform Risks Overkill in Emerging Markets

By ***Reuters (mailto:)***
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BANGKOK, May 24 - (Thirachai Phuvanatnaranubala is the Secretary General of Thailand's Securities and Exchange Commission. He is also chairman of the ASEAN Capital Markets Forum. The views expressed in this article are those of the author and should not be seen as representing the views of Reuters News.)

By Thirachai Phuvanatnaranubala

There is no doubt that some of the busiest people since the financial crisis are at the Financial Stability Board.

The G20 recommendations have been wide ranging, from private sector practices such as compensation schemes of financial institutions to much broader issues such as developing macroprudential tools to promote global financial stability.

But it raises a question whether there are too many things going on. People say a crisis is not a thing to be wasted, but issuing rules and regulations in direct response to one can often lead to over reaction.

We only have to look back to the 2001 Enron scandal. The U.S. Congress felt they needed to react by revamping the rules on accounting and governance standards for publicly listed companies. They launched the Sarbanes-Oxley Act in the aftermath of the scandal. Today there are still debates going on whether the costs of compliance would outweigh the benefits.

As for the Dodd-Frank Act which was enacted in 2010, many experts assess that today only 10 per cent or so has taken effect. There is much more to go through. And now that more stability has returned to financial markets, calls are becoming louder not only for more careful assessment of costs and benefits, but also to ensure that there is adequate balance between the need for more protection and the risks of constraints to future growth and investment.

What this financial crisis did was to reveal gaps and shortcomings in the highly developed markets. They included such things as weaknesses in the mortgage origination process, poor due diligence processes in the bundling of risks, inadequate disclosure of shadow banking liabilities and many others. These are valid points of concern and new regulations will indeed be useful.

However, for the emerging markets where financial transactions are still much simpler, there is a clear risk that there may be too many new regulations and standards. These standards will be adopted as global. And the emerging markets that do not implement them can be singled out by analysts, market participants and rating agencies as non compliant.

THE KEY REFORMS

Having said that, I will highlight three recommendations that should be carefully considered by the emerging markets.

The first is the risk of interconnectedness of financial institutions.

Derivatives trading in the over-the-counter (OTC) market tend to enlarge financial institutions' balance sheets. The institution that takes positions in opposite directions cannot simply cancel out the first deal, but instead have to

construct another contrary deal. When the counterparty balances are too big, one bank that fails can quickly pull down a large part of the rest.

The recommendation is to steer OTC derivatives trading onto exchanges with central counterparty clearing house so that opposite balances can be netted out. This is a very important recommendation.

The Asian crisis showed that banks can lose confidence in each other almost overnight. It will cause the interbank market to dry up very quickly.

The same can happen to the OTC derivatives market. Fear of delivery and settlement failure can cause financial institutions to refrain from dealing with each other. The only market that can ride out the storm will be that with central counter party clearing.

OUT OF THE SHADOWS

The second area is the reform to shadow banking. In this financial crisis, the shadow banking problem referred to securitization in the developed markets where liabilities suddenly arose because of both legal and moral obligation.

Their appearance very much surprised the observers simply because, prior to this, they had never been adequately reflected in the financial accounts. However, this problem is confined to the advanced markets. Regulators in the emerging countries may therefore fall into the trap of thinking it not applicable to them. But it can be!

One example is where banks are allowed to sell investment products, mostly from subsidiaries within their own groups, through the bank counters and country-wide branches. The close involvement by the bank may lead the investors to believe they are buying the banks' products. In effect, they might think that their money is safe based upon the bank's reputation. In the incidence of failure, it is very likely for the banks to step in to prevent panic from spreading to their other operations. In this example, the banks can be caught having insufficient capital to cover such losses.

The third important area is the reform related to too-big-to-fail institutions. Are there better alternatives than using tax payers' money to bail out too-big-to-fail banks?

One interesting provision in the Dodd-Frank Act allows the U.S. government to levy from the remaining banks to cover the loss. Another is Sir John Vickers of the UK Independent Banking Commission's proposal to ring-fence retail banking capital from wholesale businesses, and recently, the Institute of International Finance's idea to create the option for bank's creditors to bail-in, meaning bank's creditors will be forced to share losses when a bank fails or is rescued by government.

A BIGGER VOICE FOR SMALLER MARKETS

The last issue I wish to point out is the work process of the Financial Stability Board (FSB) itself. In the structure of the International Organization of Securities Commissions, there are four regional committees that act as focal points to collect information, concerns and feedbacks from members to report or respond to the Technical Committee, the rule maker. Instead, the FSB is dominated by developed countries and some powerful emerging countries such as BRICs. Medium and small emerging countries' participation is absent.

Therefore it is time for the work process of the FSB to be more open and embrace participation by a wider group of emerging countries. (For more stories on financial regulation reforms click [ID:nLDE64915B])

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