

Regulatory Arbitrage: Swirling In The Eye Of The Storm

The global financial crisis, which originated in the United States, still continues to plague the world's economy. Many issues surrounding this crisis such as where it came from and how will our markets be restored also remain at the forefront of the attention. In the May of 2008, the chairman of Board of Director and permanent representative to United Nation, Mr. Nechemia accepted the interview with the International Financing Magazine, during the interview, he predicated with remarkable accuracy the devastating financial circumstances that would overcome and nearly cripple the United States economy, and by extension ripple throughout the world's economy. Continuing to monitor global financial events, six months later, in November of '08, Mr. Nechemia was interviewed again and featured him for February cover story regarding his observations about the current global economic crises and its impact on Global's economy and on the China. In the May of '09, IFM gave Mr. Nechemia with the third interview on the roots that the global financial crisis erupted, he pointed out that the lack of regulatory oversight and imprudence in governance gave rise to what he and other industry experts call, regulatory arbitrage, that greatly contribute to the global financial crisis. He also urged that with the 80-year old the world's regulatory system with localization has not been in conformity to development of the current global economic integration; it will leave the more serious hidden trouble than current global financial crisis if we only focus on the remedy of the old regulatory system, but not make a thoroughly reform on it.

IMF: *Can you provide us with an overview of the world economy and insight as to the conditions of our global financial system? (question 1)*

Mr. Nechemia: The world economy is facing its most difficult situation in years, against the backdrop of a deepening financial crisis that originated in mature markets. Advanced economies are slowing markedly and some are already in deep recession. The slowdown has been greatest in the advanced economies, particularly in the United States, where the housing market correction continues to exacerbate financial stress. Among the other advanced economies, growth in Western Europe has also decelerated. The emerging and developing economies have been greatly affected by financial market developments which crippled their growth. The continued strained financial conditions will continue to dampen global growth prospects.

The financial shock that erupted in August 2007, as the U.S. subprime mortgage market was derailed by the reversal of the housing boom, the negative impact has spread quickly and unpredictably inflicting extensive damage on markets and in many cases, casualties upon institutions at the core of the financial system.

The fallout has weakened capital adequacy at major banks, and prompted the repricing of risk across a broad range of instruments. Liquidity remains seriously impaired despite aggressive responses by

major central banks, while concern about credit risks has intensified and extended far beyond the subprime mortgage sector. Equity prices have also retreated as signs of economic weakness have intensified, and equity and currency markets have remained extremely volatile.

As we entered 2009, global financial institutions and markets have been badly shaken. Threats to systemic stability became manifest in September 2008 with the collapse or near-collapse of several key institutions. The far-reaching nature of the events that are unfolding is illustrated by the fact that within a period of only **one** week, large stand-alone investment banks disappeared from the U.S. financial landscape.

IMF: *The collapse or near-collapse of several key institutions leads to a call for reform of the international financial architecture and many countries around the world are reconsidering the institutional structure of regulatory and supervisory agencies in the financial sector; can you elaborate on the reform needed and what are the issues the reform should be addressing? (question 2)*

Mr. Nechemia: I urge that is required, what is paramount is a call for a revised, reinvigorated global governance. The collapse or near-collapse of several key institutions, the rapid fall in value of housing, stock markets and assets around the world, along with a global credit crunch has unleashed a torrent of proposals for reinforcing or re-structuring global economic and financial system governance. The governance of the global economy and financial system is in fact quite limited – mostly to standard setting, surveillance, advice and provision of capital. There is no formal grouping of the institutions that carry it out.

Around the world, many countries are reconsidering the institutional structure of regulatory and supervisory agencies in the financial sector. This reconsideration reflects the concern that the existing structures—which were often established in a significantly different market and institutional environment than exists today—may have become inappropriate to meet the key regulatory objectives effectively in the 21st Century. These objectives include fostering market efficiency and promoting market confidence and stability. As countries reassess and then implement changes in their regulatory and supervisory architecture, a number of issues are raised in relation to both the developmental and stability aspects of the financial sector’s evolution.

From the developmental perspective, the main question that arises is whether the existing organizational structure of the financial regulatory and supervisory function is adequate to oversee an often rapidly evolving financial sector that is characterized by new types of financial institutions and new institutional structure (such as financial conglomerates.)

It is also feasible that a poorly structured supervisory function could impede financial innovation or encourage inappropriate forms of innovation. For instance, if the structure gives rise to significant supervisory gaps—that is, differences in regulation of activities that have a similar function but that are performed by different institutional types—market participants are likely to seek opportunities for “regulatory arbitrage” and to engage in financial operations that are not appropriate from a regulatory perspective.

This regulatory arbitrage over the past two decades lead to a developmental outcome for the financial sector that is suboptimal from the stability perspective; several key issues pertain to the

institutional structure of regulation. The first concerns the question of regulatory gaps and the implications for regulatory arbitrage. Unsupervised, or inadequately supervised, institutions have been the primary cause of financial instability. As clear and compelling evidence, simply look to the events leading up to, and then following when the tip of the financial iceberg emerged in August 2007; this was the first public glimmer that the U.S. subprime mortgage market was derailed by the reversal of the housing boom. In this instance, in hindsight it is clear that the weak institutions had sought out the lines of least supervisory resistance, engaging in overly risky types of financial behavior.

IMF: *What are the global trends that led to the rapid evolution in international banking and the development of global financial markets that you believe contributed to the regulatory failures of the systemically important financial institutions?* (question 3)

Mr. Nechemia: Well, first and foremost, one of the most significant occurrences was the evolution of “Shadow Banking” within the global capital markets. Until the early 1980s, national financial systems were bank dominated, relatively tightly regulated, and with limited international exposures. Starting with the modest issuance of eurobonds during that decade, cross-border financial flows and linkages started to expand dramatically. And although the 1980s debt crises arrested the integration of developing countries and the 1990s financial crisis severely hurt some emerging markets, these crises had little impact on the evolution and expansion of global financial markets.

Led by the rapid growth in international banking, global financial markets continued to boom—from just \$0.1 trillion in 1970 to \$6.3 trillion in 1990 and to a massive \$31.8 trillion in 2007. This was accompanied by a consolidation of the international banking industry—a result of a wave of cross-border mergers and acquisitions. Banks entered areas of activity that had previously been the preserve of nonbank institutions (such as underwriting, asset management, investment banking, and proprietary trading), blurring distinctions between banks and other financial institutions and leading to a “shadow banking” system with large segments of bank activity outside the perimeters of regulation. And rapid growth of complex securitized products, such as credit derivatives, sharply increased banks' leverage and masked underlying risks. The credit derivative market—which was insignificant in 2001—grew to about \$50 trillion by 2007.

The scale of relevant activities outside the regulatory perimeter depends on the definition of regulation. For the United States, it has been estimated that the total assets of the “shadow banking system”—i.e., bank-like entities not subject to bank-like prudential regulation—were roughly US\$10 trillion in late 2007, about the same size as those of the banking system. However, it is important to recognize that this total includes the assets of entities such as investment banks, which were subject to a degree of regulation, although this was often focused mainly on ensuring investor protection and appropriate business conduct.

IMF: *Industry experts, such as yourself, have also said it has been the mismanagement of banking and inadequate global financial architecture that led to the crisis. However, your assessment of the problem goes further, and includes a seemingly critical historical discussion about the innovation in the delivery of financial services and a remarkably absent regulatory oversight that is the root cause of the current problem, can you explain this?* (question 4)

Mr. Nechemia To make a comparison, the innovation in the delivery of financial services is similar to what mass-production techniques did to manufacturing a century ago. Spurred by competition and investor demand, large financial firms have harnessed the power of information technology, marrying complex modeling techniques and innovative legal structures to generate a growing array of securities with diverse risk profiles. Consumer credit scoring has allowed automated approval of housing, consumer, and student loans which, along with more-heterogeneous business and commercial real estate loans, are increasingly bundled together as securities (Federal Deposit Insurance Corporation (FDIC), 2006). Waves of securitization, flowing from one asset class to the next, have created new opportunities and—as we shall discuss—new challenges.

Reflecting the technological changes, special purpose vehicles are among the fastest growing holders of financial assets. Also referred to as asset backed security (“ABS”) pools, these pass-through structures serve as “obligors,” issuing debt backed by cash flows on the assets that they own. With those assets enjoying legal safe-harbor from any previous owner’s bankruptcy, the creditworthiness of each ABS issued is a function of two, and only two, factors: the quality of the assets in the pool, and the capital structure (Moody’s Investors Service, 2007, and Standard & Poor’s, 2007a,b).

The rapid evolution of the U.S. financial sector is creating new challenges for the regulatory structure. With large financial institutions increasingly distributing loans to investors rather than holding them, the share of financial sector assets owned by insured depositories—which, along with a few large investment banks, form the focus of U.S. prudential supervision—has fallen from around half in 1980 to under one-quarter in 2006. Thus, in a period during which the complexity of instruments and trades has multiplied, the portal through which the Federal Reserve views and influences financial markets on a day-to-day basis has, in one respect, halved in size. However, it is suggested here that parsimony in the application of safety-and-soundness oversight has been a key factor supporting innovation in the U.S. financial system.

IMF: *Who has the responsibility for oversight of global financial markets and more particularly the responsibility for oversight of the US financial markets? And in a related question, why is there a gap between the scope of regulation and the activities of financial institutions and markets? (question 5)*

Mr. Nechemia: The oversight of global financial markets evolved over time, reflecting changes in international financial markets, but the gap has continued to grow between the scope of regulation and the activities of financial markets. The *Bank for International Settlements* (BIS), established in 1930, is the central and the oldest focal point for coordination of global governance arrangements.

The *International Organization of Securities Commissions*, which is not linked to the *Bank for International Settlements*, has 109 members and covers 90 percent of the global securities markets. Another important body, the *International Accounting Standards Board*, has oversight of formulation and agreement on international accounting standards.

The U.S. oversight structure includes five independent federal regulators of depositories

(Government Accountability Office (GAO), 2004):

- The Fed, founded in 1913, is umbrella supervisor of financial holding companies (some 650 of them), lead supervisor of BHCs (5,129), and joint primary supervisor of state banks that are Fed members (892) along with the states.
- The FDIC, created in 1933, is joint primary supervisor of state nonmember banks (4,783 including ILCs) and state thrifts (433), back-up supervisor of all other banks and thrifts, and insurer of all banks and thrifts (including branches of foreign banks).
- The Office of the Comptroller of the Currency, established in 1863 as a financially autonomous bureau of the Treasury, is charterer and primary supervisor of national banks (1,705), and primary supervisor of U.S. branches of foreign banks (12).
- The Office of Thrift Supervision, established in 1989 as an autonomous bureau of the Treasury, is lead supervisor of thrift holding companies (481), charterer and primary supervisor of federal thrifts (837), and joint primary supervisor of state thrifts (433).
- The National Credit Union Administration, set up in 1970, is chartering authority and supervisor of federal credit unions (5,189), and insurer of all federal and most (3,173) state credit unions.

Once again, broadly speaking, there was a systemic failure in the regulation of financial markets. Despite the emphasis on capital adequacy, capital regulation was imposed in a way that allowed the buildup of significant leverage and promoted procyclicality. In addition, the fragmentation of regulation, especially in the United States, as noted above, contributed to regulatory arbitrage encouraging greater institutional risk taking. Moreover, large systemically important segments—such as hedge funds and the special investment vehicles created by banks—were outside the scope of prudential regulation.

IMF: *The growing consensus on regulatory weaknesses has led to many reform proposals from different quarters. Can you offer us your productive suggestion on the reform? And what is the challenge and the common theme that proposed to restore prudential regulation that is countercyclical?* ([Question 7](#))

Mr. Nechemia: The crisis has revealed important flaws in the current global financial architecture. A foundational starting point for reform might consider the following as a blueprint to implement the necessary, or rather, mandatory changes in order to repair this systemically broken system. This policy recommendation focuses on four key areas where reform is badly needed; they are as follows:

Surveillance of systemic risk. Vulnerabilities can arise from a variety of sources, including unexpected events, bad policies, misaligned exchange rates, credit-fueled asset booms, external imbalances, or data deficiencies that obscure trends. To gain traction, surveillance needs to be reoriented to ensure warnings are clear, to successfully connect the dots, and to provide practical advice to policy makers.

International coordination of macro-prudential responses to systemic risk. This cuts to the arrangements that govern collective policy decisions, involving forums such as the International

Monetary and Financial Committee, the Financial Stability Forum, and the various “Gs” (in particular, the G7 and G20). Systemic concerns about the international economy should be reported directly to policy makers with the ability and mandate to take action.

Cross-border arrangements for financial regulation. Best practices should be developed to help avoid regulatory arbitrage and assist in burden sharing across jurisdictions by international financial conglomerates, with understandings on regulation, supervision, and resolution. These ground rules need to be strengthened and made more automatic to avoid a repetition of the “go-it-alone” responses seen in this crisis.

Funding for liquidity support or external adjustment. Public funds should be made available from the International Monetary Fund, the World Bank and others to help countries weather short-term liquidity strains, or to smooth necessary adjustments from unsustainable external trajectories. Given the size of international transactions, these resources should be augmented, and processes for providing short-term liquidity better defined.

The growing consensus on regulatory weaknesses has led to many reform proposals from different quarters. A common theme has been that the balance between regulation and laissez-faire needs to be restored in favor of prudential regulation that is countercyclical, comprehensive in its coverage of financial institutions, and global in scope and consistency.

These proposals emphasize, among other things, the need for (1) improved incentives for prudent risk-taking through such steps as reform of compensation and greater risk sharing on the part of loan and securities originators; (2) much tighter capital regulation, with stricter limits on leverage and built-in stabilizers to prevent procyclicality and buildup of asset bubbles; (3) greater attention to liquidity supervision and funding risks; (4) better mechanisms for supervising large, complex cross-border financial institutions; (5) extending the scope of financial regulation to ensure that all systemically important institutions are appropriately regulated; (6) improved transparency and reduced systemic risks associated with derivatives and complex financial instruments through greater reliance on exchange-traded or electronic trading platforms rather than on over-the-counter derivatives transactions; and (7) ensuring that credit rating agencies meet the highest standards and avoid conflicts of interest.

Although there may be broad agreement on most of these elements, the devil is in the details. The views of those who propose much tighter regulation differ from those who rely on market discipline and believe in preserving room for financial innovation.

There must be reforms of the regulatory and supervisory frameworks. The evidence suggests that reforms of the regulatory and supervisory frameworks are only part of the answer however. There are a broader set of issues that includes trade, financial integration, and macroeconomic policies. Furthermore, policy cooperation at the global level requires an adequate institutional framework; for this reason, the reform of international financial institutions is once again bound to be on the menu of discussions.

There exists a great need to focus above all things on coherence of responsibility among regulatory agencies for particular aspects or objectives of regulation as it is related to effectiveness. This

coherence, in turn, raises the question of interagency rivalry and disputes and of the effectiveness of needed information exchange and coordination.

In the face of current global financial crisis, I believe, at least more than G 20s make coordinated efforts to formulate regulatory system in conformity with the global economic integration. We need to consider establishing the new regulatory system. We cannot put our hopes to save the economy on the remedy of the old system. (additional paragraph by IFM)

IMF: It is imperative to reform the structure of regulatory system, can you offer concluding remarks and a summery about the impornance of *orderly functioning* regulatory structure for the country's financial system ? (**Question 6**)

Mr. Nechemia: I would like to sound a note of caution: We must be careful not to focus excessively on new regulations intended to fight the last battle when the next one could be different. We already have made a lot of progress in recognizing that supervision should be "risk-based" and that regulation should be "incentive compatible." These principles should be kept in mind when we look ahead. The key will be to adapt these concepts to the problems of today with careful thought given to what we expect to happen tomorrow.

With regard to the institutional structure of supervisory agencies, this is not simply an administrative matter; it is important to meet the objectives of financial supervision for several reasons. The objectives of financial supervision are to promote efficiency and competition, to maintain market confidence, to protect depositors or consumers (as appropriate), and to foster systemic stability. Supervisory capacity and the supervisory process itself are the critical elements in attaining those goals. Above all other considerations, institutional structure may have an effect on supervisory capacity and process and, hence, on the overall effectiveness of regulation and supervision, because of the expertise, experience, and culture that develop within particular regulatory agencies and with the approaches they adopt.

A multiple-agency regime, especially if it allows regulated institutions an element of choice, creates the potential for regulatory arbitrage and inconsistent regulation between different institutions conducting the same type of business.

Public perceptions and credibility also may be a significant issue in that, with multiple agencies, it may not be clear to the consumer which agency is responsible for a particular issue of regulation or to whom complaints should be addressed.

There are four prerequisites for good regulatory governance in regulatory and supervisory agencies: accountability, independence, integrity, and transparency. Each may be affected by a structural change in the supervisory process. The importance of corporate governance arrangements arises from several factors:

- (a) they determine the effectiveness and efficiency of the agencies' operations;
 - (b) they have a powerful effect on the agency's credibility, authority, and public standing;
- and

- (c) they have an important effect on the authority and credibility of agency's' attempt to encourage and to require effective corporate governance arrangements within regulated firms.

Given the above, it is clear why the institutional structure of regulatory agencies is an issue of both concern (to consumers, regulators and industry participants) and significant. However, the importance should not be exaggerated. A crucial point is that institutional structure does not, in itself, guarantee what really matters, namely, the effectiveness of regulation in achieving its objectives in an efficient and cost-effective manner.