



# **Special Topic I**

## **An Overview of International Financial Regulatory Reform**

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**T**he current international financial crisis driven by US sub-prime crisis has severely shocked the global financial system and made major countries recognize the significance of reinforcing financial regulation. In order to address the weakness and gaps of the existing regulatory framework exposed in the crisis, major advanced economies in collaboration with the International Organizations and Standard Setters, such as G20, FSB, BCBS, IOSCO and IAIS, released financial regulatory reform proposals and plans with the aim to construct a more improved financial regulatory system. Making research on the direction and development of international financial regulatory reform and drawing on the experiences of international financial regulatory reform are of great importance to promote the healthy development of Chinese financial sector.

## The Basic Features of the International Financial Regulatory Reform

Taking stock of the proposals and plans released by the major countries and international organizations, one can see that this round of international financial regulatory reform has broken through the existing institutional framework and taken on new features as follows:

**The regulatory idea has shifted to strengthening supervision.** Since 1980's in the wake of rapid development of financial innovation and liberalization, a number of ad-

vanced economies represented by US laid emphasis on financial deregulation and market discipline. Particularly since US enacted *Financial Services Modernization Act* in 1999, various credit derivatives have developed rapidly and outpaced supervision. Therefore, there was a serious unbalance between financial development and financial supervision. The current crisis demonstrated that the regulatory idea featured by over-reliance on market discipline and internal risk control of financial institutions, supplemented by the external supervision could not correct the inherent flaws of the market. Since the outbreak of the crisis, current regulatory idea has been reconsidered by advanced economies and their financial regulatory framework experienced great changes. Various reform plans released by major advanced economies represented by US proposed to impose more stringent financial supervision standards.

### **Regulatory aim has been adjusted to lay emphasis on preventing systemic risk.**

The current financial supervision focuses on micro-prudential supervision, which concerns more about soundness, profitability and solvency of individual financial institutions, but it overlooks the change of financial institution's business model, interconnectedness among financial sectors, impact of macroeconomic variables on financial system soundness and the resulting and cumulated systemic risk. Some countries recognized from the crisis the shortcomings of solely putting emphasis on the micro-prudential supervision and recommended macro-prudential management should be enhanced, in which the finan-

cial sectors should be taken as a whole. Both the potential risk contagion resulting from interconnectedness within the financial system and soundness of financial system across economic cycles should be taken into consideration, so as to make up the defects of micro-prudential supervision and effectively manage the financial system risks. Among the reform plans released by concerned jurisdictions, designing a supervisory framework combining macro-prudential management and micro-prudential supervision has become an essential part of the content, which mainly included strengthening macro-prudential analysis, assessing the potential risks arising from the macroeconomic and financial system development that threaten financial stability, selecting policy measures accordingly and comprehensively and using macro-prudential tools to prevent systemic risk.

**Regulatory scope has been expanded and supervisory method has been further improved.** Certain financial institutions, markets and innovative instruments that were unregulated contributed to the current crisis. Given that G20 London Summit called on to review the scope of financial regulation and all systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight. Non-systemically important financial institutions, markets and instruments could also be subject to some form of registration requirement or oversight. The US and EU supervisory reform plans were involved with each part of the financial system and the supervisory claws have been further extended.

The standard-setting bodies such as BCBS, IOSCO and IAIS are now making efforts to revise and improve the related supervisory standards, the new standards are involved with more stringent capital requirement, liquidity, risk management, transparency, corporate governance and compensation policy etc. With the issuance and implementation of these rules, the supervision method will be further improved which will be helpful for the sound operation of financial institutions.

### **Cross-border supervisory cooperation has been strengthened and enhanced.**

The outbreak of the current crisis underscored the necessity of strengthening cross-border supervision cooperation. G20 London Summit recalled that based on the existing national supervisory framework, supervisors should collaborate to establish supervisory colleges for all large cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms; national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level and enhance information sharing arrangements between supervisors; cross-border crisis management cooperation among regulators should be enhanced; financial institutions resolution regimes and bankruptcy laws should be improved and research should be conducted on cross-border cooperation in financial institutions failure. Currently over 30 supervisory colleges for large financial institutions have been established. In April 2009, FSB released *Principles for Cross-border Cooperation on Crisis Management*, including 15 principles of

cross-border cooperation on crisis management, covering prevention, responding and resolution of risks. In addition, reform plans released by US, UK and EU all highlighted strengthening international supervisory coordination and cooperation.

**G20 has become an important cooperation platform for international financial supervision.** In November 2008, G20 held its first Summit in Washington, US, the leaders got together and discussed to address the international financial crisis and sought to achieve consensus for the global financial reform. In April and September 2009, G20 held Summits in London and Pittsburgh respectively. Since then, G20 has played a leading role in promoting international regulatory reform, strengthening effective governance in global economy and normalize economic globalization, and has become an important platform for policy dialogue and coordination in international economic and financial arena. In order to reform international financial supervisory regime, rebuild financial system and prevent crisis spread and recurrence, G20 has put forward specific recommendations and requirements for global financial supervisory reform, promoted the emerging economies to enter FSB and had FSB as the leader of global financial supervisory standard setters. Currently, led by FSB, BCBS, IOSCO and IAIS are making efforts in revising and improving related standards and codes.

## Main Content of the International Financial Regulatory Reform

### *Strengthening Macro-prudential Management and Safeguarding Financial Stability*

**Preventing systemic risk is the core aim of financial regulatory reform.** Preventing systemic risk and safeguarding financial stability have been the key content of various reform proposals and plans. G20 London Summit recommended jurisdictions to supplement micro-prudential and market integrity regulation with macro-prudential management to mitigate the build-up of systemic risk. Both *Blueprint for a Modernized Financial Regulatory Structure* by Bush Administration and *Financial Regulatory Reform: A New Foundation* by Obama Administration took preventing systemic risk as the essential aim of financial regulatory reform. *European Financial Supervision* by EU put forward to set up European Systemic Risk Council (ESRC) with the responsibility of monitoring and early-warning the potential systemic risk in EU financial market and making policy recommendations when necessary.

**The entity, responsibility and power for preventing systemic risk were clarified and the leading role of central banks has been reinforced.** The crisis has demonstrated that the split of supervisory function from central banks was not good for effectively monitoring and preventing systemic risk. Therefore, the reform proposals and plans to



some extent recommended to strengthen central banks' role in preventing systemic risk. *Wall Street Reform and Consumer Protection Act of 2009* passed in the House of Representatives in US stipulated that the Federal Reserve had the authority to request the identified large financial holding companies threatening financial stability to sale, transfer assets or terminate any specific activities to downsize, limit their concentration, and also request the identified severely undercapitalized large financial holding companies to go bankrupt. *European Financial Supervision* by EU clearly indicated that central banks should play a leading role in macro-prudential management with the main responsibility of maintaining monetary and financial stability.

**The coordination, cooperation and information sharing among supervisory agencies have been strengthened.** The regulatory reform plan of Obama Administration pointed out supervisory separation had caused serious supervisory overlapping and gap and strengthening the coordination between financial supervisory agencies was an important method to resolve the problem. *Wall Street Reform and Consumer Protection Act of 2009* required establishing the cross-agency Financial Services Oversight Council (FSOC) consisting of heads of financial supervisory agencies, with duties to advise the Congress on financial supervision, to identify financial companies and financial activities that should be supervised, to provide a forum for discussion of disputes among its members and to subject financial activities and behavior threatening financial stability to stricter regula-

tory rules and standards.

**Systemically important institutions, markets and instruments should be taken into account and the supervision of "Too Big To Fail" financial institutions should be strengthened.** G20 London Summit recommended that all systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight, consistently applied and proportionate to their local and global systemic importance. Recalled on by the G20 leaders, IMF, BIS and FSB jointly released *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* in November 2009, which put forward the standards and methodologies of assessing systemic importance of financial institutions, markets and instruments. In addition, to address the risk of "Too Big To Fail" financial institutions, some countries proposed to impose stricter regulatory standards on systemically important financial institutions, strengthen the routine supervision, and mitigate the size of large financial institutions. US President Obama proposed in January 2010 to limit the size and scope of large banks, forbid banks to engage in proprietary trading for their own interest while not for serving customers, and forbid banks to own, invest in or sponsor private equity and hedge fund.

**Counter-cyclical supervisory measures have been introduced in order to iron procyclical impact.** The procyclicality of the financial system had contributed to the cur-

rent crisis and was reflected in the supervisory requirement of capital, fair value accounting standards and credit rating etc. FSB released the *Report on Addressing Procyclicality in the Financial System* in April 2009, and proposed to establish a mechanism to reduce procyclicality. The specific measures included capital framework, loan loss provisioning and interaction of valuation and leverage. BCBS and IOSCO and other standard-setting bodies are also undertaking research on making supervisory rules to reduce procyclicality.

*Extending Regulatory Scope and Ensuring that the Entire Financial System Subject to Appropriate Oversight*

**Hedge fund.** IOSCO published a series of rules for hedge funds in June 2009, which included mandatory registration/regulation and supervision and providing information for systemic risk purposes. IOSCO also required regulators should have the authority to cooperate and share information, in order to facilitate efficient and effective oversight of global active hedge funds and/or their managers. US and European jurisdictions have initiated the regulation on hedge funds. The supervisory reform plans of the Senates and House of Representatives in US both required hedge funds to register in SEC and enhance the information reporting and disclosure. EU is formulating *Directive on Alternative Investment Fund Managers* to establish an overall and effective management and regulatory framework for investment fund managers including hedge funds.

**Credit Rating Agencies.** In April 2009,

G20 London Summit recommended to impose regulations on credit rating agencies. Since then some countries and regions had started to take measures to reduce reliance on external ratings in rules and regulations. SEC revised again *General Rules and Regulations under the Securities Exchange Act* and made further stipulations on maintaining independence, preventing conflict of interest and strengthening information disclosure of credit rating agencies. EU released *Regulation on Credit Rating Agencies* and established legal regulatory framework for credit rating agencies.

**OTC Derivatives.** In order to enhance the transparency of OTC derivatives market, G20 London Summit called to launch central counterparties (CCP) mechanism for OTC derivatives. CPSS and IOSCO set up a joint working group to strengthen implementation of the existing clearing standards of CCP and extend the standards to better address risks related to central settlements of OTC derivatives. In addition, work to strengthen the regulation of OTC derivatives market was also underway. OTC Derivatives Regulators Forum was established in September 2009 to prepare to set up the international regulatory cooperation framework for global CDS repositories and global trading repositories for interest rate derivatives and equity derivatives. In March 2009, Intercontinental Commodity Exchanges (ICE) in US formally introduced the central counterparties in CDS market for the first time and began to provide central clearing services for CDS. A number of CDS contracts Clearing Houses started to operate in UK and continental Europe.

### *Improving Supervisory Tools and Methods to Reinforce the Effectiveness of Micro-supervision*

**Enhance capital quality and increase the risk coverage of capital.** Since the outbreak of the crisis, BCBS has been making efforts in drawing lessons from the crisis and exploring to make international banking regulatory reform measures to strengthen capital supervisory framework. BCBS released *Revisions to the Basel II Market Risk Framework and Guidelines for Computing Capital for Incremental Risk in the Trading Book* in July 2009, which strengthened the capital requirement on securitization, resecuritization and trading book and widened the capital coverage on counterparty credit risk. BCBS released *Strengthening the Resilience of Banking Sector-consultative document* in December 2009, which aimed to strengthen supervisory capital framework, introduce leverage ratio and develop counter-cyclical capital buffer etc.

**Set up liquidity supervisory standards and strengthen liquidity risk management.** BCBS released *Principles for Sound Liquidity Risk Management and Supervision* in September 2008, which significantly enhanced liquidity management standards of the banking sector, clarified the procedures and methods of banks' liquidity risk monitoring and control and stipulated the basic principles and duties of liquidity risk supervision. BCBS released *International Framework for Liquidity Risk Measurement, Standards and Monitoring-consultative document* in December 2009, which established the global uniform minimum liquidity standards for internationally active

banks, introduced general liquidity risk monitoring tools, strengthened cross-border liquidity supervisory cooperation and information sharing aimed at helping supervisory authorities identify and analyze liquidity risk in the banking sector and strengthen the capacity of banking sector to address the global liquidity stress. In addition, Committee of European Banking Supervisors proposed 30 principles for liquidity risk management including both liquidity management in financial institutions and liquidity risk supervision.

**Improve the institutions and instruments for risk management to enhance risk management capacities.** While strengthening capital and liquidity supervision, BCBS responded to the requirements and recommendations of G20 and FSB and made recommendations on provisioning and stress testing issues so as to enhance the overall risk management capacity of financial institutions. On provisioning, BCBS proposed the forward-looking provisioning method based on expected loss to encourage banks to strengthen provisioning. On stress testing, BCBS released *Principles for Sound Stress Testing Practices and Supervision* in May 2009, which made an assessment of the stress testing practices in the crisis and based on that made guidelines and recommendations to strengthen stress testing for banks.

**Make alterations to the accounting standards to enhance information disclosure and transparency.** To fill up the gap in information disclosure of innovative products and address the inconsistency of disclosure standards, G20 London Summit rec-



ommended accounting standard setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments and enhance disclosure requirement, and also recommended IASB should enhance its efforts to facilitate the global convergence towards a single set of high-quality accounting standards applied globally. US FASB issued *Transfers of Financial Assets* and *Amendments to FASB Interpretation No. 46 (R)*, which strengthened the information disclosure requirement for off-balance sheet activities. In November 2009, IASB issued *IFRS 9: Financial Instruments*, which introduced new requirement for financial assets classification and measurement and reduced the complexity of financial instruments accounting. IASB and FASB are planning to complete the convergence of 10 standards including financial accounting instruments, consolidation, derecognition and fair value measurement etc.

**Improve compensation management and construct reasonable compensation incentive mechanism.** To avoid distortion of incentive mechanism as a result of financial institutions' compensation policy, FSB released *Principles on Sound Compensation Practices* and *Implementation Standards of Principles on Sound Compensation Practices* in 2009, which enhanced transparency requirement of the compensation mechanism in financial institutions to reinforce the market discipline on compensation. BCBS, IOSCO and IAIS have begun to absorb the recommended FSB Principles and Standards into their guidelines respectively and FSB members are also actively promoting implementation of the

related standards.

### *Improving Deposit Insurance System and Financial Consumer Protection System to Maintain Market Stability*

**Further improve deposit insurance system.** The current crisis showed that deposit insurance system positively contributed to preventing and weathering systemic risk. Based on the sum up of experiences of deposit insurance systems in concerned countries in addressing the crisis, IADI and BCBS jointly released *Core Principles for Effective Deposit Insurance Systems* including 18 principles for the establishment of an effective deposit insurance system, which clarified policy objectives of deposit insurance, emphasized to reduce moral hazard by reasonable institutional design and proposed deposit insurance agencies should involve the early monitoring, timely intervention and resolution of problem banks. Currently, FSB has put these principles into its Compendium of Standards, which mainly includes a series of internationally accepted standards that are necessary in maintaining a stable and well-operating financial system.

**Establish financial consumer protection system.** The mistakes of financial institutions, credit rating agencies and supervisory authorities in the crisis had severely shattered the public confidence on financial institutions. In order to restore public confidence, the concerned countries strengthened financial consumer protection system. The various US regulatory reform plans strengthened the financial consumer protection by the following ways: establishing an independent Consumer Finan-

cial Protection Agency (CFPA) and uniformly providing comprehensive protection for consumers and investors from financial harm; requiring related institutions to take reasonable information disclosure methods, communicate adequately with consumers, and fully disclose the rights of consumers and the cost, loss and risk they bear, and reforming the consumer protection system in enhancing transparency, simplification, fairness and availability. *Reforming Financial Markets* by UK proposed to fine-tune the existing financial consumer protection system. First, financial services compensation schemes are fully funded ex ante to increase the protection. Second, further strengthen the interest protection of financial consumers, including enhancing the transparency of financial services and products and timely resolving financial consumer filings.

## The Difficulties and Problems Facing International Financial Regulatory Reform

Overall, the ongoing international financial regulatory reform to some extent is beneficial to the financial system stability. However, there are still some obstacles and resistance to the implementation of reform measures and plans, therefore, the prospect of reform will be uncertain.

### *It Is Difficult to Coordinate the Concerned Interest Parties*

At the international level, the financial regula-

tory reform concerns of each country are different, so it is difficult to reach consensus for implementing all the measures of the comprehensive financial regulation. For example, before G20 London Summit, EU was in favor of external supervision supplemented by the codes and conducts constraints, while US and UK highlighted strengthening supervision by improving financial codes and conducts, and enhancing self-disciplines and transparency. At domestic level, the financial regulatory reform involves different interest groups, disputes and fights are inevitable. In the birthplace of the crisis-US, the regulatory reform plan released by Obama Administration caused disputes of related parties. The discussion on empowering Federal Reserve the systemic risk regulator involved adjusting the supervisory principles of separation of powers and checks and balances, the independence of Federal Reserve as monetary policy maker and power transferring of other supervisory agencies. On the proposal to setting up an independent consumer financial protection agency, financial institutions argued that would increase cost and limit the consumers' choice.

### *The Timing of Reform will Impact the Effect*

The current financial crisis has shocked the financial system severely and urged the international community to rethink, and therefore, the crisis has been the driving force of the financial regulatory reform. However, with the alleviation of the crisis and effectiveness of responding measures, there has seen some signs of economic and financial system recovery since the second half of 2009. The interna-

tional community generally regarded that the worst period of the crisis had passed and the weary mood in reform was increasing. The original proactive reform proposals are losing market now and the lobbyists of interest group in major countries form domestic obstacles, which is not favorable for the going forward of reform.

### *Reform Has not Touched the Core Part*

Although this round of financial regulatory reform proposed some measures with regard to the weakness and gaps exposed in the crisis. However, the reform was still limited to fixing the existing regulatory framework and was not an overhaul to the system. For instance, the reform plans still did not effectively resolve the supervisory overlapping and gaps under the supervision separation regime and the reform measures to credit rating agencies did not touch upon the root of conflict of interest. In the crisis, the major credit rating agencies contributed to the development and spread of the crisis, the root cause lay at “Issuer-Pay” model in the current rating system and rating agencies tended to protect the interest of issuers and their own but omitted the investors’ interest. The related reform plans only called on to improve the information disclosure of rating agencies but did not touch on publication of more details and better control of interest conflicts, and also did not involve reforming the “Pay for Rating” model.

### *Reform Did not Involve the Supervisory Accountability Mechanism*

Overall, this round of reform touched little

upon accountability for the weak enforcement in regulation, supervisory inaction and even failure. The crisis demonstrated that supervision weakness was one of the reasons for the high leverage ratio and increasing risk in the financial system. G20 London Summit believed that achieving the regulatory objectives required not only sound regulation but also effective enforcement. No matter how sound the rules for regulating the conduct of market participants were, if the system of enforcement was ineffective, the ability of the system to achieve the desired outcome was undermined. Although G20 Summit made recommendations on that, the following reform plans touched little upon the supervisory accountability.

In recent years, Chinese financial reform has proceeded orderly and made remarkable achievement. Currently, China should grasp the historic opportunity. On the one hand, should actively participate in the international financial supervisory reform undertaken by the international organizations and standard-setting bodies, timely follow and understand the recent trend of financial regulation and make efforts to expand China’s influence and voice in the related organizations and agencies; on the other hand, should learn from and draw on the fruits of the international financial regulatory reform when formulating domestic financial reform and development strategy, further promote domestic financial reform, improve micro-prudential supervision, strengthen macro-prudential management, improve investor protection system, construct long-term effective mechanism for preventing systemic risk and safeguard financial stability.