



Faculté de Droit, d'Economie et de Finance

Global regulation of financial markets and future of financial engineering

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I Introduction

1°) Global crisis calls for global answers

Global markets

Markets are interconnected

Financial entities (investment banks, Hedge funds...) work on a global scale

Development of international accounting standards (IFRS)

Mutual recognition of financial intermediaries (EU directives, bilateral agreements)

Global crisis

Regulatory failures in the US were felt in other jurisdictions: allowance of excessive leverage of investment firms by the SEC in 2004 (Consolidated Supervised Entities; net capital rule; leverage of 1:30), lack of consumer oriented regulation of subprime lending by the Federal Reserve (Regulation Z - Truth in lending), lack of effective regulation of Credit Ratings Agencies, ...

Global answer to the crisis

Some regulatory actions are useless unless global (ex: temporary ban on short selling) or are more efficient if global (accounting rules)

Push towards more international coordination among regulators

New regulation to develop concerning markets and financial entities involved in the financial engineering, such as Credit Rating Agencies and Hedge Funds



I Introduction

- Traditionnaly, financial innovation and regulation of financial markets were US led : not cooperation but influence
 - Sarbanes-Oxley Act, 2002: Section 404 on internal control, auditors registration
- Traditionnaly, cooperation among securities regulators mostly in the field of enforcement (eg IOSCO 2002 MoU in enforcement) and general principles
- Global nature of financial crisis creates an opportunity to have a global fix
- US origin of the crisis creates a possibility to have a more cooperative approach



I Introduction

2°) Regulatory bodies involved in global financial regulation

Political international bodies

European G-8: October 4, 2008 meeting (Paris)

Encourage cooperation. Request changes in accounting rules so as not to disadvantage European financial institutions

Group of twenty (G-20): November 15, 2008 summit on international financial architecture (Washington)

Call towards more intensified international cooperation among regulators and strengthening of international standards; List of immediate (March 31, 2009) and medium-term actions

Public technical bodies

Financial Stability Forum (FSF):

Elaboration of international financial sector supervisory and regulatory policies and standards, and coordination across the various standard setting bodies; Implementation of policies in the financial sector is the responsibility of national authorities (IMF-FSF joint statement, November 13, 2008)

Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, 7 April 2008; Follow up report on implementation, 10 October 2008

Committee on the Global Financial System (CGFS)

The role of ratings in structured finance: issues and implications, January 2005

Ratings in structured finance: what went wrong and what can be done to address shortcomings?, July 2008



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I Introduction

International Organisation of Securities Commissions (IOSCO)

IOSCO Technical Committee launches Task Forces to support G-20 aims (25 November 2008)

Short Selling ; Unregulated Financial Markets (OTC markets for derivatives) and Products;
Unregulated Financial Entities (Hedge Funds)

Important role in the oversight of Credit Rating Agencies

The role of CRA in structured finance markets, Final Report, May 2008

Report on the subprime crisis, Final Report, May 2008

Private sector technical bodies

Group of 30 (Washington)

Financial Reform: A Framework for Financial Stability (15 January 2009)

Paul Volcker, former Federal Reserve Chairman, chairman of the Group of 30 and Obama advisor

Hedge Funds Standards Board (London)

Hedge Fund Standards (2008)

Counterparty Risk Management Policy Group (CPRMPG)

Containing Systemic Risk: The Road to Reform, The Report of the CRMPG III, August 6, 2008



I Introduction

International Accounting Standards Board (IASB)

Regional or national standard setters with global impact

European Union

Proposals by the EU Commission on regulation of credit rating agencies and Hedge funds

Committee of European Securities Regulators (CESR)

Yearly report on Credit rating agencies

US Congress

Major legal answer to the crisis to be expected by August 2009

Already some proposals: Derivatives Trading Integrity Act, S. 272

US Securities and Exchange Commission (SEC)

Rules on Credit rating agencies

President's Working Group on Financial Markets

PWG's Principles and Guidelines Regarding Private Pools of Capital (February 2007)

Best practices for the Hedge Fund Industry, April 2008 (report for comment); Final Report, January 2009

Financial Accounting Standards Board (FASB)

Rules on fair value accounting

Rules on off-balance sheet vehicles



II Global regulation of financial markets

- A Temporary bans on short-selling of financial stocks
- B Modifications of accounting standards

A Temporary bans on short-selling of financial stocks

Short selling used by Hedge funds: coordinated ban on short selling by major regulators

Securities and Exchange Commission (SEC)

July 2008 : SEC ban on « naked » short selling applicable to 19 financial firms

Sept. 2008 : ban applicable to 799 financial companies (ban ended in October)

Europe: similar ban by most EU securities regulators (major jurisdictions: UK, France, Germany), starting September 22, 2009

Transparency towards the regulator if net economic position of more than 0,25% of the capital (UK, France, Belgium...)

Japan: similar ban and transparency requirement by Japanese FSA (October-November, 2008)

Important coordination among securities regulators (also through CESR and IOSCO)

- IOSCO Task Force will work to eliminate gaps in various regulatory approaches to naked short selling, including delivery requirements and disclosure of short positions (November 2008)



II Global regulation of financial markets

B Modifications of accounting rules

1°) Fair value accounting

Accounting for structured finance products in illiquid markets (« mark to model »; « Level 3 »);
lack of liquidity affects mostly complex derivatives or structured financial instruments

FSF Report on Enhancing Market and Institutional Resilience, 7 April 2008
Request to the IASB to improve its guidance on fair value in case of distressed markets

IOSCO Report on the subprime crisis, Final Report, May 2008
IOSCO task force will consider whether additional guidance and disclosure related to
measurement at fair value would be valuable in meeting the needs of investors

IASB

IASB amendments to IAS 39 (Financial Instruments: Recognition and Measurement) and
IFRS 7 to permit reclassifications of financial assets under certain circumstances in
order to reduce lossess (October 2008): alignment with US GAAP

IASB Expert Advisory Panel, Measuring and disclosing the fair value of financial
instruments in markets that are no longer active, October 2008



II Global regulation of financial markets

B Modifications of accounting rules

FASB

Interpretative guidance on fair value measurement under US standards

SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (30 sept. 2008)

Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

IASB considered the guidance consistent with IAS 39

SEC

Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, 30 December 2008

SEC does not recommend suspending FAS 157, Fair Value Measurement, or mark-to-market accounting; SEC recommends that further improvements can be made to impairment standards and recommends further guidance

G-30, Financial Reform: A Framework for Financial Stability (15 January 2009)

Developing "more realistic guidelines" for dealing with less liquid instruments in distressed markets (Recommendation 12)



II Global regulation of financial markets

B Global coordination in regulating accounting issues

2°) Off balance sheet entities

Off balance sheet entities ("special purpose entities", "structured investment vehicles") used in the securitization process

FSF Report on Enhancing Market and Institutional Resilience, 7 April 2008

"Standard setters will take urgent action to: improve and converge financial reporting standards for off-balance sheet vehicles"

G-30, Financial Reform: A Framework for Financial Stability (15 January 2009)

pending accounting rules changes for the consolidation of many types of off-balance-sheet vehicles represent a positive and needed improvement (Recommendation 13)

IASB

IASB published proposals to strengthen and improve the requirements for identifying which entities a company controls. Further proposals on off balance sheet items, covering the derecognition of assets and liabilities, are due to be published towards the end of the first quarter of 2009, consistent with the G20 target date of 31 March 2009 (18 December 2008)



II Global regulation of financial markets

B Global coordination in regulating accounting issues

2°) Off balance sheet entities

FASB

First proposals (exposure draft) to amend standards for off balance sheet entities in 2005, but opposition from private sector

Two rules govern off balance sheet entities

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

Whether it is a sale for accounting purposes (off balance sheet) v. secured borrowing for accounting purpose (on balance sheet)

FIN 46R, *Consolidation of variable interest entities*

Governs consolidation of special purpose entities

Proposal would eliminate the (Qualifying SPE (QSPE) exception

Adoption of the proposal would lead to consolidation of a significant portion of SPEs and SIVs

New model would be closer to IFRS, but FASB and IASB approaches differ



III Global regulation of financial intermediaries

A Securitization and Credit rating agencies

B Hedge Funds

A Securitization and Credit rating agencies

Group of twenty (G-20): November 15, 2008

The international organization of securities regulators should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance.

FSF Report on Enhancing Market and Institutional Resilience, 7 April 2008

Implement the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process

Differentiate ratings on structured credit products from those on bonds and expand the information they provide.

FSF Follow up report on implementation of the report on Enhancing Market and Institutional Resilience, 10 October 2008

Credit rating agencies (CRAs) to enhance their efforts to comply with the FSF recommendations, including by making industry-wide proposals for providing differentiated information or ratings for structured products.



III Global regulation of financial intermediaries

A Securitization and Credit rating agencies

IOSCO

The role of CRA in structured finance markets, Final Report, May 2008

Proposal from this report integrated in the Code of Conduct

Code of conduct Fundamentals for Credit Rating Agencies, May 2008

Where a CRA rates a structured finance product, it should provide investors with sufficient information about its loss and cash-flow analysis so that an investor can understand the basis for the CRA's rating.

A CRA should differentiate ratings of structured finance products from traditional corporate bond ratings, preferably through a different rating symbology.

CGFS, Ratings in structured finance: what went wrong and what can be done to address shortcomings ?, July 2008

Request from the FSF; 10 recommendations (more transparency on CRA models, and disclosure of sensitivity to changes in central assumptions)



III Global regulation of financial intermediaries

A Securitization and Credit rating agencies

EU Commission proposal for a regulation of the European Parliament and of the Council on Credit Rating Agencies (12 November 2008)

Credit rating attributed to structured finance instruments are clearly differentiated from other ratings (Art. 8.3 a))

Publication of a report that provides a detailed description of the rating methodology used to determine the credit rating (Art. 8.3 b)

CESR Consultation Paper - The role of credit rating agencies in structured finance (February 2008)

SEC: three proposed rules on Credit rating agencies (July 2008)

Prohibit a credit rating agency from issuing a rating on a structured product unless information on assets underlying the product was available.

Prohibit credit rating agencies from structuring the same products that they rate.

Require the public disclosure of the information a credit rating agency uses to determine a rating on a structured product, including information on the underlying assets.

G-30, Financial Reform: A Framework for Financial Stability (15 January 2009)

Force banks to hold on to a significant portion of credit risk when they package loans into securities and sell them on, in order to curb reckless underwriting of mortgages and other debt (Recommendation 13); Permit users to hold CRAs accountable for the quality of their work product (Recommendation 14)



III Global regulation of financial intermediaries

B Hedge Funds

Group of twenty (G-20): November 15, 2008 summit on international financial architecture (Washington)

« ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances »

IOSCO Technical Committee launches Task Forces to support G-20 aims (25 November 2008)

The Task Force will examine issues surrounding unregulated entities such as hedge funds, including the development of recommended regulatory approaches to mitigate risks associated with their trading and traditional opacity (report due in February 2009)

Hedge Fund Working Group

Hedge Fund Standards (January 2008)

28 recommendations (disclosure on the fund strategy, of commercial terms, of hard to value assets, segregation of functions of management and valuation of assets,...)



III Global regulation of financial intermediaries

B Hedge Funds

President's Working Group on Financial Markets

Best practices for the Hedge Fund Industry, Final Report January 2009

Report of the Investors Committee

Report of the Asset Managers' Committee

Disclosure, segregation of responsibilities in valuation, risk management, specific practices to address conflict of interests

EU Commission

Consultation paper on Hedge fund (Consultation from 18.12.2008 to 31.01.2009)

Systemic risk of Hedge funds, transparency of short selling, risk management and valuation techniques, pre contractual and on going transparency towards investors and investor protection



IV Conclusion

Global consensus and on regulation of financial engineering and financial markets

Some exceptions: short selling (repealed in the US but still valid in Europe and Japan), G-30 group more rigorous proposals

Efficient coordination among international and national standard setters

Leading role of FSF, IOSCO and Europe

But major US legislation to be expected by mid-2009

All measures tend towards a stronger oversight and probably a reduction of financial engineering



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