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## The enhanced regulation of financial markets: work in progress or exercise in futility?

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(The opinions expressed in this article are those of the author only)

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## I. INTRODUCTION

To stifle financial speculation and ban the shenanigans that brought on the devastating stock market crash of 1929, the U.S. Congress enacted a series of measures to save a moribund capitalist system. The *Glass-Steagall Act* of 1934, in barely **53 pages**, mandated a new regulatory framework for banks and other financial institutions in the United States.

Under intense popular pressure countervailed by equally intense and effective lobbying, the US Congress finally adopted in July 2010 the *Dodd-Frank Act* as a putative response to the financial collapse the world experienced in the fall of 2008. In its draft form, the Act ran to some **2,315 pages**; in its final official version (in eight-point types), the Dodd-Frank Act takes **848 pages** to mandate a new set of rules for the U.S. financial system!

A 53-page Act in 1934 versus an 848-page one in 2010 is a good indicator of the intricacy and complexity of financial markets in our time. But the act is only the tip of a new U.S. regulatory iceberg. The Dodd-Frank Act heaps upon U.S. regulatory agencies dozens of unresolved issues with instructions for them to bring forth policies and rules to cope with these issues at a specified later date. In this manner, the U.S. regulation of the financial system is at best a work in progress with an uncertain final shape.

The *Financial Stability Board (FSB)*, an off-shoot of the G20 set up to give substance to financial reform, coordinate and monitor its implementation, has also issued its own voluminous documentation and multiple recommendations. Indeed, all G20 nations have committed to implement, in a coordinated manner between now and the end of 2012, regulatory or supervisory frameworks along the lines of the FSB recommendations.

The *Bank for International Settlements (BIS)* and its *Basel III Committee for Bank Supervision* have also proposed an elaborate set of measures to strengthen the international banking system and improve its resilience and resistance to violent financial storms. The FSB and the BIS have a close working relationship.

The *European Union (EU) Commission* has also produced an abundance of policy papers and proposals on these issues, which, in several instances, go beyond the recommendations of the FSB. The financial crisis, it seems, provided the EU Commission with an opportunity to take on new powers and to assert its authority over national regulatory bodies.

The International Organization of Securities Commissions (IOSCO) has also issued a number of policy papers on key aspects of the financial system.

Although sound policies and some measure of luck have shielded it from the financial debacle of 2007-2008, *Canada*, as a member of the G20, as an active participant on the FSB and on the Basel III Committee, must implement in some

fashion the policy recommendations and regulations coming out of these bodies<sup>1</sup>.

Of course, Canadian banks, along with all banks in developed economies, will have to abide by the Basel III stipulations, under the watchful supervision of the Office of the Superintendent of Financial Institutions (OSFI).

**This article aims at providing an overview of what these long and complex policy documents aim to achieve. It assesses the adequacy of this regulatory response to the causes of the systemic crisis of 2007-2008.**

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<sup>1</sup> Indeed the Governor of the Bank of Canada is the chairman of the Committee on the Global Financial System of the BIS since July 1<sup>st</sup> 2010.

## II. THE IMMEDIATE CAUSES OF THE FINANCIAL CRISIS

Of course, any cure that is proposed is derivative of the diagnosis about the causes of the financial system blow-out in 2007-2008. There is now a broad consensus on the *immediate* causes of that crisis<sup>2</sup> but considerable divergence of opinion about the importance of each of these “causes”, about the prime movers (what came first?) and thus about the appropriate policy response.

Here is the list of those *immediate causes*, in a somewhat random order:

1. Monetary policies driving down interest rates made i) private borrowing very attractive, ii) leverage of all sort, including of bank balance sheets, very profitable and iii) institutional investors very eager for alternative highly rated, interest-bearing investments with higher yields than government securities.
2. Inadequate regulation and supervision of the international banking system incited (some) banks to circumvent capital-adequacy rules and allowed bank behavior that exacerbated, when it should have dampened, the growing bubbles in the financial system.

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<sup>2</sup> However, a vocal minority view still lingers, clinging to the notion that there is nothing wrong with financial markets; for people beholden to this ideological stance, the crisis was the result of misguided policies of the US government to foster home ownership for low-income people and of the reckless actions of government-sponsored organizations Fannie Mae and Freddie Mac (the American equivalent of the Canadian Housing and Mortgage Corporation, albeit exchange-listed entities) in implementing these policies. The *Financial Crisis Primer issued by the Republican Commissioners on the Financial Crisis Inquiry Commission* (December 15<sup>th</sup> 2010) offers a telling example of this position.

3. The implicit assumption that several key financial players had become too big and too critical to the system for governments to let them fail and go bankrupt; this observation usually comes under the name of “moral hazard”, meaning that the assurance of a bail-out leads the leadership of these organizations as well as their shareholders and other stakeholders to make or abet hazardous decisions and actions.
4. The unregulated growth of a parallel (or shadow) banking system, made up of non-bank entities originating loans, bundling them, and selling them; the business model of these entities required *a continuous growth in volume of loans originated*.
5. Lax securitization rules allowed investment banks and “shadow” banks to bundle increasingly risky loans and debts to be sold to investors worldwide; through this process of securitization, loan originators are disconnected from the risk of default, which is borne by the ultimate “lenders” (actually institutional investors); this alchemy was bound to lead to lower credit standards and weak monitoring of borrowers.
6. The overly reassuring ratings given to these securitized bundles of loans by rating agencies lured institutional investors into massive purchase of these financial products.
7. Contrary to a widely held belief, the unregulated growth of complex derivative products, such as credit default swaps, added risk and interconnectedness to the financial system in ways that were poorly understood at the time.

8. The dire consequences of “mark-to-market” (or fair value) accounting on the balance sheets of financial institutions in a time of stress, uncertainty and vanished liquidity; these accounting rules imposed on financial institutions a requirement to mark (up or down) the value of any financial instrument to reflect their latest “market” value; if such value was not readily available, the entity was to value the financial instrument on the basis of an explicit financial model; these rules compounded the simmering problems when the market froze for some type of investments; the “fair” value of these instruments nose-dived, creating huge accounting losses; in addition large swings in mark-to-market value of derivative products led to urgent calls for large amounts of collateral from counterparties at the worst possible time.
9. The unregulated actions of hedge funds and other speculators as well as large investment banks behaving as traders and speculators; the massive (often “naked”<sup>3</sup>) short-selling of shares of financial companies during the turbulent fall of 2008 added oil to a raging fire; speculation, through credit default swaps, against packages of sub-prime mortgage loans also accelerated and amplified the brewing fiasco.
10. Grossly inadequate risk measurement models, anchored in recent past experience, failed to spot the looming crisis; in fact, these models actually

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<sup>3</sup> *Short-selling* refers to the selling of borrowed shares in the belief that the share price will drop; the short-seller may then buy back shares, return them to the lender of the shares, and pocket the price difference as profit. When properly regulated, it is a legitimate operation which may contribute to market efficiency. It was not the case in 2007-2008. *Naked* short-selling refers to the (illegal) practice of failing to have made arrangements to borrow shares before selling them short.



provided false assurances to decision-makers.

- 11.** The form and level of compensation in the financial sector promoted unbridled risk-taking and grossly over-rewarded short-term performances; this “cause” is the easiest to understand and the most politically explosive. It has been the object of considerable public relations effort on the part of governments and their agencies.

Space does not permit a detailed review of all the new rules, guidelines and regulations enacted or proposed to deal with these different causes of the crisis. However, each of these specific “causes” has received some attention from one or the other regulatory body. Let’s briefly review the actions taken or contemplated by governments/agencies/regulators to deal with these *immediate* causes of the 2007-2008 version of a financial crisis.

### **1. Low interest rate monetary policies**

These remain a fact of economic life. So all efforts, as we shall see further on, aim at dealing in some partial way with the consequences:

- **monitoring of household borrowing;**
- **restraint on leverage of financial institutions;**
- **oversight of alternative investment funds.**

### **2. International banking regulation and supervision**

This issue falls squarely within the jurisdiction of the Basel Committee for bank supervision and the BIS. The Basel framework governs the level of capital that banks must maintain to ensure the safety of their liabilities (depositors).

The previous accord, termed Basel II, had introduced the notion of *self-assessed, risk-weighted* capital adequacy. Banks were to compute their required level of capital (of various tiers) on the basis of the riskiness of their assets (loans, trading positions, etc.). Clearly, it was assumed, a borrower with a credit rating of, say AAA, represents very little risk of default as compared to a borrower with a credit rating of, say BBB. Therefore, bank loans to highly rated borrowers required little or no capital reserves.

Of course, banks are listed on stock exchanges and are valued according to their return on capital. The lower the amount of capital required for a given level of operations and profits, the higher the value placed on the bank.

If loans may be packaged and sold off to other investors, the bank doing so generates fee income with no capital requirement; if loans may be transferred to off-balance sheet entities (often with a guarantee from the bank), income could be generated without capital requirement; if rating agencies give their highest ratings to securitized packages of low quality loans, these “assets” would require very little capital, yet generate more income than government securities with equivalent ratings; if lenders could buy an “insurance” against default of their debtor (called a credit default swap) and if the seller of that “insurance” was highly rated and its fees for doing so modest, then the bank could transform a loan with a middling credit rating (and thus requiring a substantial level of capital) into a highly rated loan requiring little or no capital, and so on; these operations resulted in actual leverage ratios that were much higher than what was shown on bank balance sheets as well as in high levels of hidden risks.

After much discussion and debate with the banks, a new framework, Basel III, was proposed and has now been approved by the G20 leaders at their meeting in Seoul.

The new Basel framework *“raises the quality, quantity and international consistency of bank capital and liquidity, constrains the build-up of leverage and maturity mismatches, and introduces capital buffers above the minimum requirements that can be drawn upon in bad times.”*

In clear terms, banks will have to raise their level of equity capital and other forms of capital; they will have to arrange for a “conservation buffer” of capital on which they can draw in difficult economic circumstances; they must as well be prepared for national regulators to impose a “countercyclical buffer” when their economy moves up on the cycle. Banks which do not meet fully these capital buffers will face restrictions on the payment of dividends and bonuses.

Banks were not too happy with this new framework; they claimed that it will curtail their ability to lend to businesses and reduce their profitability. They have lost this battle but have gained a generous implementation schedule; they will have to comply with the new capital requirements and capital buffers over a period that stretches out in some cases to 2019!

### 3. The “too-big-to-fail” syndrome

*“The G20 Leaders at the Seoul Summit on 11-12 November endorsed the Basel III framework and the Financial Stability Board’s (FSB) policy framework for reducing the moral hazard of systemically important financial institutions (SIFIs), including the work processes and timelines set out in the report submitted to the Summit.”*  
(G20-Press Release, November 12<sup>th</sup>2010)

The G20 approved the work plan proposed by the Basel III committee and the FSB to cope with the “too-big- to-fail” institutions, now labeled *systemically important financial institutions (SIFIs)*. The FSB and the BIS will come up with a list of *global SIFIs* by mid-2011 and, by the end of 2011, with measures to address the issues they raise for the international financial system. It is most likely that at the very least additional capital (or, in the FSB/BIS idiom, “loss absorbency”) requirements will be imposed on these global SIFIs.

The determination of which financial institutions will be declared a SIFI is the object of fierce negotiations at this time as the consequences are huge for any financial institution so labeled. It is argued that the criterion should not be “bigness” but “interconnectedness”.

#### 4. The unregulated growth of a parallel (or shadow) banking system, made up of non-bank entities

But what about financial players which may cause significant harm to the international financial system but are not “banks” and, therefore, not subjected to the Basel III strictures?

*Shadow* banks, hedge funds, and other speculative and alternative investment funds played a significant role in bringing down the international financial system. Should they to be included in a list of potential SIFIs? What regulation or supervision would be applied to these non-bank financial institutions?

Already, the FSB proposal to include *insurance companies* within the range of SIFIs has generated controversy and a good deal of push back by the insurers.

The FSB and the European Union are moving carefully here because they are uncertain as to how to proceed.

*“The FSB will need time to learn how to extend the SIFI regulatory framework from just covering banks to covering a wider group of SIFIs, including financial market infrastructures, insurance companies and other non-bank financial institutions that are not part of a banking group structure.”*

The U.S. approach to the issue of SIFIs is to create a new body and dump the problem on it. The Dodd-Frank Act creates a new organism, the *Financial Stability Oversight Council (FSOC)* with considerable powers in certain areas.

***The purposes of the Council are—***

- (A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;***
- (B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and***
- (C) to respond to emerging threats to the stability of the United States financial system.***

(Dodd-Frank Act, 2010)

The FSOC has the authority to respond to emerging threats to the stability of the financial system, *no matter which institutions are deemed responsible for this threat*. Article 113 of the Act even empowers the Council to assert its authority on a foreign non-bank entity if it determines:

*that material financial distress at the foreign nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities to the financial stability of the United States.*

Thus the FSOC's authority may extend over speculative/hedge funds, private equity funds and other alternative investment funds *wherever domiciled*, if the

Council opines that they are a source of risks for the American financial system. But it is left to this new organization to decide exactly how these objectives will be achieved.

Thus, when it comes to dealing with threats to the financial system from non-banks financial institutions, the design of appropriate regulations and supervision is at best a work in progress.

## **5. Lax securitization rules**

The global conflagration sparked by “sub-prime” mortgage loans stemmed from the process of “securitization”. Mortgages, *which had weak credit profiles when taken individually*, were assembled into a portfolio, divided into distinct tranches with different yields and credit ratings.

Although based on loans with low credit ratings, several tranches, known generically as “collateralized debt obligations” or CDOs, received high ratings from credit rating agencies, with most of the default risk presumably left in the lower rated (or non rated) tranches.

Institutional investors (pension funds, insurance companies, foundations), which are not allowed to invest in securities that have not received an “investment grade” rating from recognized credit rating agencies, were attracted to these CDOs which bore a yield slightly higher than other securities with the same credit rating. That is how and why “sub-prime” mortgages (in the form of CDOs) ended up in institutional fund portfolios all over the world.

There was much money to be made by loan originators (the infamous Countrywide Financials, Washington Mutual, New Century, Wells Fargo, etc.), by investment banks packaging the loans and selling the tranches to investors (Goldman Sachs, Morgan Stanley, Lehman Brothers, Merrill Lynch, etc.).

But there was a pernicious feature to this business model for stock-exchange traded companies: to increase earnings (and earnings per share) as is expected and demanded by the financial markets, a firm must continually originate more loans this quarter than last quarter, this year than last year. To feed this infernal machine, credit standards must be lowered even further, tricks must be found to lure borrowers with low early payments, promotion must be intense. As these loan originators took no responsibility for monitoring the loans and ensuring that payments were made and retained none of the default risk, there were no impediments to their originating activities.

The Dodd-Frank Act hopes to reduce the risks associated with securitized products by a set of measures:

- Loan originators and those who transform them into securitized products will be required to retain at least 5% of the default risk. Furthermore, these entities are not allowed use derivatives to sidestep this risk.
- The sharing of this default risk between originators and securitizers will be established by the regulatory agencies based on their judgment as to the quality of the loans submitted for securitization.



- Regulation of the credit rating agencies (which we deal with later), seen by many as the primary culprits for this fiasco, should provide a first line of defense against abuses of the securitization process.

In jurisdictions which did not participate directly in the sub-prime folly, the issue of securitization is dealt with gingerly; there are concerns that the very real benefits derived from proper securitization may be lost in the process of regulating the practice. Indeed, since the 2008 financial crisis, the securitization market has all but dried up.

*Re-establishing securitisation on a sound basis remains a priority in order to support provision of credit to the real economy and improve banks' access to funding in many jurisdictions. Numerous initiatives by regulators, central banks and the private sector to improve market practices have been undertaken with the aim of rebuilding investor confidence, and there are now mixed signs of recovery, but progress remains slow. Understanding whether, and what kind of, additional action may be needed is critical to restoring capacity and liquidity in securitisation markets. (FSB, December 2010)*

## **6. The overly reassuring ratings given by credit rating agencies**

Credit rating agencies were the butt of severe criticisms for their role in the years and months prior to the 2008 financial crisis. The whole credit rating process is rife with conflicts of interest:

- Credit rating agencies are paid by the issuers, by those asking for their securities to be rated. Revenues hinge on satisfied customers particularly when a client may “shop” for the agency that will give the best credit rating.
- Institutional investors are often precluded from investing in securities that did not receive an “investment grade” rating by a recognized rating agency (officially referred to as *nationally recognized statistical rating organizations* (NSRO)). This regulatory arrangement gives credit rating agencies a formidable influence in financial markets.
- Credit rating agencies, while have experience and doing a fairly good job rating corporate or government debt, ventured into the unknown but very lucrative business of rating highly complex products (such as synthetic CDOs, and so on). Without the required expertise to assess fully these new “products”, rating agencies relied on the designers of these innovative products, usually at the employ of investment banks, to arrive at a rating process. Not surprisingly, undeservedly high ratings often resulted.
- The credit rating agencies, looking for new sources of income, began offering consulting services to issuers, creating a clear risk of conflict of interest; here’s a rating agency giving consulting advice on how to design a “product” to receive an appropriate rating, and then the same agency rating this “product”. Of course, as always, it was

claimed that a Chinese wall separated the two parts of the organization!

- Recruitment of ratings agency employees by issuers and especially by investment banks raised another possibility of conflicts of interest.

The Dodd-Frank Act tackles directly some of these issues and calls for additional studies on others. Generally, the Act mandates fuller disclosure and closer supervision of *nationally recognized statistical rating organizations*. For instance, the rating agencies will have to disclose the models and methodologies they use to arrive at their ratings. They will have to “look back” at ratings given to an issuer over the last year when an employee of the rating agency takes up employment at this issuer or at any intermediary involved in the rating process. The Act also imposes governance rules and specific responsibilities on board members of rating agencies.

The Act sets an example by removing the terms “investment grade” as a requirement for investments by several federal institutions.

The Act calls for several studies to be completed in a stated time frame:

- 1)** A study to evaluate (1) the management of conflicts of interest raised by a nationally recognized statistical rating organization providing other services, including risk management advisory services or consulting services; (2) the potential impact of rules prohibiting a nationally recognized statistical rating organization that provides a rating to an issuer

from providing other services to the issuer; (Three years from date of enactment; Dodd-Frank Act, Section 932)

- 2) The Comptroller General of the United States shall conduct a study on alternative means for compensating nationally recognized statistical rating organizations in order to create incentives for nationally recognized statistical rating organizations to provide more accurate credit ratings, including any statutory changes that would be required to facilitate the use of an alternative means of compensation. (Report in 18 months from date of enactment)
  
- 3) The Commission shall carry out a study (1) of the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models; (2) the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products. (Report in 24 months from date of enactment)

Only when these studies are completed and new measures, if any, adopted, shall we know how credit agencies will actually be regulated in the future.

Although still engaged in a process of consultation, the European and Canadian authorities seem to favour a combination of enhanced supervision, fuller

disclosure and the commitment by rating agencies to new governance and ethics rules. Whether that will prove sufficient is an open question.

## **7. The unregulated growth of complex derivative products**

Derivative products serve two ends: a) they are part and parcel of a risk-mitigating strategy for investors and corporations or b) they are a tool for effective speculation.

Some derivative products, such as puts and calls on company shares, *are traded on an exchange* (the Montreal Exchange for instance). Then, all transactions may be monitored by securities commissions; the prices of the derivatives and their volume are public information; the sellers and buyers are all known to the exchange, which imposes rules governing risks and exposures. Transactions are settled through a clearing house; sellers and buyers never have direct contact.

But the largest part of the derivative market is made up of *over-the-counter (OTC) derivatives*, wherein sellers and buyers negotiate directly the terms of each derivative contract. These terms may be standard or tailored to the very specific needs of the parties. These derivatives include interest rate swaps, foreign exchanges, commodities, the infamous credit default swaps and so on. If one wants to speculate on the price of oil or gold, on the value of the Euro, on the possible credit default of a country or corporation, OTC derivatives are the tool.

Though formally unregulated, many derivative transactions are governed by the terms of the International Swaps and Derivatives Association (ISDA). Contracts governed by ISDA rules tend to take a standardized form and specify when and what collateral will have to be transferred from one party to the other.

As Table 1 shows, the notional amount of OTC derivatives outstanding on December 31<sup>st</sup> 2009 amounted to more than \$600 trillion, dwarfing the \$53 trillion in exchange-listed derivatives. This derivative market is global in scale and involves all sorts of buyers and sellers with all kinds of motivations.

**Table 1**

**The global market for OTC derivatives**

(As of December 31, 2009, in billions of US dollars)

<b>Types</b>	<b>Nominal Value</b>
<b>Foreign Exchange</b>	<b>\$ 49,196</b>
<b>Interest rates</b>	<b>\$ 449,793</b>
<b>Equity options</b>	<b>\$ 6,591</b>
<b>Commodities</b>	<b>\$ 2,944</b>
<b>Credit default swaps</b>	<b>\$ 32,693</b>
<b>Others</b>	<b>\$ 73,457</b>
<b>Total</b>	<b>\$ 614,674</b>
<b>World GDP (2009)</b>	<b>\$ 58,228</b>

Source: BIS Quarterly Review, June 2010, CIA fact book (2010)

A good indicator of the speculative nature of these OTC derivatives is their volume growth over the last 10 years, during which time they went from less than \$100 trillion to over \$600 trillion.

What is needed is real-time transparency on which parties are doing what in this market.

The key proposal, in the United States, Canada and Europe, is to standardize most OTC derivatives and move their trading to exchanges, have them settled through central counterparties and reported to trade repositories, limit or forbid some over-the-counter transactions and raise capital requirements for non-standard derivatives.

Implementing these measures will give regulators better and timelier information on this market. To have access to exchanges or centralized counterparties, these derivatives will need to be standardized as to their terms and conditions.

The clearing houses, having become counter-parties, will want to assess the risk worthiness of the parties to derivative transactions.

But the tasks assigned to the regulatory agencies and those future clearing houses are gigantic.

Not all derivatives that are currently traded over the counter will conform to the conditions imposed by a typical clearing house. Centralized counterparties may

refuse to handle certain types of derivative transactions that are currently negotiated on the OTC market. What will happen if that occurs? Would these transactions be banned or, as seems to be proposed, subjected to increased capital requirement. But, how would this requirement be determined? If a large volume of derivatives continues to trade over the counter, does that not defeat the whole purpose of the regulation?

The Dodd-Frank Act gives the agencies concerned (the Securities and Exchange Commission and the Commodity Futures Trading Commission) the authority to exempt certain types of derivative products from the obligation to be traded with a centralized counterparty (the transaction must however be registered with a centralized trade repository). These agencies are also authorized to forbid the over-the counter trading of specific derivative products. *However this part of the US law is convoluted enough to create new business opportunities. It calls again for several studies and leaves a number of issues unsettled.*

The European approach (and the Canadian one, according to CSA consultation document 94-401) is based on displacing most over-the-counter derivatives to centralized counterparties. Non-standard derivatives that cannot be cleared through centralized counterparties would nevertheless be recorded in a central registry so that the authorities are informed of the amounts outstanding and the identity of the counterparties. Derivatives not traded through a centralized counterparty would be subject to “more stringent safeguards and capital requirements.”



These are not easy matters. In fact, a variety of consultations are being held to come up with solutions to the problems related to regulation in this area. Given the global nature of this market and the fact that the U.S. and the U.K. represent the lion share of derivative trading, where would these centralized platforms be installed? Do countries, such as Canada, that are small overall players in these markets, merely let their financial institutions trade on some international exchange located elsewhere? Should there be a series of national platforms linked to large, global, platforms in the U.S. and U.K.?

Three Canadian options are currently discussed under the leadership of the Bank of Canada:

- (i) The expansion of global Centralized Counterparty (CCP) offerings to include a broader range of Canadian dollar products.
- (ii) The establishment of a stand-alone Canadian CCP with linkages to regional or global CCP(s).
- (iii) The establishment of a Canadian CCP that would be an affiliate of an established global CCP.

(Source: Bank of Canada, Financial System Review, December 2010)

The stakes are considerable for Canada's place as a major financial center.

Curiously, despite the fact that *credit default swaps* were the only over-the-counter derivatives directly implicated in the 2008 financial catastrophe,

provoking the discomfiture of AIG among other havoc, the regulators are intent on bringing all over-the-counter derivatives under new scrutiny and regulations.

Ironically, the Frank-Dodd Act even stipulates that credit default swaps may not be regarded as insurance, and thus should not be subject to regulation as insurance products. (In the United States, the states regulate insurance contracts).

#### **8. The consequences of “mark-to-market” (or fair value) accounting on the balance sheets of financial institutions in a time of stress**

This issue is the subject of heated debate within and around the accounting profession. Accountants are fairly enamored of the fair value accounting principles and usually resist the notion that accounting of this sort may have contributed to the financial crisis.

Academic studies have often been less positive and sometimes downright harsh in their conclusions about this accounting principle. For instance:

*[Mark-to-market accounting] creates asset bubbles and exacerbates their negative collateral consequences once they burst. It does the former by allowing banks to adopt generous valuations in up-markets that increase their lending capacity. It does the latter by forcing the hand of counterparties to demand collateral even when watchful waiting and inaction is the more efficient course of action when the downward cascades generated by mark-to-market accounting may trigger massive sell-offs at*

*prices below true asset value. (Richard A. Epstein and M. Todd Henderson, [ssrn.com/abstract=1385382](http://ssrn.com/abstract=1385382))*

On the other hand, the American Securities and Exchange Commission reported on December 30<sup>th</sup> 2008 that fair-value accounting did not appear to play a meaningful role in the bank failures that occurred in 2008.

Much work is being carried out at this time to harmonize the International Financial Reporting Standards (IFRS) developed by the International Accounting Standard Board (IASB) with the U.S. Generally Accepted Accounting Principles (US GAAP) developed by the Financial Accounting Standard Board (FASB). The IFRS is scheduled for implementation during 2011 and it is hoped that the US GAAP will be highly convergent with the IFRS.

Since the latest financial storm started in the USA and raged there with particular force, the FASB has shown some flexibility in the application of the “mark-to-market” principle. The IFRS was also adjusted to maintain convergence with the American accounting principles.

Both IFRS and US GAAP now include the possibility of classifying financial instruments as “held to maturity”; these financial instruments are then excluded from strict mark-to-market rules of evaluation. Financial institutions may thus avoid the full negative impact on their balance sheets of a disrupted, “inactive” market.

*“It is unlikely that mark-to-market will literally mean the same going forward. Recent interpretation guidance by the SEC, FASB and IASB will lead more companies and their accountants to attach less significance to market prices, particularly those in inactive markets, when determining the value of securities, which in turn could support the assertion that write-downs are not required in their individual cases.”* (Freshfields Bruckhaus Deringer LLP, January 2009)

## **9. The unregulated actions of hedge funds and other speculators as well as large investment banks behaving as traders and speculators.**

Hedge funds (or more precisely speculative funds) played an important role before and during the financial crisis certainly in the U.S. market where, contrary to the U.K, hedge funds do not have to register and report to the regulatory agencies. The key problem was that no one knew exactly what these funds were doing and what risks they loaded on the financial system.

John Paulson, ex-CEO of Goldman Sachs and U.S. Secretary of the Treasury during the crisis writes in his memoirs: *“I called Chris Cox to discuss market manipulation. The investment bank’s falling stock price and widening CDS appeared to be driven by hedge funds and speculators. I wanted the SEC to investigate what looked to me to be predatory, collusive behaviour as our banks were being attacked one by one...”*

The Dodd-Frank Act mandates, at last, registration of these funds with the SEC. Regulatory agencies will conduct periodic examinations of their books and operations. The Act applies to all alternative investment funds so that no one may escape these provisions by a change of name and designation. Of course, as pointed out earlier, the *Financial Stability Oversight Council (FSOC)* now has the authority to declare that an alternative investment fund may threaten the stability of the American financial system and to take whatever measures necessary to bring order and stability to the system.

As for investment banks (Goldman Sachs, Morgan Stanley, JP Morgan-Chase, etc.) behaving as traders and speculators, Paul Volker, a past chairman of the US Federal Reserve, proposed that investment banks *and commercial banks* be prohibited from trading for their own accounts and not be allowed to own hedge funds or private equity funds.

The Dodd-Frank Act does incorporate what became known as the “Volker Rule,” but nevertheless permits investments that were qualified as “*de minimis*” in these types of funds. Banking establishments are barred from holding more than 3% of a hedge fund or private equity fund. In addition, their total holdings in such funds should not exceed 3% of the bank’s tier one capital.

Consultations are currently under way on the implementation of these rules. Opposition to parts of these new rules is vocal, well organized and well financed. A considerable watering down of these provisions may well occur during the regulation writing phase.

## 10. Grossly inadequate risk measurement models

Most risk assessment models are based on the volatility or variance observed over a preceding period of time, rarely exceeding five or ten years. Thus, the very low volatility observed between 2003 and 2006 fed into typical risk models, resulted in low capital requirements and low level of calculated risk in investment portfolios, made high level of financial leverage seem risk-less, pushed down the price of derivatives and so on. After a prolonged period of low volatility, risk-assessment models will be very permissive of leverage and risk-taking of all sorts. No specific regulations are proposed here but a strong recommendation to submit results of risk models to stringent “stress testing”; that is, subject the results to alternative hypotheses about the future covering a wide range of possibilities. The emphasis and burden has been placed on board of directors and “risk management” committees of the board.

## 11. The form and level of compensation in the financial sector

Avarice and warped incentives have fuelled bubbles and financial fiascos throughout history. This *insatiable quest for profit* (Machiavelli) is indeed a constant of History, but, over the past twenty years, it has taken the dimension of a moral crisis.

All stakeholders (commercial banks, investment banks, pension and mutual fund managers, hedge funds, etc.), even guardians and sentinels (i.e. credit rating agencies, financial analysts), were motivated by financial incentives that were closely aligned and driving all in the same direction.

A compensation system is dangerously flawed if it doles out large incentive payments in cash for *short-term* performance, *without any claw-back provision or refund should subsequent performance undo this short-term performance*. So called pay-for-performance compensation systems rarely take into account the risks involved in achieving some level of performance. These compensation systems, which were pushed hard by institutional investors and compensation consultants, actually motivated management to take lots of undisclosed, hidden risks on their way to their performance bonus.

The American Congress and the Administration are moving and carefully on regulating executive compensation. The population's ire is palpable and politically charged but the financial industry donates a massive amount of money to political campaigns and employs a large and effective contingent of lobbyists in Washington.

So the Dodd-Frank Act includes several fairly mild stipulations on matters of compensation:

- *The law makes it mandatory for financial firms to submit the compensation of their executives to a non-binding vote by shareholders. This so-called "say-on-pay" measure has become a favorite rallying cry for champions of a certain type of corporate governance; it is believed, though many are skeptical, that the fear and embarrassment of a negative vote will motivate boards of directors to adopt more prudent, less extravagant, programs of executive compensation.*

- *Shareholders must also be called to a non-binding vote on compensation packages) linked to a change of control of the company (the infamous golden parachutes). Such vote to be held at the same time shareholders must vote to approve or reject a contemplated merger or acquisition.*
- *Members of the compensation committee of the board must be rigorously and impeccably independent of management.* The Sarbanes-Oxley Act already mandated this independence for audit committee members; Dodd-Frank does so for compensation committee members (at least for financial entities covered by this law). This requirement, though, is already widely observed as securities commissions and stock exchanges have included a similar provision in their guidelines and rules of governance for publicly-traded companies.

It should be noted that, under both Sarbanes-Oxley and Dodd-Frank, corporations where a shareholder, or related shareholders, hold more than 50% of the votes are exempt from this stipulation.

- *The compensation committee of the board must have the authority to hire and fire compensation consultants and ensure their total independence from management.*
- *All components of executive compensation must be fully disclosed; the relationship between compensation and the company's financial performance must be clearly established and explained.* This requirement adds nothing to current disclosure practices but it is now a legal obligation



for American firms in the financial sector.

- *The ratio of the chief executive officer's compensation relative to that of the median compensation of all other employees (excluding the chief executive officer) must be disclosed.* This rather novel requirement demonstrates some concern with the equity of compensation structures within companies. This requirement may, and should, be imposed on all publicly traded companies. However, given past experience, regulators and boards of directors should be vigilant, lest various stratagems are used to reduce artificially this ratio; for instance by contracting out to a manpower supplier all clerical work, a firm could raise substantially median earnings within the firm.
- *Compensation plans must include a claw-back provision for variable compensation if the company has to restate past earnings due to some breach of accounting rules.* The difference between the compensation that was paid out and what would have been paid out if the accounting rules had been properly applied must be reimbursed. As we shall see, the EU Commission is proposing far broader claw-back conditions.
- *The company must disclose whether executives, directors and employees may resort to derivatives to minimize their downside risk on their shares and stock options of the company.* The EU Commission is proposing to prohibit the use of derivatives to this end.

- Finally, the Dodd-Frank Act contains a broad stipulation, which could change the rules of the game:

*Not later than 9 months after the date of enactment of the Act, the appropriate Federal regulators jointly shall prescribe regulations or guidelines to require each covered financial institution to disclose to the appropriate Federal regulator the structures of all incentive-based compensation arrangements offered by such covered financial institutions sufficient to determine whether the compensation structure:*

*(A) provides an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or*

*(B) could lead to material financial loss to the covered financial institution.*

No doubt, the US regulatory agencies will be subjected to enormous pressures by financial institutions between now and April 2011 to frame this article in appropriate ways for them, certainly to steer the regulators towards “guidelines” rather than “regulations”. The outcome of this process will be a telling measure of the relative power of regulatory agencies and the financial industry in the U.S.

In a document titled “Principles for Sound Compensation Practices, the *Financial Stability Board (FSB)* proposed 9 principles and 19 standards that should guide compensation policies. On July 7<sup>th</sup>, 2010, the European Parliament adopted a directive (CRD III) which broadly reflected the principles outlined by the FSB. The proposed principles, which were transformed into European Union directives, apply to hedge funds and private equity funds. These principles focus more than the Dodd-Frank Act does on the following aspects:

- The rules and guidelines on compensation apply not only to executives, but also to any employee with risk-taking responsibility.
- Much emphasis is placed on linking compensation to risk-adjusted financial performance. The compensation committee of the board must consult with the risks committee of the board on these matters. People with responsibility for compliance, control and risk assessment must be paid appropriately but should not participate in the company’s variable compensation programs.
- Rules are set for the portion of variable compensation which must be held back and paid over future years. Between 40% and 60% of variable compensation must only be paid out over a period of between three and five years after it was earned, subject to adjustments if performance were to deteriorate during that time period.

- No less than 50% of variable compensation must take the form of shares (or equivalent instruments). These in turn, must be held for an appropriate period of time.
- Executives and employees may not use derivative products to protect the value of their deferred compensation.
- For the European Union these rules will take effect in 2011 and will apply retroactively to compensation for the 2010 year.

Canada, a G20 member and an important participant to the *Financial Stability Board*, has to implement the compensation principles outlined above. However those principles may be put in place either through regulations or through supervision (or a combination of both, as in the United States).

Canada, with China, Spain, Japan and Hong Kong, chose an approach that is exclusively and entirely based on the supervision and oversight of compensation practices of Canadian financial institutions.

In short, excessive, misaligned compensation, which caused, or at least amplified the financial crisis, have led governments to intervene in an area that hitherto had been the responsibility of boards of directors, signaling a lack of confidence in boards' competence and vigilance in matters of compensation.

The Dodd-Frank Act, the FSB principles and the EU directives all insist that variable compensation should be linked directly, linearly, mathematically, if possible, to financial performance. This is unhealthy and may lead to problems in

years to come. It speaks of a vision of the company as entirely dedicated to creating value for shareholders; it assumes wrongly that senior management's performance can be reduced some quantitative measure. The FSB principles do try to loosen the link between short-term performance and compensation but their rules/guidelines will be easily deflected and circumvented.

### III. CONCLUSIONS

The financial crisis is slowly fading away, leaving in its wake chastised regulators, unrepentant financial actors, vanishing culprits, sobered-up investors and a bewildered citizenry.

Clearly, the effectiveness of the new regulatory framework will depend on the actual rules, yet to be formulated, that will give substance to the stipulations of new laws and regulations; for this reason, *what is in front of us is at best a work in progress.*

Some of these measures will help ensure that the banking sector serves as a shock absorber, instead of a transmitter, of risk to the financial system and broader economy.

There is little doubt that taken together *and when fully implemented*, the measures proposed in the United States, Europe and Canada will lower the probability that the world will experience another financial crisis of the same type and with similar origins as the 2007-2008 episode.

One or the other of the various regulatory agencies has tackled, in some fashion or another, the “immediate” causes of the crisis. Whether by new laws, new regulations, new supervisory guidelines, most participants to the international financial system are now, or will soon be, operating in a very different context.

Yet, one cannot escape a sense of the futility of this massive effort, a sense that it does not address the fundamental causes of these recurrent crises<sup>4</sup>, that it is mere preparation to fight the last war.

Nothing in what is proposed really changes the character of financial systems, the motivations that drive them, the greed that infects them. Thence will come the next crisis...

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<sup>4</sup> About which, see Allaire and Firsirotu *Black Markets and Business Blues*