WEAKNESSES IN THE REGULATORY POLICY OF FINANCIAL DERIVATIVES INSTRUMENTS AND THEIR IMPACT ON INTERNATIONAL FINANCIAL CRISIS

Prof. Jenica POPESCU, PhD
University of Craiova
Assoc. Prof. Dorina POANTA, PhD
Financial and Banking University, Bucharest

1. Introduction

The supervisory authority is charged with assuring safety, stability, and the observance of rules aimed to ascertain that participants are adequately and appropriately behaving as well as protected.

Since the advent of globalization and the stellar rise of derivatives instruments, there has been a great deal of concern regarding:

- the heterogeneity of financial supervision in global financial markets;
- the too rapid pace of growth in derivative instruments and their unknowns;
- the increasing sophistication and complexity in instrument design and trading;
- the policy of rewarding bank traders and executives by compensation mechanisms encouraging risk-taking at the expense of financial stability.

In spite of their generous compensation, or because of it, many senior bank executives are falling behind in their knowledge of how their banks deal, or they are even unaware of the risks involved in trading structures created by high-powered trading desks, that are under their watch. Additionally, several board members estimated that the bank‘s clients are being sold financial instruments that they do not understand, and therefore cannot manage.

Evidence that a new regulatory system is needed to ensure safe and orderly markets, as well as appropriate use of new financial products.

2. Derivatives and Governmental Policy

Analysts say that the hold of governments over market regulations needs to be rethought and resettled, including imposing discipline on:

- Banks;
- Traders;
- Borrowers;
- Issuers of money as lenders of last resort.

In light of these events, is pure irony that monetary decisions taken by central banks (such as rock-bottom interest rates of 2002-2004) drove pension funds, mutual funds and other investors (who should be conservative) towards highly geared derivatives. It is like not only institutional investors but also central banks and regulators do not understand the risks taken by:

- Each of them individually, and
- The economy, as well as the global economy as a whole.

One of the issues raised against derivatives legislation and stricter supervision is that such instruments can not be regulated as a single product, because a transaction may include several financial areas: exchange, equities, debts and commodities. Professional investors who have been affected by exposure of the derivatives still believe that derivatives can be regulated - and very effective so - if there is necessary political will.

Invested interests highlight the contribution of derivatives toward reducing risk by covering the potential currency devaluation when residents invest in assets outside their country. In particular, in the United States because the weak dollar, this strategy failed. One of the more classic examples is that of investors who tried to reduce their exposure by using foreign currency derivatives to protect the value of their Japanese equity investment against the possibility of a severe collapse of the yen. The hedging had a reverse effect because the dollar depreciated and the yen's appreciated.

In other cases, losses have increased as investors have trouble understanding the tools that work, or they are suddenly the object of speculation. Practically all financial instruments can be manipulated - even those thought to be well stable. And there are asymmetries as well. For example:

- A requirement for transactions limit values;
- But an investor does not need to post a margin for bonds, though bonds are also volatile.

This asymmetry was not lost by speculators who, capitalizing interest rates low in 1993, rushed to enter the bond market bought for resale. The collapse followed when the Fed increased interest rates in February-March 1994 and continued to do so in successive steps. It was a good example of how derivatives materially change, through their impact, the technical nature of so far conservative financial instruments.

One of the major problems of national regulations is that banking in general and especially derivative financial instruments have become a global process led by open financial borders. They have significantly reduced the jurisdictional and territorial control. Borders have fallen not only between countries but appeared also between different financial sectors such as banking and insurance.

Markets exist primarily on computer networks and the old way of describing the physical location is no longer valid. This has a strange effect on the power of international finance, including the power of surprise. Risk quite frequently, and especially systemic risk, appears to be perverse. So, bankers are confident that new products can be safely handled wrong in fact:

- In their reasoning, complexity does not equal risk;
- But the truth is the opposite, the risk is increased by complexity.
- These are problems that should alert supervisors, but many diminish their importance in the exercise of their duties.

Chairman of Selection Committee of the Treasury has made a lucid presentation of the dangers of passive approaches regulations. If a lack of coordination and an associated lack of action happens in one country, then it is to consider how big is the challenge of coordination in the supervision in the few countries that count in the world economy today. Some experts now suggest that if regulators really want to tighten up their supervision of bank activities, as they should do, then this would obviously require the killing of some habits (sacred caws), and to look elsewhere when the banks loan using capital investment beyond measure. Expansion of use of loan capital investments (leverage) in response to a financial environment of low interest rates and often negative (as in the United States in 2002-2003), as and relatively low inflation and rapid growth has generated significant global vulnerabilities. It also weakened defense system of banks. Subsequently, he questioned:

- The guarantee process;
- Complex product development.

Indirectly, the practice growth increasingly over the high indebtedness also question whether central banks

should continue to may act as lenders of last resort, to risk awakening inflation by injecting huge sums involved in market liquidity. Policymakers should not think that the problems will remain just of bankers.

3. The extending potential of American real estate crisis

One of the major problems is the lack of directions derivatives clear-cut line of supervision. Regulated by the Securities and Exchange Commission - SEC, securities firms run their derivatives business through branches derivative is outside the scope of the regulatory agency.

The idea of voluntary standards caused concern among some legislators because voluntary codes lack teeth. SEC Chairman answered that such arguments were effective before and seemed worried they will not cause a confrontation of powerful interests in the problem derivatives. At the same time, however, he warned that:

- Use of exotic financial products was inappropriate for certain low-risk mutual funds and
- Complex financial instruments should not be used before it is fully understood by all parties.

Based on these assumptions, the president urged the SEC to sell mutual funds risky derivatives. This concern highlighted priority SEC for better protection of small investors. But not reached any results.

A few years later, the discussion about regulating the derivatives market needed, especially trading shares that do not appear on the official list of stock exchange (OTC) has grown. In 1998, the Commodity Futures Trading Commission (CFTC) has suggested that rules could be established on OTC derivatives. This was a major change from a policy established in early 1993 when:

- CFTC has exempted most of the derivatives market from regulation and
- Reportedly, do so in the idea that market professionals require minimal supervision.

In one year, non-interference policy in 1993 has proved to be wrong, leading to increase in number and complexity of OTC derivatives transactions. In October 1994, the new president promised CFCT tougher policies for derivatives market, but actually went to CFTC regulation of derivatives under the Brooksley Born (1996).

He raised the need to regulate the derivatives market. Born warned the professional markets exemption could lead to disorders of the world, limiting the power of governments to provide protection against fraud, manipulation, financial excesses and other hazards.

In May 1998 CFCT gave official statements about the need to regulate the OTC derivatives market. This was followed by a wave of protests, not just the banks, brokers and fund risk protection, but also by other regulators / supervisors including the FED, SEC and Treasury Department, which, as analysts said, they were afraid that some orders could be imposed on the bureaucratic chaos that loosely formed the regulatory landscape of the United States. Different types of powerful interests have set in motion to oppose of supervision prudential, concluded that CFTC has no jurisdiction to specify the OTC derivatives market and urged Congress to clarify the absence of authority on derivative instruments of the list official stock exchange.

The whole issue of derivatives regulation was delayed, and on Wall Street this was served as a good result. However, many experts have gradually started to have doubts, not only on the need for regulation of OTC derivatives, but also on (primarily) the regulation of risk-protection funds as a major landmark of derivative instruments.

Alan Greenspan said he saw no reason to regulate protection funds. This was surprising.

Conflicts of interest are the only way of interpreting the entire opposition to the legislation. What SEC regulation said was that protection fund managers must be registered with the stock and debt securities, which should be done with good will by each shareholder / dealer. Registering allows similar financial inspections which are subject to banks - and how to know, a lot of hedge founds is not in off-balance-sheet outfits of commercial and investment banks.

SEC should work more on how we will use the registration data to assess risk, as industry protection fund:

- Is vast and growing, and
- Certainly, should be monitored.

4. The need for new financial regulations

There was again evidence that a new regulatory system is needed to ensure safe and orderly markets, and appropriate use of new financial products - particularly after the credit crisis of 2007. Ironically, before this financial disaster, its often hear the argument that the risk was "diminished" because it was dispersed more widely than ever over:

- geographical areas
- financial institutions and
- a growing range of investors.

This ill-defined system of munitions, which eastern suddenly, was considered to be able to absorb the load factor of risk which is growing rapidly, especially in credit exposure. It has also been documented that "wide dispersion of risk" did more harm than good. Economists, as well as central bankers and regulatory authorities, are now saying that it is hard to know exactly where the risks are when:

- they have been divided up,
- structured in a variety of ways,
- repackaged with unreasonably high credit ratings, and
- sold off to all sorts of different companies and people in the world market.

Credit crisis precipitated by subprimes brought in focus the need for modernization, re-thinking the regulatory issues that had become important for a number of years. At the top of the list is greater transparency in the banking sector and, in particular non-banks, such as hedge funds, private equity funds, financial investment vehicles, and more. According to expert opinion, after the disaster, will be required in all kinds of financial entities, including the most obvious credit institutions, to provide more information on:

- capital reserves for incremental default risk;
- how they are integrated exposures assumed;
- how these exposures are assessed and managed, and
- what extent will high-level management when the main risks are found to be out of balance-sheet.

But indeed this will happen? Still not found the way to prudential supervision. Will investors to assess the true creditworthiness of the institutions with which they deal?

IMF does not saying so explicitly, but for such disclosure to be successful on their regulation and control must be established in a global framework - with direct authority to supervise them and take corrective measures. It is not enough to have rules governing only American-European only or just in Asia.

What registers to fluctuations in the stock market are not events in themselves, but human reaction to these events, how millions of people feel that these events may affect the future. Any regulatory requirements and actions that forget about the people and only reward wealthy people are doomed to failure.

Along with concern for people comes the need to strengthen banking regulations so that banks must hold more

capital in respect of Off-balance sheet positions, special investment vehicles, and other controlled entities that might fail, damaging the reputation of banks and financial condition. In this regard, the October 12, 2007, Basel Committee on Banking Supervision issued a consultative document, "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book".

The banks needed additional capital to face the risks of derivative instruments, but additional capital in itself does not ensure adequate liquidity. Moreover, as recently seen a financial publication, number of regulators are now concerned about dependence on rating agencies to assess the risk weights under Basel II.

Perhaps reflecting lessons learned from the loss of liquidity due to subprimes crisis, Basel consultation paper's book an important reference plane of liquidity, considering the fact that the trading positions tend to be traded actively and in a more clearly than the positions of the banking portfolio. By definition, the reference plane is time to cash:

- sell items, or
- protecting all major credit risk factors in a market troubled.

It also should be clauses and sanctions to protect against repeated the same mistakes.

In addition, government authorities who care for the proper functioning of the financial system, seeking tougher accounting rules that prevent certain categories of banks to move assets off balance sheet, and to stop inventing another approach to generate bonuses and hidden risks assumed. The background is that free markets depend on the capital and trust, but, in the opposite, the capital goes as confidence goes.

5. Conclusions

The exposure to subprimes and other unsuitable financial operations, credit and other financial entities will continue to bleed. Based on statistics from the International Monetary Fund, the following figure shows that the chain reaction that began in 2007, can last for years - until 2012 or even beyond that horizon, according to various estimates.

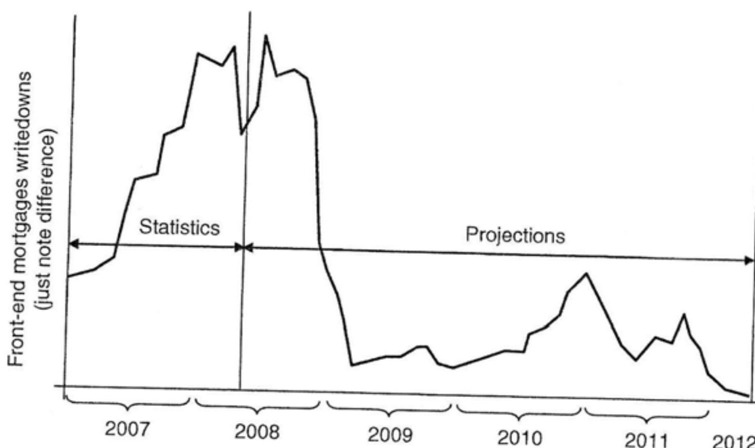

Figure no. 1-U.S. mortgages fall estimated by early 2012 (IMF statistics and projections)

All over the banking industry, management decisions have ceased to be factual, as of 2002/2003 violating prudential and regulatory standards was such that longer-term perspective is awfully dark.

The lack of regulations has contributed to the idea that modern finance can be turned into a perpetual machine of large bonuses, regardless of the damage created by banks and the economy.

Banks have brought the crisis on them, but the parliaments, governments and regulators are able to avoid systemic risk and financial restructuring?

REFERENCES

Chorafas, D. N.	Reliable Financial reporting and Internal Control: A Global Implementation Guide, Wiley, New York, 2000;
Chorafas, D. N.	Financial Boom and Gloom: the Credit and Banking Crisis of 2007-2009 and Beyond, Palgrave Macmillan, Basingstoke, 2009;
Cooper, G.	The origin of Financial Crises: Central banks, credit bubbles and the efficient market fallacy, Harriman House Ltd, Petersfield, 2008;
Cohan, W.	The Last Tycoons, Doubleday, New York, 2007;
Friedman, B.	The Moral Consequences of Economic Growth, Knopf, New York, 2005;
Moss, D.	When All Else Fails: Government as the ultimate risk, Harvard University Pres, 2002;
European Central Bank	Monthly Bulletin, February, 2008;
Merrill Lynch	European Banks, October, 2007;
Merrill Lynch	Investment strategy, March, 2007.