

Reform Trend and Evaluation of Financial Regulation in Post-crisis Era: Discussing the Necessity of Establishing a Macro-prudential Supervision System

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Abstract. In the context of 2008 financial crisis, the impact on the global economy and finance continues. The paper points out that it is necessary to establish a prudential supervision system for macro-finance through analyzing the financial regulatory reforms of world's major economies. And, it also analyzes the relationship between cultural heritage and financial supervision.

Introduction

The outbreak of the global financial crisis in 2008, to a certain extent, reflected the defects of “micro-prudential supervision of financial system” which had always been firmly entrenched. The crisis made people realize that it is not enough to rely on the regulation of the micro economy to maintain the healthy development of financial market. It can hardly cope with the current financial market where endless stream of innovation activities increasingly emerge. After all, the financial crisis is also related to the macro prudential supervision of financial system born in the whole economy and finance. To review the financial regulation of each country, we can see that financial regulation loopholes appear from many aspects. Meanwhile, in order to perfect the regulation system, to restore consumer and investor's confidence, and to revive the market, the directions and measures of financial regulatory reform have also been put forward according to the conditions of each country, so as to get out of the crisis shadow as soon as possible.

Throughout analysing the financial regulatory reforms of the United States, the European Union, the UK and Japan, it is obvious that the financial regulatory system has been shifted from pure micro prudential supervision to an organic combination of micro prudential supervision and macro prudential supervision. The governments have paid more attention to the influence of core systematic financial institutions on their economy and have generally strengthened the monitoring of systemic financial risk. In addition, problems such as the lack of liquidity, the excessive leverage, a twisted salary incentive mechanism and management issues of credit rating agencies caused by excessive interest pursuit have fully exposed during the financial crisis. Meanwhile, we also deeply think about the regulatory vacuum problem which exists in financial regulatory authorities regarding the credit securitization and financial derivatives.

Overview of Financial Regulatory Reforms of Different Countries in Post-crisis Era

Financial regulatory reform of the United States

To some extent, the outbreak of the financial crisis has something to do with American relaxed regulatory environment, excessive financial innovation liberalization and blindly advocating the freedom of economic activity. In USA financial regulatory process, freer and tighter prudential regulation system has been implemented and the fundamental starting point is whether it is conducive to the economy development and the global economy status of America.

The United States has suffered the greatest depression since the financial crisis in 1930s. So the American government introduced the Glass-Steagall Act which strictly restricted the mixed operation of financial institutions to prevent another crisis and promote economic rehabilitation. The act symbolized that the United States had entered an era of separated operation and separated supervision, as well as the start of financial micro-prudential regulation. The American economy kept developing for several decades under such micro-prudential system. As time goes by, especially after the Asian financial crisis in 1997, the pattern of separated operation formed by the Glass-Steagall Act passed in 1933 reduced the profit of commercial banks, and weakened the financial status of USA in the world. As a result, the Clinton Administration signed the Financial Services Modernization Act in 1999 which allowed commercial banks to operate in a mixed way. And financial regulation became loose and free as the Glass-Steagall Act was abolished.

Unfortunately, the United States got into financial crisis again approximately ten years after the Financial Services Modernization Act was signed. Precisely, the reason was the overdevelopment of financial innovation with a loose rein. After the eruption of the crisis, American government signed the Financial Regulatory Reform Act on July 21th, 2010. Aiming at the deficiency of regulation, the act was thought to be the most far-reaching and comprehensive financial regulatory reform act ever since the Glass-Steagall Act was signed.

Aiming at the various issues that appeared after the financial crisis, many solutions were put forward in the context of the *Financial Regulatory Reform* to remedy the loopholes of existing regulatory system. It mainly covered the aspects of building FSOC to overcome systematic risk, increasing capital base of financial institutions to ensure the safety of the entire financial system and enhancing the supervision of credit rating agencies. In addition, various solutions to the problems that multipoint supervision models could lead to regulatory gap were put forward in the act, and the benefit of ordinary consumers and investors was easily impaired in crisis.

Overall, many attempts have been taken in the Act to stabilize the financial development, to enhance the information transparency, to protect vulnerable groups, etc. In addition, hard work has been tried to find a rebalance point in stabilizing financial market, maintaining financial viability, keeping moderate financial innovation, etc.

Financial regulatory reform of the EU

In general, with a prudential attitude, the EU considers the financial regulation of Germany as its learning model. Although inferior to the United States in terms of financial innovation and the scale of development, the European Union, subjected to the effects of financial globalization, has not been immune to facing a no small attack after the sub-prime crisis. The reason is that many financial institutions in the EU use the U.S. sub-prime bonds prevalently as their main investment target. Then the sub-prime bubble burst, and the institutions were caught implicated.

In short, "the EU financial regulatory system reconstruction" reform bill has received strongly support from Germany and France, but it did not involve the EU members' fiscal powers and it is lack of specific measures in how to strengthen the communication among each country's domestic regulatory system. Therefore, the result of the bill is not ideal.

Financial regulatory reform of the UK

As one of the world's most important financial center, the UK has many laudable aspects in its financial regulatory system and the financial regulatory culture, but it has also paid a heavy price in the current round of financial crisis. Different from the long-term regulation and supervision of the United States, the integrated regulatory system of the UK has been practiced. As early as the year of 2000, the UK issued the "2000 Financial Markets and Services Act," to implement a comprehensive regulatory on financial markets through the formation of a relatively complete regulatory system and the implementation of integrated regulatory system. Furthermore, the regulatory authorities of the UK were no longer just confined to agency regulatory or function regulatory before the financial crisis, but had already implemented principle regulatory to some extent. To tackle the exogenous financial crisis, the regulatory reform of the UK is better to modify the existing regulatory regime in details and to fill the regulatory loopholes in a relatively sound regulatory system.

In February and July, 2009, the British successively adopted the *Banking Act 2009* and the *Reform of The Financial Markets* to build the Center for Financial Stability (CFS) of the UK and gave it the right to collect transaction information and data of financial institutions. It is mainly responsible for monitoring the systemic risk in financial system. In dealing with the crisis of financial institutions, the regulatory authorities had explicit powers and procedures and developed the bank insolvency procedures to strengthen regulators' information exchange and the cooperation & communication of international regulatory, as well as the legislation on general consumer protection.

Regarding to this kind of regulatory reform, there is a divergence among various departments. Supporters argue that, on the one hand, the regulatory reform has improved the existing regulatory system, and can effectively maintain the market stability. On the other hand, it maintains the vitality of the domestic financial market and boosts the UK's international financial market competitiveness. Critics argue that the authorities' endeavor to reform is too mild. Merely superficial reform measures make the UK miss a rare opportunity for structural reforms and it is not conducive to long-term development of the financial system.

Financial regulatory reform of Japan

The financial crisis mainly impacted the macroeconomic level of Japan. Due to the high dependence on foreign trade, Japan's macroeconomic decline in the financial crisis is obvious. However, the impact on micro-finance system is relatively limited. It mainly because Japan has focused on the treatment in non-performing assets of banks and formed a stable operating and nonprofit guidance concept in the financial system since the Asian financial crisis in 1998. In this crisis, except a small insurance company (Daiwa insurance company) which collapsed, there were no other financial institutions in Japan falling into great danger. But Japan's robust financial system still suffered from asset shrink, core business downturn, high asset liability ratio and other pressures in the financial crisis.

Overall, Japan is making adjustments towards comprehensive regulations, including increasing market transparency, strengthening international cooperation, adjusting market incentives, etc.

Necessity of Macro Prudential Supervision in Financial Regulation

It is not difficult to conclude from the financial reforms of different countries above that although their specific reform measures differ, the reform trends are all based on the modification of existing financial regulatory system, to reach a balance point among protecting market development, strengthening the market vitality and supervision, and reducing market risk. After all, the essence of a country's financial reform lies in its self-balance and coordination when one element is unbalanced with the other three (the four elements are monetary policy, financial regulation, micro-finance operations and financial openness). That is to say, a country's financial reform is a reform to the "short board" element which is not stable compared with the other three. It is necessary for the financial system to reach a balance among the four elements, which need to be achieved through prudential macro-financial regulation.

The footstone of precautioning systematic financial risk

From my perspective, the lack of macro regulation was mainly responsible for the financial crisis. Therefore, a consensus has been reached that a macro-prudential supervision system should be established, and every country is emphasizing the importance of reinforcing the financial regulation by establishing trans-department regulatory institutions. Taking FSOC, ESRC and CFS for example, they supervise the systematic risks of the entire financial market. At present, the instruments involved are mainly capital reserve in conversion period, reduction of lever ratio, enhancement of liquidity, securitization of credit, and supervision on derivatives, which can reinforce the bearing capacity of financial institutions and prevent risks from diffusing in the financial system.

The important component of comprehensive regulation

Another important reason for this financial crisis is the lack of some crucial fields of supervision, such as supervision and information disclosure of non-financial institutions. Therefore, a remedy to the regulatory loopholes naturally becomes one of the important directions of regulatory reform. The

Americans firstly proposed the supervision of private investment funds including hedge funds, PE and VC funds to some extent. The British indicated that hedge funds should be asked for more strict information disclosure and more detailed information submission including financing, lever ratio, strategies of investment, and specific investment position. The European Commission paid more attention to the qualification of investment fund managers. The Japanese brought credit rating agencies into regulatory objects.

Furthermore, in the sight of remuneration mechanism reform, and macro-prudential supervision makes much sense. A traditional viewpoint before financial crisis said that the remuneration mechanism, as a result of competitive market, was a kind of micro subject behavior, so it shouldn't be supervised by government. But the eruption of crisis made people realize that distorted salary incentive mechanism did no good to the stability of finance, which would definitely distort financial executives' attitudes to risks and result in excessive ventures. The key point of current salary reform lies in the excessive rewards for short-term financial performance and behavior of maximizing market value. We should try hard to make risk match up with income.

The promotion of unification and cooperation of international regulation

The main challenge of cross-board supervision is that the life of global banks has no borders while the demise does (Wenhong Li, 2009). This crisis reflects the contradiction between globalization of financial activities and localization of financial regulation. Nowadays, with global finance highly integrated, it's impractical and impossible to maintain the stability of domestic financial market only through one country's effort of enhancing its own regulation. If global regulatory standards are not promoted synchronously, the interest arbitrage will grow, which will definitely reduce the effectiveness of regulatory reform. Therefore, every country emphasizes the importance of promoting international communication and cooperation to synchronously raise the level of international regulation.

In addition, to reinforce the protection of ordinary consumers and investors, and complete the relevant protecting mechanism are highly stressed in the regulatory reforms of the United States and the UK. The Americans put forward the extra rules of disposing the problems of financial institutions, which require some momentous financial institutions to make full preparations like detailing ways to cope with crisis and bankruptcy proceedings in case of the moral hazard caused by 'too big to fail'.

Thoughts of Consummating Financial Regulatory Models

The influence which the latest financial crisis has brought about is far more beyond the revolution of current financial regulatory model. What's more, it makes us ponder on the entire regulatory models like how to establish a perfect model to satisfy the needs of future regulation.

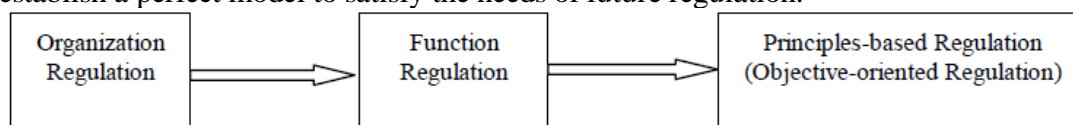


Fig.1 Evolution of regulatory models

It seems that the organization regulation model carried out by most countries before the crisis fails to cope with creative activities in financial market now. Present modification can only eke out the operation of financial market. In the long term, however, it should be hardly achieved to keep financial market stable on the premise that it maintains dynamic, even if the organization regulation model is comparatively perfect. Because of this, the regulatory administrations of each country consider transforming regulatory models to adapt to the constantly changing financial market. The U.S. Department of the Treasury depicted a blueprint of future regulation in 2008. It put forward that American regulatory model would be changed into an objective-oriented one(a principles-based one) through three stages^[11].

Compared with the organization regulation model, the objective-oriented regulation model attaches more importance on the goals of regulation. It is no need to distinguish industries of bank, insurance, security and futures. According to the goals of regulation and types of risks, the regulation will be divided

into different levels. Aiming closely at different levels of regulatory objectives and regulatory framework, the regulators can adopt unified regulatory standards to the same financial products and risks, which will significantly improve the effectiveness of regulation.

Tab.1 Comparison between Organization Regulation and Principles-based Regulation

	Organization Regulation	Principles-based Regulation
Object	Financial institutions of all industries	Entire financial market
Method	Each industry is supervised separately	Divide the market into different levels by objective and risk to supervise
Objective	To promote the stability of entire macro financial market by ensuring the stability of micro financial institutions	To promote the stability of macro financial market
effectiveness	Can maintain single micro financial institution stable, but can't prevent risk diffusing between institutions and industries, and can't prevent systematic financial risks effectively	Can make the regulators adopt unified regulatory standards to the same financial products and risks aiming at different levels of regulation, thus greatly improving the effectiveness of regulation

As far as I am concerned, the principles-based regulation should be the ideal model in the future. It consists of basic principles of financial institution business (such as integrity, necessary skills, diligence, prudence, inner management and control, market behavior and so on), as well as basic principles of protecting financial consumers (such as treating consumers fairly, communicating with consumers, preventing conflicts of interest, protecting customer equity and so on) and supervision by regulators (such as maintaining the stability and fairness of market and so on). Its core concept is to attach importance to the spirit of honesty and credibility, bona fide manager's obligations, justice and fairness. Besides, its ultimate objective is to guarantee financial consumers' rights and interests (Yuan Liu, 2010). The principles-based regulation model can not only secure the effectiveness of regulation, but also allocate resource reasonably and cultivate the innovation ability of regulatory targets. It is able to overcome the deficiency of supervising financial innovation in the organization regulatory model and the function regulatory model. It will also make up for passive regulatory situation when financial innovation occurs, which can definitely avoid the vicious circle of remedying endless regulatory loopholes.

As an ideal regulatory model, the principles-based regulation can not be implemented without certain foundation. Except for the specific social factors like economy, politics, culture and legislation, it takes a full consideration on interest games behind regulation when principles-based regulatory measures are established. Actually, it will reduce the efficiency of regulation if the principles-based regulation is implemented blindly, which may turn out to be another form of organization regulation, let alone improving the quality of regulation.

The Relationship Between Culture and Financial Regulation

There is a complementary relationship between regulation and culture. The culture is the precipitation of history, and the regulation is charged with the functions of recognition, strengthening and dissemination during the precipitating process. No matter how completed the regulatory system is, it's doomed to be passive and low-level (given the activeness of financial market, without which the regulation makes no sense). A benign cultural background is active, which instead is able to make people move towards regulatory objectives in a subconscious way. It is particularly significant for financial market where innovative behaviors of regulation emerge in endlessly. A benign cultural background urges people to avoid excessive accumulation of risks during continuous innovation, to overcome the blind pursuit of interest, and to remain modest and prudent attitude.

A benign cultural background is absolutely necessary for the principles-based regulation. It doesn't require so much about the details of regulation because the principles-based regulation lays more emphasis on the objective design of regulation, which allows micro financial institutions to have more choices. When it comes to practical operation, the objective of the principles-based regulation will never be achieved if people pursue interest blindly regardless of risks without a benign cultural background. On

the contrary, people under a benign cultural background will make moderate decisions in which both the risk and the return are considered when they face risks, so as to avoid the accumulation of risks effectively. It was the benign cultural background of self-discipline that made the principles-based regulation put into practice very early in the UK. But the regulation system is still far backward in China for the past few years, although the excellent cultural background of integrity, kindheartedness and justice has been inherited since ancient times. The reason lies in the laggard economic foundation. Because it is a relative concept whether culture is advanced or backward, economic foundation is the crucial criterion (Yifu Lin, 2011). The laggard economic condition for the past century has heavily restricted the development of culture in China. What's worse, the fickle environment in modern society has a negative influence on people of learning from previous excellent culture. It is quite insufficient to supervise financial institutions just by laws and regulations. The binding effect of laws can only meet the minimum regulatory requirements, so it can't substitute for spontaneous observance from people's inner identity. A benign cultural background should be emphasized to achieve ultimate regulatory objectives if our society is supervised by the principles-based regulation without definite rules. Then the financial institutions will act consciously when they are confronted with matters that are not expressly stated by law, thus the principles-based regulation can play an active role. In consequence, a benign cultural background is an indispensable factor in implementing the principles-based regulation.

Summary

Every country makes effort to transform its regulatory model into principles-based one, but it takes a lengthy process. A principles-based regulation without the support of a benign cultural background will unfortunately become excuses for lawbreakers utilizing loopholes in the system. Besides, to consummate the regulatory details is exactly to follow the old pattern of regulation, and to remedy regulation afterwards is not the form of ideal regulatory models either. So we must try to deal with the synchronous construction of regulation culture to build a highly efficient and stable principles-based regulatory system. Only a high degree cultural identity is achieved, can the principles-based regulation play an effective role.

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