Regulators' Perspective on Risk and Financial Innovation

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The Indian Scene

- The financial markets witnessed rapid growth, in terms of size, product profile, participants, infrastructure, etc
- Derivatives exhibited explosive growth across the world
- Turnover in options and swaps outpaced traditional OTC products
- India’s share in the global forex market increased from 0.4% in 2004 to 0.9% in 2007
- Reserve Bank is empowered to regulate the markets in interest rate, forex and credit derivatives
- Have framed comprehensive guidelines in April 2007 to ensure greater clarity on regulations
- The guidelines make a clear distinction between the ***users*** and ***market makers***

The Principles

- Set out the broad principles for undertaking derivatives transactions
- Market makers should be in a position to determine the fair value of all products
- The transactions should be contracted only at the prevailing market prices
- Analyse and document all risks arising from derivatives exposures
- Management of derivative activities should be integrated into the bank’s overall risk management system

The Principles

- Market makers should have ‘suitability’ and ‘appropriateness’ policies for offering derivative products
- Market-makers should offer derivative products in general, and structured products, in particular, only to those users who understand the nature of the risks inherent in these transactions
- Products being offered should be consistent with users’ internal policies as well as risk appetite
- Market makers, where considered necessary, maintain margin/collateral on a mark-to-market basis

The Issues

- Innovation is inevitable, particularly in the financial markets
- Risk of mis-selling and under- pricing of risks
- Hedging tools have been used as a revenue stream and not as a mitigant
- Use of sophisticated instruments, without understanding downside
- Have compounded the risks; the so called “zero cost” structures
- The shift from “buy and hold” to “originate- to- distribute” strategy undermined risk management systems

The Issues

- Use of external agencies in risk assessment and capital allocation
- Macroeconomic conditions leads to weak measurement and pricing of risk
- Use of conduits, to bypass regulatory rules or actions
- Lack of transparency; unable to locate and assess the potential risk of losses
- Undermining of the need for effective liquidity risk management systems

The Issues

- Failure to recognize the impact of “fire sale” of illiquid assets
- Fair value accounting not only fosters active risk management but also makes reported earnings and capital more sensitive to asset price volatility. The lack of traded prices compounding the problem
- The accounting standards are also equally important. AS 30 (equivalent of IAS 39) is mandated only from 2011

The Conclusion

- Financial stability is core to the supervisors
- Risk profile of even individual institutions has global implications
- Complex financial instruments, changes in business strategies, risk management approaches, etc have made assessment of exposures a difficult task
- Lack of transparency complicates the situation and undermines *ex ante* market discipline
- Need to re-assess the efficacy product- specific and principle- based regulations