8. Country-Based vs. Global Regulation: Failures of the Present Framework

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The last two years have seen a period of turmoil in the financial markets which revealed numerous weaknesses of the current system. Lack of oversight supervision with regard to structured financial instruments contributed to the rise in unsound underwriting practices, especially by mortgage lenders. Historically low interest rates in combination with a high risk credit policy, abuse of Originate-to-Distribute (OTD) model, as well as increasing use of leverage are well known examples of the decline in standards in financial markets. Therefore, governments and supervisors must respond to these challenges and consider what changes in the regulatory framework are needed to strengthen the stability and resilience of the financial system.

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Over the course of the current crisis, authorities' ability to deal with the risk of default of cross-border financial groups both on a local and global level has been tested on several occasions. These tests have proved that national regulatory frameworks are not interconnected enough to provide solutions on a global level, mostly because of the lack of cross-border cooperation between supervisors. Inadequate cooperation arrangements and varying crisis regulatory toolkits may have compromised effective supervision of financial institutions.

In the context deteriorating global economic conditions there is a significant need for a global standard setter. However substantial divergences between national economies imply that the transposition of such global standards should take into account specific national economies and their legal frameworks. It is justified to claim that adapting regulations to local circumstances may be beneficial to the stability of undeveloped, emerging markets, because tailor-made implementation of global rules contributes to more efficient supervision of the financial sector in these markets. The example of the Polish economy can serve as an argument to underpin this thesis.

This paper focuses on the experience of consolidating Polish regulations with European Economic Area (EEA) area regulations. It examines issues linked with the harmonization of supervisory regulations in the context of host supervisor (in EEA area the Polish supervisor acts as the host for most banks) and conclusions resulting from current financial crisis.

Priorities for the New Regulatory Regime

What do we mean by global regulation? This term refers to standards developed for global cooperation. The implementation of those standards by national legal systems is the next step necessary to increase the quality of the global regulatory

framework. A coherent and harmonized system of principles and rules is necessary since the largest financial institutions operate as cross-border financial groups. Comparable requirements for prudential supervision are advantageous for both supervisors and supervised entities. Harmonized regulations make it more efficient to combat international financial crime. A good example of the need for a global initiative to ensure a high quality of regulation is the Wolfsberg Anti Money Laundering Principles for Private Banking established by the Wolfsberg Group consisting of the largest international banking groups. These groups agreed to comply with the stricter rules of this global principle, so as to ensure that their institutions have the same level of protection against money laundering crimes.

When considering the correlation between domestic and global regulation, one has to take into account that the current diversity of national legal frameworks makes cross-border coordination of supervisory practice almost impossible. The absence of a global regulatory concept of the efficient supervision of international financial groups is rooted in specific legal frameworks in particular jurisdictions (different corporate and insolvency law regimes) as well as the lack of a globally workable deposit-guarantee scheme. The security of domestic investors is a priority for all supervisors: it is their primary responsibility. The harmonization of regulations is indispensable for stabilizing markets and improving the efficiency of the global economy.

The relationship between country-based regulation and global regulation (understood as an authority as well as regulatory system) should ensure three basic regulatory goals: protection of the customers, safeguarding of the financial stability and the sustainability of economic growth. However, key responsibilities regarding the licensing process, ongoing supervision and consequences of these should be assigned to the country-based regulatory scheme.

The relationship between country-based regulation and global regulation should ensure three basic regulatory goals:

- **Protecting customers**
- **Safeguarding financial stability**
- **Sustainability of economic growth.**

Taking into account the current situation of the global financial market, it would seem to be justified to undertake more intensive measures in order to introduce a closer consultation of country-based regulation with market participants. Local supervisors should exchange information about the new trends and processes that appear on their markets, with particular regard to the new financial instruments, the means for using these products and the nature and extent of the risks being taken by using these instruments.

Global Standards, Local Implementation

One of the most important issues for the further coordination of global and local regulation is the improvement of risk-control for cross-border financial groups. In EEA member states the problem is covered by the Credit Requirements Directive, which ensures that the same rules of assessment and reinforcement of additional capital on institutions are applied when necessary. The advisory Committees to the European Commission (so-called 3L3 Committees) play an important role through the issuance of relevant guidelines that aim at the coordination of supervisory practices at the EEA level.

The coordination of regulation globally should also make provisions for problems arising from local markets and specific risks linked with the local economic environment. The same principles included in global and local regulations should not necessarily imply exactly the same set of measures and techniques to supervise

institutions. Bearing in mind that the primary objective is a sound financial system, in order to carefully identify the risks associated with supervised institutions, supervisory measures should take account the diversity of institutions' activities and risks. For example, risk assessment methods may differ as a result of certain distinct types of institutions operating in different countries (eg. investment banks vs. small cooperative banks).

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Implementing global regulation, one may also bear in mind the possible introduction of laws that would empower international bodies to decide on issues within the scope of national jurisdictions. It has to be underlined that the shift of powers (from the country to the international level) should always be accompanied by an appropriate shift of responsibilities. For instance, a harmonized regime of financial supervision—envisaging that decisions are based on international regulations and/or made by international authorities—should also ensure that responsibilities are borne accordingly. It is particularly visible today—a time of economic slowdown, or even recession, when so many financial institutions require capital injections and banks' clients expect that their deposits are guaranteed to the highest level possible. In both cases national governments are ultimately the ones who had to provide necessary support. So, countries (and their relevant authorities) cannot be deprived of powers if at the same time they are still obliged to be "the lender of the last resort". As the citizens of any country are rather unlikely to be willing to bear the costs of helping other economies, then the focus should be on regulatory coordination rather than on creating supranational authorities.

Another key element of a sound regulatory regime, in the context of regulations' convergence, is effective implementation and compliance with established regulations and principles by institutions. This issue concerns regulations at both the local and global level. The effective implementation of regulation is especially important but difficult with reference to the rules regarding qualitative aspects, such as risk management and internal control systems. Since it is impossible to set up one common solution concerning detailed risk management techniques that would fit all institutions, it is their responsibility to properly identify, measure, control and mitigate the risks embedded in their activities. In this regard one of the supervisors' tasks is to verify that the institution complies with both external and internal regulations as well as to assess risk management systems, especially those with an overreliance on assessment-results made by external institutions that may create risks.

The harmonization of regulation is desirable when one takes into account the global nature of economy and financial markets. Coordination improves financial stability and allows for better management of cross-border financial institutions. Existing differences in global regulations (e.g. different reporting duties, bankruptcy law or definitions of economic capital) complicate the process of crisis prevention and recovery. Furthermore, the present day crisis has shown that financial decisions and actions taken in one country may significantly impact other countries. Nevertheless, taking into account a diversity of banking systems around the world, harmonization and convergence of regulation has its limits. Harmonization should not affect the national sovereignty and should respect existing differences. Regulations should take into account risks and factors specific to local markets. Therefore, the European Economic and Financial Affairs Council, during the meeting on 9 October 2007 agreed to develop the appropriate policy instruments stressing that: "Arrangements and tools for cross-border crisis management will be designed

flexibly to allow for adapting to the specific features of a crisis, individual institutions, balance sheet items and markets. Cross-border arrangements will build on effective national arrangements and cooperation between authorities of different countries".

Transferring Responsibility to the Global Level Is Not the Best Solution

In order to ensure the effectiveness of the new approach to potential financial crisis, all actions taken should be proportionate to the nature and the complexity of the risks inherent to the business of companies. The above could be recently seen in some cases, such as the current troubles of the AIG group. As a result, the relation between global and country-based regulation of the insurance market should be assessed regarding the financial market as a whole.

Bearing this in mind, the right division of the supervisory powers between the group and the local level remains important (i.e. in the context of the risk-based supervision, adopted or planned to be adopted by a number of financial market supervisors). The necessary relationship should be based on the following process: regulation should become global, but enforcement of these laws must be treated locally. The local authority will generally have a better knowledge of the specific issues relating to the particular market. As a result, they will be better prepared to act accordingly in case the global turmoil impacts the local market. Nevertheless, an extensive cooperation and exchange of the relevant information is required in this respect. It is also necessary to eliminate the most grave differences between the laws of different countries. However, in talking about the relationship, the questions should be about not only the systemic laws within countries, but also the practice of using them correctly. In designing the international regulations, it should be stressed that they will be effective only when domestic regulators are compelled to examine the fulfillment of these regulations by the proper institutions. Finally, with relation to the insurance supervision, we cannot forget about the customers' protection. Usually, insurance contracts relate to the sensitive or at least important issues from the client's perspective. Thus, the relevant level of clients' protection remains one of the main tasks of insurance supervision. And although global cooperation enables a quick response to market troubles, the proximity of the supervisory authority ensures the greater level of confidence to the market from clients' perspective. International and European leaders should concentrate on building a united front against the global financial crisis. The necessity for global dialogue and coordinated actions has never been greater.

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Having this in mind, we must say that setting the right relationship between country-based and global regulation is not easy. To give an example, we may refer to the European Commission's proposal for the Solvency II Directive in respect to group supervision. One of the aims of the Directive's proposal should be to find appropriate ways of streamlining the supervision of insurance groups in the EU. However the initial proposal introduced a solution to this problem based on the concept of a "group supervisor", a single authority responsible for supervising the top entity of the group, with concrete coordination and decision powers like group solvency, intragroup transactions, risk concentration, risk management and internal control. In this respect, the draft directive waives certain powers belonging to the local supervisory authorities in favour of the (re)insurance undertakings licensed,

when those undertakings have been part of a group. This concept itself may raise questions of a legal nature: the group supervisor would be compelled to adopt legally binding decisions for entities or supervisors outside its jurisdiction. Moreover, the group supervisor empowered to make such decisions would not be responsible for them.

The even more important questions refer to the responsibility of local supervisors for the solvency of the authorized undertaking and the adequate level of policyholder protection resulting from that. According to the draft directive, the local supervisor was not originally allowed to enforce solvency of the undertaking it had authorized (nor was the group supervisor allowed to do it). In addition, the local supervisor was also banned from adjusting the undertaking's capital requirements by way of imposing a capital add-on when the insurance undertaking's risk profile was not adequately captured.

Both powers normally exercised towards other insurance undertakings he had licensed but which were not in a group and were not therefore encompassed by group supervision. At the same time, the undertaking's obligation to pay out all claims resulting from concluded insurance contracts is not waived. In no way are those obligations transferred to the dominant entity within the (re)insurance group, nor is any responsibility for the insolvency of the undertaking transferred onto the level of group supervisor. In case of ultimate problems, it is the local authorities who have to deal with them.

The Solvency II Directive waives the supervision of group entities' solvency and as a consequence, can bring about their insolvency and inadvertently weaken the stability of the entire group. In light of the current situation in financial markets, this kind of solution should be perceived as imprudent and unsafe.

The analysis of the issues raised by the Solvency II Directive leads to the conclusion that the group supervisor—as a legal figure—is not necessarily the optimal solution to provide cross-border supervision. However during the negotiation process for the Directive, the original proposal was changed by member-states, and the final resulting Directive shows the direction of some rule—makers, which in their opinion will provide the convergence and better supervision of insurance institutions. But indeed the Directive waives the supervision of group entities' solvency and as a consequence, can bring about their insolvency and inadvertently weaken the stability of the entire group. In light of the current situation in financial markets, this kind of solution should be perceived as imprudent and unsafe.

The Proper Balance Between Global Stability and Local Responsibility

The crucial factor that shaped trends in international financial markets in 2007 and 2008 was the excessive default of US mortgage loans, including high-risk subprime loans. In the process of securitization, the credit risk of subprime loans was transferred from originators to other financial institutions, such as with the Originate-to-Distribute model. Market participants did not possess sufficient information on which institutions assumed which risk and what was the scale of their exposure.

The subprime crisis has had the greatest impact on the money market in the United States and the Eurozone. The situation in the international financial market has impacted the Polish market to only a limited extent since the Polish financial sector is subject to a tight micro-prudential regulatory framework. The influence of market turbulence in the US on domestic financial institutions has not yet led to a substantial deterioration of the financial sector's situation.

The Polish banking sector has a significantly different structure than its American or West-European counterparties, (e.g. it can be characterized by small volume of securitization transactions and rare usage of OTD model). Banks hold credit risk related to extended loans in their balance sheets. In addition, Polish banking law has quite a conservative approach toward capital adequacy requirements. Therefore, Polish banks are much less tempted to neglect risk assessment than was the case with their US and Western European counterparts.

The performance of the Polish financial sector in 2008 was good. The average level of credit institutions' capital adequacy ratios in Poland continues to be higher than the regulatory minimum, however the international turmoil has influenced domestic institutions to a moderate extent. Consolidated regulatory rules on a global level may enable a more effective response to the increasing integration of the financial market and to the matter of emerging new global prudential regulations.

Simultaneously with intra-national discussions on the models of regulation, another process has become an issue of great controversy in the European Union: the home state/host state relations in financial supervision over large financial groups. In the course of legislative work over the Solvency II Directive and Capital Requirements Directive (CRD), we observe a tendency for shifting supervisory powers over subsidiaries of international financial groups (e.g. the approval of capital requirements from host-state to home-state authorities (the latter being described as "consolidating supervisor" in CRD and "group supervisor" in the version originally proposed by the European Commission of Solvency II Directive). At the same time, all responsibility for the outcome of a solvency crisis in any of the subsidiaries of the group remains in the host country. Therefore, it is not a beneficial situation from a regulatory perspective if some relevant regulatory competencies are transferred from a local supervisor to the group one.

As far as the formal EU procedure regarding amendments to the CRD is concerned, our authority consistently claimed that financial regulations on a global (European) level will make host supervisors responsible for ensuring that standards are met by subsidiaries with their registered seat in the host country. We believe that host supervisors have the best possible credentials to properly assess and—if necessary—enforce the sound manner in which financial institutions conduct their business activities. Some of the locally incorporated Polish banks belonging to the EU (EEA) cross-border banking groups are systemic and significant for the Polish banking system. At the same time, their importance at the group level is marginal (a small percentage share in the group's risk-weighted assets).

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And what is the case for Poland, is also true for other European countries. For example, in the process of model validation at the group level (by the home supervisor for the parent company), the home supervisor will in practice not spend resources on host-country local model assessment. Practical examples show so far that assessment of local models, being part of the group application, is unnecessarily subject to the final authority of the consolidating supervisor. Such a solution is burdensome and adds an additional layer of bureaucracy at the home level. What should be a decision of concern mostly or solely to the local subsidiary becomes an unreasonable preoccupation for the home group supervisor. Therefore it is clear that local models created according to the advance internal-rating based approach should be subject to the decision (validation) of a host supervisor, who would work in coordination with a consolidating supervisor.

Conclusions

The attention of those creating global regulation should be focused on better coordination between home- and host-country supervisory authorities as well as on the enhancing of certain regulations covering macro- and micro-prudential policies. From a European perspective it is remarkable that introducing common standards for supervisory practices and interpreting financial regulations is considered fundamental for a stable and efficient financial market. There is a clear need to improve the convergence and cooperation mechanisms between regulators in particular countries especially with regard to cross-border financial institutions.

The macro-prudential regulatory framework is meant to be global, but micro-prudential oversight and the supervision of conduct of business should remain local.

However, any legislative actions should be aimed first at re-establishing confidence, stabilizing financial markets and enabling business and people to get through the global collapse. Second, they should aim at reforming and reinforcing the global financial and economic system to ensure such a crisis cannot occur again. New regulations may require statutory change, institutional reconstruction and diplomatic efforts. Finally, we have to do everything possible to put the global economy back on track. It is inevitably true that the global regulations to be developed will provide common, universal standards for financial institutions to operate. It is a necessary prerequisite for operational convergence of corporate standards worldwide. However one must bear in mind that necessary adjustments to these common rules will have to be made on the local level. The macro-prudential regulatory framework is meant to be global, but micro-prudential oversight and the supervision of conduct of business should remain local.

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The views expounded are an expression of the author's personal ideas.