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The Global Financial Crisis, Regulatory Responses and Their Relevance to Hong Kong

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Introduction

This paper addresses the global financial crisis and regulatory responses to prevent its further occurrences by: (1) discussing the overriding causes and effects of the global financial crisis; (2) summarizing the 2010 summit report of the G-20 which was held in Toronto in June 2010; (3) presenting the Dodd-Frank Act of 2010, the new financial regulatory reforms in the United States, intended to provide protection for investors and consumers; (4) describing the Basel III rules setting higher capital requirements for global banks in order to protect them from excessive risk; and (5) examining the relevance of these global regulatory reforms to banks and businesses in Hong Kong. Taken together, these regulatory responses aimed in reforming and strengthening the resilience of financial systems, reducing broader and systemic effect of bank failure, protecting investors and consumers, improving banking systems and preventing further occurrences of financial crisis.

Global Financial Crisis

The financial crisis initiated in 2007 in the United States affected the entire world economy and financial markets for the past several years. The global financial crisis has been caused by many factors and requires comprehensive and international regulatory responses and effective coordinated actions by governments, policy-makers central banks, regulators and the business community worldwide. There has been much debate on the key causes and effects of the financial crisis. The global financial crisis has caused by a combination of many macroeconomic and microeconomic factors including[i]:

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1. Global macro-imbalances and resulting financial innovation (derivatives)
2. Ineffective global regulation and supervision of banks
3. Ineffective government policies promoting home ownership
4. Greedy and incompetent executives
5. Subprime mortgage crisis
6. Falling asset pricing, including houses
7. Inactive credit markets
8. Highly leveraged financials and expanded credit growth
9. Credit-driven rather than equity-driven markets
10. Securitization of mortgage-backed assets
11. Inadequate risk assessment of business transactions
12. Lack of transparency of public financial information
13. Failure of accounting standards to properly measure fair value of financial instruments
14. Inadequate regulation of financial systems
15. Collapse in the asset-backed commercial paper (ABCP) market

The current financial crisis began in the financial markets of developed countries where these markets have traditionally been considered the catalysts of the global economic system. The recent global financial crisis has affected all aspects of the global business from unemployment to home foreclosures, bank failures, insufficient economic growth and international budget deficits. The most prevailing effects of the financial crisis are:

1. Global crisis that will take time to cure
2. Investor confidence in the global capital market and financial systems
3. Efficiency, liquidity and safety of global capital markets
4. Global regulatory reforms
5. Significant risk to the global economic growth
6. Global economic meltdown
7. Bank bankruptcies and business failures
8. Global unemployment
9. Global financial deficits
10. Proper trading balance

Regulatory Responses

A number of strategies and ideas have been discussed that businesses, organizations, institutions, individuals, and families can use to potentially avoid another financial crisis. More robust regulatory reforms and keen focus on risk management and corporate governance can guard against the occurrence of further crisis. The initial solution to the financial crisis has been bailouts of banks, financial institutions, and other large firms which were on the brink of failure during the recent economic meltdown. These bailouts, generally funded by the government can only, at best, temporarily repair the global financial stability. The existence and persistence of the global financial crisis requires bold responses by policymakers, regulators, central banks and the business community worldwide. In this paper we discuss several recent initiatives taken to address the global crisis including the 2010 Summit of G-20, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the 2010 Basel III.

The 2010 summit of the 20 largest advanced and emerging countries, better known as the G-20 was held in Toronto in June 2010. The primary purpose of the summit was to ensure international economic cooperation by addressing the global economic crisis, reforming and strengthening global financial systems and promoting a full return to growth with quality jobs. The 2010 G-20 agreed to[ii]:

1. Reduce budget deficits by cutting the global deficit in half by 2013.
2. Promote growth through global economic stimulus and more government spending.
3. Full return to growth with quality jobs.
4. Reform and strengthen financial systems.
5. Create strong sustainable and balanced global growth.
6. Reduce government debt-to-GDP ratios by 2016.

The important provisions of the 2010 G-20 are:

- Framework for Strong, Sustainable and Balanced Growth by assessing global policy actions and strengthening policy frameworks.
- Financial Service Reform by establishing a more resilient financial system, improving risk assessment, promoting transparency and reinforcing international cooperation.
- International Financial Institutions (IFI) and Development as a global response to the financial and economic crisis and a platform for global cooperation including $750 billion by the IMF and $ 235 billion by the Multilateral Development Banks (MDBs).

- Fighting Protectionism and Promoting Trade and Investment by refraining from raising barriers or imposing new barriers to investment or trade in goods and services at least until the end of 2013.
- Accounting Standards by adopting a single set of high-quality globally accepted accounting standards.

The Dodd-Frank Act was signed into law on July 21, 2010 and its provisions pertain to banks, hedge funds, credit rating agencies and the derivatives market. Dodd-Frank authorizes the establishment of an oversight council to monitor systemic risk of financial institutions and the creation of a consumer protection bureau within the Federal Reserve. Dodd-Frank requires the development of over 240 new rules to implement its provisions over a five-year period. Important provisions of the Dodd-Frank Act are[iii]:

1. Broadening the supervisory and oversight role of the Federal Reserve Board (Fed) to include all entities that own an insured depository institution and other large and nonbank financial services firms that could threaten the nation’s financial system.
2. Establishing a new Financial Services Oversight Council to identify and address existing and emerging systematic risks threatening the health of financial services firms.
3. Developing new processes to liquidate failed financial services firms.
4. Establishing an independent Consumer Financial Protection Bureau to oversee consumer and investor financial regulations and their enforcement.
5. Creating rules to regulate over-the-counter (OTC) derivatives.
6. Coordinating and harmonizing the supervision, setting and regulatory authorities of the SEC and the Commodities Futures Trading Commission (CFTC).
7. Mandating registration of advisers of private funds and disclosures of certain information of those funds.
8. Empowering shareholders with a say on pay of non-bonding votes on executive compensation.
9. Increasing accountability and transparency for credit rating agencies.
10. Creating a Federal Insurance Office within the Treasury Department.
11. Restricting and limiting some activities of financial firms including limiting bank proprietary investing and trading in hedge funds and private equity funds as well as limiting bank swaps activities.
12. Providing cooperation and consistency with international financial and banking standards.
13. Making permanent the exemption from its section 404(b) requirement for

non-accelerated filers (those with less than $75 million in market capitalization).

14. Requiring auditors of all broker-dealers to register with the PCAOB and gives the PCAOB rulemaking power to require a program of inspection for those auditors.
15. Empowering the Financial Stability Oversight Council to monitor domestic and international financial regulatory proposals and developments, to strengthen the integrity, efficiency, competitiveness and stability of the U.S. financial markets.
16. Making it easier for the SEC to prosecute aiders and abettors of those who commit securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940 by lowering the legal standard from “knowing” to “knowing or reckless”.
17. Directing the SEC to issue rules requiring companies to disclose in the proxy statement why they have separated, or combined, the positions of chairman and CEO.

On September 12th, 2010, global bank regulators agreed to require banks to significantly increase their amount of top-quality capital in an attempt to prevent further international crisis. The Basel III will require banks to maintain top-quality capital totaling seven percent of their risk-bearing assets compared to currently required two percent. Effective compliance with Basel III rules would require banks to raise substantial new capital over the next several years when the rules become effective in January 2019. The primary objective of Basel III rules is to strengthen global capital standards to ensure sustainable financial stability and growth for banks worldwide. These rules are intended to encourage banks to engage in appropriate risk business strategies to ensure their financial health and their ability to withstand financial shocks without government bailout supports. The increased capital requirement, on the other hand, could reduce the amount of fund available to lend out to customers.

Specifically, Basel III will require banks to: (1) maintain top-quality capital (tier1 capital, consisting or equity and retained earnings) up to 4.5percent of their assets; (2) hold a new separate “capital conservation buffer” of common equity worth at least 2.5 percent of their assets; and (3) build a separate “countercyclical buffer” of up to 2.5 percent when their credit markets are booming. The Tier1 rule will take effect from January 2015 and the requirement for the capital conservation buffer will be phased in between January 2016 and January 2019. Other rules of Basel III are: (1) provisions for reducing risk-taking by banks; (2) requirements for liquid banks’ assets; and (3) the treatment of tax assets.

Important provisions of Basel III are[iv]:

1. Basel III rules are more robust than Basel II in the sense that they require higher capital standards, which more than triple the ability to withstand a future financial crisis.
2. The new capital conservation buffer (2.5 percent) will not be effective until January 2019.
3. The total capital requirement of 7 percent is expected to become a norm or standard floor for banks in order to avoid curbs on their payouts such as dividends, bonuses or share buybacks.
4. Basel III rules along with global liquidity standards which will become effective January 2015 will help banks to build up reserves of cash-like assets and more capital than Basel II rules
5. Financial institutions may reconsider financial market trading in light of the new tougher capital requirements.
6. Big financial institutions may build up more capital than Basel III rules to mitigate the negative effects of the perception of “too big to fail”.
7. Regulators may require an excess counter cyclical buffer.
8. Banks may attempt to adopt Basel III capital requirements prior to the dates specified in the Basel rules to demonstrate their commitment to sound banking system and proper risk assessment.
9. Investors will perceive early adoption of Basel III rules as positive steps toward a more sustainable, liquid and sound banking sector.
10. It is also expected that large banks adopt Basel III rules earlier than the required timetable because they have more resources and incentives to do so to rule out the perception of “too-big-to-fail”.

Relevance of Global Regulatory Reforms to Hong Kong

Many provisions of new regulatory reforms including the G-20 Summit, the Dodd-Frank Act, and Basel III rules are considered to be positive and useful in protecting consumers and investors worldwide including the establishment of a consumer protection bureau and a systemic risk regulator provisions requiring derivatives to be put on clearinghouses/exchanges, reducing global deficits and creating tougher capital requirements for banks. These global regulatory reforms are intended to prevent further financial crisis, create more stable banking systems and promote the corporate culture of honesty, integrity and competency. The lesson from the financial crisis is cost-effective, efficient, enforceable and scalable regulations are needed to create a framework within which businesses can operate in generating sustainable performance while they are prevented to defraud investors and consumers. The relevance of these

global regulatory reforms to Hong Kong and their implications for businesses and banks in Hong Kong are:

1. Understand the global nature of business markets and economy.
2. There is an urgent need for convergence in corporate governance reforms, including regulations, laws and rules.
3. Make regulatory reforms globally enforceable.
4. Continue support for effective, efficient and robust global regulatory reforms.
5. Support the move toward the adoption of international financial reporting standards (IFRS).
6. Strengthen transparency of financial markets through enhanced disclosure of complex financial products.
7. Improve accountability by ensuring proper risk assessment.
8. Comply with Basel III rules regarding new capital requirements, even though many Hong Kong banks are now maintaining more than the required 8 percent capital ratio.
9. Promote integrity in financial markets to protect investors, avoid conflicts of interest, prevent illegal market manipulations, and prevent fraudulent activities and abuse.
10. Promote corporate culture of integrity, competency, sustainability and ethical behavior.

Conclusion

The recent financial crisis was caused by many factors including the subprime mortgage debacles, lack of transparency among financial institutions, greed and incompetence of executives, ineffective and inefficient regulations, highly leveraged financial institutions. The effects of the financial crisis have been far reaching, not only in the United States, but also in the global marketplace. Key effects include increased unemployment rates, record numbers of home foreclosures, government deficits and insufficient economic growth. A number of market correction mechanisms and regulatory reforms are adopted to prevent further occurrences of these global financial crises. While these suggested mechanisms and reforms are expected to have positive effects, there is an urgent need to promote a corporate culture of honesty and competency with a keen focus on sustainable performance.

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[i] Rezaee, Z 2011. .Financial Institutions: Valuations, Mergers and Acquisitions, third edition, John Wiley & sons, forthcoming, July 2011.

[ii] Ibid

[iii] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111- 203 (2010).

[iv] Basel III Accord: The new Basel III framework,, Available http://www.basel-iii-accord.com/