Toward a new paradigm of International Financial Regulation

The world has been engulfed in a financial crisis that encompass almost every aspect of our lives for the past two years. The causes of this crisis are many and took many years until they reached this stage. While it is generally agreed that the crisis began in the United sates and spread into the rest of the world I think it is valuable to understand some of the root causes of the crisis if we want to comprehend some of inevitable corrective measures we will experience in the coming years. Ten years ago in the US Glass-Steagal, the law that prohibited commercial banks from operating as investment banks, was repealed. In addition the US Congress made the decision to forbid regulations on credit derivatives such as Credit Default Swaps which at the time were about one trillion dollars and have since ballooned to 33 trillion dollars. In 2004 the SEC raised the leverage ratio for financial institutions from 10 : 1 to 30 : 1. This nonregulatory environment set the stage for many of the financial innovations that drove the boom and the bust that would follow.

Subprime mortgage became major tool for predatory mortgage lenders who aggressively recruited marginally qualified borrowers to take the mortgages. The lender sold the mortgages to investment banks who then sold them to the public in the form of bonds (MBS mortgage backed securities). The bond holders purchased Credit Default Swaps (a form of insurance contract) to protect themselves in the event their MBS defaulted. Between 2000 and 2007 trillions of dollars of securitized subprime mortgages and Credit default Swaps were initiated. As long as the prices for residential homes in the US kept increasing all the participants in these structures were earning lots of money. In 2007 the price of US houses declined and the default rate on subprime mortgage loans greatly increased. These events set off a chain reaction, the value of MBSs' declined, the CDS insurance contracts were triggered and by the end of 2008 such illustrious banking houses as Bear Sterns and Lehman Brothers had disappeared. What also happened in late 2007 was the implementation of an obscure GAAP rule called Mark to Market (FAS 157) that as we shall see not only further exasperated the crisis but also contributed to its subsequent recovery.

FAS 157 is an accounting standard that was issued in September 2006 with the objective of defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. FAS 157 was intended to achieve greater consistency and comparability in the fair value measurements and to provide better information , i.e., more transparency, about the extent to which fair value is used to measure assets and liabilities, the inputs used to development the measurements , and the effect of certain measurements on earnings for the period. FAS defines "Fair Value "as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In short, the standard requires that assets and liabilities must be valued at a price in a hypothetical market transaction based upon the assumptions of a current participant who is independent, knowledgeable, and willing and able to transact. To help achieve consistency and comparability in fair value measurements , FAS 157 establishes a hierarchy (level1,Level 2 and Level 3) prioritizing those assumptions ("inputs") that a market participant would use in pricing an asset or liability. Generally, Level 1 inputs are current quoted market prices for an identical asset or

liability in an active market; Level 2 inputs are quoted current market prices for similar assets or liabilities in markets that are not active; other observable inputs for the asset or liability in question such as interest rates , yield curves , volatilities, prepayment speeds, loss severities and credit risks; and Level 3 inputs are unobservable, meaning they are the reporting entities own assumptions that market participants would use in pricing an asset or liability "based on the best information available in the circumstances"

When the housing prices declined and the default rates increased in late 2007 investment banks had to write down a vast amount of mortgage backed securities and credit default swaps they were holding in order to comply with FAS 157.For institutions holding on to bank loans –assets which there is an active secondary market- marking to market was relatively simple. If markets priced bank debt of companies with a particular credit rating at 85 cents on the dollar, banks had to write down 15 cents of the value of each dollar of the loan. This process helped drive the massive write downs seen at banks like UBS and Citigroup in late 2007. Mark to Market accounting (FAS157) greatly amplified the financial crisis because when prices are on the way down , particularly when buyers are thin on the ground and sellers are distressed the downward price movements can themselves trigger the need to unwind investments, further depressing prices and they soon become self-reinforcing. In 2007-2008 there was no market for toxic assets like mortgage backed securities backed by subprime mortgages. If there is no market FAS 157 says a bank must mark the investment's value down, possibly all the way to zero .As I have tried to demonstrate the mark to market (FAS157) rule was most controversial and helped to create huge losses for many banks and contributed greatly toward the bankruptcy of Lehman Brothers on September 15, 2008 which was the catastrophic event of the crisis

For most of 2008 Congress, major banks and the US Chamber of Commerce lobbied the FASB (US GAAP rule making organ) to change FAS 157 so it would not have such an adverse effect on the financial statements of banks. Finally on April 3, 2009 (right before the stress tests for banks were due to the Federal Reserve) the FASB announced some major changes. The FASB changed FAS157 so that a bank was no longer required to write off distressed asset that had no active market if the bank stated that it intended to keep the asset. Thus, under the April 3rd rules banks no longer had to write off most distressed assets. Some analysts estimate that the new rule increased the earnings of banks by 20%.

The FASB came under much criticism for it's' decision to soften FAS 157 and it was accused of succumbing to "outside pressures ". The Fair Value issue is of extreme importance because the way in which Fair Value is determined can have a significant impact on a bank's capital adequacy ratios and thus its' ability to lend. In July the FASB together with the IASB have issued a joint exposure draft on mark to market accounting in which they try to simplify the rules and classify assets into two categories loans and securities which share the characteristics of loans. The emphasis of these new rules as they apply to impaired assets will be on the expected cash flows of the asset. Perhaps this new exposure draft will end what the Economist magazine calls a" religious war between those who want financial assets shown at fair value and those who want those assets shown at cost".

Until September of 2008 many thought Russia to be a safe haven which was immune to the effects of the global financial crisis. After the collapse of Lehman and an almost simultaneous drop in the price of

oil Russia’s banking system suffered from a severe liquidity crisis. Since 2008 nonperforming loans have increased dramatically and are now a controversial issue. Western rating agencies and other authoritative sources have little faith in the nonperforming loan figures . The Central Bank recently estimated NPLs at 10% leading rating agencies estimate that NPLs are in the range of 35-50%. The Central Bank and IFRS have different definitions of Nonperforming loans. In Russia when a debtor misses a repayment, banks are required to report as delinquent only the amount missed, while IFRS defines a NPL as more than 90 days overdue or individually impaired. Western analysts also have problems in reviewing the financial statements from Russian banks because most banks do not provide IFRS consolidated financial statements. At this point the Central Bank is reluctant to require consolidated financials because they are concerned that they might be manipulated. Which NPL numbers are more credible, it is difficult to determine.

Since the 1998 crisis the Central Bank has been very risk adverse in its Instruction No.110 establishes prudential ratios that are more conservative than Basel recommendations. A finding by the supreme Arbitration Court held that derivatives constituted a form of a wager and thus could not be held the norms of the Civil Code. The Central Bank’s strict liquidity requirements have also made it impossible for companies to have a loan agreement of more than one year, this is why banks may allow a credit line for 3 years but 3 one year loan agreements .Many Russian Banking experts I have talked to believe the NPL situation in Russian banks is manageable and that a second wave of banking crisis is unlikely. Leading analysts will have more faith in the financials of Russian banks when Russia fully adopts IFRS and it becomes possible to do a reliable analysis of the financial health of Russian banks.

In responding to the Global Financial Crisis TheG20 has taken the lead. Since last November the G20 has coordinated a global recovery strategy and the world avoided a worldwide depression. The G20 implements Financial Reforms through the Financial Stability Board. There are many reforms that that this group is trying to implement. For example the FSB is currently working on issues that were considered to have caused the crisis such as abuses with credit Default Swaps and securitizations and also issues credit rating agencies. The FSB is also working with Basel to establish a new minimum global liquidity standard. A major issue that the FSB addresses is the need to strengthen accounting standards. It recommends that a global set of accounting standards (IFRS) be adopted by member countries by 2012. It also specifically supports the efforts by the IASB and FASB to adopt a new accounting standard on impaired assets (replacing FAS157 and IAS39) using expected cash flows as a basis for writing off nonperforming loans(NPLS). This issue as we have seen is of great significance in both Russia and internationally because it can affect how a bank makes loans to business. The implementation of IFRS along with the establishment of consistent rules on loan provisioning will greatly enhance the transparency of financial statements and will increase capital flows between countries while reducing the probability of fraud.