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NEW ARCHITECTURE OF THE FINANCIAL SUPERVISION OVER THE OPERATIONS WITH DERIVATIVES: INTERNATIONAL PRACTICE AND UKRAINIAN REALITIES

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In the article the author will provide detailed analysis of the tendencies in the regulation of the derivatives' operations on the global market and understand what approaches are prevailing in Europe and the U.S. Moreover, the author will provide meaningful research of the possible options for Ukraine in terms of regulation and supervision development over the derivatives' operations and choose the best one basing on the current peculiarities of the economic and legislative areas. The regulation effectiveness has always been an important item even during pre-crisis period. However, the latest financial crisis led to the increased attention to this issue on the global and national levels.

Introduction. The recent financial crisis has clearly demonstrated that the current regulation system of the financial markets is unable timely response on crises and prevent them adequately that can be tracked both on national and global levels. The regulation effectiveness has always been an important item even during pre-crisis period. However, the latest financial crisis led to the increased attention to this issue on the global and national levels. Nowadays, previous regulating approaches on derivatives' market are sharply criticized and are treated as the major cause of the crisis. Mainly, the scholars highlight that derivatives and regulatory gap have been the route-cause of the latest financial crisis. Currently, less than 30 % of the financial markets under "G−20" are controlled by or subjected to The National interests. Current scale and scope of derivatives market, its misappropriation impose the need to revise current regulating approach [10].

Until now, the regulating approach of the derivatives in the international financial sector was not considered at all or liberalization was regarded as the most suitable option in order to support further development. Derivatives were taken on account out off the balance sheet at the market value that did not allow them to be monitored and regulated [10].

With increasing globalization of the financial markets, their regulators are becoming larger that clearly determines macroregulating tendency in the financial system. More than 40 countries out of 260 have chosen macroregulating approach as lead option for financial market supervision that enables to ensure market transparency more effectively and protect interests of the investors and the country. "Macroregulating" model is becoming more and more popular in the world that is explained by excessive liberalization that took place on derivatives' markets before crisis and increasing integration on the market and creation of financial conglomerates.

Thus, the question of further regulating approach requires the establishment of the special mechanisms of regulation. Establishment of the universal and comprehensive regulating requirements for derivatives is a necessity in the overcomplicated financial environment. The increased risk of globalized financial conglomerates with regard to the information asymmetry view is forcing regulators to limit the systemic risk, generated by these institutions, in order to stabilize entire financial system.

Discussion. Nowadays, the regulating system of the derivatives' market does not fully meet the requirements in the face of the current financial challenges that may collapse the financial system through the scale of transactions with them. Besides, the low level of regulating requirements to the accounting and reporting can lead to the underestimated risk, financial difficulties and bankruptcy. The lack of clear tax laws in this area serves as the basis for tax evasion and other fraudulent manipulations that are often used to conceal the real state of the businesses [9].

We should consider that international practice has gained a number of regulating and supervising models. However, recent financial crisis has shown that these models are unable timely respond and prevent them.

Currently two models are prevailing on the global financial market: European and American.

The European model. There are various approaches for derivatives market regulation in the EU that vary by countries. For example, Austria, Denmark, Estonia, Great Britain, Latvia, Germany, Hungary have single macroregulator that monitors the functioning of the entire financial market and its participants. At the same time Italy, Lithuania, Poland, Portugal, Slovenia and France have separate supervisors for transactions with derivatives, that are carried out by banks and non-bank financial institutions.

On 23rd of September 2009, the European Commission approved the establishment of two-tier system of financial supervision, which began its work in 2010. This system included the creation of the European Systemic Risk Board (ESRB) to implement macro-prudential surveillance and early detection of risks to EU financial stability.

The new authority has the authority to develop recommendations to separate countries, groups of countries and their supervisors regarding the implementation of the necessary changes to ensure the financial stability of the European Union. Besides, the Council of Systemic Risk and the European System of Financial Supervision (ESFS) were formed and would provide a full-fledged system of prudential supervision on the micro level and work directly with The National financial supervising authorities in order to create a unified system of standards for the provision of financial services to the European Union [9].

We think that the existence of multiple regulators today will not solve the problem itself but creates additional risks regarding the allocation of powers between them, the order of appointment and dismissal of senior officials and promote "bureaucratization" of these institutions.

From another hand, the existence of one macroregulator may lead to the monopolization of the financial supervision and potential emergence of crises in the future, as this authority will be out of any control.

Therefore, we suppose that there is a reasonable interim option. There should be one macroregulator on the EU financial market, which should be chosen among supranational international organizations (e.g. UN, IMF, etc). Thus, the basic controls, determination of the current financial policy and further regulation improvement in this sphere will be assigned to a single authority, but the monopolization of power would be impossible due to the enhanced prudential supervision by selected supranational organization.

The American model. As the recent financial crisis has led to the revision of the supervising and regulating system, it seems logical to review the approach to regulation of the financial market in the country, which caused the crisis. Unlike the EU, the U.S. doesn't plan to create macroregolators of the market, although, the work that has currently been doing by U.S. government, can be considered as the most scalable since the 1930s. The aim of these innovations is reformation of the regulating approach that has been implemented after "Great Depression". So the relevant segregation of duties between regulating authorities will be implemented in order to maximize the effectiveness of the institutions that are operating on the market.

Moreover, more strict requirements will be deployed for supervision under financial conglomerates that are influential not only for a separate economy but for the global business environment overall.

In the U.S. the key legislation acts that somehow regulate the derivatives' market are: the Sarbanes − Oxley Act (2003), National Securities Markets Improvement Act (1996), Gramm − Leach − Bliley Act (2000), Future Trading Act (1976, 1982, 1986, 1989, 1991) [7].

On the basis of the adopted legislation for the regulated derivatives market (Farm Bill as of June 18, 2008), the unregulated derivatives' market (Lincoln − Dodd as of April 21, 2010) and the draft of regulating proposals, we may conclude that regulating and supervising programs over financial sector in the USA aim to:

- Integrate supervision of the financial market without any exception;
- Pay special attention to highly risky business models and strategies;
- Balance approach to the prudential supervision and codes of conduct for market participants;
- Increase attention to the macro-prudential supervision and cross-sectoral risks;
- To be able to make decisions about future risks and requirements for the companies to mitigate these risks [8].

Also, in 2011 Timothy Geithner (the U.S. Treasury Secretary) appealed to the creation of new global derivatives' trade standards to prevent "race of concessions".

He said that we need global minimum standards for derivatives' trade as we have global minimum standards for the bank capital level recorded in the international agreements. Without international consensus risk will be concentrated in the jurisdictions with minimal supervision and this is a formula for new crises.

The U.S. moved in the direction of regulation improvement much further than others endorsing in July 2011 the Dodd – Frank's Act that has introduced a legal basis for the regulation of banking activities in the United States. The law, in particular, requires financial institutions to conduct transactions with derivatives through clearing houses to reduce risk. But there is a risk that derivatives' traders will move their operations out of the United States, where this area is less regulated.

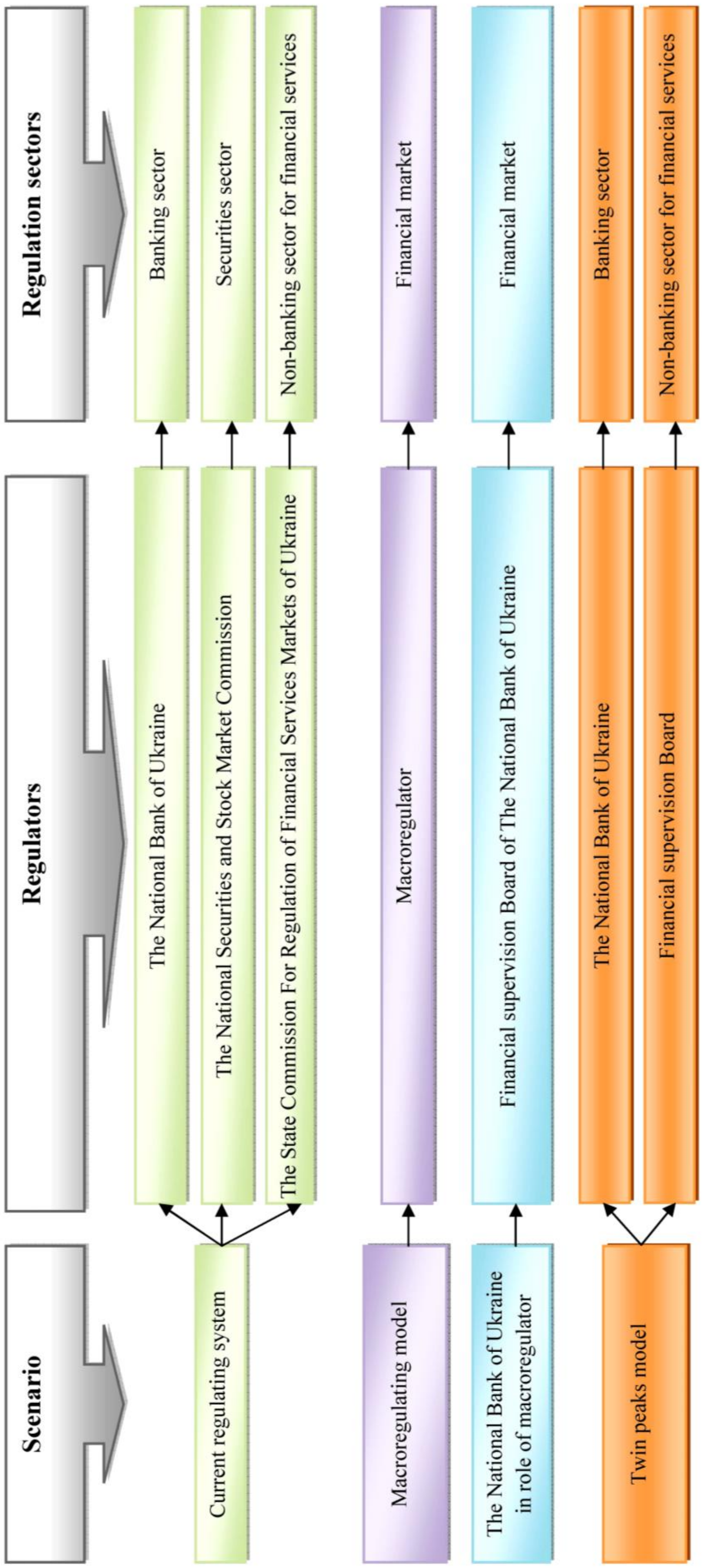
Therefore, effective reform of regulation on derivatives' market should be implemented in the following areas:

- Introduce relevant legislation for derivatives' dealers;
- Increase transparency and standardization into derivatives' trade;
- Reduce the risk of public financial institutions through derivatives standardization and centralized clearing.

Thus, the U.S. insists on a more conservative model. We believe, the American model is more secured as dedicated to the improvement of the current regulating system, while the European model is completely new and untested. Thus, the potential risks of its introduction are more dangerous, while the stability of the global business environment is more prioritized, than the ambition and protectionist of "macroregulator".

The Ukrainian model. The necessity of a single supervising authority of the derivatives' market as a part of the financial market was often seen before and after financial crisis. The main contribution to the development of the idea was made and is currently been doing by The State Commission for Regulation of Financial Services, that aims to create a marcoregulator that will be interconnected with The National Bank of Ukraine.

However, in our opinion, it isn't thoughtful decision for Ukrainian immature economy. Currently, Ukraine doesn't have all necessary preliminary factors to implement single macroregulator. After detailed analysis of the Ukrainian economical and legislative situation, we would like to provide more realistic scenarios for further development of the supervision over derivatives, taking into consideration all pros' and cons' (Picture).



Potential scenarios for the regulation and supervision development over the operations with derivatives in Ukraine

Source: compiled by the author based on [8].

Scenario № 1 “Further development of existing regulators by enhancing their independence”

In the current regulating system, that implies further development of The National Bank of Ukraine, The National Securities and Stock Market Commission, The State Commission For Regulation of Financial Services Markets of Ukraine by strengthening their independence, we will need to make some changes to the Law of Ukraine “On The National Bank of Ukraine” and adopt a special law “On National Securities and Stock Market Commission”, “On The State Commission For Regulation of Financial Services Markets of Ukraine”.

The main purpose of these changes is to increase independence of The National Bank of Ukraine by the appointment and dismissal of the Chairman and a member of the Board, setting them additional qualification requirements, effective mechanisms of accountability to the Ukrainian Parliament, the Government, etc [8].

Advantages

- No changes in the legal framework regarding the redistribution of powers;
- No additional funding in the organizational structure of regulation and supervision;
- No transition risk

Disadvantages

- Difficulties during introduction of the consolidated supervision;
- Low coordination level of the regulating and supervising authorities;
- Extra load on the State Budget;
- Low protection level of investors’ and consumers’ rights;
- Lack of macroprudential supervision

Scenario № 2 “Implement macroregulating model”

A separate macroregulator will control and supervise banking and non-banking financial institutions, securities and derivatives’ market.To implement this scenario, it is necessary to adopt a relevant decision, modify and supplement the legislation on the definition of its main tasks and responsibilities, recognize it as a public authority with special status that does not belong to the system of central executive bodies, to identify sources of funding [8].

Advantages

- Fixed responsibility for the development of the financial sector policy;
- Reporting simplification (standardization) and reduction;
- More efficient usage of resources (financial and human);
- Unified approach to the regulation and supervision of financial institutions

Disadvantages

- “Bureaucratization” and transition risk;
- Extra load on the state budget for the maintenance of the regulator;
- Lack of macro-prudential supervision;
- Low level of investor protection

Scenario № 3 “Point The National Bank of Ukraine as macroregulator”

The main idea of this approach is to assign The National Bank of Ukraine as macroregulator. It will require amendments to the Law of Ukraine “On The National Bank of Ukraine” regarding the establishment of macroregulator status after The National Bank of Ukraine, expansion of the functions list, identification of the key tasks and strengthening its independence [8].

Advantages

- Fixed responsibility for the development of the financial sector policy;
- Create a single database of financial institutions;
- Reporting simplification (standardization) and reduction;
- Implementation of macroprudential su-per-vision;
- More efficient usage of resources (financial and human)

Disadvantages

- Transition risk for non-banking sector;
- Extra load on the State Budget; due to increased funding for the development of legislation and organizational changes;
- Low level of investor and consumer protection

Scenario № 4 "Twin peaks model"

This scenario implies introduction of the two separate regulating authorities, two independent controllers, one of which will be located in The National Bank of Ukraine and carries out prudential regulation and supervision of financial institutions, the second authority (under the Ministry of Finance) will be responsible for setting the rules and supervision of the financial markets, protecting investors and consumers of financial services.

To perform this scenario, it will be necessary to amend the Law of Ukraine "On The National Bank of Ukraine" and expand the functions' list of The National Bank of Ukraine (as it will regulate and supervise non-banking financial institutions), a mission statement, the main tasks and responsibilities of the governing authorities of The National Bank of Ukraine, determining the interaction between The National Bank of Ukraine and financial market regulators.

Advantages

- No transition risk in the banking sector;
- Reporting simplification (standardization) and reduction;
- Development of the unified approach to regulation and supervision;
- Implementation of macro-prudential supervision;
- Enhanced protection of human rights

Disadvantages

- Transition risk for the non-banking financial institutions;
- Coordination of risk management and supervision;
- Extra load on the State Budget due to increased funding for the development of legislation and organizational changes

Conclusion

The latest financial crisis has revealed the weaknesses of the current regulating system of the global financial market. It demonstrated that the global nature of the financial sector requires a influential regulating levers on The National and global levels. The developed countries as well as countries that are developing are trying to create of more effective regulating tools. The EU countries are lobbing macroregulating model, while the U.S. aims to improve the current sectoral regulating structure.

Despite the differences between the models and taking into account the aspect of the financial market, we believe that the functions performed by new system should be universal, namely: prudential supervision, protection of investor rights, consumer protection.

To determine the optimal vector for Ukraine towards improving regulation over derivatives' transactions, the Ukrainian government should consider governmental vector to harmonize Ukrainian and European legislations that is an element of legal reform conducted in Ukraine. The hailed course includes entrance into the European legal space. Thus, the optimal scenario is to create a single macroregulator.

In our opinion, the creation of a single authority is not relevant for Ukraine at the present time. First of all it is connected with manifestation of the crisis in Ukrainian economy as during initial phase of the introduction of the macroregulating model, financial transactions will be out of control with decreased level of attention on it, that can lead to the deterioration of the overall financial condition of the country.

Besides, the establishment and successful functioning of the diversified financial institutions, the concentration of information flows should precede the creation of macroregulator that will make national financial market more mature.

Moreover, the existence of diversified financial groups will help to shift to the sectoral and cross-sectoral regulation that is a prerequisite for creation of an integrated financial supervision in Ukraine.

However, in our view, the best option for Ukraine is “Twin peaks model”. First of all, macroregulating responsibilities will be held by The National bank of Ukraine and there will be no need to create absolutely new authority to perform these functions.

As described above, the deterioration is possible during initial phase and can be prevented by the second authority under the Ministry of Finance.

Basically, these two institutions will be able to monitor market more efficiently due to well-judged segregation of duties that will give possibility to monitor economical situation and implement new regulating tools for the derivatives’ market.

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НОВАЯ АРХИТЕКТУРА ФИНАНСОВОГО НАДЗОРА НАД ОПЕРАЦИЯМИ С ПРОИЗВОДНЫМИ ФИНАНСОВЫМИ ИНСТРУМЕНТАМИ: МЕЖДУНАРОДНАЯ ПРАКТИКА И УКРАИНСКИЕ РЕАЛЬНОСТИ

А.И. ФРАНЦУЗ, Т.Ю. ЛЕБЕДЕВА

Подробно проанализированы тенденции в регулировании операций с производными финансовыми инструментами на глобальном рынке и подходы, преобладающие в Европе и США. Рассмотрены возможные варианты развития для Украины с точки зрения регулирования и развития надзора за операциями с производными финансовыми инструментами и предоставления наиболее привлекательных из них на основе текущих экономических и законодательных особенностей.