

***A regulatory approach to Innovative  
financial products***  
***11<sup>th</sup> OECD-ADBI Roundtable on Capital  
Market Reform in Asia***

***Comments by  
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## ***Volcker and Turner on Financial Innovation***

- **“I wish somebody would give me some shred of evidence linking financial innovation with a benefit to the economy.” Mr. Volcker’s favorite financial innovation of the past 25 years? The ATM. “It really helps people, it’s useful.” 9 Dec 2009**
- **“there does not appear to any compelling proof that increased financial innovation over the last 30 years in the developed world has had a beneficial effect on output growth.. Lord Adair Turner, FSA, 14<sup>th</sup> Chintaman Deshmuk Memorial Lecture, RBI, Mumbai, 15 Feb 2010**

# ***Why should we regulate unregulated entities, products and markets?***

- Regulation is necessary to address systemic risks, fairness, efficiency, orderliness and transparency of entities, products and markets
- Need for comprehensive, system-wide oversight so as not to miss systemic risk
- Other risks are principal-agent cheating/mis-selling [investor protection], [market abuse] market manipulation, insider-trading, false info, e.g. CDS etc.
- Threats to system, if –
  - ✓ Critical to availability of credit and capital flows
  - ✓ Too big, global or too interconnected to fail

## ***Non-transparency of entities, products and markets***

- **Entities – hedge funds are designed for regulatory arbitrage, tax arbitrage and information arbitrage**
- **iBank is hedge fund with implicit deposit insurance and access to central bank funding**
- **Production Origination/Derivatives aim to increase complexity for seller to increase fees and trading income**
- **Huge hidden leverage not transparent to investors and regulators, hence move to centralized clearing (CCP)**

## *Financial Derivatives*

- **Not all financial derivatives are bad – the simpler ones actually help risk management.**
- **A derivative is almost always sold, never bought**
- **A derivative tries to make up-front 3-5 times spread on an underlying credit spread that is shrinking.**
- **Layers of derivatives really increase leverage**
- **Hence, profits from financial products were really from leverage, trading and passing buck to state and last holder (Devil takes the Hindmost)**

# **Suggested regulatory approach – IOSCO Consultation Report on Unregulated Financial Markets and Products, May 2009**

- **Skin in the game – originator must have residue stake in product (e.g. for CDOs), but traders in CDS has no skin in game, hence prices can be manipulated in thin markets through double play – short bond, sell CDS to raise premium**
- **CDS can be dangerous due to Soros Asymmetry – long only strategy loses all your capital, but short derivative strategy can lose everything**
- **Impose disclosure obligations and origination due diligence**
- **Ensure independence of experts and agents**
- **Experts to review products**
- **Strengthen investor suitability tests – investor protection**