

## Optimum Level of Regulation and Market in Risk Management

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### Introduction

The state -the machinery and power of the state- is a potential resource or threat to every industry in the society.

Stigler [1].

As an instrument for managing/optimizing firm/industry wide risks, risk management is useful tool for companies and regulators. Companies and agencies use various risk management instruments to fulfill their responsibilities to stakeholders, and eventually society. In this respect, Kane [2] suggests that it is instructive to view financial services as a product that is supplied jointly by financial institutions and their regulators. However this approach represents an ideal point, both parties have different and uncompromising *raison d'être*. It has observed during global financial crisis while owners/ managers of companies lost their reputation and wealth, central banks paid the bill through taxpayers' money. This picture reveals that to save the "system" state may take ultimate responsibility for firm/industry wide risk management practices due to statutory objectives of relevant agencies.

The world struggles to cope with capitalism's near apocalyptic failure Fernandes [3]. The bitter expectation is that global financial crisis will not probably be the last stop. Hence, in the context of new financial failures/crises, we will probably discuss again about what will be the optimal level of regulation and self regulation in firm/system wide risk management. Without understanding the political economy of financial markets all research questions may be pointless, but our purpose is not to provide an exhaustive study on the role of government in free market economy. Instead, we briefly analyze the role/function of disciplinary mechanisms and their effects on firm/system wide risk management practices in the light of lessons of global financial crisis.

What we learn from previous financial crises is that less perfectly tested theoretical knowledge is dysfunctional in practice. Ironically, after each failure, one may also observe there are so many new things under the sun: brand new institutions, heavier regulations (i.e. Basel 1/2/3), new faces in finance bureaucracy, new finance movies etc. However this expected picture could not probably stop next perfect storm probably due to the nature of free market economy combining bubble economy, white collar crimes, short-termism of all economic agents (namely corporations, government, and household) etc. So, the question we are attempting to address in this discussion note is that is there any perfect tool (s) to stop evils of over risk-taking in financial markets. Or, what would be the best tool to minimize unexpected loss of next crisis. We have some answers with some questions on this puzzle.

### Self, Market and Official Disciplines

Can capitalism survive? No. I do not think it can.

Schumpeter [4].

The words of Schumpeter should not break our concentration to find a superhero to pursue effective risk management structure in highly sophisticated financial markets. Basically, we have three candidates to discipline firm/system wide risks, namely self, market and official disciplines. As discussed in Coşkun [5] self discipline, which is made up of an accounting and reporting system, internal control, internal audit, risk management and corporate governance, is the most critical part

of effective governance in financial intermediaries. But, as recorded in finance history, a number of financial firm failures ranging from banks to hedge funds around the world imply that risk management, control and discipline problems are among the most important reasons for failures. Thanks to global financial crisis, we have now longer list of failed institutions from insurance firms to investment banks. Therefore, it is fair to say that self discipline tools may not be effective due to motive of over risk taking with less care on control mechanism.

Second candidate of superhero to discipline firm/system wide risks is market discipline. Many like the idea of market discipline due to its nature of "less state". But the idea of effective transparency may not work in the financial system. Because, instead of disclosing all material information on a specific transaction/risk item or firm's financial condition/performance, financial firms may prefer to chasing/distorting information by using various instruments from complicated explanations to statistical lies.<sup>1</sup> Just try to memorize many cases from Enron to Madoff or masked Greek debts.<sup>2</sup> But, even market discipline channels would work effectively, it is hard to imagine that not only ordinary investors but also sophisticated investors (and their advisers) may correctly analyze/understand all material information in their decision making. Again memorize how institutionally "sophisticated" risk takers, expectedly analyze each move in marketplace, failed during subprime mortgage crisis. Therefore, indicated in Coşkun [6], as observed in the previous single/systemic financial failures, over emphasizing the importance of the concepts of transparency/disclosure/market discipline have not created effective solution framework for the inherent/clear problems of financial markets. Instead of emphasizing more on transparency policy, to improve firm/system wide risk management, investor protection and market efficiency, optimal risk management framework of financial firms should involve higher risk-based capital requirements, better risk management framework with manageable leverage and also better regulatory/supervisory framework.

As the last candidate for superhero, official discipline aims to manage financial firm level risk management practices through government intervention tools (regulation, supervision, and enforcement). The aims of the government intervention are to improve firm level self discipline practices and hence minimize systemic crises. But, the intervention has not also worked well as observed in several crisis in different countries. Hu [7] discusses that regulators slept at the wheel, taking comfort from

<sup>1</sup> Maybe it is the time to remember famous words of Mark Twain: "There are lies, damned lies, and statistics."

<sup>2</sup> Available at: <http://www.spiegel.de/international/europe/greek-debt-crisis-how-goldman-sachs-helped-greece-to-mask-its-true-debt-a-676634.html> (accessed on 01/07/2014).

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Received August 28, 2014; Accepted September 07, 2015; Published September 11, 2015

Citation: Coskun Y (2015) Optimum Level of Regulation and Market in Risk Management. J Stock Forex Trad 4: 159. doi:10.4172/2168-9458.1000159

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the self regulating and self-corrective capacity of efficient markets. For example, in the context of global financial crises, it is specifically important to note that regulation/supervision/enforcement tools have not simultaneously worked well in the case of structured finance [8].

## We Still Need an Answer

Regulation of any kind is inevitably an imperfect risk container, and it is good that it is.

Farrant [9].

We define above that all disciplinary approaches have tested in several financial failures and clearly implied that they have serious imperfections/deficiencies. However it is clear that there is no best tool to minimize firm/industry wide risks, the system demands more politically correct answers to improve its short-term visibility. In this respect, many national and supra national bodies (i.e. G-20, FASB, IMF, OECD, World Bank, IOSCO, BIS, Basle Committee etc.) need to focus on to implicit/explicit problems of existing disciplinary approaches. As one may observe, these institutions have published high quality reports analyzing the problems of financial system “just after the failures”.

There is no simple solution to define best risk management instrument, but the missing point would be to find optimal balance of all disciplinary forces in each case (in the level of industry/sub-sector/firm/ even single important transaction). In this context, decision makers should first clarify whether only official discipline (mainly regulation) may work in a specific case or self-regulation (through combination of self and market discipline) would be sufficient enough to manage firm/system wide risks. This theoretically sound determination is partially employed in financial intermediaries either implicitly or explicitly in the context of Basle Accords. But, the outcome may not be satisfactory. For example, before its failure, AIG has attracted very little supervisory attention but eventually created systemic threat. We can translate this case as lack of regulation (or sole self-discipline) did not work. Other example is that official discipline simply could not work in the case of valuation problems in primary/secondary mortgage markets. Moreover, market discipline could not catch the signals but feed the

disaster during subprime mortgage crisis. And more importantly, neither market/self nor official disciplines did work in the case of OTC derivatives. This one was complete disaster.

We are seeking best tool to manage firm/system wide risks in a highly imperfect real finance world and it seems that there is a strong atonality in risk management. We may underline in the light of above discussions that financial markets/firms do not need a pure self/official/market discipline but optimum combination of them in each specific case. In other words, the right policy would be a more balanced disciplinary framework combining all disciplinary tools. In this context, we may argue that each market/industry/firm may deserve different type and degree of discipline. And the most important task of policy makers is to find optimum level of each disciplinary tool in each specific case in financial industry/firm/transaction.

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