



Monthly Report
March

Fixed income seminar comprises financial crisis and regulation

NEARLY 250 EXECUTIVE OFFICERS IN THE FINANCIAL SECTOR PARTICIPATED, ON THE 19TH, IN THE **3RD INTERNATIONAL SEMINAR ON FIXED INCOME**, PROMOTED BY ANDIMA AND CETIP IN SÃO PAULO, AIMED AT DISCUSSING, AMONG OTHER THEMES, REGULATION, TRANSPARENCY AND CAPACITY TO ANTICIPATE TRENDS, WITH A FOCUS ON CONJUNCTURAL ASPECTS RELATED TO THE WORLDWIDE ECONOMIC CRISIS. OPENED BY THE PRESIDENT OF THE ASSOCIATION, ALFREDO NEVES PENTEADO MORAES, AND CLOSED BY THE CHAIRMAN OF CETIP'S BOARD OF DIRECTORS, EDGAR DA SILVA RAMOS, THE EVENT WAS ATTENDED BY AUTHORITIES OF THE CENTRAL BANK, THE BRAZILIAN NATIONAL TREASURY AND THE CVM, WHOSE INTERNATIONAL LECTURERS WERE ECONOMIST ALBERT FISHLOW, OF COLUMBIA UNIVERSITY, FABRICE TOMENKO, RESPONSIBLE FOR THE COLLATERAL MANAGEMENT AREA OF CLEARSTREAM, AND THE OFFICER OF COMPLIAX CONSULTING, JOHN CARSON, WHO IS INTERVIEWED IN THIS ISSUE OF FONTE ANDIMA. THE FULL CONTENTS OF THE PRESENTATIONS ARE AVAILABLE AT THE ASSOCIATION'S WEBSITE. FOLLOWING IS A SUMMARY OF THE MAIN TOPICS DISCUSSED IN THE SEMINAR.



Impacts from the crisis in developed and emerging countries

A historic perspective of the crisis was the opening theme of the presentation given by economist Albert Fishlow, who recalled that since the postwar period the international trade has been growing twice more than the world GDP, and that as from the 1980s, with the intensification of globalization and the deregulation of the markets, expressive financial flows and production gains started a virtuous cycle in the North-American economy. Such a growth was characterized by the significant increase in credit, with direct consequences to the increase in financing in the real estate area and in American families' consumption, in the sophistication of operations with derivatives and the increase in oil prices and other commodities.

With the end of this cycle and the worsening of the crisis as from September 2008, the only short-term strategy that could be adopted by the government would be an expansive tax policy aimed at avoiding a systemic crisis in the financial segment and enable agents' credit recovery with solvency problems.

At the end of the presentation, Fishlow defended the idea that the new post-crisis worldwide configuration would have China with greater political power, formally undertaking the role of great creditor of the North-American bonds. In his opinion, emerging countries, for having entered the growth virtuous cycle with delay in the 1990s, will suffer less with the impacts from such an unfavorable scenario. For the United States, however, the adjustment will undergo the recovery of the domestic savings account jointly with the need for lower tax and current account deficits in view of the high expenses the government shall contract during the forthcoming years.

At the second panel of the meeting, "Impacts from the crisis in Latin America's debt market", the reconstruction of an environment which enables credit growth and, as a result, of the securities market, was a recurring theme among lecturers.

According to Rodolfo Fischer, Vice-Chief Executive Officer of Banco Itaú Unibanco, the international financial crisis reflected more in the emerging countries by means of the credit channel, in this case represented by the access to foreign resources, which was interrupted as from September. As from then, there was an expressive increase in demand for domestic financing; however, the concession of resources became more selective.

In this regard, despite the lower systemic risk in the Brazilian market, the new domestic financing conditions show an increase in spread due to the elevation of the credit risk perception by financial institutions ratified by a punctual increase in default rates.

However, it is a common opinion that the Latin American countries are under better conditions to face this crisis than it was in the past. João Cesar Tourinho,



former officer of ANDIMA, said that the long worldwide growth period allowed these countries to consistently make pre-crisis adjustments, such as lower foreign exchange exposure, accumulation of international reserves and the gradual improvement of the debt/GDP ratio. This has been enabling handling margin for these countries to adopt anti-cycle policies to weaken crisis effects.

Paulo Valle, deputy secretary of the Public Debt of the National Treasury, remembered that the intervention of the government in the market was important to avoid higher deterioration of agents' expectancies. This operation was possible by means of tax discharges with the releases of resources from compulsory collections and special credits, those from official institutions, which focus was on reducing any systemic risk pressure in the financial market, in addition to maintaining a liquidity level compatible with a growing economy. Another important element to the government's strategy was the operation in the foreign exchange market, with strong sales of exchange values in the market and use of resources from international reserves for the maintenance of credit lines to finance foreign trade.

As to the 2009 outlook, the assessment is that, at least this year, even if the foreign capital flows return to the country at a lower level than the level observed in previous years. Tourinho believes that the Latin American countries shall only have access to foreign funds by means of unionized loans, instead of traditional financings. In addition, this major credit restriction, jointly with expressive decrease of commodity prices, should make it difficult to refinance the debt in the market of various emerging countries during the year. Paulo Valle, however, forecasts a calmer year to manage the debt. In this regard, the officer of Proventus Invest, Reinaldo Le Grazie, observed that in the debt stress test, the Treasury is in a favorable position, and the risk should be managed by the private sector.

Post-crisis regulation and self-regulation

In the panel which comprised the new ways for the regulation and self-regulation after the international crisis, John Carson presented the main models of self-regulating entities, indicating pros and cons of each, as well as the trends in this field and the matters related to the management of conflicts of interest. Although the amount of self-regulation has been questioned in view of the international crisis – especially in Europe, whose markets usually are not supported by this kind of structure –, according to Carson, in countries where self-regulation is more developed, it got even stronger, extending its credibility. Other trends indicated were the movement for governance independent from the control of its own members and a higher concern with the interests of a higher number of agents that can be affected by their decisions.



Carson indicated four main reasons for supervision flaws that occurred in the crisis: the regulators trusted in the sophistication of the risk management of large companies; regulators were reluctant as to challenging the risk models of these companies; there were flaws in the corporate governance of financial companies; and companies and regulators excessively trusted in the risk models, especially VaR, which does not comprise all market risks. Carson said that new rules and laws are necessary to regulate markets and products not regulated, and that the rules based on principles shall be retaken. However, the main answer to the crisis shall be the strengthening of supervision.

Also referring to the international crisis, CVM's CEO Maria Helena Santana says that the problem does not lie on self-regulation itself, but yet on the "exaggeration observed in some jurisdictions". The officer of Rules and Organization of the Brazilian Central Bank, Alexandre Tombini, highlighted as the cause of the crisis the creation of instruments and financial innovations that resulted on higher leverage, stimulated by a low interest rate scenario, with significant growth and lower volatility, which induced to the pursuit for an increasingly higher profitability. Since these instruments were little transparent as to the extension of the leverage they generated, its risk was underestimated, causing significant losses. For Tombini, the crisis also evidenced the strong intersection between the financial and capital markets, as well as the interconnection among regulated and non-regulated markets, contributing to worsen the problems. This diagnosis indicated flaws in the risk management, the existence of products and operations not regulated and the lack of transparency.

Tombini observed that in Brazil, however, contagion was lower, especially due to the application of prudential and leverage rules common to different kinds of institutions, due to accounting rules which make all operations be framed "within the balance sheet" and due to the fact that the securitization market is proportionally small, if compared to the credit volume in the country (less than 10%). The worst case, in its assessment, occurred in the derivatives market, with operations named "toxic hedges". It also indicated as a benchmark all over the world the fact that regulators, in Brazil, hold information, usually extracted from record systems or clearings, on all operations practiced in the financial market. For Maria Helena, the guarantee mechanisms at the stock exchanges and clearings also helped to protect the Brazilian investor.

As a response to the crisis, Tombini said that the reinforcement of regulation and supervision is unavoidable, which should involve macro-prudential concerns in the determination of regulatory capital, extension of supervision for non-regulated entities and the monitoring of markets and institutions already supervised – highlights to those systematically important – in addition to the improvement of liquidity provision mechanisms. He also commented on the need



to seek the regulatory uniformity among financial and capital markets and the possibility of countries' having one single central regulator. Maria Helena said that the main challenge, in this case, is to satisfactorily coordinate the functions of prudential regulator, involving secrecy, with those of protection to investor and suitability, involving transparency and wide access to information.

Maria Helena mentioned some recommendations resulting from the G-20 meeting held in November 2008 as the need for higher regulation of over-the-counter markets. As Tombini, she believes the evolution seems to be in the development of collateral management (as detailed in the presentations of Fabrice Tomenko and Jorge Sant'Anna, available on ANDIMA's website, at "ANDIMA/Event Presentations"). Although as to the over-the-counter market, Tombini recommended the improvement of rules, procedures, formation of prices and transparency, so that the over-the-counter market grows stronger, however without losing its function to enable operations not available in the standard markets. He also suggested the use of recording technology, for the better follow-up of operations and the elimination of legal and regulatory barriers which prevent the broad access of regulators to the information. Maria Helena said that the CVM is studying prudential aspects related to liquidity and leverage and that, in this case, the coordination is necessary among the regulators, which already occurs in Brazil. He also mentioned as a challenge to avoid regulatory arbitration, with the construction of common sustainability principles, which also occurs in Brazil and should be reached among countries that are members of Iosco.

Regarding self-regulation, it was observed that CVM Rule 461 brought an important institutional change, especially with the demutualization of the Stock Exchanges and Cetip. She affirmed that the rule implied a change in governance, protection and independence of these entities, as well as rules of disclosure of information, which became more detailed and frequent, and it is possible to notice some benefits. It was also observed that, although some countries have disregarded such a model, it is still early to evaluate it, and it is advisable for entities to be effectively involved in the supervision of their members, under penalty of retrocession.



Interview – John Carson

Market should have minimum standards of operation to all institutions

IN AN INTERVIEW TO FONTE ANDIMA, THE OFFICER OF COMPLIAX CONSULTING, JOHN CARSON, LECTURER OF THE 3RD INTERNATIONAL FIXED INCOME SCENARIO, DEFENDS THE ADOPTION OF A SET OF MINIMUM STANDARDS OF OPERATION TO BE REACHED BY ALL MARKET PARTICIPANTS AND SAYS THAT THE ENFORCEMENT, ALTHOUGH NECESSARY, SHALL BE REGARDED AS A LAST RESOURCE: “AN ENTITY CAN ADD VALUE TO THE SYSTEM BY PROVIDING SUPERVISION AND GUIDANCE, WITHOUT USING THE COERCION ‘HAMMER’”.

Due to the international crisis, everybody is asking for more regulation. In your opinion, what is the trend for regulation, self-regulation, and what would be the role of SROs?

There’s no one answer for every country and every situation. I think the biggest opportunity for SROs applies to SROs that have some jurisdiction over the corporate governance and business conduct of their members. Some SROs only have powers to make rules in the area of sales practices, or trading and markets. Often the government regulator is the authority when it comes to corporate governance and compliance infrastructure. These are the areas where the greatest needs for better regulation are, these are the areas that all of the international authorities are talking about.

When I talk about compliance infrastructure, I mean, first of all, corporate governance. It is the responsibility of the board and executive management to ensure that there’s accountability and a robust system for risk management, internal controls, supervision, and compliance. So, it starts with corporate governance. Then you have the supervision system, which is business supervision; compliance, which is regulatory supervision; risk management systems, which involves both a business process and a control function; and, on the financial side, you have financial internal controls relating to minimum capital requirements and financial compliance. Those were the areas where there have clearly been failures.

A regulatory body that wants to reduce the risk of such failures in the future needs to do a better job in regulating and supervising those areas of financial firms’ operations. The terrible thing is, as regulators, we all thought we were doing a good job, and we also thought that at least the big players, the big global banks, were doing a good job of internal supervision and risk management. And now we



find out that neither was doing a good job! The big banks, the big financial intermediaries clearly cannot be largely self-regulated within their own operations, even to the degree that they were, because they failed!

So, a regulator that has the power to regulate and supervise the areas I mentioned potentially has a lot of value to offer. My theory, from years of experience, is that in many countries an SRO actually can bring greater value, because no government body is ever going to have the detailed market and product specific expertise, capacity and experience to do that job by itself. Unless they have virtually unlimited resources – and how many regulators have unlimited resources? Certainly not even in the US, in fact the US has acknowledged that regulatory agencies require greater resources, even if the system continues to rely heavily on SROs. So there is an opportunity for SROs going forward. And people at organizations like ANDIMA have specialized expertise in the specific market segment that they both represent and supervise, or regulate. It's an opportunity to add value to the system.

Do you think that the role of SRO's should be limited to just setting best practices?

No. Best practices supplement rules, but are not a core set of standards. I have a long history of regulation, and I believe the core must be a set of minimum standards. Everybody has to meet the minimum standards. The best practices are what you layer on top of the minimum standards, because best practices are guidance, they are not mandatory. This raises the whole debate about principles-based regulation – I think you must have specific rules that are mandatory. And then, on top of that, you can have guidance, which can be about accommodating different kinds of businesses, structures, different sizes of firms, different types of clients. You don't have one-size-fits-all for everything, but the rules must set a minimum standard that everybody must meet.

Guidance notes, or guidelines, may address how different types of businesses can implement those minimum standards, and the best practices in the industry. Guidance is kind of an education tool. When you issue guidance on best practices, you're trying to lead the firms to adopt higher standards voluntarily. And it's value added too. Value is not primarily in enforcement; value is in improving standards and practices across the entire market. Enforcement is the last tool, because it is expensive and only addresses problems after harm has been done. So, a regulator can add a lot of value by providing effective supervision and guidance, without using the hammer of enforcement.



How should an SRO separate industry association tasks from the self-regulation tasks?

Stock Exchanges are an example of how member associations have evolved. Before stock exchanges demutualized, most Exchanges had member Committees that voted on issues and had the right to make certain decisions under the constitution of the Exchange. But in the demutualized model, since shareholders generally own the Exchanges, these Committees are just there to provide their expertise and their advice. They don't have any power to govern or to operate the institution. So, the issue is how to obtain the benefit of industry expertise and knowledge – and not lose that, because you have to give industry people a good reason for coming to the table – but, at the same time, to make sure that you have a form of corporate governance that is appropriate. For a Stock Exchange, that is a listed-company type model of governance now, because it's a shareholder organization.

For an SRO, corporate governance is an evolution. For an organization like FINRA -- Financial Industry Regulatory Authority – it took decades of evolution as a member organization before they got to the stage of being an independent member SRO, with half of the Board being independent directors. When the NASD started, it was similar to ANDIMA. It started as a member association that was involved in regulating the OTC market. And it was only after many years of evolution that FINRA got to the stage they're at today.

The corporate governance system that is appropriate depends on what the organization's functions are. I don't want to come and say that there's one model and everybody must apply this model -- that doesn't make sense. You need to ask, what is going to work in the market, what's practical? What is achievable? And then, based on that knowledge, start to put in place the governance processes that would bring integrity to the organization's functions and make them more open and transparent to more stakeholders.

Some of the markets are regulated by Finra and some are not regulated by anyone. In the near future, do you think there is going to be one centralized body or there's going to have many of them? Could Finra replace the Securities Exchange Commission?

Well, that's clearly not going to happen, because FINRA is a private body and the foundation of any regulatory system is government regulation. Some of the questions from the financial journal that I receive by e-mail reflect the idea that self-regulation could largely replace government regulation. Of course that doesn't make any sense. Obviously the foundation is always going to be strong government regulation. Self-regulation is supplementary; it can make a system



more effective by adding more resources, more capacity and more expertise, but it's not the foundation for market regulation.

What will happen in the US? Who knows – it's very political. They have many, many self-regulators. A lot of them are Exchanges. But where they really need to consolidate is at the government level. They have too many government supervisors. They're not sharing enough information.

Theoretically, it is more efficient to have one regulatory body. Canada is a smaller country when it comes to capital markets, so the industry and the banks wanted to have one Stock Exchange and one SRO, because it would be more efficient. Also it would be easier for the government regulators to supervise the overall system. In the context of the financial crisis, look at the UK, which has some of the worst banking problems anywhere, and some of the worst supervisory failures. The core of the subprime mortgage problem is an American issue, and yet the British banks seemed to have some of the largest exposures to those risks. What does that say? The UK has a universal regulator. The FSA covers all financial services. It didn't prove to be a better regulatory system.