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Risk Regulation of Inter-Bank Bond Market Innovation

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Abstract

By analyzing the status quo of financial risk regulation and the issue of financial regulatory risk caused by insufficient innovation of inter-bank bond market, we put forward the suggestions to risk regulation on unifying regulatory system, strengthening self-regulation, improving the regulatory system, developing innovative products and so on.

Key words: Inter-Bank bond market; Risk; Regulation

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INTRODUCTION

In recent years, China vigorously promotes the construction of multi-level capital market, with particular emphasis on the importance of the bond market. At present, China's bond issuance scale grows rapidly. The inter-bank bond market has already become the important financing and investment platform for government, financial institutions and enterprises. And it is also the significant operation platform for monetary policy. The inter-bank bond market plays a more and more important role in efficient allocation of financial resources, ensuring effective conduct of monetary policy and maintaining the healthy run of macroeconomic. But China's inter-bank bond market still exists lots of risks, however, it is rather difficult to regulate the risks on the aspects of various regulators and imperfect system of bond information disclosure and credit rating. The inspection of inter-bank bond market in April 2013 exposed several illegal incidents which gradually revealed the problems behind market innovation acceleration and scale expansion of inter-bank bond market, also it contributed to more and more urgent needs for risk regulation on inter-bank bond market.

1. THE STATUS QUO OF FINANCIAL RISK REGULATION

1.1 Lack of Unified and Effective Regulatory System

At present, China's bond market is not divided equally, based by the inter-bank bond market and supplemented by the exchange market. Meanwhile, it lacks integrated unified regulation and there are three regulators of bond issuance: The Commission is responsible for approving the listed corporate bonds mainly traded in Shanghai and Shenzhen Stock Exchange; Development and Reform Commission is responsible for approving the unlisted corporate bonds dominated by local government platform companies, and some cross-market transactions are made in Shanghai and Shenzhen Stock Exchange; Dealers Association managed by Central Bank is responsible for short-term financing bonds, medium-term notes and other financial instruments of non-financial corporate debt, which are mainly traded in inter-bank bond market and some cross-market transactions are made in Shanghai and Shenzhen Stock Exchange. In addition, the effective regulation is insufficient after the bond issuance. Analyzing the evolution of China's laws and regulations, it has not clearly defined on the aspects such as operation and repayment after the corporate bond issuance, whether the use of funds in accordance with the approved use and whether debt service according to the relevant regulations. So it desiderates to improve relevant laws and regulations.

1.2 Deficiencies in Regulatory Method and Device

At present, the regulation method of China's inter-bank market is quite simple, mainly relying on external regulation. But because of the market segmentation leading to regulatory fragmentation, the regulation lacks unified collaboration. The self-discipline organizations are rare. Self-restraint and self-management mechanisms are not perfect, so the self-regulation does not play a big role. There exists a serious institutional weakness that the offices of accountants, auditors and other social regulators only audit and examine the primary market before the bond issuance, however, there is no unified and effective regulation on secondary trade market. From the aspect of regulatory device, the regulation should be carried out according to the related legislations, but the fact is that the legislations themselves are not perfect, lacking implementing rules. The imperfect legislations always result in the problems during the specific regulatory operations such as no legislation to follow, lack of bonds, arbitrariness in operation, lack of effective regulatory devices and so on. Hence the effectiveness of financial regulation is greatly reduced.

1.3 Insufficient Self-Regulation

China's financial regulation mainly rely on external regulation of regulatory authorities, but the financial institutions themselves lack internal control, making it difficult to build a stable, sound and efficient financial self-loop system. In China's existing self-regulatory organizations (such as stock exchanges, securities registration and settlement companies, China and local securities association and so on) of securities industry, except stock exchanges has some regulation authority over listing corporate bonds, the others have little self-regulatory function. For inter-bank bond market, except the inter-bank market dealers association, China Government Securities Depository Trust and Clearing Co., Ltd., China Foreign Exchange Trading System and National Inter-bank Funding Center and Inter-bank Market Clearing House Co., Ltd. play the self–discipline function to some extent, but they are far from being able to achieve self-discipline regulation.

2. FINANCIAL REGULATORY RISK CAUSED BY INSUFFICIENT INNOVATION OF INTER-BANK BOND MARKET

The fundamental reason for inter-bank bond market exposed so may violations recently is that bond products lack innovation and overall demand exceeds supply. To view from the facts of China's financial industry, we need to continue to carry out financial innovation to prevent and eliminate the risk. The financial innovation in China is still far behind western developed countries either in the technical aspect or in the institutional aspect. It is also far from meeting the demand for preventing and resolving financial risk in China, so it needs further development and improvement.

The international experience indicates that well-developed bond market can effectively reduce the risk of a country's financial system. On one hand, the corporates' long-term financing through bond market can not only reduce the burden of financing through financial system, but also benefit matching the corporates' assets and liability structures, and reduce the sensitivity of the economic environment. On the other hand, the credit risk of bond financing is taken by bondholders so that the credit risk is dramatically dispersed. In addition, the development of bond market provides bank and other financial institutions with asset-liability management and interest rate risk tools, which can help to resolve the risks in economic systems.

However, China's inter-bank bond market did not play its due role in risk aversion. The main aspects go as follows:

(1) There exists the lack of hedging instruments, currently there are only outright repo, bond forward transactions and other products, lacking interest rate swaps, interest rate futures, forward rate agreements and other most common hedging instruments in international market. And the problem of severe illiquidity in the existing products unable to make it play its role effectively.

(2) Short-mechanism is imperfect, and the market can easily evolve into unilateral market, which leads to increased volatility in bond prices. As the market has become increasingly active, the influence of fluctuations in interest rates, market expectations and so on to China's inter-bank market price is more and more evident. At the same time, the pace of reform is further accelerated in marketization of interest rates, and the bond market is increasingly exposed to the gradually emerging risk of interest rate.

3. SUGGESTIONS TO RISK REGULATION OF INTER-BANK BOND MARKET

3.1 Unify the Regulatory System

Given the current stage of development, we should aim at strengthening the unity of the regulatory power and stepping up the enforcement when allocating the power of government regulatory institutions. Therefore, we can learn from the mature experience of debt market regulation of the U.S. to integrate the government regulatory authority into China's Securities Regulatory Commission. Its mature experience in stock market and organizations guarantees the management on corporate audits, market construction and regulation, investor protection and so on. Bring the existing corporate bonds, financial bonds, municipal bonds and other types of corporate bonds into the regulatory framework of China's Securities Regulatory

Commission. Change multiple regulators to one unified regulator, thereby we can improve the management efficiency. Under the premise of the Commission carrying on centralized regulation on bond market, it is still necessary to establish related coordination of market risk regulation in order to achieve information sharing which is good for resource integration.

3.2 Strengthen Self-Discipline

In the foreign bond market, regulation and self-discipline combined mode is adopted. Besides the unified regulation of Securities and Exchange Commission, the National Association of Securities Dealers, Municipal Securities Rulemaking Board, the Office of Federal Housing Enterprise Regulatory and so on are also important self-regulatory bodies. Self-discipline has always been an irreplaceable major component of market regulatory system. The experience of international mature markets indicates that any good regulatory system should be an effective combination of government regulation, self-discipline of participants in the market and intermediaries.

To compensate for the hierarchy of China's corporate bond market, we should offer some legal and institutional rights to vigorously establish the non-governmental regulatory bodies. At the meantime, in order to equip the regulation of bond market with the properties such as integrity, continuity and early warning, we should give full play to the monitoring effects of securities intermediaries (such as accounting firms, auditing firms, credit rating agencies, public opinion and so on). Also we should strengthen the responsibilities of securities intermediaries in participating the regulation on bond market, and let them fulfill their obligations of risk reveal on the micro-level. We need to coordinate the roles of different self-discipline organizations in the regulatory system. So according to the characteristics of different self-discipline organizations, we should form a regulatory complementary and coordinated mechanism as well as related guidelines of risk control.

3.3 Improve Legal System

The inter-bank bond market is an evolving market. The innovation of market players, market structure, trading mode and trading objects is very fast. We must build an effective and comprehensive legal system to accommodate and regulate the market change. Up to now, several most basic rules of inter-bank bond market have basically formed, they are "Measures for the Administration of Bond Transactions in the National Inter-Bank Bond Market", "Interbank Bond Transactions Rules", "Settlement Rules for Inter-bank Bond Transaction", "Bond Repurchase of Inter-bank Bond Market Master Agreement" and so on. But because of the expansion and acceleration of market development, the system construction is relatively backward, and its function of guidance and protection has been constrained. Therefore, sound institutional arrangements become the "booster" of inter-bank bond market development. To ensure reasonable liquidity of market members by establishing a complete set of access and exit mechanisms. This is a minimum standard developed for inter-bank bond market. Meanwhile, during the various segments of market issuance and trading, we need to enhance examining the requirements and compliance of mandatory information disclosure, and strive to improve its ability of risk self-control while stimulating the passion for innovation of the inter-bank market players.

3.4 Develop Innovative Products

Besides investment, financing, resource allocation, price discovery and etc., risk management is one of the important functions in financial market. There is no exception in inter-bank bond market. The financial institutions' need for risk management has become increasingly prominent with the interest rates marketized and flexibility of exchange rates enhanced. Compared with the problems of excessive speculation and lack of regulation in the Financial Derivatives Market of U.S., the bond market of China exists the problem of underdevelopment of financial derivatives (including credit derivatives deficiency), which to some extent restricts the play of market risk configuration function. The lack of risk management tools, which in turn will restrict the further development of bond market. Therefore, one of the paths to further innovation of inter-bank bond market is to accelerate the innovation in financial derivatives. Curb all kinds of private transactions by strengthening the regulation on financial innovation products, particularly derivatives regulation. Make regulatory system of financial derivatives, strengthen the regulatory device, and take the methods of control and inspection techniques to closely monitor the significant financial events and transactions. Meanwhile, releasing risk warning in time to prevent speculation of financial derivatives and market bubble.

CONCLUSION

Financial innovation is a "double-edged sword", which contains new financial risks in the meantime of bringing huge benefits. It will cause tremendous harm to the whole economy if not handled properly with the risk management. The outbreak of the U.S. Subprime Crisis in September 2008 was a tremendous disaster caused by misuse of financial innovation and lack of risk regulation, which also resulted in a severe impact on the world's economy. Now China is at the key moment of endeavoring in promoting financial innovation, as well as deepening and expanding capital market. The U.S. Subprime Crisis undoubtedly provides us a very rare opportunity to learn something from the case and introspect. Neither can we deny the boom brought to the capital market by financial innovation nor underestimate the harmful effects of propagating risk. We should revaluation the original financial development strategy and related policies to remodel the financial regulatory system, pay attention to prevention of financial risk and maintain financial security while accelerating financial innovation. The regulation of innovation risk of inter-bank bond market on one hand improved the financial mechanisms and ensured the healthy development of bond market, on the other hand effectively protected legitimate rights of investors and reduced the investors' risk.

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