



The Complex Path towards a Principles based Regulation

Guillermo Larrain

Superintendent

Superintendency of Securities and Insurance, Chile

Presentation prepared for the National Association of Insurers
Commissions (NAIC) International Insurance Forum

Washington DC, May 18, 2009



Why should regulation move towards principles?

The deregulation process at the turn of the millenium:

- The dismissal in 1999 of the Glass-Steagall Act has increased integration of commercial and investment banking. In Europe, the development of *bancassurance* has erased limits between banking and insurance.

New unregulated market segments, in particular, hedge funds

- The consolidation of several financial innovations from securitized products, option pricings, credit default swaps,...

How can regulators face these challenges:

- rules cannot follow the path of dynamism imposed by reality
- need to rely on other complementary private supervisory bodies



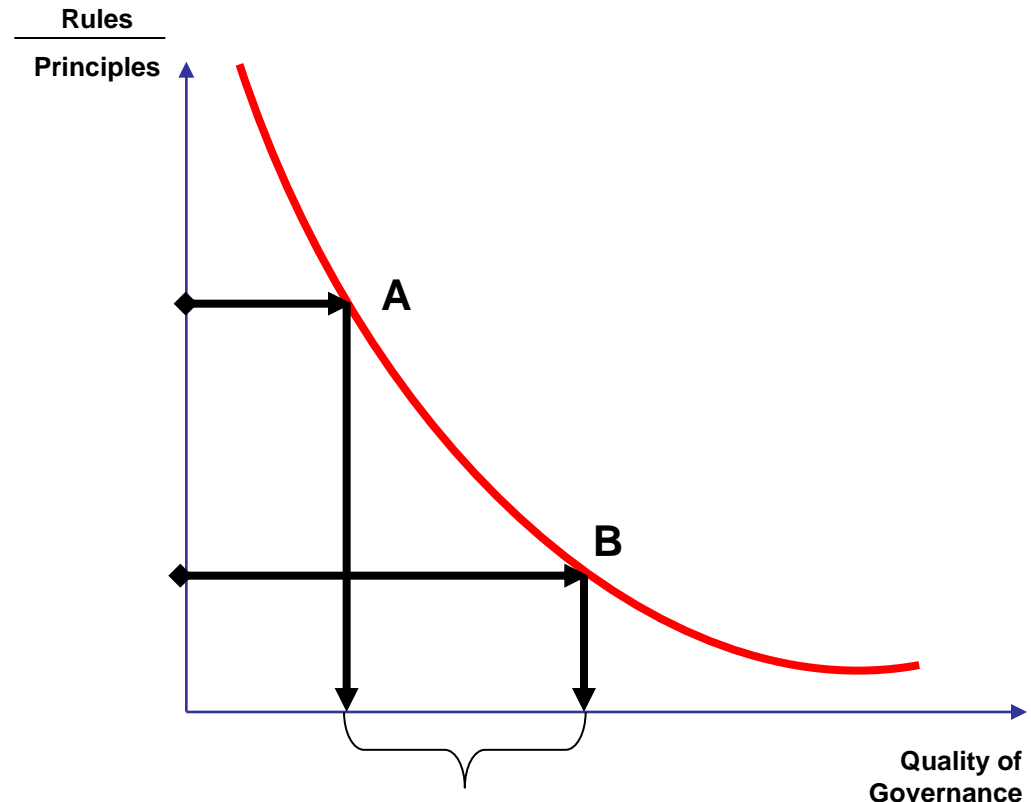
Financial Regulation and Governance

From a systemic/ regulatory perspective:

moving from a rule based towards a principle based supervisory system does not mean deregulation necessarily, but...

relying more on complementary private supervision:

- auditors
- rating agencies
- institutional investors
- corporations

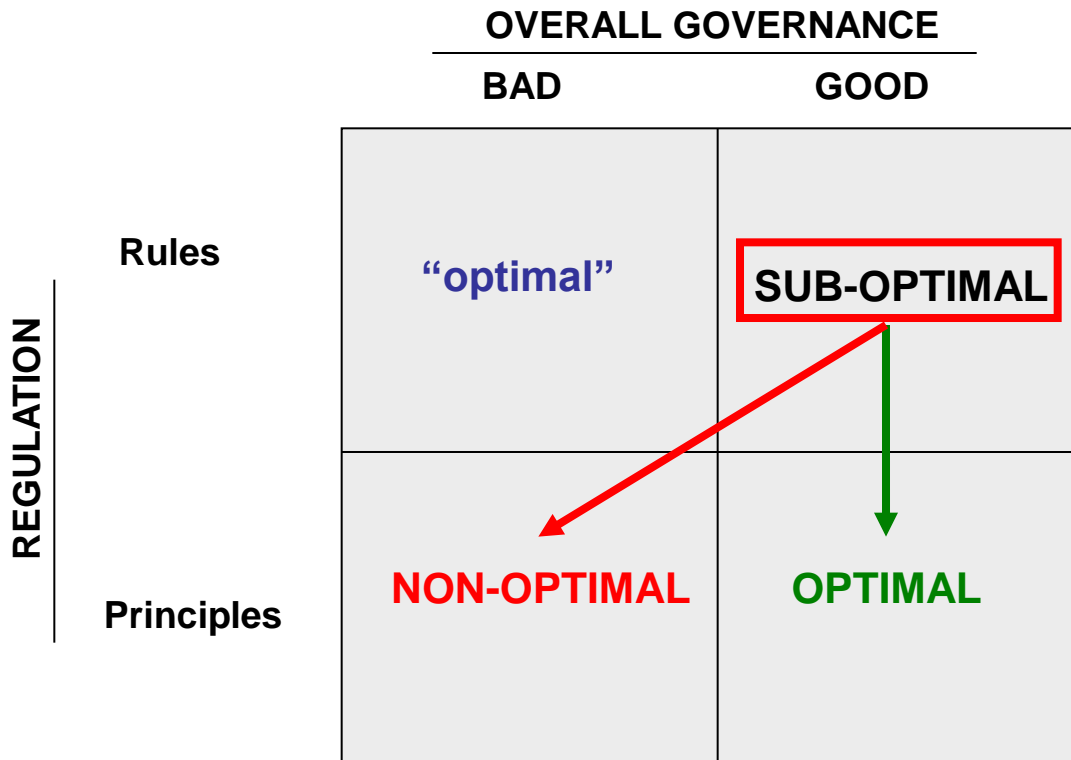


Auditors, rating agencies, inst investors, corporations...

The Supervisor



Poor governance and Principles is maybe not a good idea...





Why should we be cautious in moving towards Pples?

- Two problems of “nature”:
 - Nature of “homo oeconomicus”: the rationality argument faces limits and most of regulatory thinking is based on it. New findings on behavioural finance
 - Corporate governance: self control
 - Qualified investors: bounded rationality
 - Nature of the regulatory process: regulation is not the pure outcome of a well intentioned *fonctionnaire*. Need to consider the impact of politicians, industrial interests, other stakeholders, lobbyists:
 - Autonomy of supervisor or international bodies
 - Accountability
 - New focus: (industry based – solo – **twin peaks**) & (**national** or state)
- Several unresolved conflicts of interests diminishes governance effectiveness
 - Auditors: audit vis-à-vis taxation, legal advice and others
 - Rating Agencies: financial dependance on issuers money



The Complex Path towards a Principles based Regulation

Guillermo Larrain

Superintendent

Superintendency of Securities and Insurance

Presentation prepared for the National Association of Insurers
Commissions (NAIC) International Insurance Forum

Washington DC, May 18, 2009



Controlling rights and rationality

The regulator's challenge consists on identifying psychological biases induced by these heuristics.

PSYCHOLOGICAL HEURISTIC	EFFECT	REGULATORY DECISION
Overconfidence, optimism representativeness and anchoring	Myopic assessment of the likelihood of losing prestige or being caught incurring in bad governance practices. Underestimation of risk and risk measurement Bad corporate governance worked in the past, it might still work in the future.	Information disclosure. Rules are more effective than principles.
Excessive subservience	Bad corporate governance seconded by the CEO's own staff and perhaps also directors.	Enforcement.

