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How should we regulate our financial institutions to find a balance between stability and risk? SMU Assistant Professor Tharindra Ranasinghe investigates.

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AsianScientist (Feb. 5, 2015) - By Yamini Chinnuswamy - Love them or hate them, financial regulations have an important role to play in preserving the financial and economic stability of a country. Whether you are applying for a home loan or investing in the stock market, you will have to fall in line with some form of financial regulation.

But lured into complacency by bullish financial markets, countries including the US eased up on governmental oversight, leading to the worst recession since the 1930s Great Depression. From then on, regulators learnt from their folly of depending too much on the private sector to police itself, and worked on implementing measures to build resilience in the system. Assistant Professor Tharindra Ranasinghe, from the Singapore Management University (SMU) School of Accountancy, studies financial regulatory systems around the world. He notes that the value of financial regulation is a hotly debated topic not just in the big banks of Wall Street, but also in non-profit organisations.

“Events such as the recent financial crises and scandals have placed great attention upon the effectiveness of regulations of all kinds, particularly those dictating accounting standards, the workings of financial markets, and even policies such as executive pay in non-profit organisations,” he says.

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In 2004, the US state of California enacted the California Nonprofit Integrity Act to improve governance over the accounting practices of non-profit organisations conducting business in the state. In particular, it articulated that the compensation received by executives in non-profit organisations should be 'just and reasonable'.

"The regulations were intended to ensure that executives did not get overpaid, and to address concerns that management officers would not drain resources from donors by paying themselves excessively," says Professor Ranasinghe. "But in fact, executive salaries went up after the regulations were put in place. The additional regulatory burden on these non-profit organisations ended up translating to even higher compensation for the executives."

Non-profits also started to think that they might as well behave like large corporations, paying their management at similar rates if they were going to be held to the same accountability standards anyway.

"And the consequences of governing executive pay in non-profits had the opposite, albeit unintended, effect. This shows that regulations that may work in the corporate world are not necessarily applicable to the non-profit sector," he points out.

The upsides to financial regulation

However, regulatory mechanisms are not always detrimental, as Professor Ranasinghe found in a study on US unemployment insurance programmes. The study was a collaboration with his fellow colleagues, Professors Holly Yang and Jeffrey Ng.

"States in the US regulate the provision of monetary support to staff that are laid off from their jobs," he notes. "Such support gives unemployed individuals time to retrain or find new jobs."

As he highlights, there is much debate surrounding the usefulness of providing unemployment insurance benefits. Though they are obviously very helpful to individuals who are out of work, some feel that these programmes posed as a disincentive for laid-off workers to seek for new employment.

But Professor Ranasinghe discovered that these unemployment schemes had unexpected benefits to shareholders and regulators. The "cushioning" effect of these schemes encouraged employees to be more truthful in disclosing what they knew about the company's performance, leading to an improvement in the quality of the company's financial reports.

"Agency theory dictates that employees will try to hide poor company performance as it could result in them losing their jobs," he says. "But the existence of unemployment insurance support reassures employees and mitigates their unemployment concerns such that they become more forthcoming with information."

Professor Ranasinghe notes that when policy makers contemplated these unemployment schemes, increased transparency in financial reporting was probably not one of the benefits they expected or considered.

"But this observation certainly fuels the overall debate regarding the usefulness of unemployment insurance initiatives," he says.

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Expanding to China

Due to the ample quantity of data available in the US and the statistically-intensive nature of his work, Professor Ranasinghe's studies have so far concentrated on the US.

"But governments tend to behave rather similarly regardless of geographical location," he says, adding that his findings from the US are also applicable to Singapore, where it is more challenging to acquire sufficient data for rigorous statistical analysis.

A large amount of data is also coming out of China, which is of interest to him. As the country opened up its economy in the last few decades, financial regulations in China have become an issue of global implications.

"I'm currently exploring opportunities to apply my approaches to the data from China, taking note of the important institutional variations to see how best my methods can be adapted," he explains.

Shifting gear to big data

With the recent boom in social media, Professor Ranasinghe expects that data will not be lacking anytime soon.

"These days we tend to leave a digital trail for everything we do—what we like or dislike, our hobbies and political views," he muses. As a consequence, marketing methods become personalised, he says.

"It's already happening in the US with politics. From a given candidate, you could receive a leaflet about their plans for economic policy, maybe because they used data to determine you care more about the economy. But your neighbour receives a different one, about international security."

Indeed, financial regulatory bodies have taken action to tackle the myriad of issues brought about by the social media boom: the US Federal Financial Institutions Examination Council, a formal inter-agency body which comprises the country's major financial regulators, recently issued new compliance guidelines to help banks and other financial institutions manage their social media use.

But as Professor Ranasinghe points out, "The big data revolution is very new, so there is still a lot of work needed to regulate it, especially from a financial perspective—and of course, to see what the effects of such regulations are."

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