Regulatory Fragmentation to One World Alliance: Myth or Reality

Keynote address by Tajinder Singh, Deputy Secretary General of the International Organization of Securities Committees, at Asia Risk 2013

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Let me begin by thanking Asia Risk for this kind invitation.

Allow me to mention a few words about IOSCO. IOSCO is the standard setting body for securities regulation with about 200 members of whom more than 120 are regulators. But, as I will mention later, IOSCO is not just about setting standards; it is also about helping members, a majority of whom are emerging markets, in capacity building; it is also about monitoring implementation; and it is also about looking at emerging risks. IOSCO's objectives are investor protection, fair, efficient and transparent markets and reduction of systemic risk.

I would like to share with you today the following: the present economic context from IOSCO's point of view, especially for securities markets, and the opportunities and risks for securities markets going forward; what are the three most important conditions for market based financing; and what all this means for the topic of harmonization- or fragmentation- of global regulation.

Coming to the question of "*Regulatory fragmentation to one world alliance- myth or reality*?" my answer is that it is somewhere in between- and it is up to us, now, to decide what we want it to be. I will come back to this issue later.

Present environment

Credit institutions face higher capital requirements, constraining their ability to lend. The public sector is itself weighed down by high levels of debt. The world is therefore moving inevitably towards a more market-based financing model. Strong, transparent and appropriately regulated securities markets are therefore essential for the sound functioning of the global economy and in the efforts to drive its recovery. The markets IOSCO's members regulate are therefore becoming increasingly important for the real economy. Even this year's Nobel Prize for Economics has gone for research on the way markets work!

Let me mention six **notable trends relevant to securities markets**:

1. ***Bank lending to the real economy has been decreasing due to*** new regulatory initiatives requiring banks to hold more capital. The situation in Europe is especially stark, with lending at 50% below the 2009 levels.
2. ***Corporate reliance on securities markets has been increasing despite volatility:*** In the US, equity offerings as well as corporate debt have increased 20- 25% since 2007). Asian corporate debt issuance is on the ascent, specifically from China, as is the rise in Islamic bond (Sukuk) financing. However, European corporate debt issuances have not recovered since the large fall in 2008. ***There is also reliance on securities markets for bank funding, including the use of securitised products***.

3. ***Equity markets and fragmentation:*** Equity markets have experienced significant price appreciation over the last year. Fragmentation across trading venues and the participation of dark pools has increased in many jurisdictions.

4. ***High yield bond markets:*** The low interest rate environment has allowed firms to issue debt at historically low rates. The market for high yield bond issuances has increased fivefold from $90 billion in 2008 to $450 billion in 2012. Asian bond markets have been particularly active in 2013, mainly due to increasing appetite for foreign investors in advanced economies seeking to enhance their yield.

5. ***Changes in OTC derivatives markets:*** Since the crisis, global regulation has caused OTC derivatives markets to undergo important changes. The notional amount outstanding in OTC derivatives grew 8% between 2007 and 2012 to 633 trn USD and derivatives cleared have increased steeply to $173 trillion. In terms of reform progress, trade reporting is most advanced with close to 100% of gross notional outstanding amounts in both interest rate and credit derivatives being reported to TRs, even though regulatory requirements for trade reporting have not come into effect in all the G20 jurisdictions. The next developed area is central clearing, especially of interest rate and credit derivatives with around 53% of interest rate derivatives being centrally cleared of those offered for clearing, with the corresponding figure for credit derivatives being about 40%.

6. ***Capital flows in emerging markets:*** Capital flows into Emerging Markets have increased substantially since the financial crisis.

Increased role of securities markets

Coming back to the issue of growth in an environment with constrained credit ability, it is clear that securities markets will play an important role in financing the economy. The question then is what are the necessary conditions for this market based financing to work and for markets to perform their function in promoting growth and jobs? In my opinion, the single most important condition needed is that there should be Trust: i.e., trust in the system has to be rebuilt. The next question is: how do we go about rebuilding trust?

Restoring Trust: Making the system safer

One important pre-condition to rebuilding trust is that the systems and framework in which markets operate should be safe and should be seen to be safe. With the crisis having caused a loss of 15% to global Gross Domestic Product, there is an increasingly important human rights angle: the burden of both the crisis and the policy responses has fallen disproportionately on those least responsible for the crisis and least able to bear its impacts, especially the most vulnerable and marginalized groups. It is therefore necessary to make the system safe and reduce systemic risk.

The global regulatory reform effort has been so far led by the G20 with the Financial Stability Board (FSB) having the responsibility for enhanced global regulatory coordination. The key pillars of this work are:

- Building resilient financial institutions, with measures for institutions identified as Globally systemically important financial institutions or G-SIFIs
- Regulating shadow banking

- Ending "*Too Big to Fail*" through Resolvability of systemically important institutions. This is probably the most important piece of the puzzle, where a lot of progress has been made, but there is still a long way to go

- OTC Derivatives reforms- and there is a substantial part of the agenda devoted to that, so I will not go into too much detail.

- Timely and consistent implementation

IOSCO has been working in this area of making the financial **system** safer – also called macroprudential measures- through its work on: OTC derivatives and Financial Markets Infrastructure (FMI) where it has worked with other bodies like CPSS and BCBS on issues like Principles for Financial Market Infrastructures (PFMIs) and margin requirements for non-cleared derivatives among others, and is continuing to work on recovery and resolution of FMIs including Central counterparties (CCPs); shadow banking, having issued recommendations for the regulation of money market funds (MMFs) and securitization; dark pools and high frequency trading (HFT); financial benchmarks; non-bank SIFIs; and Credit Rating Agencies, to name a few.

Making the system safer: IOSCO's focus on emerging risks and Research

IOSCO is now more pro-active in identifying emerging risks. We have produced our **first Securities Markets Risk Outlook** which looks at risks from the point of view of securities markets. It identifies four main risks:

Risks associated with the low interest rate environment and search for yield including a return of structural leverage investments.

Risks associated with collateral management in a stressed funding environment because bank capital requirements and margin requirements for OTC trades can result in increased demand for high quality collateral. Collateral transformation as well as repo and re-hypothecation, which are transactions are executed in the securities markets, can result in risks.

Risks in the OTC derivatives space: A major element of the reform package involves the mandatory clearing of derivative contracts through CCPs. Shifting risk from bilateral OTC contracts to a single point of infrastructure can be a challenging balancing act. There are three important issues:

- *The effect of competition among CCPs on collateral.*
- *Shared risk management model across CCPs.*
- *Interconnection with the banking system.*

Risks associated with reversal of capital flows to Emerging Markets: In the post-crisis period where portfolio equity investment, debt securities and non-bank lending make up a greater fraction of total capital flows, sectors where inflows are concentrated may experience a sudden drop in valuation if capital flows were to reverse even if the country's economic fundamentals did not deteriorate.

We have also produced a staff working paper on the risks of **cybercrime** on trading venues and are working on the areas of **crowd funding** and **bond market liquidity**. One crucial issue that we face globally across sectors is **data gaps** as it is still difficult to get the information on many entities, products and markets. This is an area that can greatly benefit from a collaborative effort between industry and the regulators and IOSCO is keen to help with this important aspect.

Restoring Trust: In addition to rebuilding trust in the safety and soundness of the financial system from a macroprudential point of view, there is another key aspect: which is to regain the **trust of the investors**. It is important that the investor can feel confident and that he or she will not be cheated. This calls for increased efforts at investor protection, and that is also core IOSCO work. We have worked on investor education; on disclosure at the Point of Sale; and on investor suitability for complex financial products. We also have an investor alerts system that puts out these alerts very frequently on the basis of information received from various jurisdictions. Keeping pace with the current trend, we are working on the impact of social media and automated advice. Investor education and financial literacy is an important part of IOSCO's work. IOSCO has meanwhile strengthened its efforts in this area by setting up a new Committee on Retail Investors, headed by Howard Wetston from the Ontario Securities Commission and Leonardo Gomes from the CVM Brazil. While we continue to believe strongly in disclosure, we are also looking at areas where disclosure itself might not be enough. We are looking at aspects of behavioral economics for instance, on which we had a very interesting Board Roundtable in our June Board meeting.

While talking about behavior, another important aspect is the crucial need to change behavior, ethics and incentives in firms: the importance of corporate governance reform in firms, deterrent sanctions regimes and remuneration discipline. Enforcement and sanctions are important aspect of IOSCO's work. In this context, the IOSCO MMOU is an important tool and is the pre-eminent global standard for cooperation relating to enforcement matters and is a great example of how close you can get to a "*one-world alliance*". We have close to 100 MMoU signatories now over 2000 instances of exchange of information last year. It is a really significant cross-border instrument with tough entry conditions as even banking secrecy laws are not allowed to be an obstacle. In an increasingly globalized market, the MMoU makes it difficult for perpetrators of securities market violation to escape. I can mention here that the MMOU was also put to good use in the LIBOR scandal investigations.

What I have said so far is that to enable market based financing of the economy to happen, it is important to restore trust in the financial system through measures concerned with systemic safety; and those concerned with investor protection and behaviour of firms: in other words, both macroprudential and microprudential measures. But there is another important aspect: **we have to allow markets to function**! Market participants have to know the rules of the game, what is acceptable behavior and what is not, and no doubt have to be regulated so that they act within the norms of good behavior. However, markets will need to function and risks will need to be taken: the need is for risk **optimization** and not risk minimization. In the context of the on-going regulatory thinking, it is also important to realize that everything in the financial sector does not need to be viewed and regulated as a bank. What is true of a bank in terms of its special susceptibility and systemic importance is not necessarily the same for other areas, e.g., traditional insurance or many traditional securities markets activities. This is not to say that we should not be conscious of the risks in these areas. Indeed we are acutely conscious and are examining these issues carefully. But the important thing is not to paint everything with the same brush- the "*bank brush*".

An area that is increasingly becoming crucial is that of **cross border and extraterritoriality issues**. These issues are clearly not easy. Markets are clearly more and more global; on the other hand, sovereignty, legislative mandates and mandates of regulators are national. At the same time, we should be careful that we are not substituting what critics called a "*Regulatory race to the bottom*" by another kind of race on who comes out with its regulations faster! The global effort has been to try to deal with this through the processes of mutual recognition and substituted compliance and there have been some encouraging steps in that direction. In fact, IOSCO's APRC regional committee chaired by Ashley Alder- whom you all know- has taken the initiative to raise the issue of recognition of Asia Pacific CCPs with the European Commission and efforts have been made by the European Commission and the European Securities and Markets Authority (ESMA) to reach out to Asia over the summer and to engage with countries to understand their approaches to regulating infrastructure. One of the important issues identified by the APRC is that international standards should be a core component of any assessment of a jurisdiction by another. Sufficiently granular international standards, such as the CPSS-IOSCO PMFIs, should be used as the benchmark or proxy for equivalence assessments say for CCPs. IOSCO has also taken the initiative to set up a Cross Border Task Force chaired by Ashley Alder from the Hong Kong SFC and Anne Lachat from the Swiss FINMA that will analyse these issues and come out with a toolbox of measures.

And this is the situation as it exists today. It can be argued that we have a relatively "*simple*" world today, since there are only a few big markets. So, if we were to construct a matrix of big markets and big issues, we would have, let's say, a five by five matrix. However, we are also seeing that emerging markets are growing in market development, size and confidence. Brazil, India, China, Indonesia, Singapore, Hong Kong, Russia, Turkey and Mexico to name a few will have much bigger markets than today. Indeed, securities markets are already important in these countries and provide 60% of total financing for the BRICS, similar to the U.S. IOSCO has a major role to provide technical assistance to help its Members develop their securities markets on the basis of sound IOSCO standards and principles and is stepping up its Capacity Building Efforts and has very recently set up a Capacity Building Resources Committee.

With the passage of time, therefore, it is but logical that the number of important capital markets will grow. But if we add in another 10 big capital markets, or more, in the near future and with an expanding range of issues, the matrix of big markets and interpretations would become 15 by 15, or more. This looks too complex to be solved through the current informal method of a series of bilateral understandings. This will also certainly bring much higher frictional costs for businesses which would need to face multiple sets of regulatory rules. What we therefore need is a global institutional framework, probably established by International Treaty that, in order to ensure implementation, has some enforcement authority, binding disputes settlement and sanctioning possibilities. This is something that will of course take a long time, but it is important for the thinking to start on this now.

So does it mean that till we can have further progress on this admittedly ambitious institution building, there is no hope? No. In fact this issue brings us to the importance of international standard setting being done by standard setters like IOSCO in a globalized market environment. Bodies like IOSCO, BCBS and IAIS, among others, go through a difficult but ultimately rewarding process when they set standards through a process of consultation of members and also of the industry. Governance processes of these bodies- which emphasize due process and consultation with stakeholders- encourage implementation in the absence of a global enforcement mechanism because our members realize the importance of such implementation. Internationally, peer reviews and Financial Sector Assessment Programs are being conducted to monitor consistent implementation. IOSCO has set up an Assessment Committee for monitoring implementation as part of the global effort and which undertakes thematic and country peer reviews.

It is of course paramount for international standard setting work to identify issues quickly and pro-actively and for our members to counsel patience inside their jurisdictions to national law and rule making authorities in the interest of the greatest global good. We have recently seen some good examples of this process, in terms of the global standards being set by IOSCO for the Financial Benchmarks, and the global standards on margin requirements for non-cleared derivatives by IOSCO and BCBS, to name a couple of recent examples. It is important for the international standard setting processes to be supported because, in the near term, that is the best solution to disjointed national rule making that can result in frictional losses and regulatory arbitrage- which itself can create systemic risk. The only workable and effective way today to regulate these markets is for regulators to work together and establish a harmonized framework that avoids overreach, duplication, inconsistency, and conflict. Standard Setting Bodies like IOSCO are best placed to do this as they provide the forum for active engagement with fellow regulators.

To sum up: Market based financing of the economy is going to be increasingly important going forward. For this to happen, however, we will need to look at three important issues: making the system safe; regaining trust of investors through investor protection, proper corporate governance and enforcement; and at the same time allowing markets to function in a globalized environment for the greater good of the citizens. Given the globalized markets today- fragmented regulation is suboptimal and ultimately even speedy rule making by different jurisdictions can ultimately face obstacles in implementation in the absence of harmonization and result in a time consuming series of bilateral negotiations, thereby defeating the purpose. We therefore need to start thinking of global institutions, possibly treaty based. However, till the time that can happen, the role of international standard setting bodies like IOSCO will be crucial, so that globally harmonized rules can be adopted by jurisdictions, minimizing frictional losses, regulatory arbitrage and mitigate systemic risk.

Thank you for your attention.