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Regulation in Derivatives Markets

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Good morning. I am delighted to be back in Bahrain after my visit to your fascinating country for the 2008 GCC Regulators Summit.

Bahrain and New Zealand are both small island nations. One obvious difference between us, though, is that ours is a “young” country – in terms of human occupation and culture.

By contrast, the history of the Islamic world and its major contributions to culture and civilisation go back many centuries. Bahrain was an important trading hub as long as 5,000 years ago. Today, it has the fastest growing economy in the Arab world, and one of the most diversified economies in the Persian Gulf.

I would like to congratulate the Islamic Financial Services Board (IFSB) and especially Professor Karim, for its foresight in calling us all together in the interests of remaining alert and responsive to the challenges ahead. I feel privileged to be asked to speak to you today about the global financial architecture.

This cannot be discussed in abstract, though, without looking first at the global financial crisis and the lessons learned from it.

Lessons from the global financial crisis

The likely causes of the global financial crisis have been hotly debated for two years now, and will probably continue to be for some time. It is equally probable that we may never all agree on what these causes were.

One outcome of the crisis, though, is indisputably clear: it has made us all – whether we like it or not – global citizens.

As I said yesterday to some of my compatriots here in Bahrain, before the crisis, few investors in Europe or the UK could have imagined that the mis-selling of a mortgage product to an unemployed person in the suburbs of Chicago would impact on their own economic future and the futures of those around them.

We now know to our cost that the implications of what happens in one part of the world may be immediately felt in another.

Bahrain and New Zealand may be island nations, but these days they are so only in the strictly geographical sense. The crisis demonstrated in the starkest possible way that no country's financial markets stand alone.

As I also mentioned yesterday, the crisis showed us that good governance is necessary for a stable securities market. The underlying behaviours that led to the crisis arose in market conduct and infrastructure, and the risks were transmitted through the markets. Markets matter and governance in those markets matter.

At the March launch, here in Bahrain, of a new corporate governance code, Central Bank Governor Rasheed Al Maraj observed that the crisis had provided many illustrations of the failures of corporate governance – a proposition with which I whole-heartedly agree.

At the same occasion, Industry and Commerce Minister Dr Hassan Fakhro warned that good corporate governance could not be achieved merely by establishing a set of rules and guidelines: "it needs to come from within each company director." I agree with him, too.

The centrality of Islamic markets

Where do Islamic markets sit in the new global picture?

I am certainly not an expert on Islamic markets, but evidence from many sources points to the fact that they sit squarely within the frame, both in terms of the crisis and its effects, and in terms of joining the global effort to ensure it never happens again.

As long ago as 2004, an International Organization of Securities Commissions (IOSCO) taskforce report recognised that Islamic markets were already an important feature of the international financial landscape. It suggested that Islamic capital market products and services could be introduced and developed within any existing well-structured securities market.

We have all witnessed the strength and growth of Islamic products and markets since then. Major regulators of Islamic markets, including those from this region, are active and strongly contributing members at the standards-setting level of the International Organization of

Securities Commission (IOSCO) – London, Kuala Lumpur, Hong Kong and Dubai, for example.

Islamic capital markets did not prove immune to the major global liquidity crunch. However, as we have heard from other speakers, it is becoming clear that they fared comparatively well. Professor Rodney Wilson[1] recently pointed out that Islamic banks, in particular, were less exposed to the crisis than their *conventional* peers, because they did not hold the kinds of securities that proved toxic.

General Manager of the Bank for International Settlements, Malcolm Knight, touched on this point at the 2nd Islamic Financial Services Board Forum in 2007[2].

He said that, although there were differences between Islamic and *conventional* banking, some fundamental principles applied to both: strong corporate governance, rigorous risk management and sound capital adequacy. All these were necessary to ensuring the safety and soundness of any financial system.

The increasing integration of Islamic financial services into the global financial fabric, he said, only strengthened this point.

The 2004 IOSCO report I mentioned before, noted that, while Muslims undertaking financial transactions were encouraged by various parties to use shariah-compliant financial instruments, other investors were also likely to find these instruments appealing from an ethical standpoint.

Six years on, this factor has become more important as the demand for ethical investing grows.

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[1] Complinet, 14 April 2010 www.complinet.com
[2] Frankfurt, December 2007

The global financial crisis highlighted the fundamental importance of ethical behaviour and its centrality to all liquid markets. Islamic capital markets are bound by ethical concerns. Investors around the world are now looking for ethical and sustainable investments, and Islamic markets can provide them.

Commentators[3] have recently said that the crisis has shone a harsh light on certain activities undertaken as a matter of course in mainstream finance – activities shunned by Islamic financial practices. This makes more transparent, ethical and stable Islamic markets attractive to investors and consumers.

Islamic finance is certainly a force to be reckoned with, and is developing into a genuine alternative to *conventional* finance for investors of all faiths looking for ethical investments.

Islamic markets have been and will continue to be a key player on the international financial stage. Like other markets, they have weathered the crisis and its fallout, and, like other markets, they have a strong contribution to the global push to ensure such a crisis never happens again.

Importance of a global approach to regulation

Because the crisis has changed forever our understanding of risk, it must change our understanding of regulation.

Individual risk has always been inherent in business and investment, and always will be. Regulation cannot – and should not try to – prevent it.

Individual risk arises from the nature of a specific investment. Given all the appropriate information, investors must determine whether or not they are comfortable with an investment's particular level of risk.

[3] In Complinet, complinet's i-briefing: Islamic finance, 20 April 2010

Systemic risk is another matter altogether. With the best will in the world, individual investors are unlikely to be able to avoid it. Mitigating systemic risk is the job of regulators and governments.

We have recognised for some time now that effective regulation of systemically important institutions is important in producing the right capital structures and drivers of behaviour.

Equally important, but until recently less well recognised, is the complementary need for effective regulation of markets. Even the most perfect prudentially regulated institution will founder if the markets in which it operates are excessively volatile and unruly.

Regulation of markets and regulation of systemically important institutions are the virtuous twins of financial stability. Both must be in place if we are to avoid another crisis.

From a regulatory point of view, merely minding the shop at home is no longer enough. The financial crisis has convinced most of us of the need for greater international cooperation between regulators, particularly in relation to enforcement and supervision.

Only a global approach to the aftermath of the crisis and its ongoing challenges will help prevent such a catastrophe occurring again.

About IOSCO

This is where IOSCO comes in. The organization stands at the intersection of the ideas I have outlined:

1. that market stability is crucial to economic health;

2. that good market conduct is crucial to market stability; and
3. that markets are global.

Not surprisingly, then, IOSCO has emerged as a major player in the global financial architecture. It is the unchallenged international standards setter of securities markets regulation.

IOSCO is also one of the few international organisations with a truly global reach. Its members from 115 jurisdictions span all continents and regulate more than 95 per cent of the world's securities markets.

This includes both Islamic and *conventional* markets.

The organization's fundamental purpose is to enable member agencies to:

- cooperate in promoting high standards of regulation in order to maintain just, efficient and sound markets;
- exchange information on their respective experiences in order to promote the development of domestic markets;
- unite their efforts to establish standards and an effective surveillance of international securities transactions;
- provide mutual assistance to promote the integrity of the markets by a rigorous application of standards and effective enforcement against offences.

Decisions are made by consensus, with each member jurisdiction retaining its sovereign prerogative, responsibility and capacity to set and regulate its markets as it sees fit.

A decade ago, IOSCO was a network of regulators setting aspirational standards that jurisdictions looked to import into their own domestic regulatory frameworks. However, the requirements of regulating securities markets in the 21st century gradually led to it becoming more operational.

In 2005, IOSCO endorsed a strategic direction with a set of operational priorities. These aimed to have the international standards members were endorsing effectively implemented in member jurisdictions. Beyond the development and endorsement of international standards, IOSCO started to take a stronger interest in the capacity and capability of jurisdictions to implement these.

The global financial crisis further highlighted the importance of global cooperation in regulatory and implementation efforts.

Strengthened by our achievements and lessons learned from the financial crisis, we are reviewing our strategic direction. At our annual conference in June, we will be endorsing a new strategic direction and operational priorities.

We have been delighted by the input from regulators around the world, including those from Islamic capital markets.

IOSCO's strengths lies in its capacity to devise global solutions to regulatory challenges. It uses strategic tools to see these implemented through its wide membership network. Our new strategic direction will reflect that.

The 20^{th} century was the century of structural solutions. By the end of it, some of these structures were looking out-dated. The 21^{st} century promises to be one of networked solutions.

The internet and its opportunities for global integration are an apt metaphor for the way 20^{th} century regulatory solutions are likely to be progressed. IOSCO's strength lies in its understanding and practice of such solutions. It is a network of equals.

IOSCO Principles and Multilateral Memorandum of Understanding

A key milestone was achieved when IOSCO's membership endorsed a set of objectives and high-level principles of securities regulation in 1998.

IOSCO committed itself to three objectives of securities regulation:

1. protecting investors;
2. ensuring markets are fair, efficient and transparent; and
3. reducing systemic risk.

Since then, through the adoption of a new strategic direction in 2005, there has been a strong expectation that all members will embrace and implement the *IOSCO Objectives and Principles of Securities Regulation* principles in their respective jurisdictions.

The principles were not an attempt to create a single international body of rules and regulations. Their formulation is deliberately high-level so they can be applied in all domestic jurisdictional structures and regulatory environments, and in markets covering both Islamic and conventional products.

The principles soon became the recognised global benchmark against which the IMF and World Bank assessed jurisdictions' securities regulatory frameworks. More recently, G20 leaders committed themselves to peer reviews of the IOSCO principles' implementation.

A September 2008 analysis of the application of IOSCO principles to Islamic securities products saw complete compatibility between the principles and the Islamic securities market.

This set of core principles has been periodically updated, and a review is underway to ensure the principles incorporate the findings of recent IOSCO reports and lessons from the global financial crisis. The review will ensure the principles cover the full range of regulated products in world markets. We are also looking at the boundary of regulation.

Implementation of the principles will remain fundamentally important to IOSCO for the foreseeable future. Its strategic direction review is proposing related operational measures.

In 2002, members endorsed a *Multilateral Memorandum of Understanding on Consultation and Cooperation, and Exchange of Information* – the IOSCO MMoU.[4]

This was designed to facilitate cross-border enforcement and the exchange of information between national securities regulators.

The MMoU marked a transformation of IOSCO's standard-setting role from the aspirational to the operational. In 2005, its membership endorsed the strategic aim of having all member regulators either become MMoU[5] signatories or have committed to meeting its requirements by 1 January 2010.

It seemed almost impossible. Yet by the deadline, all but five of our 121 member regulators – 96 per cent – had applied to sign up to the IOSCO MMoU. This is a huge achievement in global cooperation.

In February 2008, the Central Bank of Bahrain was the first national capital-market regulator in the GCC to become an MMoU signatory. I had the pleasure of being here in Bahrain to congratulate the governor at that time.

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[4] IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, May 2002.
http://www.iosco.org/library/index.cfm?section=pubdocs&year=2002&publicDocID=126
IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, May 2002.
http://www.iosco.org/library/index.cfm?section=pubdocs&year=2002&publicDocID=126

When we consider applications to become MMoU signatories, we not only look at the jurisdiction's legal ability to comply with its requirements, but also whether they are fully capable of undertaking the cooperation and enforcement action it envisages.

The IOSCO MMoU ushered in a new era. It has reshaped cross-border securities-market enforcement, and made it easier to track transgressors across markets and political borders. It is a cornerstone of the new post-crisis financial world order.

Addressing systemic risk

A critical element in IOSCO's work is ensuring that as far as possible the drivers of behaviour of those who control and influence markets and market participants are aligned with the interests of investors and other stakeholders.

Much of IOSCO' recent work has been driven by concerns related to market stability and systemic risk: firstly, by analysing the underlying causes of the crisis as relating to the securities sector; secondly, by addressing aspects of market conduct important in the crisis; thirdly, by development of a new IOSCO principle on systemic risk.

As I mentioned, IOSCO is also developing its own strategic direction for 2010 onwards. This will emphasise the need for greater vigilance on systemic risks. It will monitor the unregulated boundaries of markets, as crisis has shown that destabilising products and market practices may appear in otherwise well-regulated jurisdictions,.

Recent IOSCO reports address various aspects of market behaviour, including conflicts of interest, due diligence practices, ownership structures and other drivers of behaviour.

They examine approaches regulators might take, and encourage greater transparency in markets. They have required an examination of the current boundaries of regulated activity and extended the reach of regulation, in some cases beyond its traditional scope.

Transparency is necessary in these areas too since they interface with parties working within regulated markets.

The global financial crisis highlighted a range of financial reporting issues. Some commentators have even suggested that fair-value accounting either contributed to or exacerbated the causes of the crisis, [6] although the Financial Crisis Advisory Group (FCAG), on which I have the honour to serve, has since discounted this view.

The crisis increased the urgency of calls for the creation of globally convergent accounting standards to better serve investors in the world's capital markets.

IOSCO takes a keen interest in the machinery and outcomes of global standard setting for accounting. It is closely involved in initiatives to improve transparency through better quality disclosures, and in enhancements of international accounting standard-setting governance.

The future global regulatory framework

Now the dust from the global financial crisis is settling, we can hazard some predictions about the future of international regulation. The post-crisis global financial architecture may still be under construction, but promising characteristics are already emerging.

We can look forward to increasing cooperation between regulators in all jurisdictions, between prudential regulators and market conduct regulators, between regulators, policy-makers and stakeholders, such as industry, between consumer and investment groups, and between "conventional" and Islamic market players.

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[6] Joyce Joseph-Bell, Ron Joas, and Neri Bukspan : "Banks: The fight over fair value", Businessweek, 15 October, 2008.
http://www.businessweek.com/investor/content/oct2008/pi20081014_361664.htm

Standards are likely to be more convergent, with greater enforcement and supervisory cooperation across jurisdictions leaving transgressors fewer places to hide.

Global regulatory principles will continue to be implemented nationally, and that implementation assessed by independent international experts.

We are likely to see the expansion of multilateral cooperation instruments, such as the IOSCO MMoU, for exchanging information and facilitating regulatory supervision and enforcement of cross-border activities, coupled with mutual recognition of domestic regulatory frameworks, much like the New Zealand-Australia mutual recognition of securities offerings scheme operational since 2008.

Conclusion

The balance between market discipline and regulation must be carefully recalibrated. Here I suggest a warning. We must avoid heading down a path that would lead to over-regulation. Investor confidence has to be enhanced without dynamic, innovative markets being stifled.

In this delicate exercise, IOSCO's transformation from an aspirational to an operational standard setter is crucial. Much of its recent work has focused on ensuring that the standards it sets are workable by all participants in global capital markets, leaving no excuse for not implementing them.

IOSCO is playing a lead role in facilitating a cooperative solution to the challenges faced by securities regulators amid today's capital market instability. By working together we aim to foster fair, transparent international markets that investors can have confidence in.

It is critical to the development of all capital markets and economic growth – Islamic and "conventional" – that markets are facilitated.

What we all seek is improved liquidity and well functioning markets, and investor confidence is the key to this.

The more internationally consistent regulatory frameworks are, the more investor confidence in cross-border activity will grow, and the more capital markets – both Islamic and "conventional" – and the businesses that raise money through them, will flourish.