

“What Banking Supervisors need to know about the  
Securities Industry and Securities Regulation”

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## **IOSCO Strategies & Regulatory Issues for International Banks**

**Jane Diplock AO**  
**Chairman, Executive Committee of IOSCO**  
**Chairman, Securities Commission of New Zealand**

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It is always a pleasure to be on the same platform as Andrew Sheng, my fellow IOSCO chairman.

In hosting this conference, the Securities and Futures Commission and the Financial Stability Institute are drawing attention to a very important issue for securities regulators and banking supervisors - the contribution that global capital markets regulation must make towards the stability of international banks and of financial systems. It is, surely, an issue of heightened importance as banks and financial systems respond to the twin advances of technology and market globalisation.

The words of Alan Greenspan, the Chairman of the Board of Governors of the US Federal Reserve System, are true indeed. He recently commented: *“Persistent advances in information and computing technologies have meant the structure of our financial institutions is continuously changing, I trust for the better. But that evolution in financial structure has also meant that supervision and regulation must be continually changing in order to respond adequately to these developments”*.

This morning, I want to talk about IOSCO and how its regulatory strategies are changing in response to global capital market developments, and I want to reflect on the importance to banks of ensuring that regulation is effective.

### **IOSCO Strategies**

A month ago, IOSCO held its 30<sup>th</sup> Annual Conference. This event, held in the Sri Lankan capital of Colombo, was a major milestone in the organisation’s development. Decisions taken have confirmed and extended the role of IOSCO as the world’s leading body for securities market regulation. We now have a clear strategic direction for raising regulatory standards applying across virtually all the global capital markets and, perhaps more importantly, for building a strong network for cross-border cooperation between national regulators on matters of enforcement.

For those not very familiar with IOSCO - the International Organisation of Securities Commissions - I should provide some background. The organisation’s members are securities regulators and other relevant national bodies from more than 100 countries.

In fact, IOSCO coverage is more than 90% of the world's securities markets, and membership is growing. In Sri Lanka, we admitted securities regulators from Armenia, Gibraltar and Montenegro as new members.

We have a permanent secretariat based in Madrid and three principal working bodies: the 19-member Executive Committee; a Technical Committee which leads on most standard setting activity; and an Emerging Markets Committee with a broad mandate to promote efficiency in emerging securities and futures markets. In addition, IOSCO places much importance on its work in the Joint Forum, alongside the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors. This Forum of top-level regulators focuses on cross-sectoral issues including, for example, credit risk transfer and financial disclosure standards.

IOSCO clearly has a busy programme reflecting, of course, its global coverage along with the growth and complexity of capital market activity. It is important to recognise three fundamental, and unchanging, objectives of the organisation that define its unique role in the international financial community. IOSCO promotes regulation that: first, protects investors against the misuse of assets, insider trading and other forms of fraud; second, ensures fairness, efficiency and transparency in securities markets; and third, reduces systemic risk. These are the fundamental starting points for any IOSCO contribution to regulatory frameworks.

The objectives are specifically embodied in core Principles of Securities Regulation which the organisation adopted in 1998. Since then, there has been a strong expectation on all members that they embrace and implement the Principles in their respective jurisdictions. The 30 Principle statements, along with related standards and benchmarks established for regulation on specific issues, will remain fundamentally important to IOSCO for the foreseeable future. Indeed, our Annual Conference last month was a success in large part because of the continued support demonstrated by members for the Principles and for implementation across their full spectrum. We adopted operational measures to hasten implementation in jurisdictions that have until now lacked the resources or the will to make significant progress. Getting further traction with the Principles is, therefore, a critical component of IOSCO's strategy. Also critical is enhancing greater cross-border cooperation.

### **Cross-border Cooperation**

In May 2002, the IOSCO adopted a Multilateral Memorandum Concerning Consultation and Cooperation and the Exchange of Information. In IOSCO, we generally refer to this as the MOU. Its specific objective is to establish a strong international network for the exchange of information and for cooperation on regulatory enforcement. With the internationalisation of economic activity and the growth of cross-border capital flows, the MOU will become the single most important tool available to national securities regulators, if it is not so already!

As you would expect, the MOU directly reflects some of the key IOSCO Principles. We certainly see growth in the number of MOU signatories as integral to progress with implementation of the Principles. To date, 27 members have signed the memorandum. This is reasonable progress but really not fast enough, given the pace of growth in global markets and the obvious benefits of regulatory cooperation. Our

Annual Conference last month confirmed this view and took decisions to elevate the strategic importance of the MOU.

We now have a timetable for all IOSCO members to sign, or at least to have committed themselves to securing within their national jurisdictions the legal authority that they will require in order to become signatories. The Conference adopted a deadline of 1 January 2010 for members to sign the MOU under either its appendix A or appendix B. The latter will allow more time for individual regulators to meet the criteria for full signatory status. The deadline signals the importance now attached to timely and efficient cross-border cooperation in response to financial fraud and other regulatory breaches. Achieving this across as many borders as possible is another critical component of IOSCO strategy.

The organisation recognises that progress will require the commitment of time and resources that some members do not have. Again, the success of our conference can be measured by its agreement to make more resources available to them through IOSCO and to accordingly increase the annual contribution of members in general. The Conference was itself, in fact, a fine example of cooperation among regulators!

### **Financial Scandals**

The impetus for agreement, and the clear strategic direction now established for IOSCO, reflects the store of credibility built up by the organisation through its work over the past decade or more. It reflects also the severe impact on investor confidence of numerous financial scandals in more recent years. Enron in the United States and Parmalat in Italy are just two of the more high-profile cases since 2001 to have revealed serious corporate wrong doing and financial impropriety. They have raised fundamental questions about the real effectiveness of regulatory mechanisms in the world's most advanced capital markets. We have seen regulators and law makers respond in different ways in different jurisdictions.

Over the same timeframe, IOSCO's role has grown as an important forum for sharing perspectives on the nature and scale of apparent problems in regulatory frameworks and their implementation. We can see this now reflected in the strength of commitment behind our strategies for higher standards of regulation and more effective international cooperation on enforcement. Last year, IOSCO launched a particular initiative to review existing frameworks in the light of Enron, Parmalat and other scandals. IOSCO's Technical Committee set up a special Chairmen's Task Force. As Andrew Sheng put it, the brief was to view the regulation of global capital markets as "an entire interlocking system" and to identify possible areas of weakness.

The Task Force delivered a report entitled "Strengthening Capital Markets Against Financial Fraud" last February. It is a very thorough piece of work. It finds that the high profile scandals raise issues that have actually long been at the core of securities regulation. Issues of board governance; of auditor independence and effectiveness; of disclosure by securities issuers and market transparency; and of behaviour by market intermediaries and analysts.

For the Task Force, close review of these issues in context of the scandals has reinforced the need, first for proper implementation of principles and standards (many of which already exist) and second, for much more cross-border enforcement. These,

of course, define the strategic direction of IOSCO as I mentioned before. The Task Force makes a very interesting comment about the absolute importance of cross-border cooperation in today's world. I quote from the report: *"The increasingly global nature of modern capital markets means that, even if implementation of international regulatory principles and standards were universal, the benefits of these principles and standards could be defeated if financial regulators and law enforcement agencies lack the ability to take effective enforcement action, to share enforcement related information and coordinate investigations."*

Under this view, cooperation is definitely one of the keys to regulatory effectiveness in helping prevent more Enrons and Parmalats in the future. The Task Force has laid out a work programme within IOSCO to strengthen our understanding of how existing principles and standards might be deficient in preventing and detecting fraud in various areas, and of how effectively those principles and standards are being implemented, within and across national borders.

The Task Force focused specifically on financial fraud and the lessons that could be learned from a number of high-profile scandals. But its approach is applicable to the full spectrum of issues that arise in capital market regulation. We need constantly to strengthen our understanding of how various forms of market conduct, and financial fraud is but one form, may reduce investor protection, undermine market fairness and efficiency, and inflate systemic risks.

In the same context, I am convinced that we need to broaden our understanding of the issues most relevant to different forms of economic entity, including banks and financial institutions. As IOSCO moves forward with its strategic direction, we need to encourage a focus on issues that are particularly important to these entities. It hardly need be said that major problems with an international bank would have huge potential to damage investors and market confidence in general, perhaps causing more damage than the collapses of Enron or Parmalat. Now is a good time for us all to look closely at how current trends in the market conduct of banks and their counterparties might be raising issues for both securities market regulators and banking supervisors.

### **Bank Regulation**

The world is currently embarked on a revision of the Basel Framework for prudential supervision of international banks. IOSCO is fully supportive of the work ongoing under the Basel II Accord issued in June last year. We understand that the revised Framework will encourage banks to review more closely the underlying risks in their loan and trading books, and take a more forward looking approach to identifying and managing risks. The focus is, of course, on developing new measures and standards for capital adequacy that recognise the nature of risks in an increasingly sophisticated financial marketplace. There would seem strong parallels between building out the basis of prudential supervision under Basel II, and the drive within IOSCO for broader implementation of the Principles of Securities Regulation and greater cross-border cooperation on enforcement.

From an IOSCO perspective, it is important to recognise the extent to which a bank may be impacted by issues arising from market conduct - issues that are actually quite different from the traditional concerns of prudential supervision. In many cases, the threat to a bank's capital base may arise from a failure in its policies and practices for

internal control. The demise of Barings Bank in the early 1990s is the most dramatic example of such failure in recent history. But we securities regulators, not infrequently, see instances of weak internal control that might have escalated into a major issue of prudential soundness for the bank concerned.

### **Internal Control Issues**

Events at the National Australia Bank a year ago are a good case in point. Thanks to an employee whistleblower in early 2004, the bank discovered a major failure in the internal controls applying to its financial markets operation. Foreign currency options traders had made unauthorised transactions and then covered their mounting losses by falsifying records. Ultimately, the NAB sustained a loss of around A\$360 million. The loss, along with the scandal's very negative impact on the reputation of the National, knocked its share price for a time. Fortunately the losses had been stopped before they became large enough to threaten the financial stability of the bank.

Subsequent investigations produced damning conclusions on the conduct of business within the bank. Auditors PricewaterhouseCoopers attributed the losses to three fundamental forms of failure: lapses in the integrity of staff; lack of an effective risk and control framework in the financial markets operation; and failures in board governance and the bank's internal culture. In its own report, the Australian Prudential and Regulatory Authority (APRA) revealed that concerns about irregularities in foreign exchange options trading at the NAB had been flagged to its board a year before the whistleblowing incident.

As you might expect, the Chairman and Chief Executive resigned when the scandal broke, and there were very public sackings on the bank's currency desk and among senior executives. The NAB, and every other bank in the Australasian financial sector, learned a big lesson on how failures in market conduct, failures that fly directly in the face of securities regulations, can impact on the balance sheet and the share price.

Another example, from the New Zealand marketplace, illustrates just how important even apparently routine regulatory compliance is in the financial sector.

In 2002 Australian-owned Westpac Banking Corporation acquired ownership of BT Funds Management, an investment funds manager offering securities to retail investors on both sides of the Tasman Sea. After acquisition, Westpac discovered that BT had failed on and off over a seven-year period to meet certain mandatory reporting requirements in respect of its offering of Australian unit trusts in New Zealand. Under exemptions granted by the New Zealand Securities Commission, BT and others can offer these securities in our jurisdiction without a separate New Zealand prospectus. But they must file certain documents with the New Zealand Companies Office as a basic step to assisting investor protection - something which BT had failed to do many times.

As BT was operating under an exemption from the usual rules that apply when offers are made in New Zealand, non-compliance with the conditions means that the exemption does not apply and, in effect, BT was offering securities without a prospectus. The automatic result under our law was that any allotments of these securities were void, and investors were entitled to their subscription money back,

plus interest. We felt it was very important that investors with BT be made aware of the situation and informed of their rights. They numbered around a third of BT's 30,000 New Zealand resident clients. We pointed out that, ultimately, Westpac and BT could be required to repay these people, with interest of 10% per annum for the duration that each investor had funds deposited with BT.

The Securities Commission saw no fraud or intentional wrongdoing on the part of BT. The failure to file documents appeared to have been no more or less than systemic failure in the processes of this institution. BT's failure might appear mundane but it exposed the organisation, and subsequently Westpac, to substantial risk. The board and management should never have let that situation arise.

The Commission subsequently found 11 other securities issuers who admitted they had breached the same reporting requirement. These other issuers included household names from Australia and the United Kingdom, from whom we would have expected higher standards. The impact of these breaches on BT and the other issuers should not be underestimated. Some financial commentators put the potential cost to these issuers, collectively, at between NZ\$700 million and NZ\$1 billion. We said only that the potential costs were substantial. Downward trends in international equities markets had left many investors' units worth less than their initial purchase price. These investors could well seek to have their subscriptions returned.

In the event, there was an amendment to New Zealand's Securities Act that has enabled BT and others to seek protection from the full consequences of their past lapses. Matters are now before the High Court of New Zealand.

In reference to both the National Australia Bank scandal, and the New Zealand episode, I simply make the point that securities regulation can be very important to banks' financial stability. Where failures occur in internal control, even on matters that may seem of little significance in the daily run of market conduct, the consequences can be substantial.

Of course, we also need to look at market conduct beyond the bank or other deposit taking institution itself. Securities regulation has a role to play in identifying and managing exposure to risks that arise from the conduct of banks' counterparties. Hedge funds instantly come to mind. Of course, hedge funds are much in the minds of securities regulators across global capital markets for a number of good reasons. It would seem to me that their growth and operational style may pose particular risks to international banks in the current context.

### **Hedge Funds**

Hedge funds definitely have a role to play in financial markets because of their appetite for risk and their addition of liquidity to some areas. They may serve as a counterbalance to undesirable volatility in asset prices. However, we securities regulators have to be concerned about hedge funds' lack of transparency on investing strategies, on performance and even on their very existence.

In the United States, where investment into hedge funds is said to have topped US\$1 trillion, the Securities and Exchange Commission will require all funds to register in

2006. IOSCO now has a group working on possible regulatory responses to the growth of hedge funds, with an emphasis on guidelines for disclosure.

We are, of course, talking about entities that typically operate under exemptions to national securities laws and that make aggressive use of bank debt, alongside funds deposited by their investors. How well does anyone really understand the risks that arise from the in-large-part secret market conduct of hedge funds or from their strategies for high return in financial assets and derivatives markets?

The issues become all the more pressing for regulators as these funds increasingly become a vehicle for the retail investor. Germany seems to be leading the way with regulatory exemptions that open hedge funds to retail investors who channel their money through market intermediaries. In the US and elsewhere, rising inflows from pension funds and other mutual funds also represent substantial and increasing exposure for smaller, retail investors to the performance and the market conduct of hedge funds. We should also take into account the tendency among these entities to outsource many of their back-office functions and other operational needs from banks. Between hedge funds and banks, there are undoubtedly diverse and complex interactions, and substantial loan exposures by banks are, in fact, just one critical component of this. It is not hard to see the potentially devastating effect on bank stability that the collapse of a large hedge fund might have - and I am sure such scenarios are not lost on banking regulators worldwide.

#### **Basel Committee and IOSCO**

We have good grounds to expect that many relevant issues will be addressed in context of the current Basel II process. In particular, I point to the joint working group that has been formed between the Basel Committee and IOSCO to look at certain trading-related exposures and issues of double-default on lending and trading obligations. The group will make recommendations on the capital requirements necessary if banks are to adequately cover risks arising from these exposures and from the effects of double default. The group issued a discussion paper last month and all parties are invited to make submissions by a late May deadline.

The paper puts a particular focus on the treatment of counterparty credit risk for over-the-counter derivatives, repurchase agreements and securities financing transactions. We can perhaps expect that some of the questions relating to hedge funds will come under the spotlight as these issues are explored. The joint working group is, to some degree, recognizing that matters of business and market conduct are increasingly important to banking and the stability of individual banks.

Ultimately of course, the Basel Committee is reliant on national prudential authorities for the implementation of new standards. The situation parallels IOSCO's challenge to achieve securities principles and standards implementation in its member jurisdictions. I understand that the Basel II Framework is intended for implementation from June 2008 onwards. It is important to note that, in the context of prudential supervision, national authorities may chose to implement the revised framework across a broader category of institutions than traditional banks. Investment entities may, in some cases, find themselves required to hold more capital in relation to different forms of exposure.

## **Regulatory Structures**

In looking to the future, other very interesting questions arise for regulators. Does the interleaving of regulatory approaches I have been talking about touch on issues of structure? How are prudential and market conduct matters best managed in a country's capital markets? How do regulators in each area ensure they are properly informed of the other's work? Is the solution a "mega regulator" as we see in some parts of the world, or are there good arguments for keeping prudential and conduct regulators structurally separate? I know that these are questions on the minds of policy makers in Washington and in Wellington, and I am sure, in many places in between. My purpose here is not to promote particular answers but to point out the complex interleaving that occurs and to pose related questions of structure. Perhaps this audience will provide the answers. This is a challenge for domestic policy makers and for regulators, and for the international financial community.

## **Concluding Comments**

The joint Basel-IOSCO working group is an important milestone in developing cooperation between the leaders in securities regulation and bank supervision. It is an opportunity to strengthen our collective focus on the full diversity of regulatory issues facing the global financial sector and to develop an "interlocking system" of regulations, if I can borrow Andrew Sheng's term. We need business and market conduct regulation that contributes to investor confidence in capital markets - the over-arching concern of IOSCO - and also to bank and financial system stability, alongside regulatory systems for prudential supervision.

This broad focus is entirely consistent with the strategic direction of IOSCO as confirmed and extended at our Annual Conference last month. IOSCO is moving ahead with higher regulatory standards for global capital markets and with a framework for stronger, more effective cross-border cooperation on matters of enforcement. I conclude by assuring you that the interests of bank investors, and bank depositors and customers, are encompassed by IOSCO strategies.

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