The shift towards Market Based Financing: the role of financial regulation

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Let me begin by thanking IE for this invitation.

Allow me to mention a few words about my organization, IOSCO. The first thing I should probably say here is that we are your next door neighbour- the IOSCO Headquarters is located just a few minutes from here in Calle Oquendo!

IOSCO is the standard setting body for securities regulation and we have more than 120 regulators as our members. Examples of our members are the US SEC, CFTC, UK FCA, ESMA, Spanish CNMV, Japan, Singapore, Hong Kong and many others including close to 90 regulators from emerging markets. Together, IOSCO’s members regulate more than 95% of the world’s capital markets which, as someone was calculating last week, comes to around 127 trillion dollars. Let me give you some examples of what our members regulate: these include, in many jurisdictions, broker dealers, funds and fund managers including hedge funds, investment banks, stock exchanges and trading platforms, credit rating agencies (CRAs), auditors, Clearing Corporations or Central Counterparties (CCPs), Trade Repositories and many others. They have enforcement and sanctioning powers, and in many cases the result of their enforcement actions are fines and penalties but also jail sentences.

Since I am speaking at a university, I can mention that the staff at our member regulators come from the best universities, law schools and business schools- they could have gone into the private sector and made fortunes at investment banks but what sets them apart is the public interest element, the motivation to help in making the financial system safer and healthier so that it can play its socially beneficial role in the wider economy.

In IOSCO, we come out with standards, principles and recommendations that our members must follow while producing their regulations. The IOSCO Objectives and Principles of Securities Regulation are the global standard accepted by the G20, IMF and World Bank for sound financial systems. We also have a system of monitoring implementation of the IOSCO principles and recommendations through peer reviews. But IOSCO is not just about setting standards; it is also about helping members, 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 have just got back after the meeting of the IOSCO Board in Kuala Lumpur last week, which followed last year's Board meetings in Sydney, Montreal and Luxembourg. We have a roundtable with industry and other stakeholders in every Board meeting, and this year's roundtable was on the issue of risks in emerging markets. We had some of the largest industry players including fund managers (which had about 8 trillion dollars of assets under management) apart from IMF and World Bank and other key policy makers at this meeting. Our industry participants pointed out that emerging markets portfolio flows had increased by more than 30 times since 1995 and emerging markets had outperformed developed markets consistently except in 1998. GDP growth had been higher and public debt lower and the so-called "frontier markets" provided high growth opportunities. One of the important issues which stood out was the role of sensible and smart regulation in enabling growth and development, and the fact that emerging markets had learnt from the Asian financial crisis and had therefore weathered the current crisis in a much better way.

The Financial crisis and the global regulatory response

More than half a decade has passed since the fall of Lehmann Brothers which symbolizes the start of the greatest financial crisis of our times. Some estimates say that crisis has caused a loss of 15% to global trend GDP, increased unemployment, with the social fabric being stretched in many European countries.

While the root cause of the financial crisis is probably the topic for a different day, the main elements of the crisis have been traced back to global macroeconomic balances leading to depressed interest rates along with low inflation in the west- the period called "the great moderation". There were poor loan origination and mortgage underwriting standards with the "originate to distribute" model of securitization with poor performance of the CRA ratings; woefully inadequate risk management and corporate governance in firms, which, together with the perception that some firms were "Too Big To Fail" resulted in reckless risk taking. There was almost a naïve belief that markets would always be self-correcting and that the "big boys" – the large financial institutions- were sophisticated enough to take care of themselves without hurting themselves and others. This resulted in some areas that were exempt or lightly regulated, e.g. the opaque OTC derivatives markets, which at the time of crisis and stress resulted in rapid evaporation of trust between institutions and precipitated the liquidity freeze that characterized the crisis. But one of the major features of the crisis was that the financial sector, whose role it is to channel savings into investment for the growth and development of the real economy, somehow got disconnected from the real economy and took on a life of its own- and this resulted in instruments like the CDO squareds which documentation ran into thousands of pages which nobody could understand.

So what has the global regulatory response been? Together, the G20, Financial Stability Board, IOSCO and others have worked on:

- Building resilient financial institutions, with capital requirements and other measures for institutions identified as Globally systemically important financial institutions or G-SIFIs (one of the fall-outs of the crisis has been a proliferation of acronyms: G SIFIs, MIFID, EMIR…). There have been new Basel Standards for bank capital and liquidity requirements that have increased capital requirements by a factor of 10. Mortgage underwriting standards have been tightened and international principles have been issued or are being issued on securitization and CRAs.

- Regulating shadow banking

- Ending "Too Big to Fail" through Resolvability of systemically important institutions

- OTC Derivatives reforms- I will describe this later as this is a key area of IOSCO's work, but an important aspect of this work is to subject bilateral trades to central clearing at CCPs

Increased role of securities markets

But as capital requirements go up on credit institutions, in addition to their deleveraging after the crisis, their ability to lend is becoming constrained. The public sector is itself weighed down by high levels of debt as we have seen only too painfully in Europe. So what are the other options to fill this gap for financing the economy? We in IOSCO think that securities markets will have to step up and play an important role in this respect. We think the world is 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 efforts to drive its recovery.

We in IOSCO have come out last year with an IOSCO Risk Outlook which points out a few **notable trends in securities markets in this regard**:

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 50% below the 2009 levels.
2. ***Reliance on securities markets has been increasing:*** For example, the $2.2 trillion in bank loans that was raised in the US and Europe in 2012 was approximately only **half the amount raised through equity and bond markets**. Asian corporate debt issuance is on the ascent, specifically from China, as is the rise in Islamic bond (Sukuk) financing. Other innovative means of financing are coming up including crowd funding.
3. ***There is also reliance on securities markets for bank funding:*** The bank funding model relies, in part, on access to securities markets including through securitised products and covered bonds continue to provide reliable funding for banks. For example, securitised products respectively reached almost $600 billion and $350 billion (covered bonds included) in the US and Europe.
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, likely due to increasing appetite for foreign investors in advanced economies seeking to enhance their yield.
5. ***Commodity markets:*** Commodities have become increasingly important for securities markets as many financial products are linked to or based on commodity prices and indices, including futures, mutual funds, structured retail products and exchange-traded funds (ETFs).
6. ***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** between 2007 and 2012 by 8% to $633 trillion and derivatives cleared have increased steeply to $173 trillion.

These trends reinforce the point that the economy is likely to be increasingly dependent on market based financing. The question then is what are the necessary conditions for 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. It is little wonder, in fact, that the word "credit" actually comes from the Latin "*credere*" which means to believe, confide- and **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.

IOSCO has been working in this area of making the financial system safer and reducing the probability of financial crises through its work on:

- OTC derivatives: by increasing transparency through reporting to Trade repositories and trading on electronic platforms, strengthening Financial Markets Infrastructure (CCPs, TRs, CSDs, SSSs);
- Regulation of MMFs, ETFs and hedge funds
- Regulation of securitization;
- CRAs [and recently audit quality (Kuala Lumpur)]
- Dark pools and HFT;
- Financial benchmarks like LIBOR;

- Non-bank SIFIs; to name a few.

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

In IOSCO we also realize that we cannot be only looking at addressing the issues arising from the last crisis- that would be like driving by only looking at the rear view mirror. We are now more forward looking, and we seek to identify emerging risks through the working of all of our committees including the Committee on Emerging Risks. We have a new Research Department in IOSCO and we had produced the **Securities Markets Risk Outlook** last year which looks at risks from the point of view of securities markets. It identifies four main risks to from the point of view of securities markets:

Risks associated with the low interest rate environment and search for yield including a return of structural leverage investments, such as CLOs and leveraged REITs.

Risks associated with collateral management in a stressed funding environment because of capital requirements that mandate banks' holding of high-quality collateral and increased reliance by banks on secured funding, need for high-quality collateral to meet initial and variation margin requirements for OTC trades. In response, banks may use alternative and sometimes innovative practices for providing high-quality collateral like collateral transformation and optimisation services as well as repo and re-hypothecation. These transactions are executed in the securities markets.

Risks in the OTC derivatives space: Over the Counter (OTC) derivatives markets have undergone significant reform since the financial crisis. A major element of this reform involves the mandatory clearing of derivative contracts through central counterparties (CCPs). CCPs are designed to reduce systemic risk in the derivatives market by reducing counterparty risk, but this can cause more of the risk burden to be borne by clearing brokers.

Shifting risk from bilateral OTC contracts to a single point of infrastructure is a challenging balancing act.

Risks associated with reversal of capital flows to Emerging Markets: This has already materialized.

We have also published staff working papers on the risks of cybercrime on trading venues and on crowd funding and are working in the area of corporate bond markets. In fact, the work in the area of Research as well as other areas of IOSCO could present good opportunities for IE to collaborate with IOSCO.

Restoring Trust: investor protection and education, corporate governance and enforcement

In addition to making financial system safer, 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 protection of client assets; on disclosure made to customers at the Point of Sale when selling financial products; on investor suitability for complex financial products and on the regulation of retail structured products. We also have an investor alerts system that puts out these alerts very frequently on the basis of information received from various jurisdictions. IOSCO has also strengthened its efforts in this area by setting up a new Committee on Retail Investors. Investor education and financial literacy is an important part of IOSCO's work. 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 behavioural economics for instance.

While talking about behaviour, another important aspect is the crucial need to change behaviour, 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 on cooperation and the exchange of information is an important tool and is the pre-eminent global standard for cooperation relating to enforcement matters. We have 101 MMoU signatories now (the last two being Indonesia and Palestine Capital Markets Authority) with 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 for the exchange of information among regulators. 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.

Allowing markets to function in a globalized environment: the need for international initiatives

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. But there is another important aspect: we have to allow markets to function! Here I would like to relate a brief anecdote: When I was undergoing training at the Academy for the Indian Administrative Service, I had to learn, among other things, a curious skill: horse riding! While no doubt a vestige of the colonial rule in India, the story that goes around is that an Indian Prime Minister had said that if a District Magistrate cannot control a horse, how can he or she control a District?! While the Hon'ble Prime Minister may or may not have said that, what I learnt first-hand is that a horse needs to be controlled or regulated, but not so tightly that it cannot or will not want to walk, much less canter or gallop. Similarly, market participants have to know the rules of the game-- what is acceptable behaviour and what is not-- and no doubt have to be regulated so that they act within the norms of good behaviour.

However, markets will need to function and risks will need to be taken: the need is for risk optimization and not risk minimization. We also need to look close and hard at what aspects of what is called “shadow banking” should be discouraged and what aspects should be encouraged – though in a well-conducted and sensible manner- in line with the current recognition of the need for market based financing. Securitization is one such area where IOSCO is planning to work along with the BCBS and IAIS so that this economically important activity can happen in a sensible way. The issue of Long Term Investment Financing and SME financing, is also an area IOSCO is working on from the point of view of market based financing.

In the context of the on-going regulatory thinking and reforms, it is also important to realize that everything in the financial sector does not need to be viewed and regulated as a bank. We are talking of different business models here. A bank, as one esteemed bank supervisor said, is a huge “confidence trick” at the end of the day. It is an inherently unstable financial institution which has to be propped up by measures that give the appearance of stability. This 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”. There is at the same time the need to be able to recognize that different aspects of regulatory reforms interact with each other and therefore there is a need for economic impact analysis in looking at the totality of reforms.

The issue of Long Term Investment Financing, including SME financing, is clearly becoming important in this context. The development of capital markets, instruments and products will need to be carefully examined to address this concern. IOSCO is working on this issue and will aim to come out with reports later this year.

Another area that is increasingly becoming crucial is 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. We are trying to deal with this through the processes of mutual recognition and substituted compliance and there have been some encouraging steps in that direction. IOSCO has set up a Cross Border Task Force that is analyzing 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.

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 FSAPs 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 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 re 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.