IOSCO's agenda and global prospects for market-based financing

Keynote Speech by Tajinder Singh, Deputy Secretary General at the International Organization of Securities Commissions, at the International Council of Securities Associations (ICSA) 27th Annual General Meeting,

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Let me begin by thanking the ICSA for this kind invitation to IOSCO.

Allow me to mention a few words about IOSCO, even though most of you are probably aware about what we do. IOSCO is the standard setting body for securities regulation with about 200 members of whom more than 120 are regulators. Together, IOSCO's members regulate more than 95% of the world's capital markets which, as someone was calculating at our last Board meeting in Kuala Lumpur, comes to around 127 trillion dollars. But 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, especially for securities markets; what are the three most important conditions for market based financing; and what is the role of IOSCO in all this. I will also tell you a small story about horses.

Present global environment

The Global Financial Stability Report released last week by the IMF mentions that the global financial system is on the path to greater stability, but is undergoing a number of challenging transitions. A shift is needed from "*liquidity-driven*" to "*growth-driven*" financing. In the US, "*green shoots*" of the economic recovery are visible and the monetary policy has begun to normalize; the trick is to find a good "*Goldilocks exit*"- neither too fast, nor too slow, just right. There are transition challenges in emerging markets for financial rebalancing amid tighter financial conditions as the period of capital inflows comes to an end with the exit process in the US. The implementation of "Abenomics" in Japan to go towards sustained growth and stable inflation is continuing. And of course here in Europe, a lot of progress has been made with the Monetary Union with the setting up of the Single Supervisory Mechanism and Single Resolution Mechanism, but the journey from fragmentation to robust integration is still not complete and the repair of banks' balance sheets is a work-in-progress.

There is substantial corporate indebtedness in both advanced and emerging markets. The second largest economy, China, is also going through its own adjustment towards more market discipline in the financial system and again the pace here is important.

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.
2. ***Reliance on securities markets has been increasing in terms of raising funds through equity and bond markets compared to bank loans.*** Other innovative means of financing are coming up including crowd funding.
3. ***There is also reliance on securities markets for bank funding:*** securities markets including securitized products and covered bonds continue to provide reliable funding for banks.
4. ***High yield bond markets:*** In the search for yield, there has been a huge increase in the market for high yield bond issuances (in fact, we will be coming out with a paper very shortly on corporate bonds both on primary and secondary markets).

Apart from these, we also highlight the changes in the commodities markets and derivatives markets.

Increased role of securities markets

These trends reinforce the point that the economy is likely to be increasingly dependent on market based financing, especially in the context of the deleveraging of banks. 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 following the loss of trust in the crisis. 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 from a systemic risk point of view.

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

- OTC Derivatives reforms

We can see from this that the global regulatory thinking, coming from the G20, is to view the financial system as a component of (a) institutions and (b) markets. Because it is institutions that we can name, our focus is usually on institutions. But markets are also important. The whole aspect of OTC Derivatives, or of shadow banking, is about activities and products and not just about institutions. IOSCO was very aware of this aspect of the crisis and the need for regulatory reform when we revised the IOSCO Core Principles for Securities Regulation in 2010 to introduce new principles on monitoring and mitigating systemic risk for securities regulators which was not usually seen as a core function for securities regulators.

On the aspect of institutions, we know the regulatory reforms for making banking safer, in terms of shoring up capital, liquid assets and addressing leverage. In fact, the reduction in systemic risk because of banking reform appears to have encouraged investors to put risk capital to work across the financial system more broadly, compressing excessive risk premia in primary and secondary financial markets. Therefore bank financing and market based financing are not necessarily competitors, but I will come to this later.

In terms of the other component, i.e., markets, or activities, IOSCO has been working in this area of making the financial system safer. Not surprisingly, we are working on many initiatives with Basel based committees such as the BCBS and the CPSS.

- On OTC derivatives, IOSCO has been working on increasing transparency through reporting to trade repositories and trading on electronic platforms as well strengthening Financial Markets Infrastructure (especially CCPs) by working along with CPSS (CCPs, TRs, CSDs, SSSs). This includes work on recovery of CCPs. We have also collaborated with the BCBS which has resulted in their rules on the treatment of bank exposures to CCPs only last week;

- On the funds sector, we have produced global recommendations for the regulation of MMFs, ETFs and hedge funds. We are also carrying out the Hedge Funds survey to understand their systemic importance and had published a report last year.

- Regulation of securitization- but I will come to this very important topic later because it is not just about reduction of systemic risk but also about growth;

- CRAs to improve the integrity and quality of the ratings process where we are working on finalizing a new IOSCO CRA Code of Conduct
- Dark pools and HFT;
- financial benchmarks like LIBOR where we have produced IOSCO principles and are now reviewing the key benchmark interest rates;
- non-bank SIFIs: as you are aware, we have issued a consultation paper working along with the FSB on whether entities like broker-dealers or asset managers or indeed asset management activity can be systemic.

I. 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. As I mentioned, we have produced the **Securities Markets Risk Outlook** last year which looks at risks from the point of view of securities markets. It identified four main risks from the point of view of securities markets:

The low interest rate environment and search for yield.

The need for high-quality collateral by banks and for OTC derivatives, and the possible use of alternative and sometimes innovative practices like collateral transformation as well as repo and re-hypothecation (These transactions are executed in the securities markets).

Risks in the OTC derivatives space: A major element of OTC 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: There are clearly vulnerabilities for emerging markets with the exit of advanced economies from the unconventional monetary policies.

We have also published staff working papers on the risks of cybercrime in trading venues and on crowd funding and are working in the area of corporate bond markets.

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

In addition to making the 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 behavioral economics for instance.

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. We will be having a Corporate Governance Roundtable in our next Board meeting in Madrid. Enforcement and sanctions are important aspect of IOSCO's work. In this context, the IOSCO MMOU on cooperation and 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 the 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.

III. 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 behavior 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 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 fact, while the efforts on regulation are continuing, policy makers are reminding themselves that "the purpose of financial stability is to allow sustainable growth".[1]

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. It is encouraging to see that bodies like the FSB and G20 are now referring to the need for transforming shadow banking to transparent and resilient market-based financing- the term that most IOSCO members had preferred over "*shadow banking*" more than a couple of years ago.

Securitization is one such area where IOSCO is starting work along with the BCBS so that this economically important activity can happen in a sensible way. The lingering stigma attached to securitization given its role in the crisis needs to be addressed through simpler structures.

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. The risks in the banking business model are 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*".

In fact, bank-based financing and market-based financing are not necessarily competitors. For example, a vibrant corporate bond market is effectively a "*spare tyre*". If the banking system gets into difficulty, the bond market can take its place in providing credit to businesses and thus allow the economy to continue operating relatively normally. Also, it can play the role of a competitive edge, by ensuring that banks do not charge too high a price for financial intermediation.[2]

It is important that the financial system is able to support economic growth by allowing firms to raise funding directly from investors, through equity and bond markets. Non-bank and market-based finance can widen participation and enhance diversity in the financial system- in the form of funding (to complement bank lending) and in the distribution of risk exposures amongst counterparties, i.e., as both institutions and in their market activities. We are seeing

[1] Dame Clara Furse: "Taking the long view: how market-based finance can support stability" available at http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech718.pdf

[2] See "Opportunities and Challenges for Market-based Financing", speech by Philip Lowe, Deputy Governor, RBA at the ASIC Annual Forum 2014, available at http://www.rba.gov.au/speeches/2014/sp-dg-250314.html

this with Corporate Bond markets which have almost tripled in size since 2000 and where 27 new economies have recorded issuance in the last 13 years. The outstanding amount from non-financial firms continues to expand, with two-thirds of the global issuance in 2013 coming from non-financial firms. Market depth (outstanding as a percentage of GDP) is increasing and corporate bond financing is increasing as a percentage of total financing, filling an emerging gap in bank lending and long-term financing.[3] It is particularly important that the financial system is able to provide credible long-term capital to promising companies to support innovation and future economic growth.

It is important that equity markets are allowed to play their role. Committed long-term equity also provides a stabilising buffer against the inherent cyclicality of debt finance. IOSCO has set up a Task Force on Long Term Investment Financing to address these issues.

Similarly, the issue of SME financing is particularly important given their role in employment generation, and this is true both for emerging and advanced markets, particularly Europe. I know initiatives are being taken in Europe, in France, Germany and Spain. IOSCO is also working on SME financing as a project involving the Growth and Emerging Markets Committee as well as advanced markets.

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 that include terms like mutual recognition and substituted compliance. IOSCO has set up a Cross Border Task Force that is analysing these issues examining:

- what are the approaches that jurisdictions take to cross border issues (we counted about six main approaches)
- What are the main challenges: we counted eight challenges
- We also asked our members what could IOSCO do, and we identified seven areas

We are conducting roundtables with the industry this month in Asia, Europe and the US and will come out with a consultation report by the middle of the year with a final report by the end of the year. The importance being attached to this issue at ICSA is very welcome.

[3] IOSCO Staff Working Paper on "Corporate Bonds: A Global Perspective" http://www.iosco.org/research/pdf/swp/SW4-Corporate-Bond-Markets-Vol-1-A-global-perspective.pdf

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. 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.

With regard to the cross border issue, as you are aware, the G20 communique from the Sydney meeting had mentioned that leaders would "implement reforms in a way that promotes an integrated global financial system, reduces harmful fragmentation and avoids unintended costs of business". We support this communique. However, as Ashley Alder, the Chair of the Hong Kong SFC and the Chair of IOSCO's Cross Border Task Force said,[4] there seems to be a serious disconnect between the G20 ambition and the lack of basic tools necessary to achieve this, which needs a global treaty.

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

[4] Speech at the ASIC Annual Forum 2014, "Think global, act local"
http://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Ashley%20Alder_20140327_V3.pdf

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. A system with insufficient market-based financing is unnecessarily fragile. It is important that the financial system is able to provide credible long-term finance to productive companies.

Global regulation, including by IOSCO, is designed to promote confidence by making the system safe and regaining trust of investors through investor protection, proper corporate governance and enforcement; but at the same time by 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, minimising frictional losses, regulatory arbitrage and mitigate systemic risk.

Thank you for your attention.