Global challenges facing regulators in the next decade

A speech by Greg Medcraft, Chairman, Australian Securities and Investments Commission and Chairman, International Organization of Securities Commissions

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Introduction

Thank you Frances [Cassidy] for inviting me to speak today.

It is great to be back in New York City and terrific to be here at the Princeton Club.

I used to live in New York for nearly 10 years when I was with Societe Generale and, while I have returned many times since, you never, ever get tired of being here in this mighty metropolis.

I would also like to recognise Frances Cassidy and her leadership of the American Australian Association, an organisation with which I've had a long association and one that has been devoted to strengthening relations between the US and Australia for more than 60 years.

Ladies and gentlemen, I've been asked to speak about the global challenges facing financial services and markets regulators in the next decade.

My comments today reflect my views as Chairman of both the Australian Securities and Investments Commission and the Board of the International Organization of Securities Commissions – or IOSCO – a position I recently took up.

As many of you know, IOSCO is the leading international policy forum for financial services and markets regulators and is recognised as the global standard setter in this area.

Its members regulate more than 95% of the world's financial services markets in more than 115 countries.

IOSCO helps its members achieve their common objectives of promoting fair and efficient markets, confident and informed investors and the reduction of systemic risk.

These objectives, and therefore IOSCO's work, are important because they facilitate economic growth. And that is in the interests of all members.

Global challenges facing regulators

Post global financial crisis, we have found ourselves in a new economic environment to which we must adapt. I have termed this ‘the new normal’.
In this post-GFC world, regulators and the regulation of the financial system is ever more important.

The goal of many countries is sustainable economic growth – and this often requires access to cost-effective capital.

Capital can be provided in two ways:
- by the banking sector; or
- by debt and equity capital markets, or what we call ‘market-based financing’.

As one of the major ways to fund economic growth, market-based financing goes to the heart of our responsibilities as markets regulators.

For market-based financing to be effective, we need regulators and regulation to be effective.

In other words, we need markets to be fair, orderly and transparent, and investors when participating in them to be confident and informed.

Accordingly, these outcomes, along with the reduction of systemic risk, are the strategic objectives of regulators globally.

So, what are the challenges facing markets regulators?

There are three major challenges, as I see it:
- structural change;
- ongoing innovation-driven complexity; and
- globalisation.

I will go through each of these in turn.

**Structural change**

The global financial system is currently undergoing significant structural change.

Market-based financing is increasing and is now seen as a key source for funding economic growth.

This structural change is being driven by:
- increased banking regulation; and
- the growth of the pension and superannuation sectors.

New rules to strengthen the banking system are imposing higher capital and liquidity requirements.
The net effect of this is often a decreased access to debt capital and an increased cost to business.

As a result, many businesses are turning to market-based financing to source their capital.

The second driver of market-based financing is the continuing global growth of the pension and superannuation sectors – much of which is invested in debt and equity capital markets. This global growth is expected to continue in the coming decade, as:

- governments in emerging markets start or expand retirement savings programmes; and
- there is a demographic shift underway in many developed countries, as the population ages and people start to contemplate how to fund their retirement.

A good example of the growth in super is in Australia, where funds in superannuation are expected to grow from A$1.4 trillion to A$3 trillion by the end of the decade.

The growing importance of market-based financing presents a challenge for markets regulators to ensure we have the right tools and resources in place, so that debt and equity capital markets can perform their critical role in funding economic growth.

One of IOSCO's initiatives is to establish the IOSCO Foundation, the aim of which is to help develop global markets, particularly as they grow in importance.

The Foundation will fund the provision of training and education to improve the capability of markets regulators and the quality of their supervision.

It will also fund the provision of technical help to markets regulators, particularly as they implement global standards. This will improve consistency of standards and cooperation between regulators.

Last but not least, it will fund the provision of research and data analysis to regulators and policy makers so we can be better informed when we develop regulation or react to emerging risks.

This structural change, as market-based financing increases in importance, will require markets regulators to be prepared and ready for the challenges ahead. The IOSCO Foundation should help in this regard.
Innovation-driven complexity

The second challenge facing regulators, is keeping pace with innovation-driven complexity, so we can meet our strategic objectives of ensuring investors are confident and informed and markets are fair, orderly and transparent.

It's a constant struggle for markets regulators to monitor the emerging risks and respond in a way which doesn’t unduly restrict the benefits of innovation.

But, innovation can often add complexity and risk.

We see innovation-driven complexity in three areas:
- products;
- markets; and
- technology.

Complexity in products

Shadow banking is a good example of innovation-driven complexity. In 2008, we saw extremely complex products in the form of collateralised debt obligations and CDOs squared. Wholesale and retail investors were unable to understand or value the risks inherent in these products, and as a result, they lost a great deal of money.

Complex products, due to their nature, can be difficult for investors to understand. This can lead to them being mis-sold, particularly when investors are searching for yield. This is particularly relevant in the current environment.

It is important that investors take responsibility for their decisions. They should understand the risk–reward payoff and the concept of diversification. In this regard, investor education remains key.

However, product manufacturers and product issuers also have a role to play. It’s not a sustainable business model if your customers are losing money. They need to ensure the products are appropriate for the customer and aren’t mis-sold.

My position on this is clear – those selling complex products to unsuspecting investors need to wise up and do the right thing. They might get away with it for a while, but as we’ve seen since the crisis, governments and courts inevitably rule in favour of investors that have been mis-sold these complex products.
IOSCO has a working group looking at retail structured products. We are developing a regulatory tool kit for markets regulators to use in their home markets to deal with complex products. IOSCO published a consultation report on this last week.

In Australia, ASIC is also exploring the best ways to regulate these products. This includes considering the whole of the product lifecycle, not just distribution and disclosure.

From a self-regulatory perspective, e-learning modules which explain a product’s features and risks could be used to educate investors about a product. This could overcome some of the inherent weaknesses of traditional disclosure.

An online assessment could then be used to assess someone’s understanding before they part with their cash.

Globally and locally, our aim is to reduce the risk of complex products being mis-sold to investors. This is a perennial challenge.

**Complexity in markets**

In recent years globally, we’ve seen the rise of dark pools and high frequency trading. Crossing engines and HFT are the ‘new normal’, so we need appropriate regulation and a measured response.

Globally, IOSCO has developed high-level guidance to promote market integrity and efficiency, and mitigate the risks from technological developments such as high frequency trading. It’s promoting a consistent approach among markets regulators.

In Australia, ASIC released reports on these issues last month.

We found dark liquidity has caused spreads to widen for some stocks. We believe this will be managed via a new rule on meaningful price improvement. We are also recommending new rules to improve the transparency of dark pools.

On high-frequency trading, we found public concerns appear to have been overstated, with no evidence of systematic manipulation by high-frequency traders. In fact, we found their trading strategies are commonly adopted by the buy-side.

However, we will continue to monitor these issues and consider what is a ‘safe level’ of high-frequency trading. Does it provide phantom liquidity?

As I said before, we need appropriate regulation and a measured response.
Technology

Advances in technology have led to the rise of cybercrime in the financial system globally.

Online scams promoting ‘bogus’ investments, and equity trading accounts at risk of being hacked into and having the investment funds stolen, unfortunately, is part of the new normal.

At the global level, IOSCO is helping regulators to share information on scams.

And in Australia, we're working to educate potential victims and shutdown scams.

In summary, innovation-driven complexity of products, markets and technology will continue to raise challenges for markets regulators in meeting our strategic objectives. To meet these challenges, we will need to be forward-looking and proactive.

This includes identifying potential risks over the horizon, and maintaining a dialogue with industry to better understand what is happening in the market.

Also, thinking laterally and encouraging industry to use different tools, such as new media, which can lead to better outcomes.

Ultimately, investors need to take responsibility for their decisions and actions. Regulation can help them by ensuring accurate information is provided and not misleading. But investors will need to take the final step themselves.

It's important for markets regulators to keep adapting to new developments. Innovation is inevitable. We need to ensure it does not outpace regulation or compromise our strategic objectives of confident and informed investors, and fair, orderly and transparent markets.

Globalisation

The third and final challenge facing markets regulators is globalisation.

Globalisation raises two issues.

The first issue is interoperability of markets.

To facilitate economic growth, cost effective access to markets and capital is often needed.
Currently, each market has its own set of rules and regulations. Inconsistencies in regulation can reduce access to capital markets and add to costs of raising capital.

Regulators globally already have common objectives of ensuring investors are confident and informed and that markets are fair, orderly and transparent.

Given we have the same objectives, it makes sense to work toward the global harmonisation of regulation.

Global principles and a global rulebook are a good starting point. This would minimise market fragmentation and facilitate cross-border capital flows.

However, policy-makers in each country will inevitably take different approaches to implementation for various domestic reasons.

IOSCO has formed a task force on cross-border regulation to develop a tool kit of measures to overcome regulatory differences.

The tool kit will include measures such as mutual recognition and substituted compliance which recognise that the same regulatory outcomes are being achieved, just in different ways. Equivalence of regulatory outcomes ensures regulation remains appropriate for each market while facilitating cross-border activity.

The second issue with globalisation, is global misconduct. The fact that markets are global means misconduct is now occurring across borders.

Ponzi schemes can be based in offshore tax havens with different parties in different jurisdictions. Regulators will need to cooperate and help each other in both investigations and enforcement matters. This is a real challenge.

While globalisation may wax and wane, it will continue in ‘the new normal’, and global issues require a global response – thinking globally, and acting locally.

Organisations such as IOSCO have a key role to play in promoting equivalence of outcomes, a global rulebook and facilitating cooperation between regulators.

Having in place the right global infrastructure is critical to developing a global approach to market regulation.

I see these three challenges – structural change, innovation driven complexity, and globalisation – as the three major global challenges facing markets regulators in adapting to ‘the new normal’. Particularly with respect to our global objectives of ensuring investors are confident and informed and markets are fair, orderly and transparent.
Economic growth is critical and will need to be funded. Market-based financing will have an increasingly important role to play in providing this funding.

This means markets regulators will need to be alert. We will need to be forward looking and proactive. But most importantly, we will need to cooperate at a global level.

With the right people and infrastructure and the right level of cooperation, I am confident that we meet the challenge.

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