Challenges facing ASIC over the next decade

A speech by Greg Medcraft, Chairman,
Australian Securities and Investments Commission

Australian Institute of Company Directors Leaders' Edge luncheon, Melbourne

20 March 2012

Introduction

Good afternoon everyone.

It's good to be back in my hometown of Melbourne—I think the weather here is certainly better than the past couple of weeks in Sydney.

Over the last six months, I have been speaking about ASIC's three strategic priorities:

- confident and informed investors and financial consumers;
- fair and efficient financial markets; and
- efficient registration and licensing.

So today I've been asked to discuss the challenges facing ASIC over the next decade. This ties in well with our strategic priorities as there essentially three challenges that we must overcome to achieve our three strategic outcomes.

1st challenge

The growing regulatory perimeter, particularly with the exponential growth in superannuation (1.3 trillion to 3 trillion to 5 trillion)—more products, more investors and greater investment funds increases risk in the financial system;

2nd challenge

The increasing complexity of the financial system—products, information channels and financial markets are increasing in complexity which again increases risk in the system;

And most importantly, the 3rd challenge

Leveraging ASIC's resources to be proactive because it is through proactive regulation that we build resilience in the system. As Benjamin Franklin said, 'an ounce of prevention is worth a pound of cure'. Stakeholder engagement, surveillance, education and guidance are central to maintaining confidence in Australia's financial system.

Overcoming these three challenges will promote ASIC's three strategic outcomes.

I will now briefly expand on these three challenges.

1st challenge—Growing regulatory perimeter

Superannuation is expected to grow to $3 trillion over the next decade and $5 trillion over the next. It will grow at twice the rate of the economy. This will increase ASIC's regulatory perimeter as more investors come into the system and money invested increases.

This is a shift of savings out of the banking system into the superannuation/funds management sector.

A typical super fund invests in equities, fixed income, property and cash.

Growth in equities affects ASIC's market-facing teams that oversee mergers and acquisitions, capital raisings, brokers and the markets themselves.

Growth in fixed income, property and cash impact debt issuance, managed investment schemes and mortgages—activities which are regulated by ASIC.

With the growth in SMSF (currently 33% of super, growing to 40% of super in the next five years), they will be targeted with a range of products including structured products. Again, regulated by ASIC.

In addition to this, ASIC is responsible for disclosure by super funds.

This growth in super will also flow through to financial advisors, superannuation trustees, investment managers, custodians, research houses, credit rating agencies, auditors and accountants.

They all play roles in supporting investors in superannuation funds and are all regulated by ASIC.

There will also be a greater need for consumer education and financial advice due to changing demographics as baby boomers move to the retirement phase and switch to more conservative assets.

Also, a larger financial system will invariably generate more complaints and breaches.

As you can see, ASIC is significantly impacted from the growth in superannuation. With more stakeholders and investment products, ASIC's workload will increase. It will be a key challenge to ensure our regulation is sufficient and remains effective, so that overall risk in the system is contained.

2nd challenge—Increasing complexity in the financial system

While the regulatory perimeter is growing, the complexity of the financial system is increasing. This is at a time when the level of financial literacy in Australia is fairly low.

There is product complexity, complexity of technology and market complexity.

Product complexity

A superannuation fund today has a much wider range of investment products to choose from than ever before.

In addition to the relatively 'plain vanilla' products such as equities and bonds, super funds and other investors can gain risk exposure through complex products.

This includes cash and synthetic ETFs, CFDs, hybrids, credit-enhanced asset-backed securities (including CDOs), credit default swaps and equity default swaps, as well as investments in hedge funds, private equity and others.

There is also more scope to invest overseas, including in emerging or 'frontier' markets. More complex products means greater risks and greater potential losses for Australian investors.

The increased risks in complex products are not just faced by retail investors. The GFC provided clear examples of non-retail investors (universities, councils, endowment funds etc) that incurred severe losses from investing in structured credit instruments they did not understand.

Complexity of technology

Investors now have much more choice as to how to conduct their business.

Advances in technology and systems enable investors to buy securities on exchange or through dark pools. They can choose to use automated or algorithmic forms of trading, or lend their securities to earn income.

They can access a huge range of products, information and research on the internet and make investment decisions in a few mouse clicks.

Cyber crime

Advances in technology have also led to crime moving online.

Hacking into online equity trading accounts to sell their shares or for market manipulation purposes

Sophisticated scams are emerging that use fake websites combined with cold calling.

For example, Australians are induced in a telephone conversation to forward monies to overseas bank accounts on the fictitious premise that these monies are for investments in direct shares or investment products.

These scams rely on a very authentic-looking website that proves the bona fides of the cold caller. This is augmented and supported by other websites in the form of foreign exchanges or regulators (which are also fictitious) that provide 'independent' verification of the fictitious firm.

ASIC is working with the Australian Crime Commission and other federal agencies to eliminate these types of online investment fraud and scams.

The ever-growing range of products and investor operations means the regulator needs to be much more vigilant and proactive. This process of increased complexity is likely to continue in the future, especially while equity markets remain volatile and investors look for yield.

Market complexity

The operations of markets themselves are increasingly technical and complex.

Trades have moved from taking one or two seconds to milliseconds to microseconds. High frequency traders using this new technology have added to exponential increases in global order books.

In the USA, this new type of trader is estimated to be responsible for 50% to 60% of market trading. The ability to undertake high speed transactions was a factor that led to the 'flash crash' in May 2011 where US$1 trillion of shareholder equity was wiped out in minutes.

ASIC needs to keep pace with these rapid changes in technology to ensure markets are fair and efficient and investors get a fair price when trading on an exchange.

Innovation will continue and this will lead to increased complexity in products, information channels and the financial markets. This will heighten risk and the potential for loss in the financial system. It will require a proactive regulator that is 'on the ball' and forward-looking. This leads me to my next point.

3rd challenge—Leveraging ASIC's resources to maintain proactive regulation

Following the GFC, the environment for regulation and has changed dramatically. Financial markets face heightened risk which means regulators need to be on the front foot.

Rather than being reactive and arriving at the scene of the accident, regulators need to be cops on the beat, helping prevent and deter accidents from happening.

This is a major challenge for ASIC, particularly with our limited resources.

A certain level of resources must be spent on reactive regulation—that is, investigating breaches and potential misconduct, and fulfilling our statutory mandate such as registration and licensing.

The remainder of ASIC's resources can then be allocated to areas which pose the greatest risk. Proactive regulation involves engagement with stakeholders, surveillance (desk-based and onsite), investor education and regulatory guidance.

These actions build resilience in the financial system as each actor in the system (investor, product manufacturer, distributer etc) meets a higher standard of conduct and understanding.

The system then becomes more resilient to shocks, and when a market failure does occur, hopefully less money is lost.

To be proactive and forward-looking, you need to be able to identify which sectors pose the greatest risk. This requires a detailed understanding of the sector—understanding that is only gained through stakeholder engagement and surveillance.

This is self-reinforcing. The more proactive and involved in the market, more effective the regulator can be at identifying emerging risks.

Being pro-active also has a deterrent effect in that bad apples will be detected earlier. People will think twice before setting up dodgy businesses if they know they'll be brought to account.

Getting the message out there is a good way of leveraging ASIC's resources. Take insider trading, for example. We've been pushing the message that ASIC has the systems, the people and the powers to catch insider traders. If you get caught, it's likely that you'll go to gaol.

In fact, we're seeing more people cooperating and pleading guilty in the hope for leniency in sentencing. This is a tactic used quite successfully by the US Securities and Exchange Commission.

ASIC needs to maintain a high level of engagement with industry and continue its risk-based surveillances so that it can continue being proactive and forward-looking.

This comes at a time when our regulatory perimeter is expanding and complexity in the system is increasing—ASIC needs to be effective in how it leverages its resources.

Conclusion

It's critical that ASIC maintains its proactive stance and continue building resilience in the Australian financial system.

These three challenges:

- the growing regulatory perimeter;
- increasing complexity in the financial system; and
- maintaining pro-active regulation,

will be key to achieving our three strategic outcomes.

Thank you for your time.

