Systemic risk: The role of securities regulators

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Introduction

Thank you for this opportunity to speak to this important conference early in my term as ASIC Chairman. I am pleased to be speaking about the important topic of systemic risk and its management and mitigation. But first I will set out ASIC's strategic framework and our key priorities, so that you can understand our approach.

ASIC under my chairmanship has a continued focus on current business priorities.

ASIC has three key priorities:

- **Confident and informed investors and financial consumers**
  - Education: Investor responsibility for their investment decisions remains core to our system. Understanding risk / reward and diversification is paramount. Focus is on the MoneySmart website, Helping Kids Understand Finances and using new media.
  - Gatekeepers, in the widest definition of the term, being held to account: This includes accountants, directors, advisers, custodians, product manufacturers, market operators and participants. Self-regulation has an important role to play with the support of ASIC. Industry standards are critical in terms of complementing regulation. They can provide guidance on how to comply with the law and go beyond the law in setting standards, particularly in areas such as ethics.
  - Consumer behaviour: Recognising how investors and consumers make decisions. Focus is on advertising, suitability and using new media as an alternative channel.
- **Fair and efficient financial markets**
  - Market supervision and competition.
- **Efficient and cost-effective registration and licensing**
  - Particular focus on small business.

The main factors guiding our approach to setting priorities are:

- legislative responsibilities;
- systemic or regulatory risk (of course I will address this in greater depth in my speech today);
- stakeholder expectations; and
- government policy.

And the key drivers we use to achieve our priorities are:

- engagement with industry;
- surveillance;
- guidance;

- education;
- deterrence – we will continue to focus on taking on the big cases and pursuing wrong-doers; and
- policy advice.

As I have said, one of the main factors guiding our approach is systemic risk. We are seeking to build resilience in financial markets and the financial system.

Resilience is the capacity to cope with internal and external shocks;

We are strongly motivated by the Benjamin Franklin axiom that ‘an ounce of prevention is worth a pound of cure’.

In essence, we are seeking to be more forward-looking and proactive.

I endorse at the outset the regulatory structure in Australia, involving an independent central bank, and the ‘twin peaks’ of APRA and ASIC. We meet together with Treasury as the Council of Financial Regulators – a cooperative arrangement that has served Australia well through the crisis.

As a securities regulator, ASIC sees systemic risk as the risk of a major disruption to the flow of finance that threatens significant economic damage.

This encompasses disruptions to loans (credit intermediation) and to the issue of secondary trading in securities (debt and equity securities and their derivatives in capital markets).

The financial crisis in 2007 and 2008 was a clear case of excessive systemic risk leading to very severe financial instability and economic damage, both globally and locally across all regulatory boundaries.

The Council of Financial Regulators of course has been very focused on avoiding a recurrence.

There is still a lot to learn about systemic risk and the tools that can be used to promote financial stability, so we certainly encourage further research.

Systemic risk management and mitigation adds to financial system resilience and it is clearly important in delivering on ASIC’s three strategic objectives.

‘Mitigation’ is reducing the probability of a systemic risk event; and ‘management’ is strengthening the system so that a systemic risk event will inflict less damage. Both may be necessary, depending on the systemic threat.

I don’t want to set expectations too high. ASIC is not able to eliminate systemic risks by itself, not least because many systemic risks arise outside ASIC’s regulatory boundary – for instance, in banking or insurance or real estate or overseas. As a result, to be effective, what we do here will be done in cooperation and consultation with the RBA, APRA and Treasury. Even then, I have reservations about how successful we can be.

But first I will talk about actions taken by securities regulators since the crisis to be more on the front foot, to pro-actively identify, mitigate and manage systemic risk, both internationally and here in Australia.

Internationally

The International Organization of Securities Commissions (IOSCO), of which ASIC is a member, has adopted two new principles, one on mitigating systemic risk and the other on reviewing the regulatory perimeter.

First, 'the regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate':

- Such systemic risk may arise from the design, distribution or behaviour under stressed conditions of certain investment products, the activities or failure of a regulated entity, a market disruption, or the impairment or erosion of market integrity;
- therefore, regulators should pay particular regard to such factors as investor protection, market integrity and the proper conduct of business.

Second, 'the regulator should have or contribute to a process to review the perimeter of regulation regularly':

- The process can incorporate periodic and ad hoc reviews, and aim at determining whether the regulator's existing powers, structure and regulations are sufficient to meet potential emerging risks, as well as recommending any necessary changes;
- such reviews should consider whether innovations in financial products affect the scope of securities regulation, and whether the regulatory premises underlying any existing exemptions continue to be valid in the new circumstances.

All securities regulators will be reviewed, both by peers and by others such as the IMF, on their compliance with the requirements of these principles.

IOSCO members collectively have also engaged in considerable introspection, to learn lessons from the crisis and to work out how best to proceed. In February 2011 IOSCO published a discussion paper titled *Mitigating Systemic Risk: A Role for Securities Regulators*.

The main thinking in the paper is that:

- the crisis demonstrated the need for securities regulators to add monitoring and mitigation of systemic risks to their traditional responsibilities for maintaining fair and efficient markets and protecting retail investors;

- the nature of systemic risks in financial markets means that, while securities regulators can learn from the monitoring techniques used by central banks and prudential supervisors, they will have to develop their own approaches to identifying and monitoring these risks;
- securities regulators' traditional policy tools are appropriate for mitigating and monitoring systemic risks – but the necessary innovation for regulators will be to adopt a systemic risk perspective in choosing when and where to use them and when to go further.

The paper has been discussed internationally – with the Financial Stability Board, the Joint Forum, the Basel Committees, and the International Association of Insurance Supervisors – as well as amongst the membership of IOSCO.

IOSCO and its members (including ASIC) are very interested in any thoughts held by others on systemic risks that cross over into the securities regulators' regulatory perimeter. The dialogue will be an opportunity for all to learn.

For its part, IOSCO also has:

- established a Standing Committee on Risk and Research (so-called SC7 or SCRR) to bring together economists and researchers from member security regulators to assist in identifying systemic risks and other challenges; and
- set up its own – at this stage small – independent Research Unit.

ASIC has been and is active in supporting this IOSCO work on systemic risk.

Other countries are going through some extensive reforms to their financial regulatory structures, to address systemic risk – for instance the Dodd-Frank reforms in the US, which establish a Financial Stability Oversight Council, and major 'twin peak'-style reforms to the FSA in the UK, complete with a Financial Policy Committee focused on financial stability.

In Australia

In Australia there has been less need for major post-crisis reform of the regulatory arrangements. As I mentioned earlier, the Council of Financial Regulators has served Australians well.

At ASIC, we are taking systemic and other risks very seriously. We have to manage our risks pro-actively, using risk management principles, as we are resource-constrained. We do risk-based surveillances and focus on the highest impact risks. We use IOSO 3100.

Throughout my period with ASIC – both now as Chairman and previously as a Commissioner – we have been focusing on risk and risk-based approaches to our regulatory responsibilities.

One of the matters I have addressed has been the risks involved in contracts for difference (CFDs), which were not being adequately taken into account by product manufacturers, sales and distributors.

Our efforts are directed to ensure that people who are gatekeepers do help build confident and informed financial consumers and investors.

At this stage the CFD market in Australia is more a thematic risk and not a systemic risk, so this is a case where proactive steps may have reduced the chance of a systemic weakness arising.

ASIC itself is beginning to scrutinise thematic and systemic risk more closely. At my first Commission meeting as Chairman – in May – Commissioners approved a proposal to establish an Emerging Risk Committee.

A 2008 IMF report[*] regarding financial innovations that helped trigger the crisis found that 'regulation and supervision of these new instruments and techniques did not keep pace'. One aim of the Emerging Risk Committee will be to address innovations.

ASIC's Strategy group – Strategic Policy, International Strategy and Research (the Office of the Chief Economist – and members of other risk committees and those assessing the flow of complaints and intelligence, and the leaders of our stakeholder teams will focus as much as possible over the horizon on emerging thematic and systemic risks.

The Committee will meet monthly. In a year we will review the experience, to see if it has made any difference and if the effort should be revised or adapted. The issues identified will be ranked and the most important drawn to the attention of our partners on the Council of Financial Regulators.

In addition, we have been ensuring that thematic and systemic risks are taken into account by stakeholder teams in developing their annual business plans.

[*] IMF, *Global Financial Stability Report*, April 2008

Conclusion

Before the crisis, it may have been fair to accuse securities regulators of relying on the central banks and prudential regulators, on micro regulatory measures, and on the idealised workings of an efficient market, to contain systemic risk. The thrust of my talk today is intended to show you that we have learned lessons from the crisis and we are working – cooperatively – to improve the resilience of the financial system.

ASIC, like other securities regulators, cannot guarantee the elimination of systemic risk or such strengthening of the financial system that shocks cannot be systemic. As I mentioned before, the nature of innovation means that it is difficult for regulators to anticipate or even keep up with developments, and systemic risks can emerge very quickly.

Indeed, if ever the market thought there was a guarantee that financial stability would prevail, there would be a direct incitement to individual market players to gear up – creating the very systemic risks and threats to financial stability that the authorities were trying to contain.

Instead, in cooperation with their partners, the central banks and the prudential regulatory authorities, I hope you will find in future that securities regulators like ASIC will be more active in identifying, monitoring, measuring, mitigating and managing systemic risks and building the resilience of the system as a whole.

Thank you for your attention. I look forward to others' input.