Impacts of proposed regulatory reforms on unregulated or 'less-regulated' market segments (Panel 2) [1]

Opening remarks

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[1] These are personal views and do not necessarily reflect the views of ASIC.

The impacts of proposed regulatory reforms on unregulated or “less-regulated”

1 My brief comments to open this panel discussion deal with the “unregulated” or less regulated market segments.

2 These were securities and investments markets largely left alone by regulators before the Crisis with regulators relying on market disciplines rather than intervention - in contrast to exchange traded markets which were highly regulated.

3 So, 2 years or so post Crisis, where are we? What have we learned about these markets? I would like to make five points from the view of the only regulator on this panel – although one who was a poacher in another life and has now turned gamekeeper and whose views on free markets have evolved considerably!

My first point:

The securities and investments regulatory changes proposed by IOSCO for these so-called unregulated markets have been well-targeted. They responded to the problems which were immediately thrown up by the Crisis and did so in a way which balances market efficiency with improved investor protection.

4 Some of you may have come across the acronym **SARAH** as a summary of feelings when a Crisis happens. The acronym stands for Shock, Anger, Retribution, Acceptance and Help. For regulators the Crisis was a Shock. It brought with it Anger, possibly a need for Retribution. What was important, however, was to move past those to Acceptance and Help - and here IOSCO completed a number of pieces of work which have been important in dealing with the issues which arose in these so-called unregulated markets.

Let me expand:

5 IOSCO’s recommendations on **securitisation** were aimed at increasing transparency, retention of exposure (through skin in the game requirements), improved risk management and independence of service providers – all contributing to restoring confidence in these important markets.

6 IOSCO’s recommendations on **hedge funds** addressed market integrity and market stability concerns from the Crisis by making targeted recommendations to improve transparency to regulators (so we better understand hedge fund activity and the risks they pose) and investors (so they better understand the risks they pose) and to improve operational and risk management standards in the industry.

7 IOSCO's recommendations on **Credit Default Swaps (CDS) markets** and more broadly **OTC markets** were about addressing opacity in these markets and concerns about the reliability of price setting and settlement mechanisms**.** We aimed to encourage, for example, the use of well regulated central counterparties to clear standardised CDS contracts. Our current work with the Committee on Payments and Settlements (CPSS) is about outlining the elements of well designed and managed Central Counterparties (CCP's) and trade repositories for OTC derivatives.

8 Importantly, in carrying out this work IOSCO has been in close consultation with industry. For instance, our recommendations on securitisation took into account industry thinking outlined in the joint 2008 ASF, SIFMA, AuSF, ESF report on Restoring Confidence in Securitisation Markets. We continue to discuss our work with industry on securitisation, most recently in Sydney.

9 IOSCO has also been in close consultation with other bodies. An example is our work with the CPSS and the Basel Committee in developing a clear process to implement mandatory clearing and exchange for OTC derivatives regulation. Another is our work with the FSB about implementation of our recommendations on hedge funds and securitisation.

10 The principles IOSCO has set in these pieces of work provide a road map for domestic regulation and legislation. The changes themselves are intended to be measured. They deal with the problems which were identified and seek to balance efficiency and investor protection.

11 Credit for this goes to the membership of IOSCO and the task forces and standing committees which focused on the problems and the possible solutions.

My second point:

While IOSCO has been doing its work, other bodies have also been looking for solutions particularly to the prudential and accounting issues relevant to these so-called unregulated markets. As with IOSCO, their responses have been well targeted

12 Taking securitisation as an example:

- The Basel Committee has worked to strengthen capital and prudential requirements associated with securitisation.
- The Accounting Standards Setters have also been active with measures which will move many more securitisations on balance sheet.

13 These bodies have recognised the need for coordination. For example, 'skin in the game' in securitisation has different implications for the prudential regulators to securities regulators. The securities regulators like 'skin in the game' because more care will be taken by the originators and issuers, which is seen to benefit other investors. However, 'skin in the game' has implications for the capital that banks need to hold. It could cut across using securitisation to 'lay off' risk.

14 There has been a recognition of the need to look at the cumulative effect of these regulatory changes and how industry can come to grips with the cumulative effect of all changes from all these bodies.

15 The Joint Forum, which is a cross sectoral body working with the banking, insurance and securities sectors, has been working to to assess cross sectoral implications of these changes.

16 These other bodies, like IOSCO, have also sought broader industry input. These bodies, like IOSCO, have been focused on the problems and possible solutions.

My third point:

As regulators we must maintain our sense of urgency to have these changes made in each key jurisdiction. In other words, move from principles to implementation with a minimum of divergence – otherwise we will miss the opportunity for needed reform.

17 It is one thing to agree on principles at the IOSCO level and at the level of other international bodies. It is another to achieve reform and change through legislation in each jurisdiction.

18 Let me outline some of the challenges.

19 First, the challenge of maintaining a sense of urgency:

- Markets have been recovering and the real economy is improving. As momentum builds, there is less appetite and interest in radical change.
- The work of reform requires enormous detail to assess and minimise those elusive 'unintended consequences'. The principles-based approach at the international level has left a lot of important detail to be worked out. This takes time.

20 Secondly, the challenge of translating the principles into domestic laws:

- Each jurisdiction has quite legitimately reserved its right to implement the principles in the context of its own circumstances. Assessing national implications and getting them implemented (e.g. by legislation) takes time.

- The fragmentation in implementation by each jurisdiction also creates scope for different rules. These differences can lead to costs. Efficiency and the flow of global capital may be affected. An example where these differences were minimised is short selling, although even with a relatively simple set of rules, there is divergence at the national level. Less clear will be how the markets which are the subject of this panel will fare. Regulation of hedge funds is an example where (I am advised) there are differences in approach on either side of the Atlantic to capital standards and operational requirements..

21 Although a lot of work has been done, there is a way to go before we can provide clarity and certainty to the markets, and we need to maintain a sense of urgency.

My fourth point:

22 **Completion of the regulatory changes I have referred to will not be the end of the reform process. We also need to re-examine the conceptual framework which, until the Crisis, underpinned our approach to the regulation of the so-called unregulated or less regulated sector. The Crisis exposed problems with the assumptions on which this conceptual framework was built. We need to re-examine those assumptions and assess further changes which may be needed.**

23 Bodies such as IOSCO have quite rightly focused on the problems and responded to the Crisis – issue by issue or on an ad hoc basis if you like. Its work has avoided drawing broader implications on the need for regulatory reform – taking, if you like, a helicopter view.

24 The closest to this helicopter view was the IOSCO report on securitisation and CDS which outlined some early but limited thinking on broader implications for the unregulated markets.

25 In my view, regulation of these markets will not be complete until the conceptual framework is re-examined.

26 Put at its simplest the conceptual framework leading up to the Crisis was a deregulatory market-based mindset. That mindset was anchored in "efficient markets theories" and, over time, these theories became the conventional wisdom. Over time, the conventional wisdom was increasingly advocated

by governments, policy advisers, academics, financiers and the general public.

27 This mindset and theories spawned real business and financial applications: the growth and development of institutional funds management, securitisation, derivatives and other instruments and techniques to 'lay off' risk and improve investment returns. At its heart was the mindset that these markets worked best if left alone. The role of regulators was to use disclosure and to prohibit certain forms of conduct (e.g. insider trading) and let the markets do the rest. The economic prosperity of the 2000's was used as evidence that the theory and approach to regulation worked.

28 However, when tested against the problems which caused the Crisis, these theories have, in my view, been found wanting. Let me illustrate by looking at our pre-Crisis mindset:

- As regulators, we thought we could rely on markets to be self-stabilising within a reasonable period. The regulator's job was to keep out of the way – e.g. 'light touch regulation'. Regulators, after all, could impose unnecessary costs and barriers, promoting inefficiency. In the crisis, the market made a catastrophic error in underpricing risk, especially in credit. So markets, contrary to the self-stabilising assumption, showed they can be inefficient – e.g. driven by momentum trading rather than fundamentals.

- As regulators, we thought disclosure overcame information asymmetries and would deal with conflicts of interest. What this did not recognise was the power of misaligned incentives and agency conflicts – e.g. executive remuneration, CRAs and hedge funds. These were all underestimated.

- As regulators, we thought we could rely on market gatekeepers to uphold proper standards: gatekeepers such as credit rating agencies, valuers, accountants, auditors and advisory departments of the investment banks. Under the prevailing pro-market mindset, successful gatekeepers would uphold their standards in order to maintain their hard won reputations. Investors and issuers evidently thought the same. In that chain, we saw a point at which self interest from incentives outweighed reputation risk (e.g. with CRAs and investment banks). Our thinking was flawed.

- As regulators, we thought interconnections between markets and financial innovation generally added to welfare. Growth in the real economy benefitted from a low cost of capital, so innovations in financial markets came to be associated with low cost of capital and improving welfare. A good example is securitisation. The 'originate and distribute' model was developed to lay off risk by credit intermediaries and provided additional products for investors. But a point was reached and passed when this 'laying off of risk' had significant adverse consequences for investors. An investor in an asset backed security (ABS) CDO needed to read 30,000 pages to understand what they were investing in. For an investor in a CDO of ABS CDO (a CDO squared) the number of pages increased to one billion (Haldane 2009).

- As regulators, we believed that the behaviour of actors in the market is rational. This assumption of the collective wisdom of rationality was built on markets finding fundamental value and pricing for risk. Accidents could happen but the assumption was this would raise no systemic issue for securities and investments regulators. Prudential regulation handled the prudential risks and typically the central bank handled any systemic risks. Whereas in the airline industry, individual crashes are used to see if there are systemic safety issues, in the regulation of securities, accidents were seen as single events, necessary for the health of the system. Systemic risk in securities regulation is only just being recognised and developed and IOSCO now has it very much in focus.

29 The crisis has exposed quite fundamental flaws with the assumptions which were used and had become our conventional wisdom. Perhaps the key lesson has been that disclosure is necessary but often is not sufficient. In any event, there is enough evidence to now require a fundamental re-think of the flaws which underpinned these so-called unregulated markets.

My fifth point and final point:

When the conceptual review is complete, these so-called unregulated markets will no longer be known as unregulated markets. They will be very much regulated. As a guide they are likely to be regulated along the lines of those markets (like exchange traded markets) which fared better in the Crisis.

30 The conceptual review is likely to confirm that the changes which are already underway are needed. As well, it is likely to lead regulators to examine further regulation and place considerable weight on replicating those markets which fared better during the Crisis. These were:

- the exchange-traded markets;
- the markets (such as unlisted) regulated with strict disclosure regimes;
- gatekeepers (eg auditors) who were regulated; and
- derivatives markets which were cleared through, for example, CCPs.

31 The move in this direction is evident from:

- the work IOSCO has done in regulation of these markets; and
- examples of implementation in jurisdictions (for instance the most recent legislative action in the US clearly contains a significant regulation of these so-called unregulated markets).

32 Considerable debate will follow on just what these additional regulations could be. It is not clear at this stage.

33 Also considerable debate will ensue on whether this is good, bad, an overreaction or whether the trade off in better investor protection and efficiency will benefit those markets. Care, however, needs to be taken by those who advocate that this approach to regulation will be bad for the markets. Countries such as Canada and Australia who had more regulated markets fared better during the Crisis. Exchange traded markets and other regulated markets (including derivatives markets which centrally clear) fared better. Those advocating that regulated markets inhibit efficiency and increase cost of capital now have the onus of proof. Before the Crisis, the onus was on the regulators.

Conclusion

Let me conclude:

In short, the so-called unregulated or lightly regulated markets will need to be more actively regulated. The end game for them, in my view, will be similar to other regulated markets. This is so whether the markets are for retail or sophisticated investors. The debate so far has been on regulation of these markets to deal with the identified problems. All (including industry) agree on those problems.

What is more controversial is that these markets, if I am right about the need for a conceptual review, will be more heavily regulated than industry is used to and regulation industry may want as a response to the Crisis.

Coming back to the acronym which I started with, the securities regulators will want to avoid another SARAH (Shock, Anger, Retribution, Acceptance and Help). Instead they will want a new SARAH, one that stands for a System of Astute Regulations Addressing Hazards.

Thank you.