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Panel 1 - Future of the Financial Regulatory Framework

Role of market regulations and regulators

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In Pittsburgh the G20 set the goal of creating a new global framework for strong sustainable balanced growth.

How will this be achieved?

I would like to leave you with three thoughts today. The first is that effective market regulation is vital for global financial stability.

The second is that it is necessary to identify and understand emerging systemic risks in markets in a timely way and address them and the third is that strong political will is needed to implement global ideas nationally.

None of these are profound and yet the lack of comprehension of these ideas has been at the heart of the mistakes which led to the crisis.

Permit me to elaborate.

Markets Matter.

One of the major lessons of the crisis is that the effective regulation of systemically important institutions matters.

It is essential that the regulatory framework relating to them produces the right capital structures and drivers for behaviour. Our friends at the Basel Committee and Central Bankers are addressing this as we speak.

Equally important, but less recognized is the vital and complimentary need for effective regulation of markets. Market conduct and market infrastructure are the areas where the underlying behaviors that led to the crisis actually arose and the transmission mechanism for the risks, was of course, the market.

The conflicts of interest , the profligate lending, excessive leveraging, inappropriate valuations, overvalued securitisations, off balance sheet vehicles, extravagant compensation, all occurred in the area of market regulation, or the lack of it. These activities can lead to behaviors and mechanisms which have systemic implications. In other words institutions matter and markets matter for systemic stability.

The most perfect prudentially regulated institution will founder if the markets it operates in are excessively volatile and unruly.

Regulation of markets and regulation of systemically important institutions <u>both</u> matter. They are the virtuous twins of financial stability and both must be in place if we are to avoid the problems that led to the crisis.

The Financial Stability Board has been set up to operate at a global level, and similar Boards are being set up regionally. As at the FSB, these Boards need the voices of both the virtuous twins to operate successfully. Both voices need to be heard.

<u>Research is essential.</u>

The identification of emerging risks that are systemically important is essential if we are to have any chance of avoiding the mistakes of the past. To quote Andrew Lo, Professor at the Sloan School, MIT, recently in the Financial Times:

"Markets are neither always efficient nor always irrational, but are adaptive. During normal times prices can be trusted to reflect the wisdom of crowds. During times of distress investors act instinctively and emotionally and the wisdom of crowds becomes the madness of mob".

We also need to be adaptive. We need to be aware of the tipping points emerging and to look to interventions to prevent the madness of mob.

At our meeting yesterday IOSCO`s governing board, the Executive Committee made a very important, historic decision. It was decided to formulate a new stand alone, assessable principle on systemic risk.

While the mitigation of systemic risk has been traditionally seen as one of the three objectives of securities regulation along with promotion of orderly effective and fair markets and the protection of Investors and some individual principles have reflected elements of this; it was felt the time was now right to make it a clearly identified separate principle.

The financial crisis has focused us all on the importance of addressing systemic risk and the important role markets and market regulators can play in addressing this issue. The new IOSCO principle will focus on the need for market regulators to identify, assess and mitigate risks and threats within and potentially even beyond the current perimeter of regulation. It will also address the consideration of entities, regulated by market regulators whose failure may have systemic implications for the wider economy.

It is perhaps fitting that this important decision was made here in Basel, the home of our fellow international regulatory bodies, the Basel Committee, the International Association of Insurance Supervisors and the Financial Stability Board itself.

<u>Political will is key</u>

The recent meeting in Pittsburgh of the G20 Leaders also recognized the role securities markets regulators will need to play in developing new global approaches to identify and manage new market structures and products and identify areas of the markets which may harbour systemic risks.

The causes of the crisis were many and varied and the blame has been spread widely around.

Howard Davies gave a wonderful exposition of the causes of the crisis in New Zealand recently. It was called "*The financial crisis…who dunnit".* In this exposition he said:

"Now the initial shock is fading, so the Wall St Journal editorial pages have concluded that they were right all along, and that the problem was excessive government interference in the markets. Politicians on the left have decided that they were right all along, in believing that unbridled capitalism carried within it the seeds of its own destruction. The French have decided that it is the fault of the Anglo Saxons in New York, and especially London. The English have decided, with some justification, that the real villains of the piece were Scottish bankers. The Tories think the only villain is a Scottish Prime Minister. No doubt in New Zealand, there are those who blame all your economic ills on your Trans Tasman cousins. The Australians themselves, as is there wont, blame the Umpires. What do ordinary people think? Well, they seem to have a fairly balanced view. A British financial website shows a good distribution of responsibility, with all the main suspects named. Bankers take pride of place, and I would not wish to deny them that accolade"

Regulators have also taken their share of blame as well. I would like to suggest another culprit, lack of political will to regulate, even when it was suspected the entities and behaviors had systemic implications.

Just as the origin of the crisis lay in flawed assumptions about the self regulatory power of markets, it also lay in the lack of political will to regulate market conduct.

Now is the time for the G20 Leaders and others to demonstrate the necessary political will to ensure the global securities market standards, set by IOSCO are implemented in every jurisdiction in the world. They not only need to be implemented, but they should be audited or assessed for compliance and those assessments publicized.

This would ensure that each jurisdiction is totally transparent about the extent to which it complies with the global norms and it would enable investors to better gauge the risk of their investments in various countries.

These measures would require significant resources, but it's worth doing well and IOSCO is equipped with expertise to help.

The Future

The powerful notion of a global idea implemented nationally is the key to the future. A networked world of strong fully implemented international standards will be critical to ward off the next crisis. There has been considerable success with this already.

A quiet revolution of substantial proportions has been going on amongst the most unlikely partners worldwide. The IOSCO MOU which is a global idea implemented nationally has had traction right across the world. By 1 January 2010 almost every IOSCO member - covering more than 95 percent of the worlds capital markets - will have signed on to this information sharing agreement. We can count on the fingers of one hand the countries that are yet to apply to sign on.

Global capital needs global regulation and enforcement and a critical piece of infrastructure to allow that to happen is now in place.

In 2005 when we set ourselves the goal of every member jurisdiction signing the MOU we had no idea that the global financial crisis was ahead of us, had we known we would have realized even more intensely the urgency and necessity of it. Some commentators thought it an "heroic" goal at the time but despite the cynics we have achieved it exactly at the time the world needs it most!

In summary markets matter to system stability, we need to better understand market behaviour and emerging risks which may have systemic implications and we need strong political will to implement and audit standards around the globe to ensure a network of effectively regulated markets. Only then will we be able to achieve the goal articulated in Pittsburgh of a new global financial framework for strong sustainable balanced growth.

Thank you