Preparing Securities Markets for the Future: Opportunities and Risks

Keynote speech by Tajinder Singh, Deputy Secretary General of the International Organization of Securities Commissions, at the 27th Annual Conference of the International Investment Funds Association

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Let me begin by thanking the IIFA and ICI Global for this kind invitation to IOSCO. The remarks that follow, however, are personal and do not bind IOSCO in any way.

Allow me to mention a few words about IOSCO. IOSCO is the standard setting body for securities regulation with about 200 members of whom more than 120 are regulators. But, as I will mention later, IOSCO is not just about setting standards; it is also about helping members, the majority of whom are emerging markets, in capacity building; it is also about monitoring implementation; and it is about looking at emerging risks. IOSCO's objectives are investor protection, fair, efficient and transparent markets and reduction of systemic risk.

I would like to share with you today the following: the present economic context, especially for securities markets, and the opportunities and risks for securities markets going forward; what are the three most important conditions for market based financing; and how they apply to the funds management sector.

Present environment

The present environment is an unprecedented one in terms of challenges, and the pace and scope of global regulatory reform. It is also one of great opportunities for securities markets. The markets IOSCO's members regulate are becoming increasingly important for the real economy. Even this year's Nobel Prize for Economics was awarded for research on the way markets work!

Credit institutions face higher capital requirements, constraining their ability to lend. The public sector is itself weighed down by high levels of debt (and in some cases, fighting the debt ceiling!) The world is moving inevitably towards a more market-based financing model. Strong, transparent and appropriately regulated securities markets are therefore essential for the sound functioning of the global economy and efforts to drive its recovery.

Let me mention **eight notable trends in securities markets**:

1. ***Bank lending to the real economy has been decreasing due to*** new regulatory initiatives requiring banks to hold more capital. The situation in Europe is especially stark with lending 50% below the 2009 levels.

2. ***Corporate reliance on securities markets has been increasing despite volatility:*** For example, the $2.2 trillion in bank loans that was raised in the US and Europe in 2012 was approximately **half the amount raised through equity and bond markets**. In the US, initial and public offerings of equity have generally trended upwards (increase of 25% since 2007). Outside of the US, offerings have been subject to volatility or declining. In terms of corporate debt issuance, US activity has recovered, and is expected to be up 20% in 2013 compared to 2008. Asian corporate debt issuance is on the ascent, specifically from China, as is the rise in Islamic bond (Sukuk) financing. However, European corporate debt issuances have not recovered since the large fall in 2008. Alternative funding vehicles also are important sources of capital, many of which are not subject to regulatory oversight in certain jurisdictions. Examples include supply-chain financing, crowd funding and peer-to-peer lending markets.

3. ***There is also reliance on securities markets for bank funding:*** The bank funding model relies, in part, on access to securities markets. In addition, securitised products and covered bonds continue to provide reliable funding for banks. For example, securitised products respectively reached almost $600 billion and $350 billion (covered bonds included) in the US and Europe.

4. ***Equity markets and fragmentation:*** Equity markets have experienced significant price appreciation over the last year. Fragmentation across trading venues and the participation of dark pools has increased in many jurisdictions.

5. ***High yield bond markets:*** The low interest rate environment has allowed firms to issue debt at historically low rates. The market for high yield bond issuances has increased fivefold from $90 billion in 2008 to $450 billion in 2012. Asian bond markets have been particularly active in 2013, likely due to increasing appetite for foreign investors in advanced economies seeking to enhance their yield.

6. ***Commodity markets:*** Commodities have become increasingly important for securities markets as many financial products are linked to or based on commodity prices and indices, including, among others, futures, mutual funds, structured retail products and exchange-traded funds (ETFs).

7. ***Changes in OTC derivatives markets:*** Since the crisis, global regulation has caused OTC derivatives markets to undergo important changes. The notional amount outstanding in OTC derivatives grew between 2007 and 2012 by 8% to $633 trillion and derivatives cleared have increased steeply to $173 trillion. The developments vary widely per asset class and per clearing institution. In terms of reform progress, trade reporting is most advanced with close to 100% of gross notional outstanding amounts in both interest rate and credit derivatives being reported to trade repositories (TR),

even though regulatory requirements for trade reporting have not come into effect in all the G20 jurisdictions. The next developed area is central clearing, especially of interest rate and credit derivatives, with around 53% of interest rate derivatives being centrally cleared of those offered for clearing, and with the corresponding figure for credit derivatives being about 40%.

8. ***Capital flows in emerging markets:*** Capital flows into Emerging Markets have increased substantially since the financial crisis. Increased flows combined with less developed financial markets have resulted in high relative valuations in some EMEs.

Increased role of securities markets

Coming back to the issue of growth in an environment with constrained credit ability, it is clear that securities markets will play an important role in financing the economy. This means that the economy will be increasingly dependent on market based financing. The question then is what are the necessary conditions for market based financing to work and for markets to perform their function in promoting growth and jobs? In my opinion, the single most important condition needed is that there should be Trust: i.e. trust in the system has to be rebuilt.

Restoring Trust: Making the system safer

One important pre-condition to rebuilding trust is that the systems and framework in which markets operate should be safe and should be seen to be safe. Some estimates say that crisis has caused a loss of 15% to global GDP, increased unemployment, with the social fabric being stretched in many European countries. The effect has been widespread and deep in terms of public finances and on the common man. In fact, there is an increasingly important aspect of the effects of the financial crisis, especially the sovereign debt crisis, on human rights which includes the right to development. There is a perception that while wrong doers in the financial crisis have largely gone unpunished, the burden of both the crisis and the policy responses has fallen disproportionately on those least responsible for the crisis and least able to bear its impacts, especially the most vulnerable and marginalized groups. Of course, apart from the impact on the public sector and the citizens, the crisis has also affected the profits of the private sector. It is therefore incumbent on all of us collectively to reduce the probability and impact of systemic risk and financial crisis.

The global regulatory reform effort has been so far led by the G20 with the Financial Stability Board (FSB) having the responsibility for enhanced global regulatory coordination. The key pillars of this work are:

- Building resilient financial institutions, with measures for institutions identified as Globally systemically important financial institutions or G-SIFIs (one of the fall-outs of the crisis has been a proliferation of acronyms: G SIFIs, G SIBs, NBNISIFIs…)
- Regulating shadow banking
- Ending “Too Big to Fail” through Resolvability of systemically important institutions
- OTC Derivatives reforms
- Timely and consistent implementation

IOSCO has been working in this area of making the financial system safer and reducing the probability of financial crises through its work on: OTC derivatives, Financial Markets Infrastructure (CCPs, TRs, CSDs, SSSs) including their recovery and resolution; client assets protection; shadow banking, having issued recommendations for the regulation of MMFs and securitization; Dark pools and HFT; financial benchmarks; non-bank SIFIs; and CRAs, to name a few.

Making the system safer: IOSCO's focus on emerging risks and Research

While reduction of systemic risk has always been one of IOSCO objectives, we have recently increased our emphasis on systemic risk. In fact, IOSCO established two new core principles 3 years ago on systemic risk and the regulatory perimeter. We are now more forward looking, and pro-actively seek to identify emerging risks through the working of all of our committees, which include the Committee on Emerging Risks, the Growth and Emerging Markets Committee, our policy committees, the Regional Committees and the Affiliate Members Consultative Committee of which ICI Global, but others in this conference as well, are members. We have produced our **first Securities Markets Risk Outlook** which looks at risks from the point of view of securities markets. It identifies four main risks to from the point of view of securities markets:

Risks associated with the low interest rate environment and search for yield including a return of structural leverage investments, such as CLOs and leveraged REITs.

Risks associated with collateral management in a stressed funding environment because of capital requirements that mandate banks' holding of high-quality collateral and increased reliance by banks on secured funding, need for high-quality collateral to meet initial and variation margin requirements for OTC trades. In response, banks may use alternative and sometimes innovative practices for providing high-quality collateral like collateral transformation and optimisation services as well as repo and re-hypothecation. These transactions are executed in the securities markets.

Risks in the OTC derivatives space: Over the Counter (OTC) derivatives markets have undergone significant reform since the financial crisis. A major element of this reform involves the mandatory clearing of derivative contracts through central counterparties (CCPs). CCPs are designed to reduce systemic risk in the derivatives market by reducing counterparty risk, but this can cause more of the risk burden to be borne by clearing brokers. Shifting risk from bilateral OTC contracts to a single point of infrastructure is a challenging balancing act. There are three important issues:

- *The effect of competition among CCPs on collateral.*
- *Shared risk management model across CCPs.*
- *Interconnection with the banking system.*

Risks associated with reversal of capital flows to Emerging Markets: Emerging Market Economies have experienced significant capital inflows in the post-crisis period. Historically, EME capital inflows were derived from foreign direct investment and bank lending. This trend has changed in the post-crisis period where portfolio equity investment, debt securities and non-bank lending make up a greater fraction of total capital flows. This raises the concern that sectors where inflows were concentrated may experience a sudden drop in valuation if capital flows were to reverse even if the country's economic fundamentals did not deteriorate.

We have also produced a staff working paper on the risks of cybercrime on trading venues and are working on the areas of crowd funding and bond market liquidity. One important issue that we face is data gaps as it is still difficult to get the information on many entities, products and markets. This is an area that can greatly benefit from a collaborative effort between industry and the regulators and IOSCO is keen to help with this important aspect.

Restoring Trust: investor protection and education, corporate governance and enforcement

In addition to rebuilding trust in the safety and soundness of the financial system from a macroprudential point of view, there is another key aspect: which is to regain the trust of the investors. It is important that the investor can feel confident and that he or she will not be cheated. This calls for increased efforts at investor protection, and that is also core IOSCO work. We have worked on investor education; on disclosure at the Point of Sale; and on investor suitability for complex financial products. We also have an investor alerts system that puts out these alerts very frequently on the basis of information received from various jurisdictions. Disclosure is a very important and fundamental tool of securities regulation, one which has long been in the toolkit of securities regulators and is now being increasingly relied on in other areas as well: note the use of disclosure in transparency of bank stress testing and in the area of OTC derivatives. The disclosure at the point of sale is such an important area that IOSCO's work on Point of Sale Disclosure for CIS is now being taken forward by the Joint Forum which is looking at the application of PoS disclosure for other areas including in banking and insurance. IOSCO has meanwhile strengthened its efforts in this area by setting up a new Committee on Retail Investors headed by Howard Wetston from OSC and Leonardo Gomes from the CVM Brazil. Investor education and financial literacy is an important part of IOSCO's work, which we aim to further intensify with stakeholder support. While we continue to believe strongly in disclosure, we are also looking at areas where disclosure itself might not be enough. We are looking at aspects of behavioural economics for instance, on which we had a very interesting Board Roundtable in our June Board meeting.

While talking about behaviour, another important aspect is the crucial need to change behaviour, ethics and incentives in firms: the importance of corporate governance reform in firms, deterrent sanctions regimes and remuneration discipline. Enforcement and sanctions are important aspect of IOSCO's work. In this context, the IOSCO MMOU is an important tool and is the pre-eminent global standard for cooperation relating to enforcement matters. We have close to 100 MMoU signatories now over 2000 instances of exchange of information last year. It is a really significant cross-border instrument with tough entry conditions as even banking secrecy laws are not allowed to be an obstacle. In an increasingly globalized market, the MMoU makes it difficult for perpetrators of securities market violation to escape. I can mention here that the MMOU was also put to good use in the LIBOR scandal investigations.

Allowing markets to function in a globalized environment: the need for international initiatives

What I have said so far is that to enable market based financing of the economy to happen, it is important to restore trust in the financial system through measures concerned with systemic safety; and those concerned with investor protection and behaviour of firms: in other words, both macroprudential and microprudential measures. But there is another important aspect: we have to allow markets to function!

Here I would like to relate a brief anecdote: When I was undergoing training at the Academy for the Indian Administrative Service, I had to learn, among other things, a curious skill: horse riding! While no doubt a vestige of the colonial rule in India, the story that goes around is that an Indian Prime Minister had said that if a District Magistrate cannot control a horse, how can he or she control a District?! While the Hon'ble Prime Minister may or may not have said that, what I learnt first-hand is that a horse needs to be controlled or regulated, but not so tightly that it cannot or will not want to walk, much less canter or gallop. Similarly, market participants have to know the rules of the game, what is acceptable behaviour and what is not, and no doubt have to be regulated so that they act within the norms of good behaviour. However, markets will need to function and risks will need to be taken: the need is for risk optimization and not risk minimization.

We also need to look close and hard at what aspects of what is called “shadow banking” should be discouraged and what aspects should be encouraged – though in a well-conducted and sensible manner- in line with the current recognition of the need for market based financing. Securitization is one such area where IOSCO is planning to work along with the BCBS and IAIS so that this economically important activity can happen in a sensible way. In the context of the on-going regulatory thinking and reforms, it is also important to realize that everything in the financial sector does not need to be viewed and regulated as a bank. We are talking of different business models here. A bank, as one esteemed bank supervisor said, is a huge “confidence trick” at the end of the day. It is an inherently unstable financial institution which has to be propped up by measures that give the appearance of stability. This is not necessarily the same for other areas, e.g., traditional insurance or many traditional securities markets activities. This is not to say that we should not be conscious of the risks in these areas. Indeed we are acutely conscious and are examining these issues carefully. But the important thing is not to paint everything with the same brush- the “bank brush”. There is at the same time the need to be able to recognize that different aspects of regulatory reforms interact with each other and therefore there is a need for economic impact analysis in looking at the totality of reforms.

The issue of Long Term Investment Financing, including SME financing, is clearly becoming important in this context. The development of capital markets, instruments and products will need to be carefully examined to address this concern. IOSCO will be working on this issue especially through its GEM Committee in greater detail in the coming days.

Another area that is increasingly becoming crucial is cross border and extraterritoriality issues. These issues are clearly not easy. Markets are clearly more and more global; on the other hand, sovereignty, legislative mandates and mandates of regulators are national. We are trying to deal with this through the processes of mutual recognition and substituted compliance and there have been some encouraging steps in that direction. IOSCO has taken the initiative to set up a Cross Border Task Force chaired by Ashley Alder from the Hong Kong SFC and Anne Lachat from the Swiss FINMA that will analyse these issues and come out with a toolbox of measures.

And this is the situation as it exists today. It can be argued that we have a relatively "simple" world today, since there are only a few big markets. So, if we were to construct a matrix of big markets and big issues, we would have, let's say, a five by five matrix. However, we are also seeing that emerging markets are growing in market development, size and confidence. Brazil, India, China, Indonesia, Singapore, Hong Kong, Russia, Turkey and Mexico to name a few will have much bigger markets than today. Indeed, securities markets are already important in these countries and provide 60% of total financing for the BRICS, similar to the U.S. IOSCO has a major role to provide technical assistance to help its Members develop their securities markets on the basis of sound IOSCO standards and principles and is stepping up its Capacity Building Efforts and has very recently set up a Capacity Building Resources Committee.

With the passage of time, therefore, it is but logical that the number of important capital markets will grow. But if we add in another 10 big capital markets, or more, in the near future and with an expanding range of issues, the matrix of big markets and interpretations would become 15 by 15, or more. This looks too complex to be solved through the current informal method of a series of bilateral understandings. This will also certainly bring much higher frictional costs for businesses which would need to face multiple sets of regulatory rules. What we therefore need is a global institutional framework, probably established by International Treaty that has some enforcement authority, binding disputes settlement and sanctioning possibilities. This is something that will of course take a long time, but it is important for the thinking to start on this now. In the meanwhile, this issue brings us to the importance of international standard setting in a globalized market environment. Bodies like IOSCO, BCBS and IAIS, among others, go through a difficult but ultimately rewarding process when they set standards through a process of consultation of members and also of the industry. Governance processes of these bodies encourage implementation even in the absence of a global enforcement mechanism because our members realize the importance of such implementation. Internationally, peer reviews and FSAPs are being conducted to monitor consistent implementation. IOSCO has set up an Assessment Committee for monitoring implementation as part of the global effort and which undertakes thematic and country peer reviews.

It is of course paramount for international standard setting work to identify issues quickly and pro-actively and for our members to counsel patience inside their jurisdictions to national law and rule making authorities in the interest of the greatest global good. We have recently seen some good examples of this process, in terms of the global standards being set by IOSCO for the Financial Benchmarks, and the global standards on margin requirements for non-cleared derivatives by IOSCO and BCBS, to name a couple of recent examples. It is important for the international standard setting processes to be supported because, in the near term, that is the best solution to disjointed national rule making that can result in frictional losses and regulatory arbitrage. It is also important for international standard setting to be coordinated and prioritized, with the very large number of on-going work streams and international bodies. It is also important to ramp up regulatory and supervisory cooperation, and IOSCO is looking at an approach similar to its successful MMOU for supervisory cooperation.

Implications for the Investment Funds Sector:

Coming now to the implications for the investment funds sector, all of what I have said so far applies fully to the funds sector. The importance of capital markets is very well reflected in the growing importance of the investment funds. Worldwide mutual funds today constitute 36 trillion USD in assets and this sector gets about 1 trillion USD of new money every year. North America of course continues to be the biggest region by AUM size (56%) followed by Europe (31%), Asia Pacific (12%) and Africa 1%. However, new funds and fund flows are being led by Asia, especially Japan and emerging markets are receiving larger flows in both equity and bond funds. Globally Money Market Funds continue to be important, at around 5 trillion USD and Exchange Traded Funds at around 2 trillion USD. Hedge Funds are also significant in size at 2.5 trillion USD. Mutual Funds are also becoming central to management of retirement savings. In many jurisdictions, mutual funds are one of the key vehicles for democratizing capital markets and getting retail investors participation. The issue of advice and payment for such advice to investors, together with suitability, is a key issue.

As far as investment funds are concerned, in terms of making the system safe, IOSCO has worked on the area of systemic importance of Money Market Funds and come out with principles for the regulation of Money Market Funds. We have also issued recommendations for the regulation of Exchange Traded Funds; principles for Liquidity Risk Management for Collective Investment Schemes; Valuation of CIS and Suspension of redemptions. We are working with the FSB on the important area of “Other Shadow Banking entities” and on Non-Bank Non Insurance Systemically Important Financial Institutions (NBNI SIFIs), which, of course, includes the asset management sector including Hedge Funds. We carried out a

Hedge Funds survey and published the report on the Hedge Funds survey yesterday (21 October).

With regard to the sector specific issues of asset management in terms of their systemic importance, while funds can be susceptible to runs, we are conscious of the difference between the asset management sector and the banking sector:

Funds contain a specific shock absorber feature that differentiates them from banks: From a purely systemic perspective, funds contain a specific shock absorber feature that differentiates them from banks since fund shareholders are investors who absorb the effects that might be triggered by the distress or even the default of a fund, thereby mitigating the eventual contagion through the counterparty and market channels on the broader financial system. Fund investors bear both upside rewards and downside risks from movements in the value of the underlying assets. Bank depositors, on the other hand, are not in the same position and generally do not bear risk.

Separation of Fund Assets: The assets of a fund are separate and distinct from those of the fund manager and of any other client of the manager that receives investment management services from the same manager. Also, the assets of a fund are not available to claims by general creditors of the fund manager.

The risks, of course, come through the counterparty and market channels, especially herd behaviour, correlation and reputational risk as well as risks linked to leveraged and inverse ETFs. Asset managers are also important participants in financial transactions such as securities lending, repos, collateral swaps and derivatives. Large asset managers are also becoming more involved in non-traditional asset management activities such as market making. Although currently small, these activities could become significant in the future due to banking sector disintermediation.

In terms of specific investor protection measures with regard to funds, we have issued principles for the Point of Sale Disclosure for CIS; suitability obligations for complex financial products; and valuation of CIS, among others.

On the issue of corporate governance, some funds acting as institutional investors have shown that they can call for greater accountability of the Board and CEO/ Chairman especially with regard to risk management, and we welcome that.

As I mentioned earlier, we are very conscious that markets need to function, and of the role of funds in the economy. Therefore, while looking at safety of the system and investor protection, we will look at the role of funds in financing the real economy and indeed the increased role that they can play in long term investment financing.

To sum up:

Market based financing is going to be increasingly important going forward. For this to happen, however, we will need to look at three important issues: making the system safe; regaining trust of investors through investor protection, proper corporate governance and enforcement; and at the same time allowing markets to function in a globalized environment for the greater good of the citizens. The role of international standard setting bodies like IOSCO is crucial in a globalized world, so that globally harmonized rules can be adopted by jurisdictions, minimizing frictional losses and regulatory arbitrage.

Thank you for your attention.