International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valores
Organización Internacional de Comisiones de Valores

09 June 2010

Opening Ceremony
35th IOSCO Annual Conference
Montreal

The Future of Financial Regulation and Emerging Markets

9 June 2010

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SP07-10

In the last 24 months we have been shocked by a ground breaking crisis. Several pre conceived views and ideas have been challenged by reality.

It is now commonsense to say that emerging markets are no longer what they used to be. They now constitute the primary driver for economic growth and have become major players in financial markets. While this has been recognized with the constitution of the G-20 and the Financial Stability Board, the complexity and heterogeneity of emerging markets and economies will still require some more effort in terms of the inclusion of various jurisdictions in the international financial and economic debate. IOSCO is once again in the forefront of that effort with its new strategic direction.

But the crisis has not only shifted power to emerging markets, it has also challenged thoughts and ideas about how individuals, markets and the economy work. Fully assessing this is one of the most difficult and challenging tasks at this time for having regulation that promotes safer financial markets without hampering socially useful innovation.

Risks in financial markets have been shown to be less evident than what we thought. Risk transfer mechanisms we thought we understood work only imperfectly and the aggregation of individual risks is an extremely tricky task.

Indeed, risks of particular instruments, risks in particular markets and systemic risk, are much closer previously thought. And that means that securities regulators need to review their role with regard to financial stability and systemic risk as background.

This, of course, does not mean that we should compete with Central Banks or prudential regulators. The lesson we need to take from this exercise is that the functioning of financial markets, its regulations, the market segments we do not regulate, its supervision, the products that are designed and distributed, the products that are not regulated, the way financial products are traded, the expectations investors have, the information disclosed that affect such process of expectations creation, all of these have far from obvious systemic risk implications.

Beyond conventional policy tools such as interest rate changes, Central Banks have shown they are open to using various types of unconventional policy tools when facing extreme circumstances. Those unconventional policy tools remain either in the realm of money supply management, such as *quantitative easing*, or in that of banking regulation, *such as risk based capital requirements*.

But as financial markets also showed their capacity to destabilize an economy, we found ourselves with limited policy instruments available. In part this is due to the fact that for most financial regulators financial stability and systemic risk was not perceived to be under their remit. But it is.

Therefore we need to find policy instruments beyond the conventional limits of traditional financial regulation. The crisis illustrates we need *unconventional* policy tools but we have no clear views of which those instruments are, when and how should they be applied. We eventually know that markets are often driven by *animal spirits* or by irrational exuberance and while sometimes that can be due to factors external to markets, such as a too expansionary monetary policy, we have learnt in recent years that human rationality assumptions embedded in neoclassical economic theory is largely to strict. We need an exercise in humility and must recognize various limitations to individual's rationality, as it has been discussed by the growing body of literature in behavioural finance.

Now, markets can be driven by individuals, such as aggressive CEO's or successful traders, but more often markets are driven by corporations of different sizes and natures. Therefore, our discussions and considerations of rationality should not be bound to individuals but to

corporations, how do they process information, how do they take decisions, which balance of power do they have. In short, we need to review our thoughts on *corporate governance*.

Indeed, to some extent one can say that this crisis was the outcome of massive corporate governance failure: credit rating agencies and audit firms that did not manage well their conflicts of interests, institutional investors that invested in instruments they did not well understand.

I would like to add to this list that we need to take proper care of the governance of regulatory bodies themselves. Let me refer to this point briefly. During the nineties, several countries around the globe made important reforms to improve the institutional status of Central Banks, in particular giving them some more autonomy with respect to the political cycle. In the case of financial regulation the very important discussion so far is devoted to architecture and perimeter but not so much on governance and autonomy. I believe we need more autonomy from the political cycle, matched with increased accountability and sound political representation, but also better conditions to deal with from regulated industries themselves.

We would make a mistake if we believe that ideology or political pressures will not be around our work in the future as they have been in the past. The challenge is to make ideology and political pressures as transparent as possible and as accountable as feasible. And the same applies to industrial pressures. I hope that in the next couple of years we shall see a significant strengthening of the conditions under which regulatory activity develops.

Finally, what we thought were conventional good practices have been challenged by the crisis as well. In the Emerging Markets Committee we have been working over the last two years on trying to identify best practices in key markets. I would like to stress two projects undertaken by EMC task forces.

One concerns OTC markets. This task force was chaired by Turkey and discussed all relevant issues concerning OTC markets in the context of jurisdictions belonging to the EMC. And, eventually not surprisingly, the report finds that good practices exist concerning issues such as standardization of OTC products, registration of OTC products and on exchange trading, all issues that are at the centre of the discussion in the international arena. This report was approved for publication and will be sent as a contribution to the Financial Stability Board.

The second report concerns securitization. I am personally convinced about the convenience of securitization. The task force, co chaired by India and Mexico and with the technical support of the IMF, while not ready yet, has found very interesting results such as that in emerging markets jurisdictions retention practices are common in 70% of the surveyed countries. This means that the alignment of interests of originators was better.

While it may be true that eventually some of these regulations and practices in emerging markets may have prevented those markets from growing as spectacularly as in some

developed jurisdictions, nothing says that the size of those markets was the optimal from the social point of view.

Fellow regulators, the crisis started in developed markets and spread to our markets by various channels. It appears as if it has receded, but there are risks ahead, we better have our eyes wide open and continue working hard in making our regulations better and better.