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28 September 2010

**Institute of Chartered Accountants
of Sri Lanka (ICASL) Members**

Colombo, Sri Lanka

Systemic Risk and Regulation in the post crisis era

28 September 2010

Speech by

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SP11-10

It is a real pleasure for me to be here in Colombo to address this gathering of ICASL members. I have been asked this evening to discuss some recent international thinking on systemic risks and regulation in the post crisis era.

The global financial crisis of 2007-09 cast a very long shadow indeed, and we are still feeling the chill. It resulted in enormous losses of wealth, depreciation in asset values, collapses in financial institutions, bail-outs of banks and other institutions, huge increases in sovereign debt, and significant pain for people in many parts of the world.



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Before the crisis, few European investors and market participants had any idea that the mis-selling of a mortgage product to an unemployed person in the suburbs of Chicago could impact on their economic futures and that of those around them.

It could, and it did. We discovered to our chagrin that disruption in one market was capable of causing major disruptions in other, apparently remote markets, and that markets would not self-regulate.

The crisis revealed the relentless interconnectedness of the world's securities markets and that markets would not self-regulate. For many of us, this amounted to a massive loss of innocence. One we are only just beginning to come to terms with.

To speak of *innocence* is, of course, to call to mind its antonym, *guilt*. There's no denying that some people were indeed guilty of contributing to the debacle, and that thousands of others were their victims.

I don't want to underplay the greed, negligence and downright criminality of some major players pre-crisis. Nor the suffering of those who lost so much that their lives will never be the same again.

What I do want to say is that, as the defining economic event of our generation, the global financial crisis can and is giving momentum to new ways of thinking about the interplay of markets, economic policy and securities regulatory policy.

I'd like to tell you about this paradigm shift, and its implications for policy and regulation, at the national and international levels.

The failure of the old thinking

Historically, systemic risk was understood to concentrate in financial institutions such as banks.

We thought that, so long as the prudential regulators whose remit these institutions were, did their job, the financial system would remain healthy and continue to deliver sustained economic growth and welfare. We thought that the self-interest that drove markets meant markets would discipline and take care of themselves.

The crisis demonstrated that this belief was woefully wrong-headed.

Most informed observers – including former US Federal Reserve chairman Alan Greenspan – now agree that the orthodox faith in market disciplines to regulate markets was misplaced. The crisis revealed to policy makers, investors and regulators the limitations of this traditional, pre-crisis wisdom on financial stability and systemic risk.



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At least one writer¹ in the financial field has pointed out how language – and particularly, metaphorical models – shapes not only what we think but, more crucially, how we act. In the financial, as well as in other fields, some metaphors are distinctly more useful than others.

Financial system models remained for a long time grounded in 17th century physics, 19th century biology, and engineering redolent of the age of railways. These models rarely incorporated the more sophisticated vision that has long since held sway in quantum physics and ecology, and, more recently, in the internet.

Unconsciously relying on Newtonian physics as a model, we tended to see the financial world and its regulation as a machine or as a mechanistic system of interlinkages.

Politics and the media, financial market practitioners, and stakeholders themselves used – and still use – the language appropriate to this model. Because it unthinkingly reflects mechanistic images, though, it shapes actions which I and many others believe are no longer appropriate to the 21st century.

The 20th century was the century of structural solutions. By the end of it, some of those post-World War II constructs were looking outdated. The global financial crisis proved once and for all that they were.

The new “network” thinking

The 21st century is likely to be the century of networked solutions. These take account of the fact that markets are now global because technology has made them so. Capital moves around the world at the click of a mouse.

ASIC chief economist Alex Erskine notes that old, established ways of thinking about economic, prudential and securities regulatory policy partly caused the crisis and need to be rethought.

“To now rebuild without rethinking,” he says, “would expose the financial system in the future to a repeat of the crisis just passed”.

Thinkers like the Bank of England’s financial stability guru Andrew Haldane point out that seizures in electricity grids, the collapse of ecosystems, the spread of epidemics and the disintegration of the financial system are all branches of the same network family tree.

So a more holistic perspective is replacing the old mechanistic view. This new perspective is drawn from fields such as biology, ecology and epidemiology, which explore complex networks.

¹ Richard B Wagner, “Financial Metaphors: Mechanic, Organic or ...?”, *Financial Advisor Magazine*
<http://www.fa-mag.com/component/content/article/686.html?issue=31&magazineID=1&Itemid=27>



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The crucial feature of the new perspective is that it doesn't merely see a network's nodes – such as financial institutions – as sustaining the network on their own. The connections between the nodes – the markets, and the capital flows they embody – are also vital.

What this view strongly suggests is that prudential regulation of institutions alone is never enough to avoid systemic risk in global markets. Market regulation matters too.

The new thinking is that effective prudential regulation of institutions and effective regulation of market conduct comprise the “virtuous twins” of financial stability. Both are equally important in properly managing systemic risks, and recognition of this fact is a new springboard for action for the world's financial policy makers.

Implications of the new thinking for regulation

The crisis was certainly a catastrophe, but it revealed a previously un-apprehended truth about the role of market regulation in enhancing financial stability.

The concept of stability implies dynamic activity rather than static structure, something demanding a balancing act from all participants and stakeholders. It implies a system whose components are constantly in interaction, requiring the tending and encouragement more appropriate to an organism than to a machine.

Supplementing prudential regulation with a deeper understanding of capital flows will yield new insights into potential systemic risks. This understanding will in turn suggest new tools with which to promote financial stability by more effectively regulating conduct in financial markets.

The new tools

In the past, there has been little sampling of network links. Some data on the degree of linkage between financial firms exists, but it is usually partial, not often timely, and focused on institutions.

Commentators like Haldane suggest that better data collection, analysis and communication is vital to mapping and understanding the health of the network.

Stress-testing this money flow will allow us to assess network resilience much more effectively than merely monitoring institutions.

Once gathered, this information will need to be shared between market participants, regulators and policy makers in order to understand markets, look for systemic risks and enhance stability.



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Global cooperation

The signs are that independent regulatory jurisdictions around the world are willing to cooperate at this level. In contrast to many other international fields, financial regulators have already forged a productive and energetic community through the International Organisation of Securities Commissions (IOSCO), whose executive committee I have the privilege of chairing.

Many organisations lay claim to the adjective *international*. IOSCO, though, with its 119 jurisdictional members, really has a global reach. It grew from a network of individual jurisdictions, and embodies an understanding of network models. One of its main objectives is to promote financial stability, and particularly stability in markets.

IOSCO is the ideal forum in which to develop new ideas, tools and regulatory approaches. Important before the crisis, since then, IOSCO's role has become pivotal. A number of key decisions have made it so, and I'd like to tell you about three.

Ninety-seven percent of IOSCO's members have now signed a ground-breaking information-sharing agreement. This allows market regulators to track across national boundaries those who breach national regulations. This level of international cooperation gives transgressors fewer places to hide. It is an important addition to the armoury of national regulatory bodies.

Just this year, IOSCO established a research function to analyse risks across markets. It decided this research would focus on risk assessment and project management support, and, in particular, produce risk outlooks, exploratory analysis, impact assessments and data analysis.

Also this year, the organisation approved eight new principles of securities market regulation for member jurisdictions. The principles address several areas that the global financial crisis revealed as influencing systemic risk: hedge funds, credit-rating agencies, and included issues of auditor independence and oversight.

Two principles addressed the regulation of systemic risk itself. The new research function will help IOSCO develop more refined tools to enable members to focus on these two important new principles relating to systemic risk.

The updated principles affirm the importance of market regulation as one half of the "virtuous twins" I referred to earlier. They are an expression of the new understanding of stability in financial markets. They encourage policy makers to work with independent market regulators to rethink the old wisdom that financial stability would be created and maintained institution by institution.



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Conclusion

The crisis made it painfully obvious that the old notion of self-regulating markets delivering continuous growth was a fiction. The facts are otherwise. The evidence of global market connectedness and the relationship of self-interested parties acting rationally require us to rethink our approach to systemic risk in markets.

While market players' self-interest may be rational, in some cases this self-interest endangers the system as a whole. Consideration must, therefore, be given to limiting this self-interest so that, in John Bogle's words, it "does not get out of hand".²

The reality is that capital is global and therefore systemic risk in capital markets demands a global solution.

Gone are the days when we can hide behind the defence of domestic political realities. Perceived conflicts between the global and the local can no longer be cited as an excuse for avoiding the necessity of implementing global standards around the world.

Imagine how an environmentalist would laugh if you suggested that what individual countries did or did not do was nobody else's business. We should be similarly derisive about the same notion applied to securities market regulation.

The immediate post-crisis world presents us with an opportunity to redefine economic policy making. If policy makers are ready to seize this opportunity, they will find a global community of well-prepared market regulators, willing and eager to be partners in an enterprise that will benefit us all.

Thank you

² John Bogle, "Financial Reform: Will It Forestall a Future Crisis of Ethic Proportions?", *The Financial Fix*, http://www.huffingtonpost.com/john-c-bogle/financial-reform-will-it_b_656043.html