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**The Australian APEC Study Centre
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***Enhancing Financial Policy and Regulatory Cooperation –
Responses to the Global Financial Crisis***

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Good afternoon. I am glad to have this opportunity to address a symposium whose remit is to look at regulation in its regional and global context. One that gives us a chance to promote regulatory reforms across financial market sectors and international borders.

This is unquestionably the way of the future.

As the symposium's background paper¹ states, the global financial crisis left policymakers

¹ Kevin Davis, *Regulatory Reform Post the Global Financial Crisis: An Overview*, commissioned for the Regional Symposium: Enhancing Financial Policy and Regulatory Cooperation – Responses to the Global Financial Crisis, Melbourne, 8-9th March 2011.



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facing a dilemma. The dominant pre-crisis paradigm focused on the efficiency of free markets in regulating themselves, checked only by minimal regulation designed to counter inefficiencies caused by externalities and imperfect information.

Yet we know, post-crisis, that this paradigm was dangerously faulty; that future policy and regulation must be founded on a more helpful model of the financial system.

The background paper notes that some commentators, while recognising regulatory failings, point to the ideological dominance of the “free markets paradigm” as a major cause of the global financial crisis.

I am happy to identify myself as one of them, and I’d like to devote this address to:

- outlining what the crisis taught us about the old paradigm;
- the rethinking of a new paradigm; and
- the work going on, particularly through the International Organisation of Securities Commissions (IOSCO), to implement a more accurate and useful model of the financial system.

That last word – *system* – holds the key to the new thinking.

The symposium’s background paper acknowledges² the new network model. My contribution today will be to focus on how this model can lead to a better understanding of various other factors the background paper covers.

Recognition of systemic risk is vital; it has implications that policymakers and decision-makers simply can’t afford to ignore. It is also the common thread among the three major lessons the global financial crisis has taught us.

The lessons of the crisis

The cascade of events that were the global financial crisis was a vivid demonstration of the old thinking’s failure.

The crisis swept through financial markets, leading to enormous losses of wealth, depreciation in asset values, collapses in financial institutions, bail-outs of banks and other institutions, large increases in sovereign debt and significant pain for people in many parts of the world.

We *must* learn these lessons if we are not to invite recurring crises.

1. Markets matter

Before the crisis many believed that, so long as we regulated institutions such as banks,

² p13 *ibid.*



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markets would regulate themselves by means of self-interest alone.

Our understanding of systemic risk focused on financial institutions, which were seen as the remit of prudential regulators.

This view took too little, if any, account of the growth of disintermediation, whereby businesses access capital-market funding from outside the traditional banking framework. The burgeoning of the shadow banking system and of unregulated markets went largely ignored by regulators and policy makers.

What we know now is that securities market regulation *and* prudential management of institutions are the virtuous twins of financial stability and healthy economies. *Both* must be in place if markets are not to collapse in disarray.

2. Global markets are vitally interconnected

The crisis was a dramatic illustration of a 21st-century fact of life – that national borders are meaningless when it comes to capital flow.

Money moves around the world at the click of a mouse. Disruption in one market can, and often does, cause instant, major disruptions in other, apparently remote, markets.

Before the crisis, few investors and market participants in Europe or the UK would have imagined that the mis-selling of a mortgage product to an unemployed person in the suburbs of Chicago would impact on their economic futures and that of those around them.

Today's markets are indisputably global; for better or worse, technology has made them so.

3. Governance and sustainability matter

It was individuals acting rationally in their own short-term self-interest that brought global markets to their knees. Their practices – although more often than not driven by a sense of duty to shareholders – were unsustainable in the longer term.

They threatened the entire system, and that, of course, included the very shareholders such practices were intended to benefit.

The third lesson of the crisis, then, is that good corporate governance is essential to a stable securities market. This is why John Bogle,³ one of my colleagues on the Financial Crisis Advisory Group, characterised it as a "crisis of ethic proportions".

A contemporary understanding of ethics must, I believe, incorporate the principle of sustainability; must include it in the formulation and practice of good corporate governance. Governance should cover *every* aspect of how a company behaves.

³ John C Bogle, "A Crisis of Ethic Proportions", *The Wall Street Journal*, 21 April 2009, available at <http://online.wsj.com/article/SB124027114694536997.html>



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The global financial crisis amounted to a vast body of evidence that the old conceptual models failed to serve us. The implications of these three lessons go deep and wide.

Above all, they point to the centrality of the need to be aware of and address systemic risk.

The centrality of systemic risk

Writing as early as 2003, Richard B Wagener⁴ said that contemporary financial system metaphors were mechanistic, and thus failed to accurately reflect the 21st-century behaviour of money.

A paper written by ASIC Chief Economist Alex Erskine⁵ after the global financial crisis struck notes that established ways of thinking about economic policy, prudential policy and securities regulatory policy contributed to the crisis and need to be rethought.

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

Bank of England Executive Director of Financial Stability Andrew Haldane⁶ is also a thought leader.

He suggests that the financial network became progressively more complex and less diverse. In just about every non-financial field, from ecology to engineering, genetics to geology, this would have set alarm bells ringing – complexity plus homogeneity does not spell stability, it spells fragility.

Haldane draws analogies between the complex adapted network of financial markets – “a cat’s cradle of interconnections” – and other complex systems. He points out that degradation of ecosystems, the spread of epidemics and the disintegration of the financial system are each branches of the same network family tree.

On the basis of network analysis and examples from epidemiology, he argues that the incentive to generate and propagate risks in the financial sector may have been strongest amongst those posing the greatest systemic threat.

He asks whether the network structure of international finance can be altered to improve network robustness. Answering that question is a mighty task for the current generation of

⁴ “Financial Metaphors: Mechanic, Organic or ...?”, *Financial Advisor*, March 2003, available at www.financialadvisormagazine.com/component/content/article/686.html?issue=31&magazineid=1&itemid=27&id%3d1%26itemid%3d27/

⁵ *Rethinking Securities Regulation after the Crisis: An Economics Perspective*, 9 July 2010, available at [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/RethinkingSecuritiesRegulation-20100709.pdf/\\$file/RethinkingSecuritiesRegulation-20100709.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/RethinkingSecuritiesRegulation-20100709.pdf/$file/RethinkingSecuritiesRegulation-20100709.pdf)

⁶ “Rethinking the Financial Network”, speech delivered April 2009, available at www.bankofengland.co.uk/publications/speeches/2009/speech386.pdf



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policymakers and suggests that it might be useful to take network resilience as a metric of success.

Other thinkers confirm Haldane's view.

Applying the network model to finance refocuses our attention from static institutions to constantly interacting market dynamics; to the links between commodities markets, energy markets, carbon markets and the broader financial markets.

The network model highlights the basic fact that good systemic health is vital to us all, and that we cannot afford to let it take second place to individual, short-term desires. This is why that sustainability is now as crucial an aspect of good governance in the financial field as it is in the environmental.

Narrowly focused, individual profit-seeking must not be allowed to threaten the system itself. This is not mere virtue; it is necessity. Without the system that supports them, individuals cannot survive.

The new network model suggests that anything and everything related to markets and their governance, regulation, financial reporting, accounting and auditing must be globally oriented. It shows there must be curbs on market behaviour so that, as John Bogle puts it, "self interest doesn't get out of hand".

I believe that conceptualising the global financial system as a network provides us with an excellent opportunity for understanding systemic risk in markets and for developing regulatory tools for identifying, assessing and managing them.

The imperatives are, firstly, to answer the urgent need for data collection about the system and how money flows through it, and develop useful ways of interpreting it; secondly, to develop regulatory tools for protecting the system.

IOSCO work

IOSCO is well down the road of an ambitious post-crisis work programme to address these global needs. It is at the cutting edge of the new thinking and its application to regulating securities markets.

The organisation covers more than 95% of the world's capital markets, and includes the major capital markets of Europe, the Americas and Asia. Australia and New Zealand are both members, and I have the privilege of chairing its Executive Committee.

Over the last decade, IOSCO has transformed itself from a network of securities regulators setting aspirational standards, to a lynchpin in the global financial architecture. It is recognised as the global securities-markets standards-setter by the G20, the IMF and the World Bank, along with the Basel Committee on Banking and the International Association of Insurance Supervisors. It has two seats on the G20's Financial Stability Board (FSB).



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It is embarked on a massive programme of overhauling securities markets standards. The G20 has mandated implementation of all of these standards in G20 countries, and, in the wake of the global financial crisis, required their global auditing.

Issues its work plan is addressing include:

- fleshing out the concept of systemic risk as it applies to markets;
- developing concrete measures for monitoring systemic risk;
- looking over the border of the current regulatory landscape into territory previously unregulated or under-regulated, such as credit-rating agencies, hedge funds, dark pools, high-frequency trading and complex products, and setting standards for these areas;
- looking at the interface between conduct and prudential regulators; and
- enhancing cross-border supervision.

In Montreal last year, IOSCO approved eight new principles of securities markets regulation. They cover areas highlighted by the global financial crisis, including hedge funds, credit rating agencies and auditor independence and oversight.

Crucially, two of these principles address systemic risks in markets. One requires regulators to have or contribute to a process of monitoring, mitigating and managing systemic risk. The other requires regulators to regularly review the perimeter of regulation.

In no way do these two new principles derogate from the responsibilities of prudential regulators to focus their energies on the appropriate management of systemic risk in institutions. Rather, they recognise the reality that the virtuous twins of financial stability are effective prudential regulation *and* effective market regulation.

Recognising the need for data, IOSCO has created a research arm that will focus on risk assessment and project management support. It will produce risk outlooks, exploratory analysis, impact assessments and data analysis.

Securities regulators have traditionally focused on transparency and disclosure. Last year, however, IOSCO set up its Working Group on Systemic Risk to examine the role of securities regulators in monitoring and managing this risk.

The group's discussion paper was released just last week.⁷

Securities regulators and systemic risk

The paper, entitled *Mitigating Systemic Risk: A Role for Securities Regulators*, clearly states IOSCO's belief that promoting financial stability is a responsibility to be shared throughout the regulatory community. It aims to promote discussion among regulators on the ways

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The Technical Committee of IOSCO, *Mitigating Systemic Risk: A Role for Securities Regulators*, Discussion Paper ORO1-11, February 2011, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf>



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systemic risk comes under their mandates.

Thus it begins the process of developing a methodology for identifying, analysing, monitoring and mitigating systemic risk, and promoting financial system stability. This will entail securities regulators working towards:

- expanding their supervisory role so it enhances market transparency and disclosure;
- gaining a better understanding of financial innovation – one that appreciates its potential risks and finds a balance between unrestrained innovation and overregulation;
- devoting more internal resources to monitoring market developments and identifying emerging risks; and
- engaging with other national and international regulators and supervisors, such as prudential regulators, central banks and self-regulatory organisations, to produce a more robust, coordinated framework for promoting financial system stability.

The tools that the discussion paper suggests securities regulators consider using include:

- measures to improve transparency;
- business conduct rules;
- organisational, prudential and governance requirements;
- emergency powers.

Disclosure and transparency are critical for identifying emerging systemic risk. These are also what arm regulators for addressing it. Also necessary, then, is robust regulatory supervision of business conduct essential for managing conflicts of interest and the build-up of undesirable incentive structures within the financial system.

The paper urges securities regulators to focus on financial innovation and its implications for financial stability. Finally, it highlights the need for regulators to cooperate in understanding market vulnerabilities and the interconnections between the financial sector and the real economy.

The paper develops IOSCO's basic belief that securities regulators can and should play a key role in addressing systemic risk. To do this, they need to incorporate the goal of reducing systemic risk into their everyday tasks and processes.

Each IOSCO member will determine its response to this imperative – one based on its own mandate and domestic regulatory structure, as well as the size and characteristics of its securities market.

Individual regulators will need to judge the scale of their response. They will need to develop their own risk indicators in the form of both qualitative information (gained by general market surveillance, review of products and securities offerings, and business conduct oversight) and quantitative data (micro- and macro-level indicators).



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They will also need to judge the extent to which they can leverage, rather than duplicate, the work of other members of the regulatory community, particularly by sharing information, combining expertise and coordinating action through such bodies as the FSB, the Basel Committee and the International Association of Insurance Supervisors, as well as IOSCO itself.

To support this intensified focus, IOSCO has established a Standing Committee on Risk and Research. It will be led by Carlos Tavares, the Chairman of the Portuguese Securities Commission, and it will coordinate members' monitoring of potential emerging systemic risks within securities markets.

Support will be provided by the new Research Unit I have already mentioned.

Conclusion

The old ways of thinking about the financial system allowed – even encouraged – it to fail.

By developing a new model that bears striking similarities to the environmental model we all take for granted, we can see that what matters is nurturing – not exploiting – the system. Allowing the system to prosper, rather than encouraging individuals to prosper at the expense of the system, and eventually, everyone else.

The new paradigm compels us to take a broader, longer-term view of what constitutes success.

It requires courage, insight and sensitivity from regulators, participants and policymakers. It can be extremely difficult to know when to take the punchbowl away from the party. One is often called upon to do so at the point when all the guests are having a particularly good time. It helps enormously if the guests understand the necessity for doing so.

On the other hand, taken away it must be if the party is not to get rowdily out of hand.

To identify trends that may pose systemic risks to markets, we must view them through the right lens. Our conceptual models shape our actions.

Armed with network theory and concepts from behavioural economics, and applying mathematical techniques used elsewhere in modern markets, policymakers and regulators have a far better chance than before of spotting trends. A better chance, therefore, of intervening before the system tips into chaos.

Thank you.