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Lessons Learnt and Global Responses to the Financial Crisis

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I. Introduction

1. Good morning, ladies and gentlemen. I would like to thank Securities & Derivatives Industry Association (SDIA) for inviting me to speak at this forum to some of the most prominent market leaders of the Australian financial industry. A gathering like this presents the opportunity for a healthy debate and exchange on the key challenges the world faces today.

2. We are in the midst of challenging times. An economic crisis typically marks a sharp break with the past. It serves as a wake-up call to people that they cannot continue to do what they did in the past. Whilst it may be painful as we stand to witness the familiar world that we know falls apart, the very chaos presents once-in-a-life-time opportunity to witness the reform of the global economic and financial system on a scale not seen since the Second World War.

3. The heat of the crisis has melted resistance to change and provides the momentum to push through reforms which would appear extreme in better times. I hope that the global financial system would emerge better and stronger after it goes through this painful but much needed correction.

4. Today I would like to talk a bit about the failings we have identified in the financial systems from this crisis and the various international responses to restore market confidence and growth. But before I embark on that discussion, I would like to set the stage by bringing us back to the collapse of Lehman Brothers – or as I like to call it, the point of no return.

II. From subprime crisis to financial tsunami

5. The filing of bankruptcy of Lehman Brothers in September 2008 came as a shock to everyone. The contemporaneous belief at the time was that Lehman Brothers was by far too big to fail and that the US government would definitely do whatever it takes to keep it alive, especially after its earlier rescue of Bear Stearns. The unexpected collapse became a tipping point for the eventual meltdown of global financial institutions as it triggered a default on its debt. This caused the oldest US money market fund to "break the buck" (fall below par). Investors panicked when they were confronted with the unthinkable:

   - Money market funds which have the reputation of being as secure as bank deposits and an important source of funding for banks can fail and investors can lose their principal.

- Financial institutions that they thought to be systemically important could be allowed to fail.

6. The loss of confidence and heightened fears of counterparty risk led to the freezing up of the wholesale money market. The outcome was a shut-down of the inter-bank money market and corporations were unable to roll over funding from the commercial paper market to meet their operational needs.

7. The world saw the end of the independent investment banks in the US, and the voluntary change of Morgan Stanley and Goldman Sachs into bank holding companies. Institutions such as AIG were rescued by unprecedented government support. Washington Mutual became the largest bank failure in US history.

8. Several banks in Europe faced collapse and were rescued by their governments. Globally, stock markets lost more than US$25 trillion in early October 2008 from the peak in October 2007. Russia, Iceland, Indonesia, Peru, Romania, Ukraine and Austria suspended trading on their stock markets.

9. The collapse of Lehman Brothers exposed how interconnected, and hence vulnerable the global financial system is to a meltdown if one major player that is systematically important were to go under.

III. The failings uncovered by the crisis

10. So, what went wrong with the financial markets? I would put them under four broad categories:

    - Risk management
    - Incentive structures
    - Issuer model of securitised products
    - Pro-cyclical rules and regulations

Risk Management

11. The widespread use of similar valuation models in risk management undermined the statistical independence on which such models were premised. Market players making the same observations acted to enter or exit a particular sector at the same time. This has increased the tendency for markets to behave in a herd-like manner and unfortunately sending the herd off the cliff edge.

12. Such price-sensitive models were built to work under normal market conditions. However, in a buoyant economic environment the model tends to underestimate risks and conversely, during an economic downturn risks are over-estimated. Under stormy

market conditions, the models would reinforce the selling pressure into a downward spiral.

13. The sophisticated risk metrics failed to assess risk appropriately. The stability and prosperity in financial markets led to complacency among financial institutions and an unhealthy reliance on the robustness of these models. The use of complicated maths to manage risks provided false comfort to top management and boards that they failed to exercise judgement over the risks being taken.

Incentive Structures

14. One factor that contributed to the financial crisis is the compensation practices of large financial institutions. The compensation structure of financial institutions have created perverse incentives for staff to take on higher short term risks to generate higher revenues and profits, without due regard to the longer-term risks and sustainability of profits to justify the risk. Bonuses are rewarded on the basis of current revenues and profits and not spread over the years of the transaction. Taking on higher risk assures higher rewards. The golden handshake granted to top executives in loss-making financial institutions has been severely criticised.

15. Such perverse compensation structure encouraged excessive risk-taking that posed severe threats to the global financial system and firms found themselves unable to absorb the excess losses as risks materialised.

16. The rapid growth of the ‘shadow banking’ system undermined the soundness of the financial system, as banks set up SIVs (structured investment vehicles) and conduits to conduct financial intermediation without the cost of regulation. This was made possible by regulatory loopholes that regarded these vehicles as off-balance sheet entities which were not subject to regulatory capital and liquidity requirements, compliance and disclosure requirements and supervision. These entities were highly leveraged, relying on short term funding to invest in longer term illiquid securities. In reality, the regulated financial institutions remained exposed to the risks of these vehicles either through sponsorships or backstop contingency credit lines.

Issuer Model of Securitised Products

17. Investors, in the last decade or so, had a ferocious appetite for yield. This demand was met by a wave of financial innovation such as the “originate-and-distribute” model that underpinned the success of the financial institutions and the tremendous growth of the subprime housing market. As financial institutions do not retain the risks in their books, they have no incentive to ensure or monitor that borrowers have the capacity to repay. This has enabled financial institutions to generate profitable revenue streams without due regard to the creditworthiness of the borrowers. Unfortunately, this undercurrent was either not identified or not taken into consideration by the credit rating agencies at the time.

Pro-cyclicality of rules and regulations

18. Bank capital requirements tend to be procyclical, requiring banks to maintain lower capital in boom times and higher capital during downturns. These requirements seem

rational at first glance, but in actual fact they tend to encourage greater risk-taking as asset prices increase, and to deleverage in an effort to shrink balance sheets as capital requirements increase as market conditions worsen. In the current environment, banks are cutting back on lending and this has caused a sharp slowdown in economic activity.

19. The wisdom of accounting rules on fair valuation is also being questioned. They have come under spotlight for its role in exacerbating the stress for financial institutions. How does one establish fair values in the absence of active market trading and uniform valuation techniques for structured financial products? Such valuation rule may force assets into a downward spiral and over-estimate the ultimate losses but in the meantime impair balance sheets and increase recapitalisation needs. The procyclical nature of valuation is also a concern during good times, as overly optimistic valuations elevate prices and increase risk-taking.

IV. The international response to rebuild confidence and restore growth

20. The financial crisis has challenged the existing regulatory approaches. Assumptions of effective market discipline and 'market is rational and self-correcting' are being questioned. We now know that market discipline has proven to be ineffective; markets are not always self-correcting and people are not rational. And even financial innovation once regarded as a virtue has rapidly lost its allure.

21. The G-20 Leaders Summit is the culmination of the global response to the crisis, and it has called on national authorities and policymakers to battle the crisis on three fronts: first, stabilising and ensuring the continued functioning of financial markets; second, stimulating the economy to counter the recession and third, fixing the regulation of financial system.

22. National authorities realise that their national framework for financial regulation is inadequate to cope with a global problem. Global efforts are required. A lot of international efforts have been expended to identify the weaknesses and gaps in regulation and recommend measures to straighten out and strengthen the regulatory framework.

23. At the government level, the Leaders of the G-20 met in London on 2 April and pledged to do whatever is necessary to:

- restore confidence, growth, and jobs;
- repair the financial system to restore lending;
- strengthen financial regulation to rebuild trust;
- fund and reform the international financial institutions to overcome this crisis and prevent future ones;
- promote global trade and investment and reject protectionism, to underpin prosperity; and
- build an inclusive, green, and sustainable recovery.

24. The Leaders also issued a Declaration on *Strengthening the Financial System* that sets out details on the commitments in the Leaders Statement which include:

- reshaping our regulatory systems so that our authorities are able to identify and take account of macro-prudential risks;
- extending regulation and oversight to all systemically important financial institutions, instruments and markets, including hedge funds;
- to endorse and implement the Financial Stability Forum's new principles on sound compensation practices; and
- extending regulatory oversight and registration to CRAs to ensure they meet the international code of good practice.

25. International Organisation of Securities Commissions (IOSCO) has set up three Task Forces to consider the following issues: short selling; unregulated financial markets and products; and unregulated financial entities.

Short selling

26. As I am the chair of the Short Selling Task Force, I would like to take this opportunity to mention in some detail about the work of that Task Force. Short selling has been demonised to be responsible for the stock market carnage during the turmoil. This led to national authorities in Australia, the US and UK to impose temporary measures to ban or restrict short selling in mid-September 2008. Subsequently, some Asian markets including Japan and Korea also introduced similar measures. These bans had since been lifted including Australia which ended its ban earlier this week.

27. Temporary measures were also introduced to enhance transparency of short sales/positions which would give investors more information (on over-pricing) as well as provide information to regulators so that they can act more effectively and appropriately during times of financial disruption.

28. In this connection I should probably point out that Hong Kong had not taken any drastic measures in banning short selling activities back when market volatilities and uncertainties were surging. This was partly because Hong Kong had learnt a painful lesson from the Asian financial crisis in 1997 and as a result had already had a very robust short selling regime in place, including the tick rule and other pre-borrowing requirements. In addition, market statistics had indicated that short selling activities were not particularly strong or attributable to the collapse in the market. It was simply a situation where there was a total loss in confidence and everyone would prefer to hold cash.

29. Against this setting, the Task Force was mandated to develop high-level principles for the effective regulation of short selling with an objective of achieving a more consistent regulatory approach to short selling internationally. It is important to understand that short selling, per se, is not a problem. Short selling plays an important role for market efficiency. It provides pricing efficiency, provides liquidity and is necessary for a number of bona fide trading strategies and products. However, under extreme market

conditions, the use of short selling in combination with certain abusive strategies, may bring chaos to the markets.

30. The Task Force recommended four high-level principles for the effective regulation of short selling. In light of the temporary measures to restrict short selling to stabilise markets, the G20 has taken a keen interest in the work of this Task Force. The G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (WG2) has actually recommended endorsing the four principles and urged securities regulators to adapt their short selling regimes accordingly. It has also advised that IOSCO consider adding detail to the principles.

31. As you probably know, the market consultation on these four principles has just been concluded. I am glad to say that the four principles have survived the "litmus test" of public consultation. The market is very supportive of the four principles. The market also would like to see more specific guidelines on the second principle which has to do with short selling reporting, which I would elaborate a bit more here.

32. Disclosure of information and transparency are important for market discipline as well as for regulatory supervision. But asking firms to produce massive amounts of information can be just as ineffective as asking for too little. We also need to ensure that the disclosed information is accurate, informative and useful. The challenge is setting the right balance. This requires taking into consideration the different and competing interests, the reasonableness of the requirements in the context of recent experiences, and the dearth of information on short selling activities.

33. Short selling reporting is a 'greenfield' area where its regulation in many markets is being debated. Global market operators have to cope with 20 different reporting requirements if they are operating in 20 different markets. So, it is understandable that there is a demand from the market for more guidelines and greater convergence in this area. There is also a case to be made that a concerted and consistent approach to disclosure on a global basis would bring substantial benefit to strengthening market discipline and regulatory oversight. Short selling reporting is potentially an area for further work for IOSCO to consider.

Hedge Funds

34. The G20 Leaders agreed that the scope of financial supervision should be broadened. All systemically important financial institutions, markets and instruments which include for the first time, systemically important hedge funds, should be subject to an appropriate degree of regulation and oversight.

35. This is an interesting reaction to say the least, because there is little evidence that hedge funds had played a significant role in the current financial crisis. But regulators have generally been uncomfortable with hedge funds largely due to the lack of transparency of these funds. The lack of understanding and information translated to concerns of the risks that the hedge funds may pose for the stability of the financial system.

36. IOSCO Task Force on Unregulated Financial Entities has just closed its consultation on Hedge Funds Oversight. The consultation covers issues including the approach to

registration/authorisation of hedge fund managers and their ongoing supervision, direct regulation at the fund level (including ongoing information requirements), and the development of industry best practice.

37. There are also initiatives in the major markets to introduce new regulations for hedge funds. Regulators in the US and Europe now require hedge fund managers to be registered and the activities of the funds be more transparent through regular reporting. Prudential requirements may also be imposed if the funds are systemically important. In this regard, Hong Kong has already required all fund managers to be registered with the SFC regardless of the size of the funds they manage.

OTC Derivatives

38. The other area that the G20 Leaders recommended to extend regulatory oversight is the OTC derivatives market. The size of the OTC derivatives market has been estimated to be valued at $680,000 billion, a large part of which is opaque to regulators. A rapidly growing segment of this market, CDS or credit default swaps, has been blamed for exacerbating the financial crisis, as they had posed a real and present danger to bringing down AIG, and the financial system, if AIG had been allowed to fail.

39. The US has recently announced regulatory reform measures for OTC derivatives. The reform is designed to achieve four broad objectives:

- preventing activities within the OTC markets from posing risk to the financial system;
- promoting efficiency and transparency with the OTC markets;
- preventing market manipulation and market abuses; and
- ensuring OTC derivatives are not marketed inappropriately.

40. Internationally, there are initiatives to require all standardized OTC derivatives to be cleared through regulated central counterparties and for the central counterparties to be subject to a robust regime of prudential supervision and regulation. IOSCO's Task Force on Unregulated Markets and Products has issued a Consultation Report for public comment until 15 June. The focus of the Report is on securitization and CDS.

Pay and Compensation

41. The G20 Leaders have agreed to implement the principles on pay and compensation developed by the FSF in significant financial institutions to ensure compensation structures are consistent with firms' long-term goals and prudent risk taking. At this stage, it remains unclear how national authorities will implement these principles. Regulators in some markets have ruled out setting specific limits for compensation. That seems sensible. It is not for the regulators to say how much the executives should be paid. The regulatory approach would be to focus more on principles to make sure that compensation structure align executives' pay with companies' long-term performance.

CRAs

42. The G20 Leaders' agreement is that all Credit Rating Agencies (CRAs) whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration by end 2009. The regulatory regime should be consistent with the IOSCO Code of Conduct Fundamentals and national authorities will have powers to enforce compliance.

43. Following the G20 recommendation, the SEC has just held a roundtable discussion to examine oversight of CRAs. The European Parliament has approved legislation that sets up an obligation for all CRAs wishing to operate in the EU to register and comply with a set of rules.

44. In the wake of the crisis, IOSCO amended the Code of Conduct for Credit Rating Agencies (CRAs) to address issues which have emerged during the turmoil in relation to the integrity of the ratings for structured finance products, the methodology used and the CRAs' management of conflicts of interests.

45. For supervision of globally-active CRAs, a model examination module has been developed for the use, as appropriate, by those IOSCO members that regulate and inspect CRAs. This model will help create a common understanding of the types of information that regulators around the world might find useful when inspecting a CRA against regulatory requirements based on the IOSCO CRA Code. IOSCO is now exploring the use of supervisory colleges and/or bilateral cooperation arrangements as tools for international cooperation in oversight of CRAs.

V. Concluding remarks

46. It has been more than a year since the subprime crisis erupted. This crisis has taught us painful but valuable lessons. First, we learnt that regulatory framework has lagged behind market developments. Institutions operate well beyond national boundaries and markets are closely interconnected. The national framework for financial regulation is clearly incapable of governing a global financial system. Governance must be more globalised.

47. Second, we rediscovered the old truth. Risks can be easily and conveniently forgotten, especially when we take comfort from all sorts of models. The recipe of a crisis is like a recipe for baking a cake. The cake may look different but still require the few essential ingredients for baking. The underlying causes of crisis are the same - availability of cheap and easy credit, lax controls, weak internal ethics and inappropriate incentive structures.

48. Third, the stability of markets is dependent on the different stakeholders acting in a responsible manner. The market is only as strong as the weakest link in the system. This calls for the collective exercise of self-discipline, market discipline and regulatory discipline by the respective stakeholders. The discipline works like a three-legged stool; it would not stand if one leg is missing.

49. This crisis has brought a closer cooperation between national authorities to work at national and international levels to take necessary measures to rebuild confidence in the global financial system and restore growth.

50. Recently, there have been reports that there are emerging “green shoots” of recovery. The steps taken by the US and the European countries to stress test banks and addressing the banks’ asset quality problems and capital shortfalls are encouraging. Some others have proposed far more pessimistic views, including Nobel Laureate Paul Krugman, who once said that global economies are only getting worse more slowly. While there has been much discussion and uncertainty about the road to recovery whether it will be a V-shaped, L-shaped or W-shaped, there is one thing for sure – it is not an easy path to recovery.

51. The current global crisis makes a very compelling case for more regulation but over-regulation could back-fire too. Going forward, the challenge for regulators is to strike an appropriate balance between stability and efficiency, as they consider the proposals and initiatives to strengthen the national and international financial architecture.

52. Thank you.