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ASIA SECURITIES FORUM (HOSTED BY AFMA)

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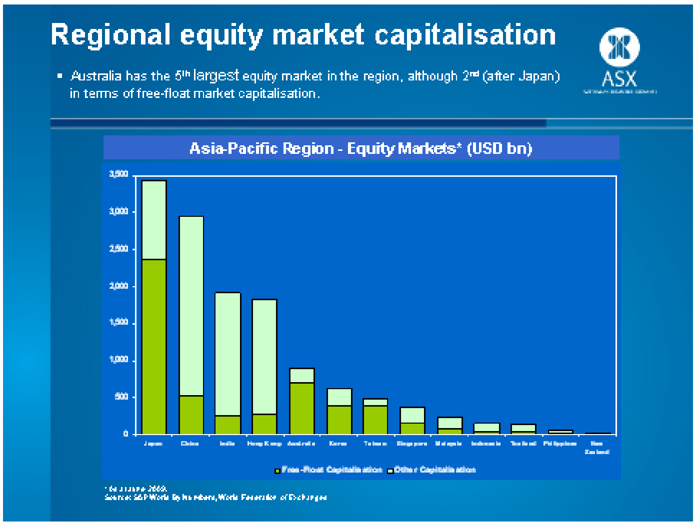
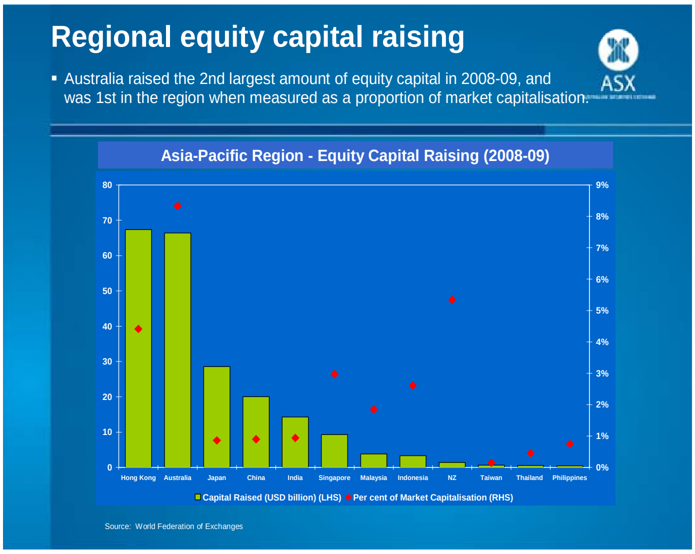
- The financial services industry has gone through a traumatic 12 – 24 months after a long period of sustained growth and significant product innovation.
- I thought it relevant to address the challenges and opportunities that face securities markets and exchanges as we collectively emerge from these severe financial dislocations and the economic downturn.
- I would like to discuss these challenges and opportunities by outlining:
  - the Australian financial system's position in our region, to provide some context to my perspective on these issues;
  - an analysis of why the securities exchanges in our region are different from those of our colleagues in Europe and North America;
  - what global lessons we can take from the GFC; and
  - the importance of considering our relative size and market structures before simply transposing policy settings from other regions without first conducting a rigorous assessment to determine whether they are appropriate for our circumstances.
- I will begin with a few simple slides comparing countries across the region in a number of key financial measures.
- These slides show that it is possible to have a deep, liquid, and innovative capital markets and financial services sector that can flexibly adjust to significant external shocks provided the regulatory regime and market structures appropriately balance the interests of a wide range of stakeholders.

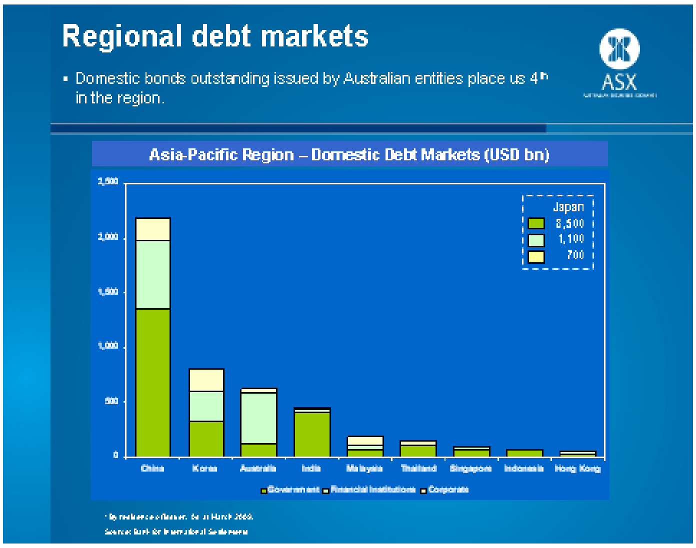
- Slide 1: Equity market capitalisation (free float and total)



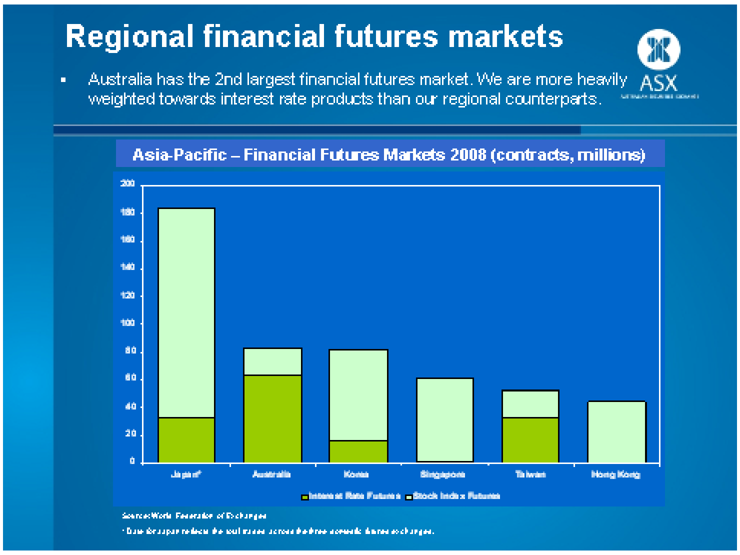
- Slide 2: Equity capital raisings (dollar value and % of market cap)



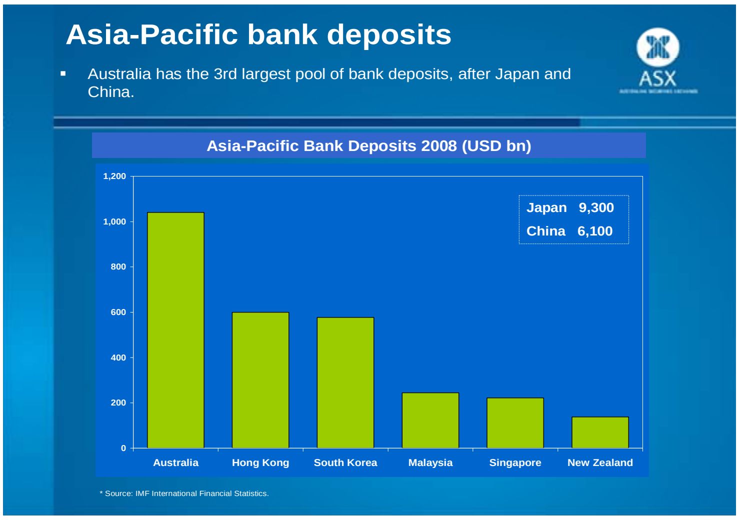
- Slide 3: Bond market



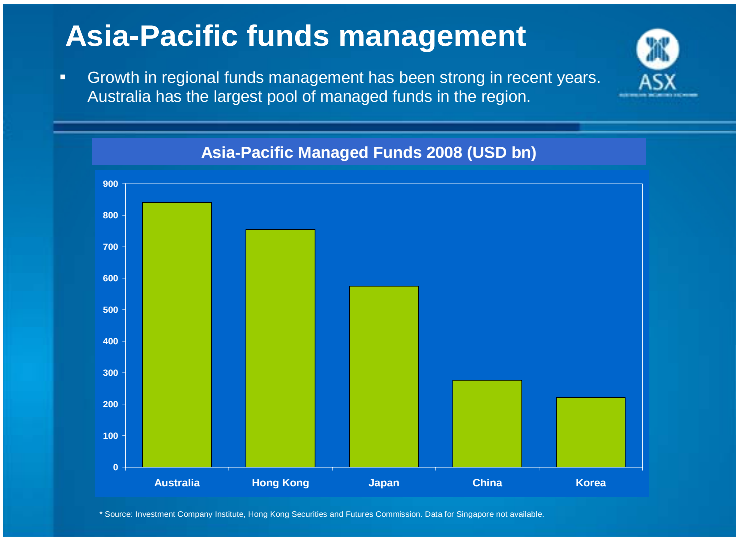
- Slide 4: Financial derivative contracts (interest rate futures)



- Slide 5: Banking sector



- Slide 6: Funds under management



- It is fair to say that historically markets and regulators in North America and Europe have been generally held up to be the global benchmarks – in terms of market structures and regulatory oversight.

- Recent experience should lead us to question that proposition. The global financial crisis emerged from outside the Asian time zone, the impacts were more extreme outside the region, and there has been more urgent and intrusive government intervention as a result of the crisis in North America and Europe.

- This should cause us to assess how well we have done as a region and feel confident that we can find our own regulatory balance, tempering calls from some to merely transpose 'solutions' from other jurisdictions into our own markets.

- The Asia-Pacific region is now, and has been for some time, the fastest growing economic region in world and the global savings accumulated in our region (Australia being an exception) have been used to finance current account deficits in other regions.

- Our capital markets have also closed what were once large gaps in the depth and sophistication of our markets with those in the rest of the world.

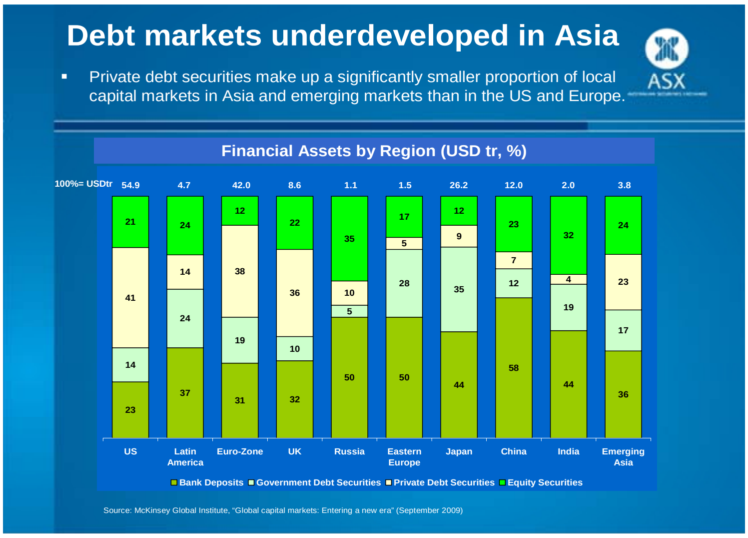
  – One of the areas where we have lagged, fortunately as in turns out, is in the area of non-standardised OTC derivatives. As these markets grew unrestrained, particularly in the US, the size and nature of the associated risk exposures were not well appreciated or managed - until it was too late.

  – Another area where we have yet to achieve critical mass in our region is in the area of debt markets. With the exception of Japan, relatively strong budgetary positions have sharply limited the need for governments to issue bonds. This, in turn, has also had an impact on the ability of corporate bond markets to emerge or thrive.

  – One side effect of the GFC may be that governments (by necessity) and companies (by choice) will be turning to bond market issuance as a more significant financing element. This may mark a critical turning point in the growth of bond markets in our region. We have already seen this trend emerging in the Australian market.

- The recent report published by the McKinsey Global Institute on the size and structure of global capital markets clearly highlights that in both Asian and emerging capital markets, privately issued debt securities make up a relatively small proportion of their domestic markets.

- Slide 7: Size and structure of global capital markets



- The 'stress testing' of regional financial systems occasioned by the Asian financial crisis of a decade ago and the subsequent policy adjustments put in place have helped Asian time zone markets weather the most recent crisis much better than the markets in other time zones.

- It is hard to fathom that it was only a decade ago that US and European policymakers were preaching about the superiority of their systems – at the same time that the forces that were ultimately to result in the GFC were gestating. These forces would eventually lead to unprecedented government bailouts of financial institutions that a decade earlier had been decried as bad policy predicated on moral hazard.

- I would like to think that policymakers in Australia have tried to strike a balance (or a 'middle ground') between the - sometimes conflicting - objectives of letting markets operate with minimal interference and the promotion of systemic stability and investor protection.

  – One of the best examples is the four pillars banking policy which contributed to the Australian banking system weathering the GFC better than its US or European counterparts.

  – I would hope that this pragmatic and practical approach to policy settings is a feature many of our policymakers subscribe to, notwithstanding the lobbying efforts of some to change policy settings to facilitate innovation irrespective of unintended consequences.

- We should also note that the nature and structure of our securities markets differ from those of our North American and European peers.

  – US market structure has been driven by the vast scale of their financial markets, which encouraged specialisation by exchanges with a history of multiple operators in each segment of the market (and more recently encouraging the emergence of alternative trading systems).

    - NYSE/Nasdaq/regional exchanges/ATS in equities;
    - CME/CBOT/NYMEX/NYBOT/ICE in futures;
    - CBOE/ISE/PSE/BOX in options; and
    - DTCC/OCC/CME/CBOT in clearing and settlement.

- European markets have been built around the multi-jurisdictional nature of the economic/financial market environment within which they operate.
  - LSE/Euronext (France, Netherlands, Belgium, Portugal)/Deutsche Borse/OMX/BME, etc, in the regulated exchange space;
  - Liffe/Eurex/LME/IPE in futures markets; and
  - Euroclear/LCH.Clearnet/Clearstream in clearing and settlement.
- In the Asia-Pacific region we have maintained the national character of our markets despite generally having moderately sized domestic markets (Tokyo being the key exception). However, this relative lack of scale drove Asian region exchanges to act strategically and broaden their product/service footprints. They have done this by being at the forefront of developing vertically integrated, multi-asset class business models and by being very early adopters of electronic trading and global distribution, led by their futures activities.

* In more recent times, exchanges in North America and Europe have been moving closer to the business models which are well established in the Asian time zone.

* At the same time, equity markets in our region have continued to deepen and mature as some economies have moved away from a heavy reliance on bank funding towards greater use of equity financing.

* We are unlikely in the near term to see a political push for the integration of our individual national markets into a single pan-Asian market, equivalent to the experience in Europe. It is worth remembering that it took Europe decades after the formation of the Common Market to adopt a common currency and they are still working through the details of forming a single seamless capital market.

  - This is not to say that more targeted cooperation between countries, such as the commitment to establish an Asian bond market, cannot deliver benefits that may not be available to countries acting on their own.

  - In fact, such cooperation may become increasingly imperative as the Asian-Pacific capital markets retain their distinct national identities within a common time zone rather than moving to form a single regional market.

* However, by virtue of their business models, securities exchanges in the Asian region are in a good position to clearly recognise the dichotomy that is emerging in the regulatory debate between:

  - equity markets, where the introduction of ‘competition’ in trade execution in North America/Europe has seen a migration in activity from ‘light’ markets to ‘dark’ markets; and

  - derivative markets, where the global push from regulators is to encourage some activity to migrate from OTC markets to exchange-traded markets.

* This, in large part, reflects the historical origins of the markets and the life-cycle of the different products.

  - Equity securities have traditionally been traded on a regulated exchange with only trades in smaller and infrequently traded companies sometimes conducted OTC.

  - Derivatives generally start as OTC products because they are often tailored to meet specific circumstances. However, over time as the products become more accepted and reach a critical mass there is momentum for standardisation of contracts and trading via exchange/electronic platforms which can bring even more depth and liquidity to the market and lower trading costs.

- This provides us, and many of our Asian exchange counterparts (who often share a similar business model), with a perspective on these issues that can be different from many of our North American or European colleagues who have traditionally had a narrower business model focus.

- The opportunities for securities markets and exchanges are clear, they include:

  – building on our central position in our respective nations' capital markets;

  – ensuring the principles of providing fair, orderly and transparent markets are not undermined as competition intensifies; and

  – cooperating with policymakers, where possible, to extend these FOT (fair, orderly and transparent) principles into areas that have traditionally been more opaque.

Lessons from the Global Financial Crisis (GFC)

- I would like to touch on some universal lessons that have emerged from the GFC and which are applicable to all regions by virtue of the influence of globalisation.

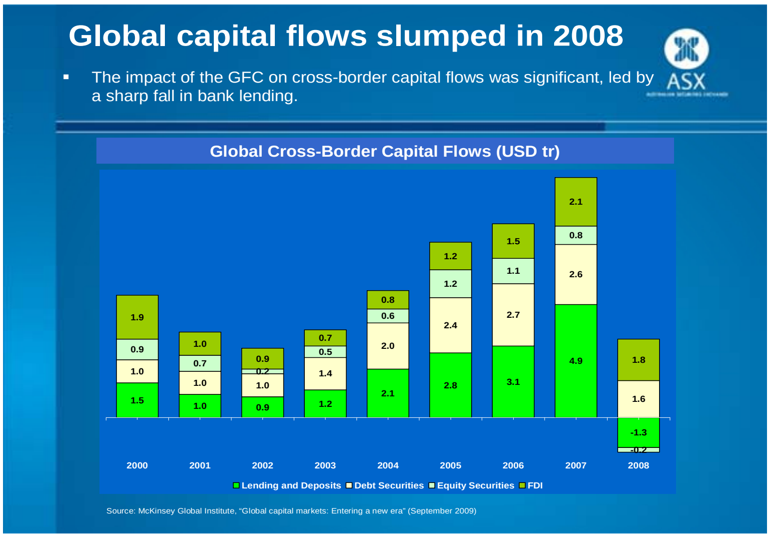
  (1) Today's markets are now more synchronised than they have ever been – across both products and countries – as capital flows have grown and new institutions such as hedge funds have risen in prominence.

    ➢ Shocks in one segment of the system can be rapidly transmitted across borders and markets even if the fundamental circumstances in each country differ markedly.

    ➢ It is interesting that most of the portfolio capital flows sourced from our countries still head to the US and Europe, reflecting current account flows and decisions by large institutional investors. This is despite the most attractive long-term investment opportunities residing in the rapidly growing Asia-Pacific region.

    ➢ The recent McKinsey Global Institute report confirmed that, at times of global economic and financial turmoil, cross-border capital flows can contract sharply and generate a contagion effect as the shocks spread throughout the global financial system. In the context of the recent credit crisis it is perhaps not surprising that this transmission was driven by a sharp curtailment in bank lending.

– Slide 8: Global capital flows



(2) The importance of a well capitalised and prudentially regulated banking system as the key cornerstone of the financial sector.

- The nature of the banking sector has changed with less reliance on funding from long-term deposits and more reliance on short-term credit markets and the packaging up and selling of securitised assets.

- Incentive systems need to appropriately balance risk and reward between product manufacturers, distributors, and financial advisers – and incentive systems for senior executives should not encourage excessive risk-taking.

- As retail investors have pursued higher returns by becoming more exposed to securities markets (either directly or through privately funded pension plans) they have discovered, less enthusiastically, the associated short-term volatility that can come with these assets.

- Retail investors need to be well informed and have access to robust and unbiased financial advice to ensure their investment choices are soundly based; that same principle also needs to apply to the looming policy issues relating to multilateral trading facilities.

- This group will also increasingly demand access to a wide range of financial products across the risk/return spectrum, ranging from existing products such as equities, through to those that may not currently be available to them (eg government and corporate bonds).

- While they may continue to use managed funds to achieve a diversified portfolio we have seen a growth in the self-managed investment segment which suggests that some may want to have the flexibility to tailor their portfolios to their individual needs.

(3) The importance of well designed regulatory frameworks (eg price transparency and effective disclosure arrangements) to minimise the danger of price bubbles forming and systemic risks emerging. We saw this manifested in areas from sub-prime mortgages to CDSs and CDOs.

Implications of the emergence of new trade execution models

- In this regard, one of the major practical policy debates confronting regulators, market participants, securities exchanges, and other stakeholders – is the question of the role of 'light' and 'dark' markets. In particular, a full assessment of their costs and benefits and how they should be regulated is needed so that both forms can work together to deliver optimal outcomes rather than potentially reducing them.

- I should make it clear that there is a role for both types of market models operating in a diverse and sophisticated capital market, but relative scale also needs to be taken account of, as well as a regulatory framework that evolves with an eye to ensuring benefits are shared by all stakeholder groups and outweigh costs and risks that are also shared across stakeholders.

- We have already seen regulated markets offering their own versions of dark pools to compete with new entrants. This can often be despite misgivings they may have about the impact such trading has on the overall quality of the market.

- The importance of market related transaction costs (ie bid-offer spreads and market impact costs) are either not understood or well articulated in the debate to date. Therefore the risk of fragmented liquidity resulting in higher overall trading costs is often glossed over.

- While light and dark markets can complement each other, addressing the needs of different customers, we as an industry (securities exchanges, participants and regulators) need to ensure the appropriate market microstructure is established. These arrangements need to minimise the risks/costs associated with the fragmentation of markets and address key issues of transparency and market integrity.

- In the era of the light and dark markets it is important to recognise not only the benefits they offer but also the potential costs that can be associated with them.

- Light markets offer:

  – Benefits – transparency and price discovery, robust infrastructure and rigorous regulatory oversight.

  – Costs – standardisation of products is required, and transparency can increase market impact costs when large blocks are traded.

- Dark markets offer:

  – Benefits – greater tailoring of products for specific circumstances and can lower costs of trading large blocks of products.

  – Costs – minimal or no transparency diminishes price discovery and makes regulatory oversight problematic.

- How are we to harness the best elements of these two different models?
  - Be wary of discarding either pre-trade or post-trade transparency too quickly.
    - Only consider reducing pre-trade transparency where it can be clearly shown that the costs of greater transparency outweigh the generally recognised benefits (this is likely to be a small subset of all trading).
    - Always maintain a high degree of post-trade transparency, both to ensure price signals are not hidden and to allow investors to compare the amount of activity going on in different trading venues.
  - Ensure that regulatory gaps/arbitrage don't distort markets and that the roles of market participants and 'market operators' are clearly separated to remove potential for conflicts of interest to arise.
  - Make use of robust centralised trading, clearing and settlement infrastructure where possible to enhance efficiency and promote systemic stability.
  - Ensure that claims about reduction in transaction costs reflect all costs (both direct and indirect), including private and public 'agency' costs.
- Policymakers in the US and Europe are having a second look at the impact the plethora of new trading venues (particularly dark pools) have had on market efficiency, stability and investor protection.
  - The SEC Chairwoman, Mary Shapiro, is already on record conceding that the SEC lacks the surveillance tools to do the same quality of surveillance as NYSE Reg and Finra in the US. It is interesting to observe ASIC's assurance to the Australian Government that the regulator in this country will be ready to assume this responsibility by the 3rd quarter of 2010.
  - The growth of exclusive and opaque trading pools (limited to small groups of traders) may be undermining the overall fairness of trading by limiting the ability of an investor's order to interact with the orders of all other investors.
- While the growth of alternative trading venues has been less prominent in the Asian time zone to date, there is obvious pressure from promoters of these platforms to simply follow the trends in North America and Europe to adopt 'increased competition'. We need to ensure policymakers in our region recognise the problems that have been experienced and design robust frameworks to ensure the same mistakes are not repeated.
- As I argued earlier, we need to ensure that the policy debates we have on these issues recognise that our market scales and structures are different to those in other parts of the world. The policy recommendations that we adopt must be tailored to complement and enhance our regulatory and market culture and not undermine it.
- This, then, is your challenge as industry associations: to jump higher than mere 'advocacy' of short-term vested interests. The global financial crisis has put a serious dent in such a narrowly focused platform of advocacy in any case. The real imperative is to contribute to thought leadership in public and regulatory policy development in your respective countries. I hope my comments here today have fuelled your enthusiasm for that.
- Thank you for your attention and have a safe journey home to your respective countries.