Dubai Financial Services Authority

"Republic of Korea: 60 and Beyond".

World Leaders Forum - commemorating the 60th anniversary of the founding of the Republic of Korea.

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"Financial Regulation and Economic Soundness"

I suspect that over recent months everyone here has been thinking hard about these issues of financial regulation and economic soundness. Over the next 10 minutes I will very briefly share some thoughts about our current crisis with you.

But first a quick word about Korea. We would do a great disservice to Korea if we permitted the current situation to obscure the great progress made by reforms implemented after the last financial crisis in 1997. Those reforms have included major structural changes to increase transparency in the financial and corporate sectors; to overhaul the regulatory system; to raise standards of governance; and to promote greater competition and diversity in the economy, including through the building of deeper capital markets capacity.

The creation of an integrated supervisory system to oversee all financial institutions has been central to that strategy; and the further fine tuning of the regulatory structure in March of this year highlights the importance of keeping regulatory arrangements under review. The integrated supervisory model adopted by Korea has served it well and has contributed to the country's substantial success in developing its bond and equities markets.

So, while there are now *new and serious c*hallenges to confront, this is a good time to pay tribute to Korea's commitment to reform –including regulatory reform- over the past decade. Those reforms have paid dividends and although a new crisis – not of Korea's making – must now be weathered, Korea is much better positioned to do so.

Moving to the international scene, I think it is clear that our regulatory architecture has failed to keep pace with the globalisation of financial markets in at least two crucial respects:-

First, our regulatory systems are national (at best) while our financial system is globally integrated.

Secondly, our prudential (or safety) regulation has been directed to only part of this global market (i.e. commercial banking), ignoring the systemic risk inherent in other parts of the financial system (investment banks; hedge funds; private equity etc).

Taken together, these factors have militated against any holistic overview of risk and have frustrated effective regulatory counter-measures.

It is time for us to critically re-examine the role and structure of our international financial standard setters. At present our key technical groups, the Basel Committee (banking); IOSCO (securities and markets); and IAIS (insurance) are all focused on their *individual* sectors of the global financial markets. Ironically, they together sponsor the work of a *subsidiary* cross sectoral committee (the Joint Forum) but this has never had the profile or influence to match the parent groups. In my view, the current crisis provides a powerful argument for completely reversing this architecture-by establishing a permanent and well resourced cross sectoral standard setter at the top of the pyramid and placing the sector specialist committees in subsidiary positions. The Financial Stability Forum, as now constituted and mandated, is inadequate for this purpose and requires drastic surgery to take it beyond its current research and advisory functions. I should also add in passing that membership of the Basel Committee should be reviewed to better reflect new world economic realities. (It is very odd that Japan is the only Asian member of that Committee).

At national level, I do not assert that there is only one regulatory model that works. But, after experiencing several structural variations, I am a firm supporter of the integrated model in most situations. Such a model would be difficult in the United States but even that country's best friends have to accept that its regulatory system is well overdue for reform. After the dot coms, Enrons and now sub-prime (all within 8 years) we all have a vested interest in encouraging the US to redesign its regulatory architecture, at least to Secretary Paulson's model but ideally even more radically.

Ladies and Gentlemen, the greatest tragedy of our current situation is that residential mortgages, which should be the safest and simplest of all financial products, have morphed into the achilles heel of the entire global financial market. The financial industry itself bears primary responsibility for this outcome, but defects in regulation and policy need to be admitted. Rather than focus on blame this morning, let me briefly list 10 issues that I believe should help to inform our regulatory responses over the coming months.

First, we need to reach an international consensus on regulatory architecture to ensure that all institutions that access lender of last resort support have a level playing field of regulatory oversight. Just how far should this safety net extend? Twelve months ago our concepts of moral hazard would have ruled out the public sector response that has since occurred. Perhaps this safety net will extend even further before we're finished, picking up additional classes of assets. We need to understand this so that taxpayer support and regulatory obligation are appropriately reciprocated. ***It will not be easy to achieve international consensus on these issues***;

Second, we need to implement improved supra-national regulatory capacity by restructuring and re-mandating existing bodies, or creating new ones. ***This also will not be easy;***

Third, we need to encourage the Unites States to restructure its regulatory system, at least to the Paulson model if not further (my starting point would be to take the twin peaks model and work backwards from there). ***I think we will see some change here, but probably not enough;***

Fourth, we need to review our current approach to ratings agencies. In the aftermath of the Enron scandals the International Organisation of Securities Commissions sent a clear signal that the ratings agencies needed to address their conflicts of interest. Comprehensive principles were published for that purpose, but the industry has paid them lip service only. The ratings agencies have foregone any credible claim for continued self regulation of their issuer paid ratings model**. I believe we will see changes;**

Fifth; we need to decide whether mark to market accounting is a problem or a solution. However, in considering alternatives, we must be careful not to decrease transparency and thereby further undermine investor and counterparty confidence in financial statements. Nor should we rush to the conclusion that the primary problem lies with the standard rather than with inherent deficiencies in instruments that are measured by the standard. Finally, we need to be conscious that some serious issues of inter-generational fairness arise from these decisions – particularly in the context of pension funds**. I have not yet seen any proposal for change that satisfactorily addresses all these concerns;**

Sixth; we need to review the operation of our OTC derivatives markets with a minimum objective of increased transparency. I spoke about these issues at a meeting here in Seoul in June, since when the urgency for change has become even more evident**. I am confident that positive steps will be implemented to increase transparency but, as my closing comment will indicate, I believe that there are more fundamental questions still to be asked about the operation of our markets, including derivatives;**

Seventh, we need to reconsider the discretion given to large banks for capital self assessment by Basel II because reliance on their internal risk models is now much harder to accept. ***I think such a review is likely;***

Eighth, we should beef up suitability rules so that financial firms have a greater onus to ensure that their products are suitable for clients. **This is one of the few practical responses to conflicts of interest and, I think, is likely to become more frequently used by regulators in future;**

Ninth, we need to discourage remuneration incentives that reward short term gain and ignore medium to long term capital impacts. It is seductive to focus on the excessive rewards of corporate chief executives. But the more systemic and serious issues relate to remuneration structures and cultures that distort institutional behaviour**. The difficulties of achieving international, competitive-neutral, industry remuneration practice seem to me insuperable. Yet if industry does not take stock the pressure for direct political intervention may become irresistible.**

My tenth and final observation has been prompted by widespread reporting of the *financial economy* as being different and separate from the *real economy***.** I realise that this is "economist speak" but I think there is something more profound at stake here. The average citizen who borrows to finance a house or to fund a small business, or who otherwise views the role of banking to be tied to production and exchange, will not easily understand this notion of two separate economies. Yet over the past two decades we have permitted proprietary trading in financial instruments and derivatives to develop as a separate industry, largely unconnected to production and exchange, and more resembling a casino than a bank. We were content to do so on the understanding that the participants were risking their own money, but we have discovered to our grief that notwithstanding huge personal gains made while the casino remained open, billion dollar losses were left for non participants to pick up when it closed. This cannot be permitted to recur and we should all be thinking about how to prevent that casino from reopening its doors.

Ladies and Gentlemen, throughout my working life I have supported a partnership between official Government regulation of our markets and the role of industry self regulation. I believe that when that partnership is working effectively, it is possible to promote the public interest in tandem with industry interest. But events of the type that we have recently experienced severely test the credibility of self regulation and call into question the degree to which industry is willing to moderate its conduct on a voluntary basis. The next 12 months are likely to see increased calls for new and tighter regulation. I hope that we will avoid excessive responses that unduly restrict the proper autonomies of Boards and management. But the financial sector, in particular, has a big job ahead of it to convince policy makers that its commitment to good corporate governance is genuine and that an on-going partnership, based on trust, is possible. A difficult task, but hopefully not an impossible one.

Ladies and Gentlemen, it has been a great privilege to participate with such a distinguished group of leaders in this celebration of Korea's anniversary.

Thank you.