"Financial Stability: What Role for Securities Markets?" Round table of the CNMV International Conference.

FERNANDO RESTOY, VICE-PRESIDENT OF THE CNMV
Madrid, 11 November, 2011

Let me welcome you to this last session of the International Conference of the CNMV. The organisers have decided to schedule a panel discussion on policy issues around capital markets and related matters. I must say, though, that from browsing through the academic papers presented in this conference, I have the impression that many of them have a direct policy orientation.

The theme selected for this panel discussion is: Financial Stability: What role for security markets? We are fortunate to have three very distinguished participants who have come from the central banking and regulatory communities and the industry. I am sure they will offer interesting insights from different perspectives on this broad topic.

By way of introduction, let me just try to present a few general ideas on the links between financial stability and securities regulation before I give the floor to the panellists.

I think we can all agree that the current financial crisis has provided a sharp illustration of the need to consider financial stability as a key public policy objective.

The crisis has confirmed that the solvency of the banking system should remain the key ingredient of any sensible definition of systemic stability. At the same time, it has also shown that prudential oversight of credit institutions should not only rely on the micro-supervision of the balance-sheets of individual institutions. Prudential regulators should also look at aggregate risks stemming from the relevant macro-financial environment.

Moreover, it now seems crystal-clear –if it was not already before the crisis- that the increase in the banks' loss-abortion capacity is far from constituting a sufficient condition to contain systemic risks.

The crisis is not only the consequence of the insufficiency of banks' own resources but also of other factors such as: the misbehaviour of credit rating agencies, the absence of adequate settlement procedures to cope with counterparty risk and, especially, the generation of a wide-spread confidence deficit. This deficit is closely linked to regulatory flaws in areas such as transparency requirements for issuers (e.g. accounting principles), for financial products (e.g. sophisticated ABSs, CDOs, etc.) and for actual market conditions for some important markets. That is the case of CDS and other debt and derivates markets which are subject to little or no pre- and post-trading transparency requirements.

All these latter factors do exceed the perimeter of prudential regulation and enter into the territory of securities markets regulation.

Securities Regulation and Financial Stability

It is therefore clear that securities regulators have a contribution to make to financial stability. In my view, that contribution can be summarised in three relevant sets of actions:

First, actions related to the effective oversight of investment firms and market infrastructures such as CCPs of systemic importance.

Second, actions aiming at preserving agents' confidence in the functioning of capital markets, including those designed to foster transparency and the proper conduct of business by credit rating agencies, financial intermediaries and other market players.

And third, regulatory actions affecting market rules and practices and market players' strategies, aiming at correcting features that trigger excessive volatility and unduly amplify the impact of external shocks on market prices.

Here is where the regulation of market micro-structure (high-frequency trading, circuit breakers, short-selling, market fragmentation, dark liquidity) –which you have covered in this conference- enters the picture.

Should Financial Stability therefore Become and Explicit Objective of Securities Regulators?

Since it is quite uncontroversial that securities regulators do have a relevant contribution to make to financial stability, a question that could be (and has been) asked is whether financial stability should explicitly become one of the primary objectives of securities regulators.

Although at first sight this question may look almost rethoric, I do have some concerns about some practical implications of such an enlargement of the official remit of securities regulators. As I see it, the contribution that securities regulators provide to financial stability is actually channelled through the fulfilment of their standard statutory objectives; namely, fostering transparency, adequate price formation and investor protection. Those are objectives which are socially desirable by their own sake and not only because of their link with the concept of financial stability.

Moreover, it is clear that although good market functioning is a pre-requisite for financial stability, not all dimensions of this polyhedral concept have the same relevance. In particular, we can be sure that the solvency situation of a systemic credit institution has a more direct impact on financial stability than the way banks comply with conduct of business rules, even if the latter is more relevant for another important public policy objective: investor protection.

Therefore, if financial stability was to be explicitly considered as one of the primary objectives of securities regulators, the argument could be made that from time to time they may have to sacrifice the attention they pay to foster transparency or adequate conduct of business whenever that would imply additional constraints for financial institutions in an unstable situation. That possible conflict between objectives would naturally damage confidence on the determination of market regulators to ensure good market functioning.

You will observe that a similar argument has often been made to justify why monetary policy authorities, despite having a substantial contribution to make to financial stability, should not attach to this objective the same priority as the price stability goal.

Practical Implications

What I have tried to convey so far to you is basically two ideas: First, securities markets and, therefore, securities market regulation should be a relevant part of any assessment of the stability of the financial sector. And second, that the very best contribution that securities regulators can offer to financial stability is precisely by delivering on their traditional remit, namely to ensure a sound functioning of markets by enhancing transparency, adequate price formation and investor protection.

What are the practical implications of these ideas? Let me outline three of them:

First, any arrangement organised to identify risks for financial stability and measures to face them should include the input provided by securities regulators. That is already the case of the ESRB in the EU and of the FSB at the global level.

Second, merging sectorial supervisors to create a single, integrated financial supervisory authority does not seem the best conceivable solution. With such a model, multiple goals for a single authority would tend to be ranked according to their perceived contributions to the primary objective of financial stability. This is likely to yield occasionally policy actions which tend to unduly penalise socially relevant objectives such as proper conduct of business or investor protection.

More specifically, although the crisis has shown that a perfect supervisory model does not exist, an institutional arrangement along the lines of the twin-peaks models, where the prudential and the conduct of business dimensions of regulation are neatly separated into two different –albeit coordinated- authorities, seems a superior alternative.

And the third practical implication is that, relevant policy actions with a bear on financial stability pursued by securities regulators should be motivated on the basis of their main statutory objectives. More concretely: any restriction on trading activity, such as short selling bans, circuit breakers or special controls for high frequency trading should be assessed not only in terms of its contribution to dampen market volatility but also with respect to its potential impact on market quality (measured in terms of liquidity, market depth, effectiveness of the price discovery process, etc.).

Let me in particular stress this very last point to end my intervention. At times of heightened financial, macroeconomic and political uncertainty, such as the ones we are now facing, markets naturally reflect those conditions and sometimes even overreact to them. However, it is often not well understood that the role of securities markets regulators is not always to aim at mitigating the impact of relevant shocks on market prices even when some overreaction by market participants cannot be ruled out. Rather, the role of regulators in this regard is to ensure that the market's functioning is not adversely affected by frictions or imperfections that could dampen adequate price formation, particularly if those deficiencies are contributing to amplify market instability.

That is why high market volatility should not be seen as a sufficient condition for market regulators to introduce restrictions on trading rules. Any sensible regulatory action should be based on an assessment on whether volatility is ultimately generated within or outside the markets themselves. In the current environment, unstable market conditions can rarely be attributed to the malfunctioning of the market venues. Although there are exceptions – the 2010 flash crash is one of them - the original cause normally lies outside the remit of securities regulators.