

The Future of Financial Regulation and Turkish Securities Markets

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2007 - 2009 Story of Finance

- ▶ **Global macro - imbalances**
 - ▶ 10–15 years of current account surpluses in the east and deficits in the west
 - ▶ In the east: savings > investments → risk-free western government bonds → decreasing real rates (1 – 2 %)
 - ▶ Rapid growth in credit markets (in emerging markets and sectors)
 - ▶ Wild search for higher yields
 - ▶ Financial innovation (CDO, credit derivatives CDS etc) CDS volume of \$62t in 2008!
 - ▶ Most of “new credit” is *within the financial sector* !

The Crisis

- ▶ **Did not happen out of nowhere...**
 - ▶ In 1985-1995, more than 1,000 S&Ls went under
 - ▶ Enron, Tyco, WorldCom... scandals and bankruptcies
 - ▶ The 1995-2001 dot.com balloon and its eventual burst (prices cannot increase all the time!)
 - ▶ LTCM's failure in 2000 (debt / equity > 25)
 - ▶ Russian, Asian and similar "small" crises
 - ▶ Madoff event (a huge Ponzi scheme managed by 3 accountants!)
- ▶ **There were signals of warning but they were much ignored**
- ▶ **The financial industry almost collapsed**
- ▶ **Serious shortcomings were revealed in the regulatory system**

Notes and Lessons for the Regulator

- ▶ Sustainability of maximum self – interest in the long-run sometimes requires short-term sacrifices
- ▶ The probability of “something being wrong” in consistently and continually very high profits is very high
- ▶ The crisis is not due to lack of regulation, but to poorly designed and enforced regulation
- ▶ Regulatory gap between
 - ▶ Public markets and private markets
 - ▶ Countries
- ▶ Regulation shaped by historical crises and not by its own objectives

Notes and Lessons for the Regulator

- ▶ Since 1980s, technology, financial theory, and hence the global financial system has undergone dramatic changes
 - ▶ Globalization and the resulting mobility of capital
 - ▶ Increased competition among financial institutions
 - ▶ Ease of regulatory arbitrage (nationally and internationally)
 - ▶ Elimination of differences between historically separate financial instruments and institutions
- ▶ But the regulatory system has failed to adapt to these changes and as a result “Market” >> Regulator

Notes and Lessons for the Regulator

- ▶ A considerably reformed international regulatory system is in the works.
- ▶ The reform path must not only address the specific causes of the current crisis but also remember the basic goals of financial regulation:
 1. Price stability (via monetary policy)
 2. Financial system stability (management of systemic risks)
 3. Protection of investors and confidence in the financial markets

To – Do List

1. **Increased systemic risk must be dealt with seriously**
 - ▶ Innovation and risk-taking must not be prevented.
 - ▶ The idea of “too big to fail” is not acceptable. Poorly managed firms must be allowed to fail.
2. **Protection of investors/lenders is ever more important**
 - ▶ Enhanced disclosure and competition
 - ▶ Exchanges and clearing houses to trade more derivative products
 - ▶ Fuller transparency in “complex” contracts
3. **Incentives leading to taking excessive risks**
 - ▶ Detailed disclosure of management styles and sources of return
 - ▶ Some regulation and supervision to private markets

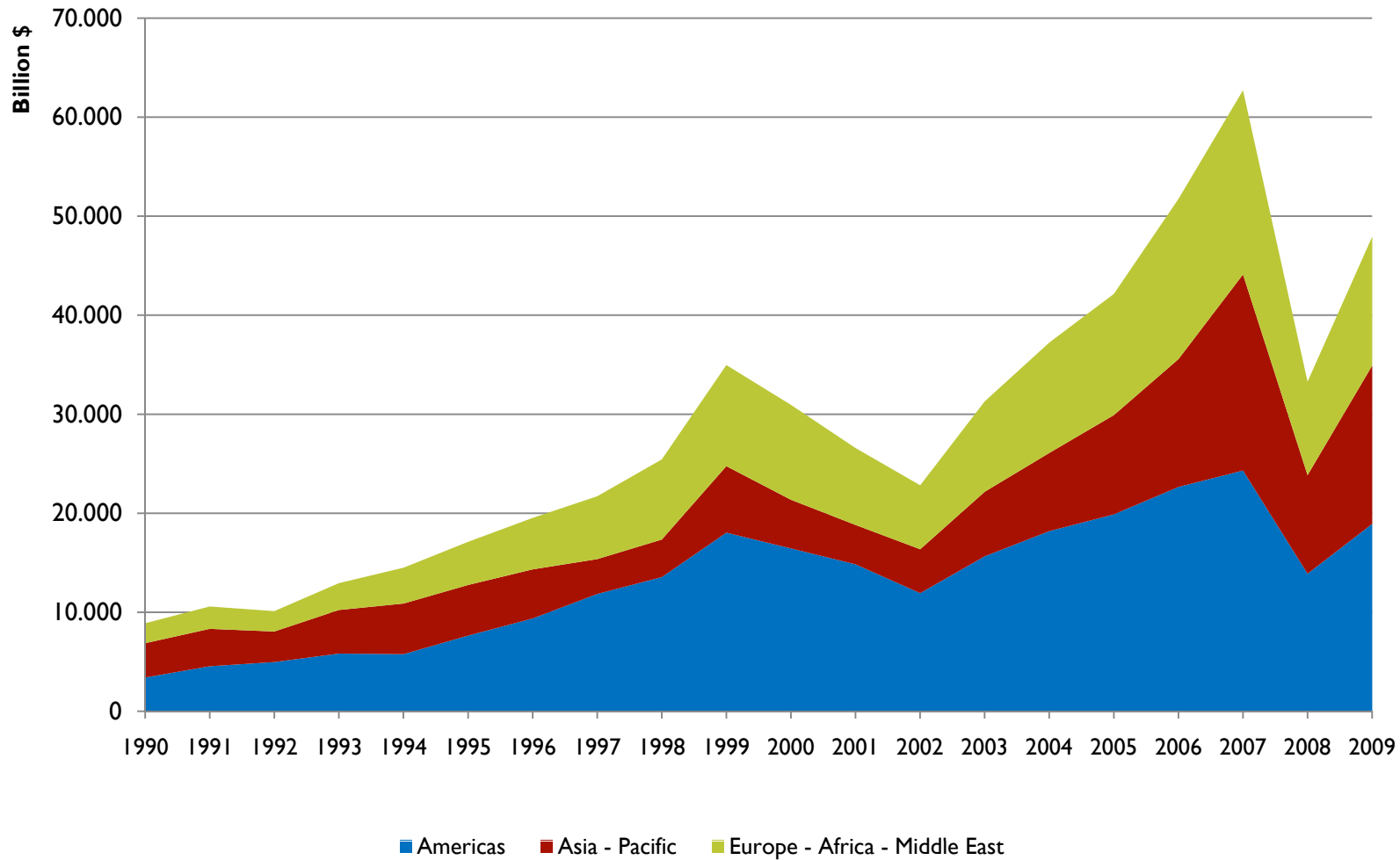
To – Do List

4. **Problem of regulatory arbitrage must be addressed**
 - ▶ Fungibility of financial products and markets with seemingly separate functions (securities, banking, or insurance) resulting in “functional arbitrage” with capital seeking more regulatory comfort
 - ▶ Differences of regulation in different countries coupled with the ease of capital mobility resulting in “international arbitrage”
5. **Difference between market regulation and “style of supervision” must be remembered**
 - ▶ Supervision of banks and insurance companies must be conducted more discretely
 - ▶ Supervision and enforcement of securities regulation should often be more aggressive and “publicly visible”

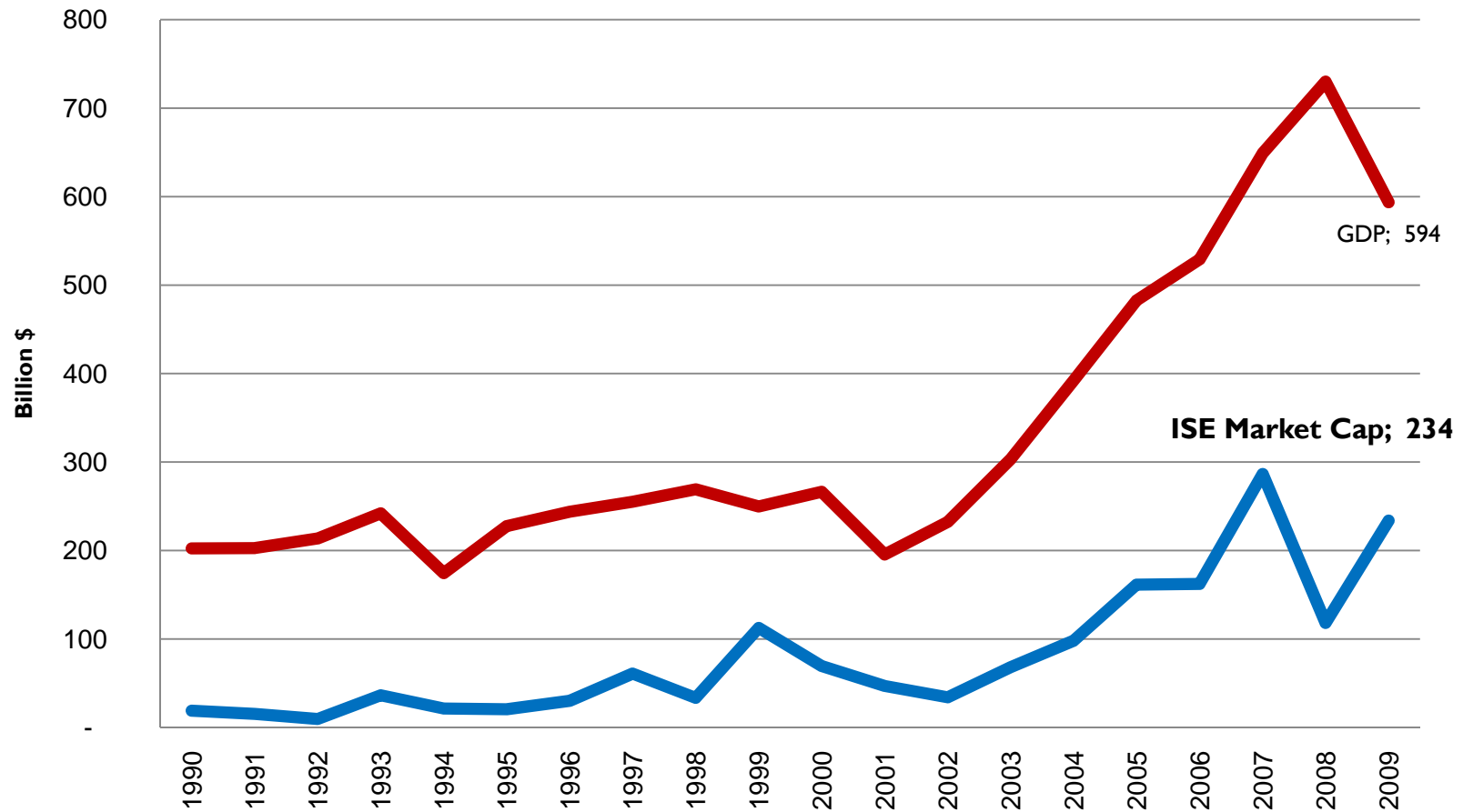
The New Regulatory System

- ▶ Enhanced risk management covering not only the financial industry but also using feedback from the real economy
- ▶ The rules of regulation and supervision should be enforced based on market parameters and triggers (CDS prices, early warning signals, information indexes etc.) → forward-looking regulation
- ▶ A new architecture designed around the basic goals of financial regulation and effective coordination between agencies
- ▶ Efficient and effective international “regulatory harmony” (IOSCO, BCBS, IAIS → G20) free of political influence

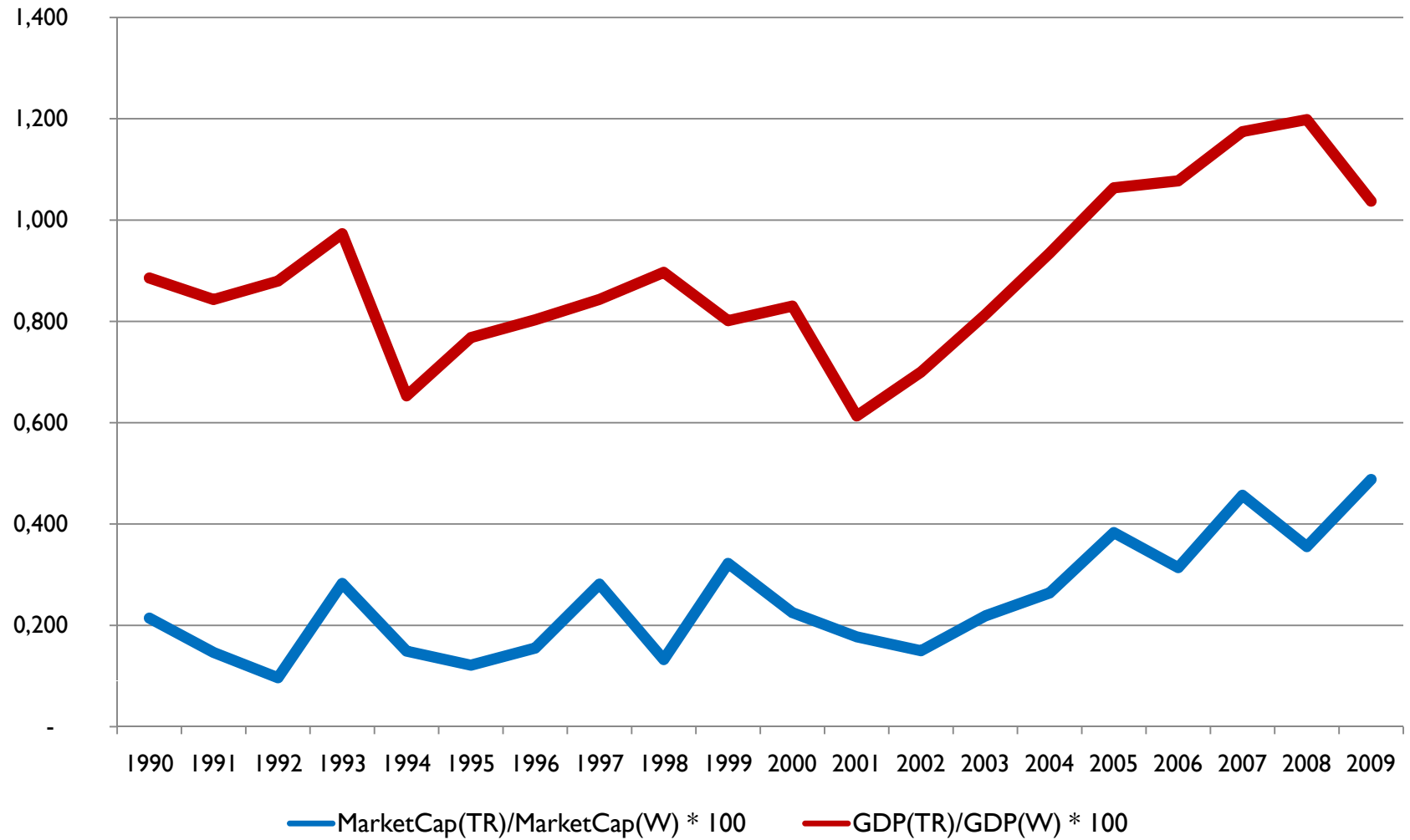
World Equity Markets



Turkish Equity Markets



Turkish Equity Markets



Debt / Equity Ratios

	2006	2007	2008	2009
Turkey (ICC500)	154	126	268	(*)300
Turkey (ISE)	113	104	158	122
USA	32	25	49	50
Europe	74	76	89	132
China				28
Japan	98	97	106	157
Emerging markets				36
World				83

Other securities

- ▶ Corporate bonds (very recent)
- ▶ Derivatives
 - ▶ Global share of stock index contracts in TurkDex
 - ▶ Notional value %0.26, # contracts traded %3.5
 - ▶ Global share of all derivatives (notional value)
 - ▶ \$155 billion / \$605 trillion = 0.00025
- ▶ Commodities
- ▶ Government bonds (biggest market, not under CMB regulation)
- ▶ OTC leveraged-FX trading (gold and currencies, fully unregulated internet-based market)

To – Do List

- ▶ **Grow the equity markets to reduce the dominance of bank credit**
 - ▶ Number of listed companies and the float ratio
 - ▶ Support the growth of investment funds
- ▶ **Expand the derivatives markets**
 - ▶ More exchange-traded futures and options
- ▶ **Start a Commodities Exchange**
 - ▶ Licensed warehousing
 - ▶ Agricultural and energy products
- ▶ **A common technology platform for the collateralization, clearing and settlement of all exchange and OTC trading**

To – Do List

- ▶ **New Capital Markets Law (2010)**
 - ▶ Full compliance with all non-conflicting international standards
- ▶ **Closer and more strategic cooperation with all relevant international organizations**
- ▶ **Due and long-forgotten emphasis on research**
- ▶ **Istanbul Financial Center**
 - ▶ Regional hub in 5 years
 - ▶ Globally competitive thereafter