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Australian Securities & Investments Commission

The future of funding economic growth: Reframing capital markets – a focus on infrastructure and SME financing

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CHECK AGAINST DELIVERY

Good morning, everyone. I would like to thank the ADC for the opportunity to share my thinking with you on a topic dear to my heart.

I'd like to make three points:

- one – to emphasise the opportunities for capital markets in supporting economic growth;
- two – to highlight some of the challenges the infrastructure and small-to-medium enterprise (SME) sectors are facing in accessing finance through capital markets; and
- three – to outline actionable solutions that might make capital markets a more effective and viable source of finance for both sectors.

I will make these comments as Chairman of the Australian Securities and Investments Commission and as Chairman of the Board of the International Organization of Securities Commissions (IOSCO), providing a global perspective.

IOSCO brings together regulators from over 120 jurisdictions, including 29 from the Asia-Pacific region. It has emerged as the key global reference point for financial services and markets regulation. Because of this, and on behalf of the world's markets regulators, I'm a member of the Financial Stability Board.

My main message today is that we need to:

- think creatively about how our capital markets can support economic growth; and
- recognise that one size does not fit all.

We need to experiment and take risks in market design and regulation to support capital markets in providing funding for the real economy, to support the growth our economy needs.

Capital markets and economic growth – the opportunity

Now, to my first point – the opportunity for capital markets in driving economic growth through financing infrastructure and the SME sector.

Capital markets have always played a role in supporting economic growth. They bring together those with savings to invest and those who need capital.

The opportunities for capital markets have increased significantly since the global financial crisis. Much of this has been because of increased constraints placed on the banking sector, and the growth of the superannuation sector.

Resilient market-based finance can be a viable alternative to bank finance. Let me highlight salient facts which demonstrate this opportunity.

The infrastructure opportunity

First, in relation to infrastructure:

- *Fact one* – There is a pressing global need for huge investment in infrastructure. The Asian Development Bank has estimated \$US750 billion a year is needed through this decade to build essential infrastructure. Significant investment is needed, particularly in greenfields energy, transport, telecommunications and water infrastructure to support increasing urbanisation. If delivered, this infrastructure could generate real economy gains of about \$US13 trillion across the region during this period and beyond.
- *Fact two* – Governments and the banking sector are simply unable to finance the level of investment activity needed for infrastructure. The Organisation for Economic Cooperation and Development (OECD) estimates that the funding gap in some countries in the Asia-Pacific is as high as 2% of gross domestic product (GDP).
- *Fact three* – There are huge and growing pools of funds, in the asset management sector in particular. The Group of 20 (G20) has estimated that \$US85 trillion is available globally from these sources.

The SME opportunity

Let me turn now to some salient facts that highlight the opportunities in the SME sector.

- *Fact one* – The SME sector is the engine room of economic growth, a key source of innovation and a driver of competition – both here and globally. In many countries it accounts for a significant percentage of GDP and jobs. In Australia, it is estimated that small business accounts for around 43% of private sector employment and contributes around 33% of private industry value added. In China, it accounts for 80% of job creation, 60% of GDP and 50% of tax revenue.
- *Fact two* – Since the crisis, the banking sector has been less willing to finance, particularly the more innovative and higher risk SME ventures. It is estimated that in 2012 in Europe new bank lending to SMEs was 50% lower than pre-crisis levels.

- *Fact three* – SME businesses often pose financing challenges. They are seen as risky, lack collateral to offer as security and generally have no track record they can share with investors. These features have driven SMEs to look for alternative funding sources, including crowdfunding and other sources of micro finance.
- *Fact four* – As with infrastructure financing, there are huge and growing pools of funds, in the asset management sector in particular, which can potentially be accessed.

The challenges

Let me now turn to the challenges the infrastructure and SME sectors are facing in accessing market-based finance.

Financing infrastructure

First, financing infrastructure. The enormous pool of funds I mentioned earlier is not flowing through our capital markets. There are a range of reasons why this might be happening:

- some say this is because of a paucity of bankable projects;
- some argue that greenfield projects in particular carry risks that private financing sources are unwilling to bear;
- some say it is because we have not spent the time developing debt capital markets – for government, municipal and corporate bonds;
- some point to the absence of appropriate regulatory frameworks; and
- lastly, others point to barriers to cross-border investment.

Financing SMEs

Let me now turn to financing SMEs. Again, the opportunities are not being harnessed. Soon-to-be-published IOSCO research on SME financing highlights why this may be the case. Reasons include:

- the perception SMEs have about the high upfront and ongoing costs of sourcing finance through capital markets;
- the fact that SMEs don't have the expertise, experience or understanding to access capital markets;
- investors lack the information they need to assess the risks an SME may pose; and
- investors are concerned about the liquidity of secondary markets in SME debt and equity.

There are real opportunities for policymakers and regulators to work together to build the right environment for capital markets to address these reservations. We need to think

creatively about changes to capital markets to make them more attractive for investors and those needing capital.

Actionable solutions

This takes me to my third point – how the opportunities might be harnessed with actionable solutions. IOSCO, and other international organisations, have done some thinking on this.

Financing infrastructure

Let me first turn to financing infrastructure. I see the need for actionable solutions in three areas:

- the market environment;
- for investors; and
- for project developers and issuers.

The market environment

The G20 and the OECD – through their *High-level principles on long-term investment financing by institutional investors* – have recognised that governments have a clear role to play in:

- setting an agenda for developing infrastructure; and
- enabling a stable regulatory environment, which allows this agenda to happen.

The challenge for policymakers and regulators is to create the right environment in which these pools of funds can be mobilised to meet infrastructure financing needs.

So, what does this mean?

Drawing on my experience as an investment banker, and now as a financial services and markets regulator, this means developing an environment that gives investors – particularly those with ‘patient capital’ – and project developers and issuers the incentives and confidence to use capital markets.

Investors

This takes me to the next area where I see a need for actionable solutions – investors. For investors, confidence in using capital markets will be an issue of trust, based on having accurate, timely and complete information(both upfront and on an ongoing basis) about the risks and the returns of investing in infrastructure financing projects.

I expect investors will tell us they will be looking to standardisation, consistency and common elements in projects and financing documentation. They will be looking for high standards of project and corporate governance and the rule of law. They will also be

looking for ways to assess the credit risk of projects – perhaps even credit ratings for issuers.

Project developers and issuers

For project developers and issuers, confidence in capital markets will be an issue of:

- trust in the integrity of markets; and
- being allowed to innovate in a cost-effective and efficient way when compared to other funding sources.

Project developers and issuers will also want to be confident that the market will deliver investors in sufficient numbers and volume to meet their needs.

The challenge is to balance investor and project developer and issuer needs. IOSCO's research paper on long-term finance, published last September, sets out a number of examples of the innovative use of capital markets to fund infrastructure while seeking to balance these needs. The examples – which cover the use of equity and debt capital markets, securitisation and pooled investment vehicles – point to the importance of a flexible approach by regulatory authorities in tailoring regulatory requirements to particular projects.

There are particular challenges in the greenfield space for greater public sector involvement. Given the particular risks greenfield investments pose, there is also a good case for well-structured support mechanisms or targeted public investment. The recent initiatives in New South Wales, encouraging the recycling of brownfield developments to fund new or greenfield infrastructure, are a great example of the direction this might take.

Financing SMEs

Let me now turn to opportunities in financing the SME sector. Our research at IOSCO has highlighted steps regulators and policymakers can take to support financing SMEs. They have two key features:

- the first is simplifying and easing access to capital markets – which is really about cost; and
- the second is giving SMEs and investors confidence in the use of market-based financing solutions.

Let me identify five steps open to us.

The first is the establishment of exchanges specifically for the SME sector as alternatives to main board listing. This is particularly important in the Australian environment, where more competition in our markets could help realise the potential of market-based finance for SMEs.

Of 27 jurisdictions surveyed by IOSCO as part of its study on SME financing, 19 had either established separate exchanges for the SME sector or had created junior boards in main exchanges specifically for SMEs. Many of these were in growth and emerging markets.

Key features of these platforms include lower entry thresholds, lighter listing rules and lighter ongoing disclosure requirements. The most successful of these (in Canada and the United Kingdom) have taken some time to get off the ground – but now see almost as many, if not more, companies listed as are listed on the main exchanges. In the case of China, close to 2,000 companies have been listed on their alternative markets.

The second is proportionate regulation – which is in effect easing the regulatory burden for SMEs. There are many recent examples of initiatives in this space. A number of jurisdictions – including Germany, Sweden, Norway, the United Arab Emirates and the United States – have recently reduced disclosure requirements applicable to crowdfunding. The Australian Government is also looking at reform in this space.

The JOBS Act in the United States has reduced disclosure requirements for small fundraisings. This initiative has helped small businesses to raise funds from non-accredited investors and allowed financial groups to use online marketing methods to find new investors. Uber, Snapchat and Airbnb have taken advantage of these in their start-up phase – and built huge businesses without a public offering.

The third is measures to develop active secondary markets supported by a deep investor base. Consideration might be given, for instance, to introducing market making systems to drive liquidity. Thought also needs to be given to deepening the investor base by exploring methods to engage institutional investors with longer term investment timeframes.

The fourth is addressing information asymmetry through encouraging the provision of research about SMEs to market participants. IOSCO's soon-to-be-published report on SME financing recommends creating incentives to foster independent research and ratings of SMEs.

The fifth is about assisting SMEs access to these markets. We need to explore ways of addressing the unfamiliarity and reluctance of SMEs to access capital markets, by providing advice and support to help them understand the regulatory context in which they operate.

Conclusion

In conclusion, let me again emphasise the key role capital markets can and should be playing in financing the infrastructure and SME sectors.

We need to create and build a market environment that gives project developers, SMEs and investors the confidence to use our capital markets. In doing this, we need to think creatively drawing on the experience and successes of other jurisdictions. Jobs, opportunities and economic growth depend on it.