

Speech

Speech by SFST at seminar hosted by HSBC USA, Hong Kong Economic and Trade Office in New York and the Hong Kong Association of New York(English only)

Tuesday, May 13, 2008

Following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, at a seminar hosted by HSBC USA, the Hong Kong Economic and Trade Office in New York and the Hong Kong Association of New York in New York today (May 12, New York time):

Distinguished guests, ladies and gentlemen:

This is the first time I have the honour of being hosted by three organisations. I am grateful to HSBC USA, Hong Kong's New York Economic and Trade Office and the Hong Kong Association of New York for jointly sponsoring my maiden appearance in the US.

Whenever the Chinese want to draw someone closer, they would say that 500 years ago, they belonged to the same family. Here in New York, I want to say definitely that if we reach far back enough, New Yorkers and Hong Kongers had to be cousins. We are too much alike. We are both impatient, some say rude. We both love the urban jungle. Trade is in our blood. And complaint is constantly on our lips. But we also manage to get a lot accomplished. In fact, we don't tolerate inefficiency, and money is always on our minds.

We may be separated by a continent and an ocean, but there is a definite affinity between the people of our two cities. Anytime New York blows its nose, Hong Kong wants to sneeze. Like the sub-prime problem --it has been our breakfast table conversation since the problem came to the surface.

We even experience time in the same way. I have heard of the expression "in a New York minute". Well, I can tell you that "a Hong Kong minute" is just as fast, if not faster.

We may not be as big as New York, but as an international financial hub,

we are known for being nimble. You know that Hong Kong returned to Chinese sovereignty almost 11 years ago. You might wonder if Hong Kong is still the same society. I can tell you that under the "One Country, Two Systems" principle, we have retained our essential character as an international city, enjoying freedom of the press and freedom of information. Our rule of law is still our pride, and so are our low taxes and clean and efficient government. We are an open society where citizens are free to call officials like myself names. But there is one big change, and it is a change Hong Kong people are thankful for. I am talking about our special relationship with our sovereign, and our unique economic ties with the Mainland.

Hong Kong's change of sovereignty coincided very happily with China's economic revolution. Many people predicted that when China joined the WTO, Hong Kong's unique role as the bridge between East and West would be eroded. But quite the opposite is true. Today, we are building many bridges, literally and figuratively, between us and the Mainland. The Hong Kong-Mainland Bridge is now stronger and more sophisticated than ever before.

With China's continuous double-digit growth comes a massive accumulation of wealth, and the urge for Mainland enterprises to expand outward and raise capital through our market. The Mainland factor has been one of the major forces that power our robust economic growth, despite a rather sombre outlook for the global economy, due in part to the US sub-prime turmoil. Our GDP grew by 6.3% in 2007, higher than the trend growth for the past 10 years, and is expected to reach a healthy 4.5% trend growth over the next four years, from 2009 to 2012.

Our financial services sector has performed impressively. As of the end of March 2008, our stock market ranked seventh in the world and third in Asia in terms of market capitalisation. The total equity funds raised reached over US\$3.2 billion, ranking ninth globally and second in Asia as of the end of February 2008. As far as initial public offerings are concerned, we ranked fourth in the world and second in Asia in 2007. We are also one of the world's largest banking centres, with the presence of about 70 out of the world's top 100 banks. Insurance company executives in the audience would be happy to know that we have the highest concentration of insurers in Asia. To complete the list, we are one of the largest asset management centres in the region.

With the rapid growth of Mainland enterprises and their ambition to go global, Hong Kong is favoured as the trusted platform for its outward reach. This is partly because we have a mature market. But also because of our cultural and linguistic affinities, our dependable regulatory structure, a legal system that is the finest in Asia, and the transparency of our government. The icing on the cake is our legendary low taxes.

For these reasons, Hong Kong is currently the most preferred platform for the listing of Chinese Mainland enterprises outside the Mainland. Mainland enterprises now account for about 60% of the total market capitalisation of our stock market. Hong Kong stands to gain even more with a scheme that may sound alien to American ears, but is music to the ears of Hong Kong businessmen. It goes by the name of Qualified Domestic Institutional Investors or QDII to players in the region. Under this scheme, Mainland commercial banks, securities firms, fund management companies and insurance companies will be allowed to invest in Hong Kong stocks and other specified securities. This scheme cements Hong Kong's role as the premier asset management centre for the Mainland.

These are powerful reasons why American investors should come east to Hong Kong. But there are others: our safe streets, a splendid public transportation system, zero capital gains tax, plus our army of well-trained and well-connected financial experts who have Mainland market data at their fingertips. Don't forget, we also speak your language, English of the Starbucks variety.

So, I say there is no place better than Hong Kong to access the immense Mainland market. Our financial services and our stock market are growing in tandem with the explosive growth of the Chinese economy.

Our new-found status is featured in a Time Magazine article called "A Tale of Three Cities" in which New York, London and Hong Kong are said to form a link in the global economy by a common economic culture. Time coined a new term "Nylonkong" to describe a financial network that will ease entry into the modern world of China and its economy.

Despite our success, standing still is not an option. We are doing everything we can to enhance our competitiveness as an international financial centre. For

example, we have exempted offshore funds from profits tax since 2006. We also abolished estate duty in the same year to make us more attractive as a major asset management centre in Asia.

Hong Kong is diversifying even as it deepens its relationship with the Mainland. We are reaching out to tap business opportunities in emerging markets such as Russia, Vietnam, India and the Middle East. Our market infrastructure and regulatory regime are being upgraded to align them with the evolving global market. As a new initiative, we are working to put in place an Islamic financial platform to harvest market opportunities in the Middle East. You can be sure of one thing: Hong Kong will not leave well alone, our nervous energy will make us better.

Now, time to change the subject. I cannot be in New York at this time and not talk about the sub-prime crisis in the US. For the US economy, this has been a body blow. Luckily for Hong Kong, it has so far been nothing more than a glancing blow, leaving us largely unscathed. But we are watching how the deterioration in lending and housing price drop will affect economic growth in the US market. This will affect Asian economic growth as well.

I do not intend to join the chorus of criticism of the current crisis, but I think it is useful to know how the problem is being viewed internationally. The roots of the sub-prime crisis are now exposed for all to see. First there is a problem in the originate-and-distribute model of mortgage loans. The model of taking the mortgage loans and distributing them among different investors is supposed to spread the risk around, and lead to an overall reduction in the systemic risk. But in the process, because the parties that do the loan origination do not hold the assets, there is a lack of incentive for the loan originating party to do the credit analysis. The investors that are at various stages of the originate and distribute model, and the regulators, have failed to come to grips with the credit quality, the pricing of risk, of these mortgage assets. In the model, mortgage assets are securitised, and then sliced into tranches for sale to investors with different risk appetites. Investors would have difficulty in understanding the risk of the individual tranches, and that is where the credit rating agencies come in. Papers that are not of investment quality can be upgraded to investment quality through a purchase of bond insurance. The crisis shows that risk has been under-priced. Credit rating agencies and the bond insurers have not provided the comfort investors thought they were

buying. The crisis also reveals the risk control problems at the banks. Banks have over-relied on what their risk models are telling them about the risks they have in the portfolios, and how to hedge these risks. They have overlooked the concentration risk, and when liquidity dries up, they end up having a large portfolio of assets whose values have collapsed.

The current financial crisis has been described as the largest financial crisis in the last 50 years. It has elements of many past banking crisis, namely, over lending, poor credit standards, bank runs and the credit crunch. It has elements of the financial crisis involving derivatives typified by the crisis of 1998 that saw the collapse of LTCM. The current crisis also reflects the degree of globalisation of our financial market. Financial products that are originated in one country are packaged and sold to financial institutions around the world. Financial institutions that have global presence are pursuing very similar trading strategies. Thus the hallmark features of a financial crisis, such as bank runs, and liquidity crunch, take on international dimensions.

What lessons are we to draw from the crisis?

The current crisis is a full scale financial crisis in a globalised world. It exposes many gaps in our financial system. There are gaps in the understanding and management of risk in our financial institutions. There are gaps in the regulatory system in many countries, such that many of the financing activities are unregulated. There are gaps in the international system of regulators. It shows the need for more information sharing, and coordination in dealing with financial stability issues.

I think these gaps are real. The current crisis shows in a dramatic way how individual weaknesses in our financial regulation and risk management can come together and put our global financial system at risk. It demands that we take seriously the task of reforming our regulation.

In times of crisis, there are always pressures to be doing something. We should avoid knee-jerk action that will do damage to our financial system. We should also resist the urge to over-regulate. For example, we should recognise that it is not the purpose of financial regulation to prevent market participants from making mistakes. No regulation can prevent asset bubbles from happening, or traders from taking excessive risk. Crashes will happen, just as

bubbles will build up. It is the prospect of periodic crashes and the risk of failures that will check the risk taking behaviour of traders. It is not the purpose of regulation to prevent failures. However, the purpose of regulation should be to raise the level of transparency so traders and investors have knowledge of what they are trading, and set prudential standards that will prevent trading losses from affecting the stability of the financial system.

Two recent reports on the diagnosis of the crisis and recommendation on how to reform the system are insightful and timely. These two reports are the U.S. Treasury's Blueprint for a Modernised Financial Regulatory Structure and the Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience. There are many serious-minded and practical recommendations on how we can reform the financial regulatory structure. Many recommendations are far reaching and no doubt will generate debate for some time to come. But the crisis reveals there are serious shortcomings in our regulation and there should be a serious-minded discussion on how to improve our system.

From Hong Kong's perspective, how do we see the prospect of changes in regulation? We are a small market and we are a very liquid market. We have succeeded so far in building a financial market because we are open to international investors and we have committed to building a high quality market with a transparent, high quality regulatory system, and a strong financial infrastructure supporting trading and settlement.

One thing we have learned from our own past brushes with bank closures is that we should set a high standard of prudential regulation. Our banks have done well because of the strong prudential regulation of the Hong Kong Monetary Authority (HKMA) on Hong Kong's commercial banks, including the 70% loan to value ratio on residential mortgages. This conservatism has served Hong Kong well. No banks went into liquidity problems even during the long period of housing bust from 1998 to 2003 that saw home prices fall by more than 60%.

Our policy is welcoming to financial innovations. The HKMA set up a Hong Kong Mortgage Corporation to help develop a mortgage backed securities market. Our stock exchange has active trading of futures, option, and warrant products, with participation of institutions and retail investors.

We are a hedge fund hub in Asia. We have adopted a licensing standard that makes it easy for experienced hedge fund managers to set up in Hong Kong. And Hong Kong is unique in that hedge fund products can be sold to retail investors.

In Hong Kong, we know that financial innovations are good because they lead to risk diversification, lower the cost of capital, and improve the efficiency of the economy. As an international financial centre, we are committed to pursuing a policy that will encourage financial innovations, that will make our market more attractive to both the companies which raise capital in our market and investors who buy products from our market. As an economy which has experienced some of the most destabilising financial crises, like the Asian Financial Crisis, we place great premium on sound regulation and international co-ordination. It is why we look at the current crisis as an opportunity for international regulators to come together to address some serious weaknesses in our global system.

That sounds like a sombre note to end my talk. But there is a silver lining even in the worst crisis, because this may now spur international co-operation on tackling problems with a global dimension, and a new awareness of just how globalised our economy has become. Maybe this is a good time for our New York cousins to look east, because that is where the sun will next come out.

Thank you.