

## Speech

### Speech by SFST at Euro Finance Week Lead Conference (English only)

Wednesday, November 18, 2009

Following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, at the Euro Finance Week Lead Conference today (November 17, Frankfurt time):

Opening

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Ladies and gentlemen,

It gives me great pleasure to speak at the Euro Finance Week.

I am honoured to speak on the same panel with the brains behind the European and international regulatory reforms going on today. As we are discussing the reforms to the international financial architecture, I would like to offer an Asian perspective on the financial crisis, how we have weathered the storm and the way we propose to move forward.

The financial crisis to Hong Kong

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It has been a little over one year since the financial crisis began to unfold in front of our eyes. Governments around the world have had no choice but to focus all their energy on kick-starting their economies and refining and strengthening their own financial regulatory regime. US and European regulators have been faced with the additional task of stabilising their own markets and systemically important institutions.

Fortunately for us, Hong Kong has been able to tide over well and has not experienced any systemic failures. Our banking system continues to be fundamentally sound, healthy and robust. It remains liquid. The capital adequacy ratios of locally incorporated banks remain strong and are consistently well above the local statutory requirement and international

standard of 8%. The securities and insurance sectors in Hong Kong also remain financially sound and healthy. Indeed, the Hong Kong Government need not "rescue" any bank, nor is there any default of intermediaries. That said, we are aware that further efforts should be made to boost confidence and better contain the contagious effects of the global financial crisis.

We are not without problems of our own but they are just of a different nature from that faced by the West. Our attention has primarily been focused on handling complaints of mis-selling products which failed from the collapse of Lehman Brothers. Hence our proposed reform has veered towards reforming and strengthening our regulatory structure to enhance investor protection, rather than tightening prudential regulations on our banks.

If there is one thing that we learnt from this crisis it would be that the financial system runs on a global platform and the problem faced by one economy could quickly spread to others. Hong Kong will not be spared by the collapse of any major financial institutions regardless of how far away we are by distance, how far removed the company is in structure terms, or how well our local economy is holding up. Only a seamless approach to regulation that goes beyond borders and has the capability of overseeing the organisation in its entirety will serve the purpose.

#### Over-the-counter (OTC) derivatives

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Many blamed the current turmoil on the financial innovators cleverly repackaging risks into complex derivatives. These instruments are often traded over the counter whose risks are opaque and few people outside or even inside the companies which are taking the risks have the expertise to understand them, let alone assess their potential aggregated impact and exposure.

We are supportive of the global efforts towards enhancing transparency of the OTC derivatives markets. In particular, the G20's recommendations to require all OTC derivative contracts to be reported to trade repositories and move all standardised OTC derivative contracts to exchanges or electronic trading platforms, and be cleared through central counterparties (CCPs) by end-2012. The increased transparency of this previously mysterious market would give the authorities a more complete picture of the positions that are

building up and hence a better handle on the potential risks to global and domestic financial stability. This is clearly an important piece previously missing from the financial regulation jigsaw.

Getting all trades on a platform would be the ideal situation. However in reality, jurisdictions with less developed markets may not be able to establish a meaningful clearing house as larger market players may prefer to settle trades (especially those denominated in US dollars) in the developed market. For the same reason, it may not be feasible for these jurisdictions to set up central repositories to collect data on OTC derivative trades, making it impossible for their regulators to obtain a full picture of their OTC derivatives market.

Nevertheless, relying on each regulator to independently collect information without regard to what the others are doing will not get us where we want to be. Market fragmentation due to the establishment of clearing houses in different jurisdictions and information asymmetry amongst different regulators may give rise to regulatory arbitrage and defeat the very purpose of the current reform on the OTC derivatives market. It is clear that global co-operation among the regulators in overseeing clearing houses and sharing information collected by trade repositories is essential. In this regard, we welcome the establishment of the OTC Derivatives Regulators Forum under the auspices of the Financial Stability Board in September 2009 which comprises central banks and regulators in 15 countries. The Forum has "hit the nail on its head" by making clear that one of its objectives is to co-ordinate the sharing of information among regulators or to the public by OTC derivatives CCPs and trade repositories - this may seem a small task, but the success of the current reform hinges on it.

It is important that we have access to information kept by the CCPs and repositories that is needed for our financial stability surveillance. More information sharing with the relevant regulators would be welcomed especially on (i) positions of Credit Default Swap (CDS) on Hong Kong-related entities, (ii) positions of CDS taken by Hong Kong incorporated financial institutions. It would also be helpful if Hong Kong authorities could have access to information on positions related to Hong Kong dollar denominated OTC trades registered with overseas trade repositories, as they may be settled offshore through overseas clearing platforms or on a bilateral basis. All such information would help us monitor potential risks in Hong Kong equity,

interest rate and foreign exchange markets.

## Hedge fund

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Hedge fund regulation is another area which many regulators have recently homed in on. It is generally recognised that hedge funds did not cause the financial crisis, but the speed of growth of this industry has raised concern that sooner or later "systemically important" hedge funds will emerge and we need to be prepared for any potential risk to financial stability caused by their failure. We support the International Organisation of Securities Commissions' recommendation for co-operation between regulators and the hedge fund industry associations to identify the reporting standards of hedge fund managers.

Reciprocal information is not only important among regulators but also to investors in different jurisdictions. There must be a level playing field for investors globally in terms of information disclosure and protection offered by regulators. It is also conducive to financial stability to have a regulatory regime which promotes active due diligence and risk monitoring by the investors themselves.

The EU Directive released in April provides that only authorised funds established in Europe can provide their services in the EU unless non-EU funds are domiciled in countries which impose EU-equivalent regulatory and supervisory standards. While this proposal has good intentions, if not executed properly and with the co-operation of the other countries, it may easily result in market fragmentation and protectionism. It will cause uncertainties and anxiety among the fund managers and EU investors may be stripped of investing choices. But I am glad to hear that the rules may be significantly amended before they are rolled out.

## Executive compensation

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Executive compensation is another politically charged topic that has grabbed the attention of the public. Instead of rewarding long term performance that is in the best interest of the company and its shareholders, the banking

sector has rewarded recklessness and short-term gains. This compensation model is not limited to the traders who took home multi-million dollars, but everyone from the front line sales whose commission is proportional to sales volume, to senior management whose bonus reflects the current year's profit. I wouldn't attribute this pay matrix merely to individuals' greed but more the accepted way the "game" was played, the rules of which were allowed to be formulated under a cloud of failed risk management. We believe a sound remuneration model is a critical element for effective risk management.

As an international financial centre and an active member of the Financial Stability Board, Hong Kong is committed to adopting international standards and best practices. To this end, we have developed a set of guidelines on the basis of the principles issued by the Financial Stability Board with a view to providing broad guidance on the governance and control arrangements for, and operations of, a sound remuneration system for the banking sector. We are currently consulting the local banking sector on the guideline and aim to finalise the guideline for implementation by the end of this year.

## Conclusion

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The central theme weaving through the various areas of regulations seems to point to the fact that unilateral action by individual regulators would jeopardise the chances of a successful regulatory reform of the financial industry which has gone global in every sense of the word. Despite the temptation to find a quick fix to the problem, there is no room for protectionism or inward thinking. What is required now is a recommitment to co-operation between governments and closer collaboration among regulators in leading markets to deal with the financial crisis.

Hong Kong stands ready to be part of this global effort to restore stability to our financial system. You can count on us to play our part as an international citizen and we look forward to working closely with all of you in the future.