Press release

LCQ2: Measures to improve regulation of financial institutions and financial products

Wednesday, October 21, 2009

Following is a question by the Hon Frederick Fung Kin-kee and a reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (October 21):

Question:

It has been more than a year since the outbreak of the financial tsunami and the European and American economies have earlier introduced a number of financial reform proposals, including reform of regulatory framework, as well as regulation of derivative financial products and remuneration of senior staff of financial institutions, to prevent recurrence of financial crisis, and some of the proposals have even been implemented already. Regarding the situation in Hong Kong, apart from minor changes introduced by the authorities to the approaches and procedures for selling financial products, and the recent consultation paper issued by the Securities and Futures Commission on proposals to enhance regulation of the sale of financial products, the authorities have not yet come up with any concrete direction and proposal for reform in areas such as the overall financial system and establishment of a mechanism empowered to protect investors, etc. In this connection, will the Government inform this Council:

(a) regarding the reform of the overall financial regulatory framework, whether any proposal (e.g. establishment of a unified regulator or the adoption of the "Twin Peaks" model of regulation and appointment of an independent financial ombudsman, or consideration of amending the existing regime only) is being studied by the authorities; if so, of the specific scope and contents of the proposals and consultation schedule therefor; if not, the reasons for that;

(b) given that one of the causes of the financial tsunami was that senior staff of European and American financial institutions, in seeking high return and robust business growth, had created a large number of complicated and high risk derivative products, resulting in incessant expansion and transmission of risks, and the G20 Summit earlier held in the United States has therefore reached an agreement to regulate the remuneration schemes of senior staff of financial institutions, how the authorities will implement this agreement in Hong Kong, including whether they will effect regulation by way of legislation and require financial institutions to set up comprehensive risk management systems; if they will, of the specific measures; if not, the reasons for that; and

(c) whether the authorities will consider establishing a central clearing and trading platform for off-market derivative financial products, so as to strengthen the regulation and enhance the transparency of such products; if they will not, of the reasons for that?

Reply:

President,

(a) Our financial system has emerged from this global financial crisis without any systemic problems. As the Chief Executive has mentioned in the 2009-10 Policy Address, we will, with the experience gained, seek to further achieve the two main objectives of investor protection and financial security when formulating policies on financial regulation.

The collapse of Lehman Brothers triggered the Minibond incident. After receiving the review reports from the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) on December 31, 2008, the Administration has formulated an Action Plan in consultation with the regulators for taking forward in phases the various recommendations put forth in their reports. Some of these measures have been implemented. Since September 25 this year, the SFC has also been consulting the public on a series of proposals designed to enhance the existing regulatory regime for the sale of investment products to the public. The Financial Services and the Treasury Bureau (FSTB) also plans to consult the public on the proposals to establish an Investor Education Council and a financial dispute resolution scheme by the end of the year.

We aim to strengthen investor protection in every aspect by proposing a series of improvement measures catering for the various stages of making an investment decision. This ranges from investor education, authorisation of investment products, disclosure requirements, sales practices, conduct of intermediaries to financial disputes resolution.

We recognise that our financial regulatory regime should move forward in tandem with market development. Yet, the regulatory regimes in different places vary, and there is no particular structure or model which is universally applicable. Any reforms to our regulatory regime must suit the unique background and market needs of Hong Kong, and be carried out prudently having regard to all relevant factors. In this connection, we will pay due regard to the views of the markets and various sectors of the community, including the Legislative Council. We will also take account of other factors like the global financial developments.

(b) The Financial Stability Board (FSB) issued in April this year the Principles for Sound Compensation Practices (the Principles). As a member of the FSB, Hong Kong is working to implement the Principles. In this regard, HKMA has prepared a draft "Guideline on a Sound Remuneration System" (the Guideline) based on the Principles. The objective of the Guideline is to ensure that authorised institutions (AIs) have in place remuneration systems that are consistent with and conducive to effective risk management. The draft Guideline was endorsed by the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee in early September.

To strengthen adherence to the Principles, FSB issued a set of Implementation Standards (the Standards) in late September, providing specific guidance on compensation governance, structure and disclosure. HKMA is in the process of incorporating the Standards into the draft Guideline, which will be issued for industry consultation by end October. HKMA plans to issue the final Guideline by end 2009. AIs are expected to take prompt action to follow the Guideline and to achieve full compliance within 2010.

As the formulation and implementation of international standards on remuneration practices within banks are still evolving, it is impossible and inappropriate for us to attempt to regulate the remuneration system of the banking sector through legislation at this point. While the Guideline issued by HKMA does not have the force of law, failure to adhere to the standards set out in it may call into question whether an AI continues to satisfy the minimum criteria for authorisation in the Banking Ordinance. In addition, according to the supervisory review process of the existing capital framework, HKMA will, in determining the minimum capital adequacy ratio of a locally incorporated AI, take into account the AI's compliance with the Guideline.

(c) Trade in over-the-counter (OTC) derivatives is generally transacted through direct negotiations between the buying and selling parties without going through an exchange. Many of these derivatives are tailor-made to suit the practical needs of individual customers, such as the instruments used in oil hedging by airlines. It is therefore difficult to establish a central clearing for such non-standardised OTC derivatives.

Since the outbreak of the current global financial crisis, many countries and financial regulators worldwide have put forth proposals on enhancing the transparency of the markets of OTC derivatives. They include requiring the clearance of some of those OTC derivatives that are suitable and can be standardised to take place on specified central clearing platforms in order to reduce counterparty credit risk and enhance transparency. We support this development.

Hong Kong's financial regulators (such as HKMA and SFC) have been actively involved in the international dialogue and also closely monitoring the latest development. FSTB will work with HKMA and SFC to study the feasibility of introducing central clearing to some standardised OTC derivatives, taking into account the latest international development and consensus, as well as local market conditions.

Separately, the Hong Kong Exchanges and Clearing Limited (HKEx) announced in September this year that it is planning to introduce flexible index options in early 2010. This will help attract some of the index options contracts that are currently traded in OTC markets to shift the trades and clearance to the platform of HKEx. Flexible index options are a kind of OTC derivatives whose terms can be standardised. They are Hang Seng Index and H-shares options contracts which allow market participants to request customised strike prices and expiry months, provided that the contracts are bought and sold through the block trade facility. HKEx believes that the introduction of flexible index options will give OTC market players an attractive alternative with lower counterparty risk, and help enhance market transparency by bringing such OTC trades under its block trading facility.

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