Speech

Speech by SFST at the 2010 International Swap and Derivative Association Regional Conference (English Only)

Monday, October 25, 2010

Following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, at the 2010 International Swap and Derivative Association (ISDA) Regional Conference of the New Environment for Over the Counter (OTC) Derivatives today (October 25):

Thank you Connie for the introduction.

Good Morning everybody. First of all, I would like to thank ISDA for hosting this regional conference in Hong Kong. Judging by the speeches given by Connie, it is clear how much ISDA has done in the past - and especially during the two years since the global financial crisis, when we were all trying to figure out what to do. ISDA has played a very important role in providing a bridge between the government, the regulators, and the industry.

I would like to talk a little bit about the regulations, what Hong Kong has been doing and some developments in our market. Also to tell you what direction we might be taking and what opportunities there are for investors and the market.

Now, of course, the ISDA conference has a heavy focus on regulations. You can see regulations and regulators all over your agenda. People who are not in the finance industry may not realise finance is a highly regulated business. And why is finance so highly regulated? The financial industry, all the intermediaries that we have, including banks, hedge funds, and mutual funds and so on, are essentially taking investments from millions of investors and they channel this capital across various assets. By definition, these institutions have very little capital of their own because they are using other people's capital for investment. As a result, capital adequacy has always been a concern in regulations.

As financial intermediaries provide mediation across various risk classes, there are many potential risks. Financial intermediaries are trading to take advantage of profitable opportunities, and that may also create potential risk. For these reasons and others, the finance industry has always been a regulated business.

We know that the quality of regulation depends on how much we know about the financial market and what risks are there. Clearly, we have seen in the periods before the global financial crisis, a period in which investors mispriced risks in the market. The counter party’s risk was also underestimated and when the market went into trouble, liquidity disappeared.

With the benefit of hind sight, many people who are not in the financial industry, particularly blamed the regulations and the lack of regulations as a cause for the financial crisis. I think in the last two years to the credit to the industry and the regulators, we all tried to come up with some solutions on how to provide better regulations for the financial market.

There are a lot of regulations coming out from Washington, EU, in different aspects of financial markets. I think one of the good examples of how the co-operation between the industry and the regulators has worked quite well is the issue about the transparency of OTC derivatives market.

With the global financial crisis, we can see how OTC derivatives was one of the key reasons why the market ran into troubles in those dark days, so these were the issues we have to tackle. We have come to a consensus that increased transparency will give the authorities, all the government regulators, a more complete picture about the positions that are building up and get a better handle on the potential risks of the financial system.

I think what we should understand is that having transparency does not really solve every problem. You can have reporting of positions but still the government and the regulators will need to figure out how to connect those dots and see potential positions, how they are related from one market to another market and what kind of macroeconomic risk you have to be concerned with. But at least we have more data, more reporting, more transparency, and hopefully we could encourage the industry to do more research on the risks we need to face for the system as a whole. I think that is a very good progress.

For market regulators, this global co-operation shares the information we needed and could monitor the risk on a global scale. There is also consensus reached that OTC contracts should be traded on exchanges and electronic trading platforms and be cleared by the potential counter-parties (CCP) by the end of 2012.

In fact, over the weekend, the G20 Financial Minister's meeting endorsed the idea and so this is something definitely going to happen soon.

No doubt that this will actually increase the cost of doing business in OTC derivatives. Even if that is the case, the cost of the collapse of financial system is bigger to the economy and to all the tax payers. We all have to accept the higher cost of doing businesses on OTC derivatives.

Increasing standardisation would have benefits beyond maintaining financial stability and transparency. It would facilitate automated processing of transactions; increase the fungibility of the contracts which enables greater market liquidity; improve valuation and risk management; increase the reliability of information; reduce the number of problems in matching trades; and facilitate reporting to trade repositories. So there are some good sides, hopefully the technology will enhance the transparency for the market players themselves.

Hong Kong is an active member of the Financial Stability Board and an important international financial centre in this time zone. We are committed to adopting the international standards and best practices.

Currently, the Financial Stability Board is leaving it to local regulators to determine which OTC products need to be standardised and put on the exchange. In bringing these principles to a local implementation level, we bear in mind that these principles need to be adapted to the local market needs as well as the regulatory regimes and practices that we have built over the years. In this process, Hong Kong will actively engage the relevant stakeholders such as financial institutions, investors and professionals alike. We will continuously keep an eye on the developments in the international scene in order to come up with our own local implementation.

One thing I would like you to bear in mind in Hong Kong is that, we believe the kind of regulatory system that we have in place has been good for the market development, also good for our own stability. So in making any changes in OTC derivatives clearings, or in making changes that we have done for the last two years, or in response to the financial crisis, we always bear in mind that we should keep the regulation simple, predictable, transparent, and fair. We engage the stakeholders and market and consult them in order to come up with workable solutions, and not to increase the cost of doing business in Hong Kong. This is a principle we will always bear in mind in dealing with changes in regulations.

Our approach to regulation should help us tackle the new opportunities that Hong Kong is facing with. While the other governments are still working on saving the banks or improving the balance sheet of the banks, changing the regulations and merging regulatory agencies and so on, Hong Kong does not seem to have the need to do any of that. In fact, the crisis gave the investors more confidence that we are very transparent and consistent. I can only mention one example, which is the short sell rule that we haven't changed during the financial crisis, to tell you how consistent we are in our regulation.

And going forward, as we are seeing more opportunities in the financial market development in our market, we believe that this approach of regulations is going to be an asset and a comparative advantage of Hong Kong.

Talking about opportunities, I do not have to go through all the details because you see the excitement in the marketplace from IPOs and all kinds of corporate finance activities happening here. The key reason for that excitement, in my mind, is the perceived shift of economic opportunities from the Western markets to the Asian markets, largely because of the China factor. China is emerging as a very important economic power and China's performance during and after the crisis have reinforced the notion of here is where the economic opportunities and the growth going to be.

Hong Kong is riding on these good opportunities. We believe by reinforcing Hong Kong's considerable advantages as an international financial centre, as a place with free flow of capital, as a place with good regulations, as a place to have good access to the Chinese market and products, and also good co-operation with Chinese financial regulators, we can actually capture all these opportunities.

One example I can talk about is the birth of a new market. I am talking about a historic opportunity for Hong Kong to start an off-shore business in RMB. Depending how fast it is going to grow, but the increasing use of RMB in the region is both a growth driver for Hong Kong market and for China market.

We are already off to sterling start on RMB business. The pool of RMB deposits in Hong Kong grew from RMB56.7 billion to RMB130.4 billion in a 12-month period between August 2009 and August 2010. And the figure is growing rapidly by the day, through a combination of conversion by local residents, the inflow of the Mainland's enormous wealth, and RMB cross-border trade settlement. In the second quarter of 2010, the value of RMB trade settlement grew to RMB48.7 billion, which is 2.7 times of that in the first quarter 2010. In the two months of July and August of this year, the value reached RMB87 billion, which is a further significant gain over the period.

The RMB deposits in Hong Kong grew rapidly in line with the expansion in the scale of RMB trade settlement. Between June 2009 and June 2010, the value of deposits grew from RMB55 billion to RMB89 billion, by 35 billion in a 12-month period. And then, the value of deposits grew from RMB89.7 billion to RMB130 billion, by another 40 billion within a short 3-month period. So we are seeing a rapid expansion in trade settlement and deposits over the last 3 months.

It is natural that the RMB accumulated in Hong Kong would be looking for RMB products investment opportunities, and hence fuelled the expansion of RMB products available here. In July this year, a revised settlement agreement was signed. All companies and organisations, including financial institutions, can open RMB accounts at banks. Restrictions on RMB interbank transfers between personal accounts and corporate accounts were removed.

One month later, the Central Government opened up Mainland's interbank bond market to overseas clearing banks, participating banks and central banks. This gives rise to opportunities for financial institutions in Hong Kong, through investing in mainland China's bond market, to launch more yuan-denominated products catering for the varied needs of investors.

The development of RMB bonds is an area that has picked up momentum. We have attracted a mix of issuers to launch their RMB bonds here - from our Central Government, to financial institutions, to corporates, to fast-food company and now as of last week a supra-national agency, the Asian Development Bank. The International Finance Corporation, the private arm of the World Bank is also preparing to launch their RMB bonds here.

Now we recognised more is needed to be done to build up our offshore RMB business to support the internationalisation of the RMB. In the Chief Executive's Policy Address, he highlighted the importance of enhancing our financial cooperation with the Mainland and particularly outlined four short term goals, three of which are related to RMB business.

To echo what the Chief Executive has said, I will describe the work as follows. First, we want banks in Hong Kong to promote the use of RMB in trade settlement. Because the idea of using RMB is new to many overseas corporate customers, we need to show them the benefits of switching from say, US dollar, to RMB in settling trade, and to help them understand the rules and procedures involved.

Second, we need to develop an interbank market on RMB to increase the efficiency of bank lending to their customers. The revised settlement agreement announced in July has lifted many restrictions. Hopefully as the RMB deposits build up and as trade settlement volume increases, this will lead to an efficient local RMB interbank market. We should also try to improve the linkage between the interbank markets in Hong Kong and the Mainland.

Third, we need to expand investment channels for RMB funds accumulated in Hong Kong. By offering investment opportunities denominated in RMB, we can help grow the demand for holding RMB assets offshore, and the expanded pool of funds will facilitate the growth of RMB trade settlement. The Chief Executive mentioned that he would like to see expansion of channels for RMB capital raised by enterprises in Hong Kong to be invested in the Mainland. Foreign direct investment is one example of the investment opportunity we have in mind. Another example is for RMB funds in Hong Kong to be invested in the Mainland market through a QFII-like arrangement.

In the past many years, Hong Kong has a unique role to play in the development of China’s financial market. We are always pioneering for the changes in the market and financial reform in China. The new market opportunities in the RMB business are a new reminder to Hong Kong of the strength of our city, and our historic role in supporting the economic development of our country.

Conclusion

In concluding, I would like to remind you that while we have opportunities ahead of us, we also see a considerable risk around us. We are finding ourselves in uncharted waters two years after the global financial crisis. Economic growth in Western economies is slowing down. Because of the deficit concern as well as lack of political consensus, many countries cannot use fiscal expansion as a means to increase demand. So monetary policy becomes a tool to the US and some of the EU countries, such as the controversial QE2 which is being talked about as a way to revive demand. We believe such loose monetary policies could lead to asset price bubbles in emerging markets. We have a curious mix of macro-economic conditions - slow growth in developed markets and high growth in emerging markets - and loose monetary policy coming from countries with large reserve foreign currency. This curious mix of macroeconomic and monetary conditions could very much lead to volatility in currency market and other asset market. Not only is that a source of risk to the financial markets, the large changes in the exchange rates can lead to tension between countries.

For people in the financial industry, this becomes either a period for considerable investment opportunity, or a period calling for risk management. Of course people in this room know this idea about risks and opportunities. I hope to remind ourselves that let's not forget about the Financial Crisis. Let's do our homework. Let's care about the capital flows because asset liquidity can take a U turn as soon as the global conditions change. That is the risk we have. I look forward to seeing you more in Hong Kong, and that you continue to build an excellent platform to talk about the change in regulation and how industry can help to come up with a solution to deal with opportunities and challenges ahead.

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