Speech

Speech by SFST at the IMF High-level Regional FSAP Outreach Symposium (English only)

Friday, December 9, 2011

Following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, at Session II titled "New International Regulatory and Supervisory Standards - Their Role in Addressing Systemic Risks?" of the IMF High-level Regional FSAP Outreach Symposium on "Monitoring and Managing Financial Stability in the Post-Crisis World: Lessons From and For the FSAP" in Shanghai today (December 9):

Thank you for inviting me to speak at this session. In the next hour, we will be discussing the readiness of our region to implement Basel III, Solvency II and the new guidance from the International Organisation of Securities Commissions (IOSCO) on securities markets. We will also share some of the lessons each of our markets has learnt from the never-ending financial crisis which began in 2008.

Basel III for banks

Let me start by giving you an overview of Hong Kong's plans for the future. First of all, we intend to implement the Basel III framework in full and meet the Basel Committee's time frame. We do not expect our local banks to have any major problem with complying with the new Basel III requirements given their existing capital levels and composition of capital base.

Solvency II

On the solvency regime, we are aware that the international trend is moving towards a risk-based capital framework for the insurance sector. The EU, for example, has developed Solvency II which sets out quantitative, qualitative and disclosure requirements, as well as the risk levels and risk management in assessing solvency adequacy. Hong Kong is formulating policies in that direction whilst taking into account our local needs.

New guidance from the IOSCO on securities markets

In the aftermath of the financial crisis, regulators are expected to contribute to monitoring, mitigating and managing systemic risk. I am glad to say this is not foreign to Hong Kong - in fact, reducing systemic risk has always been a statutory objective of our securities regulator.

The Securities and Futures Commission (SFC), our regulator looks at a wide range of indicators when assessing the potential risk posed by institutions, markets or instruments to the orderly and effective functioning of the securities markets. In many ways, the monitoring of systemic risk is already embedded in the daily work of the SFC.

Needless to say, no matter how capable a regulator is, it cannot predict all the threats that a financial system may be faced with. Any sudden and unexpected financial turmoil or the demise of any major overseas financial institution will send the financial system tremoring, particularly in times of high market volatility and low levels of investor and consumer confidence.

What we can do is to mitigate that threat.

(a) For exchange-traded products, our regulator is looking at concentration of trades, distribution of outstanding positions and volatility. We study the interplay among different market segments and assess their associated risks. For exchange-traded funds in particular, we have imposed counterparty exposure limit and collateral requirements.

(b) Corporate CRAs and their individual rating analysts are now subject to greater oversight via a licensing requirement and are regulated by the SFC.

Clearing houses are subject to our close oversight. Reform of the over-the-counter (OTC) derivatives is underway and will be consistent with the G20 objectives. Local trade repository (TR) is also being set up by the Hong Kong Monetary Authority, and Hong Kong Exchanges and Clearing Limited is building a local central counterparty (CCP) for OTC derivatives in Hong Kong. The TR and CCP are scheduled for launch in 2012.

How to ensure that regulatory reforms and higher prudential standards are applied consistently across countries and without undue disruption to the ability of the financial system to support growth?

It's all very well that each country is putting in place their own regulatory regimes, however potential differences in the scope and application of rules could encourage regulatory arbitrage, increase systemic risk, and market fragmentation. Coordination among international regulators is a "must" if we want to ensure an internationally consistent approach in implementation of the G20 commitments.

The IMF-World Bank Financial Sector Assessment Program (FSAP) is by far the most comprehensive and in-depth analysis of the financial sector. It assesses an economy’s actual implementation of financial sector standards and codes, including the IOSCO Principles and Objectives of Securities Regulation and the Basel Core Principles for Effective Banking Supervision.

The Financial Stability Board (FSB) has also put in place a peer review mechanism for more focused and detailed monitoring of implementation progress. Various standard setters such as the Basel Committee have established their own monitoring programmes.

The chances of successfully and smoothly implementing new policies depend to a large extent on whether there was effective engagement of relevant jurisdictions in making policies in the first place. In this regard, we note that the Basel Committee expanded its membership in 2009. In addition, the FSB has recently established regional consultative groups to further engage non-FSB members in six different regions. Meanwhile, regional economies are also encouraged to make more use of regional platforms, such as the Executives' Meeting of East Asia-Pacific Central Banks, to discuss issues of their common interests and relay their views to the international setting bodies where appropriate.

A more resilient financial system with well-capitalised and liquid financial institutions will go a long way in reducing the risk of future crises and promoting sustainable growth in the long run. However, it is important to ensure that the regulatory reforms themselves will not introduce new risks and additional procyclicality to the financial system. The macro-economic impact and effects on market dynamics and liquidity of the new capital and liquidity rules under Basel III must be carefully assessed. Consultation with the industry must be done to ensure normal economic activities are not disrupted inadvertently. Phased implementation would allow the "kinks" to be ironed out in an orderly fashion. A good example is the transitional arrangements for Basel III implementation - the two newly introduced minimum liquidity ratio requirements (i.e. the Liquidity Coverage Ratio and the Net Stable Funding Ratio) will only be implemented on January 1, 2015 and January 1, 2018 respectively, each preceded by an observation period starting January 1, 2011.

<u>What more needs to be done to improve the quality and effectiveness of financial supervision in the region?</u>

The global financial crisis has exposed a number of weaknesses in financial supervision. We welcome the work of the FSB on enhancing supervisory intensity and effectiveness, and by coming up with important findings and recommendations for financial supervision.

Data gaps are an obvious area which if minimised would lead to improvement in financial supervision. For example, data from banks on their credit exposures may not show their largest exposures by economic sectors. Regulators may not have sufficient information on the source of bank deposits to determine the stability of banks' funding sources. Closing data gaps and improving the information systems of banks and supervisors would allow risks to be identified at an early stage and facilitate better understanding of inter-linkages between financial institutions.

Supervisors need tools such as unambiguous mandates, appropriate powers, and sufficient resources for their functions. They also need to constantly upgrade their technical expertise and understanding of latest market developments, so that they are able and willing to challenge banks' business models and act early if necessary.

Supervisors should also adopt a more forward-looking approach to supervision and stand ready to employ prudential tools to "lean against the wind". There has been a growing recognition of the use of macro-prudential policies to reduce the procyclicality of the system. A good example is the introduction of the countercyclical capital buffer under Basel III. In Hong Kong, we have been cautious about the build-up of an asset bubble and the rapid credit expansion so we have proactively deployed various prudential tools such as raising the levels of banks' regulatory reserves, lowering mortgage loan-to-value ratios, tightening credit underwriting standards, etc.

Given the inter-connectedness of our financial system and the global nature of systemically important financial institutions, financial supervision would only be effective if it is supported by strong cross-border co-operation. Supervisory colleges and crisis management groups have been set up for banks and other financial institutions with significant international operations to enhance information sharing, supervisory co-operation and crisis resolution. Hong Kong's regulators, being the major host supervisors of the banks and financial institutions concerned, have been participating constructively in the relevant supervisory colleges and crisis management groups.

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