

ANTHONY NEOH

**Life after Barings -
the Shape of Things to Come**

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I am honoured to have been invited to speak this evening, particularly, when I am sharing the occasion with my friend, Andrew Large, Chairman of the UK Securities and Investments Board. Andrew has been one of the principal moving forces in promoting the international effort to improve the regulation of securities and futures activities following Barings and the co-promoter of the Windsor Declaration.

The Barings Report prepared by the Board of Banking Supervision of the Bank of England makes fascinating reading. Like many of my colleagues who have read the Report, I was struck by the graphic description of the fundamental breakdown of internal controls in an outwardly sound and venerable organisation, particularly so, when Barings had experienced credit and risk managers as well as the relevant management committees. The case represents a salutary lesson to us all. The age-old caveat that no organisation can merely rely on structure and written rules but true understanding of the business and vigilant supervision on the part of its managers rings true once more.

Every major financial institution that I have come across since the collapse of Barings has made a detailed review of their systems of risk management and internal controls. I am impressed by this speedy response. I shall therefore devote my remarks to the regulatory response to the Barings collapse. It is worthy of note that whilst the failure of management has been clearly described in the Barings Report, the failures in the system of regulation have been less clearly articulated.

We know for certain that an exception was allowed to Barings in respect of the legally imposed large exposure limit of 25% of its capital base on the basis of assurances from Barings management but pending review of the overseas exposure. In the event this review never took place. Clearly the exposure, which proved fatal, was very large indeed. That was, as noted in the Report, an error of judgment on the part of a member of the banking supervisory chain. But, error of judgment apart, the Report fairly points to the fact that Banking regulators primarily look to capital adequacy and were not attuned to the day-to-day risks involved in securities and futures transactions. The Report therefore point, quite rightly, to the need for better co-ordination between banking and securities regulators.

I cannot agree more with this conclusion, but we in Hong Kong, face a special problem. Whereas the securities and futures activities of a UK bank are regulated by the UK Securities and Futures Authority, banks in Hong Kong are exempt from regulation of the Securities and Futures Commission. When the Securities Ordinance was enacted in 1974, it was envisaged that banks would only deal in securities as an incidental part of banking business. For example, banks acted as custodians of securities or accepted or disposed of shares or other documents of title in securities as loan collateral. Thus the Ordinance envisaged banks being exempt from licensing under the Securities Ordinance. The situation has however drastically changed in recent years. Banks now offer services, as either agents or principals, to their clients in the sale and purchase of securities and derivative products. In so doing, they raise two sets of issues. The first is the effect such activities have on their soundness as financial institutions, and the second, is whether their conduct as intermediaries in securities and derivative transactions should equate with licensed institutions which are not banks.

The Oversight of Financial Soundness

The oversight of financial soundness requires firstly, ability on the part of regulators to ensure that adequate internal controls are in place

in a financial institution; secondly, formulation of capital adequacy rules which are sensitive to market conditions; thirdly, a system to ensure that financial reporting is adequate and timely, and fourthly, effective co-ordination between regulators, if more than one exists.

Internal Controls

As to internal controls, you will, by now be familiar with the G30 recommendations which formed the basis of the guidelines on risk management and internal controls jointly issued a few months ago by the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC). A subsequent Survey by the HKMA shows an impressively high level of compliance with the Guidelines. The SFC Survey has not yet been completed and I look forward to publishing the results.

There is within Hong Kong a consensus, proven to be absolutely correct in the light of the Barings Report, that controls should include informed management oversight throughout the management strata up to the highest levels, effective understanding and clearly defined lines and divisions of responsibility and accountability, an independent risk management function and a strong and experienced internal audit function which should liaise closely with external auditors. Specifically, it is commonly agreed that internal control must be exercised vigilantly, particularly when staff performance is heavily geared to profits. Furthermore, proprietary trading should be clearly distinguished from client trading and there should be a clear division between front and back offices.

The SFC will extend its on-site inspections relying on the risk management and internal control guidelines issued earlier this year, and on the more detailed guidance on internal controls which we shall publish later this year.

Capital Adequacy

Coming to capital adequacy, you will agree that in securities and derivatives transactions, price fluctuations and hence market risk fundamentally affect a firm's ability to function on a sound financial basis. Capital adequacy rules should therefore take into account capital available to meet not only vested but also potential liabilities - namely, the payables as well as the potential payables. At the same time, the imposition of capital requirements should not be so onerous as to place undue pressure upon an intermediary to take high risks in order to seek high returns. A reasonable balance will clearly have to be struck. A start has been made by the SFC by recently amending the Financial Resources Rules (FRR) to cater for the treatment of assets and liabilities arising from options trading on the Stock Exchange. These amendments take account of net open positions. In relation to market makers in the Traded Options Market in the Stock Exchange, the SFC will be prepared to consider the adoption of the net positions produced by proprietary hedging models for all relevant exchange traded products. In making these revisions we hope we have struck a reasonable balance between capturing market risks and effective employment of capital. Of course, these revisions refer only to exchange traded products where we as regulators can still rely on the Exchanges, and their Clearing Houses in particular, as the front line of risk management. In over-the-counter trading of derivatives a much more complex set of considerations will come into play and there is no clearing house to manage the risks. Here, a wide range of derivative products is being bought and sold and the problem of quantification of potential liabilities becomes complicated indeed. However, even here, recent developments within large international financial institutions and international collaborative efforts among regulators and the industry point the way to a solution.

International financial institutions are more and more disposed to managing their client and proprietary transactions on a global basis. Many institutions that I have recently come across have already gone to global portfolio and risk management. The benefits are obvious:

risk as well as deployment of capital can be managed on a global basis. For regulators whose powers are restricted by national boundaries, this raises the urgent need for collaboration in the following respects:

- The development of consensus on quantification of risk as part of capital adequacy.
- The financial reporting framework for subsidiaries and conglomerates.
- The development of standards of conduct.

The International Organization of Securities Commissions (IOSCO) and the Bank for International Settlements (BIS) have been working on achieving international consensus on these issues. Recently, a Tripartite Group has been formed to include insurance regulators. At the same time, in the United States six large securities firms have formed a Derivatives Policy Group to help US regulators formulate risk quantification models, and framework for internal control and financial reporting. The Futures Industry Association has also developed a series of recommendations for exchanges, intermediaries and their customers. Hong Kong has been playing a very active part in this international effort and we will continue to do so.

Co-operation between Regulators

In conclusion, let me now return to the special problem of banks in securities transactions. Because of the passage of time, you may now have forgotten that in 1991, the SFC completed public consultation on the issue and concluded that there was general support for the proposition that where banks engage in securities activities beyond securities dealing incidental to mainstream banking work such as lending and custodianship, they should be regulated in the same way as securities intermediaries. The logic is perhaps obvious: less so for level playing field reasons, the public must be entitled to the same

level of protection. In order to implement this, legislative amendment was deemed necessary. The revisions have been included in the legislative rationalisation exercise recommended by the 1988 Securities Review Committee. This exercise is nearing completion and a consultation should begin early next year. Meanwhile, we should in the near future be concluding a Memorandum of Understanding with the HKMA so that we may lend assistance to the banking supervisors of the HKMA in their general supervision of the securities activities of banks.

I have just given you a quick view from Hong Kong's perspective of the shape of some of the things to come after Barings.