

**The Art of Financial Regulation
Managing Stability in
Changing Times¹**

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*2002 ASIC Summer School
Brisbane, 18 February 2002*

I am very honoured to be invited to give this Keynote Address to the ASIC Summer School. The ASIC Summer School is an excellent example of how securities regulators can get together and share knowledge and experience with each other. I want to congratulate ASIC, under the able leadership of David Knott, for sponsoring another Summer School in this beautiful city of Brisbane.

In May 2000, I attended the Sydney IOSCO Annual Meeting, where Harvard Professor Malcolm Sparrow was invited to give a talk following his lectures to the Summer School that year. Professor Sparrow's lecture, based essentially on his book "The Regulatory Craft"², made such a powerful impression on me that I was determined to go back to Hong Kong and implement his key message. I put his message on my PC screen saver to remind me what he was trying to drive at. This was: *"Pick Important Problems, Fix Them and Tell Everyone"*. His book is the most important book I have read about regulation in general.

The other main academic source for this lecture stems from the work in financial regulation by Professor Charles Goodhart, the doyen of central banking and monetary policy economist, famous for Goodhart's Law of Monetary Policy. In November 2001, the Bank of

¹ I am grateful to Ms Tan Gaik Looi of the Securities and Futures Commission (SFC) for research work in the preparation of this lecture. The views expressed are entirely personal, and not necessarily those of the SFC.

² Sparrow, M.K. (2000), 'The Regulatory Craft: controlling risks, solving problems, and managing compliance' (US: The Brookings Institution Press)

England invited me to give a "Festschrift" essay in his honour, entitled "Is there a Goodhart's Law of Financial Regulation?"³ The answer of course is Yes. This is because the relationship between the financial regulator or central bank and the market is reflexive or inter-related. The nature of the financial regulation game changes because the regulator and the regulatee are part of the same game. Your behaviour changes the regulatee's behaviour and the market's response in turn could change your policy behaviour.

Goodhart⁴ sees financial regulation as a contract between the regulator and the regulatee with very important incentive structures. If the incentives are wrong, for example, then markets can become distorted. For example, excessive deposit insurance can create moral hazard behaviour in bankers.

Consequently, this lecture draws upon the theoretical input of Professor Goodhart, the regulatory insights of Professor Sparrow, plus my own experience in finance, first as an accountant, then as a central banker in banking and insurance regulation and currently, as a securities and futures regulator.

A Changing Financial Landscape

Since the Asian crisis, we have got a much better understanding of the nature of financial sector problems but we don't necessarily have good answers. We know we should raise accounting standards and bring regulatory standards toward global standards. Given increased risks, we understand we need to enhance surveillance, share information

³ Sheng, A., and Tan, G.L. (2001), 'Is there a Goodhart's Law of Financial Regulation?' Paper presented at Bank of England Festschrift for Professor Charles Goodhart, 15-16 November (London)

⁴ Goodhart, C., Hartmann, P., Llewellyn, D., Rojas-Suarez, L., and S. Weisbrod (1998), 'Financial Regulation: Why, how and where now?' published in association with Bank of England (London: Routledge)

and make contingency plans. But the environment is changing far too rapidly because of four major trends: technology, globalization, competition and restructuring.

Technology: technological growth is so fast and bewildering that like you, I have struggled to understand its implications. I have finally understood *that all financial markets are networks*. Metcalfe's Law⁵ basically says that the value of a network is exponentially related to the number of its users. So the wider the network of users, the more valuable the network and its network externalities. This explains why banking networks are converging horizontally and vertically, linking and merging with securities networks, insurance networks and even consumer networks.

Networks are public utilities, which create a public good. But the minute you link disparate networks together, their problems are your problems, and, your problems their problems. So network economics and network externality effect drive globalization, which is the linking of local networks to form global networks. It has driven on-line trading, which has created 7 x 24 (7 days a week 24 hours a day) transactions. Consequently, markets don't sleep, so regulators can't sleep. In other words, technology and globalization have changed the whole market structure and also the nature of competition.

Convergence in the name of economies of scope and scale has also created vertical and horizontal mergers and alliances between exchanges as well as larger global financial conglomerates. A recent BIS research article has tried to explain why foreign exchange trading globally has actually declined. Part of the answer is, of course, the emergence of the Euro, which eliminated the need for multiple cross trading of European currencies.

⁵ Carl Shapiro and Hal R. Varian (1999) 'Information Rules - A Strategic Guide to the Network Economy' (US:Harvard Business School Press)

But the BIS also pointed out that the number of foreign exchange players has physically declined because of mergers and acquisitions.⁶ Banks have merged with insurance companies and fund managers. Fund managers have become so large that Fidelity alone manages over US\$1 trillion in assets, larger than many banks and countries. These mergers have created multinational "large and complex" financial institutions (LCFIs), which provide the whole range of financial services, some under one brand name, while others are part of a holding group of local and boutique entities.

Once they consolidate, they do not need so many branches or even many regional offices. This local and global trend of concentration and consolidation of activities into larger and more powerful players is quite similar to how Wal-Mart, with its supermarket quality of service, has forced the mom and pop retail business to restructure in the United States.

Globalization has blurred the jurisdictional lines, both within markets and cross-border. Where does an electronic transaction stop, when an Australian trades Brazilian bonds via a Hong Kong broker who clears the transaction via New York? Property rights are being exchanged across different time zones and different geographical boundaries, cutting across the jurisdictions of banking and securities regulators.

We have global markets, but our laws and regulations are all local. Hence, how do we protect the investors' property rights when there are no global laws?

Amidst these technology and global changes, *competition* has become very intense. The range of new financial products that is emerging is bewildering, and new players, such as hedge funds, are changing the way we look at markets. Who would have expected that in the first half of last year, one quarter of Hong Kong's savings went to capital-guaranteed products with derivative features? These products were offered by banks that are now launching hedge funds of their own to compete with brokers and asset managers.

⁶ Bank for International Settlements (2001), 'Why has global FX turnover declined? Explaining the 2001 triennial survey', *Quarterly Review: International Banking and Financial Market Developments*, December

Indeed, hedge funds are new financial animals that are neither homogenous nor aptly described. Many of them don't even hedge. They simply use very different, complex derivative tools and investment strategies. Many of them operate from offshore financial centres, and they are not properly supervised. In some markets, they account for as much as one quarter of market liquidity.

As we all know, when financial innovation and competition arrives some people gain while others lose. The financial sector must undergo *restructuring*. Domestic banks are facing foreign competition, while smaller financial institutions cannot compete against larger institutions. Old franchises are eroding, so losses begin to accumulate in the financial sector. These losses appear either in the form of non-performing loans or intermediary failure. Of course, intermediary failure is not simply due to excessive competition or bad management. Real sector shocks also cause weaker financial institutions to fail. But the fact that intermediaries fail under regulators' watch means that we can never escape part of the blame.

Pressure for Regulatory Reform

Because of these rapid changes, there's huge pressure for regulatory reform. These structural issues basically challenge the regulators' competence, effectiveness and efficiency. It forces us to question what we are all about. Thus, we need to understand why we regulate, how we do so, and how we are accountable to the public. Recent questions about regulatory costs, clarity of responsibilities, accountability, conflict of objectives, regulatory arbitrage, competitive neutrality and public confusion of who does what are all part of the social debate over the proper role of financial regulation.

In sum, financial regulators need to understand the environment around us. Given that regulatory polices and processes need to change, the big question is "How do we build a flexible regulatory structure that responds to such dramatic changes?" Either we change or a crisis will force us to change. It's as simple as that.

Public Sector and Financial Regulation Objectives

The role of financial regulation and its objectives and processes must be put in the context of public sector reform objectives. The best statement of public sector objectives is the view of the Australian Government⁷ that the public expects a public service that:

- uses resources efficiently, effectively and ethically, to achieve the best results at least cost to the Australian taxpayer;
- provides honest and robust policy advice to the Government;
- delivers fair, effective, impartial and courteous service for all Australians and is responsive to community needs;
- ensures high standards of public accountability;
- competes with, and benchmarks against, best practice in other sectors on both cost and quality;
- fosters a more contestable environment;
- manages for results;
- promotes innovative organizational arrangements; and
- contributes to Australia's international competitiveness.

This set of criteria applies equally to the role and performance of financial regulators.

⁷ Public Service and Merit Protection Commission (1998), 'An overview: Reforms to the APS - What we are doing' (Commonwealth of Australia)

Objectives of Financial Regulation

So what are the objectives of financial regulation? Professor Charles Goodhart suggests that it is to influence the behaviour of intermediaries so that the policy objectives are achieved. Of course the policy objectives can be very different in different economies. But there is a regulatory cycle that applies in every economy. Once you have defined your *policy objectives*, like any decision cycle, there must be a set of *processes or procedures* to achieve these objectives. The operation of these regulatory processes results in a set of *policy outcomes*. As the old saying goes, "the road to hell is paved with good intentions" or in regulatory speak, the outcomes do not fit your objectives. You therefore need a policy review to see whether the objectives are wrong or the processes are wrong.

Which brings us back to Malcolm Sparrow's classic example of policy objectives and policy outcomes. That is the case of income tax non-filers. The policy objective is to collect as much tax as possible. The tax collection process was based on filing an income-tax form, upon which the tax was collected. When the US Inland Revenue reviewed this problem, it discovered to its horror that the biggest tax loophole was that of the non-filers. If a person does not file the income tax form, you can't tax him. There was no process to tax the non-filer and there was no process to catch the non-filer. So the policy outcome was that people who were reporting and paying tax bore the tax burden, while the non-filers did not pay tax at all.

In other words, the processes did not meet the policy objectives, and the result may be a wrong policy outcome.

Surely we need to review many of our own financial regulatory processes or procedures that were put into place in the 1980s or 1990s to see whether they meet policy objectives of the 21st century?

What Malcolm Sparrow suggests is that you need to clearly define your objectives, then lay down effective processes to achieve the desired

policy outcome. If the outcomes do not fit the objectives, the credibility of the regulator is eroded. Everyday I ask myself, "Have I picked important problems, fixed them and then told everybody?" It sounds like common sense, but common sense is not too common.

The bit about "tell everybody" is important, because as financial regulators, we have to be tough in enforcing the law. Many of us do very good work but we don't tell anybody. Because the public does not understand what we are doing, they may not support us when we need laws that give us the powers to enforce the law effectively. Hence, we need to explain what we do to the public in order to achieve regulatory credibility.

The International Organization of Securities Commissions (IOSCO) sums up the objectives of securities regulation as:

- Protection of investors
- Ensuring fair, efficient and transparent markets
- Reduction of systemic risk

The UK Financial Services & Markets Act 2000, sets out the objectives of the FSA as promoting:

- market confidence
- public awareness
- the protection of consumers
- the reduction of financial crime

The US SEC's mission statement is simply: "we are the investor's advocate".

While these objectives are correct, applying the Sparrow dictum, I would simply say that *our job is "to make the market work better"*. In other words, when financial markets don't function well, the investor gets hurt. Allow me to illustrate what I mean.

The Functions and Nature of Financial Markets

How do we make markets work better? Applying the Sparrow dictum again, we can only identify important problems if we understand clearly the functions and nature of financial markets. Basically, there are four functions of financial markets:

- price discovery
- resource allocation
- risk management
- corporate governance

The Asian crisis was an excellent example how these four functions were not performing well in Asian markets. First of all, price discovery. Are financial market prices reflecting the risk? In the Asian crisis countries, the average non-performing loan ratio was between 15% to 50% of total bank loans. Since the average bank spread (lending rate less deposit rate and administration costs before provisions) was roughly 1.5%, how could the banks clean up their non-performing loans from their current bank spreads? Another example is an excessively high price-earnings (PE) ratio. A PE ratio of more than 50 implies that the cost of funds to issuers is less than 2%, which may encourage issuers to waste such cheap funds on investment in inefficient capital assets.

Secondly, resource allocation - is the market distortive? Nearly three quarters to over 100% of domestic savings in Asian financial systems are in the banking system, while debt markets are shallow and securities markets tend to be speculative. Are capital markets exercising sufficient discipline on the use of savings in Asia, particularly if governments, through policy guidance on interest rates or directives, determine the use of domestic savings? Why has Asia been more prone to asset bubbles in the 1990s?

Thirdly, capital markets are supposed to help investors hedge their risks. But how can investors and borrowers or issuers hedge their risks when derivative markets in Asia are generally underdeveloped? Moreover, do policy makers and investors understand that long only strategies actually increase risks for investors?

Finally, are financial markets punishing poor corporate governance? If not, how can regulators help to raise the quality of corporate governance?

Quality of Markets

If regulators care about the quality of markets, then I propose that we examine this by breaking down the quality of markets into seven components - what I call the seven "I's" of markets. They are:

- Information
- Incentives
- Issuers
- Intermediaries
- Infrastructure
- Investors; and finally,
- I, the regulator

Information and Markets

The first thing to remember is that *timely and accessible information is a market fundamental*. Markets cannot function well without highly reliable information. When information is not accurately disclosed in a timely manner, or when selective or misleading information is given, market fairness, integrity and the level playing field are called into question. You also cannot engage in sound financial regulation unless you have good information on the state of the financial system.

To have good information, you need to have international accounting standards (IAS) and good auditing standards. Enron, which is currently the largest corporate failure in history, has demonstrated clearly that without good information and good checks and balances in accounting and audit, large companies can fail even in the best-regulated markets.

My personal lesson drawn from the Asian crisis is that bad accounting = bad information = bad decision making = bad risk management = financial crisis.

Incentives

A long-serving securities regulator told me, when I first became a securities regulator, that securities markets are all about greed and fear. I did not understand this well, as I came from the background of a banking regulator. Bank regulators are referees, in a world where bankers are generally risk averse. On the other hand, the securities markets understand very well the nature of risk and speculation. Securities are relatively easy to manipulate through insider trading, market manipulation and fraud. Millions can be made or stolen because markets trade quickly and often opaquely. If a market manipulator thinks that he cannot or will not be caught, he will simply rob the market blind. The only thing that stands in the way of financial crime, often times, is the quality of financial regulation.

Of course, not all securities regulators are financial cops. In Hong Kong, the regulation of securities markets is shared between the Stock Exchange as regulator of financial disclosure, the SFC on insider trading and market manipulation, the Commercial Crime Bureau of the Police on fraud and theft, and the Independent Commission Against Corruption on corruption in the industry. In addition, the Financial Secretary can appoint Inspectors under the Companies Ordinance to investigate special cases of fraud. What deters

manipulation of the market is whether we can catch the perpetrators. Consequently, we need to co-operate very well with other agencies in the enforcement field in order to minimize financial misconduct and crime.

In other words, for markets to function well, the incentive structure must be evenly balanced. If the risks and rewards are imbalanced, the markets will be distorted by greed without the fear of being caught.

Such incentive structure also applies to regulators. Charles Goodhart recognized very well that regulation is a thankless task, where the public is quick to blame regulators for mismanagement where failures occur. In many emerging markets, financial regulators are grossly underpaid relative to the market, while the laws or the criminal investigation and enforcement systems are not well developed to deter financial crime.

Moreover, since regulators get their power from regulation, it is totally understandable why they may concentrate on areas that enhance regulatory power, such as licensing, and shy away from very tough and unpopular areas, such as enforcement and sanctions. In the words of Taiwan lawyer, Professor Lawrence Liu, "Asian regulators tend to over-regulate and under-enforce." Tough enforcement wins no friends, but it is a job that has to be done effectively for markets to function cleanly and fairly.

Issues

The quality of a market is determined by the quality of the companies that raise capital from the public. At the end of the day, they have to provide an appropriate risk-adjusted rate of return to investors. Well-performing companies would attract more investors and enhance the liquidity of their stocks. Liquidity begets liquidity, attracting better quality issuers, financial intermediaries and investors in a virtuous circle that improves the quality of markets.

The first and foremost persons responsible for the quality of a company are its management and controlling shareholders. They set the standards of ethics and performance that the company is judged by.

Good corporate governance is all about three levels of *discipline*. First of all, rely on the management or controlling shareholders to exercise *self-discipline*. This works when the controlling shareholders or management are highly ethical and treat minority shareholders fairly.

The system breaks down when the internal checks and balances, such as independent board committees, internal and external audits, and the transparency of disclosure do not function well. The OECD has published a Code of Corporate Governance that benchmarks corporate behaviour.

Where self-discipline alone does not work, we need *regulatory discipline*. Regulators must set the rules of the game in consultation with the private sector, preferably to international standards, and enforce these agreed rules, fairly and transparently. They must also protect investors through greater public education and disclosure rules. When cheating or fraud occurs, there must be the discipline to take necessary enforcement action.

In Asia, policy makers have tended to rely on self-discipline and regulatory discipline, without paying enough attention to *market discipline*. Companies, when protected from competition, may develop cartels or monopolistic tendencies that do not treat consumers or investors fairly. These may deter foreign or minority investors from entering the market when they perceive that they are not treated equally.

Good corporate governance requires all three disciplines to keep the checks and balances for healthy companies.

Intermediaries

Financial intermediaries are the middlemen between the suppliers of capital and the users of capital. They perform also the front-line

quality control work in capital markets. Investment bankers act on behalf of issuers, advising and underwriting IPOs and mergers and acquisitions. They are supported by accountants and legal advisers who play a key role in due diligence of information disclosure to professional standards. The higher the quality of intermediaries, the more the financial regulators can rely on the market to exercise discipline on the market participants.

For intermediaries to function well, they have to act professionally and ethically, free from the conflicts of interest that could cloud their independent judgement and due diligence. The quality of information depends critically on the quality of such independent professional advice, benchmarked against international standards.

Indeed, it is precisely the lack of high quality intermediaries that many securities regulators find themselves having to take direct supervisory action on markets. Consequently, in many emerging markets, securities regulators find themselves in a developmental role, trying to nurture the growth of quality intermediaries. Unfortunately, the tendency of many markets to protect domestic intermediaries and resist the importation of foreign intermediaries with their international skills, means that market development tends to be retarded.

Infrastructure

Financial markets have trading, clearing, settlement and payment processes that are transacted across networks. The infrastructure in place may either be paper-based or provides for electronic transactions. The quality of the infrastructure determines the size of the *operational risks*, since failures due to human error, hardware or software failure, and natural or terrorist attacks can disrupt markets as September 11 has shown so dramatically.

The financial infrastructure comprises not only the platform and processes to ensure that markets function in an orderly and robust manner. It comprises also a legal framework and efficient and fair judiciary that protects property rights of market participants.

Increasingly, IOSCO and the Committee of Payment and Settlement Systems (CPSS) of the Basle Committee of Banking Supervisors have recognized the importance of the robustness of trading, clearing, settlement and payment systems in managing financial market risks.

In addition, there is a need for balanced markets for risk management. The Asian crisis demonstrated that not only was there incomplete information, but also incomplete markets. In many parts of Asia, the bank-dominated financial systems did not possess cheap and liquid bond and derivative markets to enable investors and issuers to diversify and hedge their risks at reasonable cost. Regulators must therefore pay attention to the market development dimension so that there is a sufficient range of instruments and markets for overall national risk management.

The concentration of risks in a few sectors without the ability to hedge such risks was one of the problems exposed by the Asian crisis - a failure that is still unresolved in many economies.

Investors

Ultimately, the quality of markets depends on the quality of the investor. All too often, uneducated investors chase rumours and are underserved by poor quality intermediaries, resulting in continuing losses through poor risk management and following the herd. Investor education is an important supervisory tool to promote investor protection. Regulators normally provide sustained outreach programmes to educate investors. The SFC has an investor education website (HKeIRC - electronic investor resource centre) that provides the essential ABCs of investment, games to test the knowledge and understanding of investors, and also 550 links to over 400 websites around the world.

It is important for investors to understand the concept of risk and return, know their rights, ask the right questions of their brokers and financial sales people, and know where to check to verify

information and clarify their doubts. Shareholder activism is also good for markets as it imposes greater market discipline on companies and protects minority interests.

I, the Regulator

Last but not least, the quality of markets must depend on the quality of the regulator. In his book, Malcolm Sparrow has this quote from an OECD report -

"Too often, legislators issue laws as symbolic public action, rather than as practical solutions to real problems. Regulatory inflation erodes the effectiveness of all regulations, disproportionately hurts small and medium businesses, and expands scope for misuse of administrative discretion and corruption."

All financial regulations have a cost, which creates incentives for regulatory arbitrage. Goodhart points out that there is also the danger that regulators could over-regulate, particularly as the public may perceive regulation as a free good. Whenever there is a crisis, regulators may over-react to minimize future failures and avoid blame by supplying more regulation. The balance between the need to enforce without over-regulation is a fine line.

No financial regulator can exercise his powers without public support. To obtain public support, regulators must have four public attributes. Three of these (Gong Pin 公平, Gong Zheng 公正, and Gong Kai 公開) are enshrined in the Chinese Securities Law, to which I would add a fourth Gong Xin 公信. Namely, fairness, integrity and transparency, to which I have added public trust.

The Tools of Regulation

No survey of financial regulation can be complete without a quick overview of the tools of regulation. There are different types of regulation: prudential regulation, conduct of business, systemic stability, competition, market

supervision and disclosure, system integrity, etc. Each type of regulation requires different regulatory approaches and tools as determined by their defined objectives.

There are prescriptive rules and differentiated rules. Prescriptive rules apply one rule to everybody: one size fits all. Differentiated rules do not apply standard ratios but apply rules according to the level of risk.

There are entry rules that govern licensing, capital and liquidity requirements. There are also rules on conduct - surveillance, monitoring and discipline, and exit - failure management, investor compensation schemes and insolvency. But we should not forget, rules are only as good as their enforcement. Regulators have to be visible - they must be seen to be regulating and enforcing the law.

What Sparrow points out is that if we have scarce resources versus a whole array of problems, we have to focus our attention on problems where the risks are greatest. We have to adopt a risk-based approach to regulation. In adopting this approach we need to understand that different tools may have conflicting objectives. For example, licensing requirements can be used to discriminate against foreign entry or entry by smaller intermediaries, which may inhibit competition.

To quote Sparrow again, "The essence of the Regulatory Craft lies in picking the right tools for the job, knowing when to use them in combination and having the system to recognizing when the tools are inadequate so that new ones can be invented."

In other words, given different regulatory objectives, the regulator must choose a combination of regulatory tools to achieve these objectives. However, there is a trade-off of objectives and tools, so that the regulator must exercise judgement on the effectiveness of regulation and the policy outcomes. Regulation is as much a craft as an art.

Models of Regulation

I will round off this part of the regulatory survey with the question: “Who regulates what?” Who regulates depends upon the regulatory model. There are four basic models of financial regulation.

The US model is the most functionally duplicative system of specialist regulators in the world. In the banking area, there are four regulators: the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the State Regulator and the Federal Reserve. In the securities area, there is the SEC plus the CFTC. And the securities business of investment banks is partly overseen by SEC and partly by the Fed. There are different state regulators for insurance.

Hong Kong is closer to the US model. The Hong Kong Monetary Authority is in charge of the currency board and banking supervision. The Insurance Commissioner looks after insurance. The SFC takes care of the securities and futures markets and there is a Mandatory Provident Fund Authority that oversees mandatory retirement funds.

Australia has gone for a twin peaks model, organised on the basis of regulatory objectives. ASIC looks after corporate regulation and public offering of securities. Australian Prudential Regulatory Authority looks after banking supervision and supervision of intermediaries. And the Reserve Bank of Australia looks after monetary policy and systemic stability. On top of all that, Australia also has a competition authority to look after competition policy.

What the UK did was to merge several self-regulatory organizations (SROs) and the regulatory wing of the Bank of England into a super-regulator, the Financial Services Authority (FSA). The FSA looks after the whole range of banking, insurance, securities, pension and mutual funds, and also consumer interests.

There is no ideal division of labour between central banks and supervisory authorities. The super central bank model is the Monetary Authority of Singapore (MAS), which is in charge of every aspect of its financial sector including financial market promotion.

Which model is ideal for which economy depends upon local conditions of institutional and legal history and the defined set of policy objectives. There is no single structure that fits all markets and all economies. Irrespective of what model is adopted, my view is essentially pragmatic: as the late Chinese leader, Deng Xiaoping liked to say, "It does not matter whether the cat is black or white, as long as it catches mice." What is important is the need for better coordination and information sharing among regulators in order to achieve the objective of making the markets function better.

Malcolm Sparrow's Six Themes of Regulatory Practice

Let me now try to use the Sparrow methodology to look at how regulators can work better to make the market function better. He has characterized old-style regulators as, "nitpicking, unreasonable, unnecessarily adversarial, rigidly bureaucratic, and incapable of applying discretion sensibly."

For the new-style regulator, Malcolm Sparrow suggests six main themes on regulatory practice:

- cut obsolete regulations;
- reward results, not red tape;
- create regulator-regulatee partnership;
- negotiate, do not dictate;
- reduce regulatory reporting burdens; and
- search for results that count.

There are essentially three core elements:

- Focus on effect/impact/results;
- Adopt problem-solving/risk-control approach; and
- Invest in collaborative partnerships.

Pick Important Problems...

The problem with our daily jobs is that we pay too much attention to the urgent and not the important. Let me illustrate with how we drew lessons from the Asian crisis and applied them in our daily work.

I was asked to assume the Chairmanship of the SFC in October 1998, in the midst of the Asian crisis. Although there were myriad problems to solve, I asked myself what were the big important problems to tackle. Fortunately, I met a good friend, Dr Noordin Sopiee, Director-General of the Malaysian Institute of Strategic and International Studies (ISIS), who told me that in a crisis, don't pick all problems, pick the top three.

This good advice is a rediscovery of a Chinese maxim from 1st millenium BC, Zuo Chuan: "To stabilize a country, top priority must be given to the most significant matters". (安定國家，必大焉先。)

In 1998, in the wake of the Asian crisis, the Hong Kong Administration embarked on a three-pronged reform programme to address structural issues in the securities industry as follows:

- Market reform: demutualization, merger and listing of stock exchange, futures exchange and clearing house to align the institutions with market incentives;
- Infrastructure reform: to move rapidly to a fully electronic web-friendly world-class infrastructure to enhance efficiency, reduce costs and risks;
- Legislative reform: the consolidation of 11 separate Ordinances into a new Securities and Futures Bill.

I am pleased to report that almost all of these reforms have been achieved, with the New Bill likely to be approved by our Legislative Council in March, after nearly ten years in the drafting and debate. We are now in the second phase of reforms, which is also three-pronged: market and product development; strengthening and monitoring the institutional structure, and internal strengthening of the Commission to meet the challenges of the new Millenium.

... Fix Them, and Tell Everyone

Indeed, I have discovered that analyzing the technical problems and coming up with the technical solutions is far easier than the problem of managing human communications and mobilizing support for reforms. That turned out to be a more complex problem and challenge than I had earlier anticipated. To engage in any public sector action, such as restructuring or reforms, you need support from the community and the major stakeholders.

The greatest challenge in problem identification and its solution is essentially how to sell the message that any reform is widely accepted as a win-win situation. Stakeholders and vested interests are by nature suspicious of change, and they automatically adopt a defensive or adversarial approach towards the proponents of change.

The natural reaction was: "How can I support the reforms if I don't understand what they do to me?" This is why the "tell everyone" part is so important.

In the drafting of the Bill and the demutualization of the exchanges, we had to engage the securities and community leaders, and persuade them that the suggested reforms were for the best interests of Hong Kong. During the process of engagement, we discovered that we may not have thought through clearly all the issues and the implications. And through long hours of dialogue and dinners with stockbroker associations and registrants, we were able to slowly *build ownership* and consensus on the need to move forward.

To do so required transparency, accountability and credibility on the part of the Commission, none of which could be achieved overnight. The Commission revamped its Advisory Committees, created a Shareholders Group, Academic Advisory Groups and also launched stakeholder and investor surveys on how the SFC was perceived, whether it was effective or not, and where it could improve. The

Commission stepped up its investor education programme, started to publish quarterly reports and newsletters such as SFC Alert, to reach out to the public. Our website has an average daily page hits rate of over 200,000.

To assure the public that the Commission would not use its investigatory powers capriciously or arbitrarily, a Process Review Panel was established last year, chaired by a prominent banker and comprising stockbrokers, accountants and legal experts, to independently review all completed cases by the Commission. The Panel would examine the work of the Commission to ensure that proper procedures of due process and fairness have been followed by the Commission. As far as I am aware, we are the first securities regulator around the world to adopt such stringent checks and balances.

Thus, Malcolm Sparrow is right that you need to tell everyone that you are fixing problems. But you cannot tell everybody unless you have a good story to tell. You have to be very clear in your own mind what your objectives are, what your processes are and how you manage for concrete results. Credibility is important because the job of securities regulators, for those of us who are financial cops, is not a popular one. The community must understand why you have to be tough to exercise regulatory discipline, and should back you in such work.

To sum up, problems in processes and procedures occur in all markets. But often, people are blamed and they naturally resist these changes. The point that I want to make is that more often than not, it is the lack of clarity in policy objectives and obsolete processes and systems that are to be blamed. Change is the only constant and regulators need to change to be on top of the job. We need to get ownership by those who are affected, including the staff of our own organization, before we can change. Moreover, we need to get the public behind us in order to have the mandate to regulate and enforce.

Supervision, Crisis and Restructuring

I want to conclude this survey of financial regulation by making some comments on the issue of financial sector restructuring. Most regulators are concerned about the bread and butter work of the supervision of entry and conduct of intermediaries in the marketplace. They tend to forget that the exit of intermediaries is part of the natural cycle of markets. If there is no orderly way of exit, some intermediaries disappear through financial crises.

Because we are in a changing world, crisis occurs. This is most prominent in the area of banking, since banking failure is a distinct feature of the 1990s. Securities markets witness much more market volatility, and securities intermediaries are quite good at managing market risk. However, September 11 and the recent failure of intermediaries, such as the collapse of a small broker in Hong Kong, remind us that we all need to deal with intermediary failure.

One of the lessons I drew when I researched at the World Bank about banking failure⁸ in the 1980s, was that *bank crisis is an event, but bank restructuring is a process*. What is more important is how we deal with it or prevent it from recurring.

Financial crisis is a messy business, which usually starts off with everyone blaming everyone else, resulting in lots of confusion and little action. But the essence of financial restructuring is very simple. It is a process that is about four fundamental steps, sometimes sequential, sometimes in parallel: *diagnosis, damage control, loss allocation and getting the incentives right*.

In the Sparrow language, *diagnosis* is about identifying the problem. The list of seven I's is a useful checklist for the diagnosis of where the problems lie in the marketplace. If you ask the right questions, the answers very often become fairly obvious. In identifying the problems, you may wish to ask these types of questions:

- What are the risk implications of market and macro economic developments?

⁸ Andrew Sheng (1996), ed. 'Bank Restructuring: Lessons from the 1980s' (Washington, DC: The World Bank)

- Are there emerging gaps between regulations and market developments?
- Have you stress-tested the markets and infrastructure relative to the risks?
- Are current incentive structures reducing or magnifying risks?
- Are there patterns of risk concentration?
- Are markets and investors aware of emerging risks?
- Have you double-checked your analysis and solutions with market practitioners?

Damage control means that regulatory action must be taken to stop the bleeding. If action is not taken quickly, losses can escalate rapidly. Regulatory forbearance only delays the pain. No decision is still a decision. You got to keep the relevant decision-makers informed and prepare the public at the appropriate time for the emerging problems.

The recognition of losses, and *loss allocation* is politically the most difficult to accept and implement. Financial crises typically occur when the losses have already been incurred but are not critically recognized. There is a natural tendency to defer dealing with the issues, precisely because they are difficult. As in taxation, everybody avoids paying taxes where they can. In essence, intermediaries fail when the shareholders no longer have the capital to bear the losses, and these losses are either passed to their creditors or to the public. The losses will not go away on their own accord, even if they are ignored.

The best illustration of this is in bank failure, although parallel instances can be found in the failure of other types of financial intermediaries. If a bank fails, either the shareholder pays up or the depositor pays. Because the Government does not want the depositors to lose, through implicit or explicit deposit insurance, the public pays. Strictly speaking, the Government pays either by taxing the people today (which is not popular) or by taxing future generations by borrowing to finance the losses.

Once you've understood this issue, you need to mobilize political and public backing for your action. The process of communication to the public has to be well co-ordinated and managed.

The next question is, "Have you adequate resources and skills to undertake this damage control?" That is a managerial and policy issue. That's why regulation is a thankless task but it is a job that needs to be done, however unpopular the task. We want to be financial doctors, not under-takers.

But fixing the problem and telling everyone would not solve the problems if the basic structure of the market is distorted. In other words, if you wish to remove the underlying problems, you have to *get the incentives right*.

For example, the only way to solve financial misconduct is a tough enforcement process. And financial crime and bad intermediary conduct will thrive when there is no regulatory credibility that the perpetrators will be caught. They will continue to break the rules because it pays to do so. Hence, very often the only downside to financial crime is the enforcement process. Justice must not only be done, but also seen to be done. That is why credible enforcement action must be visible. There is an old Chinese saying that describes this well: "Kill chickens to scare monkeys".

But given scarce resources, and checks and balances, we have to be realistic that we cannot prevent all financial crime, deliberate fraud, or even managerial incompetence. We also cannot prevent ignorant investors from being gullible to promises of quick gains. In boom times, regulators who warn about the need to be tough may be ignored, because everyone wants the bubble to carry on. But the least we can do is to try and minimize financial misconduct and crime, and educate the public about what we are doing. Regulatory credibility is hard to earn but is easily lost.

We also have to be realistic that financial risks and vulnerabilities are changing daily. September 11, Enron and other headline cases are all the aftermath of a decade of unprecedented growth and inflation where even the integrity of information has sometimes become inflated.

We are not clear how the global deflation and structural changes in the real economy will affect the financial systems that we are responsible for supervising.

All we can understand is that markets always adjust, sometimes smoothly, sometimes abruptly.

Conclusions

To conclude, what I am trying to say is that the markets are changing so fast that financial regulators have to change with the times. Such dramatic market changes imply that regulation is still a craft and not a science. We must make regulatory judgements every day, to ensure that the markets we supervise are resilient to shocks. To do our job properly, we must have the range of tools and judgement to use them effectively. But regulators are also human. We need to be independent but we are not independent of the environment in which we work. Our rules and regulations shape our environment and our environment shapes us.

We need to understand our environment, understand our strengths and weaknesses and what our role is in shaping the incentives structure in the financial system. No other job presents such formidable challenges. So, as a comfort to all young aspiring regulators in this Summer School, our craft may be tough, unpopular and thankless, but it is an important one.

Go home, pick important problems, fix them and tell everyone!