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Asia Securities Forum 2008
The Asia Era –
Challenges and Opportunities for Asia Pacific after Subprime
"A Regulatory Perspective"

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I am delighted to be here this morning before this impressive gathering of stockbrokers and other market participants from across Asia. To our international guests, I hope you have an enjoyable stay in Hong Kong. To our hosts, the Hong Kong Stockbrokers Association and its members, it is always a pleasure to interact in forums like this.

The theme of this 13th Asia Securities Forum is "The Asia Era - Challenges and Opportunities for Asia Pacific after Subprime", and there are three panel sessions that will touch on risk management, opportunities in Asia, and market structure. I will focus my remarks on the challenges from a regulatory perspective. But first allow me to talk briefly about the Asian story and the implications of the subprime crisis for Asia.

The Asian story

The success that Asia enjoys today is the result of a combination of factors: the diligence and perseverance of its people, the commitment to sound policies and reform for the long-term prosperity of its people in a pragmatic way, and finally the opportunities that came with liberalisation and globalisation.

Asia's emergence as an economic force started with the successful growth strategy of Japan in the 1960s, and reinforced in the 1970s by the rapid growth of Hong Kong, Singapore, South Korea and Taiwan. Next came the Southeast Asian economies, and starting from the late 1990s, China and India emerged and are increasingly viewed as the future economic power houses. And in recent years, Vietnam has started on this path.

The highly performing East Asian economies have been described by the World Bank as the "Asian Miracle", and at the dawn of this millennium, some have described the 21st century as the century of Asia, the Asia era. But the journey has not been without a few bumps along the way.

More than a decade ago in 1997, the Asian Crisis demonstrated how harsh financial markets can be in punishing economies with unsustainable economic and financial policies. The good that came out of this experience was that most Asian countries had the opportunity to rebuild and strengthen its economies and financial systems on a sounder footing. This served Asia well in the past year in withstanding the after shocks of the subprime crisis as it rippled around the world.

The implications of the subprime crisis for Asia

The spillover effects have been fast and far reaching. This is the first financial crisis of the 21st century that is unprecedented both in terms of its effects and reach, as well as its demand on solutions. Immediate policy responses, for example, in the US and UK had called for somewhat unusual measures, and the longer-term solutions to strengthen their financial systems, may have far reaching consequences on the regulatory structure.

Initially, there was a prevailing view that Asia would not be affected as its economies were "decoupled" from the fortunes of advanced economies. As the year wore on, the "decoupling" view was challenged by the view that the ultimate customers of Asia's externally-oriented economies are still the advanced economies and therefore the ability of Asia to be insulated would depend on how severe and protracted the economic downturn would turn out to be in the US and Europe and what policy responses Asian economies would initiate to address the new challenges.

What then are the prospects for the Asia Era? The Chinese character for "crisis" [危機] has two elements: danger and opportunity. I view the subprime crisis as an invaluable learning opportunity. The subprime crisis offers invaluable lessons to Asia, and a timely reminder that financial stability cannot be taken for granted and there is a high price to pay for excesses.

The world is taking a welcome pause after a long period of relatively strong growth in a benign environment, which many thought was too good to last. Asia should take this opportunity to apply the lessons and further strengthen its financial infrastructure and economy. This is vital if Asia wants to retain its competitive position when the global economy fully recovers from the current downturn, and for Asia to reap the promise of the Asia Era.

Markets and crisis – back to basics

The current crisis is the first crisis of this century, but it will not be the last. History is peppered with one financial crisis after another. It is not because lessons are not learnt and necessary corrective measures not taken. But it is because the improvements that come after a crisis are perceived to make a system much stronger, resilient and efficient than ever before, and this eventually leads to complacency.

These improvements include financial innovations or liberalisation that creates new markets or products and tools for better management of risks. In this environment of enhanced efficiency, competition and profitability, it is easy for a false sense of security to set in and a belief to grow that this time round the system would not suffer the same fate. This perception could make market participants take a more relaxed view of risk and lower their guard.

The subprime crisis is a case in point. The markets were convinced that the financial innovations have enabled financial institutions to take on higher and more risk at lower cost and to widely disperse risk throughout the system. The dot.com mania under the banner of the New Economy, where investors pursued concept stocks and overlooked revenue streams and profits, is another example.

Experience shows that in good times optimism is highly contagious, while common sense tends to take a back seat and many believe that the party will carry on. But eventually, at some point, sentiment changes and the market goes into reverse mode. This could be triggered by negative news, or a reassessment of risk by the market. Then confidence is undermined and pessimism prevails.

Markets also tend to move in a herd. Investors and market participants pile into a market so as not to miss out on an opportunity to make money. Likewise, they make for the exits to minimise losses. But this kind of behaviour results in overshooting, both on the way up and down, with the implications that it brings.

Regulatory challenges

Moving on to regulatory challenges, I would like to make two points. The first point is that regulation cannot guarantee against zero failures or against crises. For financial markets to remain robust and well-functioning, it calls for the exercise of self-discipline, market discipline and regulatory discipline by the different stakeholders in the marketplace.

The exercise of self-discipline by corporations and market intermediaries means having in place robust risk management and internal control systems which provides the necessary checks and balances to guard against excessive risk-taking. Regulatory discipline helps to reinforce self-discipline through regulatory requirements and guidelines, as well as compliance checks and enforcement action to deter market abuse. Market discipline is equally important, as investors and counterparties in financial markets exercise due diligence and vote with their funds allocation, thus providing the necessary pressure and incentives for fund raisers and financial intermediaries to have sound risk management and internal control practices.

The second point is that regulators have to ensure that there is not too much regulation or too little regulation. Regulators have to decide on a regulatory framework that protect public interest and maintain market confidence, while not hindering the ability of a financial market to provide competitive financial products and services. In other words, regulators have to achieve regulatory balance.

The post-mortem of what caused the subprime crisis and the regulatory debate on what needs to be done to maintain financial stability provides an excellent window into the complex issues surrounding the appropriate regulatory structure, the regulatory tools and authority for effective action to restore confidence, and the need to minimise moral hazard.

As in any post-crisis situation, there is always a demand for more regulation to plug the loopholes. At the same time, there is recognition that over-reaction in tightening regulation could kill the market. Getting the right balance between regulation, incentive structures and market discipline is not easy. The debate as it evolves would offer much food for thought for Asia.

The regulatory approach in Hong Kong

The SFC adopts the Objectives and Principles of Securities Regulation established by the International Organization of Securities Commissions (IOSCO), which has three core objectives: the protection of investors; ensuring that markets are fair, efficient and transparent; and finally the reduction of systemic risk.

Hong Kong has included a market development objective in the Securities and Futures Ordinance (SFO). It provides for the SFC to promote a competitive securities industry and to be mindful of the need for Hong Kong to remain competitive as an IFC, over and above the normal objectives of securities regulation. To sum up, what this means is that the SFC is entrusted to –

- regulate and enforce to protect investors and maintain market stability;
- facilitate market development and innovation so as to maintain a competitive securities industry and Hong Kong's status as an IFC; and
- educate investors.

What the SFC does is to look closely at how we discharge our statutory role with a view to cutting back red tape and unnecessary bureaucracy. We would make the necessary modifications where rules, processes or regulations create structural barriers to efficiency and competition or where they are obsolete or create unintended consequences because of changes in the operating environment.

At the same time, we would tighten regulations, or re-regulate, where the regulations are deficient in achieving the desired regulatory outcomes, again because of changes in the operating environment, loopholes or regulatory gaps.

Investor education is an important complement to regulation, as it helps to empower the investor with basic knowledge of products and risks, of their own rights and responsibilities, as well as channels for complaints in case of unfair treatment or misconduct. Enlightened investors would be equipped to ask the right questions, make informed decisions and be more alert to scams.

A robust regulatory framework benchmarked to international standards has been a hallmark of Hong Kong that has made it a successful international financial centre. Hong Kong is uniquely placed to provide a bridge between the Mainland and the rest of the world for a two-way flow of capital. Hong Kong offers the attributes that international investors seek – certainty and predictability in regulation and the rule of law; liquidity, efficiency and choice in the financial markets; and a pro-business environment served by professionals and intermediaries from around the world.

The structure of Hong Kong's securities industry is quite unique in that it has not only the top investment banks and securities brokers from the advanced markets, but it has also a large population of local stockbrokers of various sizes. This structure also reflects the profile of the investors and issuers. More than half of the market capitalisation in Hong Kong is attributed to Mainland corporations, and the investor profile is distributed between Hong Kong and international investors roughly in the order of 60 per cent versus 40 per cent and about 30 per cent versus 70 per cent between retail and institutional investors.

The regulatory challenge is to strike a balance between these competing interests. Sometimes, this presents a dilemma. But by and large, at the end of the day, the benefits should roughly even out among the stakeholders. As an IFC, Hong Kong has to benchmark to international standards and practices to remain successful. Capital and transactions flow to the market which best serves the interests of the investors. A successful financial centre brings the benefits of liquidity, volume, choice, efficiency and competitive transactions cost. These are tangible benefits that are enjoyed by all market participants, be they big or small, local or foreign.

The SFC adopts a consultative approach in the introduction of new rules and regulations. This provides an opportunity for all stakeholders to have a say. However, as in any market, the interests of different stakeholders cannot be fully satisfied. But the due process of consultation aims to facilitate the making of an informed decision that best serves the interests of the market as a whole and Hong Kong as an IFC.

Concluding remarks

In concluding, I would like to make a few observations. First, the cloak of the present crisis may look different – subprime loans, CDOs and the originate-and-distribute business model. But the underlying problem is the same – availability of cheap and easy credit, lax lending standards, weak risk management culture and inappropriate incentive structures.

Second, the stability of markets is dependent on the different stakeholders acting in a responsible manner. The market is only as strong as the weakest link in the system. This calls for the collective exercise of self-discipline, market discipline and regulatory discipline by the respective stakeholders. The discipline works like a three-legged stool; it would not stand if one leg is absent.

Third, with the integration of markets across the world, crisis tends to be more global in nature, thus demanding global solutions. The present crisis has revealed structural, operational and regulatory shortcomings that require solutions that cut across markets, regulators and borders.

Fourth, the only certainty at the moment is that much uncertainty remains as to whether the worst is over, how protracted the crisis will be, and how severe the impact would be on global growth. If one looks for the silver lining, it is that it has brought together concerted efforts at the national and international levels to take the necessary measures that would restore market confidence, the foundation stone for a well-functioning financial market.

Finally, Asia has been relatively fortunate thus far because of its stronger position after the Asian Crisis, and also because their financial markets have much less exotic and complex financial instruments. However, Asia should embrace the opportunity that the crisis presents to ponder on what not to do and what needs to be done to further strengthen the economic and financial infrastructure of the economies in Asia. This would place Asia in good stead to meet the challenges and opportunities that lie ahead in an Asia Era.

Thank you.