SECURITIES AND FUTURES COMMISSION
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China Enterprises Economic Research Study Centre

Global Financial Crisis

-- Implications on future reform and regulatory approach

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Three-pronged approach to combat global financial crisis

- Restore confidence in the financial system
- Stimulate economic growth
- Strengthen financial regulation

1. Restore confidence in financial system

- Protect bank deposits
- Guarantee interbank lending
- Inject liquidity to banking system
- Segregate non-performing loans
- Increase bank’s capital adequacy ratio

2. Stimulate local economies

- Boost public sector expenditure
- Encourage domestic spending
- Reduce interest and tax rates
- Increase export incentives
- Government’s special grant/loan to SMEs

3. Strengthen financial regulation

- Close monitoring of financial institutions that have a systemic impact on the market
- Extending regulatory oversight to unregulated institutions, markets and instruments:
  - Over the counter trades
  - Structured products and derivatives
  - Hedge funds
  - Credit rating agencies
- Reporting of short-selling positions
- Powers to obtain data from major institutions, markets and instruments to monitor their contribution to systemic risk

Effect on Asian region

- **The subprime crisis did not have severe impact on the financial systems in the Asia Pacific countries**
- **To boost public confidence, governments offered protection to depositors**
  - HK, Taiwan, Singapore, Malaysia, Australia and New Zealand
- **Economic recession in Europe and America has exerted huge pressure on export prices and demand, causing export countries in the Asia Pacific region to cut production, resulting in massive layoffs**
  - Reportedly as many as 70,000 factories on the Mainland have closed down, affecting the employment of a large number of workers
- **Most of the governments in the Asia Pacific region have focused their resources on stimulating the economy**
  - e.g. the Mainland has introduced a 4-trillion-yuan economic stimulus package
  - Japan has approved economic stimulus plans worth a combined 75 trillion yen

Effect on Hong Kong economy

- **Hong Kong has strengthened the risk management of its financial system after the Asian financial crisis in 1998**
- **Hong Kong's financial market is not exposed to significant systemic risk in the current financial tsunami**
  - The HKD has remained stable all along
  - The banking system remains stable with no bank failure
  - Financial intermediaries are financially sound with their trading activities remaining stable
  - Hong Kong's securities market still operates in an effective and orderly manner
  - There are no excessively concentrated positions in the futures and options markets
  - Short-selling activities remain at levels consistent with those prior to the current financial turmoil
- **Confidence in real economy however has weakened**

Implications on the Mainland

- **China has several favourable factors to help it withstand the global financial crisis**
  - Impact of subprime fallout on China is limited given that the direct exposure is manageable.
  - Foreign exchange reserves of US$2 trillion and fiscal surplus
  - Total foreign borrowing is manageable, negligible risk of sudden unwinding of foreign debt to disrupt domestic investment
  - Prudent level of leverage
    - Government's domestic debt is 15 per cent of GDP, down from 20 per cent at the beginning of the decade
    - Household savings are 75 per cent of GDP, and mortgage loans amount to only 35 per cent of the value of home sales during the past seven years
  - Most importantly, its banking system is functioning and credit continues to grow. In the first quarter of 2009, lending increased significantly.

Impact of global financial tsunami on major markets

Performance of major markets in 2008/09

		31/12/08 Index Level	2008 Full-Year Change (in domestic currency)	8/5/09 Index Level	Change from end of 2008 (in domestic currency)	8/5/09 P/E Ratio
HK	- HSI	14,387.48	-48.3%	17,389.87	20.9%	14.49
	- HSCEI	7,891.80	-51.1%	10,051.90	27.4 %	15.88
Mainland China	- Shanghai SSE Composite Index	1,820.81	-65.4%	2,625.65	44.2 %	22.42
	- Shenzhen SSE Composite Index	553.30	-61.8%	879.93	59.0 %	32.76
Singapore	- STI	1,761.56	-49.2%	2,238.21	27.1 %	11.80
Japan	- Nikkei	8,859.56	-42.1%	9,432.83	6.5 %	37.77
US	- Dow Jones	8,776.39	-33.8%	8,574.65	-2.3 %	17.98
	- NASDAQ	1,577.03	-40.5%	1,739.00	10.3 %	26.33
	- S&P 500	903.25	-38.5%	929.23	2.9 %	15.11
UK	- FTSE 100	4,434.17	-31.3%	4,462.09	0.6 %	9.80
Australia	- AOI	3,659.30	-43.0%	3,919.60	7.1 %	26.56

Sources: Bloomberg and websites of relevant exchanges

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International response to crisis (G20)

- **In November 2008, the Group of Twenty (G-20) held the Summit on Financial Markets and the World Economy in Washington and approved the Washington Declaration which aims at tackling the current financial crisis**
- **G20 members: eight major industrial nations comprising the G8, China, Argentina, Australia, Brazil, India, Indonesia, Mexico, Saudi Arabia, South Africa, South Korea, Turkey and the Czech Republic**
- **Four working groups have been established to fortify financial markets and enhance regulation**
- **In April this year, the G20 met in London to examine the implementation of the relevant principles and action plan and the Leaders pledged to do whatever is necessary to:**
  - restore confidence, growth, and jobs;
  - repair the financial system to restore lending;
  - strengthen financial regulation to rebuild trust;
  - fund and reform international financial institutions to overcome this crisis and prevent future ones;
  - promote global trade and investment and reject protectionism, to underpin prosperity; and
  - build an inclusive, green, and sustainable recovery.
- **The next G20 Finance Ministers and Central Bank Governors Meeting will be held in Scotland in November this year**

Repair banks to restore lending, growth and markets

- **Given that the crisis stemmed from the banking sector, reforms have been focused on the banking system**
- **Business model likely to revert to "basics"**
  - Banks should return to the traditional business approach
  - Commercial banking and investment banking should be separated
  - The primary business of commercial banks is to support commercial activities
  - Investment banks are mainly responsible for buttressing the development of capital markets
- **Recovery of the real economy hinges on the restoration of stability in the banking system**
- **Recovery of the securities and real estate markets hinges on the recovery of the real economy**

Regulation and oversight of all systemically important financial institutions, markets and instruments including hedge funds

- **Monitor macro-prudential risks across financial system to limit systemic risk**

- **Powers to obtain information from all major financial institutions, markets and instruments in order to assess their contribution to systemic risks**

- **Register hedge funds and managers and impose disclosure requirements. Information sharing among regulators**

US and Europe proposed regulation of hedge funds/private pools of capital:

- Registration of all fund managers
- Investor disclosure
- Regulatory reporting which include information necessary to assess threats to financial stability
- Imposing prudential requirements
- Sharing of macro-prudential data among regulators for macro-prudential oversight.

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Oversight of credit rating agencies

- **All CRAs whose ratings are used for regulatory purposes should be subject to regulatory oversight including registration.**
  - Establish regulatory oversight regime by end 2009 consistent with the IOSCO Code of Conduct Fundamentals. IOSCO to coordinate full compliance.
- **National authorities to enforce compliance and require changes to a rating agency's practices and procedures for management of conflicts of interests; and**
- **The oversight framework should be consistent across jurisdictions with appropriate sharing of information between national authorities, including through IOSCO.**

Implement FSF Principles on Pay and Compensation

- **Significant financial institutions to implement FSF Principles by 2009 to ensure compensation structures are consistent with firms' long term goals and prudent risk taking.**
  - Boards to design, operate and evaluate compensation schemes
  - Schemes to reflect risk, and timing and composition must be sensitive to time horizon of risks
  - Rigorous supervisory review
  - Provide clear, comprehensive and timely information on schemes to the public
- **Supervisors will assess firms' compensation policies as part of their overall assessment of their soundness and, where necessary, intervene (e.g. increased capital requirements).**
- **The principles are to form part of BCBS risk management guidance by 2009 but no specific mention whether intermediaries within the securities sector would be subject to the principles.**

Challenges facing reform of regulatory system

- **As the financial situation varies, each country has its own considerations**
  - Exchange convertibility
  - Markets are in different stages of development
  - Local legal framework
  - Diversified regulatory agencies
- **As new products are introduced and markets converge, regulatory bodies are struggling to keep up with market changes**
  - Structured products and over-the-counter derivatives
  - Insurance-linked financial products
- **Where and how to exert regulatory authority over multi-location entities**
  - At point of sale or
  - At the headquarters
- **Regulatory bodies from different countries may not share the same goal and co-operate with each other**
- **Difficulty in reaching an ideal regulatory approach that can suit all**

Financial regulatory framework – Four main approaches

- **The Institutional Approach**
  - A firm's legal status (for example, a bank, broker dealer, or insurance company) determines which regulator oversees its activities from both a safety and soundness and a business conduct perspective
  - USA, PRC and HK
- **The Functional Approach**
  - Supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of business has its own functional regulator
  - France, Italy and Spain
- **The Integrated Approach**
  - A single universal regulator conducts for all sectors of financial services business
    - safety and soundness oversight and
    - conduct-of-business regulation
  - The UK and Germany
- **The Twin Peaks Approach**
  - Separation of regulatory functions between regulators: one performs the safety and soundness supervision function and the other focuses on conduct-of-business regulation
  - Australia and the Netherlands

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Conclusion – lessons from the financial turmoil

- It is imperative to strengthen international regulatory co-operation, particularly in worldwide activities conducted by international financial institutions
- Regulators must widen their perspectives and keep up with rapid market developments
- While financial innovation may be encouraged, financial institutions have to take responsibility for the associated risk
- Leverage can be employed but must not be excessive
- Regulators must strike a balance between regulation and market development
- The financial system should be employed to support the real economy and not an end to itself. Excessive financial transactions can lead to imbalance between the real economy and the financial market

Regulation cannot guarantee zero failure

We need :

- Self discipline by institutions
- Market discipline by investors
- Regulatory discipline by government/agencies

Thank You