

5th Hong Kong Investment Funds Association Annual Conference Keynote Address “A Review and Outlook of the Regulatory Landscape”

Ashley Alder
Chief Executive Officer
Securities and Futures Commission
Hong Kong

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Drivers for global financial reform

I'm going to start off with just a few words about the drivers behind a massive sea change in regulatory attitudes after the 2008 crisis.

One of them is a move to re-appraise the basic role of finance, which is traditionally looked to as a bridge connecting savings to productive investment. The 2008 crisis put the financial services industry and its role in society firmly in the spotlight, raising questions about complex and opaque products, layers of intermediaries and fees, new and unknown counterparty risks... etc.

When I talk to international regulators, one of the underlying questions behind much discussion was this: “Does the financial system extract more value than it creates for investors and entrepreneurs, and if it does, should regulation have a role in redressing the balance?”

There have of course been critics before and after the financial crisis. We have had Lord Turner, Chairman of UK's Financial Services Authority, who has spoken about some financial innovation as being socially useless. We had Paul Volcker in the US talking about ATMs being the only big innovation in the past 20 years. And of course we had Warren Buffet referring to derivatives as “financial weapons of mass destruction.”

So the question is to what extent should finance go back to basics to perform its primary function of financing economic growth and what role regulation plays in any shift of emphasis. Views differ across different markets. It is also relevant to note that there is a significant political dimension to all of this; proposals for a Tobin tax, which are gaining traction particularly in Europe, is a good example.

There is at least a broad consensus on what went wrong from a regulatory perspective. There is now a very long list of issues looking for solutions. The following are a few examples:

- whether easy money distorted the cost of capital and encouraged excessive risk-taking;
- whether leverage had also disproportionately amplified risks and magnified losses;
- skewed incentives within the financial industry, including compensation;



- activities (often known as “shadow banking”) that fall outside the normal capital and liquidity rules and the traditional perimeter of regulation;
- herding (you might have heard of the phrase “as long as the music is playing, you’ve got to get up and dance”);
- a suspension of disbelief over mispriced securities. Problems included over reliance on efficient market theories and a “this time is different” approach, which reminds me of the “new economy” themes associated with the dot-com boom and bust in the early 2000s;
- a breakdown in risk management – an aspect of this was the reliance on credit ratings which relate to default but not liquidity risk;
- Finally, complexity and the “originate and distribute” model has been likened to a daisy chain; the chain is only as strong as its weakest link.

Why is the main response been to re-regulate? A central factor is that de-regulation, which took place some years ago, has been identified as a principal cause of what went wrong.

There is also an attitude – which is perfectly understandable – that in a crisis as deep as the one that unfolded in 2008, you’ve just got to “do something”. The regulatory pendulum tends to swing markedly over time in response to successive crises. A light touch approach has in many places now been replaced by a prescriptive approach.

We are fortunate in Hong Kong because the amplitude of our pendulum is not normally as extreme as elsewhere. That will continue to be the case, but I should be clear that it is incredibly important that Hong Kong also remains in lockstep with the main goals of international regulatory reform.

The overall response to the crisis boils down to a real need – the need to fix a broken system.

Key issues relevant to global financial reform

I have been asked whether more regulation is a good or a bad thing. I don’t think that’s the right question. The issue is not “how much regulation?” but rather “what is quality regulation?”

Quality regulation should develop from a collaborative process, which is why it is important for organisations like ours to continue to interact closely with a cross section of the market in formulating reform. We cannot do our job in isolation. We need to develop rules that work in practice whilst addressing the fundamentals of investor protection.

From the international perspective, it is clear that in recent years regulators have not kept up with market developments. The gaps are now clear, including “shadow banking” – one example of which is the enormous size of largely unregulated money market funds and their relevance to the availability of credit. Significantly, there has been no clear mandate in relation to the role of securities regulators as far as international systemic risk is concerned, whilst large financial institutions increasingly operated globally. By and large, regulation has remained segmented and national.



The result is a huge and unprecedented regulatory and policy challenge which is global in scale. It goes far beyond the traditional perimeter of regulation and involves a lengthy programme of reform – for example, the Vickers report proposes full implementation of retail bank ring-fencing by 2019.

There are basically two key strands of new regulation. The first is structural, which is largely about institutional risk. For example: Basel III, the Volcker Rule, the Vickers Report and the Financial Stability Board's Principles for Compensation.

The second concerns conduct. It is clear that banks' business model has been squeezed and that as a result different lines of business have become popular because they generate fees which do not attract higher capital requirements. Frontline staff may be unskilled but can be set some pretty testing sales targets around what they're offering to bank customers. These are the conditions in which mis-selling can all too easily occur.

Last week, Lord Turner was quoted in the Financial Times. This extract neatly captures some of the issues that regulators are now wrestling with. Although he talks about banks, his commentary is relevant to a range of financial institutions.

“As free banking involves banks treating their core services as a loss-leader, they must necessarily make up the shortfall elsewhere –for instance, through higher charges and the sale of unnecessary products. The pressure to find such revenues has only intensified in the low-return environment of recent years, resulting in scandals such as the mis-selling of payment protection insurance (PPI) policies. The scale of the abuse in this case was staggering, involving as it did the tacking on of policies to loans without customers’ knowledge,” said Lord Turner.

In order to deal with this type of challenge the way in which regulators interact is changing rapidly; globally-mandated solutions have uncovered serious potential gaps and overlaps which can only be dealt with through close cross border co-operation.

In this respect the global financial crisis is a genuine game-changer for how regulators operate; the crisis is not only changing the behaviour of financial institutions, but also the behaviour of regulators and central banks.

Paul Tucker (who had a close involvement in the Ian Hay Davison Report in the late 80's and is now deputy governor of the Bank of England) was earlier this year talking about the way in which securities regulators and prudential regulators need to work together.

What he said captures what the new regulatory landscape is all about.

“Once upon a time banks extended and held illiquid loans, overseen by banking supervisors. And in a largely separate universe, securities regulators policed the integrity of individual transactions and offerings on public exchanges served by specialist intermediaries. The growth of private markets, over the counter markets, derivatives, securitization, and banks as intermediaries in capital markets has changed all that, as the crisis cruelly exposed. Banking supervisors are having to recover their historic mission for systemic stability, but this time round that calls for greater attention to markets and, in particular, not simply assuming that what's in a bank's trading portfolio and warehouse must be liquid. Securities regulators are having to look well beyond their roots, accepting that their rules and policies influence the



resilience of the system. And financial stability authorities, including central banks, have to become as comfortable debating the (hard and soft) infrastructure of core capital markets as they are with, say, the intricacies of the capital structure of banks. All of that is essential if we are to make progress with comprehending the network characteristics of the financial system. Securities regulators and financial stability authorities will have to meet half way.”

Hong Kong’s position on global financial reform

So, let’s have a look at Hong Kong’s position.

The impact of the financial crisis on Hong Kong to date has been very different to the impact elsewhere; the G20 reforms principally address problems that have the US and Europe at the epicentre – Asia was only affected indirectly. But of course, any notion of “de-coupling” has been completely debunked.

One of the issues now current in the US and Europe is whether or not Asia is fully on board to push through with other regulators the essential reforms necessary to ensure, as far as possible, future financial stability. In short, a fear of regulatory arbitrage.

Hong Kong’s position on this is actually pretty straightforward. Our key advantage is the fact that we have first-class regulatory system, and we have a strong rule of law tradition that is unique in Asia. This is the foundation on which the quality of our market is built.

We should not seek to join in a race to the bottom so far as regulation is concerned and I do not believe that regulation should be used as a competitive tool. We are committed to the key G20 reforms; to ensure that they are directed at containing systemic risks and protecting investors is now our overriding concern.

The main challenge is implementation, which involves areas of extreme complexity. Proposals concerning the reporting and mandatory clearing of standard OTC derivatives is a good example; this project demands very close international co-operation to achieve a workable solution. And of course there is the challenge of harmonizing or otherwise dealing with different national or regional responses to the G20 programme such as Dodd-Frank and MiFID II. We will do our best to steer a sensible course, whilst taking account of local factors and differences.

Some reform may take too long and market dynamics might change in the interim. On the other hand, if we rush to put rules in place too fast, there may be too many unintended consequences. In addition, new rules involve more time and cost: all of this reminds me of the Sarbanes-Oxley debate a few years ago when much was said about whether the cost-benefit analysis was correct.

SFC’s response

The SFC’s current focus is mainly on strengthening of investor protection after the 2008 crisis. For example, in the funds/products area, the SFC has introduced key facts statements, mandatory ongoing disclosure, cooling-off periods and also a new general principle that products need to be fair to investors in terms of design and payout. We will today be completing a surveillance of SFC authorized-funds in relation to key facts statements and will be publishing the results shortly. It is very important that we then interact with fund



managers and other stakeholders to make sure that new regulations in fact strike the right balance for investors and the financial industry.

In relation to higher level G20 recommendations, the SFC now regulates hedge funds, and credit rating agencies are now licensed under the Securities and Futures Ordinance.

Securities regulators work very closely through our international organisation, IOSCO. In response to the financial crisis, two new principles have been added by IOSCO to the existing set which govern the activities of securities regulators around the world. These concern managing systemic risk and we are also required to review perimeter of regulation. These principles underline the need for regulators to work in lockstep to address properly market stability as well as formerly unregulated sectors.

Closing

I have been away from the regulatory scene for eight years and returned just four weeks ago. The last time I was at the SFC the agenda was dominated by corporate governance, the dot-com bust, Enron, Worldcom, etc. While this topic remains extremely important, what is striking this time round is that the agenda is very different – and more complex and fundamental. The key concerns are global systemic risk, and the stability and conduct of financial firms. As a result we have no option but to formulate our entire regulatory approach in tandem with the global effort and on the basis of open, honest and effective communication and co-operation between regulators and the financial industry.

Have a great conference.

Thank you.