Five years on — Lessons, challenges and opportunities
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Mr Stephen Bird, CEO Citi Asia Pacific, distinguished guests, ladies and gentlemen,

A very good morning to you all!

I must confess that this is the first time that I attended the Citi Investor Conference since my net worth clearly does not qualify for me to be included in the invitees' list!

In the company of so many distinguished economists and investment experts, I am sure you will not be disappointed to know that I won't be giving any investment advice. Anyway, regulators should not be giving any and therefore the only investment advice I will give is the standard health warning on shares investment — that is, share prices can go down as well as up!

The month of January is a time of new beginnings which allows us to set our ambitions and gives us a whole new year to work on achieving our personal resolutions, investment goals and corporate plans. I hope this conference will set you on your path for a very successful year ahead!

I saw from the conference brochure that you have a fairly intensive agenda over the next two and a half days, covering a wide range of subjects, so I will not be focusing on any specific technical matters in my speech. Instead, I will try to set the scene for the conference by providing an overview of the five years since the financial crisis.

I will discuss the lessons learnt, the global responses to the crisis and look at the current economic environment. I will then bring us back to what is happening here in Hong Kong before I share with you my own conclusion from the crisis.

The global financial crisis — Lessons and reforms

While a new year holds promise of opportunities and also challenges, it would be worth our while to remember 15 September 2008, the day that the failure of Lehman triggered a near total meltdown in major financial markets, precipitating a global economic recession that sparked fears of a potential depression. To avoid a repeat of such a devastating crisis, the remaining effects of which are still being felt five years on, we need to bear in mind what lessons the crisis has taught us. I believe there are five key lessons:

a. the first is that leverage is a double-edged sword. Leverage allows investors like you to reap huge profits for a given amount of capital if the market moves in accordance

with your expectations. However, when markets turn and asset prices start to fall, losses are amplified by leverage and margin calls. Panic selling can then add downward pressure on prices, triggering further selling in a vicious cycle.

b. the second lesson is that liquidity may not be real. The illusion of liquidity is illustrated by the credit derivatives, which saw exponential growth but were in reality highly illiquid as they were hardly traded. The evaporation of liquidity created severe dislocations in financial markets in 2008.

c. thirdly, transparency and information disclosure are vital for markets to function. As it was difficult to establish the extent of risk and where it ultimately resided for complex products such as collateralised debt obligations and credit default swaps (better known as CDOs and CDSs), uncertainty and fear of counterparty risk led to a credit crunch. The deleveraging process that followed severely disrupted financial markets.

d. the next lesson is that when incentives are skewed, it encourages a risk-reward equation that is not sustainable and may create a perverse incentive for staff to take on higher short-term risks to generate greater revenues and profits, without due regard to the longer-term risks and sustainability of profits to justify the risk. The last thing anybody wants is paying astronomical compensation as a result of some traders' excessive risk-taking when losses materialise.

e. finally, to stay in business, governance and risk management have to be front and centre. Many did not fully understand the nature of the risks and how the risks relate to one another. Consequently, the market under-estimated the extent of leverage in the system and over-estimated the dispersion of risk. Over-reliance on valuation models — some of which are based on untested assumptions and historical data of benign and stable market conditions — increased the tendency for herd-like behaviour which sent markets off the cliff.

That said, based on a series of SFC meetings with senior executives of global systemically important financial institutions (G-SIFIs) over the last few months, we note they are highly aware of the importance of improving risk governance and culture following the 2008 crisis. In December, we published our observations in a report that aimed to help you and your organisations embed enhanced risk governance and culture at all levels. The report discusses five ways your firms can strengthen risk culture:

- via incentives, which include a proper balance of rewarding good behaviour and punishing bad behaviour;
- by setting a strong tone from the top in deciding not to pursue businesses or activities which in the short run may be lucrative, but in the long run may threaten the reputation of the organisation;
- by disentangling complex matrix reporting lines so that locally-based senior executives can have an up-to-date picture of local activities and associated risks;
- by further increasing the authority and prominence of the risk functions; and
- by adopting a forward-looking approach to risk identification through understanding the evolution of the business.

This is the first edition in a series of risk-focused industry meeting reports, and we plan to have further meetings in the future to work towards continuous improvement in risk governance and culture.

Risks aside, other broader problems have surfaced as a result of the crisis. In the pre-crisis days, there was no one regulator responsible for overall financial stability and equipped with the appropriate authority to monitor, mitigate and manage systemic risk. Markets operated without borders, while regulators operated within national borders and their respective mandates. Today, all regulators are urged to be aware of systemic risk given that failure to manage it could de-stabilise financial markets and spill over to the real economy.

I also observed that the financial system is as strong as the weakest link. The nature of financial activities has undergone a rapid transformation from traditional borrowing and lending to trading in financial instruments. Many of these activities occur beyond the scope or reach of regulators.

This is aggravated by the growing sizes and complexities of financial firms, which have become too big for management to fully understand and effectively manage, and who had to be rescued as their failure would have systemic implications on financial stability.

Global responses to the financial crisis

Now, to spare you from too much talk of the past, let's set our eyes on the global responses to the financial crisis.

As you all know, the crisis sparked an international debate on the fundamental role of financial institutions and a call for a return to basics. Regulators around the world have responded by initiating global financial reforms with new focus on systemic risk, macro-prudential regulation and international co-operation.

These reforms are continuing with progress monitored by the Financial Stability Board (FSB) and the G20 process. The FSB is closely monitoring implementation of six priority areas:

a. First, Basel III, the core of which is the recognition that building more resilient banks requires higher and better quality capital, by setting higher levels for capital requirements. A new global liquidity framework has been introduced;

b. second, over-the-counter (OTC) derivatives market reforms concerning standardisation, central clearing, exchange or electronic platform trading, and reporting of transactions to trade repositories. The objective is to improve transparency in the OTC derivatives markets, mitigate systemic risk, and protect against market abuse;

c. third, compensation practices, which were a major contributing factor to the crisis. To align employees' risk-taking incentives with the long-term profitability of the firm, particularly at major financial institutions, the Principles for Sound Compensation Practices and their Implementation Standards have been developed;

d. next, policy measures for G-SIFIs, aiming essentially to end "too big to fail" by addressing systemic and moral hazard risks posed by SIFIs. Measures include

additional loss absorbency requirements, resolvability assessments, recovery and resolution plans, and the establishment of cross-border co-operation agreements;

e. resolution frameworks, which mean having in place appropriate legislation and necessary powers to enable resolvability of G-SIFIs and the legal capacity for cross-border co-operation; and

f. lastly, shadow banking, which is a major source of systemic risk, both directly and through its interconnectedness with the banking system. Shadow banking reforms aim to ensure appropriate oversight and regulation of bank-like systemic risks that emerge outside the regulated banking system, while not inhibiting sustainable and resilient non-bank financing models.

So, what about Hong Kong?

Needless to say, these complex and fast-moving global reforms affect our markets. Hong Kong, as a member of the FSB, is committed to implementing the above international standards. We, the Hong Kong Securities and Futures Commission (SFC) and Hong Kong Monetary Authority worked jointly on a Bill, which is now before the legislature, to introduce a new regulatory regime for the regulation of OTC derivatives markets in Hong Kong as soon as practicable.

Separately, to bring Hong Kong's existing supervisory arrangements into line with the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions, the Government and the financial regulators, including the SFC, last week launched a three-month public consultation on establishing an effective resolution regime for financial institutions and financial market infrastructures in Hong Kong. Your views and comments would be more than welcome.

Another major global financial reform is the implementation of Principles for financial market infrastructures (PFMIs) published jointly by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the International Organization of Securities Commissions (IOSCO). We have issued a set of guidelines for recognised clearing houses concerning the application of these principles to provide better clarity.

The global economic environment

Five years on, so what is the current economic environment? Are we in much better shape now when compared to five years ago, and are we out of the woods yet?

The global economy is seemingly continuing on the path of recovery amid abundant liquidity and low interest rates. However, macroeconomic challenges remain that could affect the recovery process.

One of the key macro-economic concerns is the impact of US and European economic policies. In December, US economic data showed continued improvement, prompting market expectations of possible tapering before the end of 2013. The Federal Reserve signalled that tapering is likely to continue at a measured pace at each Federal Open Market Committee meeting depending on economic data. It is expected that interest rates will

eventually normalise and rise, and the timing and pace of tapering and interest rate increases are data-dependent. Both factors may impact capital flows and market sentiment.

Europe's austerity and the resolve to "do whatever it takes", including a backstop from the European Central Bank, has helped to calm markets and restore financial stability. However, the concern is that the unfinished business of structural reforms could hamper Europe's ability to sustain its recovery. In addition, concerns of disinflation and potential deflation pose new challenges.

The second concern is a sharp withdrawal of capital flows from emerging economies as US economic recovery becomes entrenched and markets expect interest rates to rise. Such withdrawal of funds could impact currencies, asset prices, debt servicing, and the cost and availability of new credit. While some Asian economies have already experienced a reversal of flows, the general view is that Asia is in a much stronger position to withstand the stress compared to conditions prevailing before the Asian Financial Crisis in 1997. In addition, the US and China economic situation is a stabiliser for Asia. The recovery of the US, if it is sufficiently robust, would generate greater demand for Asia's exports which will help absorb the impact of higher interest rates. Mainland China has managed an economic slowdown and is steering its economy to a more sustainable and balanced growth path.

Whilst there has been a significant net inflow of liquidity into Hong Kong's financial system since the US launched the Quantitative Easing policy five years ago (there had not yet been any noticeable outflow since tapering started). Having said that, higher interest rates in the US will affect the cost of borrowing and asset prices in Hong Kong and the allocation of international capital.

Much uncertainty remains in the global economy, complicated by geopolitical tensions. Managing risk in this environment will be challenging as market sentiment, more than fundamentals, would influence investment decisions and create much greater volatility in markets.

Hong Kong — A quality market and continued opportunities

So, where does all this leave Hong Kong?

To date, Hong Kong has gone through a number of financial crises and come out relatively unscathed, thanks to its many pillars of success. Hong Kong has the reputation as the freest economy with free capital and information flows and strong institutions that upholds the rule of law and protects property rights. It is this institutional structure that provides certainty and predictability to investors around the world and Hong Kong's value proposition which underpins its success as an international financial centre.

Globally, Hong Kong is benchmarked against other markets and has achieved high rankings based on a host of key indicators, including people, business environment, market access, infrastructure, general competitiveness, and financial stability. Hong Kong is in third place after London and New York in the Global Financial Centres Index and tops the World Economic Forum's Financial Development Index.

Hong Kong is also a diverse marketplace where top investment banks and securities brokers from the advanced markets operate alongside a large number of local brokers. Mainland enterprises account for more than half of stock market capitalisation whilst the investor profile is distributed roughly evenly between Hong Kong and international investors. Retail investors constitute about one quarter of investors whilst two-thirds are institutional investors. Funds from non-Hong Kong investors have consistently accounted for more than 60% of Hong Kong's asset management business.

The Hong Kong stock market has demonstrated time and again that it has both the depth and liquidity to handle the largest initial public offerings (IPOs) whether from the Mainland or from overseas. In terms of market capitalisation, it is the sixth largest worldwide at approximately US$3 trillion, and ranked second globally for IPO fund-raising last year.

The Third Plenary Session of the Communist Party of China's 18th Central Committee in November last year launched the roadmap for mainland China's next stage of reforms that, among others, will see a more "decisive role" for the market in the allocation of resources, and a greater role for the market in price determination. The reforms are expected to encourage a bigger role for direct financing, relaxation of the IPO registration system, further exchange and interest rate liberalisation, as well as further capital account opening.

Policies from the Mainland and the pace of its reforms could affect the development of Hong Kong's financial market and its role as an offshore renminbi centre.

Hong Kong has traditionally provided a platform for two-way capital flows between mainland China and the rest of the world. Hong Kong has facilitated the Mainland in its experimentation in "going out" over the past three decades. Hong Kong will continue to play this role and provide investors with the opportunity to participate in the dynamism of China's evolving economy as it moves onto a more balanced growth path, while enjoying the familiarity, certainty and predictability that Hong Kong's financial system will continue to provide.

Hong Kong has played an important role in facilitating the internationalisation of the renminbi and is the largest offshore renminbi trading centre, having enjoyed the "first mover advantage" due to its proximity and special relationship with the Mainland.

There has been some excitement on the opportunities that will emerge from the mutual recognition of funds scheme that is being worked jointly by us and the China Securities Regulatory Commission. Presently, due to capital controls, funds outside China are not accessible to Mainland investors. With mutual recognition, qualified funds domiciled in Hong Kong can be sold on the Mainland, and vice versa.

As a financial regulator, the SFC strives to maintain a robust regulatory framework that is in line with international standards and the quality of our markets.

It is our mission to ensure the integrity and efficiency of our markets for the protection of investors; we have introduced a number of initiatives over the last couple of years:

a. we began in September 2012 weekly publication of the aggregate reported short positions in specific shares on our website;

b. we established the continuing disclosure regime for listed companies which requires companies to disclose any price-sensitive information in a timely manner with effect from 1 January 2013. Based on the significant increase in the number of corporate announcements since the law came into effect, the signs are positive that corporations are beginning to develop a disclosure culture;

c. effective 1 October 2013, we introduced new requirements for IPO sponsors to carry out thorough due diligence on the companies which aspire to join our stock market before a listing application is made;

d. to ensure the proper governance of our listed companies, we decided recently to take a more proactive role in overseeing corporate conduct of listed companies. This will mean more surveillance, analysis and enforcement work on our part. By actively detecting misconduct and following up on suspicious activity, we hope to identify red flags and enhance our role in maintaining quality markets and high corporate governance standards, as well as protecting investors; and

e. finally, on the enforcement front, we continued to send strong deterrent messages in all areas of responsibility with more cases before Hong Kong's courts and tribunals. These included more injunctions and disqualification orders against company wrongdoers, increased insider dealing cases as well as actions against sponsors and other intermediaries over a range of issues, including hidden fees and charges, mis-selling, internal control and due diligence failures. We have had a number of successes in the Courts recently to compensate investors for losses arising from illegal share trading based on inside information.

Concluding remarks

In conclusion, I would like to say that history offers invaluable lessons but we can benefit only if we take them to heart and make the necessary changes. Whilst, unquestionably, the developed world has worked hard to introduce new regulations and rules to avoid a repeat of what happened in 2008, I believe that despite all these efforts, the key to a quality and efficient capital market is that all players, including listed companies, banks and other intermediaries alike, uphold strong business ethics and practise sound corporate governance.

The question senior management should ask themselves when faced with a business or strategic decision is not "is this legal or not?", but instead they should ask themselves, "is this the right thing to do?"

What is most important as recommended by the SFC report I mentioned earlier is "tone at the top", which drives the culture of the entire organisation. I would advocate that the role of all of you, as investors, can play is to reward those companies that demonstrate strong corporate governance practices and punish those that do not.

As a regulator, we will ensure that investors are protected and markets are fair, efficient and transparent. We will continue to facilitate market development while ensuring that the integrity of financial markets will not be eroded.

Last but not least, we will continue to co-operate with other regulators at home and around the world, and also participate in global regulatory efforts to promote sound and well-functioning global financial markets.

Thank you for inviting me to share a few thoughts with you today. I wish you all a successful conference and a very prosperous Year of the Horse!