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Dialogue on Financial Innovation and Emerging Markets – Opportunities for Growth vs Risks for Financial Stability

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Session 1: Benefits and Risks of New Instruments: Derivatives and Securitisation

Current trends in National Capital Market Innovations

I. Overview of Hong Kong's capital market

1. Hong Kong is one of the leading international financial centres in the world. According to City of London Corporation's Global Financial Centers Index published in March 2008, Hong Kong was ranked third worldwide, just behind London and New York, in terms of financial centre competitiveness. In particular, Hong Kong has been recognised as retaining advantage in the five key competitiveness areas including people, business environment, market access, infrastructure and general competitiveness.

Securities Market in Hong Kong

2. At present, Hong Kong's stock market is the seventh largest in the world and the third largest in Asia, with market capitalization of US$2.4 trillion. During 2007, the total capital raised by the stock market was US$74 billion, making Hong Kong the fifth largest fund raising centre in the world.

3. For the stock market, institutional investors accounted for 60% of total trading, and overseas investors accounted for 40% of the total trading. The large and well-diversified investor base attracts international firms to introduce various new financial products in Hong Kong and these new products in turn attract new sophisticated players such as hedge funds and alternative asset managers to Hong Kong, thus adding depth and breath to the market.

4. In addition to stocks, our market also provides a wide variety of other financial products such as stock futures and options, index futures and options, derivative warrants, callable bull/bear contracts, exchange-traded funds, retail structured notes, equity-linked instruments and real estate investment trusts.

5. The daily average turnover of our stock market was US$11 billion in 2007. The total volume of futures and options traded reached 88 million contracts in 2007. Furthermore, our derivative warrants market was one of the most active in the

world and last year's turnover was over US$600 billion. Meanwhile, a total of about US$31 billion in retail structured notes and equity-linked instruments was issued in 2007.

Debt Market in Hong Kong

6. Turning to the debt market, despite the global credit market turmoil, the Hong Kong-dollar debt market has continued to expand. As of the end of 2007, the total outstanding Hong Kong-dollar debt was US$98 billion. This was about 47% of the GDP, up from 36% in 2000. Overseas borrowers remained the major issuer of debt instruments and accounted for about half of the total debt outstanding, whilst banks and the Hong Kong Monetary Authority roughly shared the other half. The total amount of debt instruments issued in 2007 was over US$55 billion with the Exchange Fund Notes accounting for half of this. In order to further develop the debt market, the Hong Kong Monetary Authority has implemented a series of measures including extending the yield curve, refining the market-making system and launching an electronic trading platform in recent years.

7. Furthermore, the Mainland government made a breakthrough in 2007 and approved Mainland financial institutions to issue renminbi-denominated bonds in Hong Kong. During 2007, such bonds with totalling RMB 10 billion were issued in Hong Kong. All the issued bonds were over-subscribed within a short period. With the continuous appreciation of the renminbi, we expect the RMB bond market in Hong Kong has great potential to grow because of the strong demand from investors.

8. As for other new developments, the Hong Kong Government has announced the wish to develop Islamic finance in Hong Kong. Our futures exchange will introduce a gold futures contract to the market in the coming months. Just last week, there was an announcement to establish a new commodity exchange which plans to introduce a fuel oil contract in the first quarter of 2009. These new initiatives will help Hong Kong further strengthen its position as a leading financial centre.

Hong Kong as the gateway to Mainland China

9. Hong Kong has been fortunate as it played a supporting and facilitating role as China experimented with capital market reforms. Hong Kong provided the platform that integrated the Mainland capital market with global capital markets, and has benefited from the growth story of China.

10. When Mainland China first embarked on its economic transformation, Hong Kong was the window to China for the rest of the world, and played the role of a fund-raising centre for Mainland companies, providing the platform for State-owned enterprises (SOEs) that sought to raise capital to finance expansion.

11. Hong Kong's role started in the 1980s with the listing of "red chips". This was followed by the listing of "H-shares" in 1993. The first H-share company listed on the Stock Exchange of Hong Kong was Tsingtao Brewery Company Limited – maker of the famous Tsing Tao beer. For those of you who may not be familiar with Mainland stocks –
    - "H-shares" are foreign shares issued by enterprises incorporated in China that are primarily listed in Hong Kong and traded in Hong Kong dollars. PetroChina is an H-share company.

- "Red chips" are shares issued by companies with business, assets, markets and ownership that have a strong Mainland orientation, but the companies are incorporated outside China. China Mobile, the largest market cap mobile phone company in the world, is an example of a red chip.

12. When IPO activity on the Mainland was suspended in the period 2005-2006 in support of a plan to convert the state-owned shares into tradable shares in phases, Mainland enterprises seeking capital came to Hong Kong. The listing of H-shares companies on Hong Kong's stock market accelerated.

13. Hong Kong has been uniquely placed to facilitate and support Mainland enterprises in raising capital:

14. First, one country two systems. The Mainland market is at a development stage with institutional constraints (such as capital controls), and Hong Kong is an established international financial centre ready to provide an invaluable service to Mainland companies seeking global capital.

15. Second, we have the advantage of close relations and proximity to the Mainland, and are also familiar with the language, culture, practices and systems on the Mainland.

16. Apart from a need to raise capital in the early days of China's emergence, the reason for listing Mainland companies in Hong Kong was motivated by a conscious and deliberate policy to expose and subject Mainland enterprises to Hong Kong standards and fast track their transformation to world class companies that meet international norms on governance and performance.

17. Hong Kong's regulatory and corporate governance standards and our Listing Rules are on a par with international standards. International investors looking to tap into the fast growing China market can invest in H-shares and red chips in Hong Kong. They can take comfort in knowing that Mainland companies listed here meet international standards and practices, and be assured of the institutional and legal infrastructure of a thriving international capital market.

18. In 2007, the world's largest IPO by the Industrial and Commercial Bank of China raised about US$16 billion in Hong Kong. We also saw the listing of another state-owned bank, the Bank of China which raised about US$11 billion in the same year.

19. Of the 150 Mainland-incorporated companies listed on overseas markets, 148 are listed in Hong Kong as H shares. During 2007, the total amount of funds raised by Mainland companies directly and indirectly through Hong Kong amounted to US$25 billion. As of 30 April 2008, there are over 240 Mainland companies listed on Hong Kong and these Mainland companies accounted for 48% of the market turnover and 53% of the market capitalization of the Hong Kong stock market.

20. The rapid economic growth of the Mainland has resulted in a surge in foreign reserves. This has created a demand to seek investment opportunities outside the Mainland. This presented Hong Kong with another unique opportunity to play a role in bridging the capital from the Mainland with investment opportunities outside the Mainland.

21. Many of you would have heard of the Qualified Domestic Investor Scheme, or the QDII scheme, which started in 2006 with the following objectives:
    - widen investment opportunities for the enormous amount of savings and minimize risks through portfolio diversification;
    - create a more balanced two-way flow of capital;
    - provide a training ground for Mainland investors; and
    - converge with international practices and raise the regulatory framework in the Mainland.

22. At present, the QDII scheme has granted a total investment quota of about US$55 billion to banks, fund management companies and securities firms to invest in overseas markets.

23. Another channel to invest China's huge savings is the China Investment Corporation (CIC), which was established in 2007 as a sovereign wealth fund (SWF) to begin managing part of China's official foreign exchange reserves. Starting with an asset size of US$200 billion, this initiative presents new opportunities for international financial markets and their participants.

II. Impact of the recent market turmoil on Hong Kong

Impact minimal given Asia's less capital market-oriented financial system

24. Emerging market economies in Asia have been relatively unaffected by the market turmoil given that Asia has less exposure to sub-prime credit and structured credit products. This can be attributed to the very different financial landscape in Asia compared to the US and other developed markets.

25. First, Asia is still very much a bank-oriented financial system with a capital market that is mainly focused on equities. By contrast, the US and other mature financial markets are highly capital market-oriented and have huge markets in bonds and credit derivatives.

26. Second, the mature markets are much more institutionalised compared to Asia. The presence of a wide range of institutional investors such as insurance companies, mutual funds, endowment funds, pension funds, municipals, hedge funds, and private equity funds in these markets creates a natural demand for more sophisticated financial instruments in the OTC market. In Asia, the derivatives market is not as well developed. As mentioned earlier, Hong Kong has a very active derivative warrants market. In Hong Kong, the warrants are listed and traded on the stock exchange and have attracted significant retail interest. Products offered to the general public or retail investors require the prior authorisation of the Securities and Futures Commission (SFC). There are also more sophisticated financial instruments in Hong Kong, but these are available only to professional investors and high net worth private banking clients. In addition, most of them are equity-linked instruments.

27. Third, the extent of leverage. In Asia, intermediation is mainly through the banking system and leverage is subject to prudential limits. Housing mortgages in Hong Kong, for example, require the borrower to come up with a down-payment of 30 per cent for the purchase of the home. Stock brokers are subject to limits on margin financing rules and haircuts on the collateral. Asian households are typically not highly geared and the savings habit is strong,

driven by a need to be self-reliant given the absence or minimal provision of an official social safety net.

28. The flipside is that Asia's savings and trade surpluses, which are largely invested in US Treasuries, have helped to keep yields low. Benign conditions of ample liquidity, subdued inflation, stable economic growth globally have worked to increase investors appetite for risk in their search for yield, at a time when easy credit helped push up asset prices, kept risk premia at unprecedented low levels, and caused leverage to increase in a reinforcing cycle. Asia also does not have the kind of shadow banking system as in the US that has been an important player in supporting the rapid growth of the credit risk transfer market. The conduits and structured investment vehicles (SIVs) had been able to grow without similar constraints on capital as those imposed on the regulated banking sector.

29. Fourth, the Asian Financial Crisis was painful as the real economy was severely affected and Asia took the necessary reforms to strengthen the regulatory framework, infrastructure and corporate governance. For affected economies, prudence and caution has very much been the watchword since. In Hong Kong, for example, the failure of a major local securities firm at that time led to the tightening of the regulation of margin financing for stock trading. These measures and the economic recovery which picked up in recent years placed Asia in a much stronger position when the current turmoil unfolded.

Asia's exposure

30. According to the IMF, the limited exposure reflects a combination of factors. One factor is that Asian financial institutions are relatively less familiar with products related to the US subprime mortgages compared with their counterparts in the developed countries and therefore less likely to purchase these products. Another factor is that the relatively high domestic yields in some countries in the region have lessened the need to search for high yield investments overseas.

31. In Asia, mortgage-related exposure is concentrated in financial institutions in Japan, China, Hong Kong and Singapore. The overall exposure in other Asian countries seems to be smaller and more manageable.

32. According to the Asian Development Bank (ADB) in its report issued in December 2007, banks in Indonesia and Malaysia had virtually no direct exposure to the US subprime market. While banks in the Philippines and Thailand dealt with structured credit products, they are largely dispersed rather than systemic, and small in size, according to ADB.

33. According to data compiled by Bloomberg as of 26 June 2008, globally, financial institutions suffered a total of some US$400 billion from the sub-prime mortgage crisis. Of this, Asian financial institutions accounted for about 5% or US$21 billion. In Asia, major Japanese financial institutions reported a total loss of some US$12 billion. The other major groups were some Mainland banks and Singaporean banks.

34. There are seven active retail structured credit products issuers in Hong Kong. Our findings showed that the collateral of their structured credit products had no linkage to mortgage-backed securities or sub-prime credit, and the sub-prime

crisis had no direct impact on such collateral or their retail structured credit products.

III. Major challenges and risks facing Asia

The challenges

35. The Asian Financial Crisis had roots in structural weaknesses in the financial system, inappropriate exchange rate regime, and selective and uncoordinated liberalisation of capital controls. The sub-prime crisis is a crisis of the structured credit markets. A benign economic environment with ample liquidity supported the rapid growth of the credit risk transfer market. Both crises were preceded by excesses in liquidity, leverage, large capital flows and rising asset prices.

36. Time and again, crises have underlined the importance of ensuring compatibility in the development and growth of the financial system and the real economy. If development is not in tandem, economic development could be retarded by a backward financial system. Similarly, if financial sector activity runs way ahead of real economic activities, the euphoria of rising asset prices would lead to a boom and bust scenario. The financial system is the lifeblood of an economy, and the robustness of an economy is dependent on the robustness of the financial system, and *vice versa*.

37. Balance is the key to maintaining macroeconomic stability and financial stability. This calls for having in place sound macroeconomic policies, an appropriate institutional and financial infrastructure, a robust regulatory and supervisory framework, appropriate incentive structures that promote self-discipline and market discipline, and maintaining an appropriate regulatory balance between market efficiency or development and market stability.

38. Liberalisation has unleashed global competitive forces and integrated economies and financial markets. The result is that businesses and authorities find that, increasingly, it is no longer an option whether there is a need to benchmark to international best practices and standards.

39. Capacity building is a major challenge in Asia as their economies and financial systems evolve and mature. One aspect relates to institutional and infrastructure building. A simple analogy is to think of this as the "hardware". This would include the legislative and regulatory framework, the institutions necessary to the functioning of a market economy, and the market microstructure. In the capital market, the microstructure refers to the trading, clearing and settlement systems, the price formation and discovery process, the trading rules, and information dissemination and disclosure. This is where international best practices and standards offer a ready guide for adoption and adaptation.

40. The more difficult aspect of capacity building is what I call the "software" that is required to put the hardware to work, and work properly. This relates to the people skills and attitudes and involves extensive investment in acquiring the necessary knowledge, skills, expertise, and experience. It will usually take much longer time to achieve any fundamental progress in this area. In sum, underpinning the success of capacity building efforts is having the sustained commitment in implementation.

41. Asia has come a long way, and it has learnt from the lessons of the Asian Financial Crisis. Managing reforms is not easy and requires a change of mindsets. This is the greatest challenge facing Asia going forward if it is to continue to build on its successes.

The risks

42. A major issue for Asia and the rest of the world is how the effects of the turmoil play out in the US economy. Much has been done to restore calm to financial markets, but uncertainty remains as to whether problems in other segments of the financial markets have yet to surface and whether more losses would materialise. Until confidence fully returns, financial markets are cautious and reluctant to lend. Affected financial institutions have been consolidating their balance sheets and strengthening their capital base.

43. There are concerns that the worst has yet to come in the US housing market, and as delinquencies increase among borrowers the banking system would be directly affected. Property markets in other major economies have started their downward adjustment, and stock markets have also retreated from the highs of last year and reached new lows recently.

44. Initially, concerns were very much focused on the impact of an economic slowdown in the US, the severity of which would depend on the depth and duration of the downturn. Since then, in addition to the urgency of normalising the financial markets in the US and other major markets, oil prices spiked and a food crisis emerged. While the sub-prime crisis did not affect Asia directly, the food and fuel crises have affected all economies, the poor being the worst hit.

45. In Asia, the focus of policy-makers has now shifted to fighting inflation and to slowing down the over-heating economies. At the same time, however, there are some concerns that these tightening measures could cause Asia to experience stagflation, depending on the interactions between the various domestic forces and the external environment driven by the economic situation in the US and other developed economies. There is also concern that the tightening of monetary policy would affect the ability of bank borrowers to service their debt at a time when they are squeezed by rising food and fuel prices. Finally, if the asset markets adjust significantly, banks would be faced with non-performing loans, followed by a contraction in economic growth as deleveraging increases.

IV. Lessons for Asia

46. While Asia has been relatively unaffected by the current financial turmoil, it cannot decouple itself from developments in the US, which is the world's largest economy and Asia's largest trading partner.

47. Asia's less well-developed capital markets has been a blessing in this case. However, this does not mean that Asia should not proceed to develop its capital markets. A lesson of the Asian Financial Crisis is that Asia is too bank-dominated, and the lack of well-developed capital markets has hindered risk management and resulted in a concentration of risks in the banking system.

48. Capital markets play an essential role in the efficient allocation of capital, risk transfer and diversification, price discovery and corporate governance. Asia

should continue with its plans to develop its capital markets, including the bond market.

49. Asia can learn from the experience of the sub-prime crisis and understand the functions and risks of new financial instruments and their market dynamics and inter-linkages, the need for transparency and disclosure, and the importance of ensuring that there are no gaps in supervision. The regulatory and supervisory regime also has to be robust and yet flexible enough to respond to changes in the financial landscape. There are also valuable lessons on the need for information sharing, coordination and cooperation among national and international regulators and central banks, and to equip these agencies with the appropriate tools and authority to restore confidence and maintain stability in the face of a looming crisis. In this regard, the Financial Stability Forum and the IMF have made comprehensive recommendations on enhancing market and institutional resilience.

V. Conclusion

50. In conclusion, it is important to remember that regulation aims to reduce excessive risks and not to eliminate risks, and crises cannot be eliminated. The market is always ahead of regulators; otherwise there will be no innovation. What is important is to foster a market and regulatory environment that has the appropriate incentives and discipline for markets and financial intermediaries to behave in a manner that wins the trust and confidence of investors.

51. Time and again, we see financial markets go through a cycle of *liberalisation* to facilitate financial innovation and development, followed by increased *liquidity* and rising *leverage* induced by irrational optimism, and finally *liquidation* as asset prices collapse which often leads to *limitation* that re-regulates or tightens market and intermediary activities. The cycle then repeats once markets rebound and think that this time it would be different. The role of the regulator is to strike a judicious balance between market development and innovation on one hand, and the protection of investors and the maintenance of market stability on the other.