

**Asian Financial Forum**  
**“Asia in the New Economic Order”**  
**Striking a balance between financial innovation and regulation**

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### **Introduction**

I will begin by looking at what are the benefits and concerns surrounding financial innovation, and the international regulatory response to these concerns. I will also touch on the Securities and Futures Commission's (SFC) own approach towards financial regulation and market development.

### **Financial innovation**

The recent financial crisis placed the spotlight on the role of financial innovation in the crisis. For example, innovation has increased the complexity of financial products that hid the true nature and extent of interconnected risks across financial markets. Illiquidity was another problem as these products were hardly traded, and the embedded leverage in these products amplified losses. The exposures were also not appropriately backed by capital as they were off-balance sheet.

Given the role of these products in the crisis, and the huge bailout cost borne by taxpayers and the massive job losses, this has prompted strong criticism against unfettered financial innovation as costly at best, and useless at worst. Some view such innovation as having created unnecessary complexity that allowed financial institutions to charge more for something the customer does not need or understand, and in the process, generated huge profits for banks and fat bonuses for their staff.

It is, therefore, not surprising that there have been some calls to restrict financial innovation. However, warnings have been sounded against such action as it would deprive savers, borrowers and investors of the benefits that innovation can bring in terms of allocating capital, improving risk management, and investment opportunities. Some point out that financial innovation has had a bad rap, and many other factors are to blame for the crisis, and innovation should continue to be allowed to thrive.

Using securitisation as an example. It was an innovation that enabled the expansion of available credit, lowered the cost of borrowing, and enabled banks that originated the loans to better manage their maturity risk by reducing the mismatch between the maturities of their assets and liabilities. Likewise, CDS offers protection to investors against default of debt securities that they hold.



However, inappropriate use of innovation increases risk in the system, as we saw in the multiple tiers of securitisation of sub-prime loans into mortgage-backed securities and layers of CDOs. Similarly, in the CDS market, we saw a phenomenal growth as investors with no insurable interest in the reference entities also bought protection against default, or sold protection through synthetic CDOs. They bought or sold depending on their view of likelihood of default of the reference entities. Well, we know what happened to safe bets like Lehman and AIG.

In between the two extremes for and against innovation, there is a view that there is a role for financial innovation but such innovation must be subject to appropriate regulatory oversight. This is to ensure that financial innovations do not expose investors to risks that they do not understand or are unable to bear, and that the market in these new products does not undermine the orderly functioning of markets or pose a threat to financial stability. This is a sensible approach, and regulators are largely in this camp.

There have been calls for financial institutions to “go back to basics”, and that finance should focus on capital allocation for productive use and in helping the economy in risk management. The financial system should grow in tandem with, and not overtake, the real economy. Financial institutions should create products that meet the needs of their customers, and which are suitable to their capacity to understand and absorb the risks.

I will now turn to the regulatory response to the crisis.

## **Financial regulation**

The response of governments and authorities to the crisis is a comprehensive revamp of regulation in respect of capital adequacy, liquidity risks, compensation, insolvency arrangements, disclosure and transparency, CRA, hedge funds, OTC market, clearing and settlement systems, consumer protection etc. The SFC participates in these proposals through the International Organization of Securities Commissions and the Financial Stability Board.

At the heart of the regulatory reform is the need to ensure that there are no gaps in supervision, risk management is appropriate, oversight of risks includes the system as a whole rather than just at the institutional level, and orderly insolvency resolution arrangements are put in place.

The crisis has raised the issue of whether there should be a clear demarcation of banking and non-banking activities. Banks intermediate between savers and borrowers and operate the payments system. We have seen how the breakdown of the banking system can lead to a credit crunch and a recession. Banks are therefore subject to prudential supervision to ensure that their balance sheets are sound so that deposits are safe, and they have access to the lender of last resort facilities of central banks and orderly resolutions so that there are no dislocations in the banking system. The regulation of non-banks such as securities firms, on the other hand, focuses on their conduct to ensure investor protection and market integrity.

Following deregulation, traditional commercial banks expanded into non-banking business. They took on wholesale investment banking activities, earning fee income on structured finance and derivatives without much impact, if any, on their balance sheet and capital (shadow banking). At the retail level, they sold financial products to eager investors in



search of higher yields, and there have been many complaints around the world of staff not understanding what they were selling, as well as allegations of mis-selling. So, it appears that banks had moved into new business activities that have escaped regulation, and banks have not upgraded their risk management systems and expertise, exposing their customers and the banking system to new and unknown risks.

Should banks then be allowed to continue to engage in non-banking activities or should they focus on narrow banking? One view is that banks should operate like a utility (deposit taking and lending, and payments system) and not a casino (investment banking), if they are to enjoy lender of last resort facilities and government support in the event of failure. This is one way of reducing interconnectedness among financial institutions, so that non-banks can be allowed to fail without threatening stability.

Another view is to allow non-banking business, but the unregulated aspects of their business should be brought onto the balance sheet and subject to capital and liquidity requirements and properly risk managed. However, concerns remain on how to deal with the moral hazard of “too big to fail”. To deal with this, there are proposals to set up orderly resolution arrangements so that non-banks that are systemically important would be assisted to have an orderly wind-down but they would not be bailed out. The UK is also looking into “living wills” or contingency plans of financial groups to deal with orderly winding down in the event of failure.

To address concerns relating to financial innovations, the regulatory response includes strengthening customer suitability rules, greater clarity in the disclosure of risks that is understandable to investors, tightening selling practices, and better risk management. The US is introducing new consumer protection legislation. Investor education is another important supervisory tool that is being reinforced.

### **The approach of Hong Kong**

In Hong Kong, the Securities and Futures Ordinance provides that in performing its functions, the SFC should have regard to the desirability of maintaining the status of Hong Kong as a competitive international financial centre (IFC); the desirability of facilitating innovation; and the principle that competition should not be impeded unnecessarily.

Our approach in regulating the securities market in Hong Kong is 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

In Hong Kong, investors suffered losses when Lehman Brothers failed. The SFC’s report to the Financial Secretary in December 2008 found that the common generic complaints of investors were:

- Misrepresentation – that the products were wrongly presented as a low risk alternative to deposits and that the risks and complexity were not properly explained;



- Complexity – the products were too complex and risk disclosures were ineffective in alerting investors; and
- Suitability – that as a result of the above, and the failure of brokers and banks to do proper customer due diligence, inexperienced retail investors were left holding products not suitable to their investment profile.

To address this, the SFC has issued a consultation paper on proposals to strengthen our regulatory regime regarding the sale of investment products to retail investors and better protect the interests of investors:

- The first part is in relation to the way in which disclosure on product risks and features should be enhanced and the obligations that the product issuer or arranger should bear;
- the second part is in relation to revisions to be made to the Code of Conduct which, as we all know, governs intermediary conduct and selling practices;
- the last part involves a newly introduced cooling-off concept for long term illiquid products.

Equally important are the proposals on the establishment of the Investor Education Council and Financial Dispute Resolution Mechanism. On the international front, the SFC would continue to benchmark its regulation to international standards or higher, if it better suits Hong Kong.

### **Concluding remarks**

Financial innovation does bring benefits, but it must be subject to appropriate regulatory oversight.

The world is undergoing the greatest overhaul of financial regulation since the Great Depression. However, there is no perfect solution, as you can see from the many different view points on how to address the issues. What we end up with is the best in the circumstances, taking into account the views of stakeholders. The more important challenge is successful implementation once the regulations are in place.

The world is also aware that crisis cannot be eliminated. So we should be on our guard to try to spot new risks and deal with them, so that the impact would be less devastating the next time round.

Finally, regulation is no substitute for discipline on the part of all stakeholders. It is in the interest of everyone – market players, intermediaries, investors, and regulators – to play their part in conducting themselves in a responsible and professional manner so that we can safeguard the continued functioning and stability of financial markets and maintain economic prosperity.