

## 7th Asia Pacific Trading Summit

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Today I would like to talk a little bit about the changing financial landscape and how Hong Kong practices would adjust to tougher global regulation. I am constantly asked what we expect out of this crisis. I can tell you with absolute confidence that you should expect more regulation. I don't know what exact form it will take yet, but we will undoubtedly see more regulation emerging out of this process. History says that this is always the response to a financial crisis. If you look back to the 1930s, the Great Depression created the impetus for the Exchange and Securities Act, the Glass-Steagall Act, and much of the infrastructure which is still there in the US today. More recently, the Robert Maxwell pension fund incident created the world of corporate governance that we now have today and that is still evolving. I would also like to talk a little bit about the importance of corporate governance.

Sometimes the responses are well designed structures that stand the test of time and are good, but occasionally there are responses like the Sarbanes-Oxley Act, the response to the Enron crisis, which many believe had a negative impact on the US markets. Hopefully, the response can usually be moderate and sensible enough that we end up with better structures for our markets. So I think the question today is really how big the changes will be and what the impact on Hong Kong will be.

The first consideration is what is driving the change. In many markets around the world, this isn't just a crisis where a few investment bankers have lost their jobs, and a few hedge funds or wealthy individuals have lost money. This is a crisis where in many parts of Europe and the US, economies and companies are on the brink of collapse, particularly the case in Eastern Europe, Spain and Ireland; jobs are being lost; people are being forced out of homes; and taxpayers have had to bail out the failures of the banking system. As the taxpayers' money has been bailing out the system, you can expect the politicians would have very strong reactions to this crisis. This is what we are seeing in the EU and in the US at the moment – a very strong political urge to take very strong action.

We haven't had a major systemic failure in Hong Kong. We haven't had anything akin to the failure of the Icelandic banks, the failure of the Landesbanks in Germany, numerous bank failures in the US, and obviously a very high profile case of Lehman's, the buyout of Bear Stearns, the saving of AIG, and the collapse of the US auto industry. We've avoided most of those because the regulatory structure in Hong Kong is in a reasonable shape. In the banking sector, there hasn't been massive exposure to CDOs and toxic assets. There hasn't been aggressive mortgage lending, of 100% loans, teaser rate loans, the sort of loan structures that became prevalent in the West Coast, and certainly in the UK and Spain as well. The hedge funds in Hong Kong are relatively smaller and less leveraged than some of the funds that we saw in the US. And the brokers here are relatively less leveraged.



So overall, we got a structure that has held up to the crisis quite well. And we haven't therefore, either as a regulator or the government, felt the need to make knee-jerk reactions to this crisis. What is interesting is that some of these failures make you question whether companies or investment banks have properly understood the nature of the risks they have. A recent one, reported in the Economist, was about how the Milan local government was on the brink of collapse because it lost money in a currency contract it had entered into. In Italy, you cannot restructure debt unless it is shown to be to the advantage of the local municipality. So they swapped the fixed interest rate contract of 1.6 billion Euro of borrowings through a floating rate, presumably having been told by one of the investment banks that this will save them 60 million Euros. So far, it has cost them 300 million Euros.

In the same story, there is a suggestion that as many as 700 German authorities have also lost money and virtually every Italian town council has also lost money on currency swaps. Why did they do that? Why would they enter into these very complex instruments? Clearly they were doing it because they believe, and believed at the time, that the downside risk was very limited but they could save money for their local taxpayers, the local municipality.

In Korea, there's an extraordinary amount of litigation going on at the moment where Korean corporates entered into currency hedges to protect their currency exposure and are losing hundreds of million of dollars because of the depreciation of the Korean Won over the last year. The interesting thing is that you can expect that people need to hedge risk – for example against copper prices, fuel prices, and currency fluctuations. And obviously you can accept that there is a cost to hedging risk. You pay a margin premium to buy a call option, and that protects you if oil goes above 140 dollars a barrel and the Aussie dollar goes above parity with the US. But people didn't want to pay the premium. Is there a way I can get the protection without paying the premium? And the clever bankers would say “yes of course, you can”. If you write a put option in our favour then you will collect some premium from that. And if you double it up you will collect enough to cover the cost of your hedge. And that's typically the trade that everybody entered into, whether it be currency, whether it be fuel, whether it be commodities. That way you are protected on the upside and you are exposed on the downside. And of course you don't have to worry about the downside, do you? Not when oil is already 140 dollars a barrel and going up to 200 according to the analysis. You don't worry too much that you might get exposed if it goes below 80. And the Aussie dollar was moving to parity so you don't worry too much if it goes below 80 cents to the Dollar.

Everybody made the assumption that there won't be sufficient downside to lead to them paying out or delivering on that put option. Actually, that's exactly what happened. Everybody lost money on those trades because they didn't think about what the downside risk is. That happened in the corporate sector, has happened in airlines, has happened in every company that we see reporting at the moment. And these are not hedges. These are speculations where people have tried to say “how can I make some money from taking a view on the market”. And you have to ask why did that failure happen, what was it that led to that? Was it greed? Was it that the treasury of the company simply thought he could avoid paying this cost by taking a punt or actually I can even make some money if I take this punt if I get my bet right. So it was simply greed. Or was it, as the Milan authorities are claiming, that they didn't understand the product, that it's just too complex? It's quite difficult to argue that in a court because you are basically saying “I am incompetent please sack me”, and that's quite a hard argument to deliver. Or were they mis-sold it? And again this is what's being alleged in the Korean courts and elsewhere that banks were mis-selling products, misrepresenting the product features.



We have obviously had our own experience here in Hong Kong on many of these issues. We have had the corporates announcing that they are losing money on instruments or products that you would imagine they should not be losing money on. We have had private individuals complaining that they lost money on complex products that were misrepresented to them that they didn't actually understand - the Minibond products which failed with the collapse of Lehman Brothers.

And all of these beg quite a big question – should regulation stand in the way of a person structuring the product to the buyer of the product? What should the role of a regulator be? By and large, our role is two-fold. First and foremost, when the product is being distributed to the public, we make sure that the documentation of the product discloses the risks and has the product features significantly disclosed in the product such that an average person could form an understanding of the product. What we do not do and what no regulator does is to say that this product is good for everybody.

And similarly, the role of approving documentation is not to say that here's a structured product that is suitable for every single individual. It's potentially suitable but that suitability can only be judged through the selling process. And so the second role for the regulator is to make sure the selling process is conducted to a good standard. And to do that, we have the Code of Conduct, which requires that the organisation which is selling – the intermediaries, the banks, and the brokers selling the product, has done proper due diligence on the product. This is so that they can understand the features and the risks of the product, which can then be adequately explained to the client. The Code also requires the seller to have conducted know-your-client and due diligence of the products so that they can understand what the particular needs are for individuals, what their circumstances are, what might be suitable for them, and then they can make sure the product matches up with the particular characteristics of the individual.

That's how the system works here in Hong Kong. By and large that's how the system works pretty well everywhere in the world, with some slight variations. It's a case of making sure any product which is for public sale has sufficient information for people to form a judgment, and setting a code to make sure people selling the product operate to reasonable standards and those standards as I say are about customer and product due diligence.

Clearly that did not happen in every case. We have already had two cases where we have settled with the brokers concerned where the brokers, in response to the concerns we raised about the failure of those processes, have offered to buy back at par from their clients. We are still in the process of dealing with the 20 odd banks which have also sold the product. That's an ongoing investigation.

But another question is whether there was mis-buying. Did the person buying the product, whether at corporate or private level, simply ignore risks that were explained to them? Or was the product so complex in the first place and the risks were so poorly explained that they could not possibly have understood the product. And it's interesting that in a number of the Korean cases, the courts of first instance have accepted the corporates' explanation that they didn't really understand the product and they had no idea that the Korean Won would depreciate 30% against the Dollar.

So what further changes can we expect? As I have said at the start, all failures will lead to a regulatory change. We have seen some of it so far. What has already been implemented in



Hong Kong is greater segregation within banks, greater segregation of their operations and of their client-facing staff who can carry out due diligence and who can sell the products. That's something the HKMA has already required banks to do.

We have already required product issuers to have more upfront disclosure of risk, in particular the kinds of risk which were never really thought about in the past. Nobody thought of counterparty failure as a risk. When you buy a product from your bank, you think that's good. Clearly, people didn't think too much when they bought products that relied on the creditworthiness of Lehman Brothers. So one of the things we are asking people to be much clearer about is counterparty exposure. We have also asked for the product features to be more clearly described. This is the first level of change that has already happened.

There is the next level of change which we are moving to now, which is to review our Code of Conduct. Is the Code of Conduct working adequately, and are there areas where it needs to be amended?

We are also moving to a product code which would cover all products distributed to retail clients. We will be moving to a code where all products that are distributed are subject to the same sort of disclosure rules and the same sort of marketing rules.

We will be making some changes. We will do away with inappropriate inducements to the sale of products, we will do away with pressure timelines on the sale of products, and we will require greater disclosure on simple fact sheets of products that are sold.

But the important thing, and again, I come back to my theme at the start - there will be more regulation out of this whole process. The very important theme from our point of view is not to over-react. We will do what we always do, we will work through a soft consultation with small groups to try to develop the ideas. We will publish a consultation paper seeking the industry's views and will come forward with new proposals based on those industry views.

One of the biggest challenges for regulators in this process is not to over-react. We saw a very good example of that in September last year where many markets around the world moved to an immediate ban on short-selling. Hong Kong stood firm and we said we would not ban short selling. We are comfortable that the structure works well here - many markets did it because the politicians said "short sellers are driving down the prices of stocks". Well I got the same question and my answer was always: "yes actually sellers are driving down the prices of stocks, they are not necessarily short sellers". Sellers do drive down the price of stock when they think the stock is over-valued. Surely that's a good thing that the stock reaches a new price point that reflects the fundamentals. What the rapid changes meant was, at the most extreme, fund managers in London would get out of bed in the middle of the night because the Australian brokers could not work out whether to execute the trades on open on Monday morning because they didn't know if it's a covered or uncovered short. So that was the first change.

Secondly, the convertible bond market completely dried up because the regulators have failed to understand entirely that people who buy convertibles like to short stock at the same time. If you can't put one part of the strategy on, you lose the other part of the strategy. Spreads widened and liquidity drained in most markets around the world because what the regulators had forgotten was a large part of liquidity was driven by people running long-short strategies. If you can't do the short bit of strategy, you don't do the long bit of strategy.



So there were a lot of mistakes made through a knee-jerk reaction. I am proud and pleased that we didn't get drawn into that and we stayed firm within Hong Kong. I think the experience has vindicated that as many regulators have subsequently regretted the decision. So for the changes that will come, we would think about them very carefully. We won't rush into those changes. You will see, coming out of the G20, calls for regulation of systemically important institutions. There were already some proposals coming out in Europe and the US for greater oversight of hedge funds, credit rating agencies and private equity pools.

There will be some changes in Hong Kong that we will pursue. We will come forward with proposals on short position reporting which we think is an important issue for Hong Kong. There will be some changes to the Securities and Futures Ordinance and to the Companies Ordinance. They will be through the normal process of consultation with the market. I think the one thing we can expect is that there will be a push for greater transparency of off-market products, greater reporting, and greater centralised clearing. But it's very much unknown at this stage exactly how we will implement those changes here, but the one thing I can guarantee is that we here in Hong Kong will take a very strong approach to bring in forward changes that we think would benefit the market and not getting drawn into knee-jerk reactions where the pendulum swings too far in the opposite direction.

We got a very healthy market in Hong Kong. We are very proud of our industry here. We think in most cases, the structure works well and we have avoided the calamity of other markets. But as with anybody, we have to learn from the crisis. We will bring forward those changes that we think are beneficial to the market as a whole.

Thank you very much.