

Speech at 3rd Pan Asian Regulatory Summit

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Thank you to Mark and to Thomson Reuters for organizing this conference and inviting me to open the first day.

I am going to spare you any forced humour on this occasion because the points I want to make are serious and I don't have much time to make them. What I want to do is concentrate on the continuing revolution in financial regulation in the US and the EU and its relevance to Asia. And I hope that this is a theme that will be picked up again during this conference.

Make no mistake – the reforms still underway in the West are ground breaking. And notwithstanding the best efforts of some in the financial industry to preserve aspects of the credit fuelled “good times”, there is every indication that we are in the midst of the creation of a radically different regulatory landscape. The fact that so much of finance now freely crosses national borders means that none of us have any realistic option but to engage with this new world. This is essential so that global finance is protected and also that global solutions are adapted to local differences.

The most recent example of reform was the publication last week of the Financial Stability Board's (FSB) consultation on its recommendations for the regulation of the US\$67tn so – called “shadow banking” system. This is the system which Paul Tucker, Deputy Governor of the Bank of England, called “Russian doll finance” back in the days of the credit boom in 2006 and 2007. He pointed out that the world of collateralized debt obligations, structured investment vehicles, originate to distribute, repos and securities lending were connected to real banks and the real economy – and posed real risks. Of course everyone was making too much money to take much notice at the time.

And we all know what happened next.

But back then the problem was made worse by the fact that it was unclear who was responsible for looking at this non bank - world. Bank regulators watched the micro level of deposit taking banks, Central banks monitored macro - financial stability and securities regulators concentrated on the conduct of stock markets, brokers, asset managers and others interacting directly with public investors. This is the classic silo problem where big issues fall between the cracks.

As the Financial Times commentator Gillian Tett pointed out recently there was also another problem. This was that there was no catchy label for Mr Tucker and his ilk to express their fears at the time. His phrase “Vehicular Finance” didn't really cut it. The term “shadow banking” was finally coined by Paul McCulley of PIMCO at the 2007 Jackson Hole economic conference. And this did help shift the policy debate.



It is also true that the term “dark pools” has influenced the discussion about boring sounding alternative trading platforms. I have some sympathy with those who say that these labels are too negative. But at least they have helped highlight real issues which demand wider attention. But the main thing is that the crisis has put the policy debate on an entirely different level. Over the year I have been at the Securities and Futures Commission (SFC), it has struck me that there is now a deep commitment amongst international regulators to leave no stone unturned to capture areas of potential instability in the financial system, not to be afraid to tackle unfamiliar subjects and not to accept at face value claims that reform will stifle liquidity or other areas of financial activity. The FSB paper on Shadow Banking is just the latest example of this, to be set alongside bank resolution and the work being done to shine a light on the obscure world of OTC derivatives.

But to return to my theme: what relevance does all this have for Asia? Those who say that we should not spend time and resources replicating reforms being pushed through in the US and EU, notwithstanding our G20 commitments, seem at first sight to have some pretty good arguments.

First, many aspects of the huge regulatory effort in the West targets problems that many see as being relevant only to these highly developed economies. One big difference is that the political and media demand for change in the West is intense, and is mainly a reaction to government intervention in the depths of the crisis. Another is that Asia has never had big securitisation, money market or OTC derivatives sectors, which are some of the principal targets of reform in the US and the EU. Of course the crisis in the West has certainly had an effect in Asia, with reduced demand impacting exports and extremely loose monetary policy and super low interest rates affecting asset prices. But these are secondary infections caused by Western Flu, not Asian Flu.

It is also true that ever since the Asian Financial crisis of the late 90's our financial system has avoided dangerously high leverage, consumer credit has not been a problem, banks have been run conservatively and savings remain high. Of course, Asia has its fair share of other issues, including low incomes, immature institutions and corruption. But overall the financial system itself is close to the dull model regulators in the West now see as one of the goals of reform.

It's also interesting that one major cause of the crisis in the West was completely absent in Asia. This was the subprime meltdown, where Fannie Mae and Freddie Mac, urged on by government policy to expand US home ownership to low income families, bought loans, packaged them into securities, sold them and guaranteed them. Triple A ratings didn't help. Everyone knows now that this ended disastrously as mortgage defaults mounted.

A recent book on sub prime by Oonagh MacDonald – called “Turning the American Dream into a Nightmare” – lays the blame for the crisis on a distortion of the entire financial system to achieve US domestic political ends.

And neither have we had in Asia anything like the type of scandals which continue to shape public opinion. Just this year we have had the London based UBS rogue trader, the Libor story, the JP Morgan “London Whale” and the pursuit of Standard Chartered by US authorities about forex dealings and Iran. [As an aside, it's interesting to see that The Whale unintentionally succeed in torpedoing the argument used by banks to try to limit the Volker rule. This was to the effect that they weren't really trading at all, but rather pursuing useful



activities like hedging and so called client facilitation. These claims are now viewed – understandably – with a lot of skepticism.]

And perhaps the most significant difference of all is that Asian taxpayers were not called on to bail out any financial system, unlike those in the US and EU.

Against this background it is perfectly legitimate to ask why a comparatively healthy Asia should take medicine which has been prescribed for a very sick patient languishing in intensive care. The worry would be that this could cause a nasty adverse reaction in the healthy patient. As you will have already guessed, it is my view that this conclusion would be dead wrong.

The answer to those who think that Asia can ignore or water down the global reform agenda lies in the aspiration in Asia for continued growth, to mobilize savings properly and the need for greater financial sophistication to fuel these objectives.

In this context it is interesting to see that a fundamental debate now taking place in the West is in many ways the reverse of that in Asia. Especially in the EU there is a perception that financial sector development has outstripped that actually needed for healthy growth, and to cut down what has been called socially useless financial intermediation is a big driver for reform. There is also a running argument about austerity and regulation snuffing out the ability to compete.

The situation in many emerging economies is the opposite; many have got nowhere close to the level of financial sector maturity achieved in the West but growth prospects remain high. Their concern is to broaden and deepen their financial systems to sustain continued progress towards greater prosperity. Although places like Hong Kong, Japan and Singapore have advanced financial systems, much of Asia's population live in places that do not. But they will get there and it is inevitable that Asia's financial sector will eventually rival those in the US and EU in size and sophistication.

This means that we have a golden opportunity to ensure that, adapting Oonagh Macdonald's phrase, we don't "turn the Asian Dream into a Nightmare".

And this is my central point. It is easy to blame the financial crisis purely on Western excess and to claim that Asia is "different" and can plough its own furrow. But in my view it would be unbelievably stupid to attempt to grow the Asian financial sector whilst ignoring some of the deep problems revealed by the crisis in the West. If we can learn from the mistakes made elsewhere and ensure that they do not occur here, we will lay the foundations of a safe and socially useful financial system. If we do not, we risk a repeat of the crisis here.

It is also important to realize that there is another issue lurking out there; if Asia does not get properly involved in the global regulatory agenda, we will find that the US and the EU rules will be extended to us whether we like it or not. The problem is that this type of "one size fits all" approach cannot work because it ignores the huge diversity and varying stages of development of economies in this part of the world. The result could be an isolation of Asian markets from international finance.

But it is important to realize that from the US and EU point of view there may be good reason to try to push their rules out to cover the rest of us. Many there still fear that Asian countries will decide not to implement key reforms agreed on by the G20 in order to attract business



from those firms who want to escape the straightjacket of Dodd Frank and similar rules. They worry that this would hurt domestic financial interests and make the whole system riskier because many of these firms are global players. I should be clear at this point that because much Asian financial activity is dominated by firms headquartered in the EU and the US, there is no doubt that their regulators have an ability to export their own rules to Asia. The threat is that if we or Asian firms don't play ball international firms would find it difficult to operate here and could withdraw from some activities, seriously harming liquidity in our markets. It could be a case of my way or the highway.

So against this background how should Asia move forward?

First, we must all recognize upfront that there is no advantage in lowering our standards to attract business. This type of regulatory arbitrage ends in tears and scandal, and very quickly repels international investors from participating in our markets - or at the very least causes them to demand a hefty risk premium. In fact investors are motivated to come here to participate in accelerating Asian growth, not to escape strict home market rules, and strong regulation will underpin their confidence in our markets. This is why the SFC is determined to do all it can to maintain a quality market - whether through reforms such as that aimed at raising standards amongst IPO sponsors or enforcement action sending a strong deterrent message as well as getting redress for innocent investors.

Second, we must acknowledge that many of the lessons learned from the financial crisis in the West are not unique to the EU and the US. At its core the crisis involved massively skewed incentives, which meant that trust, confidence and ideas of fiduciary responsibility were virtually destroyed.

This connection between distorted incentives and loss of trust is seen everywhere. It certainly lies at the heart of the 'originate to distribute' model which saw big mispricing problems in packaged assets in which sellers had no continuing interest. This is why part of the global reform of securitisation proposes that issuers must retain an investment in every product – so-called skin in the game - to align its incentives with those of its buyers even though the product has been sold down a chain.

Similar issues are being tackled in consumer finance, where widespread mis-selling has been attributed to internal incentives pressuring bank staff to push unsuitable products to retail customers. Commissions paid by product manufacturers to tie independent agents meant that the agents were incentivized to recommend unsuitable products because the commission was higher. This is an area where much has been achieved, particularly in Hong Kong after the Lehman minibond incident, but there is more left to be done in all markets.

There are many other examples of where trust has been eroded to vanishing point. In fact to a large extent the current focus on using regulation to contain systemic risks is filling the void left by the disappearance of trust. This can be seen in reforms such as Basel III, OTC derivatives regulation, restrictions on rehypothecation and tougher requirements for collateral.

And it might be said that those firms that complain that this is hampering their business only have themselves to blame because they jettisoned trust long ago.

But the message for those of us in Asia is this: the problem of trust which underlay much of the crisis in the West also exists here. You only have to look at the cases involving mis-



selling of products to retail customers to see what I mean. We therefore have every incentive to participate in the global agenda to put in place reforms aimed at restoring trust in the system. A structure that lends itself to abuse will, whatever its claimed merits, be abused at great cost to economies. And if incentives reward reckless behaviour further harm will follow. Full participation in this global project by Asian regulators enables them to place their own financial systems on a sound footing.

My final point is that Asia must participate in global reforms with a far stronger voice. The financial system is global, but there is a danger that it will fracture into regions because of competing regulatory responses. The concentration of some of the more recent scandals in London has enabled other financial centres to try to seize a competitive advantage, and can be an excuse for a return to domestically focused policy by some. Regulation, supervision and enforcement can appear as much as ever a weapon in the war for competitive advantage between financial centres. This threatens to undermine the global approach to financial regulation, which is essential if we are to get a proper grip on a system which is now intensely cross border. And even worse, Asia gets caught in the crossfire.

A good example of this is OTC derivatives, where the US has attempted to extend its rules far beyond its borders, and the EU has been trying to do something similar as the price of access to EU markets. Discussions aimed at sorting this out are continuing.

In a very recent speech Paul Tucker also made the point that in a world where public money has been used to bail out banks there is every incentive to pull up the drawbridge and embrace protectionist agendas. This is because governments are then accountable to their own taxpayers – and to nobody else. His view is that by delivering the FSB's global agenda we can eliminate this most basic force towards balkanization. As I have already pointed out a fragmented financial system would deny Asia the benefits of a more globalised real economy.

And it is here that Asia can truly shape the debate. In doing so we should pursue two main goals. First, all national regulators should refer to the maximum extent possible to internationally agreed standards when applying cross border rules. It is fortunate that the International Association of Insurance Supervisors, the Basel Committee on Banking Supervision, and the International Organization of Securities Commissions (IOSCO) and others are now producing detailed standards that are nowhere close to the lowest common denominator. This means that these standards are sufficiently credible to be used as a benchmark. It also means that a greater emphasis should be placed on cross-border supervisory cooperation rather than to attempt to export national rules to other countries. The second goal is that we should be explicit about where Asia is different to avoid the one size fits all problem. But we should also be clear that these differences must not undermine the main objective of ensuring overall consistency and financial system safety.

If we get all of this right Asian markets will be able to work on solutions to the breakdown in trust and skewed incentives alongside the US and EU. This will position Asia to develop a more sophisticated financial system with confidence. And by emphasizing global standard setting we will ensure that Asia continues to participate in a global financial system which is not beset by a fragmentation of markets across national or regional lines.

If all this sounds a bit theoretical I can assure you that the SFC is spending a lot of time on making this real. There are quite a few strands to this work, but one of the most important for us is that the SFC will chair the Asia Regional section of IOSCO from next year. We want to



start using this as a platform to properly express Asian views to global regulators. A very good example of what can be achieved was a letter sent at the end of August to the US Commodity Futures Trading Commission (CFTC) signed by regulators in HK, Australia and Singapore. This was about proposed CFTC extraterritorial rules for OTC derivatives. We basically said that more attention needed to be paid to international standard setters and that a proposal to force OTC derivatives to trade on exchanges would not work in Asia because there was no real liquidity to support reliable pricing. The fact that this letter came from multiple regulators had a real impact and it undoubtedly changed the debate. It was also crucial that we made clear that none of us were intent on joining a race to the bottom. This is only one example, but I think demonstrates what can be done for Asia if we have the will to coordinate on important issues.

I will stop here, and I hope that you all have an enjoyable and useful conference.