Asian Financial Forum

Striking a Balance between Financial Innovation and Regulation

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Financial innovation and the crisis

- Criticism that financial innovation contributed to the crisis –
  - Complexity in financial products hid the true nature and extent of interconnected risks across financial markets
  - Illiquid as products were hardly traded
  - Embedded leverage amplified the losses
  - Off-balance sheet exposures that were not adequately backed by capital

- Given the huge cost to taxpayers and massive job losses, financial innovation viewed as –
  - Costly at best and useless at worst
  - Creating unnecessary complexity to charge more for something the customer does not need or understand, and generate huge profits and fat bonuses
Different views on tackling financial innovation

- Popular view is to restrict financial innovation
- Counter view is to continue to allow financial innovation to thrive as other factors caused the crisis, not financial innovation
- Financial innovation has benefits: capital allocation, risk management and investment opportunities
  - Securitisation has increased credit availability, lowered borrowing cost and reduced maturity mismatch of banks’ assets and liabilities
  - CDS offers protection to investors against default of debt securities
- But, inappropriate use of innovation increases risk in the system –
  - Securitisation of sub-prime loans into mortgage-backed securities and multiple layers of CDOs
  - Buyers and sellers of CDS protection did not have insurable interest in the reference entities
- Middle view – role for financial innovation but must be subject to regulatory oversight
Middle view and “back to basics”

- **Regulatory oversight of financial innovation necessary**
  - Ensure that investors are not exposed to risks that they do not understand or are unable to bear
  - Market in these new products does not undermine the orderly functioning of markets or pose a threat to financial stability

- **Calls for financial institutions to “go back to basics”**
  - Finance should focus on capital allocation for productive use and in helping the economy in risk management
  - 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
International regulatory response to crisis

- **Comprehensive revamp of regulation**
  - capital, liquidity, compensation, insolvency arrangements, disclosure and transparency, CRA, hedge funds, OTC market, clearing and settlement systems, consumer protection

- **At the heart of regulatory reform**
  - no gaps in supervision
  - risk management is appropriate
  - oversight of risks includes the system as a whole rather than just at the institutional level
  - orderly insolvency resolution arrangements are put in place
Demarcation of banking and non-banking business

- Should banks conduct non-banking activities?
  - Banks traditionally intermediate between savers and borrowers and operate payments system and are the lifeblood of the economy
  - To avoid dislocations to the economy, banks have access to lender of last resort and orderly resolution arrangements are in place
  - But, banks moved into new business - (shadow) investment banking and retail sale of structured finance products – without adequately upgrading risk management and product expertise/knowledge
  - Non-banking activities not regulated and exposed customers and banking system to new and unknown risks

- One view favours sticking to traditional narrow banking (utility function) to reduce interconnected risks

- Another view is to allow non-banking business provided properly regulated and risk managed
The approach of Hong Kong

- Under the SFO 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.

- SFO also 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;
  - the desirability of facilitating innovation; and
  - the principle that competition should not be impeded unnecessarily.
SFC’s consultation on enhancing investor protection

- Investors suffered losses when Lehman Brothers failed. Common generic complaints of investors were
  - Misrepresentation – products wrongly presented as a low risk alternative to deposits and that the risks and complexity were not properly explained;
  - Complexity – products were too complex and risk disclosures were ineffective in alerting investors; and
  - Suitability – misrepresentation, complexity and failure of intermediaries to conduct proper customer due diligence, retail investors held products not suitable to their investment profile.
SFC’s consultation on enhancing investor protection

- Proposals aim is to strengthen the regulation of the sale of investment products to retail investors and better protect investors
  
  I. The way that disclosure on **product** risks and features should be enhanced and the obligations that the product issuer or arranger should bear;
  
  II. Revisions to be made to the Code of **Conduct** which governs intermediary conduct and selling practices;
  
  III. A newly introduced **cooling-off** concept for long term illiquid products

- **Investor Education Council and Financial Dispute Resolution Mechanism**
Concluding remarks

- Financial innovation does have benefits, but must be subject to appropriate regulatory oversight
- No perfect solution to reform, but the “best” given different stakeholders views and interests
- Reforms are the first step. The challenge lies in implementation
- Crisis cannot be eliminated. Need to 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
- Regulation is no substitute for discipline on the part of all stakeholders
- All must act in responsible and professional manner to safeguard the continued functioning and stability of financial markets and maintain economic prosperity