Foreign Correspondents' Club lunch
Surfing the Financial Tsunami

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Many thanks for inviting me here to speak at the Foreign Correspondents' Club – it is the first time in 4 years I have been invited here to speak and it coincides with an unparalleled global interest in the role that regulators have played in the current financial crisis. On this basis, I hope you do not invite me too often!

You generally do not want to hear from regulators too much from when things are going well. You, by and large, want them out of the way – dealing with real villains but not impeding market development. You want them facilitating business, granting licences, approving products and generally not stopping beneficial innovation which benefits markets and creates wealth, or at least that is what the investment banks tell me should be the role of the regulators. But, when problems hit, you want to know where was the regulator? Were they asleep? Why were they not doing their jobs?

In many respects, regulation, and I say this in a global sense, regulation is in the dock at the moment, regulators globally - that is: securities regulators, banking regulators, super regulators and regulators in pretty well every model, are being questioned as to whether they should have had the foresight to see the problems ahead; whether they have the competence; the staff to actually deal with it, to ask the right questions. Whether their investigations were effective, and whether they actually collaborated effectively across borders - because a lot of what we are dealing with now is the contagion effect that has not necessarily happened in any individual market but crosses the borders from one market to another. And they are also being asked questions of whether they were sitting on their hands when all of these chaos emerged or, conversely, why all these knee-jerk decisions of introducing rapid changes without thinking through the effect of those changes. And one of those that has been much talked about, and I will come back to a little bit later on is short-selling, which has been quite a controversial issue certainly here in Hong Kong and pretty well everywhere.

So we are in the dock currently, regulators are in the dock, to be judged. Now, we are used to being challenged. We get challenged every day. Every time we send out a notice requiring brokers to account to us as to who they are trading for; every time we summon somebody to come and talk to us, we get challenged. Sometimes we get challenged in the court, sometimes we get judicial reviews. We are used to being challenged. It is part of our job. And therefore we have to take a pretty thick-skinned approach to being challenged. What is being challenged this time around however is different - it is the regulatory structure itself, the effectiveness of the regulatory structure that is being challenged. Not just did we use our legal rights effectively, did we use the administrative tools effectively, but should we exist in the current form. That is being asked pretty well everywhere around the world. It is

being asked to a degree in Hong Kong because of what happened with Minibonds. It is being asked in the US about the SEC and it is being asked in the UK about the FSA model.

And in every model of regulation, almost regardless of what the current structure is, the fundamental question is: "do we need a new structure?", "do we need a new structure globally?"; "do we need a new structure nationally?". I will talk a little bit about different regulatory structures later and the differences between them and what they do give and what they do not give. But let me start by reflecting a little about what went wrong. I have been told I have got to speak in 20 minutes, so I am not going to give an in-depth analysis. But there are two things that I think are broad issues that underlie most of what happened.

A couple of years ago, we had Mervyn King, Governor of the Bank of England gave a speech here in Hong Kong. He described the current phase that we were in (and remember this was back in 2006). The phrase he used to describe that period was "the great moderation". We were in a low interest-rate environment, a high-growth environment, an easy credit supply environment and everything looked rosy. But his question at the time, and a lot of people were asking the question at the time, was actually, "are we sufficiently aware of the risks embedded in the system, or are we getting lazy about risks?". It was "the great moderation" - everybody believed that this would carry on. Therefore the downside risk was something that we did not need to worry too much about.

The second issue was the belief that reliance on enlightened self-interest, particularly in the investment banks, would be sufficient in addition to the regulatory structure that we had, to prevent excessive build-up of risk in the system. And so we believed that a degree of self-regulation in terms of how investment banks managed their own book would act as a brake on itself. We were wrong, and Greenspan was one of the strongest advocates of this – a position he has since changed in evidence to the US Senate in saying "we got that wrong" - you cannot simply trust the industry to regulate and protect itself from itself.

Those two phenomenon, "the great moderation" that we were in and the belief that reliance on enlightened self-interest would overcome excessive risk-taking meant that we found ourselves with markets that were significantly mis-pricing risk, whether it be the risk that a mortgage would default, whether it be the risk that a large investment bank would fail, whether it be the risk, heaven forbid, that accumulator contracts would actually start losing money. Nobody thought too much about these things because everything was assumed to be positive – the sea was calm, there were no clouds on the horizon or so it seemed – until it all started to go wrong from early 2007.

The question that we are now being asked and everyone is being asked is – "where were the regulators when this happened?" Now, we do have some 'global' regulatory organisations. We have the Financial Stability Forum, we have IOSCO, and others, which are forums to discuss regulation and what needs to be done at a global level. But when the crisis hit, some interesting aspects of the global system became clear: ultimately, all regulation is national. All regulation is domestic. It is because regulators, myself and other regulators included, are accountable to governments and governments are accountable to tax-payers and voters, which means ultimately it has got to be domestic issues and domestic priorities that become the most important priorities in a crisis.

As a small example of that, when Lehmans went bankrupt, I was on an aeroplane probably somewhere across Russia I suspect, I am not sure of the air route taken, on my way to an

IOSCO meeting in Madrid. The first thing I found on landing, was that Lehman had gone bankrupt over that weekend. The second thing I found was that every single regulator had clamped down on what was in its own jurisdiction. We talk about global co-operation and international co-operation - important concepts at times of systemic crisis. But I can tell you at times of significant crisis, the first worry is about the domestic issues. Every regulator's first responsibility was to secure what they could – cash, assets - all were frozen in whichever jurisdiction they were in. The fact that the Hong Kong entity therefore had bank balances which were transferred between Hong Kong and Frankfurt or operations between Hong Kong and Tokyo, meant that Hong Kong operations were squeezed by every other part of Lehmans being frozen by different national jurisdictions. So whilst global responses are important at a time like this, the first response is to freeze what is local while we can work out later how the remains can be divided up.

The second example of this global/national divide is short-selling. Again what we saw was a very difficult market, very volatile markets around the world and a suspicion, unproved, that short-selling was being used as part of broad manipulative strategies to de-stabilise either the financial sector in general or individual companies, and a strong call from the heads of corporates, or politicians and media, that we had to ban short-selling - which was an "evil thing" and "was creating a chaos in markets". It is interesting that if you look today, six months, three months on from some of those bans, the general view is actually they have got it wrong. We have seen the US regulator come out with statements that said it was a mistake to introduce the ban on short-selling. We have seen the UK FSA announced the end of the ban this week. Most markets around the world now take the view that actually there are more negatives to the market than positives to the market from the bans.

It is a curious concept for people outside financial markets to understand, how "short-selling" creates more efficient markets. I face this issue whenever I go in front of politicians, they will say, "hang on, let me get it right. You are saying that it is ok if somebody can sell something they do not have?" But the truth is, if done right, it is. It enables more rapid price discovery, it enables people who have done the analysis and take a bearish view of the stocks to put that into practice and it enables markets to reach the price equilibrium more quickly without otherwise adverse effects. But if allowed in excess, it becomes a problem. It becomes a bad thing.

We are fortunate here in Hong Kong, because the short-selling regime was put on a strong footing many years ago – certainly after the Asian Financial Crisis. It does not allow 'naked' short-selling. It requires documentary evidence to be available before short sales are taken. It requires that short sales cannot be undertaken on a downward price movement. A number of features are in place which actually means you can short-sell in Hong Kong but you cannot short-sell to the extent that you distort the market. If you look at the average statistics of Hong Kong compared to the data in the US or the UK, HK's short-selling volume daily is about 8-10%. It is true that is not very much. In the UK and US, it is 25-30%.

An interesting thing is when other markets introduced their bans on short-selling, so for example you could no longer short-sell HSBC or Standard Chartered in London, we did not see a significant increase in that business in HK. So by and large, we have put a tight structure in place and therefore we have been, one of the few markets around the world that has not had to tinker with its short-selling regime. I think that is respected by the market because at the end of the day, what markets respect most is a consistency of interpretation and consistency of rule-making. Generally, what they fear most is rapid decision-making. I

know that following one of the bans, brokers were waking up their clients in London at 3 am in the morning to say, “Can you just clarify that trade that you gave me?”. That was really what you did not want to hear at 3 o’clock in the morning. But that was one effect of the rapid changes that were being made.

Part of the reason for the confusion is the degree of ambiguity into what actually is allowed. So the US system is a very interesting one. Ostensibly, it looks a bit similar. You must have stocks available to borrow before you can short sell.

But when you test it a little bit and push it a degree further, it is not quite like here where you have to have documentary evidence - the rules in the US were that you must have a reason to believe that stock will be available to borrow and to sell. So you could say “I thought it would be, I spoke to him two months ago, and he had stocks to lend, I thought the stock would be available.” In Australia the system is again complex because there was no real distinction between what we call ‘covered’ short-selling and ‘naked’ short-selling. So different national jurisdictions all took slightly different approaches to dealing with the emergency – and global markets were severely disrupted. So short-selling is again one of those areas where the immediate response is to deal with a national issue. And the national issue was to protect banks, to protect rights issues, and to protect certain vulnerable companies and certainly respond to the corporates who said “short-selling is evil, crocodiles are ruining my stock, you cannot let this happen”.

The general consensus is now we need to have something closer to a global standard and that is something I am working on within IOSCO, trying to establish a model that will work across all major markets in the world. Now, IOSCO is not a rule-making body, so, it does not have the ability to enforce. It requires that we agree a consensus and that consensus is adopted in different countries. But it is very much down to each country to work out how to adopt any new standard. So, that is the example of where again national issues became the forefront in crises. Over time, we will move it back into an international co-operative level. That is the stage we are working on at the moment.

I mentioned earlier that the mis-pricing and the misunderstanding of risk was part of the crisis. I know I cannot and will not be allowed out of the FCC without talking about Minibonds. One important caveat please. We are investigating and we have a number of investigations under way. Therefore, I am not going to say anything that you should not already know .

Minibonds were a phenomenon that was not unique to Hong Kong. It is a product that was sold in Hong Kong and in Singapore. But derivatives or variants of the product have popped up pretty well everywhere around the world, albeit slightly different investor groups that have been hurt. In Australia, it is mainly local authorities that got hit hardest by the collapse of Lehmans. In Spain, private investors suffered losses, private banking clients in Switzerland, and the same in Germany, same in Taiwan. So all around the world, different types of audience were affected by complex products that were linked to Lehman’s failure. They were sold here as a low-risk alternative to deposits, and many people thought that was what they were buying. So, at the time when deposits were paying probably less than one percent here, we have got banks and brokers saying to you, “here is something that is paying six and a half percent. Isn’t that nice? What would you rather have?” “I would rather have the one that is paying six and a half percent, please”.

The risks were fully disclosed in the offer document. But who reads the offer document? That is part of the problem - few actually read the offer documents, as our lawyer friends here will know. The risks were also disclosed in the marketing leaflet. In order to get the risks into a single page marketing flyer. It ended up being in the print size that appeared to be quite difficult for many people to read. With twenty-twenty hindsight, we have been told that these products should never have been approved in the first place "You the regulator, should have never approved these documents. They were clearly complex risky documents that were not suitable for retail investors". But two or three years ago when these were being sold, or four or five years ago when these were products that were being launched and brought to us, there were basically three risks. The first risk was that one of the reference names would go bankrupt – HSBC, Cheung Kong, MTR Corporation, etc. These are the sort of names, and people were told, if one of them is going to go bankrupt, you are going to lose your money.

Somewhere a little bit further down a bit, there is a secondary risk, which is that the collateral underpinning the product had to lose value. Now, at the time, these were Triple A rated products. Now, as everybody knows, Triple A rating was taken at the time as meaning of very very low likelihood of default. Therefore they were seen as a reasonably good reservoir of value.

The third risk was the swap counterparty, ie, the person who sits behind the structure would fail. In this case, it was the fourth largest investment bank in the world. So they are the risks that you run when you are saying you want six percent or one percent. Triple A securities could end up worthless or the fourth largest investment bank in the world would fail or a major name would go bankrupt. They are the things that today we have been told that you should have seen, that they were unreasonable risks at the time.

The way the Hong Kong regulatory system works, like other major jurisdictions, is that we do not make a final judgement about product suitability. What we do is to make sure that where products are brought to us for document approval, the issues are fully disclosed, the product features are properly disclosed - such that a reasonable individual would be able to assess the risks and features. It is the first leg of the regulatory system we have. It is all about disclosure.

The second leg of the regulatory system is about conduct. That is, that the person who sits in front of you and says here is a product that pays six percent and here is one that pays one percent - has actually done (maybe themselves or within their organisation) a proper due diligence on two things: firstly on the product and secondly on you, and made sure the two things match up, so that the product is suitable for you as an individual. This includes the big question that we are looking at (and we are still in the middle of) which is whether the selling process (conduct) was adequate at the point of sale - because the regulatory structure requires these two things, to work. If either of those things fail, then we have got a problem. So, the two things are disclosure – of the risks, the issues, the features, they are properly explained - and secondly the conduct of the person selling, to make sure that it is suitable for your particular characteristics as an investor. Actually, that is pretty well the model that works everywhere else in the world. It is not odd to Hong Kong. Everybody works from disclosure and conduct to ensure product suitability.

The system appears not to have worked in every individual case – but it is a big leap to conclude from that, that the regulatory system has failed. But let me tell you what has not

gone wrong in Hong Kong first. We have not had a Madoff, and we have not had a major hedge fund or giant Ponzi scheme (as Madoff himself has called it). We have not seen that in Hong Kong. We have not had a major broker failure. We have not had a Bear Stearns or a Lehmans in Hong Kong. We have not had a bank failure, as we saw in the UK, or in Iceland or amongst Landesbanks in Germany and I have lost count of the number of banks that have failed in America. We have not had any of those major institutional failures that have existed in many other markets around the world. What we have had is a mis-selling issue which we are in the middle of investigating, and which we will get to the end of. But we have had that in the context of the worst financial situation that any of us here in this room has seen and maybe the worst since the Great Depression.

We are facing this crisis because of a whole set of quite extraordinary events that have happened. We should not simply give up on the Hong Kong structure, in the context of those massive global events. But equally, one should not be afraid to question whether our regulatory structure is ideal. Would it be appropriate to consider changes to our regulatory structures in Hong Kong. There are effectively three broad models of regulation. It is not quite as simple as that, but effectively there are three models of regulation.

The one we are closest to today is what we call the “Institutional Model”: who you are regulated by, depends on who you are. If you are a bank, then you are regulated by the banking authority; if you are a broker, you are regulated by a securities authority; if you are an insurance company, by the insurance commissioner. So it is an institutional model. That is where we sit, and that has worked pretty well for the last 20 years when banks were banks that took deposits and when brokers sold stocks and insurance companies sold products that actually were insurance. But it has all moved on a bit and actually the products that are being sold today through these different types of institutions now are very much akin to each other. What is sold as ILAS products or structured products or funds are actually not that different but have a slightly different wrapper.

So to make that institutional model work, you have to recognise that actually all of those organisations are operating on a similar client base and are offering very similar products. So you have to ensure that the standards work across all of those different institutions, and the standards whilst may be not absolutely identical, are equivalent. And that is the first question we have got. Question one is “can that model still be made to work?”

And if it is concluded that it does not work, we should consider the various options open to us. This is not just the “Super Regulator Model” which is most often talked about in the press, but we could also explore what we call the Twin Peaks Model. Twin Peaks is a term that describes what we call a “functional model” of regulation, where you have two regulators. One looks after the prudential supervision of systemically important institutions and one looks after conduct. And that is the model that works in Australia, in the Netherlands, and if you believe what is being talked about in the US Senate, it is the model that the US is currently looking at. So two regulators: one on prudential and one on conduct.

And the third model of regulation, which everyone jumps to (and I would rather use the word Integrated Regulator) is the “Super Regulator”. With an Integrated Regulator, you bring all of those functions under one roof, and the most obvious example is the UK FSA, but a number of them exist elsewhere in the world.

These are all different models, and they each bring different benefits and different drawbacks. And in truth none of them have actually protected all investors or depositors from what has happened in the current market conditions. For example, the Integrated Regulator approach did not protect the UK from Northern Rock, and the extreme situations in HBOS or Bradford and Bingley. It has not protected most markets around the world from things going wrong.

So in conclusion, things do go wrong but, hopefully they do not go wrong that often, and when they do go wrong, they can be contained quickly, with minimum damage to investors. What has gone wrong in Hong Kong did not start here – it is the effect of failures in the US.

Hong Kong's system has broadly worked well. We have not had an institutional systemic failure which I think is important for Hong Kong because many other markets have. We do have a problem of retail selling, and we need to put that right. However, whether we need to throw out the entire regulatory structure and re-develop it in the light of the failure that we have had is a very big question, and one which requires careful and balanced consideration. Put in a global context, Hong Kong has avoided the huge institutional failures that have plagued other markets around the world. We would need to think very carefully before we abandon the current system.

Thank you very much.