Joseph Yam: International financial system – challenging issues

Welcome address by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the SIBOS 2009, Hong Kong, 14 September 2009.

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SIBOS was last held here in Hong Kong in 1991. So it has taken you 18 years to come back to Hong Kong. I wonder what took you so long. A lot has happened here in this free and open international financial centre in the past 18 years that ought to have interested you enough to bring you back here earlier. I can think of, for example, the establishment of the Hong Kong Monetary Authority in 1993! Seriously, financial globalisation and innovation have made life here, where there is a high degree of market freedom and ample liquidity, rather challenging, perhaps a little too challenging for the financial authorities. And on a couple of occasions we had to take controversial, remedial action to safeguard monetary and financial stability. On top of this, there were of course the market excitement, or interestingly the lack of it, surrounding the reversion of sovereignty; the inevitable bursting of the housing bubble that did not, I repeat not, lead to a collapse of the financial system; the construction of our multi-currency and multi-dimensional financial infrastructure that made RTGS DVP and PVP possible for anybody wanting to manage risks more properly here in this time zone; and the emergence, more recently, of the RMB offshore market here that is also serving as a laboratory for testing financial liberalisation on the Mainland, a development that is of increasing importance to global finance. But it is still a great pleasure, after all these years, to welcome SIBOS back to Hong Kong.

I understand that the objectives of SIBOS this year are "learning lessons from the past, exploring the post-crisis landscape and paving the way for future innovation". These are indeed important objectives, having regard to the current state of global finance. Indeed, for the past couple of years they have been occupying much of the time of the financial authorities and the industry. The G20, the Financial Stability Board and its Standing Committees, and the Standard Setting Bodies are all working hard and there is no lack of specific subjects to address – the Basel capital framework, the accounting standards for valuation and for off-balance sheet activities, capital requirements for trading activities, compensation practices, central counterparties, principles for the oversight of hedge funds, supervisory colleges, cross-border cooperation on crisis management, oversight regimes for the rating agencies, etc, etc. Some of you may already be suffering from meeting fatigue and, like me, somewhat sick of these subjects already; so I do not want to add to your agony. I am fortunate to have had the privilege of setting up and heading a central banking institution over a relatively long and exciting period in a significant international financial centre that is free and open. And as the time for retirement draws near, after sixteen and a half years, I do have a few reflections, from a rather different perspective than those of present pre-occupations, which I would like to share with others. They are nothing profound or technical; just a few issues that I have found particularly challenging over the years.

The first concerns a **conflict**. This is the conflict between the private, particularly short term, interest of financial intermediaries in maximising profits, and the public interest of effective financial intermediation that provides crucial support to the economy. This conflict has not been talked about much, if at all, even in central banking forums; but it is, I am quite sure, one important contributing factor to the making of financial crises. Financial intermediaries are often, and rightly so, rewarded handsomely for their innovative efforts, which, it is claimed, bring a higher rate of return for those with surplus money and a lower cost for those in need of money; in other words, a narrowing of the intermediation spread, or greater financial efficiency. But there is an internal contradiction in this phenomenon. Greater profits for financial institutions and larger bonuses for those employed in them mean, to me at least,

a widening, rather than a narrowing, of the intermediation spread; in other words, lower financial efficiency.

Yet we do observe greater profits and larger bonuses in the financial system along side (probably apparent) improvements in financial efficiency. For example, the innovative effort variously described as "securitisation", "originate-and-distribute", and "credit risk transfer" did raise the rate of investment return and lower the cost of credit. The explanation for this, if I may venture a guess, is in the time dimension. The observed narrowing of the intermediation spread comes at the expense of, or presages, a future, possibly sharp widening that often occurs in the context of a financial crisis. Indeed, we have just had a case of co-occurrence of highly remunerated financial innovation and a temporary narrowing of the intermediation spread that was built upon, among other things, a serious erosion of credit standards. We all know how this ended; rather miserably with investors losing a lot of money and borrowers finding credit expensive and hard to come by, and consequently considerable damage to the economy.

How do we deal with this conflict? I am afraid I have no answer, other than always to be alert to it and be ready, as protectors of the public interest (in terms of maintaining stability, upholding integrity, promoting diversity and efficiency in financial intermediation) to act whenever the private interest of the financial intermediaries threatens to override the public interest. But this is easier said than done, particularly when financial innovation is often packaged and presented skilfully by financial intermediaries as an effort to enhance financial efficiency. Furthermore, in capitalist, free-market economies, the authorities generally do not have a lot of influence over innovation. The financial intermediaries often constitute a strong political lobby against regulation, arguing quite forcefully that regulation stifles innovation and progress. And so, regrettably, we have an environment that is often not conducive to the financial authorities taking preventive measures to protect the public interest. You have I am sure heard of the rather unkind and unfair street talk that the US Treasury was being run largely by Wall Street. I am sure it is not true but it conveys a misconceived perception that perhaps we should not ignore.

I am not suggesting that the socialist-market economy model, practiced for example on the Mainland of China, with considerably greater influence over and ownership of the financial system by the authorities, and therefore greater attention by operators within the financial system to the public interest, has become the superior model, although I noticed at least some involuntary movement lately of the so-called Anglo-Saxon model towards that direction. “Thou shalt lend”, says the government to banks that have received capital injections from the public purse. It is I think a matter of degree, not so much in the ownership of the financial system, but more in the legal and institutional framework whereby those with the responsibility to protect the public interest can exert the appropriate influence at the appropriate time, whether it is through prudential supervision, conduct regulation, the provision of safety nets or the design of crisis resolution mechanisms.

My second issue is a **dilemma**. This is a dilemma mostly for emerging markets – a dilemma between pursuing financial openness and maintaining financial stability. I support financial openness as a means of greatly extending the universe within which the risk appetite of domestic savings and the risk profile of domestic borrowers can be satisfied. Indeed, for borrowers and investors of a particular jurisdiction, taking financial intermediation into the international dimension should lower borrowing costs and increase investment returns. And so measures are taken by emerging markets in financial sector development to enhance and eventually liberalise the international mobility of investors and borrowers, and their funds, and the international mobility of financial instruments and financial institutions; in other words, they embrace financial globalisation.

As we all know, there are risks to monetary and financial stability associated with such mobility, and events in the past two decades have indicated clearly that these risks are considerable. Many have pointed out that financial openness has to be supported by prudent

macroeconomic policies and so financial openness serves also to impose needed discipline on policy making in emerging markets. I fear, however, that this is true only to a certain degree, in that the discipline imposed by capital mobility on emerging markets seems to be a lot tougher than that imposed on developed markets. The small size of emerging markets relative to the pool of international capital may be one reason behind this. The greater volatility of international capital relative to domestic capital is perhaps another. Also of concern is the willingness of some emerging market jurisdictions, in a perhaps doubtful attempt to attract the household names in international finance to set up shop as part of their strategies to develop their financial systems, to promulgate rules that may be unsuitable for their domestic circumstances. This often results in structural defects in the financial systems that are not conducive to the maintenance of monetary and financial stability; for example, regulatory gaps, low transparency and market concentration. These defects also breed unethical behaviour. Indeed, free and open emerging markets are considered by some as markets that can be rather freely manipulated. They also call them ATMs.

But I still believe that financial openness outweighs the risks of financial instability, and that the risks I mentioned just need to be, and can be, managed, simply by being sensible in the development of the financial system, reminding ourselves always that the primary purpose of the financial system is financial intermediation that supports the economy. Although it provides employment for quite a number of people, including us, and profits for a lot of capital, the financial system does not and should not have a life of its own. Gradualism is perhaps a prudent attitude, even if this means taking a little more time or appearing for a time to be not as welcoming as the top players in international finance would like. "Because others have it" is definitely a risky attitude to take in financial development. And as developed markets are going back to basics, a no-frills approach to financial development may not be a bad idea. Financial openness does not mean getting all the top brand names to set up shop in your backyard and importing innovative financial instruments and practices. Indeed, some of those innovative financial instruments may be toxic.

My third issue is a **reality**. The reality here is that in finance, and perhaps in other areas, it is difficult if not impossible to find a textbook perfect market, where, for example, market participants are all price takers and not in a position – and therefore not having the incentive – to try and move markets in their favour. Fear or greed, fed by information or misinformation, stoked by manipulative or predatory behaviour by a few, often takes hold, to such an extent as to produce volatility well beyond prudent risk management parameters, threatening a complete meltdown of the financial system or other forms of systemic breakdown.

As supervisors of financial institutions and regulators of financial markets, our duty is to do our best to prevent these situations from occurring, but we have to accept that we too are not perfect, particularly when supervision and regulation at the national level have their shortcomings in dealing with financial institutions and markets that are already global in nature. Whatever combination of market freedom and regulatory oversight one cares to design and try out, markets do fail, sometimes inflicting huge damage to the public interest, defined in terms of ensuring that the financial system operates effectively in support of the economy. The damage to the public interest could well be much greater than that arising from not allowing the free market to find its equilibrium on its own.

We certainly hope that these situations do not occur too often. But when they do, very simply there is a need for intervention to put things right so that the financial system can continue to function to support the economy. But market intervention is always controversial. We learned that in 1998 and many of our critics then learned the same more recently. The purists wave the free-market banner and condemn any market intervention, pointing out the moral hazard involved, the cost and the unfairness of intervention. Many become instant experts in managing financial crises and alternative courses of action proliferate. Politicians, whether or not they have the authority over the decision to intervene, want to satisfy themselves that intervention is justified and what is proposed is the right way forward. Often the process of

arriving at a consensus takes time and meanwhile the problem worsens and the effectiveness of the actions to be taken is eroded.

I believe therefore that those responsible for the maintenance of monetary and financial stability should have the necessary emergency powers to do what is required independently and promptly. There is of course the need for transparency and accountability when exercising these powers to ensure appropriate checks and balances. At a time when many jurisdictions and international forums are reviewing the financial regulatory structure, the ability or inability of the financial authorities to take unusual action, independently and promptly, to protect the public interest should be addressed.

My fourth and last issue is an **involvement**. This concerns the extent to which the authorities should be involved in the development of the financial infrastructure. I am sure you are aware of the huge amount of public money spent in all jurisdictions in the development of the physical infrastructure, building highways, bridges and airports to take people and goods from one place to another safely and efficiently, thus facilitating the conduct of economic activities for the benefit of all. Authorities, however, seem to devote only disproportionately small amounts of resources to the development of the financial infrastructure to move money and financial instruments from one entity to another safely and efficiently for the purpose of enhancing financial efficiency that promotes economic prosperity. To some extent, the development of the financial infrastructure can be left to the market, with SWIFT being a sterling example of private sector initiative in this area. But many of the important elements of the financial infrastructure are public goods, the provision of which, in a form that serves the public interest best, may not be financially viable for the private sector. Furthermore, the conflict I mentioned earlier often comes in, affecting the willingness or the enthusiasm of the financial intermediaries to develop and use a financial infrastructure that promotes financial efficiency. I believe this is one of the main reasons why X in T+X in the settlement of some financial transitions is still a number other than zero, or why T+X is still not replaced by RTGS DVP even though the technology to do so has been available for some time.

Very simply therefore there is a case for the authorities to get involved, as a developer or a service provider, when a private sector solution that is in the public interest is not available. And the public interest is not just in the enhancement of financial efficiency but also in the limitation of contagion and the more effective achievement of financial stability. The Hong Kong Monetary Authority has devoted much effort to the building of the financial infrastructure of Hong Kong. I can assure all of you that it is well worth the effort and the amount of public money involved is really quite modest, although it may take a little time, and some appropriate prudential guidance concerning, for example, the management of payment and settlement risks, to convince potential users before traffic in these financial highways builds up.

Allow me to end this address with an advertisement. In Hong Kong we now have RTGS systems for the Hong Kong dollar, the US dollar, the euro and the RMB. They are all linked together to achieve cross-currency PVP in our time zone and they are linked up with our debt-clearing system to achieve DVP. We welcome external users accessing these systems for their payment, clearing and settlement needs, through directly becoming members of these systems, indirectly using the services through corresponding relationships with the existing members, or having them linked up with their own payment, clearing and settlement systems. Some of you may, for example, be wondering how you could use the RMB for trade settlement, something that is being promoted by the Mainland authorities. You can, of course make use of correspondent banks on the Mainland, and therefore pay or receive RMB arising from imports and exports there, where the money stays. But should you wish to pay or receive RMB offshore where there is greater freedom in the mobilisation of the relevant funds, albeit for the time being there is still a dearth of RMB denominated financial instruments, you can do so in Hong Kong.

Thank you and I wish this year's SIBOS great success.