Norman T L Chan: The power of 3Cs

Address by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the Treasury Markets Summit 2012, Hong Kong, 12 October 2012.

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Good morning, ladies and gentlemen,

I welcome you all to this fifth Treasury Markets Summit co-organised by the Treasury Markets Association and the Hong Kong Monetary Authority. In the past four Summits, discussions focused mainly on business opportunities available to financial market participants. This year, I am glad to note that, the Summit will also devote a session to analysing some of the fundamental elements of a first-class financial centre. Being an ardent believer of these fundamental elements, I would like to take this opportunity to share with you some of my thoughts on them.

From time to time visitors from overseas come to see me and, during our conversations, the question of how Hong Kong has turned itself into a thriving and dynamic financial centre in Asia is often raised.

It is not surprising that Hong Kong's transformation from a trading port into an IFC within several decades has drawn a great deal of admiration as well as envy from neighbours within the region and beyond. This is because of the fact that an IFC will bring about much-desired economic growth, employment and prestige. So it is also not surprising that many cities in the region harbour ambitions of becoming international financial centres. While such ambitions are quite legitimate, most of them would find achieving this goal very challenging. Why? Because an IFC, by definition, serves not only domestic customers on its own turf, it also captures financial businesses and money-flows either from a large hinterland or the neighbouring areas or both. This is a big challenge because it entails serving customers from the other jurisdictions or cross border transactions. It also entails the need to deliver consistent and efficient financial services in order to be competitive in international financial business. The truth of the matter is that only a small number of cities can successfully become international financial centres because IFCs need a critical mass and market depth. It should be noted that international financial transactions and money tend to migrate towards those centres that provide the most efficient and competitive services to customers. In other words, domestic financial centres will need to go through very fierce competition before a few of them can emerge as successful IFCs.

Given Hong Kong's accomplishment as one of the region's premier IFCs, there are many study groups from abroad coming here to learn the tricks that have helped achieve what we have today. One visitor actually asked me point-blank when I received him in my office at IFC Two: "Give me the name of the architect of your building, and I am confident that we can build a taller and bigger building in order to turn my city into an IFC."

Of course, we all know that most international financial centres have very imposing, often elegant high-rise office towers. But building an international financial centre is not about having skyscrapers taller than anyone else's. Nor is it about having super computers or optical fibres that can transmit data and information faster than your competitors'. Then what is it all about?

In the World Economic Forum's Global Competitiveness Index, there are 12 categories of benchmarks against which major financial centres are assessed to determine their overall rankings or competitiveness. There are items relating to the physical infrastructure, such as airports, railroads and optic-fibre cables, which I would label as "hardware". But they are not the deciding factor in differentiating the average financial centre from the top IFCs. Of course, an IFC needs to have first-class hardware. After all, IFCs intermediate financial flows and in order to do that well they have to provide a high degree of connectivity linking up a large pool of clients and moneys from all over the world. However, it is relatively easy to build or copy hardware. There are many architectural firms that have a proven track record in designing and developing world-class airports and buildings. There are many IT firms that can provide top-notch computer hardware and data-transmission systems. But what differentiates the top IFCs from the rest is not the hardware but their software. So some have argued that to become an IFC is to compete and win in respect of the "soft power". In other words, the race to become an IFC is a "battle of soft power".

When I say "soft power" I am referring to a wide range of qualities and strengths, which include the rule of law, protection of property rights, free flow of information, taxation, ease of doing business, talent pool, etc. As for Hong Kong, our success has been due to the fact that we have managed to build and develop our soft power in the last few decades. It is not my intention to go through the entire spectrum of qualities that constitute "soft power" today. What I propose to do now is to focus on how we can ensure that the financial institutions and market players, which form the core part of any financial centre, can continue to stand up to the challenge of achieving and, more importantly, maintaining their competitive edge in a highly competitive world. I would like to argue that, in the remainder of my remarks, the success or otherwise of financial firms is to a large extent determined by their ability to exercise the power of the "3Cs". Let me elaborate what the "3Cs" stand for.

"Competence"

The first "C" is "Competence". This is very easy to understand. It goes without saying that, for instance, a foreign exchange or bond dealer must possess the technical competence in the respective markets to perform effectively and professionally. By the same token, a private banker or financial advisor must also have the necessary technical knowledge before he or she can recommend or market wealth-management products to customers. However, financial innovation or engineering in the last two decades have greatly increased the complexity of financial products and market dynamics. Some of the structured products and financial derivatives are so complex that it is a big challenge for traders to fully understand their features and risks, let alone for the less-sophisticated customers. To maintain technical and professional competence, financial firms and practitioners must ensure that they are kept up to date on the latest market developments and financial innovations. This is very similar to what other professions require. For example, in the field of medicine, doctors will need to keep updating themselves by reading medical journals and attending seminars to keep abreast of the latest medical advances.

"Control"

The second "C" is "Control". It refers to the control and governance of banks, insurance companies, securities houses and other firms engaging in financial services. In general financial firms engage in two main types of business. The first type is the pricing and management of risks, which include credit, foreign exchange, market and maturity mismatch risks. Clearly in the process of risk-taking, the prudential soundness of the balance sheets of the firms is crucial. They must be able to control the amount and types of risks based on prudent parameters. The history of the financial world is littered with staggering examples of breakdowns in risk control by firms, all of which inevitably led to disastrous outcomes not only for the firms themselves, but also for the societies as a whole in many instances. I don't think I need to labour today why control and governance of risk-taking are important to the continued success of financial firms, large and small.

The second type of business that financial firms undertake is the provision of advisory services and distribution of financial products. This category covers a wide range of financial services, including investment banking, wealth- and asset- management and brokerage. As these firms are offering advisory services, or marketing and distributing financial products, they are not taking risk using their balance sheets. However, control and governance are no less important than for the first type of financial firms because these firms must be able to treat their customers fairly and take into account their interests in offering their advice and products. Again, we have seen many instances in which a breakdown in the control of the sales process has resulted in mis-selling of financial products that were not suitable for the customers.

One point I wish to highlight here is that a good control and governance framework can only be established within the financial firms from the top down. No matter how good the financial regulations are or how hard the supervisors try, external surveillance can only supplement, but not replace, good internal controls. This means that a suitably designed control system endorsed by the Board of Directors must be put in place to ensure that there are effective checks and balances within the firm to monitor and detect breaches of the approved risk taking parameters and code of conduct in dealing with clients.

"Culture"

The last "C" is "Culture". This is a more difficult concept to explain than the first two "Cs". But I'll try. Competence basically means having the technical expertise to conduct financial businesses. It can be learned through different channels, such as formal education, in-house programmes or on-the-job training.

Control means having a system within a firm that monitors and manages risk-taking or the conduct of its staff. People within the firm are required to behave in a way that is prescribed by their rules. To put it in another way, people behave properly because they have to or else they would face unpleasant consequences if and when they are caught. In contrast, culture refers to a set of internal values shared by a group of people that influence and shape their mindset and behaviour. Culture and values normally define what is proper and what is not. Culture makes people behave in a certain way because they want to behave in that way and not because they have to. Let me use a day-to-day example to illustrate this point. Hong Kong is now a relatively clean city with not a lot of garbage on the streets, which is in sharp contrast to the widespread littering of 30–40 years ago. Many people believe that the reason for this welcomed change is the improvement by the Government in its street-cleaning procedures as well as enhanced efforts to catch and fine people who are found littering. But this can only explain a small part of the change. The key driving force, in my view, that makes Hong Kong streets much cleaner today is the change in people's values. These days, most Hong Kong citizens do not litter the streets not because they are afraid of being caught by the health inspectors but because they don't think it is right or proper to do so. This change of culture or values is the result of education of the young generation and the "Clean Hong Kong Campaign" that was launched by the Hong Kong Government back in the 1970s. If this had not been the case, our streets would still be filthy even if we had ten times more health inspectors and street cleaners.

In the context of building the financial services sector that befits a world-class IFC, I have explained earlier why it is very important to have professional competence and good control. However, it is equally, if not more, important that our financial institutions and their practitioners uphold the right values that protect and serve the interests of the customers who make use of Hong Kong's financial services. You may recall that in the movie Wall Street, Michael Douglas kept on saying: "Greed is good!" When this kind of mindset, which puts the individuals' interests above the firm's and the firm's interests ahead of the client's, becomes prevalent, it will inevitably lead to highly undesirable if not disastrous outcomes not just for the users but for the financial system as a whole. So while greed is probably an inherent part of human nature, a successful financial firm or an IFC must ensure that it can develop and cherish a culture and values that will restrain excessive greed in the interests of giving customers a fair deal. Only in doing that will an IFC be able to sustain its position and competitive edge over a long period of time. We all understand that an IFC also represents a brand, a quality that customers trust in terms of efficiency, reliability and integrity. It takes decades or even centuries to build a brand, but only days to destroy it if any of the qualities of competence, control or culture are eroded.

Ladies and gentlemen, I have talked about the qualities or power of the 3Cs and I hope you will agree with me that, if Hong Kong wishes to remain competitive as the region's premier IFC, we will have to do everything we can to strengthen our "soft power". More specifically, the financial services industry, the regulators and policy makers can and should work together to upgrade the 3Cs, which is essential in maintaining our competitiveness against other financial centres. Now I would like to name a few initiatives that the HKMA is pursuing in this regard in collaboration with the stakeholders.

(a) Competence: in conjunction with the SFC, the industry and professional bodies such as the TMA, the Hong Kong Institute of Bankers and the Hong Kong Securities and Investment Institute, we are seeking to revamp and formalise the professional qualifications and training for market practitioners in the fields of private banking and wealth management in general. The HKMA has also stipulated in its supervisory circular that banks must ensure that their staff have the necessary qualifications and professional training in the relevant fields. We are making good progress in this regard and we hope to be able to introduce an enhanced qualification and training framework in a few months' time.

(b) Control: under the Banking Ordinance, directors and senior management of banks must be "fit and proper", given the important roles they play in ensuring that their banks are run prudently and properly. In order to enhance the control and governance functions of individual institutions, the HKMA has recently refined the procedures for approving the appointment of bank directors and senior management. In addition to the usual vetting, we now convene face-to-face meetings with some of the nominated candidates. The purpose of these meetings is to enable the HKMA to get to know the future directors and chief executives better and to make clear the HKMA's expectations of the roles and responsibilities their appointments will entail. It is important for all of us to appreciate that the ultimate responsibility for ensuring the safety and proper functioning of a financial institution rests with the institution itself. Regulation and supervision can only supplement or reinforce the process and cannot replace sound control and governance within the institution.

(c) Culture: the latest Global Financial Crisis and the subsequent developments have exposed clearly the fact that uncontrolled greed can and did generate highly undesirable outcomes. Not only were financial firms badly hit by these outcomes, but in some instances the reputation or brand of well-established financial centres has also been tarnished by these events. Of course, after the events many people sought to apportion blame. Obviously, the institutions concerned must take the bulk of the blame. Inadequate regulation and poor supervision were also culprits. But to me there is a much more fundamental issue that needs to be tackled if we wish to reduce the risk of similar events recurring. That is the culture and values of the financial firms and the market practitioners. In making our streets clean and free from litter, it is not enough to station one health inspector at the corner of every street to catch offenders (there are simply not enough health inspectors to go round anyway), nor is it enough to raise the fines against littering to a draconian level because people will still litter if they think they can avoid being caught. The best way to keep our streets clean or cleaner, in my view, is to nurture the value among our citizens that littering is morally bad and should not be indulged in even when no health inspector is around and there is a low chance of being caught. In the context of the financial-services sector, the best way to uphold the integrity of the markets and trustworthiness of the industry is for the stakeholders to nurture and cherish a culture and values that encourage and support honesty of the practitioners and restrain the institutions from placing the maximization of profit above the interests of the customers.

This may all sound very idealistic and is “easier said than done”. We all understand that it will take a long time, years and even decades, to change people’s mindset and values. However, no IFC is built overnight. It has taken London and New York many, many decades to become what they are today. The race to become among the top IFCs in the world is a long term endeavour. It has taken Hong Kong many decades of untiring efforts to accomplish what we have today. There is a lot more that we need to do in order to maintain our niche when so many competing centres are trying very hard to catch up. To differentiate Hong Kong from its peers, we must maintain those qualities that are hard to copy and yet appeal to users and customers who can freely choose where to conduct their financial businesses. So what should we do? There are three layers of parameters that help shape behaviour and values.

The first layer is what is prescribed in the statutes, regulations and rules, and with which compliance is compulsory. The second layer is set out normally in codes of conduct issued by the various professional or industry bodies. For example, the banking industry has, under the auspices of the HKAB and with the endorsement of the HKMA, promulgated a comprehensive code of banking conduct. Similarly, the TMA has also issued a code of conduct for its members. The third layer encompasses everything from what the society does in its civic education for children to what individual firms do in managing their business and the behaviour of their employees. Very often we see firms become overly aggressive in chasing profits by taking excessive risks or mistreating their customers. Among these firms it is common to find that they have a kind of incentive system that encourages and rewards excessive risk-taking and high sales-volume without regard to the interests of the firm or of the customers.

Conclusion

In my view, there is a lot that the boards and senior management of individual firms can do in ensuring that the corporate culture and incentive system encourage and nurture sound practices and appropriate values. The regulators and supervisors should also do their part to ensure that firms have in place a proper corporate governance framework. Professional and industry bodies should also play a key role in making sure that they promulgate suitable codes of conduct that define the standard of ethics and probity for their members. More importantly, professional and industry bodies should collaborate with supervisors to ensure that there is adequate policing and enforcement of the relevant codes governing ethics and conduct.

Ladies and gentlemen, I would like to conclude my remarks by reiterating the importance of enhancing the power of the 3Cs, “Competence”, “Control” and “Culture”, if Hong Kong wishes to remain competitive as a world-class IFC. It is a difficult challenge, but competition is never easy. It will be a never-ending task as competition never ends. I am confident that if all the stakeholders share the same vision and work together to achieve the common goals, we can certainly make it.

Thank you.