Mr Latter takes a central banker's look at new challenges in a rapidly changing environment

Speech given by Mr Tony Latter, Deputy Chief Executive of the Hong Kong Monetary Authority, at The Asian Treasury Forum 2000, held in Hong Kong on 22-23 February 2000.

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There was a time, many years - or more likely decades - ago, when it seemed that the main role of the company treasurer, if indeed there was any such identifiable position in the company, was to make sure that enough money had been transferred from time deposits to current account before each month's pay day; and it seemed that the main, possibly the only, function of a company's finance director was to make sure that the accounts were compiled, audited and filed on time.

How times have changed. Not only has there been a ceaseless escalation in the range and complexity of financial instruments available to us all, and in the sophistication of accounting, but there has also been an inexorable rise in the expectations which others, such as shareholders or executive boards, have as to what can be delivered from the financial side of a business. As a central banker I feel some empathy with those who find themselves sandwiched between pressure on one side from their masters to achieve ever lower funding costs or ever better returns from financial investments, and persistent enticements on the other side from bankers claiming that you could be freed of all that pressure if you simply subcontracted everything into their capable hands.

Treasury has come to be regarded in many instances as a separate profit centre. The treasurers of some major corporates are nowadays acknowledged as being at least as significant players in the financial markets as are the banks themselves. There are some well-known examples where the profitability of an enterprise in the manufacturing or services sector has been sustained by deft treasury and financial management for considerable periods when the mainstream business has itself been floundering. And there are also examples, alas, where reputable companies have been brought to their knees by flawed financial management. You probably don't have an easy life, but you won't need me to tell you that.

I find myself wondering whether or for how long the financial scene will continue to be one of such rapid change as we have been witnessing in recent years; and what the implications are, for any or all of us here, of recent and prospective developments in financial products and infrastructure.

It is difficult to put a starting date on the financial revolution which I am attempting to describe - I mean the era of sophisticated asset and liability management techniques, of ever more exotic derivative and hedging products, and so on. But I guess it got going during the 1970s. Why not before? It seems that for most of the preceding postwar years banking and finance enjoyed a rather cosy and protected existence around the world. Capital controls and domestic regulation tended to constrain the scope for competition or diversification; many domestic banking sectors were cartelised to a significant degree, or in some cases state controlled; cross-border migration was, for one reason or another, rather rare. All in all, the incentive and scope to innovate were weak by today's standards.

The environment changed quite quickly when national administrations began to deregulate their financial sectors at the micro level and to free up movements of capital at the macro level.

Just as importantly, the electronic data processing revolution began to open up avenues for financial engineering that could never have been dreamt of before. In the dealing rooms of London - then as now the world's leading international financial centre - professional mathematicians moved in alongside, or even displaced, the "barrow boys". Perhaps I should explain that the barrow boy stereotype was a Cockney young man from the east end of London with probably no very accomplished formal education but with strong mental arithmetic and trading skills, acquired from working on market stalls. Such people were until then regarded by many as possessing the best qualifications to become dealers or floor traders in the City of London.

The IT revolution has not of course been a static one. Since the introduction of the first computers into financial product development and trading, computing power has grown exponentially. New vistas and previously unimaginable complexities for trading strategies have thus continually opened up; and the ever-increasing speed of processing and communication has progressively rewritten the definition of "time critical".

The stream of innovation requires us not only to master the mathematics but also to assimilate a whole new vocabulary of jargon - designed, no doubt, to make the underlying mathematics more easily digestible. For example, I received a document from a leading international bank the other day explaining to me that the butterfly involved three tenors where the middle was the bullet and the wing was the barbell; moreover I could long a two-five-ten by being long the two and the ten, each for a PV01 of half the sum for which I should short the five; in so doing I could profit from a bow at five but would be indifferent to any directional move provided it was parallel. Meanwhile, our universities today probably devote more teaching time to gamma trades than to gamma rays; I'm not sure whether we, as citizens of the world at large, should be elated or depressed by this.

But the world of finance is moving forward not only in the realms of such highly complex or sometimes - dare one say - gimmicky instruments. Continuous change and innovation are observable at the more prosaic level too. Looking at Hong Kong alone, over the past year there has been an impressive list of innovations, actual or planned, in the financial sector. These are not necessarily all of specific interest to the corporate treasurer but are nonetheless significant in a more general context.

Thus, first, we have established a reciprocal link with South Korea for access to each other's bond settlement and custody systems (following earlier links of this sort with Australia and New Zealand). Next, Hong Kong has launched the Tracker Fund as a means of disposing of part of the Exchange Fund's Hong Kong dollar equity portfolio; although this bears many characteristics of a conventional index-tracking unit trust, it also has some unique innovative features. In addition, the Hong Kong Mortgage Corporation has successfully introduced its first mortgage-backed securities programme. And notes issued by HKMA and HKMC have been listed on the stock exchange for the first time. Finally, we are preparing a US dollar clearing system which we hope will offer a wider range of facilities than any other offshore clearing; I would not want today to anticipate the more detailed announcements about the planned timetable for this project, which we expect to make shortly.

The foregoing is not necessarily an exhaustive list of changes which are being implemented here. And, assuming that Hong Kong is by no means the only place where new ideas are being developed across the financing spectrum, I am led to the conclusion that there is little prospect of any immediate let-up in the pace of global product innovation in finance.

That is a conclusion reached from merely observing what is at present happening in the financial world, but it does raise questions as to where in all of this lies the scope for extra value added and profit. If one assumes that the overall levels of savings and of investment demand in the economy are little affected by micro developments in the financial sector, then it follows that innovations, in order to be profitable, must be continually exploiting new arbitrage opportunities, new and more efficient ways of serving customers, and so on. One can understand how, over the years, the increased level of competition in finance, both within and between countries, as well as the communications revolution and the IT revolution, have provided the basis for extraordinary gains in efficiency. But will this trend continue? Indeed, can it? Might the financial sector now be encountering sharply diminishing returns from innovation, in which case much of the new effort put into designing new products would prove to be an expensive mistake? Or would it perhaps be more accurate to describe it as an expensive necessity, since, if you don't do it, someone else will? In the intensely competitive environment you can't afford to be left behind, but will, or can, everyone still make profits?

I pose these as questions, but I'm afraid I don't have any conclusive answers. Yet I suspect that we may continue to be pleasantly surprised by the fruits which this ongoing revolution can bear. While it is certainly clear that finance is by and large a hugely competitive business, we observe that many of the participant institutions are enormously successful and profitable. At the same time, however, those of us with responsibilities for regulation, whether for purposes of consumer protection or in order to ensure systemic stability, are surely justified in imposing capital and liquidity requirements designed to make the institutions proof against the sort of setbacks which too intense competition may eventually bring to some.

Of course, the scare story of impending diminishing returns and so on has been told many times before. What, if anything, is new, as we set off into the new millennium? I believe there are two new ingredients, both concerning the internet. They are access and speed. They are of course related.

We can all now enjoy direct access to almost anyone and anything, anywhere, without having to go through intermediaries - other than electronic ones. We are all aware that a degree of caution is required here. For example, the HKMA supervises the banks that are located in Hong Kong, and it is unlawful for anyone to solicit for deposits in Hong Kong without authorisation. But if you click onto the website of someone in a far-off country and are seduced into transferring funds into a deposit with them, we may not be able to help you if things subsequently go wrong. This is a fairly simplistic example and I’m sure that everyone in this audience, at least, would be alert to the risks and would act with the necessary caution. But the proverbial man in the street, who may nowadays have his own internet access, may be more gullible. Moreover, there may be products on offer that are more subtle and beguiling than a straight deposit, and very seductively packaged too; all of us here today are potential victims to some sort of dupe; it is a brave person, or perhaps an arrogant one, who would deny that vulnerability.

A still more significant manifestation of the internet, with potentially sinister consequences, is the speed which it brings to all dealings. Generally we marvel at the instant availability of up-to-date information, and the capability to act upon it, if we so desire, by a return click of the mouse. If the response is simply an e-mail message to a friend or colleague, the scope for loss or damage may be limited, but, even then, how often do we later rue the impulsive riposte? How many times do we go to bed composing the most fantastic letters or office memos, only to wake up the next morning to realise that they were wholly over the top, too effusive or too offensive, tactless, or whatever. The trouble is that nowadays we do not have to wait to respond until we can reach the other person on the phone the next day, or mail him a letter, or hand him an office memo; by the time we awake the next morning it may already be too late to censor our folly; we may have clicked the send button the night before. Worse still, in an increasing number of instances our counterparty will actually expect a response almost immediately. The phrase, “Let’s sleep on it”, wasn’t born for nothing, but now it may not be allowed. If you are executing major financial decisions by a mouse click, the scope for subsequent embarrassment may be substantial, to say the least.

What I find slightly worrying is that the economics of, or business case for, continuing financial innovation and the quest for new efficiencies may depend in large part on successful exploitation of opportunities that can be seized only if you are able and willing to respond with lightning speed. The ultimate manifestation of this is programmed trading, where the computer virtually takes the decision for you. As history bears witness, such strategies are as good, but only as good, as the assumptions that are programmed in, be they about economic forecasts, covariances between various events, or whatever.

But even if we felt that these particular strategies were foolproof, there are a myriad of other financial transactions which can only really be consummated by a conscious human decision. The home buyer faced with a choice between taking a mortgage from bank A or bank B is unlikely to have a sophisticated and reliable mathematical model with which to compare the offers and determine conclusively his choice. But the culture nowadays, bred at least in part by the technological feasibilities of the IT era, is one which is likely to place the home buyer under much greater pressure to reach a quick decision than his parents would have been a generation ago, or even his brother five years ago, for fear of losing the best offer - if only he could assess which was the best. There is less time to reflect; less time to seek out disinterested advice.

There are of course some areas of finance which appear relatively untouched as yet by this revolution. In the realm of corporate finance, in every jurisdiction so far as I am aware, the documents seeking shareholder support for a merger, for example, are still required to be sent by post, and with a reasonable minimum notice period for response. I wonder how long it will be before documents will be deemed to have been delivered to shareholders so long as they were sent by e-mail or posted to the person’s interactive television; and the response period may be compressed on the assumption that you can pick up your mail wherever you are and at any time. All of this may sound fanciful for the moment, but is not impossible at some stage.

What we still need, but may be in danger of losing, is the chance to pause for breath. We need time not only to think things through for ourselves but also to consult others. If, having dispensed with your human stockbroker because you resented paying his level of commission, you buy a company’s shares via the internet at what you think is a bargain price, but in ignorance of the fact that a couple of minutes previously the company issued a profits warning, you have only yourself to blame. But you may have felt forced into dealing in that manner by peer pressure, or for fear of loss of face if some colleague in the office starts boasting about what a killing he has been able to make on such-and-such a “day-trading” deal. If that is indeed a fair characterisation of the atmosphere which many of us nowadays breathe, then I have to say that I find it rather distressing. We ought not to feel embarrassed to confess confusion, to seek advice or indeed to pay for advice.

So, we live in a very challenging and pressurised environment. I am in no doubt in my own mind that the revolution which has swept through finance in the past quarter century has been beneficial to institutions and customers alike. We have, I think, now entered a phase where the basic margins may be narrower, where temptations may be greater and more varied, where the pressures to move quickly may be much stronger, and where of course the risks may therefore be rather greater. We all need to exercise skilful discernment and judgement, and I am sure this is as true for corporate treasurers and finance directors as for the rest of us. But it is not my intention to be a killjoy; as I have suggested, there will continue to be exciting new opportunities to explore; and I wish you all a fruitful couple of days here doing just that.