



National Risk Management to avoid crisis

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Global Financial Crisis

- ◆ **Greater frequency & intensity**
- ◆ **Bank NPLs 15-50% of GDP**
- ◆ **Private debt exceeds GDP and many borrowers cannot grow out of debt**
- ◆ **Global contagion real**
- ◆ **Fiscal & social costs huge**

Source: World Bank [Financial Restructuring in East Asia?](#) 1999



Technology & Globalization bring new risks

- ◆ Improvements in technology/ telecoms result in 24 hour markets
- ◆ Deregulation, tax and regulatory arbitrage mean domestic markets move offshore
- ◆ Innovation cuts intermediation, intensify competition, eliminates franchises
- ◆ Domestic protection is only temporary, as market moves around regulatory obstacles
- ◆ **Derivatives intensify leverage without transparency**



In 21st century, banking will be important, but not necessarily banks

- ◆ Free capital flows mean loss of monetary autonomy & danger of asset bubbles
- ◆ Loss of domestic franchise & competitive pressures threaten banking stability
- ◆ Domestic payment system channel of external shocks
- ◆ Asset funds larger than banks - HLIs and proprietary trading generate herding effects
- ◆ Risk management techniques inadequate



Risks

- ◆ **Credit risks**
- ◆ **Liquidity risks**
- ◆ **Currency risks**
- ◆ **Operational risks - Y2K/disaster recovery**
- ◆ **Systemic risks**
- ◆ **Legal & regulatory risks**
- ◆ **Payment risks**
- ◆ **Political risks**



Risk Management

- ◆ Identify the risk - does left hand know what right hand is doing?
- ◆ Measure the risk
- ◆ Pricing the risk - do interest rates reflect true risks?
- ◆ Hedging the risk - dynamic hedging
- ◆ Stress tests - how much can the system take?



Failure of Risk Management

- ◆ **Maturity mismatch**
- ◆ **Currency mismatch**
- ◆ **Credit risks grossly under-estimated**
- ◆ **Leverage under-reported**
- ◆ **Volatility of asset prices and capital flows grossly under-estimated**
- ◆ **Need for better VAR models**
- ◆ **Need for National Risk Management**



Functions of Financial Markets

- ◆ Provision of information - price discovery and valuation of property rights
- ◆ Allocation of real resources - exchange of property rights & obligations
- ◆ Provision of choice in timing of consumption - saving or consumption
- ◆ Risk Management - enable diversification of risks
- ◆ Role in corporate governance



Financial Markets as Networks

- ◆ Networks have positive and negative externalities
- ◆ Power surges can cause weak hubs to trip fuse
- ◆ Stability and resilience of global network only as good as domestic networks
- ◆ Hence, charity begins at home
 - ✦ Need to build strong fundamentals
 - ✦ Fair, efficient and transparent markets, with sound regulation to international standards
 - ✦ Global competition - no one is immune



HLIs: Vulnerabilities

- ◆ High leverage increases volatility in markets
- ◆ Imposes two types of risks:
 - ✦ **Concentration risk**
 - ✦ **Market monopolistic power**
- ◆ Lack of transparency of operations do not enable counter-parties to appreciate their total credit and market risk exposure, thus putting public-guaranteed bank deposit funds at risk
- ◆ **Elephant in the pond?**problem - HLIs can leverage themselves through derivatives and potentially can collude to manipulate smaller emerging markets



Need for National Risk Management

- ◆ Traditionally risks are managed separately
 - ✦ eg MoF in charge of external foreign debt
 - ✦ Central bank responsible for forex reserves
 - ✦ Need for external debt (including private debt) management policy
- ◆ Separate regulatory jurisdiction does not identify cross market risks
 - ✦ Financial markets are now seamless
 - ✦ But regulations still administered by markets, eg banking, insurance, securities, fund management
- ✦ Sectoral risk concentration can build up without one single agency being aware international crime and market misconduct, e.g. money laundering



Asset Bubbles

- ◆ **Causes - excess liquidity, domestic supply constraints, demographics, bad credit management, distorted tax incentives**
- ◆ **Solution - Tinbergen Rule - Multiple targets require multiple tools - single tool of monetary policy cannot work**
- ◆ **Example - targeting stock market bubble through interest rate policy and securities enforcement against false accounting and reporting**
- ◆ **Need for constant vigilance**



Information & Markets

- ◆ **Markets need real time, reliable information to make correct decisions, especially for risk management in highly volatile environment**
- ◆ **High quality information need: -**
 - ✦ **Good accounting standards,**
 - ✦ **Reliable, timely statistical & reporting processes**
 - ✦ **Capacity to process, analyze and decide on information critical to competitive success**



Transparency & Accountability

- ◆ Gap in Disclosure
- ◆ Gap in Incentives to use information
- ◆ Gap in GAAP
- ◆ Gap in Capacity to understand information
 - ✦ **Urgent need to raise emerging market awareness of risks and full implications of globalization**



Risk Management is therefore Knowledge Management

- ◆ Complexity of Global economy means we must shift risk management to self responsibility to everyone
 - ✱ **Consumer must know risks - buyer beware**
 - ✱ **Investor must have relevant price-sensitive information to assess risks**
- ◆ Must have clear principles, codes, standards, rules and regulations
- ◆ Need to educate: consumer, investor, intermediary and regulator of rights, responsibilities and risks



Alice Rivlin: Globalized domestic markets need

- ◆ **Flexibility and adaptability of businesses, workers and communities**
- ◆ **Willingness of workers to learn new skills, take risks and move to new jobs and places**
- ◆ **Nimbleness, flexibility and risk taking on part of businesses**
- ◆ **Communities to be adaptable, diversify economic bases, attract new jobs and residents**
- ◆ **Governments to be imaginative to design transition assistance for workers and communities to change and adapt**



Council on Foreign Relations Task Force on International Financial Architecture

Guiding Principles

- ◆ **Encourage emerging markets to intensify crisis prevention efforts**
- ◆ **Savings must go to highest returns**
- ◆ **Promote fair burden-sharing between private-public-official creditors in crisis**
- ◆ **Use market-based incentives in crisis resolution**
- ◆ **Reforms two-way between HDC & LDC**
- ◆ **Refocus mandate of IMF & World Bank**

Source: Institute for International Economics



Getting incentive structure right

- ◆ Returns must match
 - ◆ Risks, reflecting
 - ◆ Rules that ensure level playing field
- = Making market work better

Example: Do lending rates in Asia reflect historical credit risks/NPL of 15-50%?

- ◆ Returns on stocks reflect better risks
- ⇒ Must develop deep securities markets



Global Competition is Knowledge Competition

- ◆ Information needs management to become knowledge
- ◆ Knowledge is useless without risk assessment and management
- ◆ Incentives to use information key to success
- ◆ Knowledge management and incentives key to:
 - ❖ good risk management
 - ❖ and Corporate Governance



End of Presentation