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“The Future of Prudential Regulation in Asia & South
East Asia”

Keynote Address by

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Mr Paul Reynolds,
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Distinguished Guests,
Ladies & Gentlemen,

I am very honoured to be invited to address the Adam Smith Institute, an institute that honours the memory of the first philosopher of the free market economy. I was wondering what to say this morning, and I took the liberty to re-read Adam Smith’s *Wealth of Nations*, including the famous passage on the invisible hand. But what struck me as very apt and fitting for this morning, when we are discussing the role of regulation and the public sector is to quote this passage from him:

“What is the species of domestic industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him.”

For those of us who have survived the last two years, it is very dangerous to try and predict the future. All we dare to say is that in the next five years, regulation in this region *should* change significantly, if only to allow our financial markets to align more seamlessly to global markets.

We need to recognize that financial markets are like networks. The global network is currently a network that links together domestic networks that have not been designed to operate on global capital flows.

Like power grids, when large currents flow up and down the network, those weaker links are likely to blow a fuse.

Therefore, to prevent future crisis, we need to raise standards first and foremost at the domestic level. If we wish to be part of global markets, we cannot run away from the following: -

- First, to promote confidence in regional markets there needs to be an improvement in the quality of regulation.
- Secondly, regulation should respond to and facilitate the changes in the way in which financial services are being delivered: particularly via the Internet.
- Thirdly, regulation must be effective to protect investors and to reduce systemic risk and that is a special challenge for regulators when, as is increasingly the case, business crosses jurisdictional boundaries.

The challenge for governments and for regulators will be to ensure that those changes take place.

What are the incentives for change?

Better regulation will reduce costs and bring greater confidence and greater participation in the domestic markets.

Better regulation is the foundation for the international strategic alliances between exchanges and clearing houses that are increasingly recognised as commercially necessary.

I want to focus on four particular topics:

- Implementing international standards
- Regulating services provided through electronic networks
- Re-alignment of the role of the statutory regulator and self regulatory organizations (SROs), particularly exchanges
- Cross border alliances and cross jurisdictional delivery of services

But first, allow me to provide a “snapshot” of the current state of regulation in the region. I will not try to go country by country, but try to provide a realistic image of the essential features:

- *The quality of regulation varies enormously from jurisdiction to jurisdiction.* The regulators themselves are at different stages of development and the legal infrastructure that underpins regulation varies in quality.

- *The present regulatory structure does not cater well for modern ECN-type markets.* At a domestic level, regulation essentially revolves around the “traditional” market structures of a stock exchange and a futures exchange with some degree of shared responsibility between statutory regulators and SROs for the regulation of exchange members and for fair trading on the exchanges.
- *Regulation remains essentially domestic.* There is some degree of co-operation in the form of information sharing agreements between regulators and exchanges but there is no harmonization of standards. For example, there is no harmonisation of standards as to licensing or capital requirements and virtually no recognition of the positive fact that an intermediary is regulated in another jurisdiction.
- *The current fragmented approach does not aid regionalization or global market integration.* It adds to the cost of doing business internationally and may frustrate attempts to form linkages between exchanges and clearing houses.
- *Investors treat all financial markets as one seamless market, but there is insufficient dialogue between many domestic regulators who are still institutionally based rather than functionally based.* This is less of a problem for super regulators like the FSA or MAS, but regulatory gaps can occur. In Hong Kong, there is now a Cross Market Surveillance Committee, comprising the exchanges, the HKMA and SFC, chaired by the Secretary for Financial Services, which looks at risk concentration across markets.

This is not a very rosy picture of regional competitiveness. So what can be done and what is being done to improve the situation?

Well, the first thing that we can do is to get up to international standards, or at least agree what they are.

Implementation of International Standards of Regulation

In recent years, the main groupings of financial regulators have each produced a set of Objectives and Principles of regulation.

- The Basle Committee on Banking Supervision started the process with their Core Principles of Effective Banking Supervision
- The International Organization of Securities Commissions (IOSCO) followed with their Objectives and Principles of Securities Regulation
- The International Association of Insurance Supervisors (IAIS) has their key principles
- The OECD has evolved international principles of Corporate Governance

- The International Accounting Standards Committee (IASC) is finalizing a set of international accounting standards, and the
- IMF has already completed its first Special Data Dissemination Standard, Code of Good Practices on Fiscal Transparency, Code of Good Practices on Transparency in Monetary and Financial Policies.

[You can find the various standards at the Financial Stability Forum website: www.fsforum.org.]

One might say, phase one is complete with an impressive body of agreed standards, objectives and principles.

The challenge of phase two is to see them implemented.

The Financial Stability Forum, recognising the need for some co-ordination in this area, has established a working group to consider the difficult issues that arise and to propose some strategies for addressing those issues. I am honoured to have been asked to chair that working group. We hope to hold the first meeting of the working group here in Hong Kong later this month.

The mandate of the working group is not yet final but in essence it has been asked to look at how these international standards could be implemented to prevent further financial crises. But the key will be ownership by the emerging and developed markets, the incentives to get them accepted and the substantial co-operation and co-ordination efforts to get the countries, the standard setters and the international financial institutions to work together.

It will not be easy but it is necessary.

I am convinced that as a result of this work we will see a raising of regulatory standards. This is because high standards of regulation are the necessary foundation for prosperous markets.

They are important to confidence in domestic and regional markets.

They also underpin strategic market alliances, a matter to which I shall return shortly.

Regulating ECNs and Re-aligning Regulatory Responsibilities

Let me now turn to the challenge of emerging technology on market structure. At present, the regulatory landscape is being reshaped by two related phenomena: the “demutualisation” of exchanges and the growth of alternative trading systems.

The operators of these alternative trading systems may or may not be in direct competition with the demutualising exchanges. Indeed, they may at the same time be members of the demutualising exchange and competing with it for order flow.

The operators of the ECN based trading systems may also wish to provide their services across jurisdictional boundaries.

All of this requires a re-thinking of the way in which the markets are regulated.

Since exchanges are now listed themselves and face competition from other exchanges and ECNs, can we continue to rely upon exchanges as self-regulatory organizations?

Their authority as SROs derives from a contract with their members which, generally speaking, is an inadequate basis for addressing cross-border issues where statute based powers and co-operation is generally necessary.

- Because they are increasingly in competition with their own members, traditional exchanges have an increasing conflict of interest in discharging their role as SRO.
- Because they are demutualising and their relationship to intermediaries is changing, the rationale for their self-regulatory role is less clear.

In fact, demutualisation removes the “self” out of self regulation.

The proliferation of ECNs also raises an issue of regulatory consistency. It is doubtful whether all of these ECNs can be expected to replicate the SRO function.

Any inconsistency in expectations introduces an inconsistency in cost structures and competitive disadvantages for those exchanges expected to maintain a regulatory function.

Right at this moment, Hong Kong is considering these various inter-related issues. We are aware that they are also being considered in several other markets. The models that present themselves are:

- a standalone independent SRO modelled on the US NASD;
- an independent subsidiary of the exchange (which at least addresses the conflict of interest issue); or
- the statutory regulator must resume frontline responsibility for the supervision of intermediaries who provide services on an exchange.

In Hong Kong, we have chosen the third of those approaches. So from early 2000, there will be an effective transfer of responsibility

from the SEHK and HKFE to the SFC for the front line supervision of those who are now called exchange members but who under a demutualised exchange structure will be known as exchange participants.

It is too early to predict the death of the SRO but their roles are everywhere being re-evaluated. In the UK, for example, the home of SROs, the Financial Services Authority has now been given the listing function on top of its role as a super regulator.

Strategic Market Alliances and Cross-Border Activity

I said earlier that the implementation of uniformly high standards of regulation was the key foundation for recognising strategic market alliances and cross border activity. Let me now explain why that is so.

There is no need for me to list the many planned, announced and contemplated alliances between exchanges in this region and elsewhere. Some of them are not progressing as quickly or as smoothly as one would wish, but global and regional alliances are a fact of life.

As the Romance of Three Kingdoms said, "Throughout history, nations join and cleave asunder." Today, markets and networks link or de-link, almost as fast as modern marriages and divorces.

Indeed, I would expect that the focus of those alliances will shift from the trading platforms to the strategically more important clearing and settlement systems.

Perhaps we shall also see some form of "Asian 100" with regional "blue-chip" stocks listed on several regional markets with linked virtual order books.

Certainly, in Hong Kong, we will be building a Web-friendly eFrastructure that will allow scripless trading and straight through processing that will improve our already very good clearing and settlement systems to link seamlessly with other financial centres through strategic alliances.

[You can read the SCEFI Report on eFrastructure on our website:
<http://www.hksfc.org.hk>]

But those strategic alliances depend not only upon a sound economic rationale but also confidence that they will not undermine investor protection or increase systemic risk.

To put it another way, they depend upon satisfaction that the regulation in the jurisdictions involved is of a high standard and there is strong co-operation and good information flows between the regulators.

I am aware of at least one proposed alliance between an exchange in this region and an European exchange that was vetoed because of regulatory concerns over information concerns. There really is no excuse for poor quality regulation getting in the way of market development.

Similarly in the area of intermediaries, we will have to look more carefully at the concept of a “regulatory passport” in which one regulator relies upon the quality of regulation in another jurisdiction to reduce entry barriers and to avoid necessary duplication and regulatory burdens. Even in the European Union there has been difficulty in implementing the Common Services Directive.

It simply does not make sense, when Asian markets are becoming less and less of domestic markets not to have common high standards of regulation. As regulators, it is our responsibility to facilitate regional business without compromising investor protection.

In Hong Kong, we have started down that path in the managed funds area by, in effect, giving regulatory passports to fund managers from jurisdictions that we recognise as well regulated and able freely to share relevant information with us. Fund managers from those recognised jurisdictions are more easily able to obtain our permission to offer collective investments to the public in Hong Kong.

We can all move further to facilitate regional business and we are willing to work very closely with our fellow regulators to upgrade the quality of regulation to our common benefit.

Conclusion

I started this morning by saying that global financial markets are like a network of domestic networks. Networks have both positive and negative externalities. We can enjoy the fruits of foreign capital inflows, but some of us may not like the outflows, but they are a fact of life.

For the regional capital markets to grow, we must work together to build a regional network with standards that conform to the best internationally.

Asia has always been proud to have world class manufacturing and world class exports. However, we cannot build world class economies without world class services and world class regulations. Together we can do this, or we will be doomed to pockets of small fragmented markets that may succumb to global shocks whether we like it or not.

Thank you very much.

Securities and Futures Commission,

7 November, 1999

Financial Stability Forum

Task Force on Implementation of Global Standards

Proposed Terms of Reference

1. The task force should explore issues related to promoting the implementation of international standards relevant to strengthening financial systems.
2. The task force should consider a strategy for implementation of standards that may include:
 - countries announcing their commitment to implement standards and participate in credible assessments of compliance;
 - technical assistance in support of implementation efforts being prioritised;
 - relevant information on progress toward compliance of standards being made available; and,
 - compliance with sound practices being rewarded by market participants and others, thereby reinforcing further efforts at implementation.
3. In support of such a strategy, and taking account of country circumstances, the task force should:
 - identify the set of international standards most relevant to strengthening financial systems and ways of disseminating these standards (e.g. through the Compendium of Standards);
 - explore strategies for assisting countries in the practical implementation of standards;
 - explore official and market *incentives* that could encourage the process of implementation;¹

¹ Such incentives might include, *inter alia*, making access to certain types of official sources of financing conditional on compliance (as in the case of the CCL), preferential risk weights in capital adequacy frameworks, easier approval for expanded activities by financial institutions in key financial centres, more generous offers of technical assistance to enhance the capacity of countries to implement sound practices.

- outline options for generating credible *self-assessments and independent assessments* and for ensuring complementarity between the two;
 - consider how, what kind of, and to whom, information on progress toward compliance with standards could be made available;
 - consider how the *resources* required to support implementation and assessment of standards could best be mobilised.
4. The task force should consider how the various elements of the implementation strategy could best reinforce each other, and what the roles and responsibilities of various bodies in implementing it should be.
 5. In all of the above, the task force should draw upon the work already done by the IMF, World Bank, standard-setting bodies, and others with respect to encouraging implementation of sound practices.