Breakfast

"Striking a Balance"
Innovation versus Regulation

Many blame the global crisis on a failure to adequately regulate a raft of innovative, complex financial instruments. A breakfast discussion on 21 January at the Asian Financial Forum 2010 in Hong Kong wrestled with how to strike a balance between financial innovation that creates new products and regulation to protect investors.

## Hot Topic

Au King-chi, the Hong Kong SAR Government's Permanent Secretary for Financial Services and the Treasury (Financial Services), described the subject as "one of the most hotly debated topics arising from the financial tsunami."

"Some said that global standards of regulation failed to keep up with financial globalisation and innovation, whereas some others believe that ample liquidity and low interest rates were indeed the major culprits, with financial innovation amplifying and accelerating the consequences," Miss Au said.

"A review in the UK specifically identifies 'financial innovation of little social value' as one of the underlying causes of the crisis," she said. "At the same time, many would still recognise the role of financial innovation in promoting growth, efficiency and market development."

In Hong Kong, for example, financial innovation had helped attract a critical mass of financial products and services, market players and liquidity.

"But innovation should not be given free rein," she warned. "The challenge for public policy-makers and market regulators is to strike a reasonable balance between these considerations in the interest of the public."

## Vigilance Needed

Eddy Fong, Chairman of Hong Kong's Securities and Futures Commission, said Hong Kong had learned from the Asian financial crisis in 1998 and, fortunately, no local banks required rescuing during the past year.

There had been, however, the issue of investors losing money on the Lehman Brothers mini-bonds, so the Securities and Futures Commission was drafting a position paper on how to better protect retail investors and was looking into measures such as better disclosure of product risks and the possibility of a cooling-off period.

The commission was also working closely with the Hong Kong government on an investor education council, he said.

"Crisis can never be eliminated. It will come from time to time," Dr Fong said. "So we need to be on guard all the time." All we can hope for, he added, is that the impact of the next crisis will be less severe.

"Regulation is no substitute for discipline," he concluded. "We need all the stakeholders in the marketplace to work together – the investors, the market participants who are preparing the products and, of course, the regulators should also play a part. This is a three-legged stool."

**Safer Houses**

Emil Paulis, the European Commission's Director of Financial Services Policy and Financial Markets, reminded his listeners that financial innovation helped the economy as new financial products helped raise money for everything from capital infrastructure to student loans.

Now, however, it was being blamed for the credit crisis. "Trust has been badly damaged in this crisis," he said, adding that it was essential to restore this trust in financial markets.

As a result, Mr Paulis said, "we need a more mature look at innovation in the financial sector."

"Innovation should not threaten financial stability – first premise. Second premise: Innovation should not undermine investor protection."

Asked about the danger of overregulation, Mr Paulis likened the crisis to an earthquake. Investors would prefer to live in safer houses than risk having their homes collapse on them, he said, calling for "proportionate and intelligent regulation."

**The Mainland Experience**

Qi Bin, Director-General of the Research Centre of the China Securities Regulatory Commission, said China's capital market had made rapid strides in the past 20 years, but there were still a lot of problems, such as an underdeveloped bond market.

He said there was a need to improve the market's structure and efficiency, the IPO process, mergers and acquisitions activity and the debt market.

If financial reform momentum could be maintained, he said, "there's a good chance that China's economic growth will be sustainable and that the China market will be a world-class market."

Asked about innovation versus regulation, Mr Qi said, "We really need to seek a fine balance between these two. In the crisis period, there might be a tendency of overregulating, and I think we should wait for a while to reach this balance. But in China, we are in the period of further liberalising the market."

On the question of investor protection, he said, "I think both the regulator and the investor should do their due parts."