THE FUTURE STRUCTURE OF FINANCIAL REGULATION IN HONG KONG

Introduction

1. At the meeting of the Legco Financial Affairs Panel on 5 January at which I presented my review of the Hong Kong Monetary Authority's (HKMA) work on banking stability, I was asked to prepare a paper on the financial regulatory regime in Hong Kong, with particular reference to whether Hong Kong should move to a more integrated system of regulation, and if so, what form this should take.

2. In conducting this study I have taken account of the extensive literature on this subject (including the recent report of the Group of Thirty (G30) on "The Structure of Financial Supervision" as well as my own experience with the HKMA and subsequently as the head of a single financial regulator in Jersey). This paper represents my personal views.

The current regulatory structure in Hong Kong

3. Hong Kong's current approach to regulation can be characterised as ***institutional*** with ***functional*** aspects. This means that the firm's legal status (bank, broker or insurance company) determines which regulator is responsible for supervising its activities from both a prudential and conduct of business perspective. However, this has been modified in Hong Kong to allow for the fact that banks are conducting a broader range of financial services business. In particular, responsibility for supervising the banks' securities business is shared between the HKMA and the Securities and Futures Commission (SFC).

4. It should be noted that Hong Kong is by no means alone in continuing to maintain a system of multiple regulators. According to a 2006 IMF Working Paper, over 40% of the countries surveyed had multiple sectoral supervisors (at least one each for banks, securities firms and insurance companies). Moreover, all the relevant studies are unanimous in pointing out that, while the regulatory architecture is important, there is no universal ideal model; and making changes to the existing legacy systems is not something that should be undertaken lightly.

The trend towards greater integration of regulatory structures

5. Having said that, there is undeniably a general trend towards greater ***integration*** of regulatory structures. In some cases this has been taken to its logical conclusion of moving to a ***unified*** regulator with responsibilities for all the main types of financial institution and covering regulation of both prudential (safety and soundness) issues and conduct of business (consumer protection).

6. The trend towards integration has been encouraged by the blurring of financial boundaries which has removed the clear distinction between the type of institution and the kind of business that they undertake. Most notably, banks are undertaking both banking and insurance-related business either within themselves or in separate subsidiaries and affiliates. The latter has led to the growth of financial conglomerates which in some countries has been a principal driving force behind regulatory integration.

7. In these circumstances, the integrated approach should in theory be able to deliver a more consistent and harmonised approach towards the regulation of the various types of financial business and products across financial institutions, while allowing for appropriate differentiation (e.g. in capital requirements). In the case of financial conglomerates, having one regulator in charge should deliver a better oversight of all the different types of risk being incurred within the group. All this should improve the ***effectiveness*** of regulation.

8. A further advantage is that integration should help to achieve economies of scale, particularly in areas such as support services, statistical reporting and information technology, and other cost-savings from the elimination of duplication among separate regulators. An integrated regulator should also find it easier to redeploy supervisory resources within the organisation to cope with changes in market circumstances and areas of emerging risk. This should improve the ***efficiency*** of regulation.

9. Finally, an integrated regulator should deliver greater clarity of responsibility for the various aspects of regulation. The regulatory burden for firms should be reduced if they no longer have to deal with multiple regulators and the public would have one point of contact to approach if something goes wrong (as in the Lehman minibonds case). If something does go wrong, it would be more apparent which regulator was at fault (if that was the case). This should improve the ***accountability*** of regulation.

The two main models of integrated regulatory structures

The unified regulator

10. As noted above, there are many variants of the integrated approach, and none of these has been demonstrated to be clearly optimal in all circumstances. However, two models are worthy of particular attention. The first of these is the ***unified*** regulator which combines prudential and conduct of business regulation within the same agency. This has come to be associated particularly with the UK Financial Services Authority (FSA) which was established in 1997. But in fact this was preceded by the Monetary Authority of Singapore (MAS) and various Scandinavian agencies. The FSA model has since been followed by other jurisdictions in the Asian region, including South Korea, Japan and Taiwan.

11. The FSA model raises two particular issues. The first is that in the UK the FSA is a wholly separate body from the central bank (the Bank of England). The justification for this is to prevent conflicts of interest that might otherwise arise (e.g. the central bank might pursue an unduly lax monetary policy in order to bail out the banking system if it was also the banking supervisor). There is also the view that a central bank which was also regulator for the whole of the financial system would be too powerful (a point that is addressed below in the Hong Kong context). The MAS is an example of a unified regulator which is also a monetary authority/central bank, but generally the trend in most jurisdictions has been to keep the two functions separate. It is universally recognised however that there is a need for close cooperation and coordination between the central bank and the regulator, particularly at times of crisis. But the cooperative arrangements between the Bank of England and the FSA are considered to have performed poorly during the run on Northern Rock, which raises

the question of whether separation of the two bodies in the UK was such a good idea after all.

12. The other issue raised by the FSA model is whether it is right to combine prudential and conduct of business regulation. The FSA believes that it is, citing the fact that there is considerable overlap – both conceptually and in practice – between the two types of regulation, e.g. in terms of the fitness and propriety of senior management and the quality of internal systems and controls. It is also argued that prudential regulators have a strong interest in the way in which a financial institution conducts its business since wrongdoing in this context could damage confidence in the institution and lead to its downfall.

13. Others however argue that the two types of regulation are in conflict, in terms of both regulatory objectives and regulatory style and culture. The remedial "doctor" approach of the prudential regulator is often contrasted with the enforcement-led "policeman" approach of the conduct of business regulator. If the two functions are combined within the same agency this can lead to internal conflicts and possible misallocation of resources. For example, the FSA has admitted that it devoted too much attention to consumer protection issues ahead of the Northern Rock crisis and has announced its intention to place more emphasis on prudential regulation.

The Twin Peaks model

14. This potential for conflict of interest underlies the preference of some countries for the so-called ***Twin Peaks*** approach which allocates responsibility for prudential regulation and conduct of business regulation to two separate agencies. This is an example of regulation by objectives: prudential regulation being designed to promote the safety and soundness of individual financial institutions (and deriving from that, the stability of the financial system as a whole), while conduct of business regulation is directed at consumer protection.

15. So far only two countries have adopted fully-fledged variants of the Twin Peaks approach, albeit with some differences between them. These are Australia, where prudential regulation is in the hands of the Australian Prudential Regulation Authority

(APRA) while conduct of business is regulated by the Australian Securities and Investments Commission (ASIC), and the Netherlands. In the latter case, the central bank, De Nederlandsche Bank (DNB), has retained responsibility for prudential regulation of all financial services, while the Authority for the Financial Markets (AFM) is responsible for conduct of business regulation in the Dutch financial markets. The Dutch model seems to have been influenced by the predominance of financial conglomerates in the Netherlands.

16. Interest in the Twin Peaks model has recently been heightened by the 2008 US Treasury “Blueprint for a Modernised Financial Regulatory Structure” which presents a long-term optimal regulatory structure based on a separation between prudential and conduct of business regulation. The Twin Peaks model also appears to be favoured by the G30 report mentioned above, which is significant since the report was issued in the name of Paul Volcker who is a financial adviser to President Obama. France and Spain are also reported to be considering adoption of a Twin Peaks model.

17. While it may represent a growing trend the Twin Peaks model is not without its own problems. In particular, the respective responsibilities of the two regulators would need to be carefully defined to avoid overlap and duplication (this seems to have been an issue with the Australian system). Moreover, separation of prudential and conduct of business regulation does not eliminate the possibility of conflict between them, e.g. if the conduct of business regulator wished to take action against a firm or group of firms for misselling which, in the judgement of the prudential regulator, might threaten their financial viability. Hopefully, consultation between the two bodies would lead to an acceptable compromise. But if not, some external means would need to be found to reconcile tensions, e.g. through adjudication by a co-ordination committee chaired by the Financial Secretary.

The choice of regulatory model for Hong Kong

The unified model

18. Such issues illustrate that the choice of the appropriate model for Hong Kong is not an easy one. This emphasises that any move to a more integrated regulatory structure

should not be rushed into, and certainly not as a knee-jerk reaction to the Lehman minibonds affair. This view recognises that substantial change in the regulatory structure involves risks (including distraction of the regulatory bodies from their ongoing tasks and loss of key personnel) and significant transition costs. It should therefore only be undertaken after detailed study of the need for change and careful consideration of the various options. (The Australian system was introduced following the Financial System Inquiry conducted by the Wallis Committee.)

19. That being said, the trend in financial market development has moved away from Hong Kong's current institutional approach. While the Hong Kong market continues to be dominated by the banks, the scope of business of the banks has increased and this has created some tensions in the existing regulatory structure. The process of blurring of financial boundaries may be slowed down by the current global financial crisis, but it is likely to re-assert itself at some stage in the future. This provides a breathing space within which Hong Kong can consider long-term changes to its regulatory structure.

20. In considering what form these changes should take, the most obvious option would be to adopt the ***unified model***, which in theory at least would maximise the advantages of greater integration cited above (in terms of effectiveness, efficiency and accountability). It would address industry's concerns about having to deal with multiple regulators and satisfy the need for regulatory neutrality. It has the advantage that a number of other jurisdictions in the Asian region (such as Singapore) have already gone down this route so there would be a ready supply of models to study and, where appropriate, to copy.

21. The downside is that the transitional costs and risks of welding together all the current regulatory bodies would be relatively high and it might be unwieldy to manage a unified regulator on an on-going basis. Having only one regulatory body also runs the danger of having "one point of failure", i.e. one agency is being relied upon to get things right with potentially drastic consequences if something goes wrong.

22. Related to this is the possible perception that a unified regulator might be excessively powerful in the Hong Kong context. These fears might be augmented if the unified

regulator continued to exercise the monetary functions of the HKMA. There is a further concern that having the regulator linked to the monetary authority and the lender of last resort may encourage moral hazard if this prompts the perception that the official safety net has been extended to non-bank financial institutions.

23. However, recent experience during the financial crisis suggests that it may not make sense to separate the responsibilities for monetary stability and lender of last resort from the responsibility for the safety and soundness of individual banks. This may be a particularly strong argument for Hong Kong where monetary stability and banking stability are closely linked through the currency board system.

24. That being so, the question is whether a body such as the MAS would be acceptable in the Hong Kong context. If the answer to this is no, a possible compromise would be to adopt the approach of Ireland which has set up a Central Bank and Financial Services Authority (CBFSA). The Financial Services Regulatory Authority is an autonomous body within the CBFSA but shares premises and systems with the Central Bank. This is designed to provide separation between the two bodies while maximising their ability to cooperate and coordinate (e.g. the memorandum of understanding between the two provides that the Central Bank will have free and open access to the records of the Financial Regulator on matters relating to financial stability).

25. In summary, it is recommended that whatever form of integrated regulator is adopted, the monetary stability function should be part of it, or at least closely linked to it. In this respect, the UK FSA model should ***not*** be followed.

The two agencies model

26. If the disadvantages of the unified model are considered to outweigh the benefits, an alternative form of integration would be to adopt a ***two agencies*** approach centred around the HKMA and the SFC. This would mean dividing between these two bodies the responsibilities of the Insurance Authority and the Mandatory Provident Fund Authority. (This is not to say that the latter two bodies are doing a bad job, but the

issue under consideration is how the current regulatory structure could be consolidated.)

27. There are various ways in which this could be done. One possibility would be to adopt a Twin Peaks approach. There are a number of possible variants of this, but one would be for the HKMA to be responsible for monetary policy, overall financial stability of the system and prudential supervision of financial institutions. The SFC would be responsible for the regulation of conduct of business across all financial institutions and regulation of the securities and futures markets.

28. The key issues in this structure would be how the dividing line between the two regulators would be fixed and the arrangements for cooperation and dispute resolution between them. In particular, it would need to be decided:

- Which financial institutions would fall under the supervision of the HKMA? In the Australian system, APRA is responsible for the prudential regulation of banks, other deposit-taking institutions and most of the superannuation industry. However, all aspects of securities regulation, including the prudential supervision of market intermediaries, rest with ASIC. This is presumably on the basis that it would not make sense to separate regulation of the intermediaries from that of the securities markets in which they operate. A similar approach could be adopted for Hong Kong, leaving the HKMA responsible for the prudential regulation of banks, other deposit-takers, insurance companies and MPF trustees. However, this begs the question of whether there would indeed be synergistic benefits in bringing the prudential regulation of these disparate financial institutions under one roof.

- How far should the conduct of business regulation of the SFC extend? Should it be confined only to securities and futures-related activities or to all aspects of the relationship between banks and their customers?

- To what extent should the respective regulators rely on one another in the exercise of their functions, and to what extent would there be duplication between the two regulators? For example, in carrying out its conduct of business regulation, should the SFC be prepared to accept the HKMA's view of the adequacy of an institution's corporate governance, financial resources and the fitness and propriety of its management? To what extent would the HKMA feel obliged to conduct its own oversight of an institution's wealth management business to ensure that this did not pose a threat to the institution's safety and soundness?

29. This list is not exhaustive but it serves to illustrate that the Twin Peaks approach would present some of the same problems of regulatory overlap and jurisdiction that exist under the current system.

30. A simpler approach to deal with these issues might be to recognise that banks occupy a special and dominant place in the Hong Kong banking system, and that it would therefore make sense to place all aspects of their regulation (prudential and conduct of business) under one regulator, i.e. the HKMA, in addition to its responsibilities for monetary and financial stability. The SFC (renamed as something like the "Financial Services Commission") would have responsibility for all other aspects of regulation of financial institutions and markets. But this would not extend to regulation of the conduct of business of banks and other deposit-takers, which would rest with the HKMA.

31. This would strengthen accountability and clarify responsibility, i.e. the HKMA would be unambiguously accountable for anything that went wrong with banks. However, it would raise the question of how to harmonise, and achieve consistent application of, the standards for the same type of business conducted by banks and other financial institutions.

32. A final point to note is that however the regulatory structure is integrated, it would not remove the need to consider the introduction of a financial services ombudsman for Hong Kong to fulfil the role of dispute resolution between financial institutions and their customers.

Legislative implications

33. The necessary legislative changes to implement the various options discussed above would need detailed consideration, but a few initial points can be made. If a unified regulator is to be established, there would be a need for an Ordinance to set up the new body and to define its constitution, powers and functions, e.g. a Monetary and Financial Services Authority Ordinance. The various existing Ordinances (e.g. Exchange Fund Ordinance, Banking Ordinance, Securities and Futures Ordinance etc) could be retained, but it would be necessary to amend these to transfer responsibility for the exercise of the powers and functions contained within them to the new unified regulator.

34. Under the two agencies approach there would also need to be a transfer and division of the responsibilities contained in the Insurance Companies Ordinance and the Mandatory Provident Fund Schemes Ordinance. However, the opportunity might also be taken to introduce a Hong Kong Monetary Authority Ordinance, which would establish the HKMA as a corporate body and define its constitution.

Summary and recommendations

35. The general trend is for regulatory systems to become more integrated and Hong Kong may wish to consider whether to follow suit.

36. However, a change in the regulatory structure is a major decision which should not be rushed into. Despite the Lehman minibonds affair, there is no immediate need for radical change, which should be entered into only after detailed study.

37. There is no perfect model of an integrated regulator. All the various options have their pros and cons, the balance between which can only be determined by the particular circumstances of each jurisdiction.

38. This paper has considered two options. The most obvious choice is to take integration to its logical conclusion by opting for a single unified regulator. There are a number of examples of this in the Asian Region, and in theory at least it seems to offer the

best chance of achieving consistency of regulatory approach, economies of scale and clear accountability.

39. The risk however is that a unified regulator could be viewed as being excessively powerful in the Hong Kong context, particularly if it was allied with the monetary stability role of the HKMA. If so, the next best choice would be a two agency approach centred around the HKMA (which should be turned into a corporate body) and the SFC. However, this runs the risk of leaving in place some of the jurisdictional and regulatory neutrality issues which exist in the present structure.

40. Finally, it is recommended that whatever option is chosen, the responsibilities for monetary stability under the currency board system and for banking stability should remain closely aligned.

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