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SFC

China Enterprises Economic Research Study Centre

Global Financial Crisis

-- Implications on future reform and regulatory approach

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1. Restore confidence in financial system

- Protect bank deposits
- Guarantee interbank lending
- Inject liquidity to banking system
- Segregate non-performing loans
- Increase bank’s capital adequacy ratio

2. Stimulate local economies

- Boost public sector expenditure
- Encourage domestic spending
- Reduce interest and tax rates
- Increase export incentives
- Government’s special grant/loan to SMEs

Effect on Hong Kong economy

- **Hong Kong has strengthened the risk management of its financial system after the Asian financial crisis in 1998**
- **Hong Kong's financial market is not exposed to significant systemic risk in the current financial tsunami**
  - The HKD has remained stable all along
  - The banking system remains stable with no bank failure
  - Financial intermediaries are financially sound with their trading activities remaining stable
  - Hong Kong's securities market still operates in an effective and orderly manner
  - There are no excessively concentrated positions in the futures and options markets
  - Short-selling activities remain at levels consistent with those prior to the current financial turmoil
- **Confidence in real economy however has weakened**

Implications on the Mainland

- **China has several favourable factors to help it withstand the global financial crisis**
  - Impact of subprime fallout on China is limited given that the direct exposure is manageable.
  - Foreign exchange reserves of US$2 trillion and fiscal surplus
  - Total foreign borrowing is manageable, negligible risk of sudden unwinding of foreign debt to disrupt domestic investment
  - Prudent level of leverage
    - Government's domestic debt is 15 per cent of GDP, down from 20 per cent at the beginning of the decade
    - Household savings are 75 per cent of GDP, and mortgage loans amount to only 35 per cent of the value of home sales during the past seven years
  - Most importantly, its banking system is functioning and credit continues to grow. In the first quarter of 2009, lending increased significantly.

Impact of global financial tsunami on major markets

Performance of major markets in 2008/09

		31/12/08 Index Level	2008 Full-Year Change (in domestic currency)	8/5/09 Index Level	Change from end of 2008 (in domestic currency)	8/5/09 P/E Ratio
HK	- HSI	14,387.48	-48.3%	17,389.87	20.9%	14.49
	- HSCEI	7,891.80	-51.1%	10,051.90	27.4 %	15.88
Mainland China	- Shanghai SSE Composite Index	1,820.81	-65.4%	2,625.65	44.2 %	22.42
	- Shenzhen SSE Composite Index	553.30	-61.8%	879.93	59.0 %	32.76
Singapore	- STI	1,761.56	-49.2%	2,238.21	27.1 %	11.80
Japan	- Nikkei	8,859.56	-42.1%	9,432.83	6.5 %	37.77
US	- Dow Jones	8,776.39	-33.8%	8,574.65	-2.3 %	17.98
	- NASDAQ	1,577.03	-40.5%	1,739.00	10.3 %	26.33
	- S&P 500	903.25	-38.5%	929.23	2.9 %	15.11
UK	- FTSE 100	4,434.17	-31.3%	4,462.09	0.6 %	9.80
Australia	- AOI	3,659.30	-43.0%	3,919.60	7.1 %	26.56

Sources: Bloomberg and websites of relevant exchanges

International response to crisis (G20)

- In November 2008, the Group of Twenty (G-20) held the Summit on Financial Markets and the World Economy in Washington and approved the Washington Declaration which aims at tackling the current financial crisis
- G20 members: eight major industrial nations comprising the G8, China, Argentina, Australia, Brazil, India, Indonesia, Mexico, Saudi Arabia, South Africa, South Korea, Turkey and the Czech Republic
- Four working groups have been established to fortify financial markets and enhance regulation
- In April this year, the G20 met in London to examine the implementation of the relevant principles and action plan and the Leaders pledged to do whatever is necessary to:
  - restore confidence, growth, and jobs;
  - repair the financial system to restore lending;
  - strengthen financial regulation to rebuild trust;
  - fund and reform international financial institutions to overcome this crisis and prevent future ones;
  - promote global trade and investment and reject protectionism, to underpin prosperity; and
  - build an inclusive, green, and sustainable recovery.
- The next G20 Finance Ministers and Central Bank Governors Meeting will be held in Scotland in November this year

Repair banks to restore lending, growth and markets

- **Given that the crisis stemmed from the banking sector, reforms have been focused on the banking system**
- **Business model likely to revert to "basics"**
  - Banks should return to the traditional business approach
  - Commercial banking and investment banking should be separated
  - The primary business of commercial banks is to support commercial activities
  - Investment banks are mainly responsible for buttressing the development of capital markets
- **Recovery of the real economy hinges on the restoration of stability in the banking system**
- **Recovery of the securities and real estate markets hinges on the recovery of the real economy**

Regulation and oversight of all systemically important financial institutions, markets and instruments including hedge funds

- **Monitor**

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Implement FSF Principles on Pay and Compensation

- **Significant financial institutions to implement FSF Principles by 2009 to ensure compensation structures are consistent with firms' long term goals and prudent risk taking.**
  - Boards to design, operate and evaluate compensation schemes
  -

Financial regulatory framework – Four main approaches

- **The <u>Institutional</u> Approach**
  - A firm's legal status (for example, a bank, broker dealer, or insurance company) determines which regulator oversees its activities from both a safety and soundness and a business conduct perspective
  - USA, PRC and HK
- **The <u>Functional</u> Approach**
  - Supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of business has its own functional regulator
  - France, Italy and Spain
- **The <u>Integrated</u> Approach**
  - A single universal regulator conducts for all sectors of financial services business
    - safety and soundness oversight and
    - conduct-of-business regulation
  - The UK and Germany
- **The <u>Twin Peaks</u> Approach**
  - Separation of regulatory functions between regulators: one performs the safety and soundness supervision function and the other focuses on conduct-of-business regulation
  - Australia and the Netherlands

Conclusion – lessons from the financial turmoil

- **It is imperative to strengthen inte**

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Regulation cannot guarantee zero failure

We need :

- **Self discipline by institutions**
- **Market discipline by investors**
- **Regulatory discipline by government/agencies**

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Thank You