Trust issues

Norman Chan says while a sound regulatory regime is important, the best safeguard against yet another financial meltdown is for bankers themselves to choose to behave ethically

I was really encouraged by the implicit acceptance, in putting the thorny subject of ethical behaviour on the agenda of a banker's summit, that it is primarily for the banking industry to seek to regain the moral and ethical high ground it once enjoyed. This is not something which can, or should, be regarded as a "policing" or "enforcement" matter for the regulator. Getting caught out, taking the fine as a "cost of doing business" and moving on with making money is just not acceptable as a sustainable banking business model.

I do not subscribe to the view that banks' primary role is to generate maximum shareholder value, leaving the regulator to worry about the safety of deposits and the interests of the banks' customers. Having a licence or franchise to take deposits, which represent the hard-earned savings of millions of people, and use these funds for private gain is a privilege conferred by society on a bank, which merits exemplary professional and ethical behaviour.

The theme of the summit is "Regaining the moral and ethical high ground". What do we really mean here? I think, in a word: trust. With trust, comes respect.

In the past, banking was regarded as a reputable profession and bankers were highly trusted and respected. They no longer enjoy the same high degree of trust and respect from society, especially after the global financial crisis. What has changed so dramatically?

Well, the modality and governance structure of banking have changed a great deal over the last century. More importantly, these changes have created an incentive system that leads to a misalignment and disconnect between the interests of the owners of banks (that is, the shareholders), bank management and customers.

Not so very long ago, banking was a business conducted by individuals, families and (more latterly) private partnerships, where the owners and managers had ample "skin in the game". They stood to lose not only their investments but also their family wealth should their actions, or the actions of their partners, result in failure of their bank. This naturally served to temper the degree of exuberant risk-taking. This "alignment of interest" between bank owners or managers and customers and creditors clearly helped promote trust.

That said, many commercial banks have been structured as public joint stock banks with limited liability since the 19th century. So if limited liability has existed for 200 years, what else has been at work to create the problems which surfaced in the global financial crisis?

First, bank employees' time horizons have shifted. In the past, employees tended to be much more "stable" in the sense of their ties to a given employer. Nowadays, it is much more common for employees to hop from institution to institution to secure promotion or higher pay. In these circumstances, employees naturally identify less with the employing institution. They work at banks, not for banks. This is a

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two-way street, in the sense that banks, in their turn, can be very adept at severe downsizing if market conditions turn.

Business profiles and activities have also changed over time. Simple deposit-taking and lending businesses have been combined with investment banking, securities and capital markets, and even proprietary-trading activities, to form large, complex organisations, raising clear issues of cultural compatibility across businesses with very different objectives, time horizons and employee profiles. In an environment where near-term profits are highly prized and rewarded, it is all too easy to see how the more aggressive approaches introduced into the mix might prevail in shifting a culture from a client focus to one overly defined by financial performance.

Banks have also expanded from serving more limited numbers of wealthy customers to covering the mass market. Where once the local bank manager might have expected to know a significant number of his customers personally, now customer numbers are so large as to render relationship banking all but impossible. The result? Personal bonds are much weaker or indeed no longer created.

And what about their shareholders? The owners, now in the form of hundreds of thousands of shareholders, have only limited "skin in the game". Their personal or family wealth, outside of their bank shares, is not at stake if the bank fails. So their perspectives can now be much shorter term.

This mindset is more pronounced among some asset managers and hedge funds. As these asset managers are rewarded on the basis of the annual valuation of their funds' holdings, including bank shares, they have every incentive to push the banks to achieve higher profitability. So board directors and senior management were, and still are, under constant pressure to pursue higher return on equity. The result? Banks have no choice but to leverage up and take bigger risks.

So where do we go from here? While regulators clearly play an important role in influencing banking operations, it is really up to the industry to decide what it can and should do to regain the trust and respect that banks once enjoyed.

It is against this backdrop that the international community has sought to overhaul banking standards in the aftermath of the global financial crisis. While some bankers may think these reform measures represent a degree of overkill, the public sector firmly believes the current regime – in which bankers pocket huge bonuses in good times (or even in bad times) and the public sector, for fear of a systemic failure, comes to the rescue of troubled banks with a bailout using public funds – must not be allowed to continue.

So the choice is obvious. New regulations dealing with capital buffers, liquidity management, leverage, bankers' compensation, ring-fencing of deposit-taking business from riskier operations and so on have been introduced.

However, regulators and regulatory measures alone cannot possibly redress all of the problems. There is no substitute for internal governance and controls that are designed to achieve the desired behavioural change across the entire firm. In this context, it is crucial that we have buy-in from the owners, directors and management of the banks.

Banks need to promote the appropriate culture, values and practices across the firm, which are to put the safety of the bank and the interest of depositors and customers ahead of the banks' own commercial interests, just as bankers did in the past. Only when this happens will bank managers and employees change their mindset from "what can we get away with" to "what is the right thing to do". Only when this happens can the industry regain the trust and respect that bankers used to enjoy.

Norman Chan is chief executive of the Monetary Authority. This is an edited version of a speech he gave yesterday at the Asian Banker Summit in Hong Kong

Green growth

Gavin Edwards and **Shirley Poon** envision what the public funds pledged for a third runway could instead do for our environment

Hong Kong Transport and Housing Secretary Anthony Cheung Bing-leung recently joined hands with the Airport Authority to announce the construction of a new third runway at the airport, financed by user fees of HK$180 per person plus money raised through bank loans and bonds. A closer look at the funding arrangements also reveals a HK$50 billion subsidy to the Airport Authority, to contribute to the HK$141.5 billion construction fee.

Our government is the sole shareholder of the Airport Authority and, last year, it received HK$5.3 billion in dividends. This is a lucrative source of income. But it has just agreed to waive the dividends for the next decade to fund the runway construction; the equivalent of a HK$50 billion giveaway to the Airport Authority.

In his budget speech in February, Financial Secretary John Tsang Chun-wah announced few measures to protect the natural environment, on the grounds that there is no substantial new money available for conservation and sustainability initiatives.

Here are three examples of what HK$50 billion could do for the sustainability of our city. First, advance biodiversity conservation. The government is formulating a Biodiversity Strategy and Action Plan to comply with requirements in the Convention on Biological Diversity. Will the government launch a campaign to promote biodiversity conservation, and ensure that all its bureaus and departments take account of the message in their decision-making?

Second, wetland conservation. The Mai Po Nature Reserve and the wider Inner Deep Bay area is a unique natural treasure belonging to the Hong Kong people, and efforts to conserve this area are recognised worldwide. Today, the bulk of the costs for wetland conservation are borne by non-governmental organisations. Conservation work in the Mai Po marshes, for example, costs over HK$8 million per year, yet the government contributes only 21 per cent of that cost. Perhaps Tsang could do more to protect this deserving natural treasure?

Third is climate change. It is our responsibility to build a living environment for the next generation. Tackling climate change needs to be high on the government's agenda, now and in the future.

Premier Li Keqiang (李克強) recently announced a series of plans focusing on improving the environment on the mainland. These include the promotion of renewable energy and clean energy vehicles, and the introduction of a "green tax" on polluters. Beijing plans to spend a sizeable 29.1 billion yuan (HK$37 billion) on energy conservation and environment protection this year. If we were to include its investments to improve the electricity grid, this figure approaches 500 billion yuan.

By contrast, here in Hong Kong, the Environment Bureau has set aside only HK$33 million to implement our energy policy.

So, once again, while money for infrastructure flows easily, conservation is left short-changed. Funds of HK$50 billion would set us well on course to become Asia's most sustainable city. Instead, we'll have a third runway and fewer Chinese white dolphins. It's about time we struck a better balance between sustainability and development for this city.

Gavin Edwards is conservation director, and Shirley Poon is policy strategist, at WWF-Hong Kong

China must not backtrack on plans to gradually open up its capital account

Hu Shuli says the government must manage the risks involved and allow liberalisation to go hand in hand with other financial reforms

China is taking solid steps to open up its capital account, while easing control on its interest rates and currency exchange. The question now isn't how fast it can liberalise, but how to avoid the potential pitfalls of a more open system and how the process may spur wider reforms.

An open capital account will allow Chinese citizens and foreigners alike the freer movement of their assets and investments, and the free exchange of currencies.

Chinese leaders are determined to speed up the pace of liberalisation. In the government work report in March, they pledged to work towards full convertibility of the renminbi, a promise reiterated by People's Bank of China governor Zhou Xiaochuan (周小川). Zhou said the regulator has also been working to facilitate personal investments in and outside China; further open its capital market to global investors; and, revamp the regulation of foreign exchange.

These efforts are especially timely, as the International Monetary Fund could begin informal discussions as early as next month on China's application to include the renminbi in the special drawing rights, the IMF's composite currency unit.

The need for liberalisation was recognised early on. In 1993, the Communist Party's 14th Central Committee proposed to gradually allow the free exchange of the renminbi. Nevertheless, any such plans were scuttled by the Asian financial crisis that erupted several years later. The 16th committee renewed the pledge in 2003 and, a decade later, the 18th committee declared an all-out push to open up the capital markets under a sound regulatory regime.

Typically, a country takes seven years to open up its capital account after removing controls on its current account. For China, the lag is already 20 years and counting. The main reason is the snail's pace of Chinese reforms.

It's up to critics to be constructive, by suggesting solutions to potential problems

Chinese officials point out that China has already met at least partial or basic convertibility on more than 70 per cent of the criteria set out by the IMF. But much of the controls on the capital market remain intact.

For over 20 years, especially since 2012, opinions have been divided on capital account liberalisation. More and more people today agree that an open capital account can facilitate the global flow of capital and ensure efficient resource allocation. In China's case, it will also greatly aid the internationalisation of the renminbi, making its financial system more compatible with the country's growing stature as a major power. Yet, some have warned that if controls are removed before a sound regulatory system is in place and while reforms are stalled, the free movement of funds may accentuate cyclical fluctuations and trigger a financial crisis.

Some of these calls for caution should indeed be taken seriously. For instance, as critics point out, policymakers ought to pay more attention to structural reforms and risk management of financial organisations.

Nonetheless, there can be no argument that the capital account must be opened up, though within effective oversight. Some controls must remain, such as in the regulation of debt and short-term capital flows.

What China most needs is a good road map to capital liberalisation, which would in turn hasten the pace of market reform. It's also up to critics to be constructive, by analysing the pros and cons of liberalisation and suggesting solutions to potential problems.

One thing is for sure: allowing the controls to remain is no "safer" choice for China. Proponents of this view claim that China weathered the 1998 Asian financial crisis, and became one of the first to recover from the fallout of the recent global financial crisis, only because of its strict capital controls.

This is false logic. China's strength in overcoming both crises should be credited to the robust adjustments of its fiscal and foreign exchange policies. Several other factors also played a part during the 2008 crisis: financial reforms, the increase in its foreign exchange reserves and the rise in the country's global standing. Besides, studies have shown that keeping the capital account closed will not immunise an economy to a global crisis.

Fair-minded observers will conclude that China's current controls have not been working well, given the size and the openness of the economy. The government must change its model of management to one based on confidence: on the one hand, it must hasten the opening up so that all fund flows are open to scrutiny; on the other hand, it must consider exercising short-term controls to even out the market peaks and troughs.

China must press ahead with liberalisation without ignoring the risks involved. This means liberalisation must go hand in hand with the other reform measures set out during the 2012 third plenum, such as interest rates liberalisation, in order to minimise the risks of failure and maximise the profit of success.

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For Hong Kong, benefits of joining AIIB outweigh costs

Nomita Nair says it makes good sense for the city to be involved early on

The China-led Asian Infrastructure Investment Bank (AIIB) has been a hot topic in recent weeks following the flurry of countries signing up. Despite public discouragement from the US, China has won over American allies all over the world. Even Australia, where Tony Abbott was initially publicly against the AIIB, has joined the supporting ranks. Meanwhile, Hong Kong, although "actively pursuing" membership, has not yet joined, despite the many benefits of doing so.

The new institution, with a capital target of US$100 billion, will fund much-needed infrastructure projects across Asia, ranging from a new rail link from Beijing to Baghdad to port developments in Indonesia. It is positioned to be a "lean, clean and green bank", promising to meet the expectations for a 21st-century multilateral institution.

Taking an active role in the bank would significantly boost Hong Kong's global reputation as a business and finance hub. The AIIB has over 50 founding members, showing the growing importance of Asia in foreign policy.

Membership would allow local Hong Kong banks to join fund-raising projects with other members, diversifying Hong Kong's financial activity beyond its focus on the stock market. Local construction, transport and engineering firms would also benefit in bidding for contracts in overseas projects funded by the AIIB.

So what are some of the reservations in Hong Kong and elsewhere for joining? The cost of membership is one of the main hurdles. For some smaller nations, unless they have a greater say in the governance and operations of the bank, they may not see the full benefits of this initiative.

As a general rule, infrastructure investment is also not a quick money spinner. Developing roads, bridges and power plants involves long lead times and financial projections that can never be guaranteed.

Yet, Hong Kong needs to take a long-term view. Projects that are structured well can turn into

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stable, revenue-generating assets that are very attractive to investors.

Some critics have voiced concerns about transparency and governance. The US National Security Council questioned whether the AIIB can meet "the high standards" of the World Bank and other regional development banks, particularly relating to governance and social safeguards. Countries that have joined, however, signal the confidence that the best standards in accountability, transparency and governance will be met. New members such as Australia have stipulated that there should be an independent board with no one country controlling the bank.

For Hong Kong, as is the case elsewhere, it is much better to be part of the bank and be involved in those discussions at an early stage.

It is also important for Hong Kong to demonstrate its commitment to regional development across Asia, especially given the pipeline of future Chine-led initiatives in this area. Aside from the AIIB, China has proposed a New Development Bank with its fellow BRICS partners and a Silk Road development fund to boost connections with Central Asia.

The AIIB will undoubtedly be a huge player to watch in the coming months, and all eyes will be watching to see whether it can meet its promises. For Hong Kong, the benefits and privileges should outweigh any reservations. Membership to this new institution will help Hong Kong take advantage of China's New Silk Road strategy, boost its international standing and increase its regional influence for many years to come.

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