Press release

SFST addresses sub-prime crisis in his maiden US official visit

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The sub-prime crisis was a body blow for the US economy, but it had left Hong Kong largely unscathed, the Secretary for Financial Services and the Treasury, Professor K C Chan, said in New York (May 12, New York local time).

Professor Chan said Hong Kong was watching how the deterioration in the lending, and the drop in house prices would affect economic growth in the US, because this would affect Asian economic growth.

Speaking at a seminar jointly hosted by HSBC, USA, the Hong Kong Economic and Trade Office in New York and Hong Kong Association of New York, Professor Chan said that while he did not intend to join the chorus of criticism of the current crisis, it was useful to know how the international community viewed the problem.

The roots of the sub-prime crisis are exposed for all to see, and it has shown the risk-control problems at banks. The banks have over-relied on what their risk models are telling them about their risks in portfolios and how to hedge these risks, Professor Chan said.

“They have overlooked the concentration risk, and when liquidity dries up, they end up having a large portfolio of assets whose values have collapsed,” he said.

Asking what lessons were to be drawn from the crisis, Professor Chan said it was a full-scale financial crisis in a globalised world, and one that exposed many gaps in the financial system.

"There are gaps in the regulatory system in many countries, such that many of the financing activities are unregulated. There are gaps in the international system of regulators. It shows the need for more information sharing, and coordination in dealing with financial stability issues.

"I think these gaps are real. The current crisis shows in a dramatic way how individual weaknesses in our financial regulation and risk management can come together and put our global financial system at risk. It demands that we take seriously the task of reforming our regulation."

Professor Chan warned of the need to avoid any knee-jerk reaction that would damage the financial system, and the urge to over-regulate should be resisted.

"We should recognise that it is not the purpose of financial regulation to prevent market participants from making mistakes. No regulation can prevent asset bubbles from happening, or traders from taking excessive risk."

"Crashes will happen," he said, "just as bubbles will build up. It is the prospect of periodic crashes and the risk of failures that will check the risk taking behaviour of traders."

Professor Chan told the seminar it was not the purpose of regulation to prevent failures. The purpose of regulation should be to raise the level of transparency so traders and investors had knowledge of what they were trading and set prudential standards that would prevent trading losses to affect the stability of the financial system.

Hong Kong is a small but very liquid market, Professor Chan said. We have succeeded in building a financial market because we are open to international investors and we have committed to building a high quality market with a transparent, high quality regulatory system, and a strong financial infrastructure supporting trading and settlement, he said.

"Hong Kong's policy is welcoming to financial innovations. Our stock exchange has active trading of futures, option, and warrant products, with participation of institutions and retail investors," Professor Chan added, saying that Hong Kong is also a hedge fund hub in Asia.

"In Hong Kong, we know that financial innovations are good because they lead to risk diversification, lower the cost of capital, and improve the efficiency of the economy. As an international financial centre, we are committed to pursuing a policy that will encourage financial innovations, that will make our market more attractive to both the companies which raise capital in our market and investors who buy products from our market.," Professor Chan said.

"As an economy which has experienced some of the most destabilising financial crises, like the Asian Financial Crisis, we place great premium on sound regulation and international co-ordination. It is why we look at the current crisis as an opportunity for international regulators to come together to address some serious weaknesses in our global system."

Concluding his speech, Professor Chan said that the sub-prime crisis might spur international co-operation on tackling problems with a global dimension, and a new awareness of just how globalised our economy has become.

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