

Conference on Corporate Governance in the Financial Sector
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**The governance and risk management lessons
from the recent financial turmoil**

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Good morning distinguished guests, ladies and gentlemen,

I am very glad to be here today to speak to you about the corporate governance and risk management lessons learnt from the recent financial turmoil. This is indeed a very timely topic.

2. First, let's review the development of the current crisis. We can actually trace back to August 2007 when the financial market was rather volatile in that month due to concerns about the impact of the US subprime mortgage problem. This had led to structured investment vehicles and collateralised debt obligations which relied on short term funding to fund their operations to face huge liquidity problems. It was then followed by the collapse of Northern Rock, which was brought down later by the same problem. The crisis continued to deteriorate and as a result the fifth biggest US investment bank – Bear Stearns was rescued in March 08. But this was not sufficient to prevent the crisis from further deteriorating and finally a number of US regional banks had to be closed down and the fourth investment bank - Lehman Brothers filed chapter 11 bankruptcy protection in September. The collapse of Lehman has caused major repercussions to the financial markets. Immediately after its collapse, commercial banks were sceptical about the financial well being of their business counterparties. Many international banks have found it difficult to borrow money in the interbank market and were in severe liquidity problems. Many governments and central banks have to come up with different measures to help their banks including provision of huge funding to the interbank market, guaranteeing interbank borrowing, guaranteeing customer deposits and providing capital to banks etc. All these measures aimed to ensure that the banking system continues to operate in a normal manner and avoid a sharp economic downturn. So if we look back, the current crisis has developed from what was originally a US subprime mortgage problem into a liquidity crisis and then now a full brown financial tsunami. While the crisis has already been with us for more than a year since August 2007, the trouble is that we don't even know whether we have reached the bottom of the crisis and there doesn't seem to be any light at the end of the tunnel yet.

3. I can still remember that after the outbreak of the subprime fallout in August 2007, many analysts including my counterparts in the Federal Reserve were of the view that since the total amount of subprime mortgages only accounted for about 13% of the mortgage market of the US and only a very small portion of the subprime mortgages was in difficulty at that time, it would be unlikely for the subprime problem to have any substantial spill-over effect onto other financial assets and it should not cause any major concern to the US economy. With hindsight, we all know that their views at that time were too optimistic. The subprime problem has now evolved into a financial tsunami of a scale which is unprecedented.

4. Now ladies and gentlemen, I believe that the development of the subprime crisis into a full brown financial tsunami is out of the expectation of anybody. It also demonstrates clearly that with financial innovation being developed in a global manner, any problem in one part of the world, especially in the US which is the most developed financial market of the world, can spread easily and quickly to other parts of the world.

5. Many people have talked about lessons learnt from the crisis. I would like to go through some of the key lessons with you here from my perspective as a bank regulator. Many of these lessons were due to weak corporate governance and weak risk management at financial institutions.

- First, I would regard the failure to follow prudent underwriting standards as a key concern. Banks should always ensure that prudent standards are followed no matter whether the intention is to keep an asset in its own books or for securitisation purpose. One example I can quote here is our 70% loan-to-value ratio guideline for residential mortgages which has been introduced since 1991. Ever since the guideline was introduced, the HKMA has been monitoring banks' compliance very closely. Prompt actions were taken to stop practices aiming at circumventing the guideline. For example, granting of quasi mortgage loans in the form of personal loans. Earlier this year when there was a trend for banks to grant mortgage loans with principal repayment holidays which is a key feature of US subprime mortgages, the HKMA issued a circular immediately to stop such practice. The 70% loan to value guideline has helped the banking sector to avoid major problems in their mortgage books during the Asian Financial crisis notwithstanding that property prices fell as much as 65% at that time.
- The second lesson learnt relates to the work of the credit rating agencies. The fact that a paper being triple A rated was downgraded to non-investment grade within a matter of weeks or even days is something unconceivable. While it is easy to say that financial institutions should themselves evaluate

the risk concerned rather than relying solely on credit rating, this is very difficult to implement in practice as many medium and small sized banks do not have the capability to conduct such evaluation themselves. So the credit rating agencies must step up their corporate governance and rating discipline to provide rating services to investors in the market.

- The third lesson is the deficiencies in the liquidity risk management system of individual institutions and in the structure of certain financial instruments to use short term funding to fund their long term assets such as subprime mortgages. This is actually a key lesson we have learnt from the Asian financial crisis. I am surprised that our colleagues in the US have failed to learn that lesson.
- Insufficient supervision of investment banks and primary dealers is cited as another lesson to be learnt. With Goldmans and Morgan Stanley being converted into bank holding companies in the US, there is no longer any independent investment banks left in the US. All the former investment banks will be supervised in a manner same as commercial banks and this should help prevent them from overleveraging again.
- The incentive scheme for financial executives of investment banks is another reason contributing to the current crisis. It is likely that banking supervisors will monitor the compensation schemes of banks more closely going forward.
- The speed with which financial innovation is spread to different parts of the world also helps to amplify the impact of the current crisis. Supervisors world wide must ensure that they have the resources and expertise to catch up with the development of new financial products and be in a position to monitor the risks generated by these products.

6. I can continue to add other lessons learnt onto the list but those I have just mentioned are probably the key ones. The impact of the crisis is indeed very severe. With the US and many other countries economy in a recession mode, global economy is likely to take several years to recover.

7. In HK, while our local banks are still robust compared with their counterparts in other parts of the world, their performance in the second half of this year is expected to be much worse than the first half. Looking ahead, the prospect for 2009 doesn't look like very positive either. Loan loss provision is expected to go up in the light of slower economic growth.

8. What all this mean is that everything has to go back to basics. Banks should make sure that prudent underwriting standards are being followed. In HK, we have seen mortgage rates coming down to unrealistically low level earlier this

year. Banks are beginning to reprice their new mortgages to more realistic level now.

9. I believe that bank management and risk managers should always remind themselves that they have a very important job to do, i.e. to make sure that there is proper corporate governance and risk management arrangement in place in the institution and such practice is being followed at all times. In this connection, banks should ensure adherence to corporate governance and risk management guideline issued by the HKMA. During the Asian financial crisis, some directors were found to have missed board meetings for as much as 3 years. The HKMA therefore issued a Corporate Governance Guideline which requires, among other things, that :

- there should be at least be 3 independent non-executive directors;
- Board meeting should be held at least quarterly;
- Directors to attend at least 50% of board meetings.

10. If we look at the current crisis, it is important to make sure that prudent underwriting standard should be strictly followed no matter whether the intention is to put the asset on balance sheet or to securitise the asset.

11. One issue which is specifically relevant to retail banks in Hong Kong is the selling of retail investment products by banks. As demonstrated in the Lehman minibond saga, such business does carry with it very high reputational and operational risks. If not done properly, there could be major risks and costs involved. Banks should make sure that their sales representatives are following internal selling procedures rigidly and there are adequate product approval procedures in place. Additional risk management procedures e.g. tape recording, have to be followed in selling retail products to vulnerable customers including the elderly, under-educated and visually impaired customers. While this issue is still being unfolded, banks should consider establishing some enhanced measures in the selling process to help mitigate the risks involved, e.g. tape-recording of all transactions and regular review of transactions to ensure that there have been full risk disclosure and there has been no risk mismatch between customer's risk appetite and risk of product being sold.

12. Lastly, one question which many people have asked is how long would the current crisis go on and when will the market recover. I wish I could have a crystal ball that tells the answer but in fact I don't have a clue on this at all. Personally, I tend to believe that this is probably a crisis that would require at least several years to recover. I just hope that the lessons we learnt from this crisis will help us prevent future crisis. With this happen note, ladies and gentlemen, I will stop here. Thank you for listening to me.