Viewpoints on Financial Culture (2)

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The Public Interest in Finance

Finance is essentially quite a simple area of activity, at least in terms of its purpose. In any economy, there are those with a surplus of money—for example, the salaried workers who have savings to put away after spending their monthly pay on the daily necessities and those who are in need of money to support whatever they are doing—for example, farmers, manufacturers, exporters, providers of consumer services, property developers and home buyers. It would obviously be helpful to the effective functioning of the economy if there are arrangements whereby the surplus money of those who have it could be made available to those in need of it. These arrangements are collectively called finance. Given their importance to the economy, it is a matter of intense public interest that these arrangements, involving the mobilization of money from those who have it to those in need of it, should be effectively and systemically organized, bearing in mind always that the purpose of finance is to serve the economy.

The public interest in finance is, ironically, not a subject matter of noticeable interest amongst the many stakeholders of finance, to the extent that it is not often discussed or even defined in literature (including the relevant laws) on finance worldwide. This seems regrettable, and I will in future articles in this series discuss the possible reasons behind such general negligence. But I did, when in public office, manage to draw attention to the subject matter in a discussion in 2003 concerning financial governance in Hong Kong, and this led to it being articulated as ensuring stability, integrity, diversity, and efficiency in the mobilization of money, amongst other desirable objectives.

Financial **stability** is obviously important for the economy simply because disruption to the availability of funding can be very damaging to those running

businesses or paying mortgages; clearly those who are creditworthy should not all of a sudden be deprived of the use of money. The **integrity** of the financial system is essential for sustaining the confidence of users of the financial system, particularly depositors and investors, who obviously want their money to be repaid when they need it. **Diversity** in the mobilization of money provides users of the financial system with choices in accordance with their unique preferences and alternatives when the cost and benefit of those choices change for whatever reasons. And higher **efficiency** of the financial system enables those with surplus money to achieve a higher rate of return for their money and those in need of money a lower cost of funds than would otherwise be the case, in other words, a lower cost in the mobilization of money.

Market-Based Approach

To achieve effective mobilization of money, in terms of its sourcing, allocation, and use, a market-based financial system is generally considered to be desirable. A market-based system whereby money is priced and allocated to fund raisers in accordance with their creditworthiness and sourced from providers of funds in accordance with their risk appetite is considered to be of superior efficiency compared with other financial systems, for example, one in which money is allocated in accordance with the directives of government officials. Human nature is such that when money is involved, there would be greed and even extortion, amongst other undesirable intentions, and there is clearly a specific need, in a market-based financial system, to give users of financial services, particularly those who cannot be expected to be able to protect themselves, a suitable degree of protection. There is also the wider and undebatable responsibility for the financial authorities in any jurisdiction to protect and promote the (often undefined) public interest in finance.

The policy responsibilities of financial authorities, however, are also not always comprehensively and unambiguously articulated in the statutes of individual jurisdictions with their own financial systems. There are the common references to the need to protect depositors and investors, although increasingly financial stability is

becoming an additional feature, consequent upon the frequent occurrence of financial crises in recent years. There is also some confusion about where the responsibilities appropriately lie, at both the policy-making and operational levels, and how they should best be discharged. Perhaps this reflects the desire to leave matters as much to the market as possible, built upon the belief that the market will provide the best solution in the mobilization of money—a belief that should perhaps also pragmatically allow for the real possibility that markets can and do fail the public interest and for the taking of preventive and corrective action. It may also reflect political reality, characterized by the strong political influence of the finance industry on the governance of and policy-making in finance of any jurisdiction.

There is, nevertheless, consensus, whether or not the purpose is clearly defined in law, on the need for financial institutions to be supervised and financial markets to be regulated. And there are different institutional models on how such supervision and regulation are organized, notably the increasingly popular distinction between conduct regulation and prudential supervision of the finance industry, although there is less of a clear trend in the extent of involvement of the central bank responsible for the monetary system, which is inextricably linked to the financial system, in all this.

Risk Appetites and Profiles

Those with surplus money would generally want, on the one hand, to keep it safely and in a form that can be used in times of need, and, on the other hand, to earn a handsome return on it. As financial advisors often tell them, in managing their surplus money, they need first to understand their own circumstances and then work out a strategy to achieve the right balance, specific to themselves, among risk, return, and liquidity. Furthermore, in respect of specific investment opportunities, it is often emphasized that the higher the expected return of investment, the higher the risk that the money is not returned in full or at all. Understandably, therefore, the risk appetites of those with surplus money differ. Some do not wish to take any risk at all, wanting the absolute comfort that their money is there, whatever happens. Others do not mind betting all or part of it on something that may earn them a fortune,

even though they may lose all of it.

At the same time, the abilities of those in need of money to repay money when due are not the same, so are their abilities to run their businesses profitably and distribute dividends to their shareholders who have invested money in their business ventures. In other words, the risk profiles of those in need of money differ. There are those with undoubted creditworthiness, for example, governments that run their fiscal and monetary affairs prudently, and there are those in the private sector who undertake risky businesses that promise returns for money in multiples over a period of time. There are also those who are clearly in a position to repay borrowed money on time but cannot guarantee the values of their businesses as reflected, for listed companies, in the fluctuating prices of their shares traded on the stock exchange.

There are, naturally, mismatches between the risk appetites of those who have surplus money and the risk profiles of those in need of money. Furthermore, those who have surplus money may simply not be in a position to assess the ability of those in need of money to repay money. There are also mismatches between the timing and duration of which the money can be released and is required respectively by those who have it and those who need it, in other words, mismatches between the liquidity characteristics of money in the hands of the two sides. And there are other mismatches too. There is, therefore, a need in a market-based financial system for specialized groups of financial experts or financial intermediaries basically to make arrangements so as to match the requirements of the two sides—an activity generally referred to as financial intermediation, which involves, invariably, some form of transformation, transfer, and transaction of risks.

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