Viewpoints on Financial Culture (9)

Recommendations for Cultural Change

Finance is a service industry that has become self-serving. The consequence, regrettably, is the frequent occurrence of debilitating financial crises that undermine economic growth and development worldwide. For finance effectively to serve the economy, as it should, there is simply a need for a fundamental change of culture. This cultural change in finance requires political will of all those in a position to make a difference and close attention by both the financial authorities and the financial intermediaries.

Recipe for Reform for Financial Authorities

First, the financial authorities should accept that they have a clear responsibility to promote and protect the public interest in finance, which is for finance effectively to serve the economy. This public interest in finance should be widely publicized, so as to develop a deep and continuous understanding in the community, particularly amongst stakeholders of finance, as part of the political process for achieving the necessary public support to enable the financial authorities to discharge their responsibility effectively.

Second, there should be a comprehensive review of the laws relating to finance to ensure that the promotion and protection of the public interest in finance is in the spirit of the necessary legislation and is the objective of the overall legal framework and the specific provisions for the supervision of financial intermediaries and the regulation of financial markets.

Third, while accepting the superiority of the market-based approach to finance in the efficient mobilization of money in the economy, the financial authorities should recognize that one consequence of this approach is for financial intermediaries to adopt a self-serving business model that has a track record of abuse of financial market freedom and severe financial market failure. The financial authorities should be more proactive in taking preventive and corrective action to harness financial market potency.

Fourth, specifically in financial regulation, the financial authorities should, apart from focusing on the prudential and conduct aspects, satisfy themselves that the financial intermediaries licensed and regulated by them do not adopt self-serving business models and are only engaging in activities that are necessary for discharging the role of finance in serving the economy and are consistent with the maintenance of stability, integrity, diversity, and efficiency of finance.

Fifth, the financial authorities should recognize the possibility of the financial intermediaries promoting revenue-generating innovation and complexity in finance, requiring expansive and expensive monitoring, surveillance and compliance arrangements to contain and manage the relating risks, thus increasing the overall costs of financial intermediation rather than lowering it, which is not in the public interest, and be prepared to stem those questionable initiatives.

Sixth, the financial authorities should recognize the real possibility of the financial intermediaries exploiting their special position of being able to control where money comes from and goes to in the economy, and to extract economic rent that is disproportionately high, having regard to the skills needed for the provision of the relevant financial services. The financial authorities should thus regulate compensation practices of the financial intermediaries they license and supervise to ensure that those practices are established principally on the basis of how well the financial intermediaries are serving users of financial services and therefore the economy.

Seventh, the financial authorities should recognize the possibility that the efficiency of the financial infrastructure may bear an inverse relationship with the profitability of the financial intermediaries. In the design, construction, and operation of the financial infrastructure (for example, the payment, clearing, settlement, and custody systems), the authorities should therefore ensure that, whenever a private sector approach is adopted, the public interest in finance is not in any way compromised. The financial infrastructure is a public good that should legitimately be provided for and operated by the authorities in the public interest.

Recipe for Reform for Financial Intermediaries

First, the financial intermediaries or providers of financial services should humbly recognize that the purpose of their existence is to serve well the economy through the effective mobilization of money from those who have it to those in need of it, matching respectively different risk appetites with different risk profiles by transforming, transferring, and transacting those risks or risk assets. This culture to serve well users of financial services and therefore the economy should be enthusiastically promoted and firmly embedded in all business activities of the financial intermediaries as the only fair and sustainable model of finance. Self-serving business models should simply not be adopted.

Second, in whatever capacity the financial intermediaries are engaged in the transformation, transfer, and transaction of risks, for example, in the origination or distribution of risk assets, they should not, as a rule, get involved in any risk assets that they would not otherwise prudently hold on their books, in terms of the quantity and quality of, and the duration with which they hold, those risk assets.

Third, specifically in the transaction of risks, financial intermediaries should recognize that the important functions of financial markets are the provision of liquidity and the discovery of prices that clear underlying supply and demand, and that as market participants with privileged access to those markets, they have to ensure that their activities are consistent with the efficient discharge of those important functions. With a market infrastructure correspondingly designed, the norm for financial intermediaries should be only to act as agents of clients, execute client positions on a best effort basis, and charge fees or commissions appropriately and transparently for the services provided. Acting as principals and taking long or short market positions, for whatever duration, have the effect of distorting timely and accurate price discovery. The claim that position-taking by financial intermediaries is an essential part of market making that enhances market liquidity is questionable, particularly when modern information technology can already support a market infrastructure that provides direct market access to users of financial services.

Fourth, in any case, financial intermediaries with privileged access to certain financial markets have information, timing, and strategic advantages over users of financial services and other market participants who have to work through them. Proprietary trading in any form in these markets by financial intermediaries should simply be prohibited. Hedging of underlying risks on the books of the financial intermediaries, which can clearly be distinguished from proprietary trading, should of course be allowed, but hedging and risk mitigating should not be used as excuses for proprietary trading. Generally speaking, the privileged positions enjoyed by financial intermediaries and protected by licences are to facilitate the effective mobilization of money in the economy. These positions should simply not be abused by financial intermediaries in any manner for the purpose of extracting proprietary gains.

Fifth, effective financial services provided by financial intermediaries should of course be justly compensated, but there should be a high degree of transparency in how fees and charges are determined and for these to be subject to monitoring and regulation by the relevant authorities, particularly when users of financial services are not in a position to protect themselves against extortion by those in a position to control their money.

Sixth, the financial intermediaries should recognize that the increasing application of modern information technology to finance ("Fintech") will inevitably involve a significant degree of financial disintermediation. Fintech will revolutionize the manner in which the different risk appetites of those with money and the different risk profiles of those in need of money are matched and the manner in which risks are transformed, transferred, and transacted. They should realistically embrace this change and proactively modify their business models to adapt, even though the maintenance of the status quo is probably more in their short-term private interests.

Seventh, the financial intermediaries should specifically cooperate with the financial authorities in the design, construction, and operation of an economy-wide financial infrastructure that mobilizes money in the economy in the most efficient manner, desirably serving all users of financial services on a common platform, rather than narrowly just their own customers on their own proprietary platforms, and ideally covering the payment, clearing, settlement, and custodian functions for money and financial instruments, conducted with a real time gross settlement (RTGS) and delivery versus payment (DvP) or payment versus payment (PvP) modality.

This is the last article in the current series of Viewpoints on Financial Culture. Thanks for taking an interest in the subject. Time permitting, and before I turn senile, I do hope to tackle other subjects through these viewpoints, much in the same spirit, although probably more sparingly, as I did in my last ten years in office at the Hong Kong Monetary Authority, and obviously in a much less authoritative capacity.

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