Viewpoints on Financial Culture (5)

Conflicting Interests in Finance

In the governance of any jurisdiction, the authorities have the overall responsibility of promoting and protecting the public interest, whether it is in the making of policies and their implementation, or in the drafting and passing of laws and their enforcement. Articulating and, where necessary, defining the public interest in law are not always straightforward. Public sentiment and aspiration change all the time, and obviously the views and expectations of the people have to be taken seriously. And there are always opposing arguments between government intervention versus leaving matters entirely to the market, and over the subsequent balance to be struck. In Hong Kong, this is a particularly delicate issue, and thankfully an issue that is well debated, resulting over the years in many different versions of articulation of the underlying philosophy justifying government involvement or non-involvement, at the macro level or in specific markets in which the public interest is at stake.

In promoting and protecting the public interest, invariably private interests are affected, often adversely, although there are areas where the public and private interests are happily aligned. When there is conflict, specifically between the wider public interest and the private interests of some, for example, the profitability of a particular industry or the well-being of a particular interest group, it is clear that the public interest should prevail. But often natural justice, human rights, and other delicate and emotional issues may be involved. They need also to be defended in the public interest, thus presenting difficult challenges for the authorities. The political influence of those who might adversely be affected may be such that the resistance put up by them is insurmountable, and as a result private interests regrettably are often allowed to override the public interest. It takes political, communication, and professional skills to strike the right balance, including defining what the public interest is and getting sustainable community support for it.

As I have pointed out in earlier Viewpoints in this series, the focus on the public interest in finance seems to be rather blurred, and inadequate attention is given by the financial authorities to protecting and promoting it. I believe that this is the product of the politics of finance, in that the influential finance industry has been able to pursue their short-term private interests with considerable vigor, acquiesced by the financial authorities. As a result, a problematic financial culture developed, with questionable incentives leading to questionable conduct and behavior, and questionable business models and practices. This culture has made the financial system crisis-prone, causing much damage to the public interest. Finance is a service industry that has become self-serving. In jurisdictions in which the financial system is considered to be sophisticated, the leaders in finance enjoy levels of wealth, power, and influence that are perhaps as enviable as they are disgusting to many. With financial globalization, this problematic financial culture is being globalized, spreading contagiously to developing markets. In finance, there is a fundamental conflict between the public interest of the economy being well served and the private interest of the service providers. It is necessary for those interests and the fundamental conflict between them to be well understood by all concerned if there is to be a cultural change to ensure that finance serves the economy on a sustainable basis.

To recap, the financial system exists for the purpose of organizing financial intermediation that is essential for the functioning of the economy, mobilizing money from investors, who have a surplus of it and who have different risk appetites, to fund raisers, who are in need of it and have different risk profiles. This all-important task of financial intermediation is organized through the transformation, transfer, and transaction of risks, and through three channels—banking, debt, and equity. Given the importance of the financial system to the economy, it is obviously a matter of intense public interest that the system performs its tasks as best as it can. There are clear examples of how disruptive financial crises are to the functioning of the economy and how debilitating they are to the community. Thus, as mentioned before, this public interest in finance can be articulated as ensuring stability, integrity, diversity, and efficiency in the mobilization of money.

Two issues are not debatable concerning how this public interest should be pursued. First is the general reliance on a market-based financial system, and second is the need for some form of involvement by the authorities in protecting or promoting the public interest. While the market is more efficient than bureaucrats in resource allocation—in this case the mobilization of money—markets can, and do, fail, sometimes miserably; and the greed of some can, through the abuse of their privileged positions protected by licensing or registration systems, unfairly take advantage of others, in particular those not in a position to protect themselves. Furthermore, market freedom and competition have repeatedly encouraged innovation to the extent of generating unfamiliar and systemic risks, and the eventual materialization of those risks has proven to be debilitating for the economy and the general public. The purpose, form, and extent of involvement of the authorities are debatable issues, but the current norm across major economies seems to be some form of regulation of financial markets and supervision of financial institutions, either by the industry itself or by the authorities, all with a limited focus on the protection of small depositors and investors.

Across the many jurisdictions with market-based financial systems operating under some form of regulatory framework, finding the right balance between reliance on the market and regulation that best promote the public interest has proven to be difficult. Regrettably, the fundamental role of the financial system in supporting the economy is seldom given the attention it deserves in policy deliberations concerning the financial system. There is a common tendency on the part of the authorities to embrace market initiatives that are motivated by profit-making to innovate, for example, through the introduction of derivative markets and products, and refrain from questioning the utility of those initiatives in supporting the economy. The developments leading to the financial crises of the last two decades provide convincing empirical evidence of the failure on the part of the authorities adequately to protect the public interest. It has proven to be hard to harness the potency of a market-based financial system for the general good of the community on a sustainable basis.

Interestingly, the policy framework of Hong Kong is exceptionally clear on the public interest in respect of the financial system, although the awareness of this among the general public, and specifically within the financial system, seems lacking. Over the years, perhaps in response to the recurrence of financial crises, the legal framework has been updated to give a clearer focus on the public interest of finance, in addition to the more traditional emphasis on the protection of depositors and investors. There are clear references, for example, in the Banking Ordinance to promoting “the general stability and effective working of the banking system”, in addition to providing “a measure of protection to depositors”. Also, in the Securities and Futures Ordinance, there are clear references to maintaining and promoting “the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry”, in addition to the provision of “protection for members of the public investing in or holding financial products”.

Furthermore, the Financial Secretary issued a policy statement on 27 June 2003 which outlined, among other things, the policy objectives on the financial system, as follows:

> The role of the financial system is to promote economic well-being through financial intermediation, i.e., the channelling of savings into investment, and the provision of a financial infrastructure for effecting financial transactions. Given the externally oriented nature of Hong Kong’s economy, the openness of its financial markets and Hong Kong’s status as an international financial centre, the financial system of Hong Kong should operate in line with international standards. In promoting the effective performance of this role by the financial system, the Government should adopt a free market approach and keep its involvement in the financial system to the minimum, except where the private interests of financial market participants do not align with the public interests, or where the infrastructure is a public good that it may not be possible or

appropriate to provide through the market, for reasons of competitive fairness or commercial viability.

The Government should formulate specific policies to promote the efficient functioning of the financial system in the following manner—

(a) Policies concerning financial infrastructure should aim to mitigate risks, increase efficiency and enhance market transparency and liquidity, thus supporting the safety and soundness of the financial system.

(b) Policies concerning financial intermediation should aim to promote the stability, integrity, diversity and efficiency of the financial system.

(c) Policies concerning the regulatory regime should aim to provide a regulatory framework that promotes the stability of the financial system, provides an appropriate measure of protection to users of financial services and facilitates competition, and is consistent with the standards and practices of major international financial centres.

There were special circumstances in Hong Kong in 2003 leading to the Financial Secretary issuing such a policy statement on the financial system. It was not made pursuant to requirements laid down in any law in Hong Kong. But there was a need arising from unfortunate and political events for the Administration then to define clearly the responsibilities of government officials so as to enhance accountability in the peculiar political framework of Hong Kong, the subject matter of another statement issued then concurrently by the Chief Executive. However, the existence of such a unique policy statement of the Financial Secretary on the financial system seems to have become irrelevant with the passage of time. Indeed, there has since been little, if any, reference to it in policy-making and implementation concerning the financial system. Hopefully, the public interest of finance described in it has been so well understood and accepted that all concerned need not be reminded of it.

But, in any jurisdiction, there is always risk that attention to the public interest in finance wanes over time, particularly during periods in which the prices of financial assets are appreciating, and trading activities in financial markets are running at a brisk pace, in other words, when everybody is enjoying the party. In Hong Kong, furthermore, given the international dimension of finance, the public interest in finance has less of a domestic orientation than in other jurisdictions, and so the domestic financial intermediation supporting an economy of seven million people does often get subsumed by the desire to maintain the status of Hong Kong as an international financial centre in accordance with Article 109 of the Basic Law. This international orientation of the public interest in finance, involving essentially playing a significant role in the financial intermediation between the Mainland economy of 1.3 billion people and the rest of the world, is understandably of a much greater and complex dimension.

Turning to the private interest in the financial system, in a market-based financial system, there are different types of financial intermediaries doing different things, transforming, transferring and transacting risks, and managing money for those with a surplus of it and raising money for those in need of it. They are private sector institutions or individuals making a living, just like anybody else working in other sectors of the economy. Their private interests are, understandably, the maximization of profits for the benefit of the shareholders of financial institutions and the maximization of remuneration for those employed to operate those institutions. There are, of course, also self-employed individuals, such as stock brokers and investment advisors performing specialized roles in financial intermediation, doing predominantly the same things and with the same predominant objective of maximizing personal monetary gains. Reliance on market freedom to promote the public interest in finance is obviously predicated on the dictum of Adam Smith that "individual ambition serves the common good".

Regrettably, the common good in finance has not been well served. The position of being able to influence, if not control, where money comes from and where it goes to, is a privileged one. It can be, and regrettably does get, abused. Helped by the strong political clout that comes along with the privileged position, the financial intermediaries have been very successful in pursuing their private interests, working with incentive systems and operating models very much geared towards this objective. One just has to look at the profitability of financial intermediaries and the remuneration of those running them, and contrasting these with the increasingly vocal criticism of financial hegemony, to appreciate this. There is no doubt that the provision of financial services requires expertise, and expertise will need to be paid for. The question here is whether, having regard to how the financial system is structured, in terms of restrictions in becoming a service provider through licensing by the authorities and consequently the less than free competition in the provision of financial services, and having regard to other relevant characteristics, there is a mechanism to ensure that such expertise is not excessively remunerated. This question needs to be asked, and answered, in the public interest.

There is one important perspective that many in the financial system—the regulators, the service providers, and the users of financial services—have largely ignored. The profits and remuneration for the financial intermediaries, whatever roles are being played by them, collectively constitute a large part of the cost of financial intermediation in the economy. The other part is of course the sum of the overheads incurred in the running of the business, including the provision of plush offices, the continuous building of elaborate systems of monitoring and compliance commensurate with the increasing complexity of the business and in line with regulatory requirements, and lately the all-too-common hefty fines imposed by law enforcement agencies against institutional and individual misconduct, etc. Together these represent the total cost of financial intermediation, or the take of the middleman, in the mobilization of money from those who have it to those in need of it.

When providers of financial services—the middleman—extract, through whatever means and in whatever form, a fat take to pay for heavy overheads, attractive compensation for employees (astronomical for management), and dividends for shareholders high enough to secure continued control by management, investors get a low return for their money and fund raisers pay a high cost for money. The lower the cost of financial intermediation, the more efficient is the financial system; and financial efficiency is a matter of intense public interest, along with stability, integrity, and diversity in finance. Put differently, a fundamental conflict exists between the private interests of the financial intermediaries in running business models that maximize profits and compensation, and the public interest of promoting financial efficiency. It is the responsibility of the authorities to strike a balance between these conflicting interests. Specifically, if the market-based financial system does not produce a mechanism that promotes financial efficiency, the authorities have a responsibility to take action to ensure that it does. In any case, the financial intermediaries are licensed by them.

This conflict of interest, regrettably, is not often appreciated, whether it is in the community, the industry, or among the financial authorities, let alone special attention being given to strike the right balance. If the consequence of leaving the matter to the market is considered tolerable, though imperfect, by the community, then perhaps it can be argued that the situation, by and large, does not justify bureaucratic interference. But the pain inflicted on the community by the financial crises of the type experienced in the last two decades is well beyond any tolerable limits that can be considered reasonable. And, in my opinion, it was basically the manifestation of the conflict in the market-based operating environment within the financial system, allowing the private interests of the financial intermediaries of profit maximization to override the public interest of financial efficiency, that led to financial crises, particularly the one that erupted in 2008 and is still troubling the world. This unhappy state of affairs can be explained by examining how the private interests of financial intermediaries have shaped the behavior of the players in the financial system. This is the subject matter of later Viewpoints in this series.

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