# Contents

# POLICY RESPONSE TO THE BANKING SECTOR CONSULTANCY STUDY

## PURPOSE

1. This booklet sets out the policy response of the Hong Kong Monetary Authority (HKMA), which has been endorsed by the Government, to the recommendations of the Banking Sector Consultancy Study (the Study).

## SUMMARY OF INITIATIVES

2. Having regard to the recommendations of the Study and the views received from the three-month public consultation, the HKMA will undertake a package of policy initiatives as set out below to reform and further develop Hong Kong's banking system:

**(A) Overall approach**

(i) encourage market liberalisation and enhance the level of competitiveness of the Hong Kong banking sector in order to promote greater efficiency and innovation in the market;

(ii) in parallel with (i) above, strengthen the banking infrastructure with a view to enhancing the safety and soundness of the sector; and

(iii) by gradual elimination of regulatory barriers, allow market forces to play a greater role in determining the appropriate number of institutions in the banking sector.

**(B) Market reform and liberalisation measures**

(i) subject to a monitoring process as explained in paragraphs 36–39 below, adopt a two-phased approach to deregulate the remaining Interest Rate Rules (IRRs) with the first phase to begin on 1 July 2000 with the remaining regulated time deposits with a maturity of below seven days and the second phase to begin on 1 July 2001 with savings and current account deposits;

(ii) relax the one branch policy in the second half of 1999 by allowing foreign banks currently subject to the one building condition to open up to three branches initially to which customers have access (full relaxation of this policy should be considered upon a review in 2001);

(iii) subject to appropriate contractual arrangements being agreed with Hong Kong Interbank Clearing Limited, allow access by restricted licence banks (RLBs) to the Real Time Gross Settlement (RTGS) system in the second half of 1999 for the purpose of settling Clearing House Automated Transfer System (CHATS) payments;

(iv) simplify the three-tier authorisation system into a two-tier system, following review in the second half of 2000 of the detailed ways to achieve this; review the minimum paid-up capital requirements for different tiers of authorised institutions (AIs) at the same time; and

(v) review the existing market entry requirements for a local banking licence towards the second half of 2001.

**(C) Safety and soundness enhancement measures**

(i) conduct a detailed study in the first half of 2000 on the issue of establishing an explicit depositor protection scheme in Hong Kong and review the desirability of setting an asset maintenance requirement for banks in Hong Kong in relation to the Priority Payment Scheme for small depositors under the Companies Ordinance;

(ii) clarify the HKMA's role of lender of last resort for banks in Hong Kong;

(iii) continue the efforts to improve the financial disclosure requirements for banks in line with international best practices;

(iv) develop a more formal risk-based supervisory system in Hong Kong;

(v) conduct a detailed feasibility study in the first half of 2000 on a commercial credit register for the banking system in Hong Kong; and

(vi) promote high standards of corporate governance within the banking system.

3. The HKMA envisages that this package of policy initiatives will be completed within a period of about three years. A timetable for implementation of the various milestones is shown at **Annex 1**. It should be noted that this implementation plan is only an outline plan for taking forward the policy initiatives. More specific details will need to be worked out in order to implement the individual initiatives.

# BACKGROUND

4. In March 1998, the HKMA commissioned a consultancy study on the future development of the Hong Kong banking sector. The main objectives of the Study were to evaluate the strategic outlook for the banking sector over the next five years and to consider the effectiveness of the HKMA's approach to banking supervision. KPMG and Barents were appointed as the consultants to carry out the Study.

5. The consultants completed the Study and produced a report in December 1998. The full details of the consultants' findings and recommendations were published early this year for a three-month public consultation which lasted until the end of March 1999.

**The Consultants' Overall Assessment**

6. The consultants considered that Hong Kong has a sound, safe and dynamic banking sector. Overall, Hong Kong banks compare favourably with international standards in terms of profitability, efficiency and transparency. However, at the same time, the consultants identified a number of global forces and trends in financial services which will shape the future development of the Hong Kong banking sector. These global forces would likely result in increased competition leading to advances in efficiency, innovation and customer service as well as increased levels of risk in the banking sector.

7. The consultants concluded that the HKMA should consider evolving its regulatory and supervisory frameworks to improve the sector's ability to adapt to the new emerging environment and incorporate positive elements of change. The challenge for Hong Kong lies in how to exploit future opportunities while containing the risks.

8. Given the emerging environment, the consultants identified four strategic mandates for the HKMA:

- ensure that the regulatory and supervisory framework for Hong Kong remains appropriate;

- improve the competitive environment to ensure the positive benefits of global and local trends develop in the domestic market, and Hong Kong remains an attractive international financial centre;

- ensure increasing levels of risk associated with global and local trends are prudently managed and that Hong Kong's exposure to systemic risk is well contained; and

- increase the level of transparency, both within the banking sector and across financial capital markets, to allow the forces of market discipline to work more effectively.

## The Consultants' Specific Recommendations

9. In pursuit of these mandates, the consultants proposed two sets of recommendations to assist the future development of the Hong Kong banking sector. The first relates to market reforms targeted at promoting competition in the banking sector by removing incompatible regulatory features. The second set of recommendations aims to enhance the infrastructure supporting bank safety and soundness to ensure that increases in competition can take place in a relatively stable environment thereby mitigating the exposure to systemic risk. The consultants consider that this is a coherent package of recommendations, which should be introduced in parallel, using a phased approach. The specific recommendations are:

**(a) Market reforms to increase banking sector competition**

- phased deregulation of the remaining IRRs;
- relaxation of the one branch policy for foreign banks;
- allowing access to the RTGS system by non-bank AIs;
- simplifying the three-tier licensing system; and
- relaxing the market entry criteria for foreign banks particularly in respect of the time period and association with Hong Kong entry criteria.

**(b) Measures to improve safety and soundness of the banking system**

- study to enhance explicit depositor protection;
- clarifying the HKMA's role as lender of last resort;
- promoting financial disclosure by foreign banks;
- raising the minimum paid-up capital requirement for locally incorporated AIs; and
- adopting a more formalised risk-based supervisory approach.

## COMMENTS RECEIVED FROM PUBLIC CONSULTATION

10. The HKMA received a number of written responses from the banking industry (including the Hong Kong Association of Banks (HKAB), The DTC Association (DTCA) and six individual banks) as well as other organisations including the Consumer Council, the Chinese Manufacturers' Association of Hong Kong, the Chinese General Chamber of Commerce and the Hong Kong Democratic Foundation. These comments are presented in the summary at **Annex 2**, which was released to the public in early May.

11. From the responses received, it appears that there is a large measure of support from the banking industry and other sectors of the community for both the general direction and most of the specific recommendations identified by the consultants. For some recommendations, different views have been expressed on the timing and manner of implementation of the recommendations (e.g. the phased deregulation of the IRRs and study to enhance depositor protection in Hong Kong).

## THE HKMA's RESPONSE

12. The HKMA has completed a detailed consideration of the consultants' recommendations. The following sets out an overview of the HKMA's response to the consultants' recommendations, taking into account the views received from the public consultation. Although this package of policy initiatives arises mainly from the consultants' recommendations, it also contains other initiatives (outside the scope of the Study) which the HKMA intends to pursue as an enhancement to the banking infrastructure in Hong Kong to improve the safety and soundness of the system. The details of the HKMA's policy initiatives are set out below.

## OVERALL APPROACH TO THE FURTHER DEVELOPMENT OF THE BANKING SECTOR

13. The HKMA considers that carefully planned liberalisation of the financial markets is necessary if Hong Kong is to maintain and consolidate its position as an international financial centre. In this connection, the HKMA notes that the pace of market reform and liberalisation has been expedited in some other Asian countries, e.g. Korea and Singapore, after the Asian financial crisis. The HKMA concurs with the view of the consultants that there is a need to enhance the level of competitiveness of the Hong Kong banking market in order to promote greater efficiency and innovation in the market. But at the same time it is important to strengthen the safety and soundness of the banking sector as a whole so that the benefits of increased competition and greater efficiency can be fully realised.

14. The HKMA notes that this is the majority view expressed during the public consultation period. The HKMA also notes that there is a minority view among some of the smaller local banks that the playing field in Hong Kong is tilted against them and in favour of the foreign banks. They argue therefore that measures that would improve the access of foreign banks to the domestic market would cause undue hardship to them and perhaps cause instability to the banking sector.

15. The HKMA has some sympathy with these concerns, but it does not believe that a protectionist approach is in the best long-term interests of the local banks or of Hong Kong's position as a financial centre. More competition is coming whether Hong Kong chooses to liberalise further or not, and the best approach is to try to manage that process rather than resist it. The real answer is for the local banks to upgrade their skills and systems capabilities, and to offer their customers the range of products and quality of service that will enable them to retain their franchise. This will pose difficult challenges in terms of the investments in technology, risk management and human resources that will be needed. This will put further pressure on the local banks to address the issue of merger or other forms of strategic alliance that will spread the cost of such investment. While these are matters that fall within the commercial judgement of the institutions concerned, the HKMA believes that moves in the direction of consolidation of the local banking industry are both desirable and inevitable. Although the HKMA is not trying to force change, the gradual elimination of regulatory barriers will allow market forces to play an increased role in determining the appropriate number of institutions in the banking sector.

16. On the specific issue of foreign banks and the argument that they do not have the same level of commitment to Hong Kong, the HKMA would observe that many foreign banks have had a presence in Hong Kong for very many years and have made a substantial contribution to the development of the SAR. They have made substantial investments here and are major employers. They have facilitated cross-fertilisation of products, systems and talent with the local banks. It is true that some banks have either left Hong Kong or have cut back their lending here, but this has been under the extreme pressures of the Asian crisis. The majority of foreign banks have opted to stay, and a number have taken the opportunity to try to increase their market share. The HKMA believes that it is important to retain a solid core of foreign banks in Hong Kong and, where possible, to attract new entrants of the right quality. This is necessary to enable the financing needs of Hong Kong and the Mainland to be met, and to maintain Hong Kong's position as an international financial centre, as stipulated in the Basic Law. These objectives can be better achieved with a conducive regulatory environment that is free of unnecessary restraints.

## SPECIFIC RECOMMENDATIONS

***Market reforms to increase banking sector competition***

**(I) Deregulation of the Remaining Interest Rates Rules**

17. Following a review of the IRRs in 1994, the HKMA proceeded to deregulate the IRRs covering fixed time deposits using a phased approach. The first phase of deregulation took place on 1 October 1994 with the removal of the interest rate cap on deposits fixed for more than one month. This was followed by deregulation of the interest rate cap on deposits fixed for more than seven days and up to one month on 3 January 1995. Seven-day time deposits were deregulated in November 1995. It was originally intended to continue the deregulation of the remaining interest rate caps on time deposits with a maturity of less than seven days. However, this process was postponed because of increased market volatility as a result of the Mexican crisis in early 1995 and the uncertainty over the pending resumption of sovereignty. The outcome of this process was that interest rates on more than 99% of all fixed time deposits or around 70% of total deposits are now free to fluctuate in accordance with competitive market forces.

18. The remaining IRRs cover time deposits of six days or less (mainly 24-hour call deposits), current accounts and savings accounts (which amount to 0.1%, 5.4% and 25.1% of the total Hong Kong dollar deposits of the banking sector respectively). There are also a number of other restrictions concerning offers of gifts and automatic transfers to or from current accounts which are currently still in effect.

**Views from the public consultation**

19. The banking sector generally supports gradual liberalisation. Banks do not think the time is currently right for further deregulation of the IRRs. They note that in deciding on the timing and manner of deregulation, the HKMA should be aware of the impact of deregulation on AIs and the stability of the sector and the measures that banks will take to maintain profitability.

20. Non-bank respondents, such as the Consumer Council, support full deregulation as soon as possible. In particular, the Council queries whether a massive migration of deposits between institutions would actually take place if interest rates were deregulated. It believes that the concern over increased interest expense and decline in profitability upon full deregulation of the IRRs might be overstated.

**The HKMA's view**

21. The HKMA considers that deregulation of the remaining IRRs is inevitable given the direction of global banking developments and would ultimately be beneficial to Hong Kong. However, there are several important issues associated with deregulation, which must be understood by both banks and their customers.

22. The IRRs have provided an element of stability during periods of uncertainty in the local banking market. Without the IRRs, it is likely that banks would have adjusted their prime lending rates more frequently during the Asian financial crisis to reflect their cost of funds. The interest rate volatility experienced during 1998 would then have been transferred to other sectors of the economy, including the share and property markets. The technical reforms of the currency board system introduced during 1998 have been successful in their objective of reducing interest rate volatility. However, it remains the case that, in a deregulated environment, those increases in market interest rates that do occur are more likely to be passed onto the consumer (including those with residential mortgages).

23. Furthermore, the competitive pressure is likely to increase with deregulation and consequently, there will be demands on banks to preserve their profit margins by other means. Experience of deregulation elsewhere shows that banks will try to generate additional revenue through charging fees and introducing tiering of interest rates. They will also review their existing cost structures and streamline unprofitable services and branches.

24. Deregulation of the IRRs is therefore likely to result in a re-distribution of resources between bank customers that better reflects an optimal economic allocation rather than a large scale and simultaneous increase in benefits for all customers. For example, customers holding larger account balances might see an increase in deposit interest rates but new charges could be imposed on small balance accounts and on the writing of cheques.

25. The process of improving allocation of resources, reducing cross-subsidisation and introducing more transparent pricing is one of the objectives of deregulation and should not be resisted. However, **it needs to be understood that there will be both winners and losers among bank customers.**

26. There will also be winners and losers among the banks in terms of their ability to compete in a deregulated environment. It will be important (and the HKMA will require) that each bank should conduct a full self-assessment of the likely impact in terms of its competitive position, cost of funds and liquidity management.

27. Taking into account the view of the consultants and the public, the HKMA accepts that there is a need to proceed with the deregulation of the remaining IRRs. However, it is important that the community understands the costs and benefits of doing so.

**Phasing of deregulation**

28. From the prudential point of view, the HKMA accepts the view of the consultants and the banking industry that deregulation should be phased in over a period of time rather than adopting a "big bang" approach which would have a bigger impact on profitability and give the HKMA little opportunity to observe the impact of deregulation on banking stability. The HKMA also considers it vital to provide sufficient advance notice to banks for them to assess and determine the changes needed to their business strategies and systems.

29. If the "big bang" approach is eliminated, there are two main options available with regard to the phasing of deregulation. The consultants recommended a three-phase approach beginning in the first quarter of 2000 with the deregulation of time deposit of less than seven days. This would be followed by the deregulation of current accounts in the first quarter of 2001 and savings accounts a year later in 2002.

30. In subsequent discussions with the banks, it seems that the banks (large and small) generally accept that the deregulation process could be shortened by dividing it into two instead of three stages. This would enable them to move ahead on the new basis as quickly as possible.

31. One way of shortening the process is to deregulate savings and current accounts together. This has the advantage of enabling a more co-ordinated strategy to be adopted for the modification of internal systems and product sets (such as combined checking and savings accounts). It will also avoid the need to maintain temporary barriers (such as an interest rate cap on current accounts) to prevent migration from savings to current accounts if the latter were to be deregulated first. The disadvantage of this approach is that the main cost impact of deregulation would be felt in one step. However, this can be mitigated by giving the banks sufficient advance notice of the change so that they can make the necessary preparations. It will also be necessary to initiate the change at a time when there is a reasonable expectation that the banks will have recovered from the effects of the recession and the Asian crisis.

32. In light of these considerations, and taking account of the views of other interested parties that the deregulation process should be completed as quickly as possible, the HKMA considers that **it is appropriate for deregulation of the remaining IRRs to take place over two phases, as follows:**

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|---|---|
| **Phase 1** | • Removal of interest rate ceilings on time deposits of less than seven days (which only account for around 0.1% of total deposits of the banking sector)<br>• Removal of prohibitions on benefits for deposits |
| **Phase 2** | • Removal of all current and savings account interest rate rules |

**Timing of deregulation**

33. The current economic environment and uncertainties about the profitability of the banking sector rule out any deregulation in 1999. Further, as part of the HKMA's recommendations to AIs on contingency planning for the Year 2000 problem, banks have been advised to adopt a "change freeze" policy to minimise operational changes as well as hardware and software changes during the period from the last quarter of 1999 to early 2000. As deregulation of the IRRs will require banks to make certain changes to their existing processing systems, it would be sensible to begin the process of deregulation only after this period.

34. **On this basis, providing that prevailing financial and economic conditions are not unfavourable, deregulation of the 24-hour and up to six days time deposits (Phase 1) would take place on 1 July 2000. At the same time, the current prohibitions on banks providing benefits for deposits (such as gifts) would be abolished.**

35. **The second phase of deregulation of the IRRs on current accounts and savings accounts would take place 12 months after Phase 1**. This would allow the HKMA to monitor the impact of the initial change on bank and customer behaviour (e.g., to what extent banks would compete actively for deregulated demand-type deposits and the tendency of such deposits to move within and between banks). As noted earlier, it would also postpone the more radical change until a period when banks would be likely to be past the recovery phase. Accordingly, the HKMA expects the whole process to be completed by the middle of 2001. This timeframe is within that recommended by the consultants.

**Monitoring indicators for IRR deregulation**

36. **The remaining IRRs will be deregulated on the proviso that economic and financial conditions at the time are not unfavourable for deregulation to take place. For this purpose, a set of objective indicators has been developed which include both quantitative and qualitative factors.** The types of indicators taken into account correlate closely with stable conditions for banking. The nature of the indicators adopted is explained below:

Quantitative factors:

- the underlying performance of the general Hong Kong economy;
- absence of severe strains on banking sector profitability;
- comparatively low interest rate volatility over a sustained period; and
- maintenance of stable capital adequacy ratios.

37. For transparency, and as requested by the Consumer Council, specific and objective criteria have been set out for the above quantitative factors at **Annex 3**.

38. In addition to the above quantitative factors, the HKMA will also monitor for the absence of foreseeable significant international or regional economic upheavals which might create unstable conditions.

39. It should be noted that these monitoring indicators are not designed to signal "favourable" conditions for deregulation to take place. Rather, they should serve as "warning" signals reflecting weakness in the banking system as a whole which may call for a slow down of the deregulation process. For the second phase of deregulation, it would be particularly important that the quantitative indicators should be met as fully as possible. The decision will ultimately depend on the prevailing conditions ahead of the target dates set for deregulation. This decision will be taken as the result of a formal review process. The HKMA will assess prevailing conditions ahead of each of the target dates by reference to the monitoring indicators and will prepare a detailed report on whether it is safe to proceed for consideration by the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee and the Exchange Fund Advisory Committee.

**(II) Relaxing the One Building Condition**

40. The one building condition was introduced in 1978 against a background of the lifting of the moratorium on new bank licences and at a time when there was concern that excessive competition from a proliferation of branches would have a destabilising effect on the banking sector. The intended objective was to prevent over-banking in Hong Kong rather than to discriminate against foreign banks.

**Views from the public consultation**

41. Most respondents agree that this policy has outlived its usefulness and is inconsistent with the introduction of initiatives aimed at promoting a competitive environment in Hong Kong. Technological developments such as phone and internet banking have reduced and will continue to reduce the relevance of this policy. This was highlighted by the survey conducted during the course of the Study, which indicated that only a small number of foreign banks would increase their branch network if the policy was removed.

**The HKMA's view**

42. The HKMA considers that the primary motive for relaxing this policy would be to allow banks more flexibility to locate their business operations in a cost effective manner. As such, it is more of a practical and cost issue. Nevertheless, some smaller local banks have raised

concerns on the removal of this twenty-year old policy from a competitive standpoint. They argue that Hong Kong already provides foreign banks with one of the easiest access to the domestic banking market in the world and further relaxation is unwarranted. Doing so would only tip the balance even more in favour of foreign banks.

43. To address the concerns of the smaller banks and to allow time to assess more carefully the impact of removing this policy on competition in the market, it appears appropriate, as an initial step, to partially relax the one building condition to allow foreign banks to operate a limited number of branches. This will give banks more freedom to locate their branches and at the same time address the concerns of the smaller local banks regarding competition. Further relaxation could take place after a period of monitoring to determine whether the concerns over excessive competition are likely to materialise. An additional benefit of relaxing this restriction is that it will help to address criticisms raised by Hong Kong's trading partners during the World Trade Organisation negotiations on trade in financial services that Hong Kong is discriminating against foreign bank participants under this policy. This will improve Hong Kong's reputation as a free and open financial centre.

44. The current policy also restricts foreign banks to one back and one regional office in separate buildings. **The HKMA intends to remove this restriction altogether and allow banks to open any number of back or regional offices provided that these offices do not allow the conduct of banking business (or deposit-taking business in the case of RLBs) or the arranging or entering into of any other financial transactions. The number of branches, to which customers will have access, will still be limited, but will be increased from one to three[1].**

**Timing for implementation**

45. As the initial relaxation is unlikely to pose much risk to the sector, **it will come into effect in the second half of 1999.** Further relaxation will be considered in the first quarter of 2001 upon a review at that time.

**(III) Allowing Access to the Real Time Gross Settlement System by Non-bank Authorised Institutions**

46. The consultants noted that one of the principal objectives of establishing the RTGS system is to eliminate interbank settlement risk, and that participation in such schemes elsewhere in the world is generally open to a wider population of financial institutions based on specific business needs. The Study found no particular reason for the access criteria to be set based solely on an institution's licensing status, which is currently the case in Hong Kong. Given the emerging nature of financial markets, where AIs are increasingly involved in securities transactions and foreign exchange trading, this places non-bank AIs at a competitive disadvantage. Accordingly, the consultants recommended that a more appropriate means of defining access be considered.

[1] Similarly, institutions subject to this condition would be allowed to maintain additional ATMs at these new branch locations or at different locations in place of branches.

**Views from the public consultation**

47. The HKAB considers that if access were to be granted to non-bank AIs, these institutions should be required to pay for the development costs which are currently being recovered through fees levied on banks. The DTCA strongly supports relaxation of access to the RTGS system and urges that this be implemented quickly.

**The HKMA's view**

48. The current three-tier authorisation system is based on the extent of deposit-taking activities that the various types of institutions can undertake and on their ability to operate checking accounts. This would not appear to preclude participation by AIs other than licensed banks in the RTGS system for the purpose of making interbank transactions. The fully collateralised nature of the RTGS system means that the risk to the payment system will not be increased by such a move. Therefore, it appears appropriate that criteria for access to the RTGS system should be based on business needs, rather than purely on an institution's licensing status.

49. The HKMA agrees with the principle that all users of the system should be required to pay on an equitable basis. In general, the HKMA does not think that RLBs should be treated differently in this respect from new bank entrants who are presently not charged fees to recoup development costs.

50. In this regard, the HKMA will request Hong Kong Interbank Clearing Limited (a company jointly owned by HKAB and the HKMA to run the RTGS system) to consider the logistics for other types of AIs to join the RTGS system and to devise an appropriate charging policy. Applicants will be required to demonstrate a clear business need to join the system and to obtain the approval of the HKMA prior to doing so. So far, only RLBs have demonstrated a need to access the RTGS system due to their activities in debt securities underwriting and foreign exchange trading. **Therefore, the broadening of access to the RTGS system will be confined to RLBs. Given the current restrictions placed on RLBs on the provision of checking and savings accounts under the Banking Ordinance, they will not, in practice, be able to participate in paper cheque clearing and low-value bulk electronic payment items (i.e., Electronic Payment Services Company (HK) Limited items). Consequently, their participation in the RTGS system will be for the purpose of settling CHATS payments. In addition, the HKMA will examine whether RLBs, if approved to join the RTGS system, can have greater access to other clearing arrangements (e.g. the Central Clearing and Settlement System operated by Hong Kong Securities Clearing Company Limited).**

### Timing for implementation

51. Given the principle that the access criteria should be set based on business needs rather than on the licensing status of an institution, the HKMA considers that this recommendation can be implemented independently from the review of the three-tier system. **Provided that agreement can be reached on the appropriate contractual arrangements, there seems no reason why access could not be allowed in the second half of 1999.**

## (IV) Simplifying the Three-tier System

52. The rationale behind the consultants' recommendation to simplify the current three-tier system is that the current system appears to be overly complicated for the current market environment. A large number of the existing RLBs and deposit-taking companies ("DTCs") are owned by banks in Hong Kong. There seems to be room for consolidation of the current three-tier system. The present system was designed to meet the requirements of maintaining the effectiveness of the IRRs and the market conditions in the early 1980s. Given partial deregulation of these rules since 1994 and the intention to fully deregulate the remaining rules, it appears that a more simplified licensing system would be appropriate for the development of the sector. A simpler system is also consistent with trends in other international financial centres.

### Views from the public consultation

53. The HKAB finds the Study's recommendation to simplify the licensing structure by converting to a two-tier system to be generally desirable. The DTCA notes that whilst many of their members favour a unitary bank licensing system, they also recognise that there is a need to accommodate smaller financial institutions (e.g. those which cannot meet the minimum asset requirements but are of acceptable credit standing) within a tiered approach. However, they are opposed to the Study's recommendation to retain the existing definition of what constitutes banking business in terms of the ability to offer checking accounts. They advocate that RLBs should be able to offer checking accounts to corporate and high net worth clients. They also suggest that the minimum deposit amount of HK$100,000 for DTCs should not be raised for the new category of AIs and that there should be no maturity restriction on the type of deposits that the new category of AIs can take.

### The HKMA's view

54. The HKMA favours a two-tier licensing system as such a structure would achieve the dual objectives of depositor protection and appropriate level of participation in the market by entrants that do not qualify as full licensed banks.

55. Despite the general support for a change to a simplified system, there are a number of legal, practical and logistical issues that must be addressed before any change can be made. At present, DTCs are prevented from taking deposits of less than HK$100,000 and deposits with less than three months maturity. RLBs are restricted from taking deposits of less than HK$500,000 but there is no maturity restriction, except that they cannot offer checking accounts or other types of demand deposit. One possible change to the licensing structure, as suggested by the consultants, is to allow DTCs to upgrade to RLBs. However, there is a concern that an abrupt upward adjustment to the minimum deposit size may result in a number of such DTCs choosing not to upgrade and to become unregulated finance companies. Another issue in defining the appropriate distinguishing elements for the two tiers is whether there should continue to be restrictions on deposit maturity. A more fundamental issue is whether the second tier of institutions should be allowed to offer checking accounts and demand deposits, as suggested by the DTCA.

56. The HKMA's preliminary view on the latter issue is that too much of an erosion of the existing boundaries of permitted activities between licensed banks and RLBs would remove much of the rationale of having a two-tier system. Therefore, it is inappropriate to allow the second tier to offer checking or demand deposits. In other words, full access to the payment system should still be confined to licensed banks which should be distinguished from other types of institutions in their ability to take small and demand-type deposits and to take on a greater financial intermediation role.

57. The HKMA also has no intention to reduce the present flexibility of RLBs to take shorter-term deposits by introducing new maturity restrictions. Further consideration will, however, be given to the question of where the minimum size of deposit should be set (i.e., whether at or below HK$500,000). One possible option would be to relax the minimum deposit amount of RLBs to HK$100,000 which would allow for the easy upgrade by DTCs. This limit has a certain logic since it would tie in with the present priority payment scheme under the Companies Ordinance designed for the protection of smaller depositors. However, it would be appropriate to review this limit in the light of the current distribution of account balances, to determine whether it still provides a suitable demarcation line between small and large deposits. It will also be necessary to decide on the extent to which members of the new second tier would be able to use banking names or descriptions. Further discussions will be needed with market participants on these points.

**Timing for implementation**

58. Despite the general desirability of change, it does not appear that this is an immediately pressing issue. Implementation will require legislative amendments to the Banking Ordinance. There are also plans to review the issue of depositor protection (see below), which could have an impact on setting the appropriate minimum deposit restriction for the

new second tier of institutions. **The change to a two-tier system will therefore require further detailed review and consultation. This will be undertaken in the second half of 2000 and implementation of the new arrangements would not take place until the second half of 2001, at the earliest. Any change to the minimum paid-up capital requirements for locally incorporated AIs would take place at the same time.**

**(V) Relaxation of Market Entry Criteria for Foreign Banks**

59. Under the present licensing policy, a locally incorporated applicant for a full banking licence must have been an AI in Hong Kong for at least 10 continuous years. In addition, it must in the opinion of the HKMA be "closely associated and identified with Hong Kong". In reaching this opinion, the HKMA will take into account such factors as the historical association of the institution with Hong Kong, the extent to which it has a separate identity, mind and management, and the extent to which its shares are held in Hong Kong. Such restrictive criteria are intended to prevent foreign banks from entering the retail banking market through the local incorporation route. The consultants recommended that the time period in Hong Kong requirement should be relaxed from ten years to three and the criteria regarding association with Hong Kong should be removed.

**Views from the public consultation**

60. Comments received from the consultation exercise indicated some divergent views on this issue. HKAB takes the view that it is difficult to maintain discrimination between foreign and local banks, and that the consultants' recommendations seem to strike the right balance (subject to a reservation that the proposed three year qualification period might be too short). Some smaller local banks argue that Hong Kong already has an open system and further relaxation for foreign bank entry is not necessary. Respondents other than banks are generally in favour of relaxation of the criteria as this is in line with moves towards a more open financial services industry.

**The HKMA's view**

61. The balance of comments received is in favour of change and the HKMA supports this view. However, it considers that implementation of this recommendation does not appear to be an urgent issue at this stage. This is particularly so as other market liberalisation measures will be undertaken (e.g., relaxation of the one building condition and deregulation of the IRRs). Local incorporation is likely to be less attractive to foreign entrants than the ability to branch into Hong Kong if the one building condition is relaxed. It appears more appropriate to assess the impact of the latter change before deciding on the extent of, and timing for, relaxing these other entry criteria. **Therefore, this initiative should be subject to a later review, and any change in the entry criteria should take place towards the end of the reform period.**

***Measures to improve safety and soundness of the banking system***

## (I) Enhancing Depositor Protection

62. The consultants identified depositor protection as an important issue as the banking sector becomes more competitive and the level of risk in the industry increases. International developments such as the recommendation from the G22 Working Party on Strengthening Financial Systems have also encouraged a trend towards adopting more explicit forms of depositor protection.

### Views from the public consultation

63. The larger banks are opposed to any proposals for a compulsory deposit insurance scheme. They argue that such a scheme could, among other things, lead to systemic under-pricing of risk and capital misallocation and would not be able to prevent bank runs. Customers of well-managed, properly capitalised institutions would be forced to subsidise the customers of weaker banks. Another major concern is the moral hazard problem. Deposit insurance could encourage banks with a smaller deposit base to engage in more risky activities and more aggressive pricing of deposits, and there would be fewer incentives for customers to discipline weak institutions. This could be particularly noticeable in an environment where interest rates are fully deregulated. On the other hand, other respondents are more amenable to the idea of a deposit insurance scheme as an enhancement to banking sector stability.

### The HKMA's view

64. The consultants identified two options for enhancing the level of depositor protection in Hong Kong. These comprise the establishment of a deposit insurance scheme or enhancing the existing priority claims scheme under the Companies Ordinance by implementing some form of an immediate pay-out mechanism. Each of these has their respective costs and benefits and other options are also possible, including voluntary arrangements. The issue of deposit insurance was last addressed in Hong Kong in 1992. The conclusion at that stage was that such a scheme was not appropriate in view of the cost and moral hazard considerations. These are likely to remain powerful obstacles to the introduction of any scheme in Hong Kong. However, events have moved on since the 1992 study and the Asian crisis has prompted a number of countries in the region to declare their intention to move to more explicit (and limited) forms of depositor protection. **Therefore, the HKMA considers that it is timely to conduct another full study in Hong Kong on the feasibility and desirability of deposit insurance, or other forms of depositor protection.**

### Timing for the study

65. Given the work on other recommendations and HKMA's focus on the Year 2000 issue, such a detailed study can only commence in the first half of 2000. Afterwards, the findings and recommendations will be released for public consultation.

### Branch capital and depositor protection

66. Some local banks have raised the issue of whether foreign banks should be required to maintain branch capital in Hong Kong. The arguments for and against branch capital requirements were set out in the Study. The consultants concluded that, given the present liquidation laws in Hong Kong, maintenance of branch capital would not enhance the level of protection to depositors. On the other hand, such a requirement would be a disincentive to foreign banks wishing to enter the Hong Kong market or even an incentive to leave Hong Kong. The HKMA agrees with this view.

67. In the context of depositor protection, it would appear more desirable to enhance the effectiveness of the current priority payment scheme by way of imposing an asset maintenance requirement on foreign banks[2] (in the form of minimum holdings of specified assets in Hong Kong sufficient to meet priority claim liabilities). In the absence of such a requirement, there is no guarantee that foreign branches would maintain sufficient assets in Hong Kong to settle priority claims in case of a winding up. **The HKMA will consider this issue during the course of the study on enhancing depositor protection.**

### (II) Clarifying the HKMA's Role as Lender of Last Resort

68. Although the principles under which the HKMA's role as lender of last resort will be invoked have previously been articulated in a speech given by the Chief Executive of the HKMA in 1994, the findings of the Study indicated that there was a high level of uncertainty amongst market participants about the nature and extent of this role. The consultants therefore recommended the HKMA to clarify its role as the lender of last resort to the banking system.

### Views from the public consultation

69. Most of the comments received support a clarification from the HKMA in this regard. Market participants, in particular, consider that this would be conducive to banking stability. It is noted, however, that the HKMA will need to retain certain flexibility to deal with individual situations.

[2] The existing provisions in the Companies Ordinance in relation to the priority payment scheme for small depositors apply to all licensed banks and therefore a review of such an asset maintenance requirement should cover both foreign and local banks.

**The HKMA's view**

70. The HKMA has accepted that it should clarify its role as the lender of last resort, which is an important element of the safety net for the banking system in Hong Kong. This should help improve stability during crisis periods by reducing uncertainty in the market. During the Asian financial crisis, a key concern of banks was the high level of volatility in the interbank market and doubt over their abilities to obtain lender of last resort support if required. This prompted banks to remain as liquid as possible as they were uncertain whether liquidity support would be available from the HKMA. Arguably, this may also have aggravated the credit crunch during the crisis period.

71. The introduction of the discount window arrangements in September last year has helped to address some of these concerns. However, the discount window is only intended to provide overnight liquidity to alleviate temporary cash shortages at the end of the day. A lender of last resort facility is also required to meet the needs of banks with more serious funding difficulties. Prior knowledge of the availability of a lender of last resort facility should help to enhance overall market liquidity in difficult times. A formal policy framework will also help the HKMA to ensure consistency when considering provision of lender of last resort support to AIs. This would allow the HKMA to respond quickly in an uncertain environment which could be vital in restoring stability to the banking system.

72. A more detailed specification of the lender of last resort function must be balanced against the advantage of leaving a certain degree of constructive ambiguity in order to reduce the risk of moral hazard. In this connection, it is relevant to note that the problem of moral hazard has been addressed to a certain extent by developments in recent years. These include a sound and well-established regulatory and supervisory framework which limits excessive risk-taking activities, good market transparency which allows the market discipline mechanism to work effectively, and generally adequate risk control systems at the institutional level. Whilst moral hazard cannot be fully eliminated, the relatively sophisticated banking environment in Hong Kong has provided a number of measures to address this problem (as shown by the high capital and liquidity ratios maintained by banks). In fact, if a set of rules can be announced upfront and prudent criteria are established (e.g., quality collateral requirements), it could well provide incentives for institutions to hold better quality assets and in turn help promote banking stability.

**Steps taken by the HKMA**

73. In light of the above considerations, the HKMA issued a policy statement (see **Annex 4**) in late June, setting out the HKMA's role as the lender of last resort to the banking system. The following issues are also addressed in the policy statement:

- the resources available for the HKMA to take on this role;
- compatibility of the lender of last resort function with the currency board system;

- the preconditions for lender of last resort support;
- the instruments used for providing lender of last resort support; and
- the treatment of situations falling outside the framework within which lender of last resort support will normally be provided.

74. The policy statement aims to strike a balance between transparency on the one hand and flexibility on the other. The statement sets out a framework within which availability of support is more predictable and makes it clear that the Monetary Authority has the delegated power to provide support within the scope of the framework. If it is considered necessary to provide funding outside the framework of the lender of last resort (e.g., because longer-term liquidity support and/or capital support is required), this will be subject to the approval of the Financial Secretary, and the Monetary Authority would be obliged to consider the appointment of a Manager under Section 52 of the Banking Ordinance. This framework thus establishes checks and balances and is consistent with the U.S. concept of "prompt corrective action".

**(III) Improvements to the Disclosure Framework**

75. The consultants' recommendation is consistent with the HKMA's continuous efforts to improve transparency of the sector. In fact, the consultants' recommendation to require disclosure by certain foreign bank branches was already being implemented during the course of the Study and the requirement was introduced at the end of 1998. The HKMA considers the disclosure framework to be one of the most important components for maintaining effective market discipline and removing market uncertainty. Since 1994, a substantial amount of effort has been made in developing the disclosure framework which now covers all AIs operating in Hong Kong. Incremental improvements will continue to be made to the framework in line with international developments and the needs of the local market on an ongoing basis.

**(IV) Transition to a More Risk-based Supervisory Regime**

76. Following the completion of the Study, the HKMA has already taken action to initiate steps to develop a more formal risk-based supervisory approach in line with that recommended by the consultants. Adopting a more risk-based framework should allow the HKMA to continue to deliver consistent, high quality bank supervision as the sector develops and risk profiles of institutions change in reaction to competitive forces. Therefore, the improvements being made to the HKMA's supervisory regime will complement the regulatory changes to promote competition as well as the safety and soundness of the sector.

77. The HKMA has engaged the services of a consultant from the US Federal Reserve to assist in the development of a formal risk assessment framework and the preparation of guidelines on risk-based supervision. As part of this development work by the consultant, the revised risk-based framework will be piloted on two institutions to fine tune specific elements of supervision to suit the local banking environment. The HKMA has also implemented one of the recommendations of the Study with the establishment of the new Licensing and Compliance Division at the beginning of April this year. All licensing activities, including applications for authorisation, revocation, mergers and acquisition and applications to become chief executives and directors, have been relocated from different divisions within the Banking Supervision and Policy Departments and centralised under this new division. In addition, the division is also charged with the handling of other non-prudential issues, such as customer complaints and compliance with the money laundering guideline and the Code of Banking Practice. Centralising these activities into a specialised unit will promote more efficient use of the HKMA's resources and free up supervisory capacity to better focus on safety and soundness issues.

78. Some respondents to the consultation exercise commented that the HKMA should ensure that there would be no undue increase in the reporting burden of banks as a result of a change in the supervisory approach. The HKMA notes that a more risk-based approach can benefit institutions as the regulatory effort would be more focused towards areas identified to be of higher risk. This approach provides for more efficient supervision and could result in a reduction in the regulatory burden of those institutions which have lower risk profiles.

## OTHER INITIATIVES

79. There are other issues which are outside the scope of the consultants' final report but which are relevant to the general theme of enhancing the safety and soundness of banks in Hong Kong. The HKMA considers that these issues should be incorporated into the overall package of reform measures.

### (I) Establishing a Credit Register for Commercial Enterprises

80. The spate of corporate failures in Hong Kong as a consequence of the downturn in the economy has highlighted the need for banks to have better information about their customers and, in particular, about their levels of indebtedness. Too much debt borrowed from too many banks has been one of the main reasons for corporate failures during the recession. The fact that companies were able to accumulate such large amounts of debt was in part due to a lack of information available to banks at the time such loans were granted. While audited annual accounts are statutory requirements for companies in Hong Kong, the

primary purpose of these accounts is to report on the performance and financial position of the company to the company's shareholders. Moreover, statutory accounts are only prepared on an annual basis whilst the level of indebtedness can fluctuate continuously. Timely information relating to the extent of indebtedness of borrowers is generally not available to banks for credit decision purposes. This increases the risk for banks and, given the uncertainty, could also raise the price of credit for corporates.

81. On the international front, the increasing globalisation of banking business has led to calls for an international "credit register" to be established to provide information on the overall indebtedness of commercial enterprises. Such credit registers already exist in a domestic context and can assist banks in their credit decisions and enhance the prudential monitoring of counterparty risk by supervisors. Credit registers have been established as part of the national regulatory structure in several countries in the European Union, including Germany and France, since the mid-1930s and 1940s.

82. Typically, credit registers compile timely information on relatively large borrowings by corporates or other non-bank enterprises from the banking system. This information is fed back into the banking system and this helps to prevent individual borrowers from taking on excessive levels of debt. Conversely, it also enables banks to respond to their customers' borrowing needs, without incurring excessive risk. The concept is similar to that of a credit reference agency, although the information stored relates to the level of indebtedness (and perhaps the number of lenders involved) rather than credit performance.

83. Given the developments that have occurred in Hong Kong, there appears to be sufficient justification for a study to explore the feasibility of establishing some form of a credit register for the Hong Kong banking system. There are a number of major legal and operational issues involved in the development of such a system. In addition, the suitability of various credit register models for the local environment has yet to be considered, e.g. whether it should be a public sector or private sector initiative or a hybrid model involving a public sector entity to run the register using the expertise and service of a private sector company. These issues must be addressed before any steps are taken to establish an appropriate system for Hong Kong.

**Timing for the study**

84. The HKMA considers that such an initiative would be a useful and desirable enhancement to the banking infrastructure in Hong Kong. Accordingly, **the HKMA will undertake a more detailed study in early 2000 with a view to determining the feasibility of a credit register for Hong Kong.** This will require close consultation with the banking industry and other interested parties and it may be appropriate to set up a working group for this purpose. Further consultation with the banking industry and other financial services sectors will be necessary during the course of this exercise.

### (II) Enhancing the Role of the Board of Directors

85. The more competitive environment which the measures described in this paper would help to promote will increase the need for high standards of corporate governance within the banking system and improved systems of risk management. The primary responsibility for achieving these objectives rests with the board of directors.

86. Corporate governance of banks in Hong Kong compares well with the rest of the region. However, during the difficult operating environment of the last 18 months, the HKMA has come across a number of cases where the boards of directors of banks have not operated as effectively as they might. These include situations where the functions of the board have effectively been delegated, either downwards to the executive management who have operated with inadequate supervision or upwards to the shareholders. The HKMA is also concerned that policies produced by some of the boards on aspects of risk management such as liquidity are produced mainly for form's sake and do not play an integral role in helping to direct the affairs of the bank.

87. The HKMA issued a "Best Practices Guide" in 1991 describing how boards of directors are expected to discharge their responsibilities. It intends to review this document in consultation with the industry and, where appropriate, to issue more specific guidelines on governance issues, such as the number of independent directors and the composition and role of an audit committee. The HKMA will also increase the focus on high-level controls of banks as part of its move towards a more risk-based approach. It will also, as noted above, continue the efforts to improve the transparency of the banking sector through increased financial disclosure.

**Timing of review**

88. **The HKMA will review the existing guidelines in the near future with the intention of issuing new guidelines around the end of the year.**

## WAY FORWARD

89. The package of policy initiatives set out in the foregoing paragraphs will be completed within a period of about three years. As mentioned above, more specific details will need to be worked out in order to implement the individual initiatives. The HKMA will ensure that the banking industry, as well as the general public interested in the future development of the Hong Kong banking sector, will be kept informed of, and where appropriate, consulted on the implementation of these initiatives.

**Hong Kong Monetary Authority**
**July 1999**

# Annex 1

## Timetable for Implementing the HKMA's Package of Policy Initiatives

| Major milestones | 1999 | | | | 2000 | | | | 2001 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| Public consultation on the recommendations from the Study | | | | | | | | | | | | |
| Submission to the government for consideration | | | | | | | | | | | | |
| Improving the disclosure framework | Ongoing improvements | | | | | | | | | | | |
| Clarify the HKMA's role as lender of last resort | | | | | | | | | | | | |
| Allow RLBs access to RTGS system | | | | | | | | | | | | |
| Relax the one building condition to allow three branches for foreign banks. | | | | | | Review | | | | | | |
| Begin monitoring process prior to the start of deregulation of IRRs. | | | | Monitoring | | | | | | | | |
| Phase 1 deregulation of the IRRs (time deposits up to 6 days). | | | | | | | | Monitoring | | | | |
| Phase 2 deregulation of IRRs (all remaining interest rate caps). | | | | | | | | | | | | |
| Enhancing the role of the board of directors | | | | | | | | | | | | |
| Study and consultation on establishing a credit register for corporate enterprises | | | | | | | | | | | | |
| Credit register for corporate enterprises | | | | | | Consultation | | | | | | |
| Simplify the three-tier system. | | | | | | | Consultation | | | | | |
| Raise minimum paid-up capital requirements for local AIs | | | | | | | | | | | | |
| Study to enhance explicit depositor protection and consultation | | | | | | | | | | | | |
| Implementation of enhanced depositor protection scheme | | | | | | Consultation | | | | | | |
| Relax time period and association with Hong Kong entry criteria. | | | | | | | Review and consult | | | | | |
| Improved risk-based supervisory regime | | | | | | | | Ongoing improvements | | | | |

# Annex 2

## Summary of Comments Received on Specific Recommendations

| HKAB | DTCA | Consumer Council | Chinese Chamber of Commerce | Chinese Manufacturers' Association | Hong Kong Democratic Foundation | 6 Banks (3 Local & 3 Foreign) |
|---|---|---|---|---|---|---|
| **Deregulating the remaining interest rate rules** | | | | | | |
| – Not against an evolutionary approach to liberalisation<br>– But price competition will adversely impact bank profits and may result in increase in fees and charges and other cost reduction measures<br>– Deregulation should be deferred to beyond year 2000 in view of the current economic environment and uncertainty due to the year 2000 problem | – Long term deregulation is inevitable and desirable<br>– Deregulation should be postponed until all indicators are favourable | – Queries whether the concerns regarding impact of deregulation on stability are overstated<br>– Recommends full deregulation as soon as possible<br>– Important to have a transparent decision process and monitoring indicators should be made known to the public | – Further deregulation will pressurise small and medium sized banks into taking higher risk and is undesirable | – Support phased deregulation to promote competition and innovation in the banking market | – IRRs should be abolished immediately | – The larger banks consider it undesirable to eliminate the IRRs in 1999 but once it is appropriate to start the process, it could be accelerated so that the final phase is implemented before the 2002 date suggested in the Study<br>– The smaller banks hold different views on this issue. One local bank considers it destabilising to deregulate the remaining IRRs while another bank considers that decisions relating to the level of interest rates should not be in the hands of HKAB which may be influenced by the commercial interests of its members |
| **Relaxing the one branch policy for foreign banks** | | | | | | |
| – Generally desirable but this may add to the increase in competition from interest rate deregulation<br>– Proposal to allow three branches initially is appropriate | – The policy has outlived its usefulness and could be removed without undue competition from foreign bank branches<br>– However, with relaxation of market entry criteria and less demanding disclosure requirements for foreign banks, it may tilt further the playing field against local institutions | – As only a limited number of institutions would increase their branch network, there is little threat to instability if this policy is removed<br>– Eventually there should be no need for a cap on the number of branches | – Relaxation would cause undue hardship to small and medium sized banks | – Supports phased relaxation of this policy to promote a more competitive market | – Supports full liberalisation immediately | – A large bank noted that the policy is inconsistent with the desire for open markets<br>– A small bank noted that further relaxation would only cause hardship to the small and medium sized local banks and instability to the sector at a time of crisis |

| HKAB | DTCA | Consumer Council | Chinese Chamber of Commerce | Chinese Manufacturers' Association | Hong Kong Democratic Foundation | 6 Banks (3 Local & 3 Foreign) |
|---|---|---|---|---|---|---|
| **Allowing access to the RTGS system by RLBs/DTCs** | | | | | | |
| – Some banks found the arguments to allow access by RLB/DTCs to the system to be weak and RLB/DTCs will gain an unfair competitive edge over banks for payment business given their lower cost of entry<br>– But if system is to be opened up, RLBs and DTCs should be prepared to pay for the service | – Strongly supports this recommendation and urges that this be implemented quickly<br>– RLBs involved in debt securities underwriting and foreign exchange trading would have a strong business need for access to RTGS | – Supports in principle the recommendation that access to the system be reviewed in conjunction with a change towards a two-tier licensing structure<br>– More appropriate means of defining access criteria should be considered | – Disagree with this recommendation as the current system is functioning properly | – Suggest that the system be opened to all qualified participants to allow fair competition to take place | – The licensing system should not be the sole criterion for access to RTGS | – A small bank considers that the current arrangements are working well and there is no need for change<br>– A large bank agrees that a more appropriate means of defining access should be considered |
| **Clarifying the HKMA's role as lender of last resort** | | | | | | |
| – Not against clarification but the HKMA would still need to maintain flexibility to deal with abrupt changes and take timely actions<br>– HKMA's role as lender of last resort could conflict with its position as a defender of the currency peg | – Supports clarification | – Supports clarification<br>– But HKMA must improve transparency in the exercise of its discretionary power<br>– Public awareness should be enhanced about the fact that there is no assurance that an insolvent bank will necessarily be rescued | – Supports clarification<br>– HKMA should increase transparency of its policies and operations | – Supports clarification | – No comment | – A small bank agrees with the recommendation to formalise and clarify HKMA's role as lender of last resort |

| HKAB | DTCA | Consumer Council | Chinese Chamber of Commerce | Chinese Manufacturers' Association | Hong Kong Democratic Foundation | 6 Banks (3 Local & 3 Foreign) |
|---|---|---|---|---|---|---|
| **Simplifying the three-tier system** | | | | | | |
| – Simplifying the licensing structure is desirable<br>– If DTCs are to be abolished, some form of special purpose financial institution will be needed to fulfil the role of special purpose DTCs for issuers of multi-purpose stored value cards | – Recognises the need to accommodate smaller financial institutions with a tiered approach<br>– Opposed to the recommendation that the restriction on the provision of checking accounts be maintained<br>– Advocates that the future second tier of AIs should be allowed to take deposits of $100,000 and above and with no maturity restriction<br>– Concern that increasing the minimum deposit requirement will lead to more DTCs choosing to revoke their authorisation and becoming unregulated | – Agrees with the need for consolidation of the tiered system<br>– Considers it appropriate to retain a distinction between banks and RLBs to protect smaller depositors<br>– Concern that some DTCs may not opt to upgrade their licences and become unregulated entities | – The existing system is functioning properly and customers have no complaints about it and therefore suggests that the status quo be maintained | – Agrees that the current system could be simplified into a two-tier system given the insignificant market share of RLBs and DTCs | – Supports the simplification of the current system but wonders whether a unitary licensing system would be sufficient | – A small bank disagrees and believes that the current three-tier system should be maintained<br>– Two large banks agree with restructuring the sector into two tiers |
| **Raising the minimum paid-up capital requirement for local AIs** | | | | | | |
| – No specific comment | – Supports an upward adjustment of minimum capital requirements for local AIs<br>– But foreign branches should also be subject to some kind of minimum asset or minimum branch capital requirements | – No specific comment | – Supports this recommendation and agrees that capital requirement for local institutions should be consistent with international standards but should into account the ability of small and medium sized banks to meet such requirements | – No specific comment | – No specific comment | – A small bank believes that branches of foreign banks should be subject to the same minimum capital requirements |

| HKAB | DTCA | Consumer Council | Chinese Chamber of Commerce | Chinese Manufacturers' Association | Hong Kong Democratic Foundation | 6 Banks (3 Local & 3 Foreign) |
|---|---|---|---|---|---|---|
| **Conducting a study on enhancing depositor protection** | | | | | | |
| – Nearly all responses from members were against the introduction of a deposit insurance scheme<br>– Considers deposit insurance to be a fire-fighting rather than a preventive measure<br>– Appreciates that the HKMA may see a need to enhance depositor protection in view of international developments<br>– Any scheme proposed must be voluntary on the part of depositors and banks<br>– Supports the commissioning of a detailed study by HKMA on alternative forms of protection to deposit insurance | – Considers the existing priority payment scheme for small depositors to be of limited use<br>– A more explicit government-sponsored deposit insurance scheme would be much more effective in raising consumer confidence<br>– Establishment of a deposit insurance scheme should be given priority<br>– There are measures to mitigate the moral hazard problem associated with deposit insurance (e.g. setting insurance premium based on risk levels of individual institutions) | – Welcomes the proposed study on a depositor protection scheme<br>– The proposal to enhance the existing priority payment scheme deserves merit<br>– Supports the proposal to require foreign bank branches to maintain sufficient assets in Hong Kong to meet priority payment obligations under the Companies Ordinance | – Holds neutral views on this issue<br>– Considers a move in the direction to enhance depositor protection to be correct | – Deposit insurance raises the issue of moral hazard and costs would be borne by consumers, particularly commercial customers<br>– HKMA should carefully study other forms of depositor protection | – Provision of deposit insurance can actually be more destabilising since it raises the risk of moral hazard<br>– No need to revisit this issue, which was concluded in 1992 | – The large banks comment that any such scheme should be targeted where depositor protection is most needed and should be voluntary. The largest banks, measured by size or credit rating, should be exempt from any scheme.<br>– The smaller banks consider that the absence of deposit insurance benefits larger banks more and believe that there should be an explicit depositor protection scheme. |
| **Relaxing the time period and association with Hong Kong entry criteria** | | | | | | |
| – There are diverse views between foreign and local banks on these issues but the recommendations broadly appear to strike the right balance<br>– HKMA should carefully assess the impact before any changes take place<br>– The proposed reduction of the period of association with Hong Kong to three years appears to be too short | – Foreign bank entry to Hong Kong should not be too stringent<br>– The time period and association with Hong Kong criteria could be relaxed for qualified institutions | – Shares the consultants' views that the criteria appear overly burdensome and unnecessarily restrictive | – Disagrees with the recommendation as Hong Kong already allows easy entry for foreign banks and this might intensify unhealthy competition between small and medium sized local banks and foreign banks | – Suggests that the time period criteria be shortened to 5 years instead of 3 to allow the HKMA more time to assess the business and reputation of the institutions concerned | – No specific comment | – A small local bank disagrees with relaxing the criteria as the playing field is already biased towards foreign banks |

| HKAB | DTCA | Consumer Council | Chinese Chamber of Commerce | Chinese Manufacturers' Association | Hong Kong Democratic Foundation | 6 Banks (3 Local & 3 Foreign) |
|---|---|---|---|---|---|---|
| **Requiring financial disclosure by foreign bank branches** | | | | | | |
| – Supports the principle that all banks should face the same disclosure requirements<br>– Ability of depositors to make fully informed choices regarding the risks they take with foreign banks is currently limited | – Improved financial disclosure is essential in safeguarding the banking system<br>– Fuller disclosure by foreign banks particularly those with a large share of retail business would be fair and not burdensome | – Supports the HKMA's move to close the transparency gap that presently exists between local and foreign banks<br>– Emphasises the need to ensure that any local branch information be placed within the overall context of the financial strength of the whole institution | – Supports the recommendation that foreign banks should disclose more financial information consistent with that provided by local banks | – Supports the recommendation to improve disclosure for all institutions | – No specific comment | – Two small banks favour greater disclosure of financial information of foreign banks<br>– One foreign bank contends that the financial disclosure of a branch must be made in the right context with reference to the position of the whole institution |
| **Adopting a more risk-based supervisory approach** | | | | | | |
| – Supports the recommendation but warns of additional reporting burden on banks | – No specific comment | – No specific comment | – No specific comment | – Agrees that the direction towards risk-based supervision is correct<br>– Suggests that HKMA reviews the risks facing the financial and banking systems, promote the concept of risk-based supervision to staff responsible for bank supervision and the banking sector and assess the impact of the Mainland economy on the local banking sector | – No specific comment | – Two large banks comment that the risk-based approach must not result in any increase in the already heavy reporting burden on banks<br>– A foreign bank encourages the HKMA to increase transparency in its supervisory process |

# Annex 3

## Specific Criteria for Monitoring Indicators

1. *Two consecutive quarters of real GDP growth*

As a result of the Asian financial crisis, the Hong Kong economy has recorded negative real GDP growth for five consecutive quarters (Q1/1998 to Q1/1999). This indicates that the economy is still in a recession and the operating environment for the banking sector remains difficult. Deregulating interest rate rules in such an environment is likely to increase systemic risk for the banking sector.

The HKMA believes that deregulation should be carried out in a stable economic environment in order to avoid compromising the stability of the sector. Two consecutive quarters of positive real GDP growth would generally indicate that the economy is in the process of recovery and the environment is likely to be more favourable for deregulation to take place.

2. *Differential between HIBOR and US$ LIBOR has stabilised and is close to the pre-crisis levels*

The interest rate differential between Hong Kong dollar interest rates (i.e. HIBOR) and United States dollar rates (i.e. US$ LIBOR) is the premium demanded by the market for holding Hong Kong dollars. It is indicative of market confidence in the Hong Kong dollar.

A high and volatile differential between HIBOR and US$ LIBOR is indicative of fragile market sentiment. Such an environment would be less suitable for interest rate deregulation to take place.

3. *Capital adequacy ratio of the banking sector remains at traditionally high levels*

The capital adequacy ratio (CAR) is the ratio of an authorised institution's capital base to its risk-weighted credit exposures. It is an internationally accepted standard for measuring a financial institution's capital strength.

At present, the average CAR of locally incorporated authorised institutions is around 18% and this has been fairly stable over the last few years. The maintenance of the ratio at traditionally high levels provides assurance that the banking sector would be able to cope with the possible negative impacts on their financial condition as a result of deregulation.

4. *Signs of improvement in the classified loans ratio for the sector*

Authorised institutions are presently required to classify their loans and advances into five categories, namely Pass, Special Mention, Substandard, Doubtful and Loss. The classified loans ratio is the ratio of loans classified as Substandard or below to total loans outstanding. An increase in this ratio indicates deteriorating asset quality.

Since the Asian financial crisis, asset quality of the sector has continued to deteriorate. The classified loans ratio reached a high of 8.82% in the first quarter of 1999. Rapidly deteriorating asset quality has an adverse impact on both the profitability and the capital strength of banks and makes the system as a whole more vulnerable to adverse and unstable conditions. Lack of improvement in the classified loans ratio would therefore raise the question of whether deregulation should proceed.

5. *Absence of significant narrowing of net interest margins of the banking sector similar to that experienced during the period of the Asian crisis (i.e., 4Q 1997 to 3Q 1998)*

The HKMA considers that continued significant deterioration in net interest margins such as that experienced by the local banks in 1998 (a fall from 2.44% to 2.26% in relation to business in Hong Kong) would provide a warning sign that it might be safer not to proceed with deregulation.

6. *Absence of severe strains on the profitability of a significant proportion of the local banking sector*

To some extent, this follows from the two previous criteria. If profitability of a significant number of banks remained under severe stress (and in particular if some banks were recording losses), it would be sensible to delay deregulation so as not to increase these financial strains.

# Annex 4

## Policy Statement on the Role of the Hong Kong Monetary Authority as Lender of Last Resort

### Background

1. This statement sets out the policy of the Hong Kong Monetary Authority (HKMA) in respect of its role as lender of last resort (LOLR) to the banking system. This follows the report arising from the Banking Sector Consultancy Study commissioned by the HKMA in 1998 which noted that there was "quite a high degree of misunderstanding among bankers on whether the HKMA is the lender of last resort and what this role involves".

2. The principles on which the HKMA would be prepared to act as LOLR were in fact set out in a speech by the Chief Executive of the HKMA which was published in the Quarterly Bulletin for November 1994. Notwithstanding this, the consultants' report recommended that it would be appropriate for the HKMA to formalise its policy in this area and to explain this policy, especially to market participants. This policy statement is intended to fulfil that purpose.

### The nature of LOLR support

3. The funding or liquidity support provided by central banks or monetary authorities to commercial banks can be broadly classified into the following three categories:

   (a) the provision of intra-day or overnight liquidity to alleviate short-term cash flow shortages;

   (b) the provision of LOLR support to banks experiencing funding difficulties on a short-term basis; and

   (c) the provision of longer-term liquidity support and/or capital support.

4. This policy statement focuses on the second type of liquidity support, the objective of which is to provide some breathing space to an institution facing short-term funding problems to implement corrective measures. The aim is to prevent illiquidity from precipitating a situation of insolvency, and to prevent the contagion effect of bank runs. The LOLR function should be distinguished from the provision of intra-day liquidity under the RTGS system and overnight liquidity through the Discount Window, the main objective of which is to ensure the smooth functioning of the interbank payment system. It should also be differentiated from longer-term liquidity support and/or capital support, which should be decided on a case by case basis, having regard to the implications of a bank failure for the stability of the monetary and financial systems of Hong Kong.

**The resources available to the HKMA**

5. The means available to the HKMA to take on the role of LOLR are provided by the Exchange Fund, the use of which is governed by the Exchange Fund Ordinance. Section 3(1) of the Ordinance states that the Fund "shall be used primarily for such purposes as the Financial Secretary thinks fit affecting, either directly or indirectly the exchange value of the currency of Hong Kong and for other purposes incidental thereto".

6. Section 3(1A) of the Ordinance further provides that:

   *"In addition to using the Fund for its primary purpose, the Financial Secretary may, with a view to maintaining Hong Kong as an international financial centre, use the Fund as he thinks fit to maintain the stability and integrity of the monetary and financial systems of Hong Kong."*

7. Under section 5B of the Ordinance, the Financial Secretary has delegated day-to-day decisions on the use of the Exchange Fund under Section 3(1A) to the Monetary Authority. The Monetary Authority shall have regard to the primary purpose of the Fund in exercising this power.

8. Sections 3(1) and 3(1A) of the Ordinance make it clear that the use of the Exchange Fund, including for the purposes of LOLR support, must be for systemic purposes. This means that in considering whether to provide LOLR support to an individual authorised institution, the guiding principle must be whether the failure of that institution would, either by itself or through spreading contagion to other institutions, damage the stability of the exchange rate or the monetary and financial systems. Such a contagion effect could arise, for example, where other institutions are heavily exposed to the troubled institution or share similar characteristics which could be interpreted as the origin of its problems. The vulnerability of other institutions to the contagion effect will also depend on the general tone of sentiment at the time, e.g. whether there is heightened nervousness about the stability of the banking or the monetary systems.

**Compatibility of the LOLR function with the currency board system**

9. The LOLR function should be organised in a way consistent with the currency board arrangements in Hong Kong. Temporary liquidity injections into banks with liquidity problems can be funded through borrowing from the interbank market or a sale of foreign currency assets of the HKMA (outside the assets earmarked for the Backing Portfolio), leaving the Aggregate Balance of the banking system unchanged. Alternatively, the HKMA may resort to repos using Exchange Fund paper or US dollar assets. All of these options would be consistent with the rules of the currency board arrangements as the Hong Kong dollar liquidity thus created is matched either by a decline in another component of the monetary base (i.e., the Exchange Fund paper) or an increase in US dollar assets. Moreover, the HKMA has, on previous occasions, stated that when there is a risk that large scale Hong Kong dollar transactions could create extreme conditions in the interbank market and affect the stability of the exchange rate, the HKMA may lend to or borrow Hong Kong dollars

from the interbank market temporarily to dampen such extreme conditions. In the event where bank problems lead to extreme conditions in the money market and such a situation is not associated with any downward pressure on the Hong Kong dollar exchange rate, the HKMA may consider direct injection of liquidity into the interbank market to relieve market tightness and restore systemic stability.

**The preconditions for LOLR support**

10. As already noted, the basic precondition for LOLR support to be provided is the judgment of the HKMA that the failure of a troubled institution, if it is deprived of liquidity assistance, would damage the stability of the exchange rate, monetary or financial systems, (i.e. systemic risk). In addition, the following preconditions for LOLR support would apply:

(a) the institution has a sufficient margin of solvency;

(b) the LOLR support will be adequately collateralised;

(c) the institution has sought other reasonably available sources of funding before seeking LOLR assistance;

(d) the shareholder controllers of the institution have made all reasonable efforts to provide liquidity and/or capital support as a demonstration of their own commitment;

(e) there is no prima facie evidence that the management is not fit and proper, or that the liquidity problem is due to fraud; and

(f) the institution must be prepared to take appropriate remedial action to deal with its liquidity problems.

11. As a measure of whether an institution has a sufficient margin of solvency, the HKMA will generally require the institution to demonstrate that it maintains a capital adequacy ratio of at least 6% after making adjustment for any additional provisions that might be necessary.

**The instruments used to provide LOLR support**

12. Because there is not a large Government debt market in Hong Kong, the range of collateral against which LOLR support would be provided must necessarily be wider than in some other economies. There are three basic instruments which would be used by the HKMA to provide LOLR support to a troubled institution:

(a) purchase of the institution's placements with other banks which are acceptable to the HKMA – the purpose would be to assist the institution to turn its existing liquid assets into readily available cash;

(b) repos of eligible Hong Kong dollar securities – these would consist of (i) Exchange Fund Bills and Notes; (ii) other securities eligible for rediscount at the Discount Window; (iii) other investment grade securities. Investment grade securities refer to securities with a rating at or above the minimum acceptable rating from a recognised credit rating agency as set out in **Appendix A**; and

(c) credit facility against the security of the institution's residential mortgage portfolio – preference would be given to HOS/PSPS mortgages and those mortgages which satisfied the purchasing criteria of the Hong Kong Mortgage Corporation, although other residential mortgages would also be eligible as security provided that they were not "delinquent" at the time of purchase[1].

13. Liquidity support provided by way of repos or provision of a credit facility would be provided only on a short-term basis since the purpose is to provide the institution with a temporary breathing space in which to sort out its difficulties. Such funding would be provided for an initial term not exceeding 30 days although there would be provision for it to be rolled over for a further 30 days on maturity.

14. In order to mitigate the risk of the Exchange Fund, the value of the collateral used to secure LOLR funding in the form of repos or the credit facilities would exceed the principal amount of the funding according to the haircuts and loan to valuation ratios set out at **Appendix B**.

15. The interest rate charged on LOLR support would be at a rate which is sufficient to maintain incentives for good management but not at a level which would defeat the purpose of the facility i.e. to prevent illiquidity from precipitating insolvency. For repo transactions, the interest charged would be incorporated into the repurchase price to be paid by the institution to purchase an equivalent amount of the securities from the HKMA. For credit facilities, interest would be payable on the repayment date of the facility. The interest rates would be set at the prevailing Base Rate plus a margin to be determined taking into account current market conditions. For purchase of bank placements, the purchase price would be calculated at a discount using the prevailing market yield.

16. Notwithstanding the availability of suitable collateral, the HKMA will set a limit on the maximum amount of LOLR support provided to an individual institution via repos or the credit facility. The limit would normally be set between 100% to 200% of the capital base (as defined in the Banking Ordinance) of the institution concerned depending on the margin of solvency the institution can maintain, subject to a cap of HK$10 billion. An institution which meets the minimum pre-conditions for LOLR support (i.e., a capital adequacy ratio of 6%) would be able to obtain liquidity support up to a maximum of 100% of its capital base. An institution, which can maintain a capital ratio above its statutory minimum, would be able to obtain liquidity support up to a maximum of 200% of its capital base. In either case, the HKMA would retain the discretion to lend less than the maximum.

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[1] In the sense that none of the mortgagors should have been in default in making payment for more than 30 days from the due date for any payment under their mortgage loan during the preceding 6 months.

**LOLR support for branches of foreign banks**

17. The above policy applies to the provision of liquidity to locally incorporated authorised institutions whose failure might have systemic implications. It would not normally be the policy of the HKMA to provide LOLR support to branches of foreign banks operating in Hong Kong. This recognises the fact that the liquidity of a branch cannot readily be divorced from that of the bank as a whole. It follows therefore that the head office of the branch, supported if necessary by the lender of last resort in its home country, would be expected to provide enough funding to enable its branch in Hong Kong to meet its obligations. If it were unable to do so, there would be no alternative but for the branch to close its operations in Hong Kong. In such circumstances, the Monetary Authority would consider whether to use his powers under Section 52 of the Banking Ordinance to appoint a Manager to take control of the affairs, business and property of the branch in Hong Kong.

18. There are however two circumstances where the HKMA might provide financial assistance to a branch with funding problems. The first would be for the HKMA to swap Hong Kong dollars for US dollars held by the branch if no suitable counterparty could be found in the market. The second would be to provide urgently required bridging finance on a secured basis to a branch pending receipt by it of funds from head office. This would only be done if the HKMA was wholly satisfied that the funds from head office would indeed be forthcoming and on the basis of assurances from the home supervisor that this would be the case.

**Funding support requiring specific approval from the Financial Secretary**

19. The preceding paragraphs set out the criteria on the basis of which the HKMA will normally be prepared to provide LOLR support. Any such support would be provided at the discretion of the Monetary Authority. Where the criteria are not met, funding support would only be provided with the specific prior approval of the Financial Secretary. This would include the following situations:

    (a) the institution is unable to comply with the preconditions for LOLR support set out in paragraphs 10 and 11 above. This would involve more serious situations falling outside what the HKMA would consider to justify LOLR support (in particular those falling within paragraph 3(c) above);

    (b) it is considered necessary to give the institution a breathing space longer than that provided for in paragraph 13;

    (c) it is considered necessary to provide funding support which exceeds the LOLR support limits set out in paragraph 16; and

    (d) the taking of security other than the types listed at Appendix B.

20. Any funding provided in these circumstances would have to be considered on its merits in the light of the implications for systemic stability. In addition, the Monetary Authority would consider whether to appoint a Manager under Section 52 of the Banking Ordinance to safeguard the assets of the institution and to protect the interests of depositors and other creditors.

**Default situations**

21. Where LOLR support is not repaid on maturity and the HKMA is not prepared to rollover the funding, the Monetary Authority would have to consider a number of options including the appointment of a Manager under Section 52 of the Banking Ordinance to manage the affairs, business and property of the institution.

**Hong Kong Monetary Authority**
**June 1999**

# Appendix A

Investment grade securities acceptable for repo with the HKMA for the purpose of LOLR funding are those with a rating at or above the minimum acceptable rating from a recognised credit rating agency set out below:

| Recognised credit rating agency | Minimum acceptable rating |
|---|---|
| Moody's Investors Service, Inc. | Baa3 |
| Standard & Poor's Corporation | BBB- |
| FITCH IBCA Ltd. | BBB- |
| Thomson BankWatch | BBB+ |
| R&I | BBB+ |

# Appendix B

## Type of funding

| Repo of: | Haircut[1] |
|---|---|
| – Exchange Fund Bills | 2.5% |
| – Exchange Fund Notes | Minimum of 5% |
| – Other floating rate securities eligible for rediscount at the Discount Window | 5% |
| – Other fixed rate securities eligible for rediscount at the Discount Window | Minimum of 5% |
| – Other investment grade securities[2] | Minimum of 10% |
| **Credit facility secured by:** | **Loan to value ratio[3]** |
| – HOS/PSPS mortgages[4] | 95% |
| – HKMC compliant mortgages | 90% |
| – Other residential mortgages | 80% |

*Notes:*

1) The haircut under the repo arrangement would be applied to the market price of the security at the time of the transaction. The actual haircut applied to Exchange Fund Notes, other fixed rate securities eligible for rediscount at the Discount Window and other investment grade securities would be determined based on the factors including the tenor, the quality of the security and actual terms of the repo arrangement.
2) Liquidity support to banks may also be funded through repos of US dollar investment grade securities. The haircut applied and the interest rate charged would depend on the quality of the underlying security.
3) The loan to value ratio represents the amount of LOLR support over the book value of the portfolio of mortgages provided by the institution as collateral.
4) Subject to Housing Authority's prior written consent to transfer the guaranteed loan.

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