COMPETITION AND CONSOLIDATION: THE OUTLOOK FOR HONG KONG's BANKING SECTOR[1]

While most banks in Hong Kong remain remarkably strong after two years of financial crisis, there is no room for complacency. Intensified competition, global liberalisation, technological advance, and greater sophistication in services demanded by customers are all challenges that require banks to rethink their strategies. Consolidation, with its obvious benefits, is one way for banks to address these challenges. The Hong Kong Monetary Authority's role is to ensure that the regulatory structure is keeping abreast of the evolving market conditions and can facilitate closer co-operation in the banking sector.

Introduction

It is a great honour to be invited to speak at this evening's Millennium Dinner of the Hong Kong Institute of Bankers. This is the Institute's first Dinner of this kind, but I am sure that you will not need to wait another millennium for your next formal gathering. Your Institute has a long and distinguished history. As the ticker board on your website proudly reminds us, the HKIB has been 'serving the educational needs of bankers in Hong Kong since 1963', so that generations of bank employees have benefited from your courses, publications and library facilities, and from the professional identity that the HKIB has fostered over the decades.

The HKMA has enjoyed a very close and fruitful working relationship with the HKIB. Many of our staff are members of the Institute and graduates of its courses. Some of our staff have participated as speakers in the Institute's classes and seminars. All of us have been deeply impressed by the professionalism and fellowship that the Institute has promoted within the banking community in Hong Kong, and by the Institute's innovative and imaginative efforts to improve the general quality of banking services.

Among the Institute's important projects is its active sponsorship of the Master's Course in finance at Macquarie University, which has enabled local bank employees to benefit from educational programmes developed overseas. Projects of this kind, along with the many other training programmes which you undertake, contribute enormously to one of the cornerstones in Hong Kong's success as a leading international financial centre: the knowledge and skills of its people and their capacity to adapt to a rapidly changing global environment.

I have been told that we shall have an opportunity for the Institute's Members and their guests to show off their knowledge and skills in the fun and games planned for later in the evening. I am as curious as anyone to see what bankers get up to when they let their hair down, so this will be a brief speech. My themes also relate to competition and teamwork: competition in the face of the challenges to the banking sector in Hong Kong, and teamwork in the sense of consolidation among banks as a strategy for addressing these challenges.

The End of the Storm

We have all witnessed the destructive force of the storm which swept through this region over the last two years. Hong Kong felt this force with the plunge in asset prices, a decline in GDP and rising unemployment. Now, after some 18 months of painful recession, and at a time of continuing structural adjustment, the Hong Kong economy appears to be on the road to a healthy and balanced recovery. Recently announced figures show that the Hong Kong economy grew by 4.5% year-on-year in the third quarter. The Government

1 This is the text of the speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Millennium Dinner of the Hong Kong Institute of Bankers on 9 December 1999.

has, in the light of these more promising economic indicators, now revised the full year estimate of GDP growth to 1.8%. Some expert commentators, who had earlier in the year dismissed the government's initial modest estimate of 0.5% as unrealistically optimistic, are now predicting an even higher growth rate.

That the banks in Hong Kong were able to ride the storm much more successfully than their counterparts in other places owes much to the fact that they were well positioned and well prepared before the storm struck. At the end of June 1997, just before the Asian Financial Crisis erupted, the average capital adequacy ratio of authorised institutions in Hong Kong was over 17%. The average liquidity rate was around 50%. This gave the banks a sufficient cushion to withstand severe shocks when the storm struck.

Yet, even though the banks have been well able to withstand the shock to Hong Kong's system, regional financial crisis and recession have had a severe effect on their business. Owing to a combination of demand and supply factors, we have seen the amount of domestic bank credit decline, from HK$2.23 trillion at the end of 1997 to HK$1.95 trillion at the end of September 1999, a drop of about 13%. Over the same period, total customer deposits rose from HK$2.7 trillion to HK$3.1 trillion, an increase of 15%. This has inevitably given rise to excess liquidity and a subsequent struggle among bankers to find a safe haven for these excess funds.

Despite the difficult operating conditions, most banks have remained profitable. Where losses did emerge in one or two cases they did not produce any systemic problem, largely because of the cushion of capital and liquidity I have already mentioned. This must be set down as a remarkable achievement for Hong Kong's banking sector, given the severity and suddenness of the crisis that hit us. But we cannot be complacent. The tide of change in the financial markets continues to advance and we have to think hard about our strategy to meet the challenges, not just in the aftermath of regional financial crisis, but also in the context of a changing global financial landscape.

Challenges

Competition

In the aftermath of a storm, there is always the need for a certain amount of repair work. In the case of the banks, the priority has been to rebuild their balance sheets by bringing down their loan-to-deposit ratios and to contain further credit losses by being more cautious in their lending. This process is now over and the banks are anxious to lend again, providing they can find bankable propositions. The problem is that good lending opportunities are currently few and far between, particularly in the corporate sector. Private investment has been weak, although there were signs of recovery in the third quarter. Companies have also been meeting part of their financing needs in the equity market and through issuance of corporate debt, thus reducing their recourse to the banks. This has inevitably channelled banks' lending efforts into the residential mortgage market. There are very good reasons for this. It is the only area that has seen a discernible demand from borrowers, albeit a modest one by past standards. Moreover, the quality of the mortgage portfolio has remained remarkably good despite the recession, with the delinquency ratio on mortgages rising to a peak so far of only 1.16%.

The effects of this active competition have been to change the economics of mortgage lending. The days of comfortable margins over prime are long gone, and we are now seeing mortgages being offered at increasing margins below prime, with the additional incentive of upfront cash rebates for customers. This is good from the consumers' point of view, but the problem for the banks is that not much new business is being generated for the sector as a whole. Rather, we are seeing an increasing percentage of mortgage loans being used for refinancing purposes - the effect being to create a "merry-go-round" as mortgages switch from bank to bank on ever-decreasing terms.

Nor is this the only area where competition is being felt. Tax loans are becoming the next battleground, and spreads on syndicated loans are almost back down to where they were before the crisis. It is nevertheless true that, with excess liquidity, there has been less active competition for funding. Deposit margins have also been improving, which has helped to offset the squeeze on lending margins. But we need to look further ahead. When the interest rates on deposits are fully liberalised over the next two years, we can expect to see greater price competition on the funding side as well.

We should certainly not indulge in too much hand-wringing over the current situation. After what we have been through over the last two years, it is natural that borrowers should be more inclined to keep their heads down. No doubt as the economic recovery gathers momentum and market participants regain confidence, the demand for loans will re-emerge. Nevertheless, banks cannot count on a return to the lending boom of the pre-crisis years. Nor indeed do I think that this would be a healthy development either for the banks or for Hong Kong. The most likely outcome is that business will revive, but not at the speed the banks have experienced in the past. Competition is likely to remain intense, and the banks will have to battle hard to retain or enlarge their market share. It will therefore be all the more important for banks to carefully mould a competitive strategy. This requires each bank to go back to basics: to examine and understand the nature of its products, the needs of its customers, its competitive strengths and, not least, the behaviour and responses of its competitors.

A Changing Global Landscape

Quite apart from the internal dynamics of competition within Hong Kong, banks also have to take into account global trends. Among these, advances in information technology are moving at such a rapid pace that it is sometimes hard to keep up. This has a direct impact on the banking sector, since it opens up a growing array of delivery channels. On-line banking, in all its increasingly varied forms, is poised to become a key channel for transacting banking business. The importance of physical branches in a cyber-world may decline and the nature of the services they provide will probably change. Customers will demand more efficient and personalised services when they visit the branch of a bank, leaving the more routine processing to be taken care of through on-line channels. For anyone who thinks that developing these channels will be a slow process, let me cite a recent newspaper report, which quoted a local bank as saying that the cyberbanking service it had recently introduced to customers is already taking up 10% of the volume of its routine transactions. This gives a powerful indication of how quickly technology is accepted and integrated into the banking industry. It underlines the blunt point made recently by one of Hong Kong's experienced bankers that 'any institution that doesn't have an internet programme in two years will regret that decision'. Technology is here to stay and the challenge is for bankers to embrace technology to their own and their customers' advantage.

Consolidation

Why Consolidation Is Important

Intensified competition, global liberalisation, technological advance, and the greater sophistication in services demanded by customers all suggest that size will increasingly be an advantage in a bank's strategy for development. Size in banking should not be an end in itself. But, used properly, it facilitates cost reductions through economies of scale, and the reduction of surplus capacity through, for example, the elimination of duplicate branches. It allows for more effective risk management, and for greater resources to be put into technological development, diversification of services and products, and process optimisation. Size enables banks to operate on an international rather than just a local stage. Even if we look in our own backyard we can see that the current prerequisite to set up a branch in the Mainland of China is asset size of US$20 billion, which eliminates most local Hong Kong banks.

The clear global trend is towards consolidation among banks. As banking business as a whole increases, the number of banks declines. The number of commercial banks in the US shrank from 13,220 in 1993 to 10,922 in 1997, a net decrease of approximately 17%. The number of banks in the UK, Germany, Australia and Japan combined shrank by about 7% over the same period. Since 1997 the pace of high-profile mergers and acquisition throughout the world has quickened: Lloyds-TSB, BNP-Paribas, Deutsche-Bankers Trust, Chase-Chemical, Citibank-Travellers are just a few that spring to mind. Two Scottish banks are currently fighting one another for control of National Westminster Bank. Only last week, I was reading in the Financial Times about the moves towards further consolidation in the Italian banking sector. Significantly, the story was headlined, "survival of the biggest". Even in Japan where the deeply entrenched conservatism of the banking sector is well known, the trend has been towards consolidation: the IBJ-Daichi Kangyo-Fuji merger caught everyone by surprise.

You may think that these international trends, involving mega-mergers, have little relevance to Hong Kong. This view would, I feel, be wrong. First, many of today's banking giants started off as quite small banks and grew to their present size through mergers and acquisitions. Bank of America in the US is an example that springs to mind. Secondly, economies of scale apply to small banks as well as to large banks, perhaps even more so in the case of small banks since there is less risk that diminishing returns will set in as a result of mergers.

Moreover, in Hong Kong consolidation becomes of greater relevance and importance when we look at the nature of the challenges I outlined earlier. When competition in the traditional deposit and lending business becomes increasingly focused on price, the natural response for banks is to think more and more about the costs of delivering these services, whether through traditional channels or through increased use of the telephone and the internet. It also leads banks more in the direction of broadening the range of products and services they deliver, with a greater focus on higher value added and fee-earning activities. These developments require increased investment, more efficient use of technology, staff with appropriate skills, and critical mass. Smaller banks will find it increasingly difficult to flourish without these advantages, and so the pressure to grow bigger will inevitably intensify. This view is supported in the concluding statement in the IMF's recent Article IV consultation on Hong Kong. 'Consolidation in the domestic banking system,' it observes, 'will be necessary'.

Our Stance

This brings me to the role of the HKMA in this process. I am firmly of the view that it would be unwise for a regulator to seek to direct changes of the kind I have described, particularly in an economy, such as our own, which operates on free market principles. 'Mandated consolidation' or 'forced marriages' in other jurisdictions have been unsuccessful. In one recent case in the region the directives backfired and caused serious dissent among the banks that were being forced to undergo the consolidation. In the end the government felt obliged to reconsider.

We have no intention of following that path. Nor on the other hand do I feel that we can sit back and wait to see what happens. There is always the risk that, without a clear stimulus, individual banks will not respond quickly enough to the challenges that lie ahead, and that when change is eventually forced upon them by market pressure, the impact will be rather brutal. The interests of creditors, most importantly depositors which we have a responsibility to protect, may be adversely affected. Furthermore, there is a danger that systemic consequences may ensue, necessitating supervisory intervention that, in all likelihood, would be focused on the protection of the interests of depositors rather than of the owners and management of the individual banks. Gradual evolution is therefore far preferable to sudden mutation.

The question is what can be done to achieve this evolution and how can the HKMA help. One thing we can do is to use occasions such as this to advocate publicly the idea of consolidation and to put it on the agenda for consideration by those concerned, together with the justifications, as we see them. We can follow this up with private discussion with individual banks, while always bearing in mind that we cannot and should not force mergers on healthy banks, and that property rights of the owners of such banks must be regarded as sacrosanct.

What is more specifically within the remit of the HKMA is to keep the regulatory structure under continuous review to ensure that it is appropriate to current and prospective market conditions, and does not contain features that might inhibit banks from upgrading their capabilities or delaying their response to changes in the local and global financial landscape. This was the thinking behind the Consultancy Study on the strategic outlook for the Hong Kong banking sector which we commissioned in 1998 and which resulted in a report released at the end of last year. This in turn was followed up in July of this year by the HKMA's policy response to the study.

Our policy response includes a number of reforms to the regulatory structure in Hong Kong which are designed to improve efficiency and innovation in the banking sector by removing the few remaining barriers to competition. Another underlying objective is to give incentives to the banks to think harder about mergers and strategic alliances. To these ends, we have already liberalised entry to the banking system by effectively allowing foreign banks to open three branches rather than one, with further relaxation to be considered in 2001. We are also actively addressing the issue of opening up access to the payment system to restricted license banks. We hope that the framework for this can be announced quite soon. The proposed deregulation of the remaining Interest Rate Rules will, as I have already mentioned, further open up price competition on the liabilities side of the balance sheet. But I anticipate that it will also free the way towards innovation of a wider range of deposit products, such as interest-bearing current accounts. Providing that prevailing financial and economic conditions are not unfavourable, this deregulation will be carried out in two phases, beginning in July of next year and concluding in July of 2001.

This phased approach towards interest rate deregulation and the other reforms in our package serves two purposes. The first is to make sure that we balance increased competition with safety and soundness considerations. By introducing the reforms over a three-year period, the banks should have the chance to improve their risk management capabilities, while at the same time the HKMA will be endeavouring to further enhance the quality of its banking supervision. The second purpose is to establish a clear timetable within which, to use the words of the IMF, the banks will have "an important window of opportunity .... to assess their options and to take appropriate action". In other words, we are giving the banks every opportunity to plan ahead and to implement the strategic and system changes that are necessary to enable them to respond to the more competitive market.

As is generally recognised, progress towards consolidation in Hong Kong has been relatively slow so far. There have been one or two changes in the ownership of local banks over the last few years, but no mergers among banks. The reasons for this lack of progress are not hard to see. Families are still in control, or at least significant shareholders, in a number of local banks and they are understandably reluctant to give up their birthright. Moreover, the situation of the local banks has not been so dire as to force merger. As I have indicated previously, the local banks are well capitalised and highly liquid, and most of them have continued to make money during the worst recession in recent memory. But the economic pressure to grow bigger will undoubtedly increase, and the more far-sighted among the local banks recognise this. Our reform measures have certainly given them every incentive to do so. The problem is how to get from A to B.

One way is to try to achieve some of the benefits of merger without actually merging. The most notable recent example is the Bank Consortium Trust, which has been formed to develop the infrastructure for common Mandatory Provident Fund products which will be marketed through the branch networks of the participating banks. Ten banks are now involved one way or another in this project, which will enable development and IT costs to be shared and the economies of scale which are normally available only to larger institutions to be achieved. This is an imaginative response to the competitive environment and one which the HKMA strongly supports. I hope that this co-operation can be extended into other business areas, and, who knows, as the banks work increasingly together, relationships could be forged which will lead in the direction of eventual shared ownership.

One important message I have tried to convey in this speech is that banks in Hong Kong should be heading towards consolidation. They have to find a way to do so for themselves. The role of the HKMA is to ensure that the regulatory environment places no obstacles in their path and gives them every incentive to think bigger and to work more closely together in their strategic responses to an increasingly challenging world. I am hopeful that the banks, steered by the market, will be successful in achieving this.