STABILITY OF THE BANKING SYSTEM IN HONG KONG*

Banks are highly geared and closely interlinked. The HKMA is concerned with the stability of the financial system and providing a measure of protection to depositors. It therefore supervises the banks and may act as a lender of last resort in providing liquidity if systemic risks arise.

Introduction

Mr. Chairman, thank you for your kind words of introduction. I am delighted to be here to address the American Chamber of Commerce in Hong Kong.

Corporate America has a substantial presence in Hong Kong. The fact that Amcham (Hong Kong) is the largest Amcham outside the United States speaks for itself. There are over 900 US firms in Hong Kong. Amongst them are 14 licensed banks, nine restricted licence banks and twelve deposit-taking companies with a total of over 100 branches. Obviously you have a strong interest in the stability of the banking system here either as users of banking services or as providers of such services.

Why is banking stability important?

Let me start with the obvious but important question of why banking stability matters. Despite the growth of capital markets and increasing financial disintermediation during the 1980s, banks are still the major avenue whereby funds are channeled from savers to borrowers. This is particularly the case in Hong Kong. Banks also perform the important function of facilitating payments arising from all forms of transactions and serve as vehicles through which monetary policy is transmitted to the real economy. Stability of the banking system is thus important to protect depositors who place their savings in these institutions, to avoid disruptions to economic activity and to ensure that the effectiveness of monetary policy is not inhibited.

Banks are different from other companies by virtue of their high level of gearing. They rely much more heavily on borrowed money in relation to their shareholders' funds. There is also a natural mismatch in the maturity of their assets and liabilities. On one side, their deposit liabilities can generally be withdrawn on demand or at short notice. On the other, their assets, bank loans, are mostly illiquid and it may be difficult to realise these in case of need. The willingness to take on the risk of maturity transformation is indeed a main source of the value added of the banking system. However, it is also a source of potential instability in that it leaves banks vulnerable to a sudden withdrawal of funds which they may be unable to meet. This phenomenon of bank runs may be triggered by an actual or rumoured deterioration in asset quality which, by virtue of the high gearing I mentioned earlier, can wipe out a bank's capital.

Banks are different from other companies also because they operate in a network closely linked by the interbank market and the payments system. These linkages can have the effect of quickly transmitting problems in one bank to others in the system. A loss of confidence can therefore be contagious. Part of the liabilities of one bank are almost bound to be the assets of another. Through the interbank market, banks are substantially exposed to each other, and the interbank market is very large – roughly HK$ 700 bn of interbank liabilities in Hong Kong.

This potential for contagion and for resultant systemic problems explains why banks are different from other companies. It provides the rationale for the somewhat intensive and, some would say, intrusive supervision to which banks are subject.

The HKMA's role in maintaining a stable financial system

This supervisory function in Hong Kong is performed by the HKMA. Our other two key

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functions are to maintain currency stability within the framework of the linked exchange rate system and to promote the efficiency, integrity and safety of the payments system.

There is an obvious synergy between these three main functions which have often been referred to as the trilogy of central banking. From the macro perspective, an appropriate and stable monetary policy with a clearly defined objective is essential to provide a favourable environment within which banks can operate. Recent experience elsewhere should have taught us this lesson. Monetary policy in many countries was undoubtedly too vague and too lax in the 1980s leading to excessive demand, rising inflation and, in particular, to the phenomenon of "asset price bubbles". The tightening of policy which inevitably followed put pressure on borrowers and banks alike, producing a collapse in asset prices and a deterioration in banks' balance sheets.

Hong Kong went through its own version of this crisis somewhat earlier, in the period 1982-83. Although the effects lingered on in the banking sector until 1986, aided I regret to say by instances of fraud and mismanagement, the macroeconomic position was stabilised by the adoption of the exchange rate link with the US dollar eleven years ago.

Our exchange rate policy has served Hong Kong well as demonstrated by the stability of the HK dollar during the stock market crash in October 1987, the events in China in June 1989, the Gulf war, the BCCI induced bank runs in 1991 and the ERM turmoil in 1992. The exchange rate link has therefore stood the test of time and it remains the centrepiece of our monetary policy.

A stable banking system in turn provides the necessary channel through which monetary policy can be implemented by means of influencing interest rates and the amount of liquidity in the system. And a solid and efficient payments system – the final element in the trilogy – is the glue that holds the banking system together. One of our essential tasks is to ensure that the glue does not come unstuck – hence our initiative to introduce a real time gross settlement (RTGS) system to settle interbank Hong Kong dollar payments.

The role of banking supervision in maintaining banking stability

Having established the importance of banking stability, I wish now to discuss in more detail how we go about trying to achieve this in Hong Kong.

There are two aspects to this task: the preventive and the remedial. The first involves trying to prevent problems with banks from arising in the first place; the second deals with the consequences of these problems if they do arise and tries to put them right.

The preventive role lies at the heart of banking supervision. Like other supervisors, the HKMA tries to reduce the risk of failure in individual banks and other authorised institutions, and thus maintain the stability of the system as a whole. However, it is very important not to lose sight of the fact that the primary responsibility for preventing bank failures rests with the management of banks. They are the people who make the commercial decisions which determine whether a bank stands or falls. Regrettably, history shows that, left to their own devices, banks can be vulnerable to competitive excesses. The role of the supervisor is therefore to try to ensure that banks operate within a framework which keep these excesses in check, whilst not stifling competition. This is done by laying down minimum standards for capital adequacy, liquidity and risk concentrations and by trying to ensure that banks are managed and controlled by fit and proper persons.

As I have indicated, our essential task in banking supervision is to preserve the stability of the banking system as a whole. This is embodied in section 7 of the Banking Ordinance which states that my main function, as Monetary Authority, "shall be to promote the general stability and effective working of the banking system."

There is of course another aspect of supervision which is to protect the interests of individual depositors and indeed if you look at the long title of the Banking Ordinance, you will see that, apart from the stability objective, the Ordinance is also intended to provide "a measure of protection to depositors". But note that these words are carefully chosen. The Ordinance does not say that depositors will be guaranteed 100% protection or that they will never lose money. In practice, that would be difficult to achieve. No supervisory system can hope to be 100% effective – or at least it cannot be so without being so restrictive as to stifle competition and innovation by banks.

Moreover, there is also an important philosophical objection to saying or implying that banks can never fail and that individual depositors can never lose money as a result. If that were the case, it would create the familiar problem of moral hazard whereby both banks and individual depositors would lose their own sense of responsibility. Depositors would be quite happy to place their funds with risky banks which offered higher rates of interest, and such banks would be relaxed about paying higher rates of interest to attract such funds. I am sure that I do not have to remind this audience of the consequences of this kind of unholy alliance between banks and depositors. The US savings and loans crisis of the 1980s is perhaps the classic illustration of this.

Let me be clear. I am not saying that we want banks to fail and depositors to lose money, even occasionally, in order to build up a sense of responsibility among market participants. What I am saying however is that it is important, in the broader interests of the general stability and effective working of the banking system, that we do not give the impression that there is an infallible system of supervision or some other kind of safety net which means that individual bank failures will never be allowed to happen, or that there will not be unpleasant consequences from such failures.

Lender of last resort

While not claiming infallibility, we should, and do, try as much as possible through our supervision to prevent banks from getting into difficulties. This is the preventive role which I referred to earlier. But we have to acknowledge the possibility that these difficulties may nonetheless arise. They have certainly done so in the past in Hong Kong and more recently in a number of other countries around the world. This may be the result of imprudent commercial decisions by the banks concerned, or by adverse changes in the economic and financial environment within which they operate. More likely it will be a combination of the two.

When problems in a bank do occur, the focus of attention shifts, as I have indicated, from the preventive to the remedial. At this stage the monetary side of the central bank will become involved because it is necessary to decide whether to provide financial assistance to the troubled bank as lender of last resort. In some countries, the lender of last resort may not be part of the same body as the banking supervisor. Indeed, that was the situation in Hong Kong prior to the end of March last year when the HKMA was formed out of the Office of the Exchange Fund and the Banking Commission. However, since that time both functions are clearly the responsibility of the HKMA.

The function of ***lender*** of last resort must be distinguished from that of ***equity provider*** of last resort. The first of these is normally taken to refer to the provision of liquidity by the central bank to otherwise sound institutions which are facing a funding problem. The hope is that the provision of temporary financial support will give the institution a breathing space which will be sufficient to enable it to put things right. This is quite distinct from a bank rescue where an insolvent institution is bailed out with capital support of some kind or is taken over by the central bank or by the government. In the latter case, the problem has become one of solvency rather than liquidity. This raises broader questions of public policy about the extent to which the central bank's own capital or, ultimately, tax payers' money should be put at risk. In practice, of course, the two problems – of liquidity and of solvency – tend to shade into one another; and what starts off as a shortage of cash may eventually become a shortage of capital.

So far I have been talking about the general concept of lender of last resort. Let me now discuss more specifically how this concept is applied in Hong Kong.

First of all, I would like to point out that there is an official lender of last resort in Hong Kong and that this is the HKMA. Some persons, even within the banking community in Hong Kong, still seem to be not quite clear about this.

The means available for this purpose are provided by the Exchange Fund which the HKMA manages on behalf of the Financial Secretary. In fact, this is not a new feature. In a statement to the Legislative Council on 9 April 1986, Sir John Bremridge, the then Financial Secretary stated that:

> "The reserves of the Exchange Fund in connection with the authorised powers and indeed express duties of the Commissioner of Banking and the Financial Secretary with regard to the Banking Ordinance and the Exchange Fund Ordinance respectively form a lender of last resort – a quasi central government bank such as exists in so many other places in the world."

However, the advent of the HKMA has perhaps clarified the situation by giving a more precise institutional focus to the lender of last resort function. Also, it was the case previously that the resources of the Exchange Fund could only be used for this purpose when problems in a troubled bank could affect, either directly or indirectly, the exchange value of the Hong Kong dollar.

Following the Exchange Fund (Amendment) Ordinance 1992 which provided for the establishment of the HKMA, it is now clear that the Exchange Fund can also be used to maintain the stability and integrity of the monetary and financial systems of Hong Kong, except where that would conflict with the primary purpose of maintaining exchange rate stability.

I should emphasise however that the secondary use of the Fund is strictly limited to dealing with problems with ***systemic*** implications and not for supporting individual banks per se. This is consistent with the systemic concerns of the HKMA as banking supervisor to which I have already referred. Of course, there may be occasions where financial support for an individual bank is necessary to prevent a domino effect across the whole banking system.

The role of the HKMA as a provider of liquidity has been aided by the monetary reform measures of recent years. In particular, the introduction of the Liquidity Adjustment Facility (LAF) in 1992 has provided a formal channel through which overnight liquidity assistance to banks can be extended. However, the main purpose of the LAF is to assist banks in making late adjustments to their liquidity positions, defined to be the balances in their clearing accounts. LAF should not be regarded as a substitute for prudent liquidity management, and banks are not expected to make use of it on a regular basis. Nonetheless, in their normal day-to-day operations, banks do sometimes find themselves short of cash (or indeed with surplus cash) at the end of the day. And in these circumstances, they can use the LAF without any implication that they are suffering from more deep-seated liquidity problems.

The LAF should therefore be seen more as Hong Kong's version of a ***discount window*** than as a lender of last resort facility. It is there, as I have said, to enable banks to square their cash position at the end of the day. Reflecting this, the LAF is subject to certain rules as to the period during the day when it is available and lending through the facility is normally fully secured against high quality paper, such as Exchange Fund Bills and Notes.

By contrast, in providing lender of last resort assistance to a bank in trouble, the HKMA would not necessarily feel bound by the LAF rules. Each case would be different and would have to be looked at on its merits. It is however possible to lay down certain broad principles as to how we would provide lender of last resort assistance.

First, such assistance is by no means automatic. As the Financial Secretary said in 1986:

> "Each case is different and must be handled on an ad hoc basis. No banker and certainly no shareholder in a local bank should be lulled into an imprudent belief that if he gets into trouble Exchange Fund support is inevitable."

The guiding principle in considering whether to provide financial support is, as I have indicated, whether the failure of an individual bank would, either by itself or through the creation of a domino effect, damage the stability of the exchange rate or the monetary and financial systems. However, having made that judgment, it is important that we should not be inhibited in providing assistance. In other words, we should be prepared to do what is necessary to solve the problem while always being alert to the danger of throwing good money after bad.

Second, lender of ***last*** resort should mean what it says. The HKMA should not be the ***first*** resort for a troubled bank. We expect all authorised institutions in Hong Kong to have liquidity policies in place which, among other things, include contingency plans for dealing with a funding crisis. Such plans should identify emergency sources of funds and which assets could be used for pledging purposes. We would certainly expect a bank with funding difficulties to let us know of its problems as soon as possible. But we would also expect it to utilise its own liquidity resources and commercial sources of finance before obtaining support from the HKMA. In particular, we would look to significant shareholders in a bank to inject liquidity and/or capital into the bank as a demonstration of their own commitment.

Third, in its role of lender of last resort, the HKMA would act on the basis that it is providing liquidity support to institutions that are currently solvent. This is not to say that insolvent institutions would never be rescued, but this would involve wider policy considerations and a different decision-making process. A rescue operation of this kind ***knowingly*** involves the provision or commitment of public funds as risk capital and probably with the threat of some loss. This loss may be a price worth paying in the broader interests of systemic stability. But it contrasts with the position of lender of last resort who is ***lending*** money and who should make every effort to ensure eventual repayment. Of course, the lender of last resort is exposed to credit risk, but this should be in the capacity of a banker's bank rather than investor.

Finally, therefore, in keeping with its role as a prudent banker and to discourage moral hazard, the HKMA would normally only lend on the basis of security and at rates which were commercial, if not penal. It has to be recognised however that in order to provide assistance on sufficient scale, it may be necessary to widen the range of acceptable collateral beyond that which we would be prepared to take through our normal discount window activities in the LAF.

I hope that you will agree that these principles are prudent ones which strike the right balance between our duty to safeguard the assets of the Exchange Fund and to maintain the stability of the banking system. We would certainly regard them as being in the mainstream of central banking thought on the conduct of lender of last resort operations.

Conclusion

I have explained the approach which is being adopted by the HKMA to maintain the stability of the banking system in Hong Kong. The establishment of the HKMA has put us in a much better position to carry out this important responsibility as the monetary and banking supervision functions are now under one roof. We pursue a consistent policy of maintaining the stability of the exchange rate which we believe creates a stable monetary and economic environment within which business and banks can operate. We are working actively to put into effect real time gross settlement which would help to reduce the risk of contagion through the payments system. The banking supervisory framework is being constantly updated to follow the best practices recommended by the Basle Committee on Banking Supervision and adopted by other major international financial centres. In this connection, subject to the advice of the Executive Council, a substantial Banking Amendment Bill is scheduled to be introduced into the Legislative Council early next year.

I hope I have also clarified the HKMA's approach in exercising its function as lender of last resort. In particular, I have tried to distinguish the provision of liquidity support to sound institutions from the rescue of insolvent banks. The former has traditionally been seen as the accepted, though hopefully not routine, role of the central bank; the latter raises wider issues of public policy.

A stable banking system helps business to flourish. But this is essentially a two way street. In this sense you as businessmen and investors who have taken such a high stake in Hong Kong and contributed so much to our economy have also contributed significantly to the health and prosperity of our banking system. I am sure this mutually beneficial relationship will continue into the future.