THE BANKING SCENE: REVIEW AND OUTLOOK*

The slump in global markets made 1994 a challenging year for Hong Kong banks. On the supervisory front, revised policies on liquidity and loan classification were introduced and an agreed package of reforms relating to financial disclosure was released. Some of the interest rate ceilings on time deposits were removed. A number of supervisory initiatives will be undertaken in 1995 but with a sensitivity to the costs of regulation.

Introduction

It is a pleasure to be here to address this gathering of the Institute. These occasions are a valuable opportunity for the Monetary Authority to take stock of the current position of the banking industry and our supervision of it, and to report to you on how we see the way forward. The general policy of the Monetary Authority is to be accountable, both to the general public and to the institutions which it supervises. Occasions such as this are a way of achieving that.

I last spoke to the Institute in October 1993. Among the topics I discussed were asset quality, liquidity, market risk and interest rate risk. These are all areas on which we made progress in 1994 and which will continue to be a focus of attention in 1995. I will be reporting on these developments in the course of this speech.

Overview of 1994

Let me begin by giving an overview of some of the main features of the last year, starting with the economic environment faced by the banks.

Even at the time 1994 felt like a watershed year. The US Federal Reserve Board finally reversed its low interest rate policy by raising Fed Funds rate by $^1/_4$% on 4 February 1994. This was followed by successive increases in both the Fed Funds rate and the discount rate amid continuing concern in the US that inflationary pressures might be building up. The rise in short-term rates in turn caused a sharp fall in bond markets around the world.

These trends made themselves felt in Hong Kong. Our interest rates have risen more or less in line with those in the US and this has helped to produce corrections in the equity and property markets. As a result, sentiment is now decidedly more downbeat than it was a year ago. However, it must not be forgotten that the economic fundamentals in Hong Kong remain solid: real GDP probably rose by about 5.5% in 1994 and private sector forecasts suggest that it will grow at about the same rate, or even faster, this year.

Banks in Hong Kong thus found themselves confronted with a less favourable environment in 1994 and this has shown up in their overall performance. There is however nothing surprising in this. Once the trend in US interest rates reversed, it was bound to be difficult for the sector as a whole to sustain the rapid profit growth of the previous three years.

We do not yet have the profit outturn for the whole of 1994. However, based on the figures for the first nine months of this year it is evident that the income of the locally incorporated banks grew more slowly while their operating expenses grew more rapidly. The slower income growth was partly the result of a slight narrowing of the net interest margin. However a more important factor was the slump in investment income caused by the stock and bond market problems already referred to. But this did not affect all banks equally, depending on their mix of business, and some banks may therefore continue to record quite rapid growth in profits in 1994.

A favourable influence on profits in 1994 was that the bad debt charge remained very low: only 0.05% as an annualised percentage of assets in the first nine months. Too much comfort should not however be taken from this: it is likely that bad debts have reached a trough in Hong Kong and we would expect to see the next movement to be upwards.

* This is the text of a speech given by David Carse, OBE, Deputy Chief Executive (Banking) of the Hong Kong Monetary Authority to the Chartered Institute of Bankers on 18 January 1995.

Changes in the regulatory environment

While all this has been going on, the banks also had to cope with quite radical changes in the regulatory environment in Hong Kong. In particular, important changes in the financial disclosure rules for banks and in the interest rate structure were introduced during 1994. Because of their importance, I will be discussing these developments separately later on in my speech. But before I do so, I will just summarise briefly some of the other changes that have taken place in the banking supervisory regime in what was a very busy year for the Monetary Authority.

First, our revised policy on liquidity was finalised and introduced on 1 August 1994. Partly this involves revisions to the existing statutory liquidity ratio to give better assurance about the quality of the liquid assets being held. But more generally the new policy acknowledges that adequacy of liquidity depends on a variety of factors, including maturity mismatches, loan to deposit ratio and the quality of funding. Another important feature is that in dealing with liquidity risk, as with other aspects of risk management, the main responsibility rests with the board and management. As a practical demonstration of this, we are requiring all authorised institutions to submit written policies on their liquidity management.

Despite some teething problems, the new liquidity regime has been introduced quite smoothly. As might be expected, a relatively small number of institutions could not immediately meet the 25% minimum liquidity ratio under the revised definition. However, after making balance sheet adjustments, all institutions were quickly able to comply with the minimum requirement. For the system as a whole, the new liquidity ratio remains well above the 25% minimum.

Second, we have introduced our new policy on loan classification with the first report due at the end of last year. This acknowledges the point that I made the last time I talked to the Institute that poor asset quality is still the main cause of problems in banks and thus should be the main focus of attention for supervisors. The loan classification return should help to give us better information about the quality of institutions' loan books. In particular, it should give us early warning of deterioration as loans move through the various categories. We should also be better able to judge the adequacy of provisions in relation to problem loans and to make peer group comparisons among different institutions. This will be particularly important if, as I believe, we are at the trough of the current bad debt cycle.

Third, we have finalised a new return on interest rate risk which will be submitted for the first time in February of this year. This is somewhat basic in nature, but I hope that it will help to focus the attention of institutions on the need to measure and manage their interest rate exposure. The sharp rise in short-term interbank interest rates last week provided an important reminder of this.

Fourth, we have continued our efforts to combat money laundering in Hong Kong. These efforts were recognised in the report of the Financial Action Task Force on Hong Kong which stated that the Hong Kong Government had made a sincere effort to tackle the problem. It did say however that the banks themselves could do more, in areas such as staff training. The banks have responded to this in a positive way, in particular through the release in October 1994 by the Hong Kong Association of Banks (HKAB) of a training video and booklet for staff. This, and the publicity which accompanied the release, have already produced results in terms of a significant increase in the number of reports of suspicious transactions made to the authorities. However, there is still more to be done in this area and we hope to assist through the issue of a new guideline on money laundering this year.

I could continue to describe many other of the supervisory issues which we dealt with during the year, but I wish now to turn to the reforms of a broader regulatory nature which will change the environment within which authorised institutions operate in 1995 and beyond.

Financial Disclosure

I will begin by talking about the subject of financial disclosure. This is an area where there have been separate initiatives by a number of different bodies: the Monetary Authority, the securities regulators and the Consumer Council. Each of these has a somewhat different perspective. In particular, the Monetary Authority and its

predecessors have always been concerned that the stability of the banking system could be undermined if the banks were obliged to disclose substantial losses. For this reason, we accepted that banks should be allowed to maintain inner reserves to smooth their profits.

We came increasingly to the view, however, that this position could not be maintained. The international trend is towards more disclosure and there was a risk of Hong Kong being left behind. The very low level of disclosure threatened the image of both individual Hong Kong banks and the system as a whole in the eyes of investors, depositors, counterparties and rating agencies. Lack of disclosure also makes it difficult for the public to compare the relative performance of different banks. This means that an important element of market discipline on the behaviour of bank management is missing.

We thus began to develop in consultation with the banking industry proposals for increased financial disclosure. At the same time, the Stock Exchange and the Securities and Futures Commission were also preparing their own proposals in respect of listed banks. It seemed sensible therefore that we should aim for a joint approach. I am glad to say that this cooperation worked well and led to an agreed package of disclosures for the 1994 accounts and an initial package for 1995.[1]

The 1994 measures are quite far-reaching. Most banks will be revealing much more information than previously about their actual profits, provision for bad debts and the composition of assets and liabilities. The one missing item is balance sheet inner reserves, but we shall be reviewing the disclosure of these in the middle of this year.

I can see that the banks may be a bit nervous about revealing themselves more fully to the outside world. It will undoubtedly impose more discipline on banks to ensure that they present a good picture of their performance and exposure to risk. I do not however believe that they have good reason to fear disclosure. Even if profit growth has slowed down in 1994, banks in Hong Kong are still among the most profitable and best capitalised banks anywhere in the world. More transparency will give the banks the chance to show this. This should help in various aspects of their business, including in particular their ability to access the capital markets.

Interest rate deregulation

Interest rate deregulation is another current hot topic. This is an area where the Monetary Authority did not take the initiative but rather advised the Government on its response to the recommendations of the Consumer Council Report. Our conclusions were that it would be acceptable to proceed with deregulation of time deposits governed by the interest rate rules since those accounted for less than 4% of total HK dollar deposits and were already subject to competition from swap deposits.

HKAB agreed with this proposal and has already implemented two stages of the removal of the interest rate cap from time deposits: now only deposits with a maturity of 7 days or less are subject to the cap.

The Monetary Authority is following this process closely. We are talking to a wide range of institutions about their experience of deregulation and we are receiving regular monthly statistics on interest rates and the breakdown of deposits from a survey group which accounts for the bulk of the deposit market in Hong Kong. The figures for October and November 1994, the first two months of deregulation, indicate that there has been a significant movement of deposits from savings accounts to deregulated time deposits. In the two months savings deposits of the survey group fell by $11 billion or 4% while the deregulated time deposits rose by $10.5 billion or 58%.

This seems quite a close match. But the change in deposit structure is probably not solely due to deregulation. 1994 saw a more general shift of deposits into HK dollar time deposits and swap deposits: the former rose by 32% and the latter by 45% in the 11 months to November 1994. This reflects the rise in interest rates during the year which, along with the fall in the stock and property markets, increased the attractions of interest bearing time deposits as an investment medium.

1 Further information about the joint disclosure package is given in an article in the November 1994 issue of the HKMA *Quarterly Bulletin* (pp.15-19).

So far, the institutions we have talked to seem quite comfortable with the effects of the deregulation. Some even see advantages in terms of being able to attract smaller retail time deposits and reduce reliance on the more administratively cumbersome swap deposits. However, we must not become complacent. The deregulation is still in its early stages and the full effects on funding costs and on the behaviour of banks and their customers have still to become apparent. In particular, we know that there are concerns among the banks that deregulation of the very short-term deposits, and particularly 24-hour call deposits, will have a destabilising effect on the deposit structure of individual banks and push up funding costs.

The timetable for the deregulation provides however that the removal of the interest rate cap from 24-hour call deposits will be done in stages. Each stage will be subject to both the Monetary Authority and HKAB being satisfied that it will not cause instability in the banking and monetary systems. I can assure you that in reaching this judgment we shall err on the side of caution.

In the meantime, the deregulation that has already taken place has benefited consumers by providing them with wider access to market rates of interest on most maturities of time deposit. At the same time they are still able to enjoy the convenience of the transaction facilities offered by current accounts and savings accounts. This is a reasonable equilibrium that we must be careful not to upset.

Before leaving the subject of interest rates, I shall mention one aspect which has been causing us concern. The main competition for deposits is not in fact in the deregulated area but for those above $500,000 and indeed for amounts much larger than this. It is well known that certain banks are prepared to pay well above HIBOR and in some cases even to pay best lending rate for these large deposits. This is a matter of concern from various points of view.

First, such deposits are wholesale in nature and relatively short term. While they may improve the bank's loan to deposit ratio, this effect will be only temporary if the deposits move to the highest bidder on maturity. This may result in funding problems for the bank that loses the deposits.

Second, while the bank bidding for such funds may be able to absorb some of the higher cost in its lending margins, the temptation will be to go for a higher return on its loans with consequent higher risk.

Third, this type of competition may put pressure on the smaller banks by obliging them to pay the higher rates as a defensive move to avoid losing market share.

This is an area where it is difficult to lay down across-the-board guidelines. Interest rates on small deposits are being deregulated and we do not want to impose a different form of regulation by the back-door. It is however legitimate for us to examine individual banks' funding policies to ensure that they are not relying too much on these lumpy and expensive deposits. We shall be doing this in our discussions with banks over the next few weeks. I will also take this opportunity to remind individual banks that they do not operate in isolation in Hong Kong. While we are in favour of competition, each bank has a responsibility to exercise self-restraint and to avoid forms of behaviour which could establish destabilising trends.

The outlook for 1995

I will now try to look ahead to some of the developments which may affect the banking community in 1995, including those of a supervisory nature.

The latest issue of the Institute's own magazine, *Banking World*, has an editorial headed "Testing year lies ahead". That strikes me as quite an accurate description. In fact, the first two weeks of 1995 have already been testing enough for most people, including the Monetary Authority.

In the external environment, US interest rates may well go on rising at least until the middle of the year and possibly beyond. This, together with the ongoing interest rate deregulation in Hong Kong, may put some pressure on banks' margins. The repayment ability of some borrowers may also came under pressure from higher interest rates, lower asset prices and tight liquidity in China. This would push up the bad debt charge from its present very low level.

The news is however not all gloomy. The fact remains that banks continue to operate within a fundamentally strong economy with most private sector forecasters predicting that growth for this year will remain around 5.5% to 6%. Banks will however need to continue to diversify their lending and sources of income away from over-reliance on the residential mortgage market. They will also have to keep tight control on costs in the light of the deterioration of the cost-income ratio which occurred in 1994.

Supervisory initiatives

As regards the regulatory framework, there will be new proposals for additional disclosure in 1995. These will deal with such aspects as segmental analysis, cash flow statement and reporting of derivatives activities.

Derivatives will be a focus of attention in other areas. We have just issued a guideline on the risk management of this business and we will be following this up with a series of visits to the treasury operations of the main players during the first half of this year. The intention is to produce a further guideline which will deal in more detail with the operational controls over derivatives activities.

The capital requirements for derivatives activities also need to be reviewed. We will be doing this within the context of the Basle Committee's proposals for capital to be held against the market risk on debt and equity securities and their derivatives. It is unlikely however that any new regime arising from these proposals could be introduced in Hong Kong before 1996 at the earliest.

In the meantime we are refining the current capital requirements for the credit risk on derivatives by introducing a wider recognition for bilateral netting of off-balance sheet transactions. Our final guidelines on netting should be released in the next few weeks.

More policy initiatives in areas such as mortgage securitisation, money laundering and large exposures will also be studied and hopefully introduced during the year. A major preoccupation will also be to secure the passage of a new Banking Amendment Bill through Legco. This is intended principally to rationalise the current licensing regime by making the Monetary Authority responsible for the authorisation of all three types of authorised institutions.

It is inevitable that we should undertake these new initiatives in order to keep our supervisory system up to date and to maintain Hong Kong's reputation as an international financial centre. However, we also need to be alive to two related dangers. It is easy to fall into the trap of over-regulation and under-enforcement. By that I mean that a supervisory framework can look very good on paper, but what matters at the end of the day is how it is administered. We shall be looking therefore at the ways in which we actually conduct our supervision and at how further productivity gains can be achieved. This involves such aspects as work practices, training and recruitment.

Related to this is the effect of regulation on the costs of doing business in Hong Kong. In general, I believe that authorised institutions are supportive of the changes which we have made in recent years to improve the supervisory system in Hong Kong. However, we are aware through discussions with Mr David Li and other influential figures in the banking community that there is concern about the increasing burden of prudential returns and surveys.

Of course, supervisors need to have information about banking developments such as deregulation of interest rates - otherwise they are operating in the dark. However, we recognise that there is a balance to be struck. We also appreciate that as a reporting regime expands, duplication, inconsistency and redundancy can creep in. The time may be right therefore for an overall review of our reporting requirements and practices. We are still considering the right way forward on this. But one option may be to set up a joint HKMA-Industry working party to review how the reporting burden can be eased. We will be taking this forward in the near future.

On that note of cooperation which I hope is typical of our relationship with the banking community, I would like to wish all authorised institutions continued success in what is likely to be a challenging 1995.