MARKET ENTRY AND ASSET QUALITY *

As an international financial centre, Hong Kong has a large number of foreign banks. Foreign bank entry is governed by the Basle Minimum Standards but their retail operations are restricted. Most enter as branches. While Hong Kong banks have had relatively few bad debts in recent years, sectoral concentration of loans remains an issue. The HKMA has issued guidelines for property exposure. It also conducts on-site inspections of banks and has introduced a loan classification system.

This paper discusses, with particular reference to the experience of Hong Kong, a number of the key issues which face supervisors in dealing with the topics of market entry and asset quality. While the two topics are largely distinct, there are certain overlaps between them. For example, the entry of new foreign or domestic banks may fuel increased competition and, if bank management and supervisors are not vigilant, this may show up in reduced credit standards and lower asset quality.

New entrants into a banking market may be domestic or foreign in origin. While this paper touches on certain aspects that are relevant to domestic entrants, it has concentrated mainly on the foreign aspect bearing in mind the intense interest in this subject following BCCI and the international nature of the forum in which it will be discussed.

The Basle Minimum Standards

The repercussions of the collapse of BCCI clearly demonstrated that it is better for a host supervisor to deny entry to problem banks than to deal with the consequences of their subsequent failure. This has focused attention among supervisors on the principles which should govern market entry and the establishment by international banks and banking groups of cross-border operations. As in other areas, the Basle Committee on Banking Supervision has played an important role through the formulation of the 1992 Minimum Standards which are intended to govern the international expansion of international banking groups. The Standards are summarised below:

- All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision.
- The creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank's and, if different, banking group's home-country supervisory authority.
- Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home-country supervisor.
- If a host-country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

Policy on foreign entry

However, foreign entry into the domestic banking system is not exclusively a supervisory issue. The entry of foreign banks will raise broader issues of economic, monetary and trade policy, as well as reciprocity, and the relevant policy decisions may be taken at the highest levels of government, although the supervisory voice will no doubt be heard.

In the Asian region a distinct shift in attitude towards the entry of foreign banks can be detected in many countries, with previously restrictive

* This paper was presented by David Carse, Deputy Chief Executive (Banking) of the HKMA, at an International Conference of Banking Supervisors held in Vienna in October 1994.

policies designed to protect domestic banking systems giving way to a more liberal approach consistent with market-oriented financial reforms. Greater involvement in domestic economies by foreign banks is seen as providing access to foreign capital and finance as well as providing a stimulus to more competitive behaviour, technological advance and improved staff training on the part of local banks.

There is however a general recognition in the region that liberalisation must be accompanied by increased prudential supervision in order to control the increased risk-taking that may occur in a more competitive environment. This is likely to be a problem where liberalisation has allowed the creation within a short period of time of a significant number of new private sector banks, or state banks are attempting to turn themselves into commercial institutions rather than channels for state funds. In such overheated conditions, there is a risk that enhancements in supervisory policy and practice may lag behind the competitive changes that are occurring. Moreover, the unfettered entry of foreign banks may further increase the competitive pressures on an evolving domestic banking system. This suggests that, depending on the state of development of the domestic banks, while foreign entry should be encouraged as part of the liberalisation process, a balance may need to be struck in terms of numbers of new entrants and the permitted range of activities by foreign banks.

The position of Hong Kong

The position of Hong Kong in the region is somewhat different because it is already an international financial centre with a highly developed banking system. In total, it has over 500 banks, deposit-taking companies and representative offices, most of which are branches, subsidiaries and offices of foreign banks from over 40 different countries. However, Hong Kong has not arrived at this position through the application of a consistent policy on market entry designed to turn it into an international financial centre. Rather, its policy on foreign entry has evolved over the years in response to events and pressures.

Indeed, after the collapse of two local banks in 1965, Hong Kong imposed a moratorium on the granting of licences to foreign banks which was not finally lifted until 1981. The policy had, among other things, contributed to an enormous growth in the number of unregulated deposit-taking companies (dtcs), which were not subject to the banking legislation, as foreign banks used this route to get round the licensing moratorium. This gave rise to prudential concerns and eventually the government was forced to bring the dtcs within the supervisory net. In 1981, the moratorium was lifted and a formal three-tier structure of authorised institutions was introduced which survives today in the form of licensed banks, restricted licence banks (rlbs) and dtcs, the two latter categories being limited in their ability to take retail deposits.

Hong Kong's experience during this period is thus a good illustration of the way in which market forces find their way round obstacles designed to impede them.

Market entry has not, however, disappeared as an issue for Hong Kong. Despite a generally welcoming attitude to foreign banks, there is continuing caution about the potentially destabilising impact of foreign entry on the domestic retail banking sector. Thus, foreign banks which have been granted licences since the lifting of the moratorium are effectively restricted to one branch in Hong Kong. Subject to this constraint, however, Hong Kong is an integrated financial centre: once licensed, branches of foreign banks are allowed to carry on the full range of banking business, both domestic and offshore. In particular, they are allowed to take deposits in HK dollar from local as well as overseas residents.

This means that branches of foreign banks need to be subject to broadly the same supervisory regime as locally incorporated banks. However, because such branches are not required to maintain endowed capital in Hong Kong, it is not possible to set capital adequacy requirements for them or capital-based large exposure limits: these are regarded as the responsibility of the home supervisor.

Hong Kong licensing criteria

Critical mass is important for a financial centre: other things being equal, a large number of institutions gathered together in one place will tend to produce deeper and broader markets. However, while generally favouring foreign entry, Hong Kong recognises that it should not, and

cannot, "buy" success by using lower entry or regulatory standards to attract new entrants. This reflects Hong Kong's experience of past banking crises, and the need to maintain stability during the current period of political transition.

Hong Kong has therefore adopted a conscious policy of following international supervisory standards. In particular, it has incorporated the Basle Minimum Standards into its licensing criteria for foreign banks: it will only admit those banks who come from countries where the home supervisor has established, or is actively working to establish, the capabilities to meet the Standards.

However, establishing whether the home supervisor has these capabilities may not be easy, particularly since there may be gaps between what supervisors claim to do and their actual performance and practice. In Hong Kong's case, we would assess the legal and administrative powers of the home supervisor (in particular, the ability to exercise effective consolidated supervision), the supervisory framework (including application of the Basle Capital Accord) in the home country, the manner in which supervision is enforced and the resources devoted to it, and past dealings with, and the track record of, the home supervisor. A particular issue which arises in the Asian region is the extent to which the host supervisor should be prepared to look ahead, and give credit for the fact that the home supervisor is "actively working to establish" the capabilities to meet the Basle Standards.

Minimum asset size

Like a number of countries in the Asian region, Hong Kong will only grant full banking licences to foreign banks above a certain size - where the banking group of which a foreign applicant is a part has assets in excess of US$16 billion (equivalent to being one of the world's largest 300 banks). While size per se is not a guarantee of quality, a larger bank is perhaps more likely to have reached the stage at which an overseas presence can be justified on business grounds and supported. An arbitrary size limit may however unjustifiably exclude certain smaller regional banks for which a presence in a trading and financial hub such as Hong Kong would make sense. However, this is mitigated by the different types of authorisation already referred to. Thus, foreign banks which do not meet the size criterion for a full banking licence, may establish themselves as rlbs or dtcs.

Branches versus subsidiaries

Foreign banks which are granted full banking licences in Hong Kong can in practice only enter as branches (unless they acquire an existing locally incorporated bank). A rlb may be either a branch or a subsidiary, while dtcs are in practice now established only as subsidiaries.

As already indicated, this policy has developed largely in reaction to events. But in so far as there is a consistent philosophy in Hong Kong on this issue, it would generally be in favour of the branch form for international banks which wish to establish in Hong Kong, while recognising that there may be supervisory advantages if smaller banks establish locally incorporated subsidiaries.

Different countries have different views, however, depending on the supervisory and broader economic objectives which are being pursued. A requirement for local incorporation may for example ensure an inward flow of capital and help to achieve a more level playing field vis-a-vis the domestic banks. It is however inefficient from an international bank's point of view since it locks up capital in particular jurisdictions and prevents it from being transferred within the bank to areas where the business is being expanded. A local subsidiary may also be unable to build up a fully diversified portfolio of risk. Moreover, because the credit rating of a locally incorporated subsidiary will be based at least in part on its status as a separate legal entity, the funding costs of the subsidiary may be higher than they would be as a branch, and the ability of the subsidiary to lend to individual customers may be lower (though Hong Kong has addressed this in the case of local rlb and dtc subsidiaries of foreign banks by allowing the use of "letters of comfort" to support large exposures in the subsidiaries).

A requirement to enter as a subsidiary may therefore be a disincentive to some international banks; and even if they do enter, their ability to compete effectively with domestic banks may be reduced. Thus, if the objective of allowing foreign entry is to increase competition in the domestic banking sector, that objective may not be achieved. It appears that it is for this reason that Australia

has recently allowed foreign banks to enter in branch form. However, in order to ensure a high degree of protection for retail deposits, such branches are only allowed to carry on wholesale business (defined in terms of the minimum size of deposit and the source of deposit). Retail deposit-taking by foreign banks will continue to be conducted through locally incorporated subsidiaries.

From the point of view of the host supervisor, the main advantage of a branch presence is that it enables depositors to rely on the total financial strength of the bank as a whole. This was one of the reasons why Hong Kong lifted its moratorium on the granting of full licences to foreign banks, thus enabling them to enter as branches. The advantage is however subject to a number of provisos. It assumes that the bank as a whole is financially sound and that it is adequately supervised. These points should be addressed by the licensing criteria used to control new entry. It further assumes that no attempt is made, legally or contractually, to limit the extent to which head office stands behind the credit-worthiness and liquidity of its overseas branches.

Provided these conditions are satisfied, head office support for a branch in difficulties may be more assured than in the case of a subsidiary because a branch is an integral part of the bank. A subsidiary is a separate legal entity and while parental support should normally be forthcoming (and may have been promised in a letter of comfort), the parent may in the final analysis be unable to provide that support without bringing itself down, or the home supervisor may intervene to prevent it from providing support.

Conversely, when problems do affect a bank or a banking group, a branch will be inextricably bound up in these. A subsidiary, by virtue of its separate legal status, may in theory have a better chance of surviving a group crisis. However, in practice, as Hong Kong's experience with the local subsidiary of BCCI showed, it may be difficult to insulate a subsidiary ***as a going concern*** from problems elsewhere in a banking group, even when that subsidiary has been "ring-fenced" by restricting its dealings with the rest of the group. On the other hand, Hong Kong's BCCI experience also demonstrates that in a ***liquidation*** the position of local depositors in a subsidiary may be much better than with a branch.

It may be possible to replicate some of the benefits of local incorporation by requiring branches to retain endowed capital (with matching asset requirements). However, this undermines the rationale of having a branch. Moreover, the effectiveness of such rules depends critically on the insolvency regime in the host country. As discussed in studies produced by the Basle Committee, in a "single-entity" regime such as Hong Kong or the UK, banks are wound up as one legal entity. All assets of the bank are encompassed in the liquidation and all creditors of the bank can prove their claims in that proceeding, regardless of the branch with which they have dealt. Generally speaking, the assets of a branch of a foreign bank in such a country are not available to pay off local depositors in priority to those elsewhere. By contrast in a "separate-entity" regime such as the United States, a branch of a foreign bank is liquidated as if it were a separate bank : all assets of the branch, and all assets of the bank in the host country, are encompassed in the liquidation proceeding, but only creditors of the branch in the host country can prove their claims in the host country proceeding.

Two conclusions would seem to follow from this, though they are by no means clear-cut;

(i) local incorporation in a single-entity regime such as Hong Kong should generally offer greater protection to local depositors in the event of a liquidation of the parent bank, though this is not the only consideration to be taken into account in deciding upon the appropriate form of establishment. Local incorporation (and any associated ring-fencing) may, for example, be at the expense of parental support for the subsidiary;

(ii) where branch presences are permitted in a single-entity regime, local depositors are dependent on the strength of the bank as a whole and the quality of the home supervision – hence the importance of the Basle Minimum Standards.

Hong Kong as home supervisor

So far the issues have been discussed largely from the host supervisor's point of view. However,

the home supervisor has an equally strong interest in ensuring that its banks undertake overseas expansion in a prudent manner and do not establish themselves in jurisdictions which make consolidated supervision difficult or which would expose their banks to financial or reputational risk. In particular, the home supervisor needs to ensure that its banks are not setting up overseas establishments to escape the home regulatory net, eg by booking offshore transactions that they would not be allowed to do at home.

Consistent with the Basle Minimum Standards, the home supervisor should therefore have legal powers to prevent its banks from establishing overseas branches, banking subsidiaries and even representative offices. In Hong Kong's case, specific consent is required for such establishments, and in considering whether to give such consent, the Monetary Authority will take into account the following factors:

(i) the financial capacity and ability of the parent bank to establish an overseas presence, including the implications for its capital adequacy and liquidity;

(ii) the managerial capacity of the parent bank to ensure that the activities of the overseas establishment are conducted in a prudent and reputable manner (including the nature of the internal control systems within the overseas establishment and the monitoring systems within the parent);

(iii) the place of establishment of the overseas presence, including the nature of its supervisory arrangements and whether there are any secrecy constraints which would inhibit effective consolidated supervision.

This acknowledges the message of the Basle Minimum Standards that supervision of cross-border banking establishments is a joint responsibility of the home and host supervisor.

Asset quality

Poor asset quality has traditionally been the major cause of bank problems and failures. Moreover, unless the losses on problem assets are recognised and written off or properly provisioned against, the net assets of the bank in question will be overstated and any measure of its capital adequacy will be meaningless. How to assess the asset quality of banks and the adequacy of provisions against loss should therefore be major concerns of the banking supervisor.

Recent history has demonstrated the truth of this. During the late 1980s and early 1990s banks in many countries suffered serious losses due to asset quality problems. Often these losses necessitated government financial support at heavy cost to the tax-payer. The banking problems partly reflected structural changes in the financial markets as the competitive pressures on the banks increased due to liberalisation and disintermediation. As the banks suffered from squeezed margins and loss of their more creditworthy customers to the capital markets, they were driven to expand balance sheets and engage in riskier forms of lending, in particular property loans and highly leveraged transactions. This took place against a background of loose monetary conditions in a number of countries, and the inevitable tightening that subsequently took place severely damaged both banks and borrowers alike.

However, the banks' recent asset quality problems were not exclusively macroeconomic or structural in origin. In many cases, they reflected bad credit policies and practices or simply bad individual credit judgments. In particular, there was a failure by many banks to appreciate the ***industry risk*** inherent in property lending, namely that individual lending decisions which appear prudent in isolation may be undermined by the collective actions of the banks as a whole.

Hong Kong's experience

Banks in Hong Kong have remained largely insulated from the problems which have affected banks elsewhere in recent years. During the period 1988-93 the bad debt charge of locally incorporated Hong Kong banks averaged only 0.25% of total assets compared with an estimated 0.80% for selected US banks and 1.0% for UK banks during the same period. Reflecting this, the post-tax return on assets of Hong Kong banks averaged 1.3% during 1988-93. This reflected the advantages for these banks of being part of an expanding economy with a strong upward trend in property prices during much of the period.

However, this happy position has not always been the case. In particular, during the period 1983-86, Hong Kong suffered a prolonged banking crisis triggered initially by economic and political uncertainty which created difficulties for a number of institutions who were heavily exposed to the property market. Subsequently problems emerged in other banks as a result of asset quality problems often related to fraud. Two specific types of problems were large exposures arising from cheque-kiting schemes, involving advances made to customers on the strength of cheques drawn on empty offshore accounts, and "self lending" to companies or persons connected to directors or managers of the banks. Even where such lending is not explicitly fraudulent in the sense that it is being used to syphon funds out of the bank, there is a risk that it will not be conducted on a normal commercial arm's length basis.

Underlying the banking problems in Hong Kong during this period were **concentrations** – "too great an exposure to a group or a connected group or to a sector of industry in a particular country. Sometimes there has been a deadly mixture of concentration to a particular group in a particular country" (Robert Fell, Former Commissioner of Banking).

To redress the situation, a new Banking Ordinance was introduced in 1986 which strengthened the supervisory framework, particularly in relation to the ownership and management of banks and to loan concentrations, including those arising out of connected lending. As a result, unsecured exposures to all persons (corporates and individuals) connected with a bank are limited to 10% of capital base while such exposures to connected individuals are limited to 5%. In general, there is a limitation of 25% of capital base on exposures to individual persons or groups.

Property lending

While such measures have had the desired effect, the question of **sectoral** concentrations remains a supervisory issue in Hong Kong. In particular, much attention has focussed on the growing exposure of Hong Kong banks to the property market. Over the three years to mid-1994, prices for both residential and office properties more than doubled as measured by the overall indices. The rise in prices of individual properties in the main commercial and residential areas on Hong Kong Island was much more dramatic. This was the result of strong internal and external demand (sometimes speculative in nature) prompted by the strength of the Hong Kong economy, optimism about the prospects for China and negative real interest rates. Because of the lack of a well-developed debt market and of specialist mortgage institutions, the resultant demand for finance was channelled almost exclusively through the banking system. As a result, bank lending for residential purposes and for commercial property development and investment rose by 70% over the three years and now accounts for about 37% of the total domestic loans of the Hong Kong banking sector as a whole.

Loan loss experience on this lending has so far been negligible, particularly in respect of residential mortgages. Nonetheless, the rise in property prices and the growth of property lending in banks' portfolios aroused the concern of government, supervisors and banks alike. Apart from concern about the possible exposure to losses (which, as noted above, have not materialised), the banks' concerns have related to the balance sheet implications of funding an increasing proportion of long term lending with hard to come by short-term deposits.

The response to this situation can be summarised as follows:

(i) the banks have adopted progressively tighter lending criteria with the encouragement of the supervisors : in particular, for residential mortgages, a maximum 70% loan to value ratio has become the norm for all lending, with some banks adopting even lower ratios for more expensive properties (e.g. 50% for properties with a value in excess of HK$5 million). Income tests have also been tightened;

(ii) the Monetary Authority issued guidelines for property exposure in 1994: banks with property exposure in excess of 40% of domestic loans have been advised to reduce or at least stabilise the proportion. It has also been recommended that the growth in property lending should be kept in line

with that of nominal GDP (i.e. no more than 15% per annum);

(iii) the Hong Kong Government announced in mid-1994 a package of measures designed to increase the supply of residential properties and to curb property speculation.

These measures have had some success. The property market has cooled and the growth in bank lending has slackened in the last few months, helped also by the rise in Hong Kong interest rates in line with those in the US. It is too soon to say, however, whether this situation will persist in the longer term. For both government and the supervisors the dilemma has been how to produce a controlled moderation in property prices and in property lending without provoking a drastic downturn in the market, such as might be caused if the banks were to turn off their property lending too abruptly – hence the Monetary Authority's approach of setting "guidelines" for property exposure rather than rigid limits.

As a longer term measure, the Monetary Authority is also looking at ways in which a market in securitised mortgages might be developed in Hong Kong as a means of improving the liquidity of banks' mortgage portfolios and of reducing the concentration risk by spreading the exposure more widely around the financial system.

Loan classification systems

The main method used by the Monetary Authority for assessing the quality of banks' assets, the adequacy of their provisions and the effectiveness of their lending systems is the on-site examination. This has, however, been supplemented in recent years by increasing use of off-site analysis of prudential returns and use of external auditors to report on the quality of banks' internal systems, including lending controls and the systems used to generate prudential returns.

A recent innovation in Hong Kong is the introduction of a loan classification system whereby banks will be asked to report regularly to the Monetary Authority on the amounts of loans and other assets in the following categories: performing, special mention, substandard, doubtful and loss. A standard prudential return and common reporting definitions will be used for this purpose. This will make it easier to conduct peer group comparisons, eg of the adequacy of provisions against non-performing loans, and also to gain an industry-wide picture of asset quality and changes in the overall trend. It will also provide the on-site examiners with a standard framework against which a bank's own classification of its assets can be assessed.

The main objection to an industry-wide reporting system is that it may oblige banks to run two systems: their own and that of the supervisor. In the case of Hong Kong, we have said that we will allow some flexibility (albeit at the expense of absolute consistency) in the way in which banks "map" their own loan categories into those on our reporting return. The objective is to avoid where possible the need to reclassify individual loans for supervisory reporting purposes.

The Monetary Authority will not adopt the practice of some supervisors in mandating a certain level of provisions against the unsecured portion of the various loan categories (eg 50% against "doubtful" loans). Such a practice would appear to be somewhat arbitrary and mechanical. Rather, we see the loan classification system as providing a framework within which the adequacy of an individual bank's provisioning decisions can be assessed against its peers.

Market entry and asset quality

In the introduction it was noted that there is some connection between the above two topics since market entry (by domestic as well as foreign firms) into business areas previously reserved for local banks can erode the competitive position of the latter and can lead them to take on more higher risk business.

The entry of foreign banks may however raise more direct concerns on asset quality for the host supervisor. Such institutions, as late entrants into a banking market of which they will typically have little experience, are liable to pick up the more marginal, higher risk business of customers with whom the already established local banks are unwilling to deal. This can leave the branches or subsidiaries of foreign banks with chronic asset quality problems. This may be less of a problem for the host supervisor in the case of a branch than a local subsidiary, provided that the health of the

bank as a whole is not in doubt. However, the host supervisor would be unwise to disregard asset quality problems, and the resultant unprofitability, in **any** of its population of authorised institutions; and thus, even if there is no immediate threat to local depositors, supervisory resources may have to be devoted to the problem which could be better used elsewhere.

A particular aspect of this problem with which Hong Kong has had to deal is where problem assets have been transferred into the territory from another overseas branch of the bank, perhaps at the request of the host supervisor there. The Monetary Authority has thus had to make it clear that Hong Kong branches of foreign banks should not be used as a "dumping-ground" for loans which an overseas banking supervisor no longer finds acceptable. This practice is particularly objectionable where it is claimed that the provisions in respect of the problem loans are being maintained at head office rather than in the local branch.

In addition, the Monetary Authority has reminded branches of foreign banks that we expect them locally to maintain adequate documentation in respect of loans booked with them; and that we expect local management to be fully aware of the nature and purpose of such loans and of the background of the borrowers. Otherwise, as host supervisor, we have no effective means of monitoring the asset quality of the branches of foreign banks in our territory; and the risk is increased that problem loans will escape the attention of both host supervisor and home supervisor. ❀