

REGULATORY ASPECTS OF PRODUCT INNOVATION IN BANKING – THE HONG KONG PERSPECTIVE*

Innovation and diversification in banking are driven by changes in customers' needs, technological advancement and changes to regulation. They bring new risks which challenge both managers and supervisors. The HKMA's approach is not to impede these changes but to ensure that risks are being prudently managed. The introduction of a Code of Banking Practice is being considered. The HKMA and the Securities and Futures Commission are strengthening their co-operation in the supervisory area.

Introduction

I am pleased to be here today to share with you my views on the important subject of bank marketing and product innovation. This is a very timely conference as we are witnessing some revolutionary changes in the banking industry. There are two major dimensions. First, the rapid growth of hi-tech products such as derivatives and smart cards is defining a new era in product innovation. Second, we are seeing a clear trend of banks expanding beyond their traditional scope of business to embrace cross-market products such as insurance and securities.

These developments have wide implications for banks and regulators. Today, I am going to address the subject of product innovation from the regulatory angle and in the context of Hong Kong. In particular, I will try to identify the driving forces behind product innovation and the related regulatory issues, explain the HKMA's philosophy and outline our regulatory response on the subject.

I am glad to see among the audience representatives from the People's Construction Bank of China, the Agricultural Bank of China and the Industrial & Commercial Bank of China, who have recently joined the ranks of licensed banks in Hong Kong. I hope that this conference will enhance their understanding of the changing landscape of the Hong Kong banking sector. The Chinese regulators are also here, and our experience in Hong Kong should serve as a useful guide. They will probably need to tackle similar issues as the banking industry continues to grow and mature in China.

What drives innovation in banking products?

Let me start with the question of what drives innovation in banking products.

(a) Customers' needs

Banking is a customer oriented business. Satisfying customer and market needs within a competitive environment is probably the most important driving force behind product innovation. Only by so doing can banks attract customers, maintain their loyalty and generate profits. Customers demand convenience and efficiency, and banks have responded by offering around-the-clock and banking-at-home services such as ATMs and telephone banking. In addition, customers change their banking preferences as lifestyles and levels of affluence and sophistication change, and banks have responded by offering credit cards and customised private banking services.

(b) Technological advancement

The desire to create new products to meet customer needs is always there. So that alone is not enough to explain the recent surge in hi-tech banking products. The desire must be matched by enhanced capability in product design made possible by accelerating advances in technology. These twin factors are symbiotic and reinforce each other. This is best illustrated by the phenomenal growth in derivatives products. Derivatives can meet the market need for risk diversification and hedging because of advances in computer power and in risk management techniques. Smart cards are another example of technological development providing the catalyst and platform for product innovation.

* This is the text of a speech by Joseph Yam, CBE, Chief Executive of the HKMA to the Conference on Bank Marketing in an Evolving Economy on 7 December 1995.

Once such products are developed in one market, they quickly spread to others, reflecting the increasing globalisation of the banking and financial services industry.

(c) Market restrictions

The market environment, including the presence of interest rate and credit controls and line-of-business regulations, also has an important bearing on product innovation. Market restrictions will tend to slow the development of new products, though paradoxically they can also have the opposite effect. The market has a way of getting round restrictive measures. One notable example in Hong Kong is the foreign currency swap deposits which were invented by banks to offer depositors market rates on what are essentially HK dollar time deposits without offending the Interest Rate Rules of the Hong Kong Association of Banks.

(d) Deregulation

In general, however, it is deregulation and the lifting of market restrictions which provide the stimulus to product innovation. This is particularly so in emerging markets where their banking industries may be less sophisticated. Deregulation has two major effects on product innovation. First, it allows banks to introduce new products and services in areas where restrictions have been lifted. Second, it opens up the banks to new sources of competition, both internally and externally, which forces them to be innovative in order to retain market share. In the UK, for example, during the 1980s product and service diversification by the banks was driven by such events as the 1986 “Big Bang” in the stock market which allowed the banks to have a more direct role in the securities industry, including the provision of stock-broking services through their branch network. At around the same time, the banks themselves came under attack on their own territory, namely the market for retail deposits, because of deregulation of the building societies which allowed them to offer banking services for the first time. The launch by the large UK clearing banks in the mid-1980s of new interest-bearing current accounts followed the lead of the building societies in introducing this product. In the case of Hong Kong, the full impact of the recently completed deregulation of time deposits on product

innovation has yet to be seen. Some of the new products that have emerged so far include saving plans involving time deposits made in monthly instalments and time deposits with bonus point schemes.

(e) Diversification

Increased competition arising from deregulation and disintermediation puts pressure on banks’ traditional sources of income, thus encouraging them to diversify into other types of business activity. A further motivation is to reduce reliance on net interest income which is cyclical in nature and subject to variations beyond banks’ control. Banks have therefore looked to new products, such as unit trusts, credit cards or insurance to generate fee income which may be more stable. There is also a growing tendency of banks to diversify into other financial businesses, in particular securities and insurance, to take advantage of economies of scale and to make full use of the customer base which they can attract through their branch network. This has certainly been a factor in the alliance of banks and insurance companies in countries such as the UK and the Netherlands, and the growing involvement of banks in the insurance market in Hong Kong. It is generally reckoned that the chances of selling an insurance product to an existing bank customer are several times greater than “cold-calling” someone where there is no previous customer relationship.

Issues for banks and regulators

Product innovation and diversification no doubt bring many benefits – consumers have more choices, their needs are better served, and banks have a wider base of income. However, they also pose a range of important and complicated issues for banks and regulators.

(a) Management of risks

New financial products introduce new risks. Some products, in particular derivatives, can be highly complex with the result that the risks are more difficult to measure, monitor and therefore manage. This problem is compounded by the highly leveraged nature of certain derivatives products which allows users to take on much higher risk for the same capital outlay. Furthermore, there is a danger of a widening knowledge gap as new

products move beyond the conventional expertise of bankers and bank regulators, resulting in risk management, accounting and settlement systems lagging behind product development. This is particularly so if banks focus too much on quick profits and fall into the trap of allowing product innovation and diversification to outpace the ability of management to understand and control the new activities. The incidents of Barings and Daiwa have clearly illustrated that the price of mistakes, failure of control and negligence can be extremely high.

The introduction of hi-tech electronic products also raises security issues. New cash management products which allow customers direct access to the bank's computer systems open up new opportunities for fraud. In a recent case, Russian computer hackers managed to access the computer systems of a bank in the US and to issue instructions to transfer funds into accounts from which they hoped to make withdrawals. Fortunately the attempt was detected at an early stage and little money was lost. But the episode demonstrates the importance of computer security in today's electronic world.

For regulators, there is the challenge of making sure that the regulatory and legal framework as well as our supervisory capability can keep up with the pace of product innovation. It is always a catching up game. What is important is to avoid lagging too far behind and to adopt a pro-active approach of keeping the regulatory framework in line with market developments as far as possible.

(b) Customer suitability

The increasing complexity of financial products also raises the important issue of customer suitability, in other words whether the product in question is appropriate to a particular customer's financial position, level of sophistication and investment objectives. This is not purely a consumer protection issue. Selling relatively high-risk products such as derivatives and leveraged foreign exchange contracts to the wrong type of customers exposes banks to reputational, credit and legal risks. *Reputational* risk can arise from reckless or irresponsible marketing. Banks who do not take this seriously will suffer not only in pecuniary terms but also have their goodwill damaged. The dangers are illustrated by the recent legal actions brought in the US by companies against an investment bank which

allegedly sold them derivative products without fully explaining the risks. "Unsuitable" customers also expose the banks to *credit* risk, if the customer is unable to meet his obligations, and *legal* risk if, for example, it turns out that the customer did not have the authority to enter into transactions, as in the famous Hammersmith & Fulham case in the UK. There, the local government authority engaged in a large number of swap transactions without having the power to do so and the counterparty banks were unable to enforce their claims.

(c) Regulatory coverage

Diversification of banking business raises the issues of regulatory overlap and underlap. New financial products into which banks diversify, such as securities and insurance, may fall within the regulatory ambit of separate designated regulators. The regulatory burden may be increased and market efficiency impaired where banks find themselves subject to more than one, and perhaps sometimes conflicting, supervisory regimes. One way round this is to exempt banks from the supervisory framework governing certain activities, such as securities, on the grounds that they are fully supervised under the relevant banking legislation. This may, however, lead to arguments as to whether there is a level playing field between banks and other financial intermediaries. Moreover, it may open up the risk of supervisory *underlap*, that is the possibility that certain of a bank's activities may not be subject to detailed and specific regulation and thus "slip through the cracks". To some extent, the collapse of Barings' futures subsidiary in Singapore is an illustration of this risk.

The demand for a level playing field in the regulatory framework for bank and non-bank entities also raises the question of harmonisation of the regulatory systems administered by the different regulators. Much as this is desirable, it may be difficult to achieve in practice because of the differences in the nature of the business and the risks of the various financial institutions. This in turn influences the main preoccupations and objectives of the different financial regulators. For example, systemic risk is the primary concern of banking regulators but has not hitherto been such an important issue for most securities and insurance regulators. For this reason and because bank claims

tend to be long-term in nature, banking supervisors tend to place much emphasis on capital adequacy and on the need for permanence of capital. Securities supervisors on the other hand focus on the need for securities firms to have sufficient liquid assets to repay promptly all liabilities at any time. The different concepts of capital adequacy are one of the reasons why, for example, the Basle Committee on Banking Supervision and the International Organisation of Securities Commissions have found it difficult to agree on a common framework to set capital requirements on the market risks arising from the trading activities of banks and securities houses.

Notwithstanding this particular area of disagreement, it is generally accepted among the different financial regulators that the trend of banks to diversify into other financial markets does require improved supervisory co-operation. A recent report published by the Tripartite Group of Banking, Insurance and Securities Regulators set up by the Basle Committee has outlined practical ways in which such co-operation can be achieved.

HKMA's philosophy

All these issues represent challenges to us as regulators. I would like to take this opportunity to explain the principles that underpin our supervisory response to product innovation in banking.

The *first* basic principle is that we encourage competition and product innovation and do not generally seek to stand in the way of these. Of course, in a limited number of cases it may be necessary to strike a balance between these objectives and the need to preserve the stability of the banking system. One example is our approach towards interest rate deregulation. The recent decision not to deregulate HK dollar time deposits below seven days is designed to retain a "firewall" between deregulated time deposits and current and savings accounts to avoid any potentially destabilising migration of deposits. Depositors are not disadvantaged since they can receive a market rate of interest on their funds if they place them for seven days or more.

The *second* principle is that effective risk management should not be confused with risk elimination. Our aim is not to eliminate risks by regulating new products such as derivatives out of

existence but to ensure that development of such products will be underpinned by effective risk management. We should bear in mind that, if properly used, derivatives are useful both as tools for hedging and as a source of revenue from market-making, position taking and arbitrage.

The *third* principle is to avoid regulation just for the sake of it. The primary responsibility for the prudent management of banks over new products rests with the board of directors and management of the bank itself. The objective of HKMA's supervision is to reinforce the discipline and control exercised by management by laying down and enforcing a framework of minimum prudential standards and by monitoring the quality of risk management within banks. This is intended to keep in check competitive excesses which might threaten the stability of the banking system and damage the interests of depositors, while giving flexibility for the management to take commercial decisions.

In summary, we believe that the banks should be allowed to operate on the basis of commercial principles, provided this is done responsibly and ethically within a prudent supervisory framework and in accordance with fair trading principles and practices.

Regulatory response

Bearing in mind the basic principles I have just mentioned, let me outline to you the HKMA's regulatory response to product innovation.

(a) Capital requirements for market risks

Product innovation is essentially a commercial decision, but one which should be undertaken with due care and attention. As supervisors, we expect authorised institutions to identify and fully understand the risks of any new product or activity before it is introduced. Depending on the magnitude of the new product and the risks which it entails, final approval for the bank to become involved should be obtained from the board of directors. All relevant areas of the bank – risk control, accounting, legal, operations, internal audit and line management – should sign off on the product and make sure that it can be accommodated within the bank's management structure and systems and that there is sufficient capital to support the new activity. Where a product involves on or off-balance sheet

exposure, that exposure should be capable of being measured and fitted within the bank's overall structure of limits. For those products which do not give rise to direct financial exposure (such as custodian services), the legal, reputational and regulatory risks should nevertheless be carefully evaluated.

The HKMA's role is not to approve each and every new product which banks introduce. But we need to satisfy ourselves that banks are prudently managing the risks across the whole range of activities in which they are involved and that they are holding sufficient capital against those risks. Where banks are embarking on new activities or becoming involved in a class of products which by their nature and scale could have a significant impact on exposure to risk, we may have to adjust our supervisory policies, techniques and requirements in order to keep up with these developments. That is why, for example, we are currently studying the proposals of the Basle Committee to introduce capital requirements for the market risks which banks run in their trading activities in derivatives and other instruments. We are hoping to apply these proposals in Hong Kong by the end of 1996. In addition, in order to be able to evaluate the quality of the banks' systems for managing the risks on derivatives, we have also found it necessary to enhance our own supervisory capability by establishing a specialist team on derivatives within the HKMA, including experts on financial models and derivatives products.

(b) Code of Banking Practice

I have mentioned earlier the issue of customer suitability. We also expect banks to have in place policies and procedures to reasonably ensure that the customers have the capability to understand the nature and risks of the products they are being sold. Adequate risk disclosure is another key element. This does not mean simply including a "health warning" in contract documents to alert customers that the value of the contract may go down as well as up. Customers should be provided with sufficient information, such as sensitivity analyses in the case of complicated derivatives products, to help them understand the risks involved.

This is part of a more general issue of ensuring that customers are treated fairly. One means of assisting to achieve this would be to

introduce in Hong Kong a Code of Banking Practice which is now a feature in a number of other countries. In general, the main objectives of such codes are to promote good banking practices and to establish a fair relationship between banks and customers. The areas covered by the codes include for example the provision of information to customers about the terms and conditions of banking services and the relevant fees and charges as well as the procedures for handling customer complaints. We will be discussing the desirability of introducing a Code in Hong Kong with the representatives of the banking industry here.

Let me stress that in considering this proposal, we are not straying from the traditional role of the banking supervisor – that of maintaining the stability of the banking system – into the field of consumer protection. Rather, we believe that it is self-evident that banking stability depends on the confidence of the public in banks. And confidence is unlikely to flourish where banks do not treat their customers fairly.

(c) Adequate supervisory and legal framework

The need to constantly review and update the legal framework to keep pace with market developments is also very important. The emergence of smart cards, for example, has required us to address the monetary and prudential implications and to consider whether legislative changes are necessary. The HKMA is currently devising a framework for regulating the issue of multi-purpose smart cards and the proposals will form part of the next Banking (Amendment) Bill scheduled for 1996.

On regulatory issues relating to diversification, our basic approach is to try to achieve a level playing field as far as possible. Where rules have been established by another supervisor in relation to non-authorised institutions which engage in a particular class of business in which authorised institutions are also engaged, our general presumption is that authorised institutions should be subject to the same, or higher, standards. A recent example is the guideline we have issued in respect of authorised institutions' leveraged foreign exchange business. We have made it clear to authorised institutions that we expect them to conduct this type of business in accordance with standards which are at least equivalent to those set

out in the relevant Rules issued by the Securities and Futures Commission (SFC).

(d) Supervisory co-operation

We are also strengthening supervisory co-operation with the SFC. The two regulatory authorities recently signed a Memorandum of Understanding (MOU), which aims to strengthen co-operation in respect of supervision of entities or financial groups in which both the HKMA and SFC have a mutual interest and where possible, to minimise the effect of dual supervision. Under the MOU, one of the two regulators will act as co-ordinator for the supervision of each institution in which we both have an interest. The co-ordinator will be responsible for co-ordinating the exchange of information necessary to the exercise of the parties' regulatory functions and the timing of on-site examination and meetings with the management of the regulated institutions. The two regulators have also undertaken to consult each other in staff training, issuance of guidelines and formulation of policies in areas such as securities and futures. We hope that it will be possible to extend this co-operation to other regulators in Hong Kong.

Advice for the newly authorised Chinese banks

In closing, I would like to take this opportunity to offer some advice to the newly authorised Chinese banks. Your involvement in the Hong Kong market will be invaluable in allowing you to familiarise yourselves with the banking products and services that are on offer here. You will gain practical experience of marketing the services of your banks in a highly competitive market environment and I hope that this will provide lessons which can be applied in the domestic context within China. However, as I have suggested in this speech, competition involves risks as well as rewards. As you are new to the local scene and have limited exposure in operating branches outside China, it would be sensible for your branches in Hong Kong to ease their way gently into the market. It is important to lay a good foundation of management and systems before going out to actively pursue market share. For our part, the HKMA will keep closely in touch with the branch management, particularly in the early stages, and we stand ready to provide whatever help and advice your banks need as they begin this exciting new chapter in their history. ☉