

*Rating agencies are beginning to play a more prominent role in the region and it is important that they exercise their power responsibly and with restraint. The HKMA has reservations about the practice of rating agencies' assigning unsolicited ratings to banks since if the rating turns out to be a poor one, this can make it look as if the bank is being penalised for failure to communicate. But the HKMA has no plans to regulate credit rating agencies in Hong Kong.*

I was glad to take up Thomson BankWatch's invitation to speak to you this lunchtime. It gives me the opportunity to turn the tables slightly by offering a regulator's view of the rating agencies. Usually it is the rating agencies which are doing the evaluation – of our banks, of our supervisory system and of Hong Kong itself. However with the rating agencies beginning to play a much more prominent role in the region and in Hong Kong in particular, it is inevitable that they will come under closer public scrutiny themselves.

Let me assure you however that my intentions are friendly. Although rating agencies and regulators do not always entirely see eye to eye, we are fundamentally natural allies. We are both concerned with assessing the financial soundness of institutions which issue debt and trying to estimate the probability of default on that debt. In exercising this judgment we are both laying our reputations on the line. The difference is that the rating agencies are commercial organisations and it is the essence of their work that their conclusions should be made available to the outside world. The supervisors tend to do their work by stealth and they rarely comment on the affairs of an individual bank in public lest they be misconstrued. Indeed, they are usually subject to strict confidentiality requirements.

This could I suppose lead to tensions where it is banks which are being rated. The announcement that a credit rating agency has downgraded a particular bank or given it an adverse rating could result in a loss of public confidence and thus give rise to funding difficulties. Such cases should however generally be few and far between, and the possible ill-effects are likely to be outweighed by the positive role played by the rating agencies in

collecting and summarising the available information about banks and making it available for public consumption through their ratings. Regulators are increasingly looking for ways of reinforcing their own supervision with additional market discipline on bank management to behave prudently and to avoid excessive risks. Greater disclosure of financial information by banks – such as we have been pursuing in Hong Kong – with the help, I may say, of Philippe Delhaise – is one way of achieving this. However, the raw material produced by banks needs to be packaged and interpreted, and the rating agencies along with the press and the brokers' analysts are an important means of achieving this.

The rating agencies thus have considerable power to do good, though it is a power which has to be exercised responsibly and with restraint. The track record of the agencies has in fact been very good – there have been few, if any, cases where they have been shown to have abused their position or acted improperly. No doubt the agencies will continue to jealously guard their reputations. I do however have three personal observations to make, which I stress are not specifically directed at Thomson BankWatch:

first, as the agencies expand their presence to cover emerging markets in greater depth it is important that they establish a strong awareness and knowledge of the local institutions which they are rating and the environment within which those institutions are operating. There should be a recognition that banking practices can and do vary among countries and that there is no universal model.

\* This is the text of a speech by David Carse, OBE, Deputy Chief Executive (Banking) of the HKMA to the Thomson BankWatch Regional Conference - Assessing Credit Risks of Asian Banks on 4 March 1996.

- second, competition among the rating agencies is resulting in new “products” covering not only credit risk but also market risk. In general, the provision of more information is a welcome development. But there is a risk that, instead of shedding more light, a multiplicity of new ratings could sow confusion in the minds of investors and other users of the ratings. It is essential therefore that the scope and purpose of these new ratings is carefully explained.
- finally, I do have some reservations about the practice of assigning unsolicited ratings. If the company being rated has declined to co-operate with the agency by providing information, the unsolicited rating will have correspondingly limited value; and if the rating turns out to be a poor one, this can make it look as if the company is being penalised for failure to communicate. In such cases, it may be better for the agency not to give a rating at all.

That being said, the HKMA, like many other central banks and regulators, is an active user of credit ratings:

- in our role as banking supervisors, we use credit ratings to help determine the haircuts applied to marketable securities held by the banks for liquidity purposes. Thomson BankWatch is one of the rating agencies whose ratings we have recognised for this purpose. In addition, the use of credit ratings is built into the Basle Committee’s proposals for capital requirements for market risk which we hope to introduce in Hong Kong by the end of this year.
- in our role as operators of the Liquidity Adjustment Facility (LAF) which is Hong Kong’s discount window, we use ratings to determine certain of the classes of HK dollar securities which are eligible to be used as collateral to obtain liquidity assistance from the HKMA.
- finally, in our role as managers of the Exchange Fund we use credit ratings in

the conventional way to help determine our criteria for investing in securities.

Like any other user of credit ratings, we find them a great assistance in decision-making. However, official usage of ratings creates its own particular set of problems. We have already seen in Hong Kong for example that our criteria for the paper we are prepared to accept for liquidity assistance purposes, has added to the attractions of HK dollar paper with the qualifying credit ratings. This has some beneficial results in that it has encouraged some of the local banks to seek ratings for their issues of negotiable certificates of deposit so that they become eligible for discount window purposes and are hence more marketable. However, this has led to complaints from some of the smaller local banks who, by virtue of their size, are unlikely to be able to obtain the qualifying credit ratings. While this is regrettable, in performing its role of lending under the LAF the HKMA must apply prudent lending criteria, which means among other things having a preference for rated paper.

From the other point of view, there are obvious competitive implications if the official seal of regulatory approval is granted to some rating agencies but not to others. This means that there should be some means by which rating agencies should be able to “join the club” and that there should be some process for vetting new members. In other words, the rating agencies themselves have to be rated. This is not a task which we particularly relish – as all the rating agencies are aware, one becomes accused of being subjective even if one tries to use objective criteria. At the end of the day the real test is whether the market accepts and places reliance on the ratings of the particular agency in question, which may not be easy to assess. However, the HKMA has tried to develop an evaluation process which is as fair and transparent as possible.

While the rating agencies may be prepared to put up with the vetting process, at least if they are admitted to the club, a much more contentious issue is whether regulatory use of ratings should lead to regulation of the rating agencies. This would presumably entail more ongoing and systematic monitoring of rating industry standards and practices. This has been the subject of quite heated debate in the US following consultation on

the subject by the SEC in 1994. I am not aware that any concrete results have yet followed from that consultation. What I can say is that there are no plans for the HKMA to take on a regulatory role in relation to the agencies whose ratings it recognises. Having said that, we do expect such agencies to operate in manner which commands continuing respect and credibility in the investment community; and I suppose that it would be open to us to withdraw recognition from an agency which no longer had the support of its users.

After that digression from my normal supervisory preoccupations, let me turn to the more specific issue of the current state of the Hong Kong banking sector. I note that Hong Kong is going to be discussed immediately after lunch and hopefully what I say will contribute to the evaluation of the local banks.

One of Thomson BankWatch's competitors last year produced a report on the Hong Kong banking sector which concluded that: "the cycle of Hong Kong's banking has obviously peaked and has started its journey down". It is slightly unfair to take this comment out of context, but in the light of the performance of the Hong Kong banking sector in 1995 I am tempted to paraphrase the words of Mark Twain by saying that reports of the death of the banks in Hong Kong have been greatly exaggerated. Nonetheless there were factors earlier in 1995 – higher interest rates, interest rate deregulation, falling property prices, reduced consumer confidence, the liquidity squeeze in China – which did warrant caution about the outlook for the year – a caution which we in the HKMA shared incidentally. The fact is however that the outcome for 1995 has been better than expected with the banks who have announced their results so far recording growth in operating profits of about 20% on average. There are a number of reasons for this favourable outcome:

- net interest income has been more buoyant than expected, growing by about 20% for the local banks. Despite the impact of interest rate deregulation – which has actually been quite modest so far – net interest margins have actually risen due to the endowment effect of higher interest rates and, in some cases also, more effective asset-liability management. Moreover, although loan

demand as a whole was more sluggish, residential mortgage lending started to pick up from around April onwards and grew by about 16% during the year, a faster rate of growth than in 1994.

- other income also recovered, in part because the banks avoided a repetition of the trading losses which had been a feature of the first half of 1994.
- with rapid income growth and costs under reasonable control, the overall cost-income ratio for the local banks improved from about 40% to 38%. (To put this into perspective, within the HSBC group Midland Bank's cost-income ratio improved from 70% to 67% in 1995; Hang Seng Bank improved its ratio from 29% to 27%.)
- perhaps most gratifying of all, the bad debt situation did not deteriorate markedly in 1995. Provisions did indeed increase sharply in percentage terms but this was from a very low base in 1994 when some banks had benefited from recoveries. Overall, however, the bad debt charge remains at less than 0.1% of average assets. To paraphrase Sherlock Holmes this time, bad debts were the dog that did not bark in 1995; but this does not mean that they will not bark in 1996. We have seen a rise, albeit a modest one, in the percentage of loans which are classified as "special mention" by the banks and there are anecdotal reports of some customers suffering liquidity problems as a knock-on effect of the squeeze in China and the slowing down in the local economy. Having said that, we are not expecting a collapse in asset quality in 1996.

However, the year will not be without its challenges. Competition is already tough as evidenced by the current price-cutting and special offers in the mortgage market. It will certainly be difficult to improve on the performance in 1995. But what the 1995 results are showing is that the banks in Hong Kong are well-capitalised, liquid and profitable even in an external environment which has not particularly favourable. I do not think

therefore that it is indulging in false optimism to say that they are well placed to meet the challenges ahead as we approach the change of sovereignty.

Of course challenges for the banks also mean challenges for the banking supervisors. We have to ensure that our supervisory framework remains effective in the face of changing market circumstances such as the growth of derivatives. This is not an easy task as demonstrated in many other countries by the problems of banks and the attendant criticism of their supervisors. We therefore need all the help we can get, and one important source of that help is the rating agencies. To return to the point I made earlier, we do regard the agencies as our allies and we look forward to their continuing support and assistance. ☺