

## THE FRAMEWORK OF BANKING SUPERVISION: THE HONG KONG PERSPECTIVE\*

*The role of an effective supervisory system is to reinforce the discipline and control exercised by management of the AIs by laying down and enforcing a framework of minimum prudential standards. The elements of an effective supervisory system include a sound legal framework of banking legislation and a supervisory policy framework which can best be summed up in the CAMEL rating system. On-site examination and off-site analysis are the methods used to ensure banks are under proper control.*

I am pleased to be here this morning to deliver the opening address for this Asia Pacific Financial Law summit. The first day of the summit deals with the legal and regulatory infrastructure in banking and finance in various countries in the region. I shall be offering some comments on the position in Hong Kong from a banking supervisor's point of view. I will also make some more general remarks about the desirable attributes of a sound supervisory system.

The countries which are the subject of today's discussion illustrate the diversity of financial and banking systems in the region and their different stages of development. There are countries such as China and Vietnam whose banking systems are in the initial stages of deregulation. The main banks are still state-owned and likely to remain so for the foreseeable future; but they are beginning to act on a more commercial basis instead of simply performing the function of channeling policy loans to projects approved by the Government. In China, this process of developing a more market-oriented banking system has been formalised by the Commercial Bank Law which provides that commercial banks are supposed to be responsible for their own risks and for their own profit and loss. This legal structure is being reinforced by the development of markets in which foreign currencies and surplus bank liquidity can be exchanged and traded and by the admission of foreign banks. This will give a stimulus to the domestic banks to become more competitive and to develop modern banking skills. Having said this the banks are likely to remain heavily subject to direct regulatory controls for some time.

In a second group of countries the process of deregulation has already gone much further. These

countries already have well-developed commercial banking systems even if part of it remains state-owned. While recognising the differences between them, Indonesia, the Philippines and Thailand can be slotted into this category. While deregulation is more advanced in such countries, it is by no means complete. The banking and monetary systems are still evolving partly as a result of domestic pressures to increase market efficiency and partly as a result of external pressure, for example in the WTO context, to open up the domestic market to foreign competition. Some of the countries are also motivated by the desire to encourage the development of a regional financial centre in their markets.

In doing so they are at least partly motivated by a desire to emulate and compete with Hong Kong and Singapore. Both of these are major international financial centres which are also the home to highly developed domestic banking systems. As such the volume of business is much higher and the nature of the financial products is more sophisticated than in other countries in the region. You will forgive me if I pass over the merits of Singapore, but in Hong Kong's case, we are:

- the 5th largest international banking centre in the world in terms of volume of external transactions
- the 5th largest foreign exchange market in the world in terms of turnover
- the 7th largest derivatives market in the world, also in terms of turnover
- the home to the 3rd largest representation of foreign banks in the world

\* This is the text of a speech given by David Carse, OBE, Deputy Chief Executive (Banking) of the HKMA, to the Asia Pacific Financial Law Summit on 18 March 1996.

- the home to 85 out of the world's top 100 banks.

Notwithstanding the diversity of banking systems in the countries I have mentioned, they share the common characteristics of exposure to risk and to the changing nature of risk. This is perhaps most obvious in those banks which are emerging from the tight cocoon of state control, such as in China. Hitherto, they have not had to worry too much about risk. But as the banks start to operate with greater commercial freedom they will have to start to make their own credit judgments. This will require the acquisition of the necessary lending and other banking skills. The increasing globalisation and rapid development of banking markets means that that they do not have the luxury of time. The stages of financial evolution are now much more compressed than they once were. Western banks have had decades of treasury experience to prepare for the advent of derivatives. Banks in the emerging financial markets are having to cope while they are still learning the basics of commercial banking. To take another example, banks in Vietnam are in the infancy of electronic banking, but are already issuing smart cards. I shall have more to say on the subject of smart cards later on.

However, the problem of coping with change is not confined to the emerging markets. Banks in many developed countries ran into difficulties during the late 1980s and early 1990s because they over-indulged in risky lending particularly to the property sector. Essentially bank management failed to strike the right balance between risk and reward as markets were deregulated and competition became more intense. Most banking systems have subsequently recovered, but the ill-effects are still apparent in Japan. More recently we have seen with Barings that even long merchant banking experience may not fully equip banks to conduct global treasury operations. The Daiwa case illustrated a similar point, but in addition showed how that bank had failed to recognise the regulatory risk in the post-BCCI world of not keeping the US supervisors fully informed.

Although I may be accused of promoting my own professional interests, recent banking history has driven home the message that sound supervision is essential to maintain banking stability, particularly when markets are being deregulated. This is not to

say that supervision is the only determinant of banking health. Few banks will flourish if the overall macroeconomic environment is unstable or if their management is substandard. However, it is a regrettable fact of life that, if left purely to their own devices, at least some banks have a tendency to sink to the lowest common denominator in terms of self-discipline. This leads to competitive excesses which sooner or later will get them into difficulties; and because of the linkages between banks which arise through the payments system, interbank market or simply through contagion by rumour, these difficulties may spread even to healthy banks, calling into question the stability of the system as a whole. This risk of competitive excess is, as I have indicated, at its greatest when direct regulatory controls over the banks have been lifted or are being lifted, and the banks are having to deal with a changing environment.

### The elements of an effective supervisory system

The role of an effective supervisory system is therefore to reinforce the discipline and control exercised by management by laying down and enforcing a framework of minimum prudential standards. What then constitutes such a system?

Clearly, the first element must be a *legal framework* of banking legislation which defines the objectives, powers and responsibilities of the banking supervisor. This should also restrict the business of carrying on of banking business and the taking of deposits to a distinct group of authorised institutions. Careful consideration should be given whether to include “fringe” deposit-taking or lending institutions within the scope of the supervisory net since the experience of many countries, including the UK, Hong Kong, Malaysia and more recently Japan shows that financial sector problems may frequently arise in such fringe institutions if they are subject to little or no regulation.

The legal framework must also impose controls on the ownership and management of banks since this is likely to be a major determinant of whether the banks are prudently and honestly managed and the interests of depositors safeguarded. The supervisors must be given the powers to set minimum standards of prudential conduct, relating to such matters as capital adequacy and liquidity,

and to monitor adherence to these standards by gathering information and conducting examinations. Finally, the supervisors must have the ability to deal with problem institutions by taking control of them or in the last resort closing them down.

The second element is a *supervisory policy framework* of rules and guidelines which fleshes out the standards of prudent conduct to which banks are expected to adhere. These policies should be clearly expressed and consistently and fairly applied. In general, the policy framework can be summed up in the CAMEL rating system whereby policies are set in relation to Capital, Asset quality, Management, Earnings and Liquidity. Many countries rate their banks against these headings or a variant of them and this can provide a useful means of assessing the relative quality of banks and identifying those which require special supervisory attention.

One important point about supervisory policies is that they are becoming increasingly internationalised, largely thanks to the work of the Basle Committee on Banking Supervision. This is most apparent in the widespread adoption of the risk-based Basle capital adequacy ratio, but it also applies in many other supervisory areas including the minimum standards for the supervision of international banking groups. The quality of individual countries' supervisory systems is increasingly judged by reference to international standards. It is therefore important to be seen to be adhering to these standards as a means of achieving credibility and respectability as a financial centre.

It is however quite easy to construct what looks like an effective supervisory system on paper. What is more difficult is to ensure that the system is effective in practice and is properly administered. This depends on the third element of an effective system, namely the *method of enforcement*. Most countries, including Hong Kong, have tended to opt for inspection-based systems on the basis that there is no substitute for being able to go into banks on a regular basis to examine directly their books and records and internal control systems. However, this also needs to be backed up by effective off-site analysis of statistical returns and other information so that a broader picture can be obtained of the strengths and weaknesses of both individual institutions and of the banking sector as a whole. Whichever blend of methods is used it is obviously essential that the supervisory function

has the right number and type of staff to do the job and they are given adequate resources and training. The supervisors must also of course be allowed to get on with their job without political interference or influence-peddling.

### Supervisory developments in Hong Kong

Against this general background, I will now go on to describe some of the recent and prospective supervisory developments in Hong Kong.

One advantage which we have in Hong Kong is the relative ease with which legislation can be prepared and passed. Of course, not all Bills get a smooth passage through Legco, but generally it is easier to get a place in the legislative queue than in countries such as the UK. This means that we are able to bring forward regular amendments to the 1986 Banking Ordinance which forms the basis of our banking legislation in Hong Kong. Although this sometimes feels like a never-ending task - rather like painting the Forth Bridge in my native Scotland - it does enable us to keep the legislation up to date and responsive to changing market developments.

Last year was more than usually important in this respect because of the passage of the Banking (Amendment) Ordinance 1995. This was enacted on 29 June 1995 and came into effect on 15 November 1995. The Ordinance establishes the Monetary Authority as the licensing authority responsible for the authorisation, suspension and revocation of all three types of authorised institution in Hong Kong. Previously, for example, full banking licences could only be granted or taken away by the Governor in Council, the highest decision-making body in the Territory. This move is a further step in building up the role of the Monetary Authority as the central bank of Hong Kong. However, we have recognised that it is essential that the administrative discretion of the Monetary Authority in respect of licensing decisions should be exercised within a clear statutory framework. Thus, such decisions will be taken on the basis of transparent authorisation and revocation criteria set out in Schedules to the Ordinance. This reflects our general attitude that market participants should be fully informed of what the rules of the game are, and that the authorities should not be able to change these rules in an arbitrary or capricious manner through administrative edict.

Towards the same end, we have published, concurrent with the commencement of the 1995 Amendment Ordinance, a Guide to Applicants which sets out the Monetary Authority's interpretation of the authorisation and revocation criteria contained in the Ordinance, and the procedures for processing applications for authorisation. Because the authorisation criteria are of a continuing nature, they are also relevant to existing authorised institutions.

As an additional step, we have also formed an internal Banking Supervision Review Committee to advise and make recommendations to the Chief Executive of the Monetary Authority on major authorisation decisions under the Banking Ordinance. The objective is to strengthen our internal checks and balances and to reduce the risk of maladministration or misuse of power.

There is a common theme running through these changes in the legal and administrative framework. This is to ensure that we conduct our supervision in an open, fair and consistent manner. We aim to do this not simply because it is right in principle or under the threat of possible judicial review, but because we believe that this is the best way to ensure that authorised institutions co-operate with, rather than resist, our supervision and that Hong Kong remains a place where international banks will wish to maintain a substantive presence. It should be noted however that, while consistency is a virtue, we cannot slavishly follow precedent. The market continually presents us with new situations and on occasions this may oblige us to make exceptions to, or to modify, our general policy. However, the key point is that in doing so, we should continue to act in an impartial and hopefully logical manner and to give reasons for our decisions.

Market developments also oblige us, as I have already indicated, to update our legal framework and we are already hard at work on a 1996 Amendment Bill. The centre-piece will be provisions to regulate the issue of multi-purpose stored value smart cards. The objective is to ensure that this new development does not have the potential to disrupt monetary or banking stability. This reflects the fact that multi-purpose smart cards can in effect perform the function of money and the loading of value onto such a card in exchange for cash is very akin to the taking of deposits. It would

be very odd if the issue of smart cards was not regulated while the taking of deposits was. Our thinking therefore is that multi-purpose smart cards should only be issued by authorised institutions and we are presently drafting the legislation on that basis. We hope to be able to consult the industry on the proposed legal framework in the near future.

Transparency is of course not only desirable for the regulators but for the banks themselves. Over the last two years therefore we have devoted much effort in co-operation with the SFC, the Stock Exchange and the banking industry itself towards improving the amount of financial disclosure by banks. As a result banks in Hong Kong are now publishing much more information about their profitability and balance sheets, and in particular for their 1995 accounts they are disclosing the accumulated inner reserves on their balance sheet.

Hong Kong banks have a good story to tell about their financial strength and performance and greater disclosure enables them to tell that story in a more effective manner. It can of course be more uncomfortable to have to disclose when the results are not so good and when the balance sheet is in poor shape. Public disclosure does therefore impose more discipline on banks to manage their affairs in a prudent manner and not to take undue risks. To that extent, greater disclosure can complement the work of the supervisors in reinforcing the self-discipline of management.

The need for greater transparency extends also to the way in which the banks conduct their business with their customers, particularly their personal customers who may be less able to stand up for their own interests. This involves issues such as the provision to customers of information about the terms and conditions of banking services and the relevant fees and charges as well as the procedures for handling customer complaints. The Monetary Authority has formed a working group with the banking industry to prepare a Code of Banking Practice which will aim to promote good banking practices and a fair and transparent relationship between banks and their customers. The objective is to enhance customer loyalty and confidence, thus contributing to the stability of the banking system. Again, therefore, this is consistent with our role as banking supervisors.

Finally, I will say something about our attitude towards derivatives and risk management which I see is a topic on Day 2. So far Hong Kong has been fortunate to avoid any derivative-related problems in the banking sector but the growth of this business means that we cannot afford to be complacent. The Monetary Authority has therefore taken a proactive approach to the supervision of derivatives and our efforts were given an added impetus last year by the problems of Barings and Daiwa.

A review of internal controls which we commissioned after Barings revealed that about 100 authorised institutions are involved in trading in derivatives, of which about half could usefully strengthen one or more aspects of their controls. We have since been keeping closely in touch with the management of the institutions concerned to ensure that the appropriate improvements are implemented. One of the ways we can do this is to use the services of the specialist team on derivatives which we formed during 1995 for the purpose of conducting visits to banks' treasury operations. We are also preparing a new guideline on the risk management of derivatives which will draw on the

observations from the 1995 internal control reviews, the treasury visits conducted so far and the lessons of the Barings and Daiwa incidents.

The complexity of derivatives and their ability to quickly change the risk profile of institutions has led to an increased focus on the need for banks to manage their own risks more systematically and scientifically. While it is important to have adequate capital to support the risk of losses both on and off-balance sheet, it is obviously much more preferable that the losses do not arise in the first place. To achieve this it is necessary that banks should have effective systems for identifying, measuring, monitoring and controlling the various types of risk to which they are subject. This is not the place to describe such systems in detail – I hope that you will hear a bit more about this tomorrow. Suffice it to say that, as Barings has clearly demonstrated, sound risk management starts at the top with a board of directors and senior management who clearly understand the nature of the various businesses their bank is in; who establish the risk tolerances of the bank; and who ensure that these are reflected in the policies and procedures for managing risk. ☘