

ETHICS AND QUALITY IN BANKING AND FINANCIAL INDUSTRY: CONTRIBUTION OF THE VARIOUS ACTORS OF CONTROL STRUCTURES – THE HONG KONG EXPERIENCE *

It is important that banks should behave not only prudently but also ethically. The various actors in the control process – internal discipline, market discipline and regulatory discipline – all have a role to play in ensuring this. In Hong Kong, the Code of Banking Practice has been drafted to help to ensure that banks treat their customers in a fair and transparent manner.

Introduction

I am honoured to be here today to participate in this important seminar. We are here to discuss how best to promote appropriate standards of conduct and quality in the provision of banking and financial services, and the role of external and internal influences in achieving this objective. In other words, how we can try to ensure that financial institutions behave prudently, honestly and fairly towards their customers.

I shall be speaking as a representative of the Hong Kong Monetary Authority which, among other things, is responsible for the conduct of banking supervision in Hong Kong. Banking supervision is traditionally concerned with the safety and soundness of banks with the aim of protecting the stability of the system as a whole. Supervisors attempt to do this by laying down a framework of prudential rules and guidelines relating to such matters as capital adequacy, liquidity and risk concentrations. However, the concerns of the supervisors have to go beyond the issue of financial soundness, vital though that may be. Banks look after other people's money and it is an obvious prerequisite that only persons of integrity should be entrusted with that task. Otherwise, apart from the possible direct threat to depositors' funds through fraud, there is a risk that unethical behaviour by a bank or its individual managers, for example through involvement in money laundering, could lead to a loss of public confidence in the bank concerned and perhaps in other banks as well.

I would suggest that supervisors also have an interest, for similar reasons, in the concept of "fairness" in the provision of banking services. This is not to say that banking supervisors should act as

"consumer watchdogs" in individual disputes between banks and their customers regarding the cost or quality of particular services. However, they cannot be indifferent to how banks treat their customers in general. If banks consistently provide a bad or unfair service, or abuse their market position, this may erode customer confidence and loyalty. Taken to extremes, the system as a whole could be brought into disrepute.

Thus, banking supervisors have an interest in encouraging and helping to foster good banking practices whereby banks behave not only prudently but also ethically, and act fairly and reasonably in relation to their customers. Indeed, it is difficult to disentangle the notions of prudence and ethical and fair conduct in a business which is so heavily dependent on trust and confidence.

So far I have concentrated on the role of the supervisors in promoting appropriate standards of conduct among banks. However, the purpose of this seminar is to examine the various mechanisms, both internal and external, whereby this objective can be achieved. External supervision should be seen as complementing the corporate governance exercised by owners, directors and management as well as the external discipline applied by the market. I shall be talking about the role of all three of these control mechanisms in my speech.

The role of owners, directors and managers of banks

It is a well-established principle that the main responsibility for the prudent and ethical operation of banks rests with owners, directors and managers. Each of these have their own distinct function. Owners have a responsibility to keep an eye on their investment and to vote in general meetings of

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the bank on such matters as the appointment of directors and changes in the constitution of the company. Directors stand between the shareholders and managers with responsibility for setting the strategic development of the bank and its objectives and monitoring that management implements the strategy. The directors must ensure that an adequate system of internal controls is put in place and that the bank operates in accordance with ethical standards. Management is responsible for actually implementing the objectives and policies agreed by the board and for managing the affairs of the bank on a day-to-day basis.

The problem is that this neat model may not always operate as intended. Conflicts of interest may arise and the checks and balances in the three-tier structure of owners, directors and managers may break down. For example, with fragmented ownership, shareholders may not in practice be able to exercise effective oversight of directors or managers. Conversely, concentrated ownership, for example in family-owned banks, may lead to pressure on the directors to act in the interests of the owners rather than the banks. This was certainly a problem in Hong Kong in the early 1980s when a number of family-owned banks got into difficulties. Insider lending to parties connected with the owners and directors was a feature of such cases. This is not to say that family-owned banks, which are common in the Asia region, are necessarily a bad thing. Indeed, ownership by family members who have their own capital at risk in the business and their own reputation to protect, should provide an incentive to ensure that the business is well-run. However, this does depend on self-discipline on the part of the owners and on independence of the board of directors. One means of reinforcing this is through the appointment of independent non-executive directors which is a requirement of the Stock Exchange listing rules in Hong Kong and which is also encouraged by the Monetary Authority.

Because ownership can influence, for good or ill, the whole tone of how a bank is operated, most regulatory systems are not content to leave this issue wholly to market forces. In Hong Kong's case, the banking problems of the early 1980s led to changes in banking legislation and regulation to try to deal with the abuses which had been identified. In particular, the 1986 Banking Ordinance

introduced restrictions on connected lending and risk concentrations as well as increasing the powers of the regulators in relation to the ownership and management of banks. These have subsequently been refined and the present position is that the approval of the Monetary Authority is required for the acquisition of control of 10% or more, and separately more than 50%, of the voting rights of a bank (or deposit-taking company) which is incorporated in Hong Kong. Any person who exercises indirect control over the directors, even without voting rights, is also subject to our approval. In approving changes of control, we take into account whether the applicant is fit and proper and whether the bank may be damaged, directly or indirectly, as a result of the change of control. Similar considerations arise in approving the directors and chief executives of banks.

Internal control systems

Such powers of approval should give comfort that the bank will be prudently managed on a day-to-day basis and that the owners will not put their own personal interests above those of the bank and its depositors. However, for these objectives to be achieved in practice it is also necessary that the bank should have adequate internal control systems which enable its business to be operated efficiently in line with the policies and objectives set by the board of directors, and which allow for the safeguarding of assets and the accurate recording of transactions. In recent years there has been an increased emphasis, on the part of both supervisors and management of banks, on internal control systems. In particular, the focus has been on the systems used for measuring, monitoring and controlling the various types of risk to which banks are exposed. This reflects the growing complexity of banking business arising from increased involvement of banks in new markets and products such as derivatives as well as a number of well-publicized banking problems due to control failures.

Of course, the concern about the quality of control systems is not new. However, the approach of both supervisors and management to the issue has hitherto been somewhat piecemeal. What we are now seeing is a more all-embracing and scientific approach towards trying to measure and control risk across the whole range of a bank's activities, including through the use of techniques such as "value at risk" which attempt to estimate

the probability of loss. This approach encompasses not only those types of risk which can be quantified, but also the more intangible but no less potentially fatal types of risk, such as loss of reputation.

In Hong Kong, we have followed the example of a number of countries in issuing guidelines earlier this year on the prudent risk management of trading in derivatives and other marketable instruments. We are monitoring adherence to these guidelines through the use of a specialist team of bank examiners with expertise in treasury operations. Our guidelines stress among other things the need for an independent risk management unit to monitor trading activities and to ensure that limits are being observed. At the most basic level, it is also essential, as the Barings case demonstrated, for there to be clear segregation of duties, particularly between the front office trading functions and the back-office settlement. Regrettably, even after the publicity given to cases such as Barings, some banks have been slow to initiate the necessary improvements in these basic controls.

The checks and balances in a risk management system need to be supplemented by an internal audit function which is mandated to review the adequacy and effectiveness of the overall system, to test how the various operational controls have worked in practice and to investigate unusual occurrences. The internal audit function needs to possess the necessary resources and technical expertise to do its job. In our experience in Hong Kong, this is not always the case, particularly where complex trading operations are concerned. It is also of course vital that the internal audit function should have sufficient status and independence within the bank for its findings to carry weight. As the Barings case also showed, line management should not be able to water down internal audit's recommendations or stall on their implementation. The banking supervisors may be of assistance in this respect by getting closer to internal auditors within banks and by lending support to their recommendations.

The overall risk management system should be approved by the board of directors and implemented by management. The board itself is however part of the risk management process in terms of setting the overall risk appetite of the bank and monitoring that the business actually

being conducted is consistent with that appetite. In order to do this the board needs to receive information about the amount of risk the bank has taken on and the profit or loss arising from that risk. We have observed in Hong Kong that the role of the board in this respect is not always sufficiently well-developed.

Corporate culture

The board also has a broader responsibility to set the corporate culture of the bank. Culture in this context can be defined as the core assumptions and beliefs of an organization which will determine the way in which it behaves both internally and externally – in particular, the culture of a bank will to a large extent influence its attitude towards ethical standards and regulatory compliance. Cultural deterioration in a bank will display itself in a number of ways – including the pursuit of short-term profits, internal controls which exist only on paper, the bypassing of controls, lack of respect for internal audit and an uncooperative attitude towards the regulators. If left unchecked, this can provide a fertile breeding ground for bad lending and trading practices and ultimately for fraud.

The board of directors can try to combat this in a number of ways: through their leadership style, the values they stress both inside the bank and in public and the remuneration policies which they put in place. A written code of ethics may be a useful way of getting the message across to staff. As regards remuneration policies, our recent guidelines on risk management have stressed the need to avoid giving conflicting signals to employees by appearing on the one hand to advocate prudent risk management while at the same time awarding bonuses which are directly linked to short-term trading performance. This may encourage excessive risk-taking and, at worst, deliberate falsification of positions and concealment of losses. We have therefore advised banks in Hong Kong that, where bonuses are paid, they should consider how possible adverse effects may be minimized, for example by relating bonuses to longer-term trading performance, or by paying the bonuses over a period of time.

Code of Banking Practice

As I have already indicated, we believe that banks have a responsibility not only to manage their own risks in a prudent manner but also to

treat their customers in a fair and transparent manner. This leaves open however the question of what constitutes appropriate standards of conduct in the bank-customer relationship and whether it is possible to rely on competitive market forces as a means of producing the right standards. A number of countries have taken the view that market forces are not sufficient in themselves to ensure that banking services are delivered on fair and equitable terms. On the other hand, to legislate in this area may impose undue rigidity at a time when markets are changing rapidly.

This has led to the introduction in a number of countries of Codes of Banking Practice which attempt to establish minimum standards for the bank-customer relationship. This is the route which we have decided to go down in Hong Kong. While the Monetary Authority is actually drafting the code, we are doing so in close consultation with the banking industry to try to achieve a sense of ownership of its provisions. The Code will be non-statutory, but we will expect banks to comply with it and to adapt their terms and conditions accordingly.

The main provisions of the draft Code deal with similar issues to codes elsewhere, such as the provision of information in plain language about the banking services on offer and their cost, adequate notice of variation in terms and conditions or fees and charges, the arrangements relating to customer accounts, the handling of customer complaints, confidentiality of customer information and credit cards. However, one particular focus of attention in Hong Kong has been to make recommendations in the Code regarding the manner in which banks employ debt collection agents. In particular, we have stressed that debt collection agents should be prohibited from using violent or intimidatory tactics to recover money and that banks should have adequate systems to monitor the behaviour of agents which they use.

The role of the market

The board of directors appointed by the owners and the senior management should ensure that banks behave both prudently and properly. However, it is a fact of life that internal discipline may sometimes not be strong enough. History tells us that competitive forces may cause the behaviour of banks to sink to the lowest common denominator

of prudence, unless competitive excesses are kept in check. This means that there must be some kind of external mechanism to reinforce the control exercised by directors and managers. Market forces have a role to play in this respect. If market participants such as shareholders, creditors and depositors detect that a bank is taking excessive risks or is underperforming this will put additional pressure on directors and management to take corrective action. If they fail to do so, the bank may find it more difficult or expensive to raise funds and, if it is listed, its share price may fall. Ultimately, the bank may be forced to exit the market or it may be taken over (assuming that there is a free market for corporate control, as there is in Hong Kong).

However, market forces can only work if market participants have sufficient information about the financial position and performance of individual banks, including in the audited annual accounts. In the case of Hong Kong, the position until recently was that most banks published very little information in their annual accounts. In particular, no breakdown was given of net profits and such profits were shown only after transfer to or from inner reserves. The accumulated total of such inner reserves on the balance sheet was not disclosed. The rationale for this position was to avoid banks having to disclose losses or even a sharp fall in profits which might result in an abrupt loss of confidence in the bank concerned and perhaps affect the stability of the system as a whole.

However, in today's environment where greater transparency is demanded, the Monetary Authority came to the view that the lack of disclosure in Hong Kong was becoming counter-productive, in the sense that it might give the impression that the banks had something to hide - which was certainly not the case - and because it provided insufficient incentive to management to improve performance. Beginning with the 1994 accounts, therefore, the Monetary Authority has encouraged banks in Hong Kong to publish more information in their annual accounts. The result is that the level of public disclosure in Hong Kong is now on a par with international standards. In particular, the banks now publish a full breakdown of their profit and loss account and much greater balance sheet information. Profits are no longer

shown after transfer to inner reserves and the accumulated total of such reserves has been disclosed. Information is also provided about bad debt provisions and the amount of non-performing loans.

This has not been a totally comfortable experience for some bank managements. It is now easier to spot those banks which are less profitable than their peers. However, as I have indicated, this is one of the objects of the exercise and the effect will hopefully be to lead to improvements in operating efficiency and performance. What it should not be allowed to do is to encourage excessive risk-taking in order to boost short-term performance - which is where the supervisors have a role to play. Overall, the effects of the increased disclosure have so far been beneficial, for example by improving the perception of Hong Kong banks among the rating agencies and making it easier for the banks to tap fresh sources of capital and longer term finance.

The role of the banking supervisors

One of the current live issues in supervisory circles is what the balance should be between the discipline exercised by the market and that exercised by the supervisors. The conventional supervisory system consists of the following main elements:

- a legal framework which defines the objectives, powers and responsibilities of the banking supervisors and which provides for the entry and exit of banks
- a supervisory policy framework of rules and guidelines which sets out the standards of prudent conduct to which banks are expected to adhere. In general, this framework can be summed up in the CAMEL system whereby policies are set, and banks are rated, in relation to Capital, Asset quality, Management, Earnings and Liquidity
- a means of supervisory monitoring and enforcement, based on a combination of on-site examination, off-site analysis and use of external auditors.

Most supervisory systems, including Hong Kong's, are along these lines, although there is scope for differences in emphasis and approach, for example in the relative weight which is attached to

quantitative and qualitative factors in the supervisory process. A more radical approach has been adopted by the New Zealand supervisors who now rely heavily on a regime of quarterly public disclosure of information by banks which is designed to enable monitoring of banks to be carried out mainly by the private sector. There are only a limited number of prudential rules relating to capital requirements and connected lending. An important feature of the new system is the emphasis that it lays on the role of directors in overseeing and taking ultimate responsibility for the management of the bank. Each disclosure must contain a number of "attestations" signed by every director, including whether all the conditions for registration as a bank have been complied with and whether the bank has adequate control systems to control its risks. There is no on-site examination by the New Zealand supervisors and their off-site analysis of banks is based mainly on the disclosed information which is also made available to the general public.

The New Zealand system gives primacy to market discipline and to public disclosure as a means of enforcing prudent conduct. In part, this is designed to minimize the perception that the Government underwrites the prudential soundness of individual banks. However, it is not clear that the New Zealand model has more general application. In that country, there are only 17 registered banks and all but one of these are foreign owned. In countries where there is a larger domestic banking sector or where there are branches of foreign banks whose home supervisors do not fully meet international supervisory standards, it is doubtful whether the New Zealand approach would be practicable.

In any case, there may be limits on the extent to which market discipline can substitute for detailed supervision of banks. Firstly, the effectiveness of public disclosure obviously depends on the timeliness and the quality of the information which is released. This in turn depends on the accounting standards in the country concerned.

Even if these issues can be addressed there is no guarantee that the market will apply discipline in a rational or proportionate fashion. Market participants may over-react to bad news, in the worst case perhaps provoking a bank run. This risk can be mitigated if there are informed market

commentators and analysts who can interpret published information for the press and the public. But in practice, even with the benefit of reliable commentary, small depositors may pay little attention to information disclosed by banks. The main beneficiaries may therefore be the larger depositors and wholesale counterparties who may seize the opportunity to take their money out of an ailing bank ahead of other, less aware creditors.

It is not however my intention to cast doubt on the value of increased disclosure as part of the overall framework by which banks are encouraged to behave prudently. The real issue is the balance which should be struck between internal discipline, market discipline and regulatory discipline. This will tend to vary among different countries depending on such factors as the stage of development of their financial systems, supervisory systems and accounting standards. In the United States, for example, the balance has recently shifted away from rule-based supervision and testing of asset quality and more towards evaluation of banks' own risk management systems. This may lead to a more efficient allocation of supervisory resources with a lighter touch being applied to those banks whose systems are judged to be satisfactory in relation to their risk profile. It is particularly important where

trading activities are a major part of banks' business and where the risk profile of a bank may alter in a short space of time. So far as Hong Kong is concerned, although our approach towards "supervision by risk" as it is known in the United States is less highly articulated, we are trying to move more in that direction through placing greater emphasis on public disclosure and on assessment of the quality of risk management systems. We are also taking a broader interest in the manner in which banks conduct their business with customers. Our approach here is to try to agree appropriate standards with the banking industry, rather than to impose rules. Having said this, the traditional supervisory focus on capital adequacy and on verification of asset quality through on-site examination will remain a vital part of our armoury.

In conclusion, it is difficult to isolate any single element of the control process as being pre-eminent. To refer back to the title of this seminar, it is vital that all the various actors – including the internal auditors – play their part in ensuring that banks behave in a prudent and ethical manner. This seminar offers a useful reminder of that fact and I am grateful for the opportunity to be able to participate.☺