DEREGULATION OF INTEREST RATE RULES — SUMMARY OF SELF-ASSESSMENT REPORTS BY BANKS

As part of the Banking Sector Reform Programme to promote competition in the banking industry, the Hong Kong Monetary Authority has undertaken to deregulate the remaining Interest Rate Rules governing Hong Kong dollar deposits in two phases. Forty-four licensed banks have been asked to conduct a self-assessment of the likely impact of interest rate deregulation on their institutions. This article provides a summary of how these institutions have prepared themselves for the deregulation.

Background

As part of the overall plan to reform and further develop the banking sector, the Hong Kong Monetary Authority (HKMA) announced in July 1999 a two-phased plan to deregulate the remaining Hong Kong Association of Banks' Interest Rate Rules (IRRs). As interest rate deregulation will clearly have implications for the cost and availability of funds for the banking sector, the HKMA asked 44 licensed banks in Hong Kong to conduct a self-assessment of the likely impact of deregulation on their institutions. These 44 banks account for about 94% of the sector's total Hong Kong dollar deposits.

Summary of Self-Assessment Reports

Overall Impact of Deregulation

The banks surveyed in this exercise generally agree that competition in the banking sector would intensify after deregulation. This would add pressure on their profitability in terms of higher cost of funds, narrower net interest margin as well as higher cost of customer retention and solicitation.

Under the first phase of deregulation (which took effect on 3 July 2000), the IRRs on time deposits with a maturity of less than 7 days and the prohibitions on benefits for deposits (other than Hong Kong dollar savings and current accounts) were lifted. Given that the remaining regulated time deposits only constitute a small fraction of total Hong Kong dollar deposits, the banks generally believe that the impact of the first phase of deregulation would be minimal. The second phase, which will remove the IRRs on savings and current accounts, is expected to have a more significant impact. This view is shared by banks of all sizes.

Meanwhile, it is also widely acknowledged that deregulation would provide banks with the opportunity to enlarge their market share of the deposits to be deregulated. Small and medium-sized banks, in particular, view this as a chance to compete with large banks for deposits. They consider that a liberalised environment would allow more flexibility in pricing, more room for the provision of innovative banking products and more opportunities to acquire new customers. On a sector-wide level, the banks believe that deregulation would promote greater efficiency in the banking sector and add impetus to the trend towards consolidation in the market.

Impact on Net Interest Margin

As noted earlier, net interest margins of the banks are expected to narrow after deregulation. Banks' views are that the impact of the first phase of deregulation would be negligible, whereas that of the second phase would be far more significant. As expected, other things being equal, large banks foresee a more significant impact since regulated deposits account for a more significant portion of these banks' deposit base.

Strategy to Cope with Deregulation

Since the impact of the first phase of deregulation is likely to be small, the banks would in general adopt a wait-and-see approach for this phase. Only one foreign bank mentions that it would consider offering incentives (i.e. gifts) to customers in order to retain existing, and attract new, short-term time deposits.

For the second phase, most of the banks see the need to adjust their business strategies to prepare for the increased competition. Large banks indicate their intention to levy higher fees and charges after deregulation to recoup servicing costs. They also mention the need to retain high value customers, encourage customers with low and volatile balances to use less costly delivery channels (e.g. the Internet and mobile phones) and enhance fee-based income.

Aggressive small and medium-sized players say that they would offer competitive pricing and quality products to capture a larger share of savings and current account deposits. Two of these banks note that they would utilise their branch networks to expand their portfolios of small deposits which are expected to be more stable and less sensitive to interest rate changes.

Other small and medium-sized banks generally say that they would offer competitive pricing or at least follow large banks in pricing in order to maintain market share and to prevent loss of existing customers. The majority of them see the need to enhance fee-based income through cross-selling and the need to continue to improve operation efficiency.

New Products and Services Being Considered

For the first phase of deregulation, the banks generally indicate that they do not have plans to introduce any specific new products. After the first phase of deregulation took place on 3 July 2000, a few small and medium-sized banks have adopted tiered interest rates for their short-term time deposit products and added more features to these products.

For the second phase, large and small banks alike indicate that they would apply tiered interest rates on savings and current accounts and impose charges on accounts depending on account balance and usage pattern. A lesser number, but still a significant portion, say that they would provide interest bearing current accounts or combined savings and current accounts. A few banks mention that they would offer auto-sweeping services between savings and current accounts. Some banks also say that they would either launch or enhance their electronic banking services. On the lending side, a few banks say that they would consider offering more HIBOR-based loans.

Management Information for Competition in a Deregulated Environment

To implement the new strategies and products mentioned above, most banks see the need for more information regarding product and customer profitability. Management information at bank level such as regular reports on the mix of deposit base is also considered important. Some large banks mention that they would collect more information about the behaviour of individual customers in order to provide customised services to these customers or to the targeted segments that these customers belong.

Only a few banks confirm that the required information systems for implementing the new strategies or products are already in place. All the other banks respond that the necessary systems will be ready before the second phase of deregulation.

Liquidity Risk

The banks generally expect that liquidity risk would increase after deregulation as deposits would become more volatile in a liberalised environment. However, most of them believe that fundamental change to the existing liquidity risk management systems would not be necessary. To cope with the increased liquidity risk, the banks in general would adopt more prudent approach to manage their liquidity positions and closely monitor market developments after deregulation. The following measures to mitigate liquidity risks are mentioned by the banks -

(i) Introduce more transaction-based service charges or more account features to reduce depositors' sensitivity to interest rates;

(ii) Offer competitive pricing to minimise possible outflow of deposits;

(iii) Issue certificates of deposit to secure a more stable source of long-term Hong Kong dollar funding;

(iv) Diversify funding sources;

(v) Increase holdings of liquefiable assets; and

(vi) The Assets and Liabilities Committee would meet more frequently and promptly adjust liquidity strategy if necessary.

Interest Rate Risk

It is commonly agreed that the banks' exposures to interest rate risk (mainly in the form of basis risk) would increase as interest rates on deregulated deposits would likely follow HIBOR rather than the prime lending rate. In addition, most of the banks agree that the reference value of the prime lending rate would diminish after deregulation and there would be a greater tendency for the banks to set interest rates based on cost of funds (e.g. HIBOR).

Most banks believe that their existing interest rate risk management systems would continue to be applicable. Nonetheless, they would regularly assess the impact of deregulation on their assets and liabilities structure and closely monitor market developments and competitors' responses after deregulation. The following measures to reduce interest rate risk are mentioned by the banks -

(i) Introduce more HIBOR-based lending products;

(ii) Increase prime-based liabilities;

(iii) Implement a more dynamic risk management process and use scenario analysis to estimate interest rate risk exposure;

(iv) Review and adjust asset and liability structure more frequently; and

(v) Enhance fee-based income to reduce reliance on interest income.

Other Types of Risks

As the types of products and services offered by banks become increasingly varied and complicated in a more competitive environment, a number of banks point out that operational risk would increase after deregulation. These banks say that they would enhance their systems and controls to manage the higher operational risk.

Some large banks express concern about the credit risk to small banks if the latter are unable to compete in a more competitive environment. They say that the small banks may not have the resources or economies of scale to develop new products to meet the demand of sophisticated customers.

A few banks mention that their social image would be affected when new fees on deposit services are introduced. These banks will give more priority to external communication and customer education to manage this reputation risk.

Conclusion

All 44 banks have confirmed that they are prepared for the deregulation. Provided that the prevailing economic and financial environment is stable, the second phase of deregulation will take place in July 2001. As competition in the banking sector is expected to be more intense and the risk profile of banks may change after deregulation, the HKMA will take a proactive approach to assess whether banks have taken account of the various risks in formulating their business strategies in an increasingly competitive environment.

- Prepared by the Banking Development Division