BANKING IN HONG KONG AFTER THE CRISIS[1]

This speech assesses the current position of Japanese banks and the general state of banking in Hong Kong after the Crisis. While the number of Japanese banks in Hong Kong declined sharply during the recent Asian financial crisis, there are now encouraging signs that Japanese banks are preparing to resume their significant role in Hong Kong.

I am very pleased to be here to address this luncheon meeting of the Ginyukai. Although I meet Japanese banks on an individual basis quite frequently, I see them as a group less often than I used to before the Asian crisis. In my earlier days in Hong Kong, we used to meet regularly at the numerous opening ceremonies and receptions of Japanese banks who were setting up new offices in Hong Kong. Over the last two years however I have been dealing with the voluntary revocation of the licenses of many of these same banks as they depart the Territory. This is a much sadder task than cutting the ribbon at an opening ceremony.

Current Position of Japanese Banks in Hong Kong

The figures tell their own story. In March 1997, there were 91 Japanese authorised institutions in Hong Kong. This includes some banks with multiple authorisations, for example as licensed banks and as deposit-taking companies. By June of this year, the number of authorised institutions had dropped to 35, a decline of 60%.

The reasons behind this decline are varied. Some of the Japanese banks were forced to cut their overseas operations, including those in Hong Kong, because of critical balance sheet problems and heavy losses. Equally, it has to be said that a number of the regional banks who came to Hong Kong in the 1990s lacked a clear business rationale for doing so and found it difficult to make money. Given the difficult economic climate back in Japan, it was probably right for these banks to cut their losses and go home.

Even the Japanese banks that stayed have cut back on their lending here. Between March 1997 and June 2000, the total lending of the Japanese banks in Hong Kong fell from just over HK$2000 billion to HK$643 billion, a decline of almost 70%. This has reduced the Japanese banks' market share of total loans in Hong Kong from 51% in 1997 to around 25%.

Of course, I am aware that these figures are a bit misleading, as Mr Kato of Bank of Tokyo-Mitsubishi recently pointed out to the press. Most of the decline in total loans was accounted for by euro-yen loans. These are yen loans to Japanese borrowers that were formerly booked offshore in Hong Kong for a variety of reasons, including funding costs and domestic regulations. A change in these regulations now makes it more feasible to book these loans onshore in Japan, hence the sharp decline in the amounts booked in Hong Kong.

Having said that, the Japanese banks' loans for use in Hong Kong have also fallen during the Asian crisis, though to a lesser extent. Japanese banks currently account for about 8% of total loans for use in Hong Kong, compared with 12% before the crisis. However, there have been welcome signs that the decline in the Japanese banks' domestic loans in Hong Kong has been levelling off this year. Moreover, in the Hong Kong syndicated loan market, it appears that the Japanese banks have recovered some of their appetite for lending. According to the figures collected by Basis Point, in 1998 the Japanese banks had dropped to 8th place in the league table of completed loans, with deals amounting to only US$288 million. In the first half of 2000, however, the Japanese banks had completed loan deals amounting to almost US$2 billion and had climbed to 3rd place in the league table.

1 This is the text of the speech delivered by David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Luncheon Meeting of the Ginyukai on 21 August 2000

I hope that this is a trend that will continue. Japanese banks have in the past made a significant contribution to promoting the growth of the Hong Kong economy and I am sure that they will be able to resume this role in the future. This may, however, involve less reliance on straightforward lending than in the past and a greater focus on capital market activities.

The Japanese banks have been through difficult times due to the collapse of the boom economy in Japan and the impact of the Asian crisis. Things are now looking brighter. The banks have been addressing their bad debt problems and have been assisted in this by capital support from the Government; two of the weakest banks have been nationalised and subsequently sold back into private ownership; and four mega-mergers have been announced which offer the banks concerned the chance to improve their competitiveness at home and abroad.

Challenges for Japanese Banks Ahead

However, you will be more aware than I am that important challenges lie ahead for the Japanese banks. The domestic environment within which they are operating is still uncertain. Although the Japanese economy is showing signs of recovery, the IMF has recently pointed out that the pickup remains "fragile and subject to downside risks". Consumer confidence is still weak and the corporate sector remains under some strain as shown by the rise of 21% in corporate bankruptcies in the year to July. The recent termination of the Bank of Japan's zero interest rate policy has led to fears that corporate finances may be put under further pressure.

This is a difficult environment in which the Japanese banks are embarking on their mergers. From my discussions with the banks concerned it is clear that they know what needs to be done in order to achieve the desired synergies and economies of scale. But it all depends on the quality of the implementation. Unlike the case with some past Japanese mergers, the banks will need to achieve full integration in their operations, technology, management and culture as quickly as possible, and jobs will have to be lost. There must be a much greater focus than in the past on return on capital and on the generation of shareholder value rather than on pursuit of size and market share for its own sake.

This is something in which we all have an interest. It is important for the stability of the world financial system and for the economic development of the Asian region that the banks of the world's second largest economy are fully restored to health and can resume their major role in financial intermediation at home and abroad. I wish you therefore all the best in your efforts.

Business with Mainland China

As I mentioned earlier, the Japanese banks have been and will remain an important part of the financial system in Hong Kong. They also of course have a similar role to play in relation to Mainland China. I am aware that the Japanese banks felt particularly disappointed and aggrieved at the collapse of Gitic and the subsequent debt problems that afflicted other Mainland window companies. I do not intend to go over the past history of this episode that is hopefully now coming to an end. But it is possible to see some good coming out of it if it helps, as I hope it will, to restore financial discipline within China. It has also served as a useful reminder to both domestic and foreign banks in Hong Kong not to engage in name lending and not to rely on implicit guarantees. While financial transparency among Mainland companies is by no means perfect, lenders are now at least better equipped to identify those companies that have sound underlying businesses and good management.

The long saga of GDE is now drawing to a close. The banks have, I believe, managed to negotiate the best deal possible, and the last remaining step is for the banks to review and sign the detailed documentation to put the restructuring into effect. I understand that when the documentation is sent to the banks, they will have plenty to read. But I hope that they will try to do this as quickly as possible and that we can avoid any last minute problems and delays. There is unlikely to be any opportunity for renegotiation of the deal, and if it were to collapse at the final stage, the banks would certainly be worse off.

So far I have been concentrating on the position of the Japanese banks. Let me now review the more general state of banking in Hong Kong after the Asian crisis.

Banking in Hong Kong after the Crisis

The first point to make is that the local Hong Kong banks have survived the crisis in good shape. Although one or two banks lost money, most banks remained profitable and actually managed to improve their capital ratios during the period as their risk assets declined and their capital base expanded. No banks required financial assistance from the Government during the crisis, in contrast to the situation in some of our Asian neighbours where the cost to the public finances of bank rescues and restructuring could reach as much as US$100 billion.

The rapid recovery in the Hong Kong economy is now helping to improve the banks' performance and to bring down bad debts. In the first half of this year, the pre-tax operating profits of the local banks from their Hong Kong operations rose in aggregate by more than 50% over the same period of last year. Admittedly, much of this was due to the reduction of 58% in the bad debt charge, which will be a temporary factor in improving profitability. But even at the pre-provision level, profits grew by about 15% compared with 1999. Surprisingly, after the publicity about declining margins on mortgage lending, the growth in profits was helped by an increase in the overall net interest margin. This reflected the fact that funding costs remained low during the period.

The position of the local Hong Kong banks is therefore looking better than at any time since the Asian crisis. However, like the Japanese banks, the banks here are also faced by a number of important challenges, albeit on a smaller scale than those in Japan.

Challenges of Local Banks in Hong Kong

Foremost amongst these is increasing competition. This is being displayed most obviously in the decline in lending margins already mentioned, particularly on residential mortgage lending which is a major part of the loan portfolio of most of the local banks. The margin has recently reached a new low of 2.25% below prime compared with the pre-crisis level of 1.25% above prime. To some extent this reflects the temporary conditions of a depressed property sector, sluggish loan demand and plentiful liquidity. As loan demand picks up, as inevitably it will, the decline in margins will stabilise and may even reverse somewhat. But lending margins are unlikely to get back to where they were before the crisis.

Competitive pressures will be further intensified on the funding side when we deregulate current and savings accounts next year. This is due to take place at the end of June 2001, and will only be postponed if the prevailing economic and financial conditions are clearly unfavourable, which we do not expect to be the case. The banks therefore need to prepare for the pressure on margins that this will cause and to be able to quickly introduce new deposit products like interest bearing current accounts. If they do not do so, their competitors will.

How do the local banks need to respond to these challenges? Most obviously, the challenges raise the issue of consolidation of the banking sector, through either merger or take-over. This is the trend we have seen happen in other financial centres, including in Japan. It has been slow to take off here, but it is going to come, sooner rather than later, as competition gathers pace. Events such as the sale of the Chase retail banking business, the restructuring of the Bank of China Group and the renewed interest of some foreign banks in acquiring an increased presence in Hong Kong will help to alter the competitive balance and could act an catalysts for change.

Banks also need to respond by properly harnessing the power of new technology, including the internet, to bring down costs and increase their ability to cross-sell a wider range of products. They may find it easier to finance the necessary investment, and obtain the skills and human resources they need, as part of larger units - which is a further argument in favour of consolidation.

Finally, I strongly believe that banks in Hong Kong and elsewhere must become more aware of, and responsive to, consumer needs. This not only means supplying the products that customers want but also providing them with easy to understand information about the terms and conditions of these products, including the fees and charges that attach to them. Hong Kong banks have not been sufficiently transparent in this respect, as a recent Consumer Council report on credit card charges has demonstrated. This is something that we will be aiming to put right in the current review of the Code of Banking Practice.

The Role of the HKMA

What does this mean for the Hong Kong Monetary Authority (HKMA)? Clearly, we also have to upgrade our own skills and methods in our role as banking regulator to try to ensure that we can keep up with developments in the market. This is most obviously the case with the new technology that requires us to devise new policies on innovations like virtual banking and internet security. This means that we need to find and train staff who understand the technicalities and are capable of assessing through onsite examination the adequacy of the banks' controls over the new technology. As you will know yourselves, people with this expertise are in short supply.

This emphasis on technology is however only part of the process of trying to make our supervision more risk-based. This is the same approach that is being adopted by the Financial Services Agency (FSA) in Japan. It aims to focus on the "self-responsibility" of the banks themselves in ensuring that they have adequate systems to identify, measure, monitor and control the whole range of risks with which they are faced. The role of the supervisor is then to assess the quality of the banks' own systems in relation to the quantity of the risks they are running, and to require improvements if these are necessary.

We have been developing this new approach for the last year with the help of the consultant seconded from the US Federal Reserve. So far the main focus has been on the local banks, but we hope to roll it out to the foreign banks next year. Hopefully, by focussing on the key risk areas, it should reduce some of your regulatory burden.

We recognise that this process has to be transparent, in that we need to explain to the banks what the new supervisory framework involves and what standards are expected of the banks. The examination checklists issued by the Japanese FSA are a good example of this approach. I know that some of the Japanese banks feel that the HKMA could do more along these lines in the area of transparency, and this is something that we have very much in mind. We will be publishing soon a framework document that explains the risk-based approach, and we are currently engaged in the major rewrite of all our supervisory guidelines. The aim is to put them into a common format and to make the text more user friendly and easier to read. This is a big task that will take about a year to complete in full. In the meantime, all our existing guidelines are available on our website, and individual guidelines in the new format will be added as they are produced.

I hope that you have found useful this assessment of the state of the Hong Kong banking sector, and the current position of the Japanese banks within it. Let me stress again that we greatly value the presence of the Japanese banks in Hong Kong. While this presence may have diminished over the last two years, Hong Kong remains an important market for the Japanese banks and I am sure that you will continue to demonstrate your commitment in the years to come.