THE CURRENT STATE OF BANKING REFORM IN HONG KONG[1]

This speech reviews recent progress on banking reform in Hong Kong in the light of the 1998 Banking Sector Consultancy Study and the increasingly competitive environment. It focuses on a number of areas of reform, including interest rate deregulation, the promotion of competition, and the development of risk-based supervision.

I am pleased to have the opportunity to address this lunch gathering of the Hong Kong Foreign Bank Representatives Association. As an international financial centre, it is the essence of Hong Kong that it should be a host to foreign banks. And as the banking regulator in Hong Kong, it is important that the Hong Kong Monetary Authority (HKMA) should keep in close touch with foreign banks through events such as today's lunch. This gives us a chance to explain aspects of our policies and how we see the current state of banking in Hong Kong. It also gives you the opportunity to provide feedback to the HKMA on any issues of current concern to you. Hopefully, I will not have to address too many hostile questions.

The 1998 Banking Sector Consultancy Study

I have chosen to speak to you today on the subject of "The current state of banking reform in Hong Kong". This seems a good time to undertake this stocktaking. It is over a year since we embarked on the reform programme that we devised in response to the Banking Sector Consultancy Study undertaken by KPMG and Barents in 1998. A number of the measures in the programme are directly relevant to foreign banks and you may therefore be interested to hear about what we have done so far, and what more we have in mind.

The Current State of the Banking Sector

The Consultancy Study was conceived just before the outbreak of the Asian Crisis and took place during it. The Hong Kong banking sector has now come through the crisis, and can be said to have clearly demonstrated its resilience and underlying strength. It is true that the number of foreign banks in Hong Kong has fallen sharply over the last two years. This reflects the fallout from the crisis that has led to the demise of some banks and has required others to cut back on their overseas operations and return to their home base. Hong Kong has certainly not been the only financial centre to witness this retreat.

However, the important point is that the core of the Hong Kong banking system - represented by the local banks and the large foreign players - has remained intact. Although bad debts rose sharply during the crisis and a few banks lost money, the banks generally remained profitable and financially sound. The capital ratios of the local banks actually rose during the crisis period. No banks failed and no depositors lost money. The Government was not called upon to provide financial support.

The results of the banks for the first half of this year show that their recovery from the crisis is well underway. Profits rose sharply and bad debts were lower. This means that the clouds that have hung over the banking system for the last two years have now lifted. But it would be wrong to conclude that life for the banks will go on much the same way as it did before in the golden years before the crisis. The competitive environment for the banks is becoming increasingly intense. Of course, you can argue that there is nothing new in this. The banking system in Hong Kong has always been competitive, which is one of the reasons it was able to cope with the Asian crisis. But competition in past years was taking place in highly

1 This is the text of the speech delivered by David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Luncheon of the Hong Kong Foreign Bank Representatives Association on 5 September 2000

buoyant conditions and within defined limits, reflecting in part the influence of the interest rate rules of the Hong Kong Association of Banks.

The Competitive Environment

Now things are somewhat different. A number of major players in the market, including some foreign banks, are competing even more intensely than they did before. Some of them have recently increased their presence in Hong Kong or are planning to do so. In some cases, this presence may be in virtual form as banks increasingly offer their services in whole or in part over the internet. This is part of a worldwide trend towards greater competition. But it is happening in Hong Kong at a time when lending growth has still not recovered along with the economy. Domestic loans showed no increase in the first seven months of this year. The result is that loan to deposit ratios have fallen to their lowest levels for many years - around 53% for the local banks as a group. The effect on loan margins has been quite dramatic. In particular, the margin on mortgage loans has fallen from 1.25% over prime rate prior to the crisis to the current low of 2.25% below prime.

The current situation may to some extent be temporary. It is difficult to believe that loan demand will not pick up soon given the pace of economic recovery in Hong Kong. Sentiment in the property market is now looking better and this may start to feed through into increased appetite for mortgage loans. But it seems unlikely that the boom conditions of the 1990s will return for the foreseeable future.

The implication of this is that the banks in Hong Kong may have to cope in the future with an environment of more restrained loan growth and finer margins. This means that they will need to find alternative means to boost income. One option is to diversify into the sale of products like unit trusts, pensions and life insurance that offer the opportunity to earn fee income. Another is to focus on lending to sectors such as the SMEs that provide higher returns at the expense of higher risk. A common factor in such initiatives is the need to cope with greater complexity in business development and risk management. Technology can help to deal with these issues, but this creates its own set of problems. Banks need to be able to afford the necessary investment in technology and to develop or obtain the expertise to utilise technology properly.

The Objectives of Our Reform Measures

The KPMG/Barents Consultancy Study broadly anticipated these trends. The policy prescription was that we should not stand in the way of the forces of change, nor should we simply do nothing and see what happens. Rather, it was concluded that we should try to manage the process of change through careful reform. The underlying aim of our reform package therefore is to help to improve efficiency and innovation in the banking sector through increased competition. Among other things, this might provide incentives for the local banks to think harder about merger and acquisition.

If we had simply done nothing and left competitive barriers, like the interest rate rules, in place, this might have sent misleading signals to the local banks, and prevented them from reacting quickly enough to the changes taking place around them.

A further objective of our reforms was to increase the attractiveness of Hong Kong as an international financial centre. Also, bearing in mind that increased competition can bring with it increased risk, we were also conscious of the need to take steps to enhance the safety and stability of the banking system.

I am not in this speech going to summarise all our reform measures, which are due to be implemented over the period to the end of 2001. Instead, I will describe what we have done so far, and the main tasks that remain to be done.

The Progress on Competitive Reforms

So far we have introduced three main changes that are intended to promote competition:

(a) In September 1999, the one-building condition that applied to foreign banks licensed after 1978 was relaxed to allow such banks to open branches in a maximum of three separate buildings. At the same time we eliminated any restriction on the number of regional and back offices that foreign banks can maintain.

(b) In December 1999, we announced that agreement had been reached with the various parties involved for restricted licence banks to join the Real Time Gross Settlement (RTGS) interbank payment system. The detailed legal arrangements were finalised in May of this year and a formal invitation to join the system was issued to those restricted licence banks (RLBs) with a clear business need to do so.

(c) Finally, at the beginning of July of this year, we embarked on the first phase of deregulation of the remaining interest rate rules. This involved removal of the interest rate cap on time deposits with a maturity of less than 7 days. Following this, all time deposits are now completely deregulated.

What has been the reaction to these changes? The answer is that not much has happened so far. Despite the fears of some of the local banks that they would have to cope with a flood of new foreign bank branches, no foreign banks have as yet taken the opportunity to establish additional branches. Of course, many foreign banks are engaged in wholesale, corporate or private banking business in Hong Kong and do not require an extensive branch network. Moreover, a number of banks are still recovering from the Asian crisis or are in the process of merging, and are not in an expansion mode at present. As mentioned previously, however, there are some foreign banks that are enthusiastic about building up their presence in Hong Kong. But perhaps for these, the organic route of establishing new branches, and having these limited to three, is too slow and restrictive. Acquisition of an existing operation is likely to be a more attractive for such banks.

We have already said that we will review the impact of the three building condition in the first quarter of 2001. If it appears that it is serving little useful purpose - because there is not in any case a huge demand on the part of foreign banks for additional branches - we may simply dispense with the condition altogether.

Similarly, no RLB has yet applied to join the RTGS system. It is however early days for this, and we are aware that some of the more active RLBs are considering whether to apply. They will need to weigh the costs and benefits of direct membership compared with the existing practice of using a settlement bank. The important point is that the RLBs are now in a position to make that choice based on their own business needs. If the RLBs feel that there are any remaining impediments to their joining the system we would be pleased to hear from them.

Interest Rate Deregulation

The first phase of interest deregulation also produced a muted response. This is not unexpected nor is it unwelcome. We are trying to avoid "big bang" deregulation that might be disruptive. Some banks have introduced new overnight deposit accounts, which pay interest above the savings account rate. But so far we have not seen any large-scale migration from savings accounts to 24-hour call accounts.

This is perhaps not surprising given the ample liquidity in the banking system, which means that the banks have a reduced incentive to bid actively for fresh deposits. This is reflected in the unusually small differential between the interest rate on savings accounts and those on time deposits. For example, the gap between the savings account rate and the one-month time deposit rate was only about 0.5% at the end of August. This reduces the incentive for depositors to forego the loss of liquidity involved in switching into time deposits.

Of course, there could be a more significant impact in July 2001 when the process of deregulation is due to be completed with the removal of the interest rate cap on savings accounts and of the prohibition of interest on current accounts. Based on self-assessments that we asked the banks to prepare earlier this year, there is a general view that competition in the banking sector will intensify after the final phase of deregulation and that there could be quite a significant impact on the net interest margin.

That was also the conclusion of the KPMG/ Barents Consultancy Study. But the actual impact will obviously depend on the conditions at the time. If the supply of deposits remains ample in a year's time, banks will have less reason to bid aggressively for deposits. Despite this, many banks may use deregulation as an opportunity to try to gain market share and to attract new customers by offering new deposit products with an attractive interest rate. Innovation and competition of that kind is what deregulation is intended to achieve. It should also encourage more efficiency in pricing and the elimination of cross-subsidisation. Expect therefore to see more transaction fees and charges to recover servicing costs, and use of differential pricing to encourage customers with low and volatile balances to use less costly delivery channels such as the internet.

The Need for Fairness and Transparency

Banks are at liberty to impose such fees and charges, but it is essential that they should be fair and transparent in doing so. This is particularly the case if the banks are intending to get more involved in consumer and wealth management business where it is important to retain the trust of the customer. The banks cannot afford a bad image otherwise they may find their customers going elsewhere - for example, to internet-based financial institutions.

As we have seen from some recent incidents, the banks in Hong Kong have been lagging behind in the provision of clear information to their customers about the cost of some financial products such as credit card advances. Moreover, there has been recent controversy about the provisions in credit card agreements that entitle the lenders to reclaim from debtors the full legal costs and expenses of recovering overdue debts. In a recent court case, the judge ruled that the relevant provisions were unconscionable and therefore could not be enforced.

We have written to authorised institutions to ask them to review their terms and conditions in the light of the court's ruling and to ensure that they are consistent with Hong Kong law. We have also initiated a review of the Code of Banking Practice with a view to strengthening the provisions on such issues as transparency in the provision of banking services and the proper and responsible use of debt collection agents. These issues are already addressed in the Code to some extent, and perhaps if the spirit of the Code had been more closely adhered to, some of the recent bad publicity for the banks could have been avoided. However, it is evident that the Code needs to be made more specific in some areas, and the issue of how to ensure compliance must also be addressed.

The Code of Banking Practice is not part of our reform measures, but I have digressed to talk about it for two reasons. First, as already indicated, it becomes all the more important in a deregulated environment to ensure that there is a fair and balanced relationship between banks and their customers. Second, the fact that we are going to have to devote resources to this issue for the rest of this year means that one of our reform measures, namely a review of the current three tier system of authorisation, will be postponed from this year to next. This will also allow us to take into account the results of our forthcoming review of deposit protection arrangements, which may have a bearing on the minimum size of deposits that authorised institutions which are not licensed banks should be allowed to take.

Safety and Soundness of the Banking System

Deposit protection is part of what might be called the safety net arrangements for the banking system. As the name suggests the safety net is there to catch banks that are in trouble or, if not the banks, then at least their depositors. This is part of the other aspect of our reform measures that are aimed at promoting the safety and soundness of the banking system. One aspect of this is already in place in the form of a policy statement issued by the HKMA in June of last year on its role as Lender of Last Resort to authorised institutions.

The major safety and soundness issues however lie ahead. The first is whether we should introduce a commercial credit reference agency in Hong Kong which would gather and collate information from participating institutions about the indebtedness and credit record of their corporate borrowers. This would enable lenders to obtain a more complete picture of the financial position of their customers, and thus improve their credit assessment and perhaps make them willing to lend. That is the theory, which seems to be supported by both academic research and the experience of overseas countries. We are currently nearing the end of a consultation period and will consider the way forward in the light of the comments received.

As this consultation ends, we are about to embark on another that may be more contentious. I am referring to the possible enhancement of the deposit protection arrangements in Hong Kong. In their Consultancy Study, KPMG/Barents identified this as an important issue as the banking sector becomes more competitive and the level of risk possibly increases. They also considered that the current arrangements, which give priority to small depositors, did not appear to have sufficiently raised the crisis of confidence threshold to avoid bank runs. They therefore recommended that the issue of deposit protection should be looked at again.

This we have done in the form of a new consultancy study by Arthur Andersen that was completed in July of this year. This has looked at various options for deposit protection, including maintenance of the status quo at one extreme and the introduction of an explicit scheme for deposit insurance at the other. Such schemes are increasingly being introduced around the world and are advocated by a number of international standard setting bodies. The drawbacks of deposit insurance are however well known, including the risk of increased systemic instability due to moral hazard. The costs of such a scheme would also need to be carefully considered.

This is a controversial issue that will need to be fully debated. Subject to views of the Executive Council, it is our intention to undertake a consultation on the various options for deposit protection at the beginning of October. If it is eventually decided to introduce one of these options, further consultation would then be required on the detailed arrangements.

Risk-based Supervision

Of course, the best thing would be for the safety net not to be actually used. In other words, we should be trying to prevent banks getting into difficulties in the first place. This requires effective management by the banks themselves as well as careful monitoring by the banking supervisors. The first of these we have tried to address through our recent Guideline on the Corporate Governance of Locally Incorporated Authorised Institutions. This is intended to encourage high standards of management in such institutions and thus help them to deal with the challenges ahead.

These challenges also require enhancements to our system of banking supervision. As recommended by KPMG/Barents, we are introducing a more risk-based approach. This aims to be more forward-looking than the old style of supervision. It focuses more precisely on the various types of risk being run by individual banks, the quantity of such risks and the quality of the system used to manage them. If used properly, it should lead to a less intrusive and less burdensome supervisory approach towards well-managed institutions.

We have been developing this approach over the last year and have applied it to a number of the local banks. We intend to roll it out to cover foreign banks next year. It is important that the whole process should be transparent and to assist in this we intend to issue a framework document quite shortly which will outline the new approach. We are also engaged in a major rewrite of our supervisory guidelines to make them more user-friendly and to put them into a common format. This is a substantial project that will take about a year to complete. In the meantime, we shall be issuing new and revised supervisory guidelines in the new format as they come off the production line.

Conclusions

To sum up, our reform package is not intended to be revolutionary. The Hong Kong banking system is already well-managed and competitive. But even good players need to improve their game as conditions became tougher.

The main responsibility for doing this in the Hong Kong banking context will rest with the banks themselves. We in the HKMA are trying to do our bit by removing possible barriers to change in a cautious manner, and by making sure that our supervisory approach remains appropriate to the changing market environment.