BANKING TRENDS IN HONG KONG *

Hong Kong banks are well-capitalised, liquid and profitable. A cautious approach to deregulation has resulted in almost all time deposits having been deregulated but with a firewall left between current and savings deposits and the deregulated deposits. In line with international standards, banks are now required to disclose more accounting information. The Monetary Authority is studying whether to introduce new capital requirements on market risk, including that attributable to derivatives.

I am pleased to be here this morning to speak at this distinguished gathering of the Asian Bankers' Association. It is an opportune time for me to speak on the subject of "Banking Trends in Hong Kong" since the banking environment is currently undergoing some important changes. I am referring particularly to interest rate deregulation and increased financial disclosure by banks, which will be two of the main topics in my presentation. As always in Hong Kong these have generated lively debate.

The current position of the banking sector

I would like however to begin by summarising the present position of the Hong Kong banking sector and its current financial performance.

First of all it is gratifying to note that the banking sector is still expanding. Although the total number of authorised institutions has remained around 380, the number of fully licensed banks has risen from 180 to 183 in the year to September. In total, six banking licences have been granted this year against three revocations. The new entrants come from the United States, Japan, Belgium and China, reflecting the broadly based appeal of Hong Kong as an international financial centre. In total, banks from over 40 countries have a presence in Hong Kong including 85 of the top 100 banks. The external assets of the Hong Kong banking system, at US$680 billion, are probably the fourth largest in the world. A recent BIS survey has shown that the daily foreign exchange turnover in Hong Kong in April 1995 amounted to US$91 billion, having risen by almost 50% over the three years since the last survey. This growth, which was faster than Hong Kong's closest competitors apart from London, enabled Hong Kong to overtake Switzerland to become the world's fifth most active trading centre.[1]

The profitability of the banks' operations in Hong Kong has also been well sustained. In this connection we tend to look particularly at the earnings of the locally incorporated banks which have the most direct involvement in the domestic market. In the first half of this year, the post tax earnings of the local banks from their Hong Kong operations rose in aggregate by a healthy 16% over the same period of 1994. The return on assets remained around 1.6% on an annualised basis, the net interest margin rose slightly to 2.4% and the return on capital was over 15%. This performance has been underpinned by continuing good asset quality: the bad debt charge of the local banks amounted to only 0.07% of total assets in the first half of the year. This is consistent with our other indicators of asset quality which show that loans classified as "substandard", "doubtful" or "loss" account for only about 1.6% of total credit exposures, while "overdue" and "rescheduled" loans are only 1.1% and on a declining trend.

Couple this with capital adequacy ratios which are well into double figures and a loan to deposit ratio (in all currencies) which is less than 60% and you have a picture of a banking system which is well-capitalised, liquid and profitable.

This is not however to deny that banks in Hong Kong face challenges. For example, loan growth has slowed during 1995 and the banks are having to fight more aggressively for business. This has shown up particularly in the residential mortgage

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1 Further details on this survey are given in the article "The Foreign Exchange Market in Hong Kong" in this issue of the *Quarterly Bulletin*.

market where lending rates have been cut. While this is good news for borrowers, it will have some impact on profitability. This reinforces the point which we have been making to the banks for some time that it would be unwise to rely too heavily on one particular line of business such as residential mortgages and that prudent diversification into areas such as trade finance, which generate fee as well as interest income, would be desirable.

Some banks argue that mortgage lending is one of the safest forms of lending there is and query the need for diversification. Such lending in Hong Kong is indeed of high quality as evidenced by the loan default rate of less than 0.5% of the principal amount. Nonetheless, an element of liquidity and concentration risk remains. The prudent lending criteria adopted by banks in Hong Kong in their residential mortgage lending, in particular the 70% loan to value ratio, have helped to mitigate these risks. However, the HKMA is also considering ways in which the liquidity of banks' mortgage portfolios could be increased, for example by promoting the development of the secondary mortgage market.

Interest rate deregulation

Increased competition for banks in Hong Kong is a fact of life on the deposit as well as the lending side of the balance sheet. Interest rate deregulation over the last year has perhaps given added impetus to that competition, although the aggressive bidding for deposits that we saw in early 1995 has thankfully now moderated. It may surprise some of you that interest rate controls still exist in a competitive, so-called laissez-faire, banking system such as Hong Kong's. These controls take the form of Interest Rate Rules made by the Hong Kong Association of Banks governing the maximum rates that can be paid on HK dollar savings deposits and time deposits of less than HK$500,000 and prohibiting the payment of interest on current accounts. I would agree with the Hong Kong Consumer Council which raised the issue, that such controls are an anomaly in a modern market-oriented economy such as Hong Kong's. But they were introduced thirty years ago at a time of a price war among the banks which did lead to instability in the system. While the controls may be out of place now, the problem is how to remove them in a safe manner. We are mindful of the fact that deregulation in other countries, both developed and developing, has not been free of problems. These arise because deregulation, for example of interest rate controls, can erode banks' profitability leading them to take excessive risks and weakening their ability to withstand external shocks. Thus, while we accept that deregulation may indeed be in the long-term interests of the banking sector in terms of encouraging increased efficiency and innovation, we also believe that the pace of deregulation should be carefully controlled.

Bearing this in mind, we have decided that there should be no deregulation of HK dollar current and savings accounts which together amount to HK$390 billion. We have however accepted that the interest rate cap should be removed on time deposits of less than HK$500,000. This process started on 1 October 1994 with the deregulation of all relevant time deposits with a maturity of more than one month; all those with a maturity of over seven days were deregulated on 1 January 1995. We then had a breathing space to enable us to review the effects of the first two phases of the deregulation. This review, which covered the period up to end-June 1995, concluded that the banks had so far absorbed the effects of deregulation well. While there appeared to have been some migration of deposits from current and savings accounts to the deregulated time deposits, this had not so far had a significant impact on banks' funding costs or interest margins; nor did it appear that there had been destabilising movements of deposits among banks.

Nonetheless, it was felt that continuing caution was required. The experience of deregulating the longer maturities might not be a good guide as we moved towards the very short maturities. There was certainly a perception among some influential analysts that deregulation of time deposits with less than seven days maturity, particularly 24-hour call deposits, could have a more significant adverse impact on margins and on profitability. Our view that the external environment had become more volatile, as evidenced by events such as the Mexican crisis and the collapse of Barings, was another reason to proceed slowly.

We decided therefore that we should take one further step by deregulating seven-day time deposits. It was also decided that there should be no further move below seven days and that the

current programme of deregulation should come to an end.

By doing this we have deregulated over 99% of time deposits formerly covered by the Interest Rate Rules. While time deposits under seven days remain regulated there are very few deposits currently within this category. The point of leaving them subject to the Interest Rate Rules is to create a "firewall" or barrier between deregulated time deposits and current and savings accounts. This should avoid any potentially destabilising migration of deposits from current and savings accounts and should avoid the deregulation of these by the back-door.

Depositors can now choose between current accounts which do not pay interest but which offer the convenience of chequing facilities; savings accounts which pay a regulated rate of interest but also provide instant access; and deregulated time deposits which pay a market rate of interest. I would argue therefore that we have arrived at a logical structure for retail deposits which seems to balance well the interests of the consumer and the need to maintain banking stability. I should stress that further deregulation is not off the agenda altogether but we shall want some time to study the impact of the programme we have just completed before going any further.

Financial disclosure

A further environmental change faced by the banks is the need to make increased disclosure of their financial position and performance in their published accounts. I do not propose to go back too far into the history of this but it is fair to say that prior to the 1994 accounts the general standard of financial reporting in Hong Kong was close to the bottom of the international league table. The rationale for this was the view that banking stability was best maintained if banks did not disclose full information about their performance and business so as to prevent bad news from causing a loss of confidence.

This view should not be lightly dismissed. But the fact is that it has been overtaken by events. The international trend is towards greater transparency and accountability, and the market now demands more information about banks and indeed companies in general. The increased role of the rating agencies in this region is proof of this. Against this background, lack of disclosure by banks can actually be counterproductive in that it may lead to suspicions that they have something to hide and hence result in a lower than justified rating. This may affect the ability of the banks to conduct international business or raise capital.

These considerations have led us to accept the case for fuller disclosure by banks in Hong Kong. We believe that they are well able to withstand greater scrutiny from the market given their strong capital position and good liquidity. It is also the case that the supervisory system has been strengthened in recent years which has helped to put the banking system on a sounder footing. However, it is also important that the efforts of the supervisors should be supported by market discipline on the management of banks to improve profitability and to control exposure to risk. This discipline can only be exerted if the market has sufficient information to compare the financial performance and riskiness of different banks.

With this in mind we have been working with the banking industry and the securities regulators in Hong Kong over the last two years to produce phased packages of increased disclosure. The first results of this were shown in the 1994 accounts where all the local banks revealed for the first time their actual profits including transfers to inner reserves. A full breakdown of income and expenses, including the bad debt charge, was also given, along with additional analysis of balance sheet assets and liabilities. For the 1995 accounts we have introduced additional information relating to such items as the quality of assets, movements in provisions, segmental breakdown of advances and off-balance sheet business.

What will probably attract most attention, however, is our recommendation that the banks should disclose the accumulated total of their inner reserves on the balance sheet. The very fact that inner reserves are a secret adds to their mystique and perhaps leads to them being given an undue significance. I would not deny that disclosure of balance sheet inner reserves will improve the market's knowledge of the net worth of the banks in Hong Kong and this will help to ensure that they are correctly valued on the stock market. However, from a supervisory point of view it should be stressed that inner reserves are only one component

of the capital base of banks. The key measure of capital adequacy is in fact the Basle Committee's capital adequacy ratio which we introduced in Hong Kong as long ago as the end of 1989. On this measure, as I have already indicated, banks in Hong Kong are well capitalised, having ratios which are well above the 8% minimum recommended by the Basle Committee.

Market risk and derivatives

The Basle Committee's capital adequacy framework has played a major role in improving the safety and soundness of banks and in establishing a level playing field for banks to compete internationally. However, the present regime is incomplete: in particular, it focuses mainly on credit risk and takes little account of the market risks which the banks run in trading in bonds, equities, foreign exchange, commodities and the derivatives of these assets. The importance of strong capital backing for such activities has been demonstrated by the collapse of Barings and more recently the losses suffered by Daiwa.

The Basle Committee has therefore produced proposals for additional capital requirements to support banks' market risk, that is the risk of losses in on or off balance sheet positions resulting from movements in market prices, interest rates or exchange rates. One particular feature of the proposals is that for the first time the Committee has accepted that the more sophisticated banks may use their own internal risk management models to calculate the capital requirement for market risk. This would be subject to a number of quantitative and qualitative criteria laid down by the Basle Committee, including that there should be an independent risk control unit with the active involvement of senior management. This approach of allowing use of models is to be welcomed because it demonstrates a willingness to work with the market in producing supervisory solutions. However, it will make life more complicated for the supervisors because they will have to extend their own skills and techniques to understand the instruments which are being traded and the mathematics of the models which are being used to value these instruments and to calculate the risk in them.

There may be a tendency for supervisors in the region to say that the Basle Committee's proposals are only relevant to the large internationally active banks which are heavily involved in capital markets activities, including derivatives. It is true that at the moment even in a sophisticated financial centre such as Hong Kong most of the trading activity is in the hands of the branches of foreign banks. However, this may well change over time as the local banks seek to diversify their business by becoming more involved in the capital markets and local customer demand for derivatives for hedging and investment purposes increases. Moreover, the Basle proposals are relevant not simply to complex products but also to traditional foreign exchange activities and trading in simple instruments such as bonds. The Daiwa example shows that there is ample scope to lose money in even this relatively straightforward business if the controls are not right.

In Hong Kong therefore we are actively studying the Basle proposals on market risk which are due to be finalised at the end of this year. Our present objective is to try to implement them in Hong Kong by the end of 1996.

Of course, it must be remembered that capital is only there as a safety net in the event of losses. It would be much better if the losses did not occur in the first place. This means that it is important that banks have adequate internal controls over all of their trading activities, including derivatives. Much emphasis has been placed on senior management fully understanding what their traders are up to in the dealing room or on the trading floor, which was evidently not the case in relation to Barings' operations in Singapore. However, as the Barings and Daiwa cases also show, it is equally important that management ensures that the very basic controls are in place, including in particular proper segregation of duties between the trading and settlement functions. In Hong Kong, we have been focusing on such control issues in the aftermath of Barings and we plan to issue a further guideline on the subject in the near future.

The outlook

A recent report on the Hong Kong banking system concluded that there were grounds for "cautious optimism" about the future. This is a reasonable assessment, although I would tend to verge more on the side of optimism. There are a

number of reasons for this, including the better than expected performance of the local banks in the first half of this year. The halt to the current programme of interest rate deregulation should help to remove uncertainty about the banks' prospects. External monetary conditions have also turned more favourable: the rise in US interest rates has topped out and further cuts may be on the way. If so, that would give some boost to the property market and to domestic demand in Hong Kong, leading to increased lending volume. Lending should also benefit from the expected demand for finance for infrastructure development including the new airport. The inflationary situation in China also seems to be coming more under control, increasing the chances of a soft landing. So far, the tighter liquidity in China and the rise in HK dollar interest rates last year do not seem to have produced a rise in bad debts in Hong Kong, though admittedly these may still take time to show through. The banks in Hong Kong therefore need to avoid complacency, particularly in the light of the problems in other banking systems around the world during 1995. I believe, however, that they remain well-placed to move forward to meet the challenges of 1997.