HKMA's POLICY RESPONSE TO THE BANKING SECTOR CONSULTANCY STUDY

In March 1998, the HKMA commissioned KPMG and Barents (the consultants) to undertake a Banking Sector Consultancy Study (Study) on the future development of the Hong Kong banking sector. The main objectives of the Study were to evaluate the strategic outlook for the banking sector over the next five years and to consider the effectiveness of the HKMA's approach to banking supervision. The Study was completed in December 1998 and the full details of the findings and recommendations in the Study were published early this year for a three-month public consultation which lasted until the end of March 1999. This article sets out the HKMA's policy response to the recommendations of the Study.

Introduction

The consultants pointed out that Hong Kong has a sound, safe and dynamic banking sector. Overall, Hong Kong banks compare favourably with international standards in terms of profitability, efficiency and transparency. However, the consultants also identified a number of global forces and trends in financial services, which will shape the future development of the Hong Kong banking sector. These global forces would likely result in increased competition as well as increased levels of risk in the banking sector.

The conclusion from the Study was that the HKMA should consider evolving its regulatory and supervisory frameworks to improve the sector's ability to adapt to the new emerging environment and incorporate positive elements of change. The challenge for Hong Kong lies in how to exploit future opportunities while containing the risks.

The consultants proposed two sets of recommendations to assist the future development of the Hong Kong banking sector. The first relates to market reforms targeted at promoting competition in the banking sector by removing incompatible regulatory features. The second set of recommendations aims to enhance the infrastructure supporting bank safety and soundness to ensure that increases in competition can take place in a relatively stable environment. Further, it was considered important that this package of recommendations should be introduced in parallel, using a phased approach.

Comments Received from Public Consultation

The HKMA received a number of written responses from the banking industry as well as other non-bank organisations. From the responses received, there appears to be a large measure of support from the banking industry and other sectors of the community for both the general direction and most of the specific recommendations identified in the Study even though for some recommendations (e.g. deregulation of the Interest Rate Rules and depositor protection), different views were expressed as to the timing and manner of implementation.

HKMA's Response

Having considered the consultants' recommendations and comments from the general public, the HKMA devised a package of policy initiatives for the further development and reform of the banking sector. This package of policy initiatives arises mainly from the consultants' recommendations. However, it also contains other initiatives which the HKMA will pursue to improve the safety and soundness of the banking system. Details of the package were announced on 14th July 1999.

The Overall Approach

The HKMA considers that carefully planned liberalisation of the financial markets is necessary if Hong Kong is to maintain its position as an international financial centre. At the same time, it is equally important to strengthen the safety and soundness of the banking sector as a whole so that the benefits of increased competition and greater efficiency can be fully realised.

The HKMA does not believe that a protectionist approach is in the best long-term interests of the local banks or of Hong Kong's position as a financial centre. More competition is coming whether Hong Kong chooses to liberalise further or not, and the best approach is to try to manage that process rather than resist it. The real answer is for the local banks to upgrade their skills and systems capabilities, and to offer their customers the range of products and quality of service that will enable them to retain their franchise. This will pose difficult challenges in terms of the investments in technology, risk management and human resources that will be needed. This will put further pressure on the local banks to address the issue of merger or other forms of strategic alliance that will spread the cost of such investment. While these are matters that fall within the commercial judgement of the institutions concerned, the HKMA is of the view that moves in the direction of consolidation of the local banking industry are both desirable and inevitable. Although the HKMA is not trying to force change, the gradual elimination of regulatory barriers will allow market forces to play an increased role in determining the appropriate number of institutions in the banking sector.

Specific Recommendations from the Study

Market reforms to increase banking sector competition

<u>Deregulation of the Remaining Interest Rates Rules (IRRs)</u>

Following the three phases of deregulation undertaken between 1994 and 1995, the remaining IRRs cover time deposits of six days or less (mainly 24-hour call deposits), current accounts and savings accounts (which amount to 0.1%, 5.4% and 25.1% of the total Hong Kong dollar deposits of the banking sector respectively). There are also a number of other restrictions concerning offers of gifts and automatic transfers to or from current accounts which are currently still in effect.

The HKMA, along with the banking industry, considers that deregulation of the remaining IRRs is inevitable given the direction of global banking developments and would ultimately be beneficial to Hong Kong. However, there are several important issues associated with deregulation, which must be understood by both banks and their customers.

The IRRs have provided an element of stability during periods of uncertainty in the local banking market. Without the IRRs, it is likely that the interest rate volatility experienced during 1998 would have been transferred to other sectors of the economy, including the share and property markets. The technical reforms of the currency board system introduced during 1998 have been successful in their objective of reducing interest rate volatility. However, it remains the case that, in a deregulated environment, increases in market interest rates are more likely to be passed onto the consumers.

Furthermore, experience of deregulation elsewhere shows that banks will try to generate additional revenue through charging fees and introducing tiering of interest rates. They will also review their existing cost structures and streamline unprofitable services and branches. Deregulation of the IRRs is therefore likely to result in a re-distribution of resources between bank customers that better reflects an optimal economic allocation rather than a large scale and simultaneous increase in benefits for all customers. For example, customers holding larger account balances might see an increase in deposit interest rates but new charges could be imposed on small balance accounts and on the writing of cheques.

The process of improving allocation of resources, reducing cross-subsidisation and introducing more transparent pricing is one of the objectives of deregulation and should not be resisted. However, it needs to be understood that there will be both winners and losers among bank customers.

There will also be winners and losers among the banks in terms of their ability to compete in a deregulated environment. It will be important that each bank should conduct a full self-assessment of the likely impact in terms of its competitive position, cost of funds and liquidity management.

Therefore, on balance the HKMA accepts that there is a need to proceed with the deregulation of the remaining IRRs. Nevertheless, it is important that the community understands the costs and benefits of doing so.

Phasing of deregulation

From the prudential point of view, the HKMA accepts that deregulation should be phased in over a period of time rather than adopting a "big bang" approach which would have a bigger impact on profitability and give it little opportunity to observe the impact of deregulation on banking stability. It also considers it vital to provide sufficient advance notice to banks for them to assess and determine the changes needed to their business strategies and systems.

In subsequent discussions with the banks, it seems that the banks (large and small) generally accept that the deregulation process could be shortened by dividing it into two instead of three stages as recommended by the consultants. This would enable them to move ahead on the new basis as quickly as possible. One way of shortening the process is to deregulate savings and current accounts together. This has the advantage of enabling a more co-ordinated strategy to be adopted for the modification of internal systems and product sets. It will also avoid the need to maintain temporary barriers (such as an interest rate cap on current accounts) to prevent migration from savings to current accounts. The disadvantage of this approach is that the main cost impact of deregulation would be felt in one step. However, this can be mitigated by giving the banks sufficient advance notice of the change so that they can make the necessary preparations.

In light of these considerations, and taking account of the views of other interested parties that the deregulation process should be completed as quickly as possible, the HKMA considers it appropriate for deregulation of the remaining IRRs to take place over two phases, as follows:

Phase 1	Removal of interest rate ceilings on time deposits of less than seven days and removal of prohibitions on benefits for deposits
Phase 2	Removal of all current and savings account interest rate rules

Timing of deregulation

The current economic environment and uncertainties about the profitability of the banking sector rule out any deregulation in 1999. Further, as part of the HKMA's recommendations to AIs on contingency planning for the Year 2000 problem, banks have been advised to adopt a "change freeze" policy to minimise system changes during the period from the last quarter of 1999 to early 2000. As deregulation will require banks to make changes to their processing systems, it would be sensible to begin the deregulation process only after this period.

On this basis, providing that prevailing financial and economic conditions are not unfavourable, deregulation of the 24-hour and up to six days time deposits (Phase 1) would take place on 1 July 2000. At the same time, the current prohibitions on banks providing benefits for deposits (such as gifts) would be abolished.

The second phase of deregulation of the IRRs on current accounts and savings accounts would take place 12 months after Phase 1. This would allow the HKMA to monitor the impact of the initial change on bank and customer behaviour. As noted earlier, it would also postpone the more radical change until a period when banks would be likely to be past the recovery phase. Accordingly, the HKMA expects the whole process to be completed by the middle of 2001.

Monitoring indicators for IRR deregulation

The remaining IRRs will be deregulated on the proviso that economic and financial conditions at the time are not unfavourable for deregulation to take place. For this purpose, a set of monitoring indicators has been developed to help the HKMA in identifying conditions under which a delay of deregulation process should be considered. These indicators, together with their specific criteria, are set out as follows:

- Two consecutive quarters of real GDP growth;
- Differential between HIBOR and US$ LIBOR has stabilised and is close to the pre-crisis levels;
- Capital adequacy ratio of the banking sector remains at traditionally high levels;
- Signs of improvement in the classified loans ratio for the sector;
- Absence of significant narrowing of net interest margins of the banking sector similar to that experienced during the period of the Asian crisis; and
- Absence of severe strains on the profitability of a significant proportion of the local banking sector.

In addition to the above quantitative factors, the HKMA will also monitor for the absence of foreseeable significant international or regional economic upheavals which might create unstable conditions.

It should be noted that these monitoring indicators are not designed to signal "favourable" conditions for deregulation to take place. Rather, they should serve as "warning" signals reflecting weakness in the banking system as a whole which may call for a slow down of the deregulation process. For the second phase of deregulation, it would be particularly important that the monitoring indicators should be met as fully as possible. The decision will ultimately depend on the prevailing conditions ahead of the target dates set for deregulation. This decision will be taken as the result of a formal review process, including submission of a detailed report to the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee and the Exchange Fund Advisory Committee.

Relaxing the One Building Condition

The one building condition, introduced in 1978, limits foreign banks to carry on their business in one building only. The intended objective was to prevent over-banking in Hong Kong rather than to discriminate against foreign banks.

Most of the respondents to the consultation exercise agree that this policy has outlived its usefulness and is inconsistent with other initiatives aimed at promoting competition. Technological developments such as phone and internet banking have reduced and will continue to reduce the relevance of this policy. This was highlighted by the survey conducted during the course of the Study, which indicated that only a small number of foreign banks would increase their branch network if the policy was removed.

The HKMA considers that the primary motive for relaxing this policy would be to allow banks more flexibility to locate their business operations in a cost effective manner. As such, it is more of a practical and cost issue. Nevertheless, some smaller local banks have raised concerns on the removal of this twenty-year old policy from a competitive standpoint.

To address the concerns of the smaller banks and to allow time to assess more carefully the impact of removing this policy on competition in the market, it appears appropriate, as an initial step, to partially relax the one building condition to allow foreign banks to operate a limited number of branches. Further relaxation could take place after a period of monitoring to determine whether the concerns over excessive competition are likely to materialise. An additional benefit of relaxing this restriction is that it will help to address criticisms raised by Hong Kong's trading partners during the World Trade Organisation negotiations on trade in financial services that Hong Kong is discriminating against foreign banks. This will improve Hong Kong's reputation as a free and open financial centre.

The current policy also restricts foreign banks to one back and one regional office in separate buildings. The HKMA intends to remove this restriction altogether and allow banks to open any number of back or regional offices.

Timing for implementation

As the initial relaxation is unlikely to pose much risk to the sector, it will come into effect in the second half of 1999. Further relaxation will be considered in the first quarter of 2001 upon a review at that time.

Allowing Access to the Real Time Gross Settlement System by Non-bank Authorised Institutions

The consultants noted that one of the principal objectives of establishing the RTGS system is to eliminate interbank settlement risk, and that there is no particular reason for the access criteria to be set based solely on an institution's licensing status, which is currently the case in Hong Kong. Accordingly, it was recommended that a more appropriate means of defining access be considered.

The HKMA notes that the current three-tier authorisation system is based on the extent of deposit-taking activities that the various types of institutions can undertake and on their ability to operate checking accounts. This would not appear to preclude participation by AIs other than licensed banks in the RTGS system for the purpose of making interbank transactions. The fully collateralised nature of the RTGS system means that the risk to the payment system will not be increased by such a move. Therefore, it appears appropriate that criteria for access to the RTGS system should be based on business needs, rather than purely on an institution's licensing status.

In this regard, the HKMA will request Hong Kong Interbank Clearing Limited to consider the logistics for other types of AIs to join the RTGS system and to devise an appropriate charging policy. Applicants will be required to demonstrate a clear business need to join the system and to obtain the approval of the HKMA prior to doing so. So far, only RLBs have demonstrated a need to access the RTGS system due to their activities in debt securities underwriting and foreign exchange trading. Therefore, the broadening of access to the RTGS system will be confined to RLBs. Given the current restrictions placed on RLBs on the provision of checking and savings accounts under the Banking Ordinance, their participation in the RTGS system will be for the purpose of settling CHATS payments. The HKMA will examine whether RLBs, if approved to join the RTGS system, can have greater access to other clearing arrangements, such as the CCASS.

Timing for implementation

Given the principle that the access criteria should be set based on business needs rather than on the licensing status of an institution, the HKMA considers that this recommendation can be implemented independently from the review of the three-tier system. Provided that agreement can be reached on the appropriate contractual arrangements, there seems no reason why access could not be allowed in the second half of 1999.

Simplifying the Three-tier System

The rationale behind the recommendation to simplify the three-tier system is that the current system appears to be overly complicated for the current market environment. A large number of the existing RLBs and deposit-taking companies (DTCs) are owned by banks in Hong Kong. There seems to be room for consolidation of the current three-tier system. The present system was designed to meet the requirements of maintaining the effectiveness of the IRRs and the market conditions in the early 1980s. Given partial deregulation of these rules since 1994 and the intention to fully deregulate the remaining rules, it appears that a more simplified licensing system would be appropriate for the development of the sector. A simpler system is also consistent with trends in other international financial centres.

The HKMA favours a two-tier licensing system as such a structure would achieve the dual objectives of depositor protection and appropriate level of participation in the market by entrants that do not qualify as full licensed banks.

Despite the general support for a change to a simplified system, there are a number of legal, practical and logistical issues that must be addressed before any change can be made. These include whether the new second tier of institutions should be subject to size and/or maturity restrictions on their deposit taking ability and whether such institutions should be allowed to offer checking accounts or other types of demand deposits.

The HKMA's preliminary view on the latter issue is that too much of an erosion of the existing boundaries of permitted activities between licensed banks and RLBs would remove much of the rationale of having a two-tier system. Therefore, it is inappropriate to allow the second tier to offer checking or demand deposits.

The HKMA also has no intention to reduce the present flexibility of RLBs to take shorter-term deposits by introducing new maturity restrictions. Further consideration will, however, be given to the question of where the minimum size of deposit should be set (i.e., whether at or below HK$500,000). One possible option would be to relax the minimum deposit amount of RLBs to HK$100,000 which would allow for the easy upgrade by DTCs. This limit tallies with the present priority payment scheme under the Companies Ordinance designed for the protection of smaller depositors. However, it would be appropriate to review this limit in the light of the current distribution of account balances, to determine whether it still provides a suitable demarcation line between small and large deposits. It will also be necessary to decide on the extent to which members of the new second tier would be able to use banking names or descriptions.

Timing for implementation

Despite the general desirability of change, it does not appear that this is an immediately pressing issue. Implementation will require legislative amendments to the Banking Ordinance. There are also plans to review the issue of depositor protection (see below), which could have an impact on setting the appropriate minimum deposit restriction for the new second tier of institutions. The change to a two-tier system will therefore require further detailed review and consultation. This will be undertaken in the second half of 2000 and implementation of the new arrangements would not take place until the second half of 2001, at the earliest. Any change to the minimum paid-up capital requirements for locally incorporated AIs would take place at the same time.

Relaxation of Market Entry Criteria for Foreign Banks

Under the present licensing policy, a locally incorporated applicant for a full banking licence must have been an AI in Hong Kong for at least 10 continuous years. In addition, it must in the opinion of the HKMA be "closely associated and identified with Hong Kong". Such restrictive criteria are intended to prevent foreign banks from entering the retail banking market through the local incorporation route. The consultants recommended that the time period in Hong Kong requirement should be relaxed from ten years to three and the criteria regarding association with Hong Kong should be removed.

The balance of comments received from the public consultation is in favour of change and the HKMA supports this view. However, it considers that implementation of this recommendation does not appear to be an urgent issue at this stage. This is particularly so as other market liberalisation measures will be undertaken (e.g., relaxation of the one building condition and deregulation of the IRRs). Local incorporation is likely to be less attractive to foreign entrants than the ability to branch into Hong Kong if the one building condition is relaxed. It appears more appropriate to assess the impact of the latter change before deciding on the extent of, and timing for, relaxing these other entry criteria. Therefore, this initiative should be subject to a later review, and any change in the entry criteria should take place towards the end of the reform period.

Measures to improve safety and soundness of the banking system

Enhancing Depositor Protection

The consultants identified depositor protection as an important issue as the banking sector becomes more competitive and the level of risk in the industry increases. International developments such as the recommendation from the G22 Working Party on Strengthening Financial Systems have also encouraged a trend towards adopting more explicit forms of depositor protection.

The larger banks are opposed to any proposals for a compulsory deposit insurance scheme. They argue that such a scheme could lead to systemic under-pricing of risk and capital misallocation and would not be able to prevent bank runs. Another major concern is the moral hazard problem. This problem will be particularly noticeable in an environment where interest rates are fully deregulated. On the other hand, other respondents are more amenable to the idea of a deposit insurance scheme as an enhancement to banking sector stability.

The consultants identified two options for enhancing the level of depositor protection in Hong Kong. These comprise the establishment of a deposit insurance scheme or enhancing the existing priority claims scheme under the Companies Ordinance by introducing some form of an immediate pay-out mechanism. Each of these has their respective costs and benefits and other options are also possible, including voluntary arrangements. The issue of deposit insurance was last addressed in Hong Kong in 1992. The conclusion at that stage was that such a scheme was not appropriate in view of the cost and moral hazard considerations. These are likely to remain powerful obstacles to the introduction of any scheme in Hong Kong. However, events have moved on since the 1992 study and the Asian crisis has prompted a number of countries in the region to declare their intention to move to more explicit (and limited) forms of depositor protection. Therefore, the HKMA considers it timely to conduct another full study on the feasibility and desirability of deposit insurance, or other forms of depositor protection in Hong Kong.

Timing for the study

Given the need to give priority to the Year 2000 problem, the HKMA believes it would only be practical to commence a detailed study in the first half of 2000. Afterwards, the findings and recommendations will be released for public consultation.

Clarifying the HKMA's Role as Lender of Last Resort

Although the principles under which the HKMA's role as lender of last resort will be invoked have previously been articulated in a speech given by the Chief Executive of the HKMA in 1994, the findings of the consultants indicated that there was a high level of uncertainty amongst market participants about the nature and extent of this role. The consultants therefore recommended the HKMA to clarify its role as the lender of last resort to the banking system.

The HKMA has accepted that it should clarify its role as the lender of last resort, which is an important element of the safety net for the banking system in Hong Kong. Accordingly, a policy statement was issued in late June, setting out more details concerning this role. The following issues are addressed in the policy statement:

- the resources available for the HKMA to take on this role;
- compatibility of the lender of last resort function with the currency board system;
- the preconditions for lender of last resort support;
- the instruments used for providing lender of last resort support; and
- the treatment of situations falling outside the framework within which lender of last resort support will normally be provided.

The policy statement aims to strike a balance between transparency on the one hand and flexibility on the other. It sets out a framework within which availability of support is more predictable and makes it clear that the Monetary Authority has the delegated power to provide support within the scope of the framework. If it is considered necessary to provide support outside the framework of the lender of last resort, this will be subject to the approval of the Financial Secretary, and the Monetary Authority would be obliged to consider the appointment of a Manager under Section 52 of the Banking Ordinance. This framework thus establishes checks and balances and is consistent with the U.S. concept of "prompt corrective action".

Improvements to the Disclosure Framework

The consultants' recommendation is consistent with the HKMA's continuous efforts to improve transparency of the sector. In fact, the recommendation to require disclosure by certain foreign bank branches was already being implemented during the course of the Study and the requirement was introduced at the end of 1998. The HKMA considers the disclosure framework to be one of the most important components for maintaining effective market discipline and removing market uncertainty. Since 1994, a substantial amount of effort has been made in developing the disclosure framework which now covers all AIs operating in Hong Kong. Incremental improvements will continue to be made to the framework in line with international developments and the needs of the local market on an ongoing basis.

Transition to a More Risk-based Supervisory Regime

Following the completion of the Study, the HKMA has already taken steps to develop a more formal risk-based supervisory approach in line with that recommended by the consultants. Adopting a more risk-based framework should allow the HKMA to continue to deliver consistent, high quality bank supervision as the sector develops and risk profiles of institutions change in reaction to competitive forces. Therefore, the improvements being made to the supervisory regime will complement the regulatory changes to promote competition as well as the safety and soundness of the sector.

Other Initiatives

There are other issues which are outside the scope of the Study but which are relevant to the general theme of enhancing the safety and soundness of banks in Hong Kong. Accordingly, the HKMA has incorporated these into the overall package of reform measures.

Establishing a Credit Register for Commercial Enterprises

The spate of corporate failures in Hong Kong as a consequence of the downturn in the economy has highlighted the need for banks to have better information about their customers and, in particular, about their levels of indebtedness. Too much debt borrowed from too many banks has been one of the main reasons for corporate failures during the recession. The fact that companies were able to accumulate such large amounts of debt was in part due to a lack of information available to banks at the time such loans were granted. Statutory accounts are only produced once a year and are not designed specifically for banks' credit assessment purposes. This lack of timely information relating to the extent of indebtedness of borrowers has increased the risk for banks and, given the uncertainty, could also raise the price of credit for corporates.

A credit register compiles timely information on relatively large borrowings by corporates or other non-bank enterprises from the banking system. This information is fed back into the banking system and this helps to prevent individual borrowers from taking on excessive levels of debt.

Given the developments that have occurred in Hong Kong, there appears to be sufficient justification for a study to explore the feasibility of establishing some form of a credit register for the Hong Kong banking system. There are a number of legal and operational issues involved in the development of such a system. In addition, the suitability of various credit register models for the local environment has yet to be considered. These issues must be addressed before any steps are taken to establish an appropriate system for Hong Kong.

Timing for the study

The HKMA will undertake a more detailed study in early 2000 with a view to determining the feasibility of a credit register for Hong Kong. Implementing this initiative will require close consultation with the banking industry and other interested parties.

Enhancing the Role of the Board of Directors

The increasingly competitive environment which the measures described in this paper would help to promote will increase the need for high standards of corporate governance within the banking system and improved systems of risk management. The primary responsibility for achieving these objectives rests with the board of directors.

Corporate governance of banks in Hong Kong compares well with the rest of the region. However, during the difficult operating environment of the last 18 months, the HKMA has come across a number of cases where the boards of directors of banks have not operated as effectively as they might.

The HKMA issued a "Best Practices Guide" in 1991 describing how boards of directors are expected to discharge their responsibilities. The HKMA intends to review this document in consultation with the industry and, where appropriate, to issue more specific guidelines on governance issues. These would include the number of independent directors and the composition and role of an audit committee. The HKMA will also increase the focus on banks' high-level controls as part of its move towards a more risk-based approach and as noted above, continue the efforts to improve the transparency of the banking sector through increased financial disclosure.

Timing of review

The HKMA will review the existing guidelines in the near future with the intention of issuing new guidelines around the end of the year.

Overall Timetable

1999	2000	2001
• Improve the disclosure framework • Clarify HKMA's role as lender of last resort • Relax one branch policy (to 3 branches) • Allow RLBs access to RTGS system • Enhance the role of the board of directors • Improve risk-based supervisory regime	• Phase 1 deregulation of IRRs • Study to enhance depositor protection • Study on establishment of credit register • Review options for two-tier licensing system	• Phase 2 deregulation of IRRs • Establish credit register • Implement enhanced depositor protection • Convert to two-tier licensing system • Raise minimum paid-up capital requirements • Review further relaxation of branch restrictions • Review to relax market entry criteria

The HKMA considers this package to be, in essence, the strategic plan mapping out its policy agenda for the banking sector over the next three years. These policy initiatives are intended to improve the sector's ability to adapt to the new environment and incorporate the positive benefits of change while limiting the risks. The measures balance competitive issues with safety and soundness considerations and represents a coherent framework within which both banks and the HKMA can work together to develop Hong Kong's banking system.

- Prepared by the Banking Development Division