David Carse: The changing landscape of banking in Hong Kong

Speech by Mr David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, to the Hong Kong Investment Funds Association, Furama Hotel, Hong Kong, 15 August 2001.

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Ladies and Gentlemen,

Thank you for inviting me to speak to you at the Association's luncheon. My topic today is the changing landscape of banking in Hong Kong. I shall illustrate this by reference to two of the key recent events that are changing that landscape and are going to go on doing so in the years ahead. I am referring to the deregulation of interest rates, the final phase of which took place on 3 July of this year, and the introduction of the Mandatory Provident Fund scheme. I will try to describe the implications of these for the banking industry and for the regulators. I will also try to place them in the context of the broader trends and developments that are taking place in the banking industry.

Current industry trends

You are probably already familiar with some of these trends and developments. The most obvious one is the increasing intensity of competition. This is a global phenomenon, whose full effects have only recently hit Hong Kong. It has shown here up in the sharp decline in lending margins, particularly on residential mortgages. It is a sobering thought that the interest rate on a 30-year mortgage in Hong Kong is now down to as low as 4.25%, more than 1 percentage point below the yield on a AAA-rated, US Treasury bond. It is no surprise that some banks are losing enthusiasm for the downward spiral in mortgage rates and are standing back. Among other things, this is showing up in an increased appetite for investment in bonds.

The fall in lending margins is a classic case of too much money chasing too little demand. The impact is, however, being softened to some extent by the favourable impact of the excess liquidity on deposit margins. Partly as a result, underlying profits seem to have held up reasonably well in the first half of the year despite the difficult operating conditions.

We are, however, only part of the way through the reporting season and it will take a bit longer to come up with definitive conclusions about the interim results. As always, some banks have done better than others, and it is worth looking at two of the factors that help to deliver a superior performance.

The first of these is skill in asset-liability management. This is necessary to enable banks to widen deposit margins as lending margins shrink. It means, among other things, trying to reduce reliance on high cost deposits, trying to persuade depositors to consolidate deposits with your bank and looking for alternative funding sources, including long-term debt. Another objective is to reduce the basis risk that arises from having liabilities in the form of time deposits that are linked with HIBOR and loans that are linked to prime. The deregulated environment that banks now face will add new complications to the process of managing interest rate and liquidity risks. I shall return to the subject of deregulation in a moment.

A second prerequisite for success is the need for banks to develop new sources of income. It looks as if the days of easy profits from mortgage lending have gone, and the banks now need to work harder to generate income growth. The introduction of new fees and charges on deposit accounts is one manifestation of this process. Another is the increasing shift of some banks into higher margin, but also higher risk, products such as credit cards and other types of personal finance.

Banks are also trying to become financial service providers rather than just banks. The aim is not just to broaden income sources, but also to reduce the volatility of income through more reliance on recurring fees and commissions. One way of achieving this is to move into the realm of wealth management, by which I mean securities, unit trusts, insurance, pensions and private banking. The interim results of some of the local banks showed a growing contribution from this area, including particularly sales of guaranteed funds. As a result, I understand that May of this year was one of the best ever months for fund sales in Hong Kong.

The impact of interest rate deregulation

I have tried to show so far how interest rate deregulation fits into the broader industry trends. I will now say a bit more about what the impact of the latest, and final, round of deregulation has been. This involved removing the interest rate cap on Hong Kong dollar savings accounts and allowing interest to be paid on current accounts. It was the end of a process that began in 1994 when we began to deregulate time deposits. Some would say that the process has been unduly protracted. But I think that it was reasonable to be cautious, since experience elsewhere shows that liberalisation is all too often accompanied by instability.

As it has turned out, the final stage of deregulation probably could not have happened at a better time – at least from the point of view of protecting the regulator's peace of mind. The ample liquidity in the banking system has reduced the risk of an aggressive price war for deposits, which was the HKMA's principal concern. So we have ended up with a Little Bang rather than a Big Bang. But I should emphasise that less than two months have passed since the interest rate controls were finally lifted. Any conclusions about the impact of deregulation can only be tentative at this stage.

Some of what has happened was predicted at the time the decision to deregulate was taken. Deregulation has been the catalyst – the more cynical would say the excuse – for banks to introduce fees and charges on deposit accounts. Most banks have also introduced tiered savings accounts, with higher interest rates being paid on larger balances. Sometimes the rate depends on the range of the bank's products and services that the customer uses. The converse is that some banks are now paying less than the standard rate on small deposits. A further innovation is that in a few cases there are savings products that are linked to HIBOR.

Banks have not rushed to pay interest on conventional current accounts, though some have offered combined savings and deposit accounts that pay interest. At least one bank offers an auto-sweeping service from savings to current accounts. Such products are effectively offering interest on current accounts. Generally speaking, the amounts deposited in the innovative current and savings accounts are still quite small.

Perhaps the biggest surprise so far has been that some of the banks have been able to lower their benchmark savings account rate to 1.75%, which is probably 25bp below what it would have been without deregulation. A few years ago, when the debate about deregulation was taking place, the conventional wisdom was that the savings rate was artificially depressed and would rise closer to time deposit rates after the cap was lifted. So far this has not been the case. Indeed, it appears that the interest rate rules effectively imposed a floor as well as a cap.

In the current liquid conditions, therefore, the large banks have been able to cut their standard savings rate. They are therefore seen by some analysts as the winners from deregulation since they now have another lever to adjust their net interest margin. The unanswered question is whether they will be able to get away without a significant erosion of deposits in savings and current accounts. A certain amount of switching of accounts has gone on. But there is not enough evidence at this stage to conclude whether deregulation has resulted in any significant redistribution of deposits among banks. So we cannot tell how interest elastic the demand for savings accounts may prove to be, particularly in today's somewhat artificial conditions of high liquidity. However, what can be said is that deregulation does offer the smaller banks an enhanced ability to compete for savings accounts and for those customers which the large banks may be less eager to retain. While the smaller banks may have to pay a higher rate for their savings deposits, they will still benefit if they can substitute such funds for even higher cost, and less stable, time deposits.

Consumers will also benefit from deregulation through greater choice of savings products and, for those with larger balances at least, from higher interest rates. However, we have to face the fact that not all depositors will be better off in the deregulated world. The harsh laws of economics mean that those with smaller balances may suffer disproportionately from new fees and charges and receive less compensation in the form of higher interest. Competition will help to address this concern to some extent since banks have adopted different charging and interest rate policies. Customers should therefore be prepared to shop around for the best offer. Diversity of approach among banks should also help to mitigate the risk that an increasing proportion of the population will be excluded from the banking system by prohibitive costs. But this is something that both the Government and the banks will need to keep an eye on as the effects of deregulation work their way through.

The Mandatory Provident Fund

The Mandatory Provident Fund is another innovation that is bringing new challenges and opportunities for the banks and their related companies. The opportunities come from the chance to earn a stream of annuity-type revenue stretching out into the distant future. The assets under management in MPF funds are already building up faster than expected and amounted to about HK$22 billion at the end of May. This includes assets transferred from ORSO schemes. The combination of regular contributions and long-term investment returns means that MPF assets may total several hundred billion dollars in ten years time. This will earn the MPF participants an annual all-in fee of around 1.75% of the assets, though this will have to be shared among the various service providers.

The challenges come from the cost and effort of putting in place the necessary systems and personnel to handle what is a complex business and which carries a high degree of reputation risk if something goes wrong. Success in the MPF business also requires an established customer base, good distribution networks and strong brand image.

All this means that the MPF is not a business where small players can hope to be successful on a stand-alone basis. Even for the large companies that have captured the lion's share of the business, the start-up costs and the ongoing expenses mean that it will probably take a few years for them to break even and still longer to achieve a reasonable return of capital. However, this should not blind us to the strategic importance of the MPF for the banking and financial services industry in Hong Kong. This is why it was vital for the smaller banks to pool their resources in the Bank Consortium Trust. This has enabled them to establish a credible vehicle and win a market share that is probably larger than the shareholders could have achieved if they had acted independently.

The strategic appeal of the MPF lies not simply in the long-term profit opportunities that it offers directly. It is also that it will help to build a relationship with both employers and their employees that can be used to generate cross-selling opportunities. This will be aided by the fact that the relationship established via the MPF is likely to be a sticky one, and companies are unlikely to shift to another scheme unless there are good reasons to do so. This does not mean, however, that MPF providers can afford to provide a bad service. If they do, they will destroy goodwill and make it more difficult to sell other products.

The cross-selling opportunities provided by the MPF are not theoretical. There are already signs that it is making an impact on sales of other funds to individuals. As your Association recently announced, the fund penetration rate in Hong Kong has risen from 7.8% to 10% in a year. This is a creditable performance in view of the weakness in the stock market. One of the reasons for the increasing willingness to invest in funds is undoubtedly the low return now offered by bank deposits. However, it also appears that the marketing of the MPF over the last year has helped by focussing employees' attention on the attractions of funds for long-term savings purposes and on the need to plan for retirement.

The role of the regulators

I have talked so far about the involvement of the banks in MPF business. In practice, however, the role played by banks themselves is mainly to act as intermediaries, selling and advising on MPF schemes. The various MPF services – trustee, administrator, custodian and investment manager – are generally provided by other companies which may be related to the bank. What this means is that the MPF brings together a number of different companies and, along with these companies, their various regulators: the Mandatory Provident Fund Schemes Authority, the Securities and Futures Commission, the Insurance Authority and the HKMA.

The involvement of four regulators creates an obvious need for clarity on their respective roles and coordination of these roles. The MPFA is clearly in the driving seat as the lead regulator. It has the responsibility to administer the MPF Ordinance and to ensure compliance with the legislation. It approves and regulates the trustees who have the central role in ensuring that schemes are properly managed.

The MPFA has also produced a code of conduct for MPF intermediaries. However, the day-to-day supervision of such intermediaries rests with the SFC, Insurance Authority and HKMA depending on which of us is the main regulator of the intermediary in question. The SFC also has a role to play in authorising MPF funds and in the licensing and supervision of investment managers and advisers.

This may seem complicated, but it seems to work. The arrangements have been cemented by a Memorandum of Understanding among the various parties and through the establishment of a MPF Intermediaries Regulation Coordinating Committee that comprises representatives of the four regulators and the Financial Services Bureau. At a higher level, all the various parties are represented on the Council of Financial Regulators, which is chaired by the Financial Secretary and whose remit is to address cross-sectoral regulatory issues.

Similar issues of division of responsibility and coordination arise in relation to the issue of supervision of banks' securities business. As you know, this is a somewhat controversial issue because of the exemption that banks and other authorised institutions enjoy from much of the current securities legislation. Although this exempt status is retained in the new Securities and Futures Bill currently going through Legco, the scope of the exemption will be drastically reduced and the banks will in fact be exempt in name only under the new legislation.

In future, in respect of their securities business, banks will be subject to most of the same legislation, rules and standards of conduct that will apply to the brokers. These rules and standards will be set by the SFC, in consultation where necessary with the HKMA. The HKMA will act as the front-line regulator of the banks' securities business on a day-to-day basis. That way the banks should normally have to deal with only one regulator, which should make their lives simpler. But, like the MPFA in respect of MPF business, the SFC will remain in the driving seat; and if problems arise in respect of a bank's securities business, the SFC will have the right to conduct its own investigation and to exercise disciplinary powers.

There is much more that I could say on the subject of banks' securities business, but that is perhaps best left to another speech. I will conclude, therefore, by noting again that economic pressures in the banking industry are driving banks to try to diversify their income sources. This is contributing to erosion of the boundaries between different types of financial business. A consequence of this is that new approaches to financial regulation are also required. What we have done in Hong Kong is to come up with a pragmatic approach that tries to strike a balance between institutional and functional supervision. We believe that, with the goodwill and cooperation of all concerned, this can, and will, be made to work.