Mr. Carse reviews the progress being made towards global regulation

Address by Mr. David T.B. Carse, a Deputy Chief Executive of the Hong Kong Monetary Aurthority, at the Bankers' Association for Foreign Trade 75th Anniversary Annual Meeting held in Florida on 6/5/97.

I am pleased to be here this morning to talk to you about the Hong Kong perspective on the trends in global regulation.

I have been asked particularly to talk about our experience of being a host supervisor - in other words, what it is like to be on the receiving end of consolidated supervision. This is quite appropriate because, although the Hong Kong Monetary Authority is the home supervisor for a number of local banks with overseas operations, the distinguishing characteristic of Hong Kong is that it is the host to almost 500 banks from over 40 different countries. This is in keeping with its role as one of the leading international financial centres in the world with the third largest representation of foreign banks and the fifth largest total of external assets.

Hong Kong after 1997

Of course, Hong Kong's other distinguishing characteristic is that it will experience a reversion of sovereignty to China in less than two months' time. This has naturally aroused much interest and speculation among the foreign banks based in Hong Kong about the legal and regulatory environment which will apply after the handover on 30 June, and I will therefore try to explain to you briefly the main features of the arrangements that will apply. These arrangements are laid down in the Basic Law which establishes the post-1997 constitution for Hong Kong. It is based on the "one country, two systems" concept under which Hong Kong shall enjoy a high degree of autonomy as a Special Administrative region of China. In the banking and monetary areas, this means that:

Hong Kong shall retain the status of an international financial centre. The Government of Hong Kong shall be responsible for monetary policy and practice in Hong Kong and for regulation of financial markets and institutions. There shall be free flow of capital within, into and out of Hong Kong. The HK dollar, as the local legal tender, shall continue to circulate and remain freely convertible. It must be backed by a 100% reserve fund. The Exchange Fund which holds the foreign currency reserves of Hong Kong shall be managed and controlled by the Government of Hong Kong, primarily for regulating the exchange value of the HK dollar.

The framework that will apply after 1997 is therefore quite clear. The question which then follows is whether the framework will be applied in practice. I think that there are a number of good reasons to believe that it will be. In the first place, we now have institutional arrangements in Hong Kong to put the financial sector provisions of the Basic Law into practice. In particular, the Hong Kong Monetary Authority, which I represent, has the legal powers, monetary instruments and financial resources - including US$ 63 billion of foreign currency reserves - to fulfill its role as the central bank of Hong Kong and to maintain the value of the HK dollar. During the four years of its existence, the HKMA has built up a good working relationship with the People's Bank of China which has made it clear in public that it will not take over the role of the Monetary Authority in Hong Kong after 1997. The separate role for Hong Kong after 1997 is underscored by its separate membership alongside China of international organizations such as the Bank for International Settlements and the Asian Development Bank, and its participation in the IMF's New Arrangements to Borrow.

Of course, what matters is not what I say but what the market actually thinks. Judged by this criterion, there is genuine confidence about the future. This is shown by the consistent stability of the HK dollar; the strength of the stock market, though it has its ups and downs in line with expectations about US interest rates; the growth in HK dollar deposits of about 20% over the last year; and the decline in the margin of our 10-year Exchange Fund Notes over US Treasuries to around 50bp compared with 90bp at the end of 1996. So far as foreign banks operating in Hong Kong are concerned, Hong Kong political risk largely seems to have disappeared as an issue. We have seen no exodus of banks from Hong Kong; rather, we have seen an increased appetite among the foreign banks to take on long-term HK dollar assets, including residential mortgage loans and syndicated credits. Although the margin on these have come down significantly over the last year, they are still attractive compared with the margins available to foreign banks in their home countries.

The importance of international regulatory standards

We do not anticipate any radical changes in Hong Kong's system of banking supervision after 1997, nor in its attitude to the entry of foreign banks. No doubt, however, these will evolve in line with trends in global regulation. This reflects the guiding principle of our supervision in Hong Kong which is to follow international standards. There are a number of practical reasons for wanting to do so. First, it is in keeping with Hong Kong's role as an international financial centre. Reputable foreign banks will only want to do business in a market where the rules of the game are familiar and credible. Their home supervisors will certainly feel the same way. There is thus absolutely no advantage for centres such as Hong Kong to compete on laxity or to market themselves as places where dubious transactions can be conducted and concealed. Second, when trying to enforce new supervisory guidelines and rules on our local banks, one of the first questions they will ask is what is being done elsewhere. It is thus very helpful to be able to point to the relevant international standard in order to confer legitimacy on what we are trying to achieve.

Of course, this presupposes that international standards are relevant to individual countries and territories. The Basle Committee on Banking Supervision has played a major role in setting standards which do have such relevance. In particular, the Basle capital adequacy ratio, which is still called the "Cooke ratio" in parts of Asia in deference to our chairman here today, has become the de facto capital standard in most supervisory systems around the world despite the fact that it was originally intended to apply only to internationally active banks. Despite this enormous achievement, however, it can be argued that the subsequent work of the Committee did become somewhat too narrowly focused on issues which are of principal interest to supervisors from G-10 countries. This is only natural since these are the people who comprise the Basle Committee but it perhaps left something of a vacuum in the setting and promulgation of standards with more global relevance.

In particular, much of the work of the Basle Committee has been dominated in recent years by the formulation of its recommendations to extend the capital adequacy regime to cover the market risk arising from trading in derivatives and other financial instruments. I am not denying that a capital regime to cover market risk is necessary, particularly for those countries like the United States whose banks are heavily involved in trading activities. We are intending to introduce the regime in Hong Kong by the end of this year, and a number of countries in the Asian region are intending to do the same. However, they are doing so largely to be seen to be adhering to international standards, rather than because their banks are running substantial trading risks. Even in Hong Kong, which has the fifth largest foreign exchange market in the world and the seventh largest derivatives market, the incorporation of market risk will have only a minor impact on most banks' capital adequacy ratios.

The concentration on market risk has perhaps led to other supervisory areas not receiving the attention which they deserve. In particular, credit risk still remains the main risk facing most banks, and it is therefore disappointing that there are still no internationally agreed guidelines in areas such as loan classification, bad debt provisioning and non-accrual of interest on non- performing loans. Most countries in Asia, including Hong Kong, do have their own rules in these areas but the lack of an agreed standard makes it difficult to undertake cross-country comparisons of asset quality. I hope, therefore, that this is an area which can be addressed by the Basle Committee in the near future.

I am encouraged by the fact that the Basle Committee has recently intensified its efforts to reach out beyond the G-10 countries and to take a more proactive leadership role in helping to strengthen banking supervision in all countries. In particular, the recently issued consultative paper on Core Principles for Effective Banking Supervision is an important milestone. The Core Principles are intended to establish minimum requirements which would apply in all supervisory systems. It is intended that supervisory authorities around the world should use them as an agenda against which to assess the adequacy of their own systems and to press for changes to address any deficiencies. The Core Principles will also increasingly become the standard by which outside commentators, including other supervisors, judge the supervisory framework of individual countries. This external discipline will help to provide an additional incentive to improve supervisory systems.

The Hong Kong Monetary Authority is proud to have been one of the supervisory authorities which participated in the drafting of the Core Principles. We were also members of the Working Party of both G-10 and non-G10 countries which recently prepared a report on measures to foster financial stability which was submitted to the meeting of G-7 Finance Ministers last month in Washington. This includes recommendations not only on the formulation of sound principles and practices, but also on how these can be effectively implemented, including the role of international financial institutions in this respect.

Regulatory cooperation in Asia

These initiatives are being supplemented in Asia by regional cooperation on both a bilateral and multilateral basis. There have been a number of factors driving this. The aftermath of the Mexican crisis in January 1995, which saw speculative attacks on a number of Asian currencies, encouraged the view that there was a need for countries in the region to strengthen their defences in this area. We have thus seen the arrangement of an interlocking series of bilateral repo agreements using US Treasuries between Asian central banks, including the Hong Kong Monetary Authority. These agreements are intended to provide additional liquidity for exchange rate stability purposes.

More generally, there has also perhaps been a feeling among the Asian countries that the existing arrangements for central bank cooperation were somewhat "euro-centric" and did not take adequate account of the growing importance of the Asian region where over 40% of the world's foreign currency reserves are now held. This feeling has to some extent been addressed by the more participative approach now being adopted by the Basle Committee and the BIS. But there is nonetheless a view that greater regional cooperation among Asian central banks is both necessary and desirable. This has been summed up in the concept of an "Asian BIS", though this is somewhat misleading as there are no immediate plans to move towards the institutional structure which the name would imply. Rather, the current emphasis is on promoting an informal grouping of central banks called EMEAP (“Executives’ Meeting of East Asia and Pacific Central Banks) which is exploring opportunities for cooperation in areas such as payment systems, reserves management and banking supervision. Among other things, this may provide the opportunity over time to develop a more distinctive and focused regional voice on international supervisory issues.

Consolidated supervision

I will now return to the topic which I raised at the beginning of my speech, which is how we view consolidated supervision from the receiving end. I suppose that it goes without saying that we are in favour of the concept of consolidated supervision. As an international financial centre, we are vulnerable to adverse developments in banks abroad and we rely heavily on the consolidated supervision of the supervisors of those banks. The ability to conduct consolidated supervision is a key factor in whether we regard the home supervision of a particular bank as adequate - which is one of the criteria for granting a banking licence in Hong Kong. Within the legal framework in Hong Kong we try to cooperate with overseas regulators to ensure that they can effectively undertake consolidated supervision. In particular, we allow home supervisors to carry out on-site examinations of their institutions in Hong Kong subject to obtaining our prior consent - which we have not hitherto withheld. In addition, the Hong Kong Monetary Authority itself has the power to pass on information to foreign regulators to assist them in the exercise of their functions. At present, however, this power to disclose does not extend to information about individual customers, though this is an area which we are intending to review in the light of the recommendations of the Basle Committee. In the meantime, we do not impose constraints on access to customer information in the course of on-site examinations in Hong Kong by overseas regulators.

What reservations I have about consolidated supervision therefore relate mainly to how the system operates in practice:

first, it may of course be difficult in practice to assess the adequacy of consolidated supervision by a home supervisor and how much reliance should be placed on it by the host supervisor. As mentioned above, the Core Principles for Effective Banking Supervision will provide a useful checklist in this respect, but there will still be the problem of whether the Principles are being effectively implemented. A more active monitoring role by the International Monetary Fund may help in this respect. But in some cases the best judgment that it may be possible to make is that the supervisory authority is actively working to establish the necessary capability - which is essentially the view that we have taken in relation to the People’s Bank of China in licensing banks from the Mainland;

second, it is important to realize that, in undertaking consolidated supervision, the primary responsibility of the home supervisor will be to safeguard the interests of the parent bank. While this should hopefully help to promote the safety and soundness of the banking group as a whole, including overseas banking subsidiaries, the interests of home and host supervisor may not necessarily coincide. Despite this, the various regulators should, of course, try to cooperate to the maximum extent possible; third, and related to the previous point, cooperation will only be possible if there is an adequate two-way flow of information. However, the main focus of consolidated supervision sometimes appears to be for the home supervisor to obtain information from the host supervisor. There is less emphasis on reciprocal flows. For example, in the recent paper prepared jointly by the Basle Committee and the Offshore Group of Banking Supervisors on Supervision of Cross-Border Banking, only four paragraphs out of forty-three are devoted to information flows from home supervisor to host supervisor. In our experience, home supervisors can be reluctant to share information with us, either at the time of authorization or, more particularly, if serious problems arise in the parent bank. In some cases, however, the situation is improving and the recent more proactive approach of the Japanese supervisory authorities deserves a commendable mention in this respect.

I stress again that I am not intending to cast doubt on the value of consolidated supervision, but rather to point out that the reality does not always match the rhetoric. The answer can only be for individual supervisory authorities to build up a relationship of trust which allows for a free flow of information in both directions, adequate safeguards on the confidentiality of information received and an avoidance of over-hasty and disruptive supervisory action based on that information. At the end of the day the effectiveness of global regulation depends in large measure on cooperation among regulators. As a major international financial centre, Hong Kong will continue, after 30 June 1997 as it has done before, to play its part in fostering such cooperation.