Mr. Carse speaks on banking supervision in Hong Kong and the lessons learned from the financial crisis in Asia Speech by the Deputy Chief Executive of the Hong Kong Monetary Authority, Mr. David Carse, at the Asian Investment Conference "Asia: Meeting the Challenge" held in Hong Kong on 27/3/98.

1. I am pleased to be here this morning to speak to you on the topic of the supervisory lessons which Hong Kong can learn from the region and specifically from the crisis which has engulfed Asia since July of last year. This is a drama that is still being played out and we have not yet reached the final act. But I do not think that it is too early to make some kind of judgment about what went wrong and the lessons that can be drawn for the future.

The Asian Crisis

2. I think that it is fair to say that the Asian crisis has surprised almost everyone by its speed and intensity and the ease with which it spread from country to country. Even those who were sceptical about the Asian miracle did not really expect anything like this. Of course, there were warning signs such as the current account deficits in a number of countries such as Thailand. But these could be regarded as the natural consequence of the heavy demand for investment in growing economies. The Asian economies were certainly not fault-free, but in general they not exhibit the classic signs of gross macroeconomic weakness that normally lead to a balance of payments crisis. Governments ran fairly prudent fiscal policies, savings were high and inflation rates reasonably low. Even if policy mistakes were made, the punishment does not really seem to fit the crime.

3. Why then have exchange rates fallen by as much as they have and why have economies in the region been so severely crippled? It is generally agreed that a large part of the answer lies in the weakness of financial and banking systems in the region, which have amplified the initial effects of external shocks and economic downturn. In essence, banking systems that were already in weak health before the crisis broke were not up to the task of intermediating large inflows of capital. They have been part of a vicious circle whereby loss of confidence in the currency leads to loss of confidence in the banking system that further undermines the currency. This is the "run on the country" syndrome. It therefore follows that strengthening of the banking system must be part of the cure of the Asian disease and the means of preventing a recurrence. Banking supervision has an important part to play in this strengthening - hence the topic of my speech today.

The weaknesses in Asian banking systems

4. Before I go on to discuss the supervisory lessons that can be learned, It is necessary to consider in more detail the precise nature of the weaknesses that were apparent in some, though not all, of the regional banking systems.

Over-expansion of bank lending

5. A number of economies experienced rapid growth in bank credit during the 1990s, often fuelled by inflows from abroad. Much of this lending was made without proper credit assessment and went into unproductive sectors such as property and the equity markets. This pushed up asset prices and encouraged further lending. When capital outflows reversed (because of the realization that exchange rates were over-valued) this led to a decline in asset prices which weakened

the position of both banks and borrowers. The resultant rise in bad debts undermined market confidence in the solvency of the banking system, making it difficult for banks to roll over their external borrowing and provoking further outflows. The weakness of the banks made them more reluctant to lend, which further weakened the financial position of borrowers. This is the pattern, which Paul Krugman has described as “financial excess and then financial collapse”[1].

Excessive reliance on short-term foreign currency borrowing

6. What was particularly dangerous was that a combination of pegged exchange rates, relatively high domestic interest rates and moves towards financial liberalization encouraged banks in a number of economies to borrow heavily in foreign currencies to fund the lending boom. Much of this borrowing was short-term, giving rise to a maturity as well as a foreign currency mismatch, either on the part of the banks or the companies to which they on lent. When the initial pressure on currencies emerged, domestic borrowers that had previously never had to think about hedging their foreign currency liabilities rushed to do so, turning a slide in the currency into an avalanche. Those who were too late were left with liabilities to the banks that were vastly inflated in terms of their domestic currency - and the banks were left with the resultant bad debts and a crippled ability to finance the routine needs of their customers.

Captive banks

7. Why were banks not more discriminating in their credit choices and decisions? Part of the explanation is that in a number of economies banks were ordered or persuaded by the government to lend heavily to particular industries and companies. In other words, they were “captive banks”. This allowed the companies concerned to become over-leveraged (and thus vulnerable to economic downturn) and directed resources into unprofitable investments. The banks concerned had little incentive to develop proper lending skills.

Concentration risks and connected lending

8. Moreover, banks in some economies were over-exposed to single borrowers, often those connected with the lending institution. Such lending is usually of poor quality, not having been made at arm’s length, and means that the shareholders have no real capital at stake in the bank (because it has effectively been lent back to them).

Failure to recognize bad debts

9. Having landed themselves with bad debts, banks failed to face up to the problem. In particular, systems for loan classification and provisioning have been inadequate. As a result, capital ratios have been overstated, and insolvent or near-insolvent banks have been allowed to continue in business and to build up further losses. Banks have been allowed to accrue income on non-performing loans, thus overstating revenue and capital.

Lack of transparency

1 Paul Krugman, “What happened to Asia?”, January 1998

10. All this has been made worse by a lack of transparency in regional banking systems. Failure to disclose the true scale of bad debt problems has weakened market discipline on bank management and reduced the need for them to face up to the problems. Public confidence in banking systems has been undermined because, with no credible information, depositors and investors assume the worse in even relatively sound banks and rush to take their money out.

Moral hazard

11. The final ingredient has been the perception that many banks in the region are effectively government-guaranteed. This has created a problem of moral hazard whereby bank management can afford to indulge in reckless lending behaviour because they believe that government will bail them out if they fail. Similarly, depositors have less incentive to check the creditworthiness of the banks with which they place funds.

Weakness in supervision

12. How did Asian banks get into this state of fragility? Inadequate regulation and supervision, coupled with an explicit or implicit government guarantee, have attracted much of the blame, leading Paul Krugman to describe Asian banks as “over-guaranteed and under-regulated”. Inadequate supervision cannot be the whole story since a number of the weaknesses arise from circumstances which are not the direct responsibility of banking supervisors. There were some flaws in macroeconomic policy, in particular the maintenance of unsustainable exchange rates. There was undoubtedly also political interference in banks, in terms of both policy lending and pressure on supervisors not to take action against well-connected owners of banks. Another fundamental problem was weakness in the infrastructure of business laws that made it difficult for banks to take and realize collateral and to put insolvent companies into liquidation. We must also bear in mind the fact that the ultimate responsibility for poor lending and risk management practices must rest with the management of the banks themselves. However, having said all this, there have undoubtedly been failures in supervisory policies and practices, as demonstrated by the reform measures that are now being put in place in a number of countries.

The Basle Core Principles

13. Reform is not an easy task. But at least supervisors in individual countries are now in a position to tap into an international network of technical cooperation and assistance to help them to bring their systems up to scratch. At the centre of this international effort is the Basle Committee on Banking Supervision which is taking on a leadership role in devising supervisory standards that can apply to all countries and not just the G-10 countries which sit on the Committee. In particular, the Committee has produced a set of Core Principles that are intended to provide a set of minimum requirements for effective banking supervision. Supervisory authorities around the world are being encouraged to endorse the Core Principles and to implement them as quickly as possible. The IMF will have a role to play in checking that countries are indeed taking serious steps in this direction.

14. The Core Principles are not earth shattering. They have not unveiled some new secret of how to supervise banks. All they do is to summarize what are generally agreed to be the fundamentals of a sound system of supervision. This includes the following main elements:

- Clear responsibilities and objectives for the supervisor set out in a suitable legal framework
- Operational independence for the supervisor and the necessary resources to do the job
- A proper licensing regime for banks
- Sound prudential regulations and requirements that address the main types of risk faced by banks
- The means to enforce supervisory requirements and gather information through on-site examination and off-site review
- The power to take action against problem banks, including closure
- The ability to conduct consolidated supervision and to cooperate and exchange information with other supervisors at home and abroad

15. These may seem like statements of the obvious. But the necessary measures were evidently not fully in place in a number of countries in the region. Reforms are now being implemented, in some cases with the help of the IMF and the World Bank. These include tighter limits on loan growth and on lending to sectors such as property; tightening of the loan classification framework and provisioning requirements; more disclosure of non-performing loans; strengthening of on-site examination to introduce a more risk-based approach; and enhanced legal powers for the supervisors to take prompt action to deal with problem banks. In a number of countries, problem banks and finance companies have been closed down or are being merged and efforts are being made to realize as much value as possible from their bad assets. From my discussions with my supervisory colleagues in the region I know that they are serious in their efforts and I wish them every success.

The lessons for Hong Kong

16. This sentiment recognizes that it is also in Hong Kong’s interest that financial stability returns to the region. As I have already indicated, one of the special features of the Asian disease is that it has been extremely contagious. And although the Hong Kong economy and financial system have remained in pretty good health, they have not been totally immune. This suggests that we too have lessons to learn from the crisis.

17. Hong Kong’s supervisory system does indeed compare well with international standards. A review which we conducted last year showed that we had addressed all the areas covered by the Basle Committee’s Core Principles and that we fully complied with all but a few of them. In the latter cases, we are in partial compliance. This does not however mean that we can be complacent for the following reasons:

- First, the Basle Core Principles are, as I have indicated, minimum standards and we should where possible be aiming for best practice
- Second, the environment being faced by banks is changing at an accelerating rate and we need to be sure that our supervisory system keeps pace with this
- Third, even our robust monetary system can be subject to external shocks and the banks need to take this into account in the way in which they manage their business.

18. The latter point needs some further elaboration. As you will be aware, Hong Kong's monetary policy is built around exchange rate stability in the form of the link between the Hong Kong dollar and the US dollar. This is backed up by the currency board system which requires the monetary base of the banking sector - the notes and coins in circulation and the clearing balances held with the HKMA - to be fully backed by foreign currency. When the Hong Kong dollar is under pressure as it was at the end of October 1997 and again in January of this year, the HKMA buys Hong Kong dollars from the banks in exchange for US dollars and the monetary base shrinks. This tightening of liquidity will in turn cause interest rates to rise, perhaps sharply so. This will choke off the inflows and restore stability to the exchange rate.

19. It is important to realize that this is an automatic process and that the HKMA has no room to maneuver to prevent the rise in interest rates from taking place. To do so would run counter to the basic principle of the currency board and would risk prolonging any attack on the Hong Kong dollar.

20. I think that there is now a better understanding of how the currency board system works. In addition, our determination to adhere to the system and to defend the linked exchange rate has been clearly demonstrated. This should help to deter future speculative attacks on the Hong Kong dollar. However, we have to acknowledge that the possibility of short term interest rates shocks does exist under the currency board mechanism and the banks therefore need to take this into account in the way in which they run their business and manage their balance sheets.

21. Bearing this in mind, I draw three main supervisory lessons from the regional crisis and its impact on Hong Kong:

- First, it is important for banks to maintain a strong balance sheet that can withstand the interest rate fluctuations to which I have referred and maintain the confidence of the public. Banks in Hong Kong score well in this respect but it is not something that can be taken for granted. I think that it is true to say that some banks did expand their loan books too rapidly during the mortgage boom in 1997. As a result, loan to deposit ratios came under some strain. The banks were also exposed to growing interest rate risk because a substantial proportion of their assets are linked to best lending rate while their liabilities are linked to HIBOR. This has been a reminder of the need to maintain sound fundamentals: high capital adequacy and liquidity ratios; prudent loan classification and provisioning; and sound risk management.

- A second and related lesson from the region is that banks need to beware of excessive lending to finance overheated asset markets. This increases the leverage of their customers, exposing the banks to increased credit risk if prices fall. This of course is what has happened in the property market in Hong Kong, although the banks have so far been protected by their prudent lending policies and by the fact that much of their property exposure is related to the residential market. Notwithstanding the good outcome so far, we believe that the Asian crisis has reinforced the need for restraint in the growth in property lending and in other forms of asset-based finance, such as share margin financing and taxi loans.

- The third lesson is that increased disclosure and transparency are necessary to reduce market uncertainty and limit the risk of contagion. The disclosure of bad news can be uncomfortable, but it does serve the useful function of putting pressure on management to run their business prudently and to deal quickly with any problems which may arise. Hong Kong has made considerable progress in recent years in terms of disclosure of information by banks. We intend to build on this during the course of 1998 by recommending new measures such as more disclosure about non-performing loans and more specific guidelines for income recognition by banks.

Review of the Hong Kong banking sector

22. We will be building these lessons into our supervisory approach during the course of 1998. More generally, as I have already mentioned, we also have to ensure that our approach keeps up with market developments and takes account of new types of risk that may emerge. For this reason, we have recently commissioned a firm of consultants to carry out a study of the banking sector in Hong Kong over the next five years.

23 The study has two objectives. The first is to examine the strategic outlook for the banking sector in Hong Kong during the five-year period. This will include an assessment of the strengths and weaknesses of the banking sector and the opportunities and threats with which it is faced, taking into account the impact of global and local trends and issues. Among the issues to be examined will be the costs and benefits of certain features of the current regulatory system (such as the remaining interest rate rules and the one branch policy) and the potential impact of changes to these features. I should add however there is no presumption that changes to the current regulatory system should, or will, be made. We are going into this with an open mind.

24. The second objective of the study is to consider the adequacy and effectiveness of the HKMA's current approach to banking supervision and to make recommendations for any changes that seem required in the light of the strategic outlook for the banking sector. This would include any changes that needed to be made to the organizational structure of our supervisory function within the HKMA and the supervisory policies, guidelines and techniques which we use. The study will also examine whether we have the necessary resources to do the job.

Conclusion

25. In conclusion, the Asian crisis has been a major "wake-up" call to supervisors in the region and has given fresh impetus to international efforts to raise supervisory standards. One point which bears repeating however that tightening of supervision is not the whole answer, particularly if the effect is simply to impose more rules on the banks. More external regulation may indeed have to be the short-term response in a number of countries, particularly those where blanket government guarantees have been given to depositors. However, the long-term solution must lie in devising a supervisory approach which gives the right incentives for management of banks to take responsibility for their own actions.