The banking industry: competition, consolidation and systemic stability: the Hong Kong experience

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1. Structure of the banking industry

This paper describes the Hong Kong experience in relation to competition, consolidation and systemic stability with the banking system. By way of background, it should be noted that the Hong Kong banking system includes 155 licensed banks that are authorised to conduct the full range of banking business. Of these, 31 are locally incorporated (though a significant number are foreign-owned) and the rest are branches of foreign banks. Some of these foreign banks have been present in Hong Kong for many years and have built up an extensive network of branches though which they carry on both retail and wholesale business in the domestic market. In effect, the business focus of such banks is much the same as that of their local competitors. Many foreign banks, however, operate through only one branch and are not active in the domestic market. In addition to the licensed banks, there are 50 restricted licence banks and 62 deposit-taking companies that are subject to certain restrictions on the type, maturity and minimum size of deposits that they are allowed to take. Such institutions tend to specialise in a variety of activities, including wholesale banking, securities business, trade finance and consumer finance.

The banking market in Hong Kong is quite highly concentrated. The top three banking groups (one locally incorporated and two incorporated overseas) account for over half of total customer deposits in Hong Kong and almost half of domestic loans. A typical medium-sized local bank in Hong Kong would account for less than 3% of total customer deposits and normally 1% or less.

There is no overall competition authority in Hong Kong. Instead, competitive issues are addressed on a sectoral basis. The Hong Kong Monetary Authority does involve itself in competitive issues relating to the banking industry. However, its primary responsibility is to act as banking regulator with a view to maintaining the stability of the banking system.

2. Mergers of banks

The structure of the banking industry has changed very little in the last ten years. There have been a number of changes of ownership of local banking operations driven by a variety of factors, including:

- death of the major shareholder;
- privatisation of a bank acquired by the government during the crisis of the mid-1980s (following this, there are now no government-owned banks in Hong Kong); and
- change of strategy by the foreign owner, leading to sale of the business in Hong Kong to another foreign owner.

Apart from these “one-off” cases, there have been no recent examples of mergers among local banks designed to achieve economies of scale or scope. Some of the reasons for this are as follows:

- family ownership of a number of banks discourages mergers, partly because of reluctance to give up the family heritage and partly due to less pressure to generate shareholder value;
- presence of significant minority shareholders and relatively small “free floats” of shares may also lead to less focus on return on capital and complicate merger plans;
- profitability has been satisfactory in absolute terms. Local banks recorded significant growth in pre-tax profits prior to the Asian crisis (average of 15% per annum from Hong Kong operations during the six years 1992-97);

- even during the Asian crisis, all but a few Hong Kong banks remained profitable. All continued to maintain high capital ratios (over 18% on average) and none required official support. Financial distress was therefore not a driving force for merger as it has been in other Asian economies; and
- the large banks in Hong Kong already have substantial market share and are generally not anxious to increase it further, though they may well wish to take advantage of particular opportunities to increase scale in certain products or areas (such as credit cards).

The combination of all these factors means therefore that Hong Kong banks have not been under significant economic pressure to merge, acquire or be acquired.

This situation may, however, be changing due to changes in the competitive environment. These are being driven partly by economic factors and partly modifications to the regulatory structure.

As regards the first of these, the Hong Kong economy has rebounded sharply from the recession induced by the Asian crisis with growth in real GDP of over 10% in 2000. This recovery has been mirrored in a revival in pre-tax profits derived from the local banks' Hong Kong offices, which rose by 54% in the first half of 2000. While some of this reflected an underlying improvement in profits before provisions, the bulk reflected a sharp drop in the bad debt charge. To some extent, this will be a non-recurring item.

Looking ahead, the profitability of the banks is subject to some uncertainty for two main reasons. The first is that domestic loan demand has been on a declining trend since the Asian crisis and, while this may now have bottomed out, there are no clear signs as yet of a sustained recovery in domestic lending. This reflects continued sluggishness in private sector investment, recourse by the corporate sector to other types of financing (eg the equity market) and the lack of revival in the residential property market that has reduced the demand for mortgage loans. Given that residential mortgage lending accounts for a large proportion of the loan portfolios of most of the local banks, this has had a dampening effect on overall loan growth.

Related to this is the fact that the banks are flush with liquidity, and are competing actively for the limited amount of new business that is available. This is putting increasing pressure on lending margins, particularly in the all-important residential mortgage market. Margins on mortgage loans have fallen from 1.25% above prime lending rate prior to the crisis to a typical 2.25% or more below prime. This price-cutting has spread to other types of lending, such as syndicated loans and personal loans.

So far, the impact on the banks' overall net interest margin has been mitigated by the fact that the ample liquidity has kept funding costs low. But the net interest margin is likely to come under pressure in the future as more loans are refinanced or rolled over at the lower lending margins, or if funding costs rise.

The implication is that the local banks (and other players in the domestic market) will have to take advantage of new business opportunities to maintain profit growth and broaden income sources. In particular, they need to reduce reliance on net interest income, which is relatively high by international standards.

The opportunities exist for banks to do this. The high level of per capita GDP in Hong Kong and the demographics of a maturing population point for example in the direction of greater emphasis on wealth management products such as pensions, insurance, asset management and mutual funds. These are relatively underdeveloped in Hong Kong and thus offer opportunities for growth.

Another avenue for the banks is to follow their customers into the capital markets. In other words, they will become increasingly involved in helping their customers to raise equity and debt finance, and in providing facilities to trade securities. China's accession to the WTO is also expected to generate new business for the banks in capital market activities as well as in traditional banking products such as trade finance.

The problem from the banks' point of view is that the skills required to develop and market these types of product and services, and to manage the risks, are more complex than those required for mortgage loans. They are also demanding in terms of resources and technology. Banks have to spend money to make money. This argues in favour of scale to spread the costs of the technology and to save on costs. This is why a number of the local banks have joined together in a strategic alliance to provide a common business platform for the new Mandatory Provident Fund. The alliance has since branched off into other areas of cooperation, including credit cards, e-commerce, life insurance and syndicated loans. This initiative enables the smaller local banks to compete on more equal terms with their larger rivals. But it is perhaps something that can be taken only so far. The strategic partners are still competing for essentially the same pool of customers, and that may impose limits on the extent of their cooperation.

The more fundamental solution may therefore be to join together under common ownership. This is something that the HKMA has been advocating for the smaller banks. We have taken the view, however, that it is not something that we can mandate, for healthy banks at least. It would be difficult for the authorities to form a better view than market participants of what was an appropriate ownership structure. Forced marriages between banks are unlikely to be successful. The HKMA has therefore taken the position that it will rely on market forces to achieve the desired consolidation of the industry.

There are, however, certain actions that the HKMA can take to try to achieve the desired result. One is to state its position on the need for industry consolidation in speeches and media comment with the aim of stimulating public debate on the issue. This can be supplemented by private advocacy of the desirability of merger in discussions with individual institutions.

More specifically, the HKMA has taken steps to remove possible barriers to competition and resistance to change by altering the regulatory structure. A programme of banking reform, covering a three-year period to end-2001, has been put in place. The key feature of this is the final phase of the removal of the remaining controls on interest rates. All time deposits in Hong Kong have now been deregulated, and the controls on current accounts and savings accounts are due to be removed in the middle of 2001. This is intended to encourage innovation and greater efficiency in the provision of deposit products. But the HKMA has also stated that one of the purposes is to encourage the banks to think more seriously about consolidation. There are indications that this is happening, as shown by the acquisition of one local bank by another towards the end of 2000.

3. Foreign banks

Another aspect of the reform package is to further liberalise Hong Kong’s already open regime for the admission of foreign banks. Foreign banks licensed in Hong Kong after 1978 were formerly restricted to one branch (pre-1978 banks have unrestricted branching rights). This rule has recently been relaxed to allow three branches to be opened. It is due to be reviewed again in 2001, and the decision may then be taken to dispense with the restriction altogether. The HKMA also intends to review whether the market entry criteria should be further relaxed to allow greater scope for foreign banks to set up banking subsidiaries in Hong Kong. This is effectively disallowed under the current rules, because Hong Kong has traditionally had a bias towards foreign entry in branch form. This rested on the view that it was better to rely on the strength of the bank as a whole.

Such measures have aroused concern among the local banks that they may be further squeezed by foreign competition. The HKMA is sympathetic to these concerns, and this is reflected in the phasing of the reform programme. However, we believe that a protectionist approach is unlikely to be successful in today’s globalised markets and would in any case be inappropriate for an international financial centre like Hong Kong. Thus, while we believe that it is desirable to retain a strong indigenous element at the core of the banking system, the best way of achieving this is for the local banks to improve their competitiveness - which, as noted above, means that they need to think seriously about merger. While this would be the optimum solution from the HKMA’s point of view, we would not try to discourage takeover of local banks by foreign banks if the parties concerned reached a commercial decision to that effect.

Large foreign participation in the local banking sector naturally gives rise to the concern that foreign banks will be less committed to the domestic economy and more likely to cut back if conditions become adverse or head office strategy changes. There was some evidence of this in Hong Kong during the Asian Crisis, when the Japanese banks in particular reduced both their physical presence and their lending in Hong Kong. However, to a large extent, this was a special case, reflecting the particular circumstances of the Japanese banking industry. A number of other foreign banks with a major presence in Hong Kong have taken the opportunity to build up their operations, both by organic growth and acquisition. Our experience is that such banks behave in much the same way as local banks. This reflects the fact that banks which have attained a sizeable market share tend to be more committed to the market, because they take a long-term view and do not overreact to a crisis.

The HKMA considers that the experience of Hong Kong as regards foreign banks has been generally positive. Foreign banks have brought with them the latest skills and techniques, and this has both enabled the transfer of these skills to the local banks and forced them to try to emulate the foreign banks in order to remain competitive. The fact that a number of large foreign banks are at the heart of the banking system also provided stability during the Asian crisis. The HKMA believes that the relative openness of the Hong Kong banking system helps to explain why it survived the crisis in better shape than most of the other systems in the region.

4. Concluding remarks

The HKMA is conscious of the fact that increased competition following liberalisation can lead to increased risk. We are trying to address this in a number of ways. First, like many other regulators, we are trying to improve our supervisory policies and techniques by adopting a more risk-based approach. The aim is to anticipate problems rather than react to them. Second, we are trying to address the issue of the safety net. We have already released a formal statement that clarifies and sets out the HKMA's role as lender of last resort. We are also in the process of consulting the banking industry and the wider community on proposals to introduce a deposit insurance scheme in Hong Kong. If we were to go ahead with this, it is likely that foreign banks would be included within its scope given the important role of a significant number of such banks in the retail deposit system.