Banking problems: Hong Kong's experience in the 1980s

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Political and marco-economic background

The last major banking crisis faced by Hong Kong occurred in the period 1983–86. This had its roots in an earlier period of rapid credit expansion, made possible in an environment relatively free of institutional supervision. An unsustainable asset price increase reversed after a sharp deterioration in economic fundamentals. Overlending to the property market also set the stage for bank failures. These problems were compounded by a political shock.

The strong boom internationally in the second half of the 1970s produced an inflow of funds into Hong Kong. Strong economic growth, together with very low or even negative real interest rates, produced a strong demand for credit. Money flowed into the stock and property markets from 1978, and the credit expansion had also pushed the inflation rate to the double digit range between 1979 to 1982. The easy credit policy of the banking sector, helped by heavy competition among banks, was demonstrated by its rapidly increasing exposure to the property sector. Loans to construction and property development climbed steadily in banks' asset portfolio, reaching some one-fifth of total domestic loans by end-1981. By then, speculation had pushed residential property prices to a level too high to be affordable by the general public.

In an effort to cool US inflation, the Federal Reserve began to tighten monetary policy sharply in 1981. This led to a recession in the US in late 1981 and by 1982, worldwide economic recession began to bite. Although the HK dollar was on a free float, the United States remained Hong Kong's major trading partner, and Hong Kong interest rates were heavily influenced by rising United States dollar rates. Real interest rates reached a peak of 4.4% for the best lending rate in 1982 Q2 and slowed GDP growth to just 2.7% in that year. However, bank credit did not show any sign of slowing down. The key factor was the continuing growth of loans to the property sector despite the downward adjustment of property prices. The longer term financial commitment of property projects had prevented a quick adjustment of loans in response to the change in market situation. Many speculators, particularly those in commercial property, were highly leveraged. Banks had also relaxed their credit standards during the sharp rise in property prices.

Both property and stock prices fell sharply during this period. The stock market index and property prices corrected by 38% and 31% respectively from end-1981 to end-1983, and many property companies encountered problems. The credit squeeze finally came in 1983. Loans to construction and property development dropped by 4.9% in the year.

Political uncertainties added to the crisis atmosphere, following China's official statement in August 1983 that it would take back Hong Kong on or before 1 July 1997, regardless of the outcome of its negotiations with the UK. The climax was reached on the weekend of 23–24 September 1983, with the news that Sino-British negotiations had ended in stalemate. During these two days, the HK dollar depreciated by some 13% against the US dollar, closing September 24 at a record low of HK$9.6. Matters stabilised after the announcement and implementation of the linked exchange rate system in October 1983 which linked the HK dollar to the US dollar at a rate of HK$7.80/US$.

The economic gloom and the general lack of political confidence persisted, however, and did not bottom out until 1985. In the meantime, problems of mismanagement and fraudulent operations in some banks and deposit-taking companies (DTC) came to the surface. An example was the Carrian case, a property developer that collapsed after it was discovered that it was fraudulently financed by a DTC called Bumiputra Finance, a subsidiary of a state-owned bank in Malaysia.

Brief history of the problems

Between 1983–86, seven local banks got into difficulties. These included the then third largest local bank in Hong Kong, the Overseas Trust Bank.

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The Government took the view that if these banks were allowed to fail, there would be systemic implications and an unacceptable impact on the HK dollar under the circumstances prevailing at that time. Therefore, these banks were rescued by the Exchange Fund, whose main role was to maintain currency stability. Three of them were taken over by the Government and financial assistance (e.g. in the form of guarantee of assets, liquidity support etc) was provided to facilitate the takeover of the other four by private sector entities.

The causes of failure of these banks varied, but the underlying problems were all related to loan quality. Some of them had lent too aggressively during the boom period, and were hard hit in the downturn. Other failures involved outright fraud. The following summarises the more common reasons for failure:

- *Over-concentration in property and share related lending.* Historically, residential mortgage lending in Hong Kong has been relatively safe. However, during the downturn from 1982, banks suffered substantial losses in loans related to property development, property and share speculation, and commercial properties.
- *Connected lending.* Lending to connected parties, including directors and director-related companies, was another significant source of loss. These loans were extended without proper credit assessment. Many such loans were also used for speculative purposes.
- *Large exposures.* Some banks were exposed to a few very big borrowers and suffered heavy losses when such borrowers were hit by the recession.
- *Fraud.* Either in a desperate attempt to cover up loan losses, or to benefit themselves, many members of the management of the problem banks were involved in fraudulent activities, e.g. cheque kiting,[1] fictitious loans etc.

Apart from banks, over 100 DTCs left the market during 1983–86 because of the unfavourable operating environment. Of these, around 20 experienced serious financial difficulties, mainly for the above mentioned

[1] Such cheque kiting activities typically involved the bank concerned discounting US$ cheques issued by companies connected with the management. The issuers had use of the money during the 7 days it took at that time to clear the cheques. The funds required for settlement were telex-transferred to the relevant accounts in the US, often obtained by discounting another batch of cheques.

reasons. The Hong Kong Government, however, did not rescue any DTCs. Their failures were not expected to have systemic implications.

Dealing with banking problems

Nature of the problems

It is important to determine whether or not the problem is systemic in nature. In Hong Kong, this dictates the policy choice of whether or not financial assistance should be provided to the problem bank. In the 1980s, virtually all banking problems had systemic implications, given the economic and political atmosphere at the time. However, in the BCCI crisis in 1991, the BCCI Group subsidiary in Hong Kong (BCCHK) was allowed to fail and go into liquidation. This was because the Hong Kong Government took the view that the failure of BCCHK was not going to have systemic implications despite the fact that it was a substantial local retail bank. The process was nevertheless not a painless one. There were demonstrations from depositors, rumours were widespread and bank runs started on several other banks. Such bank runs subsided after a few days but this did show that the liquidation of a retail bank would inevitably cause social/political problems despite the relatively benign economic climate prevailing in 1991. This is especially true in Hong Kong where there is no deposit insurance.

Solvency of the problem bank

The next question is whether or not the problem bank is solvent. If it is, liquidity support by the central bank as the lender of last resort may be the appropriate measure. In Hong Kong, the Government effectively acted as lender of last resort in the 1980s. There were however problems. It was in practice difficult to determine whether the bank was solvent or not. Some of the problem banks in the 1980s were in fact insolvent when liquidity support was provided. That delayed the proper resolution of the problems and increased the ultimate costs of rescue.

If it is decided that a bank is insolvent, the options available will be:

(a) to close the bank and allow it to go into liquidation;
(b) Government to acquire the bank and to inject fresh capital. Eventually the bank would be privatised; and
(c) Government to facilitate a takeover of the bank by a third party.

As mentioned above, the liquidation of a retail bank is inevitably destabilising. Option (a) is feasible only when it is judged that the systemic impact arising from possible loss of confidence in other banks would not be too severe. A safety net for depositors such as deposit insurance, with all its shortcomings, will help in this aspect. Option (a) was not pursued during the 1980s, but the other two were used.

The opportunity should also be taken to consolidate the banking sector if considered necessary. In Hong Kong this was achieved to some extent in the 1980s as all the three banks taken over by the Government were eventually sold to existing banks.

Problem loans

In all restructuring exercises, a major problem to deal with is the problem loans. In the 1980s this was dealt with by Government guarantees in favour of the buyers of the problem banks. This was not the most efficient and effective solution. The loan recovery process was complicated and the bad assets remained on the banks' book for a long time. To some extent, this might also have diverted some of the banks' resources which could have been better deployed to develop other more constructive businesses.

An asset management company (AMC), to which bad assets might be transferred, would be useful in that:

- where a bank is still a going concern but has a large amount of bad loans, the purchase of these loans by the AMC would free up liquidity in the bank and enable management to concentrate on the daily running of the business; and
- in the case of insolvent (or capital impaired) banks, which need to be restructured, the purchase of bad loans by the AMC would provide the means of stripping out the bad assets to leave behind the good assets which could be sold, along with the liabilities of the failed bank, to a rescuing bank.

Addressing the weaknesses of the banking system

Prevention is better than cure. It is obviously desirable for the problem not to arise in the first place. In Hong Kong, a number of initiatives have been taken to this end since the 1980s.

Strengthening the legal framework

Following the problems of the early 1980s, the Government commissioned a study to make recommendations on improvements in the prudential supervision of banks and DTCs. As a result of the study, the *Banking Ordinance* was revamped in 1986 to tighten up the supervision of these institutions. Its provisions included the following areas:

Similar Supervisory Standards for Banks and DTCs

Prior to 1986, there were two different sets of supervisory standards for banks and DTCs under the then *Banking Ordinance* and *DTC Ordinance* respectively. The latter were subject to less stringent supervision. DTCs also provided vehicles for bank management to undertake risky business or to facilitate fraudulent schemes. As a result many problems occurred in that sector. The *Banking Ordinance 1986* replaced the pre-1986 ordinances and put banks and DTCs under the same supervisory framework. They are now known collectively as Authorised Institutions (AIs).

Functions of the supervisor

The *Banking Ordinance 1986* spelt out clearly the supervisor's duties. Reflecting the primary objective of supervision to promote the general stability and effective working of the banking system and provide a measure of protection to depositors, the Ordinance provided that the supervisor should take all reasonable steps to ensure that AIs were soundly based and prudently managed. This duty implied a different emphasis in the approach to prudential supervision which relied more on the supervisor's discretion and qualitative judgment than previously. Adequate safeguards in the form of appeal to the Financial Secretary and the Chief Executive in Council were provided as a check and balance against the supervisor's exercise of discretion. To enhance further the accountability of the supervisor, he was required to make an annual report to the Chief Executive in Council on the performance of his duties which were published for public scrutiny.

Capital and liquidity ratios

Whilst the pre-1986 *Banking Ordinance* and *DTC Ordinance* prescribed minimum capital requirements for banks and deposit-taking companies, these capital requirements did not bear any relationship to the amount and level of risk of the assets they supported. Some AIs were therefore tempted to overextend their businesses and take undue risks, making them vulnerable in circumstances where their assets became bad and needed to be written down.

The *Banking Ordinance 1986* introduced new minimum requirements on capital adequacy and liquidity. The supervisor was given the discretion to vary such requirements to cater for individual differences.

Connected lending and large exposures

The pre-1986 ordinances did not have adequate provisions to prevent imprudent lending. In particular, legislation was inadequate to regulate connected lending and concentration in exposure which was the root of many financial institutions' difficulties.

The *Banking Ordinance 1986* contained provisions to restrict lending against the security of shares of related companies, and to place limits on large exposures and connected lending.

Regulation of ownership and management

Apart from requiring locally incorporated banks to obtain the Financial Secretary's approval before reconstructing their capital, legislative controls under the pre-1986 *Banking Ordinance* over ownership of banks and DTCs were practically non-existent. Further, there had been inadequate provisions to ensure competence and integrity of the controlling managerial level of AIs.

The revised ordinance introduced new regulations for ownership and management. These included approval requirements for the exercise of voting rights by certain shareholders and the appointments of directors (including chief executives) of AIs. These have since been expanded to cover changes in the ownership and control of local AIs and the appointment of alternate chief executives.

Improvements in co-ordination with external auditors

The *Banking Ordinance 1986* enabled the supervisor to call a tripartite meeting between the supervisor, the institution's management and the institution's auditor to discuss matters relating to the AI. The supervisor

might also refer to the Disciplinary Committee of the Society of Accountants any cases of negligence or serious misconduct by the auditors.

Regular update of the legal framework

Since the *Banking Ordinance 1986* was enacted, it has been regularly reviewed and refined to take account of local and international developments, such as the Basle Capital Accord which was given statutory effect in Hong Kong from the end of 1989. It is Hong Kong's policy to keep its supervisory standards in line with international standards, particularly those promulgated by the Basle Committee.

The HKMA is currently revising the *Banking Ordinance* once again to bring the legal framework fully in line with the Core Principles for Effective Banking Supervision published by the Basle Committee. It is hoped that the legislation will be passed in the near future.

Market discipline

In recent years the HKMA has attempted to blend its traditional supervisory approach (centered around the Basle Capital Accord and verification of asset quality through on-site examination) with greater reliance on market discipline and internal governance within banks.

Financial disclosure

Market discipline on the banking system can only work if market participants have sufficient information about the financial position and performance of individual banks, including in the audited annual accounts. In the case of Hong Kong, the position prior to 1994 was that most banks published very little information in their annual accounts. In particular, no breakdown was given of net profits and such profits were shown only after transfer to or from inner reserves. The accumulated total of such inner reserves on the balance sheet was not disclosed. The rationale for this position was to avoid banks having to disclose losses or even a sharp fall in profits which might result in an abrupt loss of confidence in the bank concerned and perhaps affect the stability of the system as a whole.

However, in today's environment where greater transparency is demanded, the HKMA came to the view that the lack of disclosure in Hong Kong was becoming counter-productive, in the sense that it might give the impression that the banks had something to hide – which was not the case – and because it provided insufficient incentive to management to improve performance. Beginning with the 1994 accounts, therefore, the HKMA has encouraged banks in Hong Kong to publish more information in their annual accounts. The result is that the level of public disclosure in Hong Kong is now on a par with international standards. In particular, the banks now publish a full breakdown of their profit and loss account and much greater balance sheet information. Profits are no longer shown after transfer to inner reserves and the accumulated total of such reserves has been disclosed. Information is also provided about bad debt provisions and the amount of non-performing loans.

So far this exercise has been accomplished without any adverse effects even though banks' performance has been hard hit by the Asian financial crisis. The increased transparency seems to have enabled investors and creditors to reach an informed opinion on banks' credit worthiness and has contributed to the relative stability of the Hong Kong banking sector vis-à-vis the rest of the region.

Lender of last resort

Market discipline can be eroded by over-generous financial assistance and support from the monetary authorities. The HKMA has therefore sought to clarify its role as the official lender of last resort in Hong Kong.

The granting of such assistance by the HKMA is by no means automatic. The guiding principle in considering whether to provide liquidity support is whether the failure of an individual bank would either by itself or through the creation of a domino effect, damage the stability of the exchange rate or the monetary and financial systems. The HKMA expects all authorised institutions in Hong Kong to have liquidity policies in place which, among other things, include contingency plans for dealing with a funding crisis. Such plans should identify emergency sources of funds and which assets could be used for pledging purposes. The HKMA would expect a bank to utilise its own liquidity resources and commercial sources of finance before obtaining support from the

HKMA. In particular, it should look to its significant shareholders to inject liquidity and/or capital into the bank as a demonstration of their own commitment.

In its role as the lender of last resort, the HKMA would act on the basis that it is providing liquidity support to institutions that are currently solvent. Rescue of insolvent banks would involve wider policy considerations and a different decision-making process (see below). Therefore, in keeping with its role as a prudent banker and to discourage moral hazard, the HKMA would normally only lend on the basis of security and at rates which provide incentives for good management.

Bank rescues

While lender of last resort facilities are expected to be repaid and are extended to solvent institutions with a liquidity problem, an insolvent bank gives rise to questions as to whether it should be rescued and by whom. A key issue in this context is who should bear the losses: shareholders, depositors, other creditors or the government (and thus the taxpayers).

Hong Kong has no policy of automatically bailing out insolvent banks. As noted above, a number of banks were taken over by the Government in the first half of the 1980s in the interests of maintaining the stability of the financial system as a whole. Financial support was provided in respect of others. However, it was made clear at the time that this was not a general policy but that an ad hoc approach would be adopted in each case. This principle was followed in 1991 when BCCHK was closed and subsequently put into liquidation.

Deposit insurance

Over-generous deposit insurance will undermine market discipline and cause moral hazard problems. On the other hand, lack of deposit insurance may inhibit the authorities from placing a bank into liquidation, because of the impact on depositors, thus delaying the exit of failed banks from the system.

In the case of the BCCHK liquidation in Hong Kong, the impact on small depositors was eased because the high liquidity and generally good asset quality of the bank enabled an early payout in full to be made to small depositors. This took much of the tension out of the situation.

Following this episode, the Hong Kong Government issued a public consultation paper on whether a deposit insurance scheme should be introduced in Hong Kong. The conclusion was that, on balance, the costs of deposit insurance were greater than its benefits. Instead, the insolvency laws were amended to enable small depositors (HK$100,000 and below) to be paid out in a liquidation in priority to other creditors. This is intended to help to reduce the disruption caused by any future liquidation of a bank, though its effectiveness would depend on the bank in question having sufficient liquid assets to enable an early distribution to depositors.

Financial infrastructure

Having an advanced and efficient financial infrastructure will also contribute to greater banking stability. Set out below are some of the initiatives Hong Kong has taken in this regard.

Real Time Gross Settlement System (RTGS)

Banking stability depends crucially on the stability of the systems through which banks make and receive payments. Liabilities of the problem banks to other banks through the interbank payment system were one of the major considerations in deciding to rescue some of the problem banks in the 1980s. The introduction in December 1996 of the RTGS system in Hong Kong achieves finality of settlement on an intra-day basis, substantially reducing the risks which banks run in respect of payments between themselves. Settlement is across the books of the HKMA, and no longer across the books of a commercial bank. This paves the way for linking up with other RTGS systems abroad. The RTGS system in Hong Kong has also been linked to the HKMA's book entry transfer system for securities which allows delivery against payment for the settlement of transfers of securities lodged in the system.

Bilateral netting

As a market initiative to enable bilateral netting of foreign exchange contracts, and thereby reduce settlement risk, the Hong Kong Association of Banks has developed, and recommended to their members the

use of, a master netting agreement called the Hong Kong International Foreign Exchange Master Agreement. A legal opinion has been obtained that the agreement will be enforceable under Hong Kong law. In accordance with the Basle Committee's recommendations and subject to the conditions specified by the Committee, the HKMA has confirmed that it is prepared to allowed the bilateral netting of off-balance sheet transactions in calculating counterparty exposure for capital adequacy purposes.

Mortgage corporation

The share of mortgage loans in the domestic loan portfolio of the banking sector has increased from less than 10% to over 20% in the past 15 years. While the default rate on residential mortgage loans in Hong Kong has been very low in the past, the banks' growing involvement in this type of business gives rise to a concentration risk. It also has implications for the management of their liquidity (since they are financing an increasing amount of long term loans on the basis of short-term deposits). This maturity mismatch was a cause of difficulties for some of the problem banks in the 1980s, although it was commercial property loans that was a major cause of losses.

As a result, the Government has set up a Mortgage Corporation in Hong Kong whose role will be to buy residential mortgage loans from the banking system, either to hold on its own balance sheet or for the purposes of securitisation. The Corporation is initially owned by the Government via the Exchange Fund, but is intended that it should operate on a commercial basis. It finances itself by issuing long-term debt which helps to reduce the maturity mismatch in the system as a whole and also encourages the development of the Hong Kong dollar debt market.

Concluding remarks

Hong Kong's experience of banking problems in the early 1980s indicates that the problems stem from a combination of factors both endogenous and exogenous to the banks. As one of the freest economies in the world, excessive competition under a low level of supervision in the late 1970s, helped by a global boom, caused over-speculation in property that reached unsustainable levels. When the world entered a recession in the early 1980s, Hong Kong experienced at the same time a political shock that caused a sharp reversal in asset prices. The financial institutions that were not well managed suffered large loan losses, exacerbated by fraud and mismanagement.

The solution to the problems resulted in a strengthening of both bank management and prudential supervision. The general direction was not simply further controls, but measures to enable the market to work better. Emphasis was placed on capital and, more recently, on disclosure requirements, and generally prudential standards were brought up to international levels.