David Carse: Recreating the financial services industry for the new economy: a regulator's perspective

Keynote speech by David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Asian Banker Summit 2000 in Hong Kong on 24 October 2000.

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Ladies and gentlemen,

I am pleased to be here as a keynote speaker for this major conference organised by Asian Banker Journal. One of the themes of the conference is how the banking industry is trying to get to grips with the challenges posed by the New Economy. I will be giving the regulator's perspective on these important issues. As a banking regulator, I suppose that I am something of an Old Economy dinosaur. And it is a bit daunting to be sharing the platform with two other speakers who are obviously more expert in the New Economy than I am. One of these is Mr Jeffrey Koo Jr whom I saw described in a recent magazine article as a "30-something Net-head". I'm not sure exactly what that means, but I think that it was intended to be complimentary.

Unfortunately, some of the gloss has been taken off the New Economy in recent months. The dot.com fever in the stock market seems to be well and truly over, and has joined the long list of speculative crazes that have faded into history. Telecom stocks have fallen seriously out of favour, particularly in Europe as the companies embark upon what the Economist has just described as perhaps the "biggest gamble in business history". This is the US$300 billion investment in 3G licenses and networks - a lot of money to spend when the return on the investment is uncertain to say the least. It remains to be seen – outside Japan at least - how consumers will take to the mobile internet concept. The lukewarm response to WAP phones is not a good omen, although admittedly the technology in this case is much cruder than what is being claimed for 3G. Let us just hope that 3G will live up to the expectations.

Even with the traditional pc-based internet, the signals are mixed. Everyone can see the ability of the internet to transform communication, flows of information and business processes. But the means to turn this into revenues and more especially into profits have proved to be somewhat elusive, as the closure or consolidation of a number of e-tailers has shown. In a period of radical transformation such as we are going through at present there are bound to be a number of false starts and failures before the business models that can successfully exploit the new technology emerge. This period of uncertainty poses important strategic challenges and increased risks for the banks in their role both as major users of the technology and as providers of funds to the companies which are putting that technology in place. Banks, like other companies, need to discover what will or will not work in the internet world. They are thus exposed to their own mistakes. But they are also exposed to the potential mistakes of their customers. For example, if the telecom companies in Europe really have taken too big a gamble on 3G, this would have repercussions for the banks that have financed them.

These challenges are also confronting banks in Asia as they recover from the hangover of the Asian crisis. I do not think that bankers anywhere would ever claim that they have an easy life. But certainly the existence for banks in Asia before the crisis was easier than it is now. If I take Hong Kong as an example, the banks here have always competed actively. But that competition was taking place in a buoyant market, whereas business is currently much harder to find. A few simple statistics illustrate the point: in the six years from 1992 to 1997, domestic lending by the locally incorporated banks grew at an average rate of 21% per annum, and pre-tax profits rose at an annual rate of 15% during the same period. In contrast, the equivalent annual figures for the three years to mid-2000 were 1¼% and 4½% respectively. It is true that bank profits staged a sharp recovery in the first half of this year. But growth in bank lending has remained sluggish. Bank liquidity remains at historically high levels, and this, coupled with the fierce competition for new lending business, has pushed down lending margins, particularly in the all-important mortgage portfolio.

It is not only that the market is not growing as fast as it did. The traditional, local players are also beginning to encounter more pressure from global firms, non-bank entrants and competing sources of finance.

The competitive environment is giving added impetus to the need for banks to consider how they can use the new technology, and particularly the internet, to drive down costs and broaden income sources. In Hong Kong around 20 banks have introduced transactional banking services for retail customers. Many have already introduced corporate banking services through the internet, or will shortly do so. So far the take-up of these services seems in general to be rather slow. However, a few banks have achieved reasonable levels of usage by customers either because they were early movers or because of their leading market position.

Customer acceptance of the internet will undoubtedly grow. But it will not happen overnight, and the contribution to the bottom line will be slow to emerge. In the meantime, the banks will have to bear the extra costs of the investment in the new technology, while margins may come under pressure from the increased ability of consumers to shop around and compare prices.

In order to succeed in the internet world, banks will need to ensure that they have the products that customers actually want, and the ability to tailor these to individual customer needs. But mass customisation of this kind requires enhanced management skills as well as investment in the necessary human and technological resources, including customer relationship management systems. Smaller banks may have to recognise that it is going to be difficult to achieve this on their own.

I will not go into further detail as to how the banks should react to the changing environment because that will no doubt be covered by other speakers. Let me turn instead to what should be the response of the regulators. In doing so, I will be drawing upon our experience in Hong Kong. But I think that the same trends will be evident elsewhere in the Region.

The first thing we have decided is that we have got to carry on the process of deregulating the banking system. In particular, Hong Kong has had controls on the interest rates that banks may offer on deposits since 1965. We believe that this is incompatible with a modern, competitive banking system, and has served to hinder innovation on the liabilities side of the balance sheet. We have been dismantling the controls over the last few years, and now all time deposits have been deregulated. The next stage in the process will be to eliminate the prohibition on payment of interest on current accounts and the interest rate cap on savings accounts. This should take place in July of next year. We are also in the process of further opening up the banking system to foreign competition. Foreign banks which were licensed after 1978 were formerly restricted to one branch in Hong Kong. We increased this to three branches last year, and we may decide to remove the restriction altogether when we review it next year.

It may seem a bit strange in an environment of increasing competition, to give it added impetus by deregulating. However, we feel that we need to get rid of artificial barriers that might inhibit the response of the local banks to the changing market landscape. In particular, we want to remove any disincentives for the local banks to focus on the need to think more seriously about merger and acquisition. Our general position is that it would be desirable to see some consolidation in the local banking sector. But this will have to come through market forces, rather than being mandated by the regulators.

We are attempting to dismantle the barriers to competition in a careful way that will give the banks a chance to adapt and avoid undue risks to the safety and soundness of the banking system. For the same reason, we are also having to change our regulatory framework and supervisory approach to ensure that they keep up with changing market conditions. One priority has been to take account of the e-banking developments I have already mentioned.

A particular landmark was the guideline on virtual banks which we issued in May of this year. I will not go into the details of this except to say that it was first drafted when the dot.com frenzy was at its peak, and I believe that the cautionary notes that we uttered have stood the test of time. In particular, our guideline stressed that virtual banks must have substance rather than being a concept, and that virtual banks are subject to the same risks as conventional banks and should be subject to the same prudential criteria. Essentially, we were warning of the need not to be blinded by the technology.

We also warned against over-aggressive pricing and of the need to strike an appropriate balance between acquisition of market share and earning a reasonable return. As with other new banks that we authorise, we would normally expect a virtual bank to be making a profit by the end of its third year. This was criticised in some quarters as being unrealistic and not in keeping with the internet business model. However, as events have turned out, it was that model that was unrealistic rather than our guideline.

Under our current rules, it is not possible to establish from scratch a new locally incorporated virtual, or indeed conventional, bank in Hong Kong. That is something that we may review next year in line with the process of deregulation already referred to. In the meantime, this need not be a barrier to setting up virtual banks, either by converting existing local franchises or, in the case of an overseas bank, by setting up a branch in Hong Kong. As proof of this, we are currently considering two applications to set up virtual banks, and assuming that they can meet our authorisation requirements, I hope that these can be in operation quite soon.

One of the main tests that these applicants will have to satisfy is that they have adequate security to prevent unauthorised access to their systems and to protect customer information. Weak internet security puts the financial position and the reputation of the bank at risk, and concerns about security are the major barrier to more widespread customer acceptance of e-banking. It is essential therefore that the banks get this right. We have tried to help by issuing guidelines to the banks on various aspects of security, including the need for senior management to commission periodic independent assessments of the security aspects of their e-banking services. We have recently provided further guidance on how such assessments should be conducted and the areas they should cover. However, we also need to be in a position to conduct meaningful on-site examinations of our own. This requires us to build up our own in-house teams of IT experts and to provide them with the proper training and guidance on what to look for. We are currently trying to do this and have recently hired an external consultant to help us to develop the right processes and techniques.

This is part of a more general move to enhance our supervision to make it more sensitive to the various types of risk with which our banks are faced, and more focussed on the processes used for managing those risks. This becomes all the important in the New Economy, because although technological change presents obvious new opportunities to the banks, it also magnifies their risks in certain respects and increases the complexity of their business. Security risk is one clear example of this, as I have already mentioned. But increased liquidity and credit risk could be added to the list - the former because the internet will make it easier to move funds between banks at the touch of a button and the latter because banks may in future have a more transitory relationship with their customers.

Technology risk is also a concern. With technology changing so rapidly, it becomes more vital that banks invest wisely in new systems and choose the right moment to do so. Early movers run the risk of being saddled with systems that do not work as promised, or which quickly become obsolete. Equally, there is the risk of being left behind by competitors if you wait too long.

Such considerations mean that it is essential that banks have a sound strategy and good systems of risk management. The main responsibility for this rests with the board of directors and with senior management, although the regulators also have a responsibility to check that they are doing their job properly. To assist us in that process, we have recently issued a guideline which sets out the standards which we expect the board of directors to observe. One important feature of the guideline is the need for a strong independent element on the board provided by non-executive directors who can bring a fresh perspective to strategic planning based on their expertise and outside experience. Having said that, non-executive directors with the right degree of independence and expertise are not easy to find. This is one of the main challenges in corporate governance in Asia.

Although sound strategic direction from the top and good internal systems of control are the primary defences against increased risk, banks also need to make sure that they hold sufficient capital to support that risk. The present capital adequacy regime formulated by the Basel Committee has been in place since 1988. Although it has served its purpose well, it is showing signs of its age and needs to be replaced. The Committee is therefore proposing to introduce a new Capital Accord, the guiding principle of which is that it should be more risk-sensitive. One of the by-products of the new technology is that it does enable banks to measure risk more precisely. The Committee intends therefore to exploit this by enabling banks to use an internal ratings-based approach to calculate the credit risk for various types of borrowers and consequently the amount of capital they need to hold. Less sophisticated banks will use a standardised approach where the risk weightings for various classes of borrower will be determined by external credit ratings.

One feature that is particularly relevant to today's discussion is that for the first time there will be an explicit capital charge for operational risk. This seems to be a timely move given the increased operational complexity introduced by technological change.

The new Accord will be unveiled for further consultation at the beginning of next year. Although its implementation is still a few years away, I would strongly advise banks to start to prepare for it now, for example by upgrading their loan classification systems and beginning to measure and monitor operational risk. The new Capital Accord will be relevant not only to capital requirements but also to the pricing of risk. If regional banks wish to remain competitive with the global players operating in their territories, they will need to become more conscious of return on capital and the need to economise on the use of capital.

There is one other aspect of the changing environment to which I believe banks should pay closer attention. This is what might be termed the rise of the consumer. As I mentioned earlier, the internet shifts the balance of power from banks to the consumers by giving them increased opportunity to shop around. This has coincided with efforts by banks to switch their marketing efforts to consumer finance, credit cards and wealth management products in order to broaden their sources of income and to make up for sluggish business opportunities elsewhere. The internet should help in the cross-selling of these products to consumers, but it is not by itself a guarantee of success. The banks must also ensure that they do not alienate their customers through unfair or opaque terms and conditions. For example, in the internet context, customers should not be held liable for direct losses caused by unauthorised transactions where they are not at fault. Banks therefore need to become more conscious of the fact that they cannot take their customers for granted. They must be prepared to offer them a fair deal, and be seen to do so. This is something that we will be addressing in Hong Kong through revisions to our Code of Banking Practice. In this connection, we have recently issued for consultation some proposals on credit card practices which will eventually be incorporated into the revised Code. These include, for example, a recommendation that banks should publish standardised APRs for the cost of obtaining finance via credit cards.

I will close by returning to the theme of the New Economy. It used to be said that the days of the banks were numbered. As prime examples of Old Economy dinosaurs, they would inevitably succumb to the onslaught from new competitors like virtual banks, technology firms, monoline service providers, portals and the like. The position of the banks is certainly not secure, but it is looking a bit better than it did only a short time ago. The decline of the New Economy has seen the Old Economy strike back, with even bricks and mortar coming back into fashion. The brand names of banks and the credibility which their branch networks provide are not to be underestimated as marketing tools. The ability to marry the branch network to an internet delivery channel is a powerful competitive advantage. But it is also one that could easily be thrown away unless the banks are truly sensitive to the needs of their customers.