David Carse: The way forward for banking sector reform

Speech by Mr David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the American Chamber of Commerce Financial Services Committee luncheon meeting, Hong Kong, 9 April 2001.

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Ladies and gentlemen,

The Hong Kong banking system is going through a period of unprecedented change. This is being driven by shifts in the competitive environment and by changes in the regulatory structure. I would stress that Hong Kong is not alone in this – what we are witnessing here is similar to the trends in other major banking systems around the world. Perhaps the changes have hit Hong Kong rather later than elsewhere. But the changes are now here and they are here to stay. This poses new challenges for the banks and, I would add, for the regulators.

The purpose of this speech is to outline the current trends and how the HKMA is reacting to these through the introduction of a number of reforms of the banking sector. The underlying aim of these reforms is two-fold. First, we want to try to promote efficiency and innovation in the banking sector through removing barriers to competition. Second, we want to ensure that the safety and soundness of the banking system is maintained in an environment of increased competition and that there is adequate protection for depositors.

Current banking trends

These are long-term strategic objectives. Unlike most other banking systems in the region, we have had the luxury of being able to look ahead without being distracted by the need to cope with a banking crisis. Of course, the banking sector here has had its ups and downs over the last few years. But the results of the banks for the year 2000 showed that they have consolidated their recovery from the Asian Crisis. Pre-tax operating profits of the local banks rose in aggregate by 38% in 2000. Admittedly, this largely reflected the decline in bad debt provisions. But even if we strip this out, profits still rose by a reasonable 10%.

This recovery should however not disguise the fact that a banker’s job is not an easy one at present. This is shown in two main features of current market conditions. The first is that domestic loan demand has not yet shown a sustained recovery. This reflects continued sluggishness in private sector investment, recourse by the corporate sector to other forms of financing such as the equity and bond markets and the lack of revival in the residential property market which has reduced the demand for mortgage loans.

Related to this is the fact that the banks are flush with liquidity. A recent study by Goldman Sachs concluded that the surplus deposits in the banking system had tripled since 1997 to reach HK$1.5 trillion. According to the study, this represents 124% of GDP, the highest percentage in the world. This is putting pressure on lending margins, most obviously in the residential mortgage market where pricing has now reached more than 2.25% below prime rate.

In 2000, the impact of this on the banks’ overall net interest margin was mitigated by the fact that the ample liquidity kept funding costs low and the prime-HIBOR spread at record levels. But the net interest margin is likely to come under increased pressure as more loans are refinanced at cheaper margins and if funding costs rise relative to lending rates.

Interest rate deregulation

So conditions for the banks are, as they will tell you, currently quite tough. And they could become tougher when the final stage of interest rate deregulation takes place. This is due to happen at the beginning of July and will involve removing the interest rate cap on savings accounts and the prohibition on the payment of interest on current accounts. This move is a central feature of the reform measures that we announced in 1999. But it is part of a continuing process that began in 1994 with the progressive removal of the interest rate controls on time deposits.

Deregulation is undoubtedly the right thing to do. While the interest rate controls did serve a useful stabilising function in the past they have become increasingly outdated in a mature banking system like Hong Kong's. They have imposed rigidities and inefficiencies in the setting of deposit rates and have inhibited the development of new products on the liabilities side of the balance sheet.

The removal of long-standing controls is not however an easy process, and may bring with it certain risks and drawbacks. From the banks' point of view, the obvious problem is that they may have to pay higher interest rates, or interest for the first time, on the previously regulated deposits. The effect on margins will be exacerbated if deregulation leads to a price war with banks aggressively bidding for deposits. At this point, the banking regulator may also become concerned if it appears that the banks are neglecting the management of their interest rate risk and liquidity risk.

This is obviously something that is a potential concern with the impending deregulation. But the banks have had plenty of time to prepare. Moreover, the current excess liquidity in the system means that the incentive to bid too aggressively for new deposits should be reduced. Having said that, some banks will no doubt see deregulation as an opportunity to expand their customer base, and will price their deposits with this objective in mind.

This brings me on to the impact of the deregulation for consumers. There has perhaps been too much of a tendency in some quarters to see deregulation as something that would bring benefits for all. This was not the view of the HKMA. In our reform proposals issued in June 1999, we noted that:

"The process of improving allocation of resources, reducing cross-subsidisation and introducing more transparent pricing is one of the objectives of deregulation and should not be resisted. However, **it needs to be understood that there will be both winners and losers among bank customers**."

In practical terms, as experience in other centres has shown, removal of interest controls tends to be accompanied by moves such as the imposition of fees and charges and the tiering of interest rates. Banks will also review their existing cost structures and streamline unprofitable services and branches. They will attempt to maximise customer use of cheaper delivery channels such as ATMs, telephone banking and the internet.

These are inevitable trends that would happen with or without deregulation. The competitive changes that are already taking place in the market would in any case oblige banks to try to reduce costs and to increase fee income to make up for the slower growth in net interest income. What deregulation will do is to act as a catalyst for change and to focus the banks' minds on the need to react sooner rather than later.

This process is not without controversy, as we have seen in the reaction to the recent announcements by some of the major banks of revisions to their fees and charges. I am not going to comment on the merits of the precise measures that the banks are taking, except to say that they are in line with what we anticipated at the time the decision to proceed with deregulation was taken. They should be seen not as something that is peculiar to Hong Kong, but as part of a global trend.

This global trend is being driven partly by an increased focus by banks on the bottom line and on the creation of shareholder value. This seems the right thing to do in the interests of long-term survival. There are plenty of examples of companies around the world that lost track of what they were actually in business for and as a result are no longer in business. Banks, like other companies in a free market economy, have a responsibility to make profits for their shareholders. It is in the interests of society as a whole that they do so, otherwise we could end up with the banking sector in a mess.

But any company maximises shareholder value subject to constraints. These may be imposed by laws and regulations, such as those relating to environmental protection, or by the expectations of society. This means that if banks wish to preserve their reputation and the confidence of their customers, on which ultimately the strength of their franchise depends, they should act in a way that is seen to be fair and reasonable. To do otherwise may in the long-term be inconsistent with the objective of creating shareholder value.

What this means in practice is that in imposing new charges, banks need to be sensitive to the impact on their customers and particularly on the more vulnerable members of the community. It is important to offer customers options for how they can access banking services and at what cost, and to provide them with information about these options and the associated charges. I am pleased to say that the banks that have so far announced new charging policies have borne these considerations in mind. We intend to give this further underpinning through revisions to the Code of Banking Practice that will lay particular stress on the need for transparency in the setting of charges.

There have been calls from some quarters in Hong Kong that the HKMA should regulate banks' fees and charges. This is not something that we want to get into. The only role for the HKMA would be if it appeared that the banks were engaging in collusive, anti-competitive practices in their charging policies. There is no evidence of this as yet, and given the way in which banks compete in other business areas, the risk of collusion seems quite low. Indeed, a number of banks have already said that they will not impose new charges, for the time being at least. Nonetheless, this is something that we will keep an eye on. We are in fact already in the process of reviewing the question of whether the HKMA should play a bigger role in consumer issues, and if so what powers and resources we would need for this purpose. It is too soon to say where this will lead, but I stress again that we have no desire to get involved in the regulation of fees and charges.

Deposit insurance

Let me now turn to the other major plank of our reform package, which is equally, if not more, controversial. I am referring to the proposal to introduce a deposit insurance scheme ("DIS") in Hong Kong. In a sense, this can be seen as the other side of the coin to deregulation. Increased competition in a deregulated environment may give rise to increased risk and therefore it seems right that we should look again at the arrangements for dealing with banking failure, should it occur.

Let me hasten to add that we have no reason to believe that such a failure will occur. The banking system in Hong Kong remains profitable and robust, despite the challenges that it faces. Our system of banking supervision is also generally reckoned to be effective. But banks can still get into difficulties because of risks that supervision may not be able eliminate. There is always the possibility of external shocks or unfounded rumours that may damage confidence in a bank. Deposit insurance, like other forms of insurance, is there to deal with low probability events that have a major impact if they occur. To make an obvious analogy, you still take out fire insurance even if you do not expect your house to burn down.

Hong Kong stands out as one of the few developed banking centres which does not have a DIS. There is of course no reason why we should follow the rest of the world just for the sake of it. But we should at least keep our safety net arrangements under regular review to ensure that they are still appropriate to changing market circumstances.

This is what we did last year when we engaged an external consultant to consider whether the existing deposit protection arrangements in Hong Kong were sufficient, and if not how they should be changed. The conclusion was that an explicit and limited form of deposit insurance should be introduced. We subsequently undertook a public consultation on this proposition and on the detailed design features of the proposed scheme.

This consultation generated a heated, albeit civilised, debate. Not surprisingly, some of the large banks vehemently opposed the scheme. Opinion in the community as a whole was however generally supportive. In particular, the Legislative Council passed a motion by a wide margin urging the Government "expeditiously to implement a DIS, which is cost effective and easy for depositors to understand, for effectively protecting small depositors, and to formulate appropriate complementary measures aimed at reducing the risk of moral hazard."

The HKMA has studied the responses received during the consultation and has submitted a report to the Government on the outcome. We are seeking a decision in principle on whether we should proceed with the deregulation, subject to further work on the technical arrangements during the rest of this year.

I cannot anticipate what the decision of the Government will be nor can I provide details of what the final shape of any scheme would be. I will however comment on two key issues.

The first is that even the supporters of deposit insurance, including Legco, are keenly aware of the need to minimise moral hazard. Moral hazard refers to the incentive for increased risk-taking that may be created by deposit insurance. The problem is that both banks and their depositors may exercise less self-responsibility if they know that deposits are protected. This is a risk in any form of insurance, but it has received particular attention in relation to deposit insurance because of its alleged role in the Savings and Loan crisis in the United States in the 1980s.

Moral hazard is a real issue, but it is one that can be addressed. The first essential is that the design features of the DIS itself should provide incentives for risk-minimising behaviour by market participants. This means in particular avoiding over-generous protection and limiting the scope of the DIS strictly to the protection of small depositors. There was general agreement in the public consultation that coverage in the DIS should be kept relatively low, in the range of HK$100,000 to HK$200,000. It appears that the lower end of this range would probably be acceptable.

The second element in reducing moral hazard is to maintain effective supervision to curb excessive risk-taking by banks. In this connection, we are presently in the process of enhancing our supervisory system to make it more risk-focussed. The final safeguard derives from the market discipline exercised by those stakeholders in a bank – the uninsured depositors, bank creditors and shareholders – who are exposed to the risk of loss if a bank fails. Such persons have a vested interest in monitoring the behaviour of banks and in sending the appropriate market signals, in the form of withdrawal or higher cost of funds, or lower share price, to banks that are taking too much risk. To do this, of course, the market needs sufficient information about the financial position and performance of banks. Increased financial disclosure is something that the HKMA has been encouraging over the last few years.

The other main issue to emerge from the consultation is that of cost. The large banks in particular are concerned that they will end up paying for the bulk of the cost of a DIS from which they and their customers will receive little benefit. They have argued that the cost of insurance will inevitably be passed onto customers in the form of lower interest rates on deposits and higher fees.

Competition might well oblige the banks to absorb the cost. Even so, this is a sensitive issue about which those in favour of the DIS have also expressed concern. Of course, it can be argued that the reason why the large banks would bear most of the cost is because they have most of the deposits, from which they derive a significant competitive advantage. Moreover, large banks in general tend to benefit from the perception that they are "too big to fail" or at least "too big to liquidate". A DIS to which the large banks contribute can therefore be seen as helping to level the playing field for the small banks.

These are however rather sterile arguments. The reality is that we have a responsibility to keep the costs of a DIS as low as possible. If the decision is taken to proceed, we will therefore be looking at the size of the premium to see whether it can be brought down from the 10 basis points indicated in our consultation paper. We will also be examining, if not now then at some time in the future, whether it is possible to introduce a risk-based element into the setting of the premium so that well-managed banks pay less. It will also be necessary to keep the administrative structure of a DIS as lean as possible to minimise operating expenses.

If the go-ahead is given, these and other details will take some time to work out and to enshrine in legislation. It is unlikely therefore that a DIS could be introduced before next year. One advantage of this is that it will give us time to evaluate the impact of interest rate deregulation before the DIS is introduced.

Conclusion

I hope that I have been able to give you a picture in this speech of some of the trends in the Hong Kong banking sector and how our reform measures fit into these. In the time available I have not been able to discuss all the issues that the HKMA is currently addressing, including the proposal to set up a commercial credit reference agency in Hong Kong. However, the issues that I have talked about – deregulation and deposit insurance – are probably enough for you to think about for the time being. Assuming that they go ahead as planned, they will play a major role in helping to shape the future development of banking in Hong Kong.