Joseph Yam: Banking sector risks and challenges

Luncheon talk by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Hong Kong Institute of Bankers, Hong Kong, 16 June 2004.

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The turnaround

Thank you for inviting me to talk to you today. It is a pleasure to be here and I am delighted to see such an enthusiastic attendance. I was recently looking over past speeches (not, let me assure you, with the aim of recycling them), and I noted that the last time I spoke at one of the Institute’s lunches was on 24 October 2001. This has prompted me to reflect on how much we have all been through over the past 32 months - both as a financial community and in the larger community. When I last spoke to you the world was just six weeks on from the 9-11 attacks. There was a strong sense that we were heading for difficult times, with a worsening global environment, and with deepening deflation, unemployment, a budget deficit, falling asset prices and a rising number of negative equity mortgages within Hong Kong. Conditions were likely to get worse before they got better, I concluded.

Well, after a period of great difficulty, in which things got considerably worse than I think any of us had imagined, conditions are now at last improving. Since around the middle of last year Hong Kong has been enjoying a strong and broadening recovery. The economy has now regained much of its dynamism. The key economic numbers are providing the confirmation. Economic growth has been impressive. The unemployment rate has been coming down, albeit slowly. Deflationary pressure has been easing. The external sector has been active and we are running a substantial current account surplus. The residential property market, on which the wealth of many in our community depends, has bottomed out from a falling trend that had lasted for over five years. Domestic consumption has been picking up. Of more direct interest to us in the HKMA, the risks to monetary and banking stability, which had been worrying us for some time, have receded. The very fast dissipation in the number of cases of personal bankruptcy and negative equity mortgages is very welcome indeed.

The turnaround in the Hong Kong economy and, consequently, the improvement in the asset quality of banks, were made possible by the more favourable global economic environment and by measures taken to strengthen economic ties between Hong Kong and the Mainland. Indeed, banks in Hong Kong have also benefited directly from two of these measures. The first is the granting of easier and greater access to the Mainland banking market under CEPA from 1 January 2004 and the second is the introduction of personal renminbi business in February. These will in time help to broaden meaningfully, I am sure, the scope of banking business for banks in Hong Kong. I should add that there are other initiatives being developed, with the aim of positioning the banking system of Hong Kong to take advantage of further financial liberalisation in the Mainland. I hope they can be agreed, announced and introduced soon.

Short-term risks

However, the generally good news in recent months should not blind us to the problems that remain in our economy or to the risks that face us. While the economy has been recovering strongly, it has not been creating as many jobs as we all would like to see. It is also uncertain to what extent the budget deficit will be reduced, as government revenues recover along with the economy. To be sure, the difficult investment environment is not helping us in our attempt to meet the budgeted investment income for the fiscal reserves. Disappointments on these fronts may affect market sentiment in the short term, although the determination and ability on the part HKSAR government in tackling the remaining, structural components of these problems should not be in doubt. Furthermore, there is a risk that our financial markets could over-react to external developments, notably stronger than expected monetary tightening in the US, macro-economic adjustments in the Mainland and sharp increases in oil prices. Although it is unlikely that these external factors would derail our economy, and so this risk seems small, under extreme market conditions, short-term volatility in financial markets could have a bearing on monetary and financial stability in Hong Kong.

In contrast, there are also concerns about the effects of continuing easy monetary conditions within Hong Kong. During the past few months, economic recovery has resulted in inflows of funds into the Hong Kong dollar to the extent that the Aggregate Balance of the banking system has become extraordinarily high (despite some outflows recently associated with the corrections in the financial markets). As you know, under the Currency Board system there is not much that we can do to dampen easy monetary conditions: this is a question that the Sub-Committee on Currency Board Operations of the Exchange Fund Advisory Committee has given a great deal of thought to. If there continue to be capital inflows on the back of sustained growth and confidence in Hong Kong's prospects, the current account surplus and continuing talks about a possible revaluation of the renminbi, the risk of overheating in the economy and in asset markets will increase. I am not suggesting that this will happen soon, or making a warning. But banks in particular will need to keep the situation under close watch and adopt appropriate risk mitigation measures if the market situation warrants it. Overheating is, after all, something of an unfamiliar risk after such a long period of economic difficulty, and we do not wish to be caught off our guard.

Longer-term risks

So much for the more immediate risks and potential risks, which both you as banks and we as supervisor must pay attention to. What about the longer-term risks facing the banks in Hong Kong? Or, to put the question in a larger context, what are the longer-term processes shaping the banking sector that carry risks as well as opportunities? We in the HKMA have identified a few of these in an internal exercise that is still ongoing but I would like to share with you today our preliminary views on five of them. They are:

- structural shift in the banking sector
- China risk
- technology risk
- diversification risk
- changing international standards.

In the remainder of this talk, I shall deal with each of these areas in turn, focusing more on how we think banks in Hong Kong should tackle these processes and risks, and less on our corresponding supervisory responses or strategies, which in any case are still being developed. My main message is that, while banks need to focus clearly on the short-term risks I have already outlined, we should not lose sight of the more fundamental forces that will shape the landscape of the banking sector in the years to come. If they do not take these forces into account, individual banks not only face growing risks, but they could be in danger of losing their competitiveness.

Structural shift in the banking sector

First, the structural shift in the banking sector. Over the past few years the HKMA has been encouraging banks to consider consolidation as a way of improving competitiveness - technology, among other factors, has obviously moved the optimum size of a retail bank towards the larger end. The banking industry has responded positively: the number of locally incorporated banks has fallen from 31 three years ago to 24 at present, the result, I am happy to say, of consolidation and not of abandonment of Hong Kong. As expected, the various consolidation exercises have produced the economies of scale intended and, in some cases, immediate financial benefits for the institutions concerned.

As consolidation continues, and with the subsidiarisation of the local operations of a few major foreign retail banks, the structure of the banking sector will become increasingly polarised. At one end will be several large banks; at the other end will be a number of much smaller players. The smaller players will increasingly face two disadvantages: on the one hand they will find it difficult to compete; on the other hand, they will find that the opportunities for consolidation will dwindle over time, as the number of possible targets for consolidation declines.

It may not be quite right to classify this structural shift as purely a long-term risk. In fact, the trend is already there and the effects of consolidation on the industry as a whole will begin to be seen very soon. Smaller banks, if they wish to continue to thrive, should, as a matter of priority, carefully review their strategic direction. They should, for example, consider whether it is desirable to grow in size or develop into niche players. Neither option is an easy one. The opportunities for organic growth in the local market are limited, while competition for niche operations is intense.

China risk

The second important process is the continuing and accelerating integration of the economies of Hong Kong and Mainland China, which will be hastened in the years to come by further financial liberalisation. I have already mentioned the arrangements under CEPA, in which more medium-sized Hong Kong banks will be able to access the Mainland market. Let us not overlook movement in the opposite direction, in which more Mainland banks will seek to enter the Hong Kong market. On the macro level, as the renminbi moves at a measured pace towards full convertibility, it seems inevitable that an increasing proportion of the balance sheet of banks in Hong Kong would be denominated in that currency. The opportunities arising from the developments are promising, but they carry risks as well.

The growing banking relationship between the Mainland and Hong Kong will provide important business opportunities for banks in both places. The question for Hong Kong banks seeking to take advantage of this process is whether they have the requisite expertise to properly analyse the business and compliance risks. Failure in this task will additionally give rise to substantial operational and reputation risk, particularly for the banks that have only recently become eligible under CEPA to set up branches on the Mainland. So far, the medium-sized banks seeking to benefit under CEPA are doing so primarily to follow their customers into Mainland China. This simple business model should not pose too much risk for the banks concerned. But banks that are contemplating more aggressive expansion plans, such as tapping the local consumer market, will need at least to be aware of the risks involved and be in a position to manage them prudently.

There is a more general and important aspect about this process of growing banking relationship between the Mainland and Hong Kong. This process is likely to be characterised by policy shifts that are more frequent than any other banking environment that we are familiar with. These policy shifts - mostly in the Mainland rather than in Hong Kong, and in monetary as well as regulatory policies - are an inevitable feature of a monetary and financial system that is going through reform and liberalisation. And in the absence of deep and sophisticated financial markets in the Mainland to provide the signals and instruments, the task of risk identification and management associated with the more frequent than normal policy shifts is, to put it mildly, a difficult one. An ability to understand, closely monitor and anticipate monetary and financial market developments in the Mainland is therefore crucial, for banks and for us as supervisor. I urge banks to put in the necessary efforts. Insofar as we are concerned, I think we have developed, in a limited way, such ability and will, as in the past, share with the banking community our analyses so that banks can continually adjust their operations to meet changing market and regulatory needs.

Technology risk

The third set of forces arises out of banks' increasing use of, or rather reliance on, technology. We have seen a spate of fake bank websites and attempted email scams over the past year: indeed, the rate of discovery of such cases relevant to Hong Kong has averaged about 1.4 per month over the past 13 months. It should be pointed out that we have no report of any customer in Hong Kong having been taken in by these attempts at fraud. Nevertheless, the proliferation of fake websites indicates that careful precautions and constant vigilance are necessary. And a further area of technology-related crime - ATM skimming fraud - has had its victims, both in Hong Kong and overseas. Increased security and heightened customer awareness, we believe, have helped defeat this form of crime: there have been no new cases in Hong Kong for seven months. Even so, the elementary, "low-tech" nature of these frauds demonstrates also that there are many dimensions of the banks' vulnerability to technology.

In addition to protection against technology-related crime, the IT framework of banks also requires business continuity planning (or BCP). Banks in Hong Kong made great strides in BCP during the preparations for the onslaught of the Y2K bug. Although the onslaught never came, we were soon reminded of the importance of BCP by the 9-11 attack, which alerted us to the need for robustness in payment, clearing and settlement systems, among other things. Then the outbreak of SARS last year put the BCP capability of banks in Hong Kong to a real test. I am pleased to say that the contingency arrangements of banks - whether of a technical or personnel nature - performed very well during that difficult time. Nevertheless, the recurrence of disasters and their unpredictable nature should always be a feature of BCP and its continuous review. Indeed, the probability of occurrence of these events seems to have increased, along with heightened geo-political tension and the trend of globalisation, not just of trade and markets but also of terrorism and disease.

A further area that falls broadly under technology risk comes from outsourcing. Continuing pressure on profitability will no doubt result in more banks seeking to outsource their operations to lower-cost centres outside of Hong Kong. This will in turn give rise to additional operational risks for banks, including the risks of service outage and leakage of confidential customer data.

My main observation from recent experience with handling technology risk is that bank management should adopt a more proactive approach towards increasing the overall robustness of the IT environment, from both the crime prevention and BCP perspectives. In dealing with these IT-related incidents, we noticed the concerns sometimes expressed by bank management about the likelihood of causing unnecessary public panic if these matters were given publicity. Many preferred to deal with the problems quietly. The desire to be cautious and to avoid negative publicity is quite understandable. However, we have found that, far from causing panic, our insistence on publicity has been helpful in alerting members of the public of the nature of risks that they are exposed to as bank customers and how they can protect themselves. It enhances public education on the issues at hand and promotes the exercise of a degree of care by bank customers that the situation demands, not just to protect themselves but also to help in protecting the integrity of the system. Interestingly, nowadays, we sometimes receive reports of fake web-sites from members of the public even before the banks affected become aware of them.

Diversification risk

The fourth major force shaping the industry is the continued effort of banks to diversify their income source. This is an ongoing and inevitable trend given the increasing competition in the banking market, but it has gathered pace in recent years in response to the increasing pressure on interest income. The net interest margin of the retail banks in Hong Kong as a whole has substantially declined from over 2.19% in 1997 to an annualised level of 1.67% for the first quarter of 2004. The new sources of income include most notably the sale of investment and insurance products.

The key challenge for banks is simply whether they are capable of managing the risk arising from these new intermediary activities. This is particularly so when, encouraged by advanced technology, the range of products being offered to customers expands from plain vanilla types to more complex structured instruments. Furthermore, the awareness of customers about their consumer rights has increased, thus exposing banks to greater compliance, legal and reputation risks when venturing into these new areas of activities. We have seen in recent years an abundance of cases against the mis-selling of products by banks even in jurisdictions with more developed financial markets. Banks will need to properly equip themselves, including substantially upgrading their compliance and internal audit processes, in order to rise to this challenge.

International standards

The fifth set of influences affecting the banking industry is the number of key international standards that will be introduced over the next few years. These include regulatory and accounting standards, and Basle II is the standard most prominent in our minds. Another example is the implementation of IAS 39. The adoption of these standards will have profound implications for the operation of banks in Hong Kong.

Time is limited, and this is, after all, a luncheon speech, so I shall not go into detail about these standards. The point to make here is that, as an international financial centre, we have no alternative but to implement these standards as fully as we possibly can and as soon as international agreements have been reached on them. Many of these standards will be, to put it mildly, quite onerous. In this connection, I wish to ensure you all that the HKMA has been adopting a proactive approach in participating in the relevant international standard setting forums and in influencing the standard setting processes in the best interests of Hong Kong. We have also consulted widely in Hong Kong. Insofar as the banks are concerned, there is a clear need for bank management to allocate adequate resources to the process of implementation, which will involve substantial changes to IT systems and compliance arrangements. For Basle II, for example, banks should not be acting under the misapprehension that they can simply sub-contract the implementation processes to third party service vendors, such as their external auditors. Active involvement of bank management is crucial in ensuring that most, if not all of these international standards are properly incorporated into the daily operations of banks, especially since each bank may face different focuses and challenges in the process.

Conclusion

I have drawn attention to five processes that are likely to have an impact on the banking industry in the future, if they are not already having an impact. Each of these will, of course, have a different degree of impact depending on the nature of the operations of each bank - though I think it is fair to say that no bank can ignore them. To be sure, facing up to them has important implications for the limited resources that banks have. In formulating business strategies for the coming five years, it is essential for bank management to take into account these processes in planning their affairs. This goes for the HKMA as well, since there are important implications for the manner in which we could perform our supervisory functions effectively. As I mentioned earlier, we are currently carrying out an internal review on this subject. As a result of this internal review, there may be a need for us to make adjustments to our supervisory policies; but there will be, as usual and as necessary, full consultation with the industry before we proceed.