Joseph Yam: Reflections relevant to the banking profession in Hong Kong

Speech by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Joint HKAB – HKIB Dinner in honour of Mr Joseph Yam's retirement as Chief Executive of the Hong Kong Monetary Authority, Hong Kong, 28 September 2009.

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Peter, friends and colleagues of the banking profession,

Not only am I deeply touched by all of the kind and generous words that have been said this evening, but I have also been greatly impressed by the skits and other entertainments put on this evening. I had always assumed that whatever surplus talents bankers may have were always used up on the golf course. Now I know that these talents stretch in other, more cultural directions. Thank you all for such an enjoyable and unforgettable evening.

This is a convivial occasion, and the last thing you will want to hear is a long and earnest speech from me. However, this will be my last formal event with you as Monetary Authority. And I think you all know me well enough to expect more than just a few words of gratitude – however heartfelt – for this splendid event. I shall be brief. Much has been said and written recently about the origins, progress and implications of the global financial crisis that erupted with such fury just over a year ago. I shall therefore simply offer a few reflections that I hope will be relevant to the banking profession in Hong Kong.

The <u>first</u> observation is that Hong Kong has, so far, escaped the worst. We have not experienced a collapse of our financial system, or a nationalisation of our major banks, or other forms of government intervention that will burden taxpayers for many years to come. In fact, our banking system has been resilient throughout the crisis, and the measures taken early on to reinforce confidence and ensure liquidity were effective and at minimal cost to the public purse. This is not an observation to be made with any sense of gloating or complacency. We all recall the intense anxiety of those days, and many in our community have suffered losses as a result of mistakes and mismanagement in other financial systems. Nevertheless, our well-capitalised banks have been well prepared for shock. Crisis management, particularly when public confidence momentarily came under strain, was effective. The generally cautious approach of our bankers, your refusal to get carried away by innovation, helped minimise the damage: this is a vindication of your reputation for prudence, and a great credit to Hong Kong's banking system. We also seem to have achieved a good balance in the relationship between the supervisor and the banking system.

An excellent example of how that balance has contributed to banking stability is the 70% loan-to-value policy for residential mortgage lending by banks. This policy, now a cornerstone of our prudential arrangements, pre-dates even the foundation of the HKMA and evolved out of a productive dialogue between HKAB and the supervisor. It has survived strong political pressure for relaxation and market pressure for innovative credit risk transfer through securitisation. The policy – now nearly two decades old – fits in well with the macro-prudential approach which, particularly in the light of the recent crisis, supervisors in other jurisdictions now consider to be essential to banking stability. The fact that no such policy existed in the advanced financial systems is remarkable enough. But what is more remarkable is the level of initiative of the Hong Kong banking sector itself in seeing the importance of systemic stability and giving it precedence over the profitability of individual institutions.

We might therefore observe, in the light of this and of our experience over the past year, that Hong Kong has got it broadly right in the relationship between the supervisor and the banking system. However, this should not lead us to the complacent conclusion that there is nothing much that needs changing. And indeed, no such conclusion is in our minds. Both the

Carse Report and the recent reports to the Financial Secretary on the Sale of Lehman-related products see room for development and improvement in the way we carry out our work. Quite apart from our own Hong Kong-specific initiatives, there are movements for reform at the international level, resulting from a very different experience in the more developed economies, which we cannot ignore.

This point brings me to my second observation: the need to move with the times. The past year has seen a plethora of ideas and proposals for reforming financial regulations, and interventions by government that were unprecedented in their nature and scale. Even in economies less deeply affected by the latest crisis, including Hong Kong, it has been necessary to deepen government involvement, for example in more extensive deposit guarantees or in more intense supervision of banks' risk management – although it is gratifying that so many of the tools that we have been able to rely on, including the apparatus and contingency arrangements for ensuring liquidity, have been developed in a pre-emptive rather than a reactive way. On the various emergency measures, I am quite sure that in the fullness of time, these will either be turned into standing arrangements or withdrawn, hopefully through smooth exit strategies. But, current sentiment is clearly demanding much closer regulation and supervision of banks over the longer term. Quite what form this will take remains to be agreed on in international forums, although the thinking already seems to be towards improvements in the level and quality of banks' capital; new global standards for measuring, managing and supervising liquidity risk; and macro-prudential supervision to reduce the pro-cyclical dynamics of financial markets. No doubt the details will take some time to work out. We might be tempted in Hong Kong to respond that we have demonstrated clearly this last year that we already have the ability to maintain banking stability. The measures being contemplated internationally are designed for repairing and renovating banking systems that have effectively collapsed: some of the measures may indeed be going too far. Therefore, we might conclude that we do not need to consider them for Hong Kong. Such an attitude would, I think, be a mistake. As an international financial centre, Hong Kong must adopt international standards and best practices. We have to move with the times, although that does not of course mean we have to blindly implement everything in an inflexible, straightjacket manner.

Hong Kong is, in fact, in a good position to adopt and participate in the various measures now under consideration by the G20, the Financial Stability Board and its Standing Committees, and other international agencies. Our voice may not be so loud or strong as that of the larger economies, but we still have a responsibility to speak up, to seek to ensure that what comes out of the international forums is balanced, and realistic for local and regional conditions. The increasing participation by Asian economies, including Hong Kong, in these international forums is a good sign that the rest of the world is paying attention to, and ready to learn from, the experiences of this region. The task, for Hong Kong as for all jurisdictions, will be to translate high-level principles and universal standards into local practice, and to develop the skills to carry them out. This is an enormous challenge, but there are reasons for confidence in Hong Kong's case. We have had a largely positive experience in introducing Basel II into our supervisory system, thanks in no small part to the hard work of both HKAB and HKIB.

Regulatory reform is driven not just by objective circumstances but also by changing public expectations. This brings me to my third observation: that banks and financial institutions (and, it might be added, regulators) are now operating in a more sceptical, more demanding, even hostile environment. We see this around the world, and, particularly in the aftermath of the Lehman Brothers collapse, we have seen it in Hong Kong. There is also discontent and anxiety locally that pre-dates the crisis – for example, about access to banking services, about the risks of new technology – that result partly from the changing business landscape and partly from changing expectations. We must expect this trend to continue, and it will be necessary for the banking industry and the regulator to take more and more account of wider public opinion, and to tackle areas of concern. As the industry organisation, HKAB has already become quite deeply involved in such matters: for example, it has played an important co-ordinating and think-tank role in ensuring the safety and efficiency of e-banking, and in promoting accessibility to banking services, particularly among vulnerable groups; it is also one of the joint issuers of the Code of Banking Practice, the reference-point for relations between banks and their customers. HKAB can, I believe, contribute even more in the future, and consolidate its role as industry representative, by strengthening its resources, for example by creating a separate secretariat with a professional chief executive.

One of the key causes of the recent financial crisis was the use – or abuse – of innovation by financial intermediaries for short-term private gain at the expense of longer-term stability and effective working of the financial system as a whole. And one of the reactions to this has been a call – a very loud call in some places – for banks to go “back to basics” in conducting their business. If such a reaction were to lead to a return to the sort of inflexible banking services many of the older among us remember, then this would be a pity. If, on the other hand, it were to result in greater reflection and rethinking about the true function of banking in society, then this would, in my view, be a healthy development. At the heart of such thinking must be the view that the banking system exists to provide financial intermediation in support of the larger economy: it cannot be some abstracted, disembodied realm of activity in which intermediaries compete with each other to dream up ever more complicated ways of making a fast profit. But such thinking should not rule out innovation, as long as the objectives are clear: and the main objectives should be to serve activities in the greater economy, to increase the efficiency of the financial system without sacrificing its safety. This leads to my fourth and final observation.

We have many examples of such innovation in Hong Kong to draw upon, but there is one that is particularly appropriate on this evening of reminiscences. I refer to the introduction of renminbi business into banks in Hong Kong – a development which seemed revolutionary at the time, but which now seems a very normal activity. It had small beginnings and is a gradual, cautious process: there is, of course, scope for much further growth and development. This innovation has clear practical uses in facilitating economic relations between Hong Kong and the Mainland, in reinforcing Hong Kong's role as an international financial centre, and in supporting the liberalisation of China's financial system. How many of us here, I wonder, recall that the idea of developing renminbi business in Hong Kong was first broached in 2001, during one of the Annual HKAB visits to the Mainland which I had the privilege of joining?

The development of renminbi business in Hong Kong, and more generally the role of Hong Kong in serving the need of China in international finance depend on the pace of financial liberalisation on the Mainland. It is therefore very much out of our hands, involving policies that allow for greater cross border mobility of capital, financial instruments and financial intermediaries. Yet our survival as an international financial centre depends on our being prepared for these policies of financial liberalisation. We should also be proactive in offering advice in policy making and be ready to provide assistance and technical support in policy implementation. One very practical way of doing this is to continue to use our financial system as a platform for cautious experiment in the gradual liberalisation of the renmminbi – a process that is of benefit to our system and to the nation as a whole. The Basic Law specifies that Hong Kong's status as an international financial centre will be maintained. There are many policies and programmes in train to achieve this. But surely the key for the future is in developing Hong Kong as the offshore renminbi market. There should be no doubt that the renminbi will become an international currency one day. For Hong Kong to be unprepared for this, for us to fail to see the opportunities or build the infrastructure to make the best of it, would be to risk marginalisation. There is no shortage of awareness of this point, whether at the policy or the technical level within the government. At the practical and business level, the banks also have a role in making use of the channels that are opened up: it is gratifying to note that banks are playing their role effectively and with enthusiasm.

Ladies and gentlemen, Monetary Authorities and bankers come and go. But I have no doubt that HKAB and HKIB, and the spirit of co-operation that they embody, will go on for ever. I have no doubt that you will continue to promote the prosperity of Hong Kong and the wellbeing of all who live here for many years to come. I wish my successor, Norman Chan every success, and all of the happiness that I have enjoyed as Monetary Authority. As for myself, in two days' time I shall move from this very public role into the role of private citizen, with all of the pleasures and responsibilities that entails. This is an unfamiliar, possibly challenging position for me. But I have never been known to decline a challenge, and I look forward to the freedom to plan my own days and see more of family and friends, many of whom are here this evening. I wish all of you the very best of health, happiness and success.