Norman T L Chan: Universal banking – Hong Kong's perspective

Keynote address by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the opening session of the Asian Banker Summit 2011, Hong Kong, 7 April 2011.

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Distinguished guests, ladies and gentlemen,

1. I am very pleased to address this important conference this morning as it provides a timely occasion for us to take stock of what is happening to our banking industry at a time when the international financial markets are recovering from the Global Financial Crisis. Indeed, the landscape of banking has undergone very significant changes since the eruption of the crisis in 2008. And more changes are in store. Some might even argue that banking will evolve beyond recognition when compared with what we knew previously. Of course the international banking reform package, ranging from the new capital, liquidity and leverage regime under Basel III, the treatment of Global Systemically Important Financial Institutions to the use of macro-prudential tools etc, will have different implications for different banks and different jurisdictions. It is not my intention to discuss today the new international standards that have been and are about to be adopted as these standards have been talked about very frequently amongst bankers and regulators. What I would like to do here is to share with you our views on the following three issues that have profound impact on the way in which the banking industry, including that in Hong Kong, should structure itself:

- ***Universal Banking vs. Segregated Banking***
- ***Universal Banking vs. Narrow Banking***
- ***Branch vs. Subsidiary Operations.***

Universal banking vs. segregated banking

2. First let me talk about "universal banking", which may mean different things to different people. By "universal banking" I refer to a business model in which banks are allowed to provide a wide range of banking and other financial services to their customers, whether they are mass retail, high net-worth, SMEs or large corporates. In this connection, it may be appropriate to regard a universal bank as a one-stop financial supermarket.

3. Hong Kong has a long tradition of this type of universal banking. Notwithstanding the experiences of the recent Global Financial Crisis and the ongoing debate and scepticism in some jurisdictions, we continue to see merit in the model of universal banking. Why? Let me explain.

4. First of all, universal banking in the form of a one-stop financial supermarket provides what the customers need to meet their rising demand for investments in a wide range of financial and wealth management products. These customers can enjoy the convenience of a one-stop service, ranging from simple products such as equities, unit trusts, insurance, gold etc. to the more complex derivative or structured products that meet their investment needs. At the same time, universal banking also allows some banks, if they have the resources and expertise, to provide corporate or investment banking services to the more sophisticated corporate clients in a wide range of areas such as debt finance, equity fund raising, mergers and acquisitions and other advisory services.

5. Universal banking also makes a great deal of sense from a bank's point of view. Under this model, a bank will be able to better serve the diverse needs of its customers, and generate fee and commission income which is not subject to the same kind of credit, maturity and other risks associated with income derived from lending and trading activities.

Customers need the services and banks provide them: it does look like a perfect match, doesn't it? As always, perfection rarely exists in the real world and there is a catch inherent in this one-stop financial supermarket model. This is related to the different ways in which customers perceive a bank as a deposit-taking institution versus a brokerage house or investment bank.

6. Because of the easy access and convenience universal banks offer, they tend to attract customers along a very wide spectrum of financial sophistication and risk appetite. Some of these customers go to banks to conduct very basic banking transactions, such as cash withdrawal, rolling over fixed deposits, remittances, applications for loans, getting cheque books and credit cards etc. As universal banks seek to expand fee and commission income in distributing investment products, there may be a risk that some banks or their frontline staff could become overly keen to market products to customers without sufficient regard to the customers' own circumstances. Closer to home, the Lehman Minibonds episode has reminded us of the need for banks to take great care in the marketing and distribution of investment products to customers. It is for this reason that some have argued that the banking industry should revert to a simpler model of basic banking and leave the rest to brokerage houses and financial advisors.

7. The Global Financial Crisis and the subsequent international debate have prompted us to reflect on whether universal banking still remains an optimal model of banking for Hong Kong. Our answer is "yes". But, this is a qualified "yes" because we believe that banks must take two appropriate steps to address the potential concerns that I have just highlighted:

(a) Banks should offer their retail customers a high degree of protection with adequate regard to their interests or experience in investing in securities or other structured products. That is why the HKMA has required banks, in selling investment products to customers, to adopt extra investor protection measures on top of those promulgated by Hong Kong's Securities and Futures Commission. These extra protection measures include audio recording of the marketing process, segregation of investment corner from the main banking hall or counters, and a mandatory 2-day pre-investment cooling off period for vulnerable and inexperienced investors.

(b) Banks must take extra care in marketing and distributing investment products to their customers. They must remain vigilant throughout the entire distribution process, from product due diligence, risk assessment of the products, suitability assessment of the customers, training for the frontline staff and control and governance of the sales process.

Universal banking vs. narrow banking

8. Let me move to the second issue, with a different meaning attached to the phrase "universal banking". Here, "universal banking" refers to a business model in which banks are allowed to conduct their own proprietary trading and market making in addition to trading on behalf of their customers and offering other traditional banking services and products. This is another area which has attracted heated debate and a diversity of views.

9. We've seen the Volcker Rule in the US and we've heard the Governor of the Bank of England speak out in favour of narrow banks. Their concerns spring from the potential ability of the universal banks to leverage their cheaper sources of funds obtained from public deposits for risky ventures to raise the return on equity and to meet ever rising shareholders' expectations. As banks expand their risk taking activities, both on balance sheet and off balance sheet, some banks have become much larger and more complex, thereby rendering themselves "too big to fail".

10. On the other hand, the proponents of universal banking note that diversification can be beneficial for banks and banking stability. If one area of business underperforms, others can make up for it – making the "whole" more resilient. It can also be argued that banks that are diversified in terms of businesses or geographical operations are better positioned to offer customers the depth and breadth of services these customers require, particularly as

economic activities become ever more specialised and global. Broadening customer access to financial products enables increased flows of savings through the system, facilitating efficient investment and economic growth. These advantages are not to be dismissed lightly.

11. The HKMA takes a balanced and pragmatic view on this issue. Rather than mandating the dismantling of banks' business structure to deal with the potential problems arising from proprietary trading and overly aggressive risk taking by banks, our preferred response is to ensure the proper risk capture and management of those parts of the operations that benefit from low cost funding and yet cause a disproportionate amount of risk. As part of our on-going supervision we need to critically assess whether banks really understand what sort of risks they are taking on and seek to ensure that such risks are managed properly in order to safeguard depositors' interests.

12. As I said earlier, we have a long tradition of universal banking in Hong Kong and we have not seen our universal banks turn into aggressive trading and sales outfits or principal risk-taking hedge funds. But we can definitely see the potential danger. We therefore need to ensure that our banks do not take on excessive risks in their chase for higher profits and bonuses. Banks holding customer deposits must keep their responsibilities to their depositors foremost in their minds and not allow their proprietary trading or i-bank activities to overshadow these responsibilities. If they fail in this regard, they will make the case for narrow banking themselves.

Branch vs. subsidiary operations

13. Another strand coming out of the debates on banking structure relates to the question of whether banks should be required to operate in host jurisdictions as subsidiaries. There are two angles to be considered here: supervision and resolution. Some jurisdictions have taken the view, long before the Global Financial Crisis, that overseas banks operating in their jurisdictions should take the form of subsidiaries rather than branches. The main motivation, as I understand it, is that the host supervisors will have a much stronger regulatory handle, such as capital requirements, prudential limits, auditing, etc, to supervise a locally incorporated subsidiary than a branch. In a resolution scenario, many also favour subsidiarisation because it provides a clear legal entity structure which is easier to handle *nationally* under an insolvency situation.

14. But subsidiarisation is far from being the panacea for all ills. Many have argued that subsidiaries offer sub-optimal use of bank capital, which will be split up and locked up in separate geographical pockets or jurisdictions. In times of stress they could not so readily rely on parent level support or the home central bank. The inability of subsidiaries of international banks to leverage on the capital of their parents would limit their lending in many emerging market economies. This may in turn have negative impact on the trade, investment and other economic activities of these emerging market economies. Besides, liquidity management would likely be more efficient for a branch than for a subsidiary as funds can flow more freely within the same legal entity. On resolution, it is true that the insolvency proceedings for a subsidiary would normally be simpler than for a branch, but in practice there could be many complications such as: linkages to other group entities through intragroup guarantees and exposures, service reliance and shared management, to name but a few issues, which would affect the ultimate resolvability of a subsidiary when it actually happens.

15. After the Global Financial Crisis, the subsidiarisation model has actually gained greater support in some jurisdictions. This is because some home supervisors of internationally active banks feel that it might be easier for these international banks to undertake "de-risking" operations should trouble occur in overseas subsidiaries than in branches.

16. From Hong Kong's perspective, we believe that subsidiaries and branches of overseas banks can and do play different roles in servicing the real economy. The HKMA

takes the view that an overseas bank that wishes to undertake retail business in Hong Kong should operate in the form of a locally incorporated subsidiary. This is to offer appropriate protection to the retail depositors in Hong Kong and to do that the HKMA needs to have an effective supervisory handle on every aspect of a retail bank's operation, especially its capital adequacy ratio. We cannot achieve this if the bank operates as a branch in Hong Kong.

17. However, we also recognise that subsidiaries may not necessarily be an efficient model of operation if an overseas bank intends to undertake only corporate or private banking in Hong Kong. For example, a branch can leverage on the capital of the entire bank to finance a loan for a large corporate, which would otherwise be impossible if it operated as a subsidiary with rather limited capital in Hong Kong. Likewise, some private banking clients may prefer to deal with or book their investments with a branch of an overseas private bank rather than a subsidiary of that bank. So the HKMA keeps an open mind on whether an overseas bank operating in Hong Kong should take the form of a subsidiary or a branch. It all depends on the business model of the bank concerned. To take it one step further, we are prepared to take a liberal view if an overseas bank wishes to engage in both retail banking through a subsidiary and, in parallel, corporate or private banking that would more appropriately be conducted through a branch. We have had several precedent cases and the HKMA is prepared to consider applications on the basis of the merit of the case.

18. While we maintain an open mind on the use of branches by overseas banks, we have to take steps to mitigate the potential risks arising from cross border contagion. This is particularly important given that Hong Kong is a net provider of funds, i.e. our banks collect a lot more customer deposits than they lend out locally. Hong Kong therefore has to closely monitor intra-group or inter-bank funding that flows from Hong Kong to overseas centres. We have seen in the Global Financial Crisis very clearly how wholesale funding through this kind of cross border intra-group or inter-bank channels may be susceptible to significant shocks in times of market stress. The problem could be exacerbated if the host supervisors, in self-defence, sought to ring-fence domestic liquidity by blocking the flow of funds at the most difficult time. So the HKMA has been in discussion with banks in Hong Kong on how best they could achieve a better match between liabilities derived from Hong Kong and assets booked in Hong Kong. This should help reduce the scale of and reliance on cross-border fund flows, which should contribute to greater financial stability while preserving the flexibility of global banks to operate in branch mode in overseas jurisdictions.

Conclusion

19. Ladies and gentlemen, in conclusion, I would like to make just one last comment. The world's financial system has become ever more complex and inter-connected. It is safe to say that there is no "one size fits all" answer to what kind of business model banks should adopt as a universal rule. Each jurisdiction must therefore reflect and determine on its own what kind of banking model that would suit them best, having regard to their own circumstances and needs. No doubt there will be new international standards that all banks must comply with in order to make banks individually and collectively more resilient. However, robust standards and rules are not in themselves enough to prevent big mistakes and crises: they must be supported by sound and forward looking supervision. This is easier said than done in a universal banking model, as bankers and traders are often miles ahead of the regulators and supervisors when it comes to financial engineering and innovations which, as we have found out in the Global Financial Crisis, may not necessarily contribute to better risk management of banks and overall financial stability. Recognizing this inherent risk, the HKMA, in seeking to nurture the universal banking model in Hong Kong, must continue with its long standing conservative supervisory approach with even greater emphasis on prudence under-pinned by proactive and forward looking supervision.

20. Ladies and gentlemen, this is a rather long speech and I thank you for your kind attention. Thank you!