Eddie Yue: Hong Kong – challenges and opportunities ahead

Speech by Mr Eddie Yue, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Hong Kong Institute of Bankers Annual Conference 2012 "The year of transformation – heading into a new era", Hong Kong, 13 September 2012.

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Financial Secretary, Patrick, distinguished guests, ladies and gentlemen,

Good morning. It's my great pleasure to be here at the fourth Annual Conference of the Hong Kong Institute of Bankers.

The conference title behind me talks of "Heading into a New Era". That's a grand and ambitious statement. But, I believe, a fair one. The opportunities ahead for the banking sector are vast, particularly in terms of the offshore renminbi (RMB) market and asset management services.

Today I'd like to discuss with you the reasons for my optimism. In doing so, I will detour slightly through some of the policy, regulatory and organisational priorities I think we will all need to work on.

To start out, though, I should first acknowledge that, as with any journey, the travelling may not always be smooth. There is likely to be some occasional turbulence. I'm referring, of course, to the external economic challenges. So let me start there.

The challenges

It has now been five years since the start of the global financial crisis. Yet low growth and high volatility remain key features of the global economy. So much so that some commentators have asked whether these represent "the new normal".

Underlying this situation are challenges many and varied. Overshadowing them all is the risk of contagion from weaknesses in the advanced economies. The high level of sovereign debt at the peripheral eurozone countries, and its potential vicious feedback into economic recession, is now the principal threat to the global recovery. Meanwhile, in the US, it is still unclear whether recent encouraging signs will be sustained. A big concern there is whether public sector deleveraging will play out in the form of a fiscal cliff or a more gradual, manageable fiscal slope. Either way, via budget cuts or continued fiscal uncertainties, the near-term responses will likely continue to hold back private investment and employment.

The aggregate risk of all these challenges for us in Asia is clearly a knock-on drag on Asian economies. There are also two important side effects: first, the impact of monetary loosening in advanced economies on consumer and asset prices in Asia. And second, the potential loss of lending for infrastructure projects in Asia as European banks deleverage and retrench.

For policymakers, this is a triple-whammy: subdued growth, asset inflation and capital retrenchment. And compounding this are very high levels of uncertainty and volatility, as markets alternate between risk-on and risk-off. All of which makes policy calibration highly challenging and economic forecasting somewhere between extremely difficult and impossible.

Position of Hong Kong's banking system

Given this backdrop, it is very important that we understand and monitor the developments in the US and Europe as closely as possible. That way we will be able to calibrate our policy response and take swift appropriate action. This is especially important in view of the potential for a further deterioration in the European situation and how it might impact Hong Kong's banking system. So please allow me to make a few brief points to address this:

- First, I would make clear that the Hong Kong banking sector's exposure to the Eurozone's peripheral countries is essentially immaterial. We do not expect to have any significant direct impact should there be an escalation of the crisis in those countries.
- Second, while there have been signs of European banks reducing their lending to Asia, so far the scale has been manageable, and this has not caused significant credit tightening in Asia. In Hong Kong, any slack left behind by European banks has been effectively picked up by Japanese, Australian and other Asia banks keen to expand in the region.
- Third, if we cannot predict the future, we can anticipate a range of possible futures. As a result, as you would expect, the HKMA has been diligent in developing proper contingency plans for a wide range of possible scenarios. This of course includes working with the banking sector in Hong Kong to ensure our banks are fully prepared for potential shocks. We have, for example, asked our banks to step up their contingent funding plans and to maintain sufficient high-quality, liquefiable assets to meet any unexpected developments. In addition, we have been active internationally – both bilaterally and multilaterally to ensure we have a coordinated, well-informed and mutually supportive approach. This includes our work as a member of the Financial Stability Board.

So, while there are challenges, we are very much alive to them. We monitor the risks closely and work continuously with our partners to prepare, and stand ready to take any appropriate action.

Opportunities for Hong Kong

Having acknowledged the immediate challenges, I think it's time now to turn towards the opportunities, above all in this region. For while the challenges from the West are deep, they should not blind us to the opportunities within Asia.

I would say that the coming opportunities for the banking industry here are bright – even if at times they may appear to be obscured by clouds abroad. In fact, I believe that they put us on the threshold of a new era for the banking industry in Hong Kong.

I would like to highlight two of the most promising opportunities. The first is the offshore RMB market, which has developed rapidly over the past two years. The second is the increasing demand for asset and wealth management services, both institutional and individual.

Opportunity 1: offshore RMB market

On the offshore RMB market, Hong Kong bankers have been the first ones to exploit the new business opportunities. The development of this market in Hong Kong is a story very familiar to you, so let me focus my remarks on three specific questions which I am often asked.

First, is the RMB liquidity pool in Hong Kong big enough? Over the past year or so, the growth of RMB customer deposits has turned modest. On occasions there have even been month-on-month declines. Some commentators have seen this as a sign that the RMB liquidity pool in Hong Kong is beginning to plateau and might not be able to support future RMB bond issuances and other financial activities.

Frankly, I think this should not be a cause for concern. One needs to recognise that the level of RMB customer deposits is a useful but incomplete measure of RMB liquidity. For instance, banks have been increasingly issuing RMB certificates of deposits as a means to tap RMB funds. Taking RMB customer deposits and certificates of deposits together, these added up to 700 billion yuan at the end of July 2012, with a modest 5% increase from the end of 2011. In other words, the RMB deposit pool has remained largely stable, at a time when we are seeing very vibrant RMB dim-sum bond issuances and expansion in other RMB financing and investment activities.

This is a healthy sign that market forces are balancing supply and demand, and that the offshore RMB market in Hong Kong is maturing. Looking ahead, the level of RMB deposits may rise or fall from time to time. This is only natural as RMB financing and investment activities take place, and as RMB funds flow in and out of the system. It is what one would expect from the growing interaction between the onshore and offshore market. Similarly, the pricing of RMB funds, indicated by the offshore RMB interest rates, will also adjust in response to the fund flows, thereby restoring the balance in the supply and demand of RMB funds.

So, is the RMB liquidity pool in Hong Kong big enough? I would respond that since the scope of RMB business has already expanded from merely deposit-taking to a much wider range of banking and financial activities, the amount of RMB customer deposit is only a partial measure of RMB liquidity or the overall state of play of RMB business in Hong Kong. What is more important is how efficient the pool of RMB is moving around the system. That is, whether we are seeing the channelling of RMB savings to investments, through bank lending, bond issuance and other activities. After all, financial business is about the circulation of money, rather than everyone holding a stagnant pool of money.

The second question that I am often asked is whether the wider use of RMB and the development of offshore RMB business are still on a rising trajectory. There have been suggestions that, with the market now expecting the appreciation of RMB to slow down – or even reverse – there will be less interest in conducting RMB business.

It seems to me that this would be a one-sided interpretation of a much more positive story. From a macro perspective, given the Mainland's substantial trade and investment links with other parts of the world, it is safe to expect that a fair – and growing – portion of such activities will be conducted in RMB. Considering that the percentage of China's trade settled in RMB is only less than 10% now (compared with 30% of Japanese trade denominated in Japanese Yen), it is reasonable to expect RMB-denominated trade to grow further. And with the Mainland economy continuing to grow faster than other major economies, we can also expect that the incentive for individuals and institutions outside China to hold more RMB assets will remain, if not get stronger.

Consider also that, a more two-way RMB exchange rate will be conducive to a more balanced, and hence sustainable, development of offshore RMB business. For instance, when the RMB exchange rate expectation is no longer skewing towards just one direction, the incentives for both the payee and the payer to settle a trade transaction in RMB will be more balanced. Corporates will also be more willing to raise financing in RMB when it is not expected to appreciate strongly. On this front, we are happy to see that RMB lending business is developing progressively, with outstanding RMB loans reaching 60 billion yuan at end-July 2012, nearly four times the level of a year ago.

So, is the wider use of RMB a continuing trend? Well, I would say the scope for further development is clear, and it will be very much up to how corporates and banks can get more engaged in the new business of RMB.

Third question: does the development of offshore RMB business in other financial centres pose a threat to Hong Kong?

This question, I have to say, suffers from the fallacy of "zero-sum" thinking. As more corporates and investors worldwide are becoming interested in conducting their business transactions and investments in RMB, it is natural to see financial institutions in different parts of the world providing RMB services to meet the demand of their customers. This does not necessarily mean that RMB businesses are being diverted to other places.

Indeed, such developments will mean that banks in Hong Kong will not be dealing only with each other locally, and there will be new business opportunities to conduct RMB businesses with counterparts overseas. For instance, as a global hub for RMB liquidity and financing, Hong Kong is well placed to channel customer and wholesale RMB deposits towards corporations and financial institutions in other parts of the world. In fact, we are already seeing such a trend. For instance, the RMB amounts due from and due to overseas banks amounted to some RMB140 billion yuan and RMB120 billion yuan respectively at the end of June 2012.

So, does the development of offshore RMB business in other financial centres threaten Hong Kong? I would say that while it is correct to be mindful about competition, we should not lose sight of the business opportunities that lie ahead of us as the pie grows bigger. To maintain and expand Hong Kong's role as a global RMB hub, we need to enhance our RMB business links with banks and customers in other centres, and I am hopeful about the developments in this direction.

Opportunity 2: asset and wealth management services

Now, let us turn to the second macro opportunity I mentioned earlier, the greater demand for asset and wealth management services, both institutional and individual.

One of the results of the positive growth story in Asia, especially Mainland China, is a new dynamic along the "value-chain" of the asset management industry globally.

At the top of the value-chain are the end-investors, sometimes referred to as "asset owners". They include pension and endowment funds, sovereign wealth funds and private wealth of individuals. This group of investors is primarily responsible for asset allocation.

The asset owners would normally invest via asset managers – such as mutual funds, hedge funds and private equity funds – whom I refer to the middle part of the value-chain. At the bottom of the chain are service providers such as fund administrators, custodian banks and dealer brokers. They provide services to the asset managers.

Therefore, asset allocation decisions by end-investors, either institutional or private wealth owners, have a knock-on impact throughout the rest of the asset management value-chain.

Currently, the portfolios of asset owners in the advanced economies are still significantly underexposed to emerging markets. For example, at present, a typical US pension fund has just 6% of their investment exposure in emerging markets. Not surprisingly, given the economic challenges facing the advanced economies outlined earlier and the growth opportunities in Asia, there is growing interest from these end-investors in increasing their investment exposure to Asia, rather than relying on investing in fixed income products of the developed economies as they have in the past. This change in allocation preference towards Asia will generate significant demand for asset and wealth management services that Hong Kong's financial institutions are well placed to provide.

But the immediate question is: are we in Hong Kong ready to meet this growing demand? Well, we do start with a number of strengths and advantages.

As Asia's premier asset management centre, Hong Kong is the largest hub for Asian hedge funds and the second largest hub for private equity in Asia, only slightly trailing Mainland China. Hong Kong's private banking platform offers unparalleled access to the growing wealth pool in Mainland China and across Asia. We already have the largest number of overseas asset managers seeking to invest in the financial market in Mainland China through the Qualified Foreign Institutional Investors (QFII) framework. We are also the first springboard for asset managers from the Mainland seeking to grow their overseas footprint.

In order to attract business from asset owners, asset managers are increasingly realising they need to demonstrate their commitment to Asia. One of the main and direct ways is by setting up an office in Hong Kong. This has also cascaded further down the value-chain, with a growing number of service providers also moving here.

However, despite these strengths and advantages, we cannot afford to be complacent. We know, for example, that Hong Kong's asset management industry needs to become more diverse, with more high-value jobs. Of our asset management employee base, the vast majority are currently in sales and marketing, with only 10% in core asset management functions such as fund management, research and trading. This compares to over a quarter in the UK and US.

So to capitalise on the opportunities ahead, a top priority must be to develop our asset and wealth management sector. That's why, in partnership with asset managers here and around the world, the HKMA has been exploring how to improve our international competitiveness, including through a more favourable operating and regulatory environment. From time to time, we meet with stakeholders across the value-chain to gather practitioners' views as to what the market needs in order to develop further. We will continue our work in this regard.

Private banking

One area we know we can improve is private banking. This is a business area that is growing exponentially in the region. According to industry research, Asia-Pacific has accounted for half the growth in global wealth from 2010 onwards. It also has a fifth of the world's millionaires. And these numbers will get bigger, with global wealth expected to rise 50% by 2016.

So, the opportunities for our region are enormous. We must ensure we have a regulatory framework that recognises this, one that is user friendly to private banking clients, yet sufficiently robust to provide appropriate investor protection, as well as being on par with international standards.

To achieve this, we've recently introduced some refinements to our regulatory arrangements, following consultation with the industry. These measures were announced in June, so I'd just like to very briefly recapitulate four of the key points as follows.

First, while we want to ensure appropriate protection to all investors, it is reasonable to treat private banking and retail banking clients differently in the investment process. So the first change is that we have provided an expanded definition for "private banking customers" that caters much better for the operational needs of private banks.

Second, we have clarified that private banks may adopt a "portfolio-based" approach to suitability assessment instead of mechanically matching their client's overall risk tolerance level to the risk level of individual products on a per transaction basis.

Third, the new guidance simplifies the rationale for the recommendations process by stating that private banks may choose to document this in writing instead of via audio-recording in a face-to-face interview with the clients.

And fourth, the guidance now states that private banking clients need not go through the usual biennial risk profile reviews, so long as they can confirm that there is no material change in their circumstances.

I believe these measures offer significant facilitation and flexibility to private banks and their clients. However, I would stress that private banks must ensure that they put in place the necessary systems and internal controls, such as proper documentation. Indeed, this is not only for the client's protection but the bank's.

Talent and professional development

Well, ladies and gentlemen, so far we've discussed major economic challenges from Europe and the US and the new opportunities in this region. And we've noted the importance of having the right policy and regulatory framework. But these are not all. Overcoming the challenges and capturing the opportunities also requires each of us in our own institutions to play our part.

So before closing, I'd like to take a moment to focus on the role of talent development and professional standards. This is an area that should always be a top priority for us all. But I stress it today in the context of the risks and potential rewards I outlined earlier.

Simply put, the stakes for each of us – for our institutions, the industry and indeed for Hong Kong – are higher now than ever before. We should therefore invest in talent and professional development accordingly.

To make this concrete, the HKMA and the SFC – with, I'm pleased to note, the warm support of the private banking industry and professional bodies – have set up a taskforce to work out an enhanced competency framework for private banking practitioners. Our initial thinking is that the framework should emphasise vocational training and practical application, as well as ethics.

Under this framework, private banking practitioners could take different examinations provided by, say, the HKIB and the Hong Kong Securities Institute, and ultimately acquire a professional qualification. To ensure continuous development, practitioners would also take additional regular training. Under the same proposed new framework, the HKMA intends there to be more emphasis in future on practitioner competency, continuous professional training and adherence to common set of professional ethical standards.

Getting this right will be an important piece in the puzzle towards building a world-beating sector here in Hong Kong. Getting it right means raising competence and professional standards and, consequently, raising levels of trust and custom.

To achieve that will take a full, team effort. So I very much welcome your input to developing these ideas further and flesh out the framework over the coming months.

Closing remarks

At the outset of my remarks, I highlighted the banner headline indicating that we are "Heading into a New Era". Having journeyed this far, is this statement a fair one? Given the opportunities I've outlined, I think the answer really should be "yes". But if I'm cautious, I would have to say, "Yes, if": if we can rise to the challenges touched on earlier; if we can capitalise on the great strengths and advantages of Hong Kong; if we can invest in our people and our institutions to match the scale of the opportunities.

If we can do that, I believe we can truly make this a transformative moment in the development of the banking landscape in Hong Kong. The prize for your institutions, your clients and for Hong Kong is great. I look forward to continue working with you so, together, we attain it.

Thank you.