Norman T L Chan: How to get rid of banking supervisors

Keynote speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the Lion Rock Institute Freedom Dinner, Hong Kong, 22 November 2017.

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Nick (Sallnow-Smith), founders, directors and members of the Lion Rock Institute, Daniel (Hannan), ladies and gentlemen,

1. It gives me great pleasure in joining you today.
2. After accepting the Institute's invitation conveyed by Peter Wong, I thought hard about what to talk about in front of such a learned and distinguished audience that support and cherish economic freedom. I was also mindful that I should come up with an inviting title that helps sell the tables. I hope I have achieved this, at least by attracting a few more senior bankers to help foot the dinner bill.
3. Nowadays a common theme that bankers often talk about when they meet each other is how their lives have become so much tougher, thanks to ever more stringent standards demanded by regulators and supervisors. Not only are banks required to hold a lot more capital as well as liquidity to meet unexpected contingencies, there is constantly increasing demand by the supervisors to deal with conduct risks. Everyone is familiar with the escalating compliance burden and pressure on banks in tackling anti-money laundering, counter-terrorist financing, international sanctions, mis-selling, etc., not to mention the hefty financial penalties slapped on banks for violations or breaches. So it is natural and indeed understandable that bankers harbour grievances and misgivings towards bank regulation and supervisors. And this is why the topic I am going to talk about is a very attractive theme to them. They would like to hear from a supervisor speaking on a subject that they can normally only discuss privately amongst themselves.
4. First of all, let me give you the good news! As I see it, there are two ways to get rid of bank supervisors, one fast track and the other a slow track. Let me start with the fast track!
5. If you can find a clock or time machine that would allow you to dial back time to 100 years or so ago, then you would find yourself in a happy world where there was little or even no banking supervision. Contrary to common belief, banking supervision as a profession or industry (or, as some bankers would no doubt have it, a "black art") does not have a very long history. Until the Roosevelt New Deal era 1933 Banking Act in the USA, no depositor in an American bank could have been assured of clear supervisory oversight, following a century of uncertainty about state and national authority over banks and the issue of bank notes. In the UK, the first statutorily-backed regulatory regime was put in place only in 1979. Prior to that time, the Bank of England had exerted only informal authority, including through the venerable "Governor's eyebrow". Both the US and the UK Acts were prompted by preceding banking crises. In Hong Kong, the Office of the Commissioner of Banking was only established around 50 years ago in the 1960s, after a couple of rather unpleasant bank failures. Before then, banking was basically a free for all, although it did not mean that it was a wild jungle ruled by Tarzan or the Lion King. Back in those "good old days" during which banking supervision was not a prominent feature of our financial system, bank customers and depositors had to take care of their own interests by choosing very carefully who they could trust and bank with. It should also be borne in mind that internationally, the first Basel Capital Accord was only approved by the G10 Governors in 1988, meaning that we are only just approaching the 30th anniversary of this important milestone.
6. I know that you are going to say: you cannot find such a clock or time machine. In that case, the fast track solution is not quite available. So you will have to consider the slow track solution in trying to get rid of the bank supervisors. As I said earlier, a world in which there were no banking supervisors was not a wild jungle. For a long long time and well

before we had bank supervisors, bankers needed to earn the trust of depositors and customers in order to survive and thrive. Those who failed to earn the trust of customers would not and could not last long. So by and large bankers who managed to survive were highly trusted and respected by the community in the "good old days". Unfortunately this is no longer the case in recent decades, especially after the Global Financial Crisis (GFC). So something has changed that has led to the erosion of trust in bankers. Only if we can restore that trust, and the fundamentals underpinning it, could we have a meaningful discussion on the proposition of getting rid of the bank supervisors.

7. Banking has indeed changed a great deal from what it used to be. I would like to focus on a few key changes over the years relevant to my thoughts on trustworthiness in banking and the need for supervision. First and foremost, the alignment of interest between the owners/managers of banks and their customers has weakened significantly. In the "good old days", banks were often organised in the form of partnership and not as limited companies. The owners or managers individually and collectively had their family wealth at stake in ensuring that the banking business was run not only profitably but also prudently. Any mismanagement of the affairs of the bank could wipe out their family wealth and, in some instances, lead to imprisonment. Any partner of a bank had the duty and right to warn against and take steps to constrain another partner from taking excessive risks, if such risks could bring down not just the culprit but all the partners who were jointly responsible for the well-being of the firm. In contrast, in modern times, banks operate predominantly in the form of limited companies, often listed on stock exchanges, with very diverse public ownership. Senior managers who run the bank do not have most of their personal worth tied up in the firm and the prospects for life-long employment have become few and far between. Nowadays (in particular during the period preceding the GFC), senior bank managers are generally rewarded by a combination of very high salaries coupled with very substantial annual bonuses tied to performance in the preceding year. Even where share options are included in their remuneration packages, the lock up or vesting period is relatively short – just a couple of years at most. The effect of this change is that the previously strong alignment of long term interest between bankers and customers has been materially weakened, leading to the classic situation of an agency problem, with the bank management using depositor funds to leverage up the scale of business while the downside risk that they face in doing so is limited. The problem became rather apparent thanks to the GFC, which witnessed cases in which bank managers took excessive risks or otherwise breached the trust of their customers in the pursuit of profit and bonuses. In some infamous cases, such as AIGFP and Merrill Lynch, sizable bonuses, funded by taxpayers' money, were still paid to managers even though their actions had arguably contributed to the failure of the firms. This "heads I win, tails you lose" regime in modern banking is clearly a recipe for disaster and can do very little to help enhance the trust and reputation of bankers.

8. Another material change in banking from the "good old days" is the problem of what I call "short-termism" amongst some bank shareholders ("impatient capital" focused only on bolstering their own short-term returns). It has also become increasingly common for senior bank managers, especially at the top levels, to be hired on contract basis. While this might be justifiable from the point of view of hiring the best talent available in the market, it could have the unfortunate side effect of cultivating short-termism amongst senior bankers if they only work for a contract or two and therefore must deliver tangible and quantifiable financial results within a short period of time, such as a target RoE. In essence, like football managers, they survive on their reputation for delivering fast results during the current league season. The problem has been exacerbated by two more factors. One is the move towards higher frequency of financial reporting, from annual, half-yearly to quarterly. While this move may have been driven by good intentions of promoting transparency and accountability, inevitably it compresses further the performance measurement period faced by bank management and increases the pressure on the senior managers in delivering short term performance. The second factor is the emergence of activist shareholders in the form of hedge funds and, to a lesser extent, certain pro-active fund managers. The net effect of

short-termism in banking is that firms would tend to opt for businesses or transactions that would boost short term performance in profits or share price, such as large scale acquisitions or mergers or rapid expansion. Investments that are necessary for the longer term viability or competitiveness of the bank, such as upgrading of IT systems and internal talent development, would tend to be given a lower priority. We have seen many high profile cases of massive expansion of business through indiscriminate acquisition or a sharp rise in proprietary trading by banks, which, as we now know, ended rather badly. Fast forays into areas with insufficient expertise or chasing bulge-bracket status by combining aggressive trading businesses with more traditional banking have left banks exposed and created culture clashes in the race for profit. Again, this short-termism in the modern corporate world is not at all conducive to regaining public trust in, and respect for, bankers.

9. While many bankers did place profit ahead of the interest of the customers they serve, it is at the same time increasingly true that customers are also treating banking services more as a commodity. This means that customers shop around for the best bargain in town. They hop from one bank to another without regard to the value of any long term relationship between bank and customer. This shift of mindset from relationship banking to transaction-centric banking is another change that weakens the alignment of interest and of trust between bankers and customers. The introduction of deposit protection schemes in many parts of the world has been motivated by good intentions, but it does produce the side effect of moral hazard in that customers no longer need to care overly much about the trustworthiness of a bank because their deposits are protected by the schemes. Consequently, customers would tend to be drawn to the bank offering the highest interest rate on deposits or returns on investment products. Many customers would also opt for very large banks, regardless of their actual financial strength, in the belief that these banks are "too big to fail". Unfortunately, this belief in "too big to fail" was proved right during the GFC as some governments in advanced economies spent billions of dollars of public money to bail out some of the largest failing banks and financial firms.

10. In summary, the slow track solution to get rid of bank supervisors involves quite a number of fundamental changes to counter those trends that arise from what is now practiced in modern day banking. The measures required are not new, and are intended to restore a strong alignment of interest between bankers and their customers. This would entail, as I have explained, the creation or re-creation of a balanced and fair compensation system for bank owners and senior managers in which good performance is rewarded and bad risk management or conduct is punished. However, the crux of the matter is that the performance has to be long term and not short term. To reduce the risks of senior managers and bank staff taking short-sighted decisions, longer term or even life-time employment should be encouraged and not discouraged.

11. I know what you are going to say! You will say that I am asking for something that is very hard, if not impossible, to accomplish. The world has changed so much that it is unrealistic to go back to the "good old days". For example, most banks are limited companies listed on stock exchanges and it is just not practical for them to return to a partnership structure. Moreover, banks employ hundreds of thousands of staff at different levels and it is impracticable to insist on life employment for all of them. Nor will employees in these modern times prefer to stick with one company for the whole of their working lives. As for the short-termism of the shareholders and the financial reporting cycle, banks are at the receiving end and there is not much they can do.

12. While I agree that it is probably unrealistic to go back to the "good old days" of banking, I am not fully convinced that there is little banks can do to restore a stronger alignment of interest with their customers. But that doesn't really matter because, without these changes, the slow track solution to get rid of supervisors also does not seem to work! So I am bringing you the bad news! The bad news is that the public will need an agency entrusted with the mandate and powers to protect the safety of their deposits, to guard against banks taking excessive risk in pursuit of profits, to ensure that customers are treated fairly, to deal with

bank failure, as and when it happens, in an orderly manner to avoid disrupting the financial system and reduce the risk of having to use public funds again to bail out failing banks. What happened during the GFC is a very powerful reminder that excessive risk taking in pursuit of short term profits in modern day banking and finance can and did pose a serious threat to the economic well-being and stability of society as a whole, even in the most advanced economies. The GFC has also undermined the belief that banks can look after themselves in efficient markets and that "de-regulation" and "light touch supervision" must be good as they promote financial innovation and diversity. As a result of these bitter lessons, a series of profound reforms championed by the G20 and the Financial Stability Board, of which the HKMA is a member, have been introduced to make the banking and financial system much more resilient to shocks. An informed banker will tell you that banks nowadays have to comply with a very long list of stringent standards in capital, liquidity, leverage, margining, risk management, derivative trading and reporting, etc. At the same time, there are new and strong measures designed to address misconduct risks, ranging from anti-money laundering and counter terrorist financing, front-running, insider trading, mis-selling of financial products, etc.

13. For those bankers who feel disappointed tonight because they cherish the hope that they would learn some clever tricks to get rid of bank supervisors, I owe them an apology. However, the consolation is that, in my view, banking supervision is not an "all or nothing" game. While it is true that the kind of "cozy" or "light touch" supervision that was prevalent before the GFC is now out of the question, there is still a great deal of space in how we calibrate the "intensity" or "intrusiveness" of banking supervision in order for the process to be effective while not creating an undue burden on banks. At the HKMA, we have just introduced an initiative called "Balanced and Responsive Supervision". It involves a mechanism to regularly review with banks possible execution issues arising from the supervisory processes, as well as to collect ideas for streamlining supervisory practices and requirements. Through better and ongoing communication with the industry, we should be able to achieve a more optimal and sustainable supervisory outcome in the longer run.

14. I would also argue that banking supervision is not the only, and should not become the most important, means in protecting the interests of bank customers. It is my strong belief that regulation and supervision are most effective in prescribing what constitutes unacceptable behaviours or outcomes, e.g. minimum standards for capital and liquidity ratios, prohibition of unacceptable market behaviours such as insider dealing and rigging of interest rate or FX benchmarks, no mis-selling of financial products, etc. However, supervision is much less effective or appropriate in setting good corporate culture, values and ethical standards of a financial firm. No amount of external supervision or policing can instill and sustain the right culture and ethics of a bank. Culture and ethical standards must be from top-down, owned by the Board and filter down to the senior management and then to all levels of the firm. A bank and its staff must internalise good culture and values in such a way that they behave properly not because they are afraid of being caught and punished by the supervisors but because they think it is unethical to do otherwise.

15. But I am not so naive as to believe that good corporate culture alone is sufficient to ensure proper behaviour amongst all the staff. Good corporate culture and ethics must also be underpinned by the appropriate incentive or compensation system. A compensation system in which bonuses or promotion are determined by short term financial performance is a recipe for disaster. The unfortunate episode of the mis-selling of Payment Protection Insurance (PPI) products in the UK is a clear example. Banks involved in selling those PPI products have, between 2011 and May 2017, reached settlements with millions of affected customers totaling 27 billion pounds, and three of the largest banks involved have been fined by the UK authorities a total of 117 million pounds. There are also many instances in which bad outcomes ensued because the firms had put in place wrongly designed incentive systems to reward staff for new customers or businesses secured. According to a report by Boston Consulting Group, between 2009 and 2016, a total of about US$321 billion of financial penalties have been levied on banks, which is a clear demonstration of the

seriousness of misdeeds and misconduct of financial firms.

16. While talking about fines levied against financial firms, there is an interesting argument, by Professor Charles Goodhart of London School of Economics and Political Science, that imposing hefty fines on banks is actually not a good way of dealing with misbehaviour. By the way, for those of you who are not familiar with Professor Goodhart, he is a renowned British economist with an economic law named after him, the "Goodhart's Law". He had had special ties with Hong Kong, as he served on the Exchange Fund Advisory Committee of the HKMA in the 1990's. Professor Goodhart was also a long-time advisor to Bank of England, and a member of its Monetary Policy Committee from 1997 to 2000. In his recent article "Has regulatory reform been misdirected?"[1], he points out that it is individuals in banks, rather than banks as institutions, that take decisions and exhibit bad behaviour. Following this logic, he advocates that financial regulation challenges should be addressed through governance reforms, rather than a focus on just capital and liquidity management. Regulators should apply fines to the people responsible at the time of an offence, whether or not they have subsequently left the bank. In Professor Goodhart's words, "*if a bank CEO knew his own family's fortune would remain at risk throughout his subsequent lifetime…, it would do more to improve banking 'culture' than any set of sermons and required oaths of good behaviour.*" Harsh as it may seem, I do see considerable merit in his argument as that would help tackle the root cause of problems, i.e. the lack of accountability for individuals incentivised by short-term objectives. However, it would take a drastic shift in regulatory philosophy and changes to the fundamental fabrics of existing supervisory regimes if we want to focus more on individuals rather than the firms. But to achieve to a large extent what Professor Goodhart proposes, I believe bank regulators could attempt to require banks to focus more on governance, culture and ethics.
17. If a bank is willing and able to own good corporate culture and governance with the appropriate incentive system to induce proper behaviour, then I, as the supervisor, would be very willing to take a step back and adopt a much less "intrusive" mode of supervision. My colleagues in HKMA can keep more of a distance from a bank if they have confidence that the bank and its staff would not behave improperly, not because of constant and intensive external policing but because it would be against their core values and culture to harm the interests of their customers or of the bank through their own misconduct.
18. Ladies and gentlemen, I truly mean what I say. This is why in the last few years the HKMA has been telling banks that they need to cultivate the right culture and values. Moreover, we have instituted a new programme to engage and equip the Independent Non-Executive Directors (INEDs) of banks so they can become more effective in providing the necessary checks and balance on the management. We have also required banks to improve their corporate governance by setting up a Board level committee, chaired by an INED, to oversee corporate culture and to ensure that their compensation arrangements are aligned with the culture and values of the bank. These efforts are ongoing and I am afraid that it is not a mission that can be accomplished overnight. So for the time being, there is still a need for supervisors to be around and so you don't really have to worry that I will be out of a job any time soon.
19. Again, my apologies to those of you who have been attracted to this dinner because of the title and did not get too much joy from what I have said. But don't lose hope yet, as some of you may still be able to find or invent a time machine that can turn the clock back to the "good old days". I am sure that bankers in Hong Kong would be very willing to pay a high price for such machine.
20. Thank you very much.

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[1] Charles Goodhart, (2017) "Has regulatory reform been misdirected?", Journal of Financial Regulation and Compliance, Vol. 25 Issue: 3, pp.236–240.