Norman T L Chan: Hong Kong as a risk management hub

Welcoming remarks and keynote speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the Treasury Markets Summit 2019, Hong Kong, 16 September 2019.

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Ladies and gentlemen,

1. About 15 years ago, a senior banker suggested to me that, in order to further promote Hong Kong's position as an international financial centre (IFC), we should turn Hong Kong into a "risk management hub" in Asia. However, he did not elaborate further at the time on exactly what he meant and how this could be achieved. To be honest, it was not clear to me then what this risk management hub idea was all about.
2. Now looking back, I realise that, even without us consciously pursuing the idea as a policy objective, Hong Kong has already made major accomplishment as the "risk management hub" in Asia. Let me explain.

Prerequisites for a Risk Management Hub

3. Clearly an important pre-condition for a risk management hub is to have money or capital flowing through Hong Kong. In this context, it is important to distinguish genuine financial flows from those that are not. Many of you may recall that, in the 1990s and prior to the Asian Financial Crisis, many Japanese (regional) banks used Hong Kong to conduct the so-called euro yen businesses, through which the banks would book in Hong Kong their yen loans to borrowers in Japan, presumably to benefit from more favorable tax treatment. While this kind of booking businesses may inflate the size of Hong Kong's banking system in terms of total assets, it does not, as we have learnt from the experience of the euro yen booking in the 1990s, bring about much real benefits to Hong Kong in terms of job creation or enhancement of the credit underwriting skills of the bank practitioners. The lending institutions did not perform any meaningful risk management functions in booking these euro yen businesses. As we all know, the euro yen business in Hong Kong, driven by tax reasons, faded away right after the Asian Financial Crisis.
4. That is why the HKMA has made it clear in the past 10 years that we do not welcome banks moving "pure" booking business to Hong Kong. Our position is that, in booking any loans or other assets in Hong Kong, the banks must demonstrate that they have the necessary capability and control process to prudently manage the risks of these assets, both at origination and on an ongoing basis. Then there is still the basic question: how do we attract financial flows to Hong Kong instead of to other financial centres? There is a bit of chicken and egg problem here. Unless restrained by capital controls, money is highly agile and risk sensitive and will migrate to centres that offer the greatest efficiency and safety. In other words, money tends to move through centres that provide a high standard of risk management. By handling more financial flows, a centre will be able to further improve and innovate on its risk management capability. The process is interactive and there would be a clustering effect once a centre has established the leading position in risk management and client servicing.
5. Here I should mention several important developments in the last decade that are highly relevant and instrumental to Hong Kong's rise to become the risk management hub in Asia.

Internationalisation of Renminbi (RMB)

6. From 2009 onwards, Hong Kong has rapidly developed into the biggest offshore hub for RMB businesses in the world. Hong Kong is the source of around 50% of the global offshore

RMB liquidity. On average, Hong Kong's RMB Real Time Gross Settlement system clears and settles over RMB1 trillion a day. Moreover, over 70% of the global RMB SWIFT settlement goes through Hong Kong. All these figures suggest that Hong Kong is already the largest centre for RMB loans, Dim Sum bond issuance and RMB-related products and financial derivatives. The availability of a wide range of banking products, investment and hedging instruments in Hong Kong has made us the undoubted leader in risk management in the offshore RMB market.

Stock Connect

7. The launch of the Hong Kong-Shanghai Stock Connect in 2014, followed by the Hong Kong-Shenzhen Stock Connect in 2016, has opened up the most important part of the Mainland capital market to the world's investors through Hong Kong. The northbound Stock Connect has presented a huge opportunity for Hong Kong to develop risk management capability for understanding of the risks and the pricing of such risks for offshore investors interested in the A share markets. Apart from helping to channel foreign investments into the Mainland market, the Stock Connect has also contributed to the inclusion of bigger weights of A shares in the global stock market indices such as the MSCI.

Asian Equity Derivatives Hub

8. Another recent trend that is relevant is that several international financial firms have decided or are planning to relocate their Asian equities derivatives booking hubs from Europe to Asia. This is very logical as the underlying securities and clients are based in Asia. The HKMA welcomes these moves and stands ready to facilitate such moves, on the condition that the booking business must be accompanied by the necessary risk management functions. Again, this will enhance Hong Kong's position as the risk management hub for Asian equities and derivatives, particularly Mainland related stocks.

Bond Connect

9. By the same token, the launch of the northbound Bond Connect in 2017 has opened another window of opportunity for Hong Kong to enhance its risk management functions for offshore investors wishing to invest in the Mainland bond market. It is still early days yet, but I am confident that Bond Connect offers attraction to those investors who prefer using a nominee holding structure through the Central Moneymarkets Unit of the HKMA. Other value-add services for these bond investors would likely be launched in the months ahead.

Mainland-Related Lending

10. The bread and butter of banks are of course their lending businesses. There is no point in collecting deposits from customers if the bank cannot find useful and hopefully profitable outlet for these funds. With the rapid development of the Mainland economy and the deepening of the Reform and Opening Programme, Hong Kong has become the most important financial intermediation hub for investments into and out of Mainland. The HKMA has been collecting statistics under the category of "Mainland-related lending" by banks in Hong Kong. This category includes lending to Hong Kong and foreign corporates investing in the Mainland and to Mainland corporates, mostly large state–owned enterprises. As Hong Kong is becoming an important source of funds for foreign direct investments into the Mainland and overseas direct investments from the Mainland to overseas markets, the size of Mainland-related lending has grown from a very small amount in 2009 to HK$4.6 trillion now, which accounts for around 45% of the total bank loans in Hong Kong. This is a very significant component of our banking system and is of critical importance to the profitability as well as soundness of our banks. So clearly it is crucial that, in growing this lending business, banks must maintain a high standard of risk management in underwriting these

loans. The credit risk capability, both at the point of origination in terms of know-your-customer (KYC) and customer due diligence and for ongoing monitoring, must be enhanced to cater for the rapid growth of this new line of business. Naturally the HKMA has accorded high priority in our ongoing supervision of banks to ensure that the underwriting standards are upheld all the time. I am pleased to report that the non-performing loan (NPL) ratio, which is a key indicator to assess the credit quality of the Mainland-related lending, has remained at a healthy level of around 0.7%, which is just slightly above the overall NPL ratio of 0.56% for all bank loans.

Wealth Management

11. Given the rapid growth and accumulation of wealth in Hong Kong and the Mainland, there is a strong demand for wealth management services. The asset-under-management of private banking in Hong Kong now amounts to roughly US$1 trillion. Again, risk management is the key to the sustainable development of the private banking industry. There are two key aspects of risk management in the private wealth business. First, the banks must conduct proper KYC processes, especially on the source of funds and ongoing monitoring of suspicious fund flows for anti-money laundering / counter-terrorist financing purposes. Second, the private banks must understand the risk appetite/tolerance level of their clients on the one hand and conduct proper product due diligence before marketing them to clients. If Hong Kong wishes to remain the preferred centre for private wealth management, we must strive to strike the right balance between the need to accord appropriate investor protection and allow the banks to provide user-friendly and efficient services to clients. To succeed in this endeavour, the regulators must work in close collaboration with the industry to continue adapting the rules and practices to cater for the evolving demands of the customers and the rapidly changing financial markets. There is no magic quick fix available, and I hope that the stakeholders would agree to adopt a truly risk-based approach. What it means is that the regulators should articulate the risks or problems that they seek to address while the industry should consider how proper risk management could be achieved without over-interpreting the regulations or imposing rigid processes that drive away customers.

Soft Power

12. At the end of the day, any premier IFC must possess superior soft power if it wishes to sustain such position. Soft power is the sum of a wide range of tangible market infrastructure and intangible strengths. While there must be a robust but market-friendly regulatory regime, we need to have a high degree of professionalism amongst the industry practitioners. Fully cognizant of this principle, the HKMA has in the last decade or so launched many soft power enhancement schemes for the banking industry. One of the enhancement initiatives was the setup of the Treasury Markets Association (TMA) in 2005 through the merger of the Treasury Markets Forum and ACI-The Financial Markets Association of Hong Kong. I floated this idea in 2004 and received full support from the industry practitioners. The TMA was set up with the clear mission to enhance the professionalism of industry practitioners and the competitiveness of the treasury markets in Hong Kong. In addition to offering high-quality training programmes, the TMA has recently joined the Global Foreign Exchange Committee as Hong Kong’s representative and played an active role in developing the FX Global Code on good practices in the FX market.
13. In pursuing soft power enhancement, the HKMA has worked closely with the TMA and also the Hong Kong Institute of Bankers in launching modules of the Enhanced Competence Framework (ECF). We will launch another two more ECF modules on operational risk management and compliance shortly. You are of course aware of the launch of the Academy of Finance by the HKMA in June this year. The Academy has two core missions: financial leadership development and monetary and financial research, including applied

research. The Academy is a new venture and we will work closely with all the stakeholders, including the TMA, to upgrade the soft power of Hong Kong as the premier financial centre in Asia.

14. Ladies and gentlemen, international competition between financial centres is very fierce and will likely to be even more so going forward. Business can and will flow quickly away from Hong Kong if we somehow fail to upgrade the standards of our financial services. In conclusion, let me say that to become "an international risk management hub" is synonymous to becoming "an international financial centre". No IFC can exist or compete if it is not also a risk management hub in delivering the various forms of financial intermediation, including the money, banking, capital, asset management and insurance markets. I don't really think there is such creature as a "pure" risk management hub as opposed to an IFC. In other words, it is hard to contemplate how a place can turn into a risk management hub if money and capital do not flow through it.

15. Finally, let me share with you a couple of takeaways on what I have said today on how Hong Kong can enhance its competitive position and leadership in risk management:

    (a) Financial institutions must not put their own interests above those of their clients. The professionalism and integrity of the financial institutions and the practitioners are crucial in earning the confidence and trust of their customers. Without such trust, the prospects of Hong Kong as an IFC are doomed.

    (b) Financial firms should avoid getting carried away in boom times. Motivated by big and growing profits and bonuses, many financial firms are minded to undertake very rapid expansion without building the necessary risk management capability. Excessive risk taking or overly aggressive expansion usually lead to rather unhappy endings, as the financial history is littered with so many such failure cases.

    (c) As for the regulators, they should stay true to the risk-based approach with the right sense of proportionality and should adopt an open mind on how the risk can be addressed. The regulators should stand ready to discuss with the industry to see if there can be alternative ways of dealing with the risks identified. The industry is always closer to the markets and the clients they serve and should therefore have a better sense of how to get things done in a way that would cause less disruption or inconvenience.

    (d) The regulators must not fall into the trap of complacency, and should constantly stay on alert and maintain a sense of unease even in good or peaceful times. Banking and financial crises can never be avoided all together, but we can at least build sufficient buffers to lower their chance of occurrence or when they happen, the damage can be reduced or contained.

    (e) The industry should stand ready to challenge the regulators if the severity of the risk is overstated or there are better alternatives than what has been put on the table. On the other hand, the industry must avoid over-interpreting or gold plating the regulators' requirements in such a way that is safe from the compliance point of view but would create bad customer experience without enhancing the underlying risk management outcomes.

16. All in all, the financial industry should seek to collaborate with the regulators, more as partners than as adversaries, in developing risk management framework and practices that are most suited for Hong Kong's circumstances and needs. There is no one-size-fits-all solution for risk management and Hong Kong must find its own path to success by learning from the best practices elsewhere and by striving to upgrade on a continuous basis. Finally, may I wish all of you a fruitful and productive time in today's Treasury Markets Summit! Thank you.