Mr. Yam looks at Asian banking in a regional and global context Address by the Chief Executive of the Hong Kong Monetary Authority, Mr. Joseph C.K. Yam, at the ADB-IIF Forum on Developing Asian Financial Markets held in Fukuoka, Japan, on 10/5/97.

I am pleased to be here this morning to address you on the subject of Asian banking in a regional and global context. I will be speaking particularly about banks in the East Asia region.

The importance of banking stability

2. There is increasing international recognition of the importance of a sound banking system in promoting macroeconomic stability, sustainable economic growth and the efficient intermediation between savings and investment. The last few months have seen a series of initiatives by international financial institutions and groupings to devise principles, standards and strategies for the promotion of financial stability. While these initiatives have been directed principally at emerging markets, they also have application to the more developed markets which have been by no means immune from banking problems in recent years. A number of Asian economies, including Hong Kong, have participated in this work. This is a practical recognition that the setting of international regulatory standards must be a broadly-based process, in keeping with the global nature of today's financial markets.

3. I do not need to belabour the point about the debilitating and disruptive effects which banking problems can have on economic and monetary management. The need to restore the capital of failed banks can impose a heavy fiscal burden. In many cases this has amounted to 10% or more of GDP. Monetary policy may be side-tracked by the need on the part of the authorities when determining interest rates to take account of the possible implications on banking stability and on other, often more political, policy objectives.

4. Furthermore, in nursing weak banks, the main priority for these banks is likely to be to repair the damage to their balance sheets and they may have little appetite for new lending. This leads to the "credit crunch" phenomenon where even good-quality borrowers find it more difficult to obtain loans when banking stability has been undermined. As the Japanese experience has shown, this weakened ability of banks to lend can frustrate the authorities' efforts to get the economy moving again after a downturn.

The role of bank borrowing in funding growth

5. This possible impairment of the intermediation role of banks would be a particular cause for concern in Asia where the banks have played a substantial role in financing economic growth. By the standards of developed economies, this role for banks in Asia is significantly more important than that of other channels of financial intermediation. This partly reflects the lack of highly developed bond markets in the region, which in itself is also a reflection of the predominance of the banks.

6. Let me digress a little in this connection. There is clear consensus on the need for encouraging the development of bond markets in Asia. Like a number of other central banks, we in the Hong Kong Monetary Authority have taken a number of initiatives in this direction in Hong Kong in recent years. We now have a fairly liquid bond market with a sophisticated but user-friendly market infrastructure. We have also taken initiatives in the regional dimension to promote the networking of Asian bond markets through encouraging bilateral linkages of debt clearing systems.

7. It is hoped that these efforts could help the expansion of the role of the Asian bond markets and hence facilitate more effective financial intermediation in the domestic, regional and global context. The region's investment needs over the next decades are huge. The World Bank has estimated that private gross domestic fixed investment will amount to a total of US$ 5 trillion over the ten years to the year 2004, a large part of it associated with infrastructural development[1]. The share of bonds in financing these needs is projected to grow from only 9% to 26% by 2004.

8. I hope this can be realized for this would enable the banks' role in Asia to consolidate into more prudent proportions at least in the eyes of the regulators. It would help to achieve a more diversified and therefore a more stable framework for financial intermediation. Indeed, on the World Bank's projections, the share of bank borrowing is expected to decline commensurately from 40% to 30% over the same period.

9. But turning back to banking in the region, even if this scenario is realized, and there must of course be much uncertainty on this, the amount that banks would be called upon to finance would remain very substantial in absolute terms. For the foreseeable future, therefore, the banks will still be playing a key role in mobilizing savings in the region and channeling this into investment. And this makes it even more important that banking systems in the region remain healthy. Of course, foreign banks will play an important financing role, in particular those based in Hong Kong which is the major centre in the region for the arranging of syndicated loans. But within most of the banking systems of the region it is the local banks which predominate in terms of share of assets.

The position of Asian banks

10. So let us take a look at the current position of the Asian banks. It is in fact very difficult to generalize because the banking systems in the region are not homogeneous. But certainly if we look at what the World Bank has called the eight "high performing Asian countries", the Asian banks have been at the heart of the Asian success story[2]. This is partly due to the emphasis laid by governments on trying to ensure the stability of banks, through prudential supervision and other means, to encourage confidence among savers. While there have been periods of financial distress in individual banking systems in the region in past years, such incidents have generally been fewer and less severe than in other emerging markets. Asian banks were able to meet the Basle Committee's recommended 8% minimum capital adequacy ratio with comparative ease. Moreover, despite the fact that barriers to entry in some economies have protected the Asian banks from the full forces of competition, they have managed to survive on lower interest margins and achieve a higher level of operating efficiency than their counterparts in other regions.

11. The Asian banks have of course benefited from operating in the fastest growing region in the world, and one where the macroeconomic environment in terms of GDP growth, inflation and exchange rates has been much less volatile than in, say, Latin America[3]. More recently, however, growth in some economies in the region has slowed. I hope that this will turn out to be a cyclical, rather than a structural, phenomenon. At any rate, the economic environment is currently somewhat less benign, and this has brought into sharper focus some of the challenges which banks in the region are now facing.

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[1] The Emerging Asian Bond Market, World Bank 1995.
[2] The East Asian Miracle, World Bank 1993.
[3] BIS Annual Report 1996.

The challenges faced by Asian banks

12. Let me attempt to describe what these challenges are. There are obviously many, but I will focus on four main categories, namely:

global integration of financial markets;
financial liberalization and increased competition;
maintenance of asset quality;
innovation and technological change.

Global integration of financial markets

13. The trend of global integration of financial markets is clear. The increase in capital flows into the emerging markets has been one of the dominant features of the 1990s. During the period 1990-95, inflows into the Asian economies amounted to US$ 360 billion[4]. The effect of this has been to bind individual economies even more tightly into the global market place. While this has brought major benefits to the recipient economies in terms of encouraging increased investment and development of capital markets, it has also left them more exposed to external shocks and loss of confidence. The macroeconomic instability caused by large-scale inflows and by their subsequent reversal will clearly have an adverse impact on the banking system. The risk of this is less if inflows take the form of more stable longer-term direct investment. To a significant extent, this has been the case for the Asian economies. But for some economies short-term inflows have been relatively large, and there are doubts about their sustainability.

14. Inflows of hot money also create more direct problems for the banks as well as affecting the macroeconomic environment. In particular, they will tend to add to the liquidity of the banking system and encourage expansion of lending. Rapid growth in lending such as we have witnessed in a number of Asian economies can be a warning sign because it tends to be associated with a lowering of credit standards as banks lend to customers whose creditworthiness is more marginal. Moreover, much of this lending may find its way into the property market and stock market, adding to the upward pressure on asset prices arising from the inflows themselves. Reversal of inflows or a slowing down of the economy, as in Thailand, thus exposes the banks to both credit risk and market risk as asset prices fall.

15. With large capital inflows, banks may also find themselves incurring substantial net foreign currency liabilities. They will thus additionally be exposed to substantial foreign exchange risks if the domestic currency weakens.

Financial liberalization and increased competition

16. Associated with, and leading to the global integration of financial markets is the trend of financial liberalization and increased competition. The trend has increasingly freed banks from direct controls on interest rates and on their permitted business activities in many Asian economies. We can see this in banking systems as far apart as those in China where the process of commercialization of the banking sector is now underway and in Japan which is planning its own version of Big Bang in the next few years. This new freedom can bring increased opportunities for the banks and can be a powerful incentive to increased efficiency in

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4 International Capital Markets, IMF 1996.

the banking sector. But it can also bring new risks if the banks do not use their new freedoms well - in particular if they do not develop the credit skills and risk management techniques which are required in the kind of lending boom that may develop after deregulation.

17. The pressures on the existing banks is increased if liberalization also allows new entrants into the market. Competition in some Asian economies has already intensified as a result of the granting of new domestic banking licences and more liberal policies on the admission of foreign banks. The need to meet WTO obligations will give further impetus to this process. But while the long-term impact on the efficiency of the banking system may be favourable, the short-term impact can be to narrow interest margins and erode franchise value. This can drive the local banks to take on more high risk business.

18. I should stress, however, that the answer to this dilemma is not to stop or reverse the process of deregulation. There are examples around the region of bad debt problems embedded in banks which are either owned by the government or, even if they are privately owned, have been granting policy loans on behalf of the government. Such banks should be encouraged to develop their own credit judgment in order to play an effective role in the process of credit allocation in the economy. So liberalization is the right approach. It must, however, be properly handled if the problems of the banking sector are not to intensify during the transition to a more commercialized system. In particular, the supervisory framework should be strengthened in advance of liberalization.

Maintenance of asset quality

19. Let me turn to the challenge of the maintenance of asset quality. This applies across a wide spectrum in Asia from banks that are emerging from tight state control to those that operate on a fully commercial basis. A particular focus of concern, as I have already indicated, is that banks in some economies may have lent too freely to booming property sectors which are now suffering from over-supply. It remains to be seen whether the fears will be realized. A number of supervisory authorities around the region have tried to take measures to limit their banks’ exposure to the property sector. This is a sensible move, though the difficulties of enforcing limits should not be underestimated.

20. However, property lending is not the only problem area. In Korea, for example, the slowdown in export demand in industries such as semiconductors and in economic growth has exposed fragility in those companies which have over-extended themselves by taking on too much debt. Banks which have become used to years of buoyant economic growth may be ill-equipped to deal with these problems. There is also a perception that in some Asian economies the accounting rules and loan classification systems are not telling the whole story about the scale of the bad debt problem. Lack of transparency can result in delay in tackling the problem and erode public confidence in the soundness of the banking system.

Innovation and technological change

21. Asset quality is thus one main issue which Asian banks have to tackle. But one of the results of globalization is that even banks in relatively undeveloped banking systems are now having to cope with the challenge of product innovation and new technology. This can accelerate the transformation of such banking systems: modern computer systems can be installed and banks can make the jump straight from cash to smart cards. The downside is that banks may have less time to build up the skills properly to use the new technology and the new products which their counterparts in developed banking systems have taken many years to

acquire. Derivatives are a case in point. While the derivatives markets in the region other than Tokyo are still quite small, these products are certainly being sold to, and in some cases being traded by, local banks in the region; and a number of them have suffered losses as a result.

22. Looking further ahead, the opportunities provided by new technology will pose important strategic challenges for the banks. To what extent, for example, should they invest in new delivery mechanisms such as telephone or internet banking? These channels offer the potential to bring down dramatically the cost of transactions compared with the traditional branch network. Obviously this will depend on the availability of telephone lines and personal computers. There is also the crucial issue of public acceptance of the new technology. Such issues mean that a wholesale shift to electronic banking will not happen overnight. However, banks would be unwise to ignore the longer-term opportunities as well as the threats. If the new delivery mechanisms do develop, this will result in increased competition including from new entrants as barriers to entry are reduced. The potential for foreign banks to provide cross-border banking services, such as private banking, through the internet will also increase. In other words, foreign banks may no longer need to be physically located in a particular country in order to tap its market. This will pose interesting challenges to regulators as well as the banks.

The response to the challenges

23. What then should be the response of banks to these challenges? Despite the diversity of banking systems around the Asian region, I think it is possible to draw some broad conclusions.

24. The key point is, I think, for banks to realize that, even if they are state-owned, they are ultimately responsible for their own destiny. The Commercial Banking Law of the People’s Republic of China sums up the point well in its Article 4. To quote an English translation:

“A commercial bank operates independently, takes up responsibility for all risks that it may encounter and for its own profits and losses it may bear, and exercises self-regulating mechanisms on the management principle of economic efficiency, safety and liquidity.”

25. What this means is that the board of directors and senior management of banks have the main responsibility to ensure that effective systems of internal governance are in place to plan for the future, to identify and manage the risks to which they are exposed and to control the operations of the bank on a day-to-day basis. I believe that this point is appreciated around the region - from our contacts with fellow supervisors, we know that in many banking systems there is a heightened awareness of the importance of sound risk management. But the difficulty is in turning this into actual changes in behaviour, which requires great efforts to be devoted to the training of staff, for example in credit skills, as well as more fundamental changes in culture in some banks.

26. This change in culture may require some banks to wean themselves off property lending which is sometimes seen as an easy option, given that it is based on collateral and on expectations of ever-rising property values. This can prove to be a fallacy, as the Japanese example shows only too well. Banks need therefore to develop a broadly-based lending business where the borrower’s ability to repay is the first consideration and collateral is there as the second line of defence. More generally, it will usually be sensible for banks to try to diversify their business into areas which offer the ability to earn fee income and thus reduce their

dependence on the interest-rate cycle. I hasten to add, however, that this should only be done if the necessary systems and controls are in place.

27. In some cases, the changes required by banks to meet the challenges of a more competitive environment may be too great for them to meet on their own. Mergers may be required to produce fewer and stronger banks, and I am aware that in some countries this process is being given official encouragement.

28. This points to the fact that the regulators also have their part to play in encouraging the process of change in banks. While the prime responsibility for prudent management of banks does rest with the banks themselves, the authorities do have a role to play in ensuring that effective systems of supervision are in place. These should include incentives to discourage the excessive taking of risk by banks, including that owners should be required to have a significant amount of capital at risk and to bear the losses should a bank fail. The infrastructure of business laws, accounting rules and public disclosure requirements must also be conducive to prudent management and market transparency. Payments systems must be enhanced to reduce the risk of systemic instability.

29. These are all areas where progress is being made throughout the region. I detect few signs of complacency among my fellow regulators or of a tendency to rest on past successes. We all recognize that banking stability is something that requires constant attention to keep up with changes in the economic environment and with market developments. There is also, I believe, a strong appreciation of the need to work together to promote stability. This is shown by the regional initiatives, through groupings such as EMEAP, to promote cooperation in supervision and in other financial sector issues. International institutions such as the Asian Development Bank also have an important role to play in encouraging financial market development. I am sure that this Forum will be helpful in addressing some of the issues involved, and I am grateful to the ADB and the IIF for organizing the event and for giving me the opportunity to speak.