

SLIDE ONE: REVIEW OF THE HONG KONG MONETARY
AUTHORITY'S WORK ON BANKING STABILITY (TITLE PAGE)

SLIDE TWO: OBJECTIVE OF THE REVIEW

I am grateful to have the opportunity to present the main findings of my review to the panel.

I was commissioned by the HKMA in December of 2008 to carry out a review of how it can best discharge its functions in promoting the general stability of the banking system under the Banking Ordinance, taking into account recent and likely future developments in Hong Kong's banking system and the changing nature of the risks facing the system.

The main focus was on the HKMA's regulatory and supervisory functions, although my review also covered certain other issues such as depositor protection which are relevant to the stability objective.

The review was conducted before the full effects of the sub-prime crisis had made themselves felt from mid-September 2008 onwards following the collapse of Lehman Brothers. However, I hope that the recommendations in my report will help the HKMA in formulating its regulatory and supervisory response to the crisis.

SLIDE THREE

The review was conducted through reading external publications and internal documents of the HKMA and material published by other regulators. I also studied case files showing how the HKMA's supervisory process had been applied in practice to individual authorized institutions and discussed the issues arising from this study and other relevant matters with HKMA staff at various levels within the organisation.

Interviews were also conducted with various external stakeholders of the HKMA including individual AIs, accounting firms, rating agencies, credit analysts, the Consumer Council, academics and members of the Exchange Fund Advisory Committee.

In addition, written contributions were received from the Hong Kong Association of Banks and the DTC Association.

SLIDE FOUR; MAIN TRENDS AND ISSUES FOR THE BANKING SYSTEM

My report identifies a number of trends and issues which will affect the development of the Hong Kong banking system over the coming

years. I want to highlight three of these in this presentation.

The most immediately pressing issue is the need to deal with the impact of the global financial crisis which, as already mentioned, has intensified and broadened since my review was conducted.

The Hong Kong banking system has the advantage that it has gone into the crisis in a robust condition and the property market in Hong Kong has not displayed the symptoms of extreme overheating that has characterised those in the US and Europe. Nonetheless the global nature of the crisis means that Hong Kong and the Asian region more generally will not be unscathed, and containing the impact of the crisis on the banks' capital and liquidity must be the HKMA's first priority.

It will also be necessary for the HKMA and other regulators around the world to absorb the regulatory and supervisory lessons from the crisis to reduce the chances of a repetition. This is likely to dominate the HKMA's agenda over the next few years. I will mention some of the relevant lessons later in this presentation.

More fundamental, perhaps, is the issue of how to manage the growing economic integration with the Mainland. This will create new business opportunities for Hong Kong banks which set up operations on the Mainland, but will also bring increased risk. This is because some of the banks have ambitious expansion plans, which will increase the need for their Mainland operations to be closely

monitored and controlled. It was noted by a number of the people I talked to in the course of my review that the business environment on the Mainland is significantly different from that in Hong Kong and it cannot be assumed that the risk management systems that work here will work there.

This will pose significant challenges for both the banks and the HKMA. The HKMA will need to have a full understanding of the type and volume of business that Hong Kong banks are pursuing on the Mainland and the risk controls in place. Effective supervisory cooperation with the China Banking Regulatory Commission will be essential.

Effective regulatory cooperation within Hong Kong is also essential, in particular between the HKMA and the SFC. The need for this has increased due to the continuing erosion of financial boundaries. In particular due to securitisation and the growth of derivatives we have seen a narrowing of the boundaries between what is a banking product and a securities product.

My report suggests that the relationship between the HKMA and the SFC needs to be reviewed and their respective roles and approach needs to be clarified. I understand that such a review is being conducted in the wake of the Lehmans minibond affair. It may also be necessary to address the issue of whether there should be a more fundamental change in the regulatory structure in Hong Kong through the introduction of some form of unified regulatory body. My report

did not see this as an immediate priority, but did suggest that the matter should be kept under continuing review.

SLIDE FIVE: REVIEW AND RECOMMENDATIONS ON THE HKMA'S REGULATORY AND SUPERVISORY FUNCTIONS

- Governance issues relevant to banking stability.
- The MA's functions and powers in the BO.
- The supervisory framework.
- The policy framework.
- Authorization.
- Safety net arrangements.

The recommendations in my report cover the above areas and I will briefly summarise the main points under these headings.

SLIDE SIX: GOVERNANCE ISSUES RELEVANT TO BANKING STABILITY

My report deals with those governance issues that relate specifically to the HKMA's role in banking stability. In this context, I have suggested that:

- The role of the existing Banking Advisory Committee and Deposit-taking Advisory Committee should be strengthened. Specifically,

they should be merged into one advisory committee whose role would be to advise the Monetary Authority on matters of policy in relation to his regulatory functions.

- The current right of appeal to the Chief Executive in Council in the Banking Ordinance should be replaced with a right of appeal to an independent appeals tribunal.
- The HKMA relies on the Hong Kong Association of Banks to assist in the development of policy, provide advice and represent the views of the banking industry. There were some doubts among interviewees as to whether the Association was fulfilling its full potential. I have suggested therefore that it might be appropriate for the Association to conduct a review of its role, functions and organisational structure, with particular reference to whether it should appoint a professional chief executive and a permanent secretariat.
- Finally I have recommended that the HKMA should refine its business plan to make it more specific and make it easier to monitor implementation of its various initiatives and to assess the resource implications.

SLIDE SEVEN: THE MA'S FUNCTIONS AND POWERS UNDER THE BANKING ORDINANCE

I have considered the question of whether the MA's functions and powers in the Banking Ordinance are still appropriate.

Perhaps the main issue is the extent to which the HKMA should be

involved in consumer protection and whether the MA should be given a specific statutory responsibility for this.

One of the lessons from the handling of the supervision of Northern Rock in the UK is the need for supervisors to strike the right balance between prudential and consumer issues. An undue focus on consumer issues can lead to distraction from the main business of trying to reduce the risk of bank failure. Therefore I have not recommended that the MA be given a specific statutory responsibility for consumer protection, as has been suggested by the Consumer Council. Nor do I believe that the HKMA should be involved in the resolution of individual disputes between banks and their customers. That is the role of a financial services ombudsman and the time may have come for Hong Kong to think about setting up such a body.

I do however believe that it is legitimate and appropriate for the HKMA to remain involved in those consumer protection issues that fall within its current statutory remit to promote the general stability and effective working of the banking system. That would include dealing with allegations of misselling since this can affect confidence in the banks.

I have suggested that the HKMA should consider issuing a formal guideline under section 7(3) of the Banking Ordinance setting out definitively how it sees its role in consumer protection. And, to reinforce this role, and to deal also with non-consumer issues, it may be appropriate for the MA's powers of sanction and investigation

under the Banking Ordinance to be strengthened.

Finally, recent events in the US and Europe have shown the need for regulators to have effective means of intervention to deal with failing banks. There is no indication that the situation in Hong Kong is as serious as that in the West. Nonetheless, the HKMA should review the actions that regulators have had to take elsewhere to deal with failing banks to see what lessons can be learned, particularly in relation to any necessary enhancements to Part X of the Banking Ordinance.

SLIDE EIGHT: THE SUPERVISORY FRAMEWORK

The HKMA's supervisory framework is generally well regarded and has shown itself to be effective in dealing with past crises.

However, the current global crisis has pointed to the need for supervisors generally to enhance their risk assessment to ensure that they have a better appreciation of the risks that banks are running and focus their attention on the areas of highest risk. In this connection, it is important that the supervisory process does not impose an excessive burden on both banks and supervisory staff with the result that they are distracted from their main responsibilities and tasks.

In this context, my report presents a number of recommendations on how the HKMA's process of offsite review and onsite examination can be streamlined and rationalised. The aim is to produce a logical and efficient sequence of actions by the HKMA leading up to onsite examinations which make the best use of resources and focus on the main risk areas in individual authorized institutions. To achieve this objective the HKMA needs to try to reduce its turnover of supervisory staff.

The supervision of individual authorized institutions needs to be supplemented by enhanced macro-prudential surveillance that focusses on system-wide risks and attempts to detect early warning signs of impending shocks and stress. A key issue in this respect is improving information flows and communication within the HKMA and making best use of the work of its Research Department on macro developments and potential systemic vulnerabilities. The HKMA can also exploit its market contacts to pick up market developments and trends, including which innovative financial products are currently circulating in the market.

SLIDE NINE: THE POLICY FRAMEWORK

The HKMA has a comprehensive policy framework, albeit that there are a few gaps, in relation for example to risk management of derivatives that it should aim to fill as soon as this is practicable.

However, as noted earlier the HKMA's main priority will be to develop its policies in the aftermath of the subprime crisis following the recommendations of international bodies such as the Basel Committee on Banking Supervision.

In particular, it will be necessary to review the capital adequacy and liquidity regimes to improve the ability of the banking sector to cope with periods of extreme stress. On capital, the HKMA was one of the early adopters of the Basel II Capital Accord. But this is due to be strengthened by improving the way in which it captures the risk from exposures in banks' trading books and off-balance sheet exposures. Consideration is also being given to how banks can build up additional buffers of capital in good times that can be drawn upon in bad times.

The current crisis has also demonstrated the need for banks to maintain an adequate cushion of liquidity, including through holding a stock of high quality liquid assets which can be guaranteed to deliver liquidity in times of stress. Although the banking sector in Hong Kong maintains high levels of liquid assets, I have nonetheless suggested that the current statutory minimum liquidity ratio needs to be revised to ensure that it is a proper measure of high quality liquidity.

Apart from the content of the policy framework, I have also recommended changes to the way in which the framework is structured to make a clearer distinction between statutory and non-statutory guidelines and between minimum standards and best

practice, and to bring all the various elements of the policy framework within a single regulatory handbook.

SLIDE TEN: AUTHORIZATION

A further aspect of the regulatory framework is the system of authorization of financial institutions that applies. I consider that the criteria for authorisation set out in the Seventh Schedule of the Banking Ordinance remain appropriate but that the current three-tier structure of authorized institutions is more complex than it needs to be, particularly given the decline in the number of restricted licence banks and deposit-taking companies and their minimal share of deposits.

Accordingly, I have recommended that the current three tier-structure should be reduced to two tiers - banks and other "deposit-takers", with the principal dividing line between the two tiers being the ability of banks to conduct banking business and to take retail deposits (for which a suitable definition would be required).

In the light of the current crisis, this is not an immediately pressing issue but should be considered when things have settled down.

SLIDE ELEVEN: SAFETY NET ARRANGEMENTS

The current crisis has led to an increased focus in many banking systems on the appropriate means of protecting depositors. This has led a number of jurisdictions to increase the level of protection provided under deposit insurance schemes.

However, in the current highly stressed conditions, some jurisdictions have thought it appropriate to provide additional protection to deposits which goes beyond the formal limits in the deposit insurance scheme.

This is the situation in Hong Kong where a 100% deposit guarantee has been introduced as a temporary measure. This is due to lapse at the end of 2010, when hopefully market conditions will be back to something approaching normality.

Consideration will have to be given to the deposit arrangements that will apply when the deposit guarantee lapses. In particular, it will need to be decided what level of protection should apply.

The current limit of HK\$100,000 now looks to be quite low, particularly given the increases that have taken place elsewhere, and the report recommends that the consideration should be given to raising the level of protection, particularly if this can be done without increasing the amount of premium paid by the banks.

SLIDE TWELVE: OVERALL ASSESSMENT

The overall conclusion of my review is that “no fundamental deficiencies in the regulatory and supervisory framework or processes have been identified. But a number of enhancements can be made which will provide an even sounder foundation to cope with the challenges ahead.”

SLIDE THIRTEEN: NEXT STEPS

The HKMA has received comments on the recommendations in my report from a number of interested parties and is now considering how to proceed in the light of these comments.

It aims to produce a policy response in the first half of 2009,

I would be grateful for any comments that panel members may have.