Legislative Council Panel on Financial Affairs

Two Measures to Safeguard Banking Stability

Introduction

This paper provides information on the use of the Exchange Fund to guarantee the repayment of all customer deposits held with all Authorized Institutions (AIs) in Hong Kong and the establishment of a Contingent Bank Capital Facility (CBCF) for the purpose of making available additional capital to local banks.

Background

2. The current framework for the maintenance of banking stability - including the risk-based, prudential supervision of banks; the arrangements for the provision of liquidity, both at the systemic and institutional levels; and the safety net in the form of deposit insurance – has ensured that the banking system of Hong Kong is robust. However, the present crisis in international finance, which has created prolonged financial stress, particularly in the United States, has intensified recently. This presents new risks to the banking system and to the stability and integrity of the monetary and financial systems of Hong Kong, being a free and open international financial centre, to the extent that it is prudent to introduce additional arrangements for safeguarding banking stability in Hong Kong. On 14 October 2008, the Financial Secretary announced two such measures.

Deposit Protection

3. Elevated stress in the banking sector in the developed economies; bank failures in a number of jurisdictions; and subsequent actions taken by authorities around the world to enhance deposit protection, raising the possibility of deposit migration to jurisdictions with such arrangements from those without them, have made it necessary to review the level of deposit protection in Hong Kong. While banks in Hong Kong remain sound and robust with an average capital adequacy ratio of above 14%, non-performing loan ratio of less than 1% and liquidity ratio of over 40%, these fundamentals alone might not be adequate in securing depositors'

confidence in banks. As the recent run on a local bank showed, psychology may matter more than fundamentals at times like this. It is therefore advisable to take pre-emptive measures to enhance deposit protection at this turbulent time, which will put us in a better position to forestall problems.

4. The Financial Secretary, after consultation with the Exchange Fund Advisory Committee, has therefore decided to make use of the Exchange Fund to guarantee the repayment of all customer deposits held with all Authorized Institutions (AIs) in Hong Kong, following the principles of the existing Deposit Protection Scheme, but including Restricted-Licence Banks and Deposit-Taking Companies as well as Licensed Banks. The guarantee extends to the end of 2010 and applies to all Hong Kong-dollar and foreign-currency deposits held with AIs in Hong Kong, including those held with Hong Kong branches of overseas institutions.[1] This guarantee will cover the amount of such deposits in excess of that protected under the existing Deposit Protection Scheme.

5. The recent "Review of the Hong Kong Monetary Authority's Work on Banking Stability" included a recommendation that the level of deposit protection provided in Hong Kong and the potential for raising the protection limit (currently $100,000 per depositor per bank) should be reviewed. The Deposit Protection Board has already begun a review and will consult the banking industry and the public in the coming months before making recommendations. Since any change to the deposit protection limit will require amendment of the Deposit Protection Scheme Ordinance, the Legislative Council will be fully involved.

Contingent Bank Capital Facility

6. The capital positions of locally incorporated licensed banks (local banks) in Hong Kong are among the strongest in the world. Their Capital Adequacy Ratios, on the basis of Basel II standards, average about 14%, compared with an international minimum requirement of 8%. However, contagious and ongoing stress in the financial systems of the developed markets, if it were to continue or even

[1] The guarantee covers all protected deposits as defined in the Deposit Protection Scheme Ordinance, Cap. 581, were the Ordinance to apply to all authorized institutions.

intensify, may risk affecting the capital base of banks in other jurisdictions that are currently unaffected, including that of the local banks in Hong Kong, possibly requiring them to raise additional capital at a time when it is difficult to come by. Although this risk is currently remote, the impact of such a scenario, were it to develop, might present considerable risks to banking stability in Hong Kong, to such an extent as to undermine the status of Hong Kong as an international financial centre.

7. It is prudent to pre-empt this scenario from developing, no matter how remote it may be. An effective way of doing so is the establishment of a CBCF for the purpose of making available additional capital (CBCF Capital) to local banks, on request from them and subject to supervisory scrutiny. The CBCF will be in place until the end of 2010, by which time hopefully the ongoing stress in the financial systems of the developed markets will have subsided and conditions in international finance returned to normal. A review will be conducted by the Hong Kong Monetary Authority (HKMA) before the end of 2010 to determine whether the CBCF continues to be necessary. The form and terms of any CBCF Capital will be decided on the basis of individual circumstances, and local banks receiving any such capital will be obliged to accept conditions or restrictions deemed appropriate by the HKMA to safeguard the financial commitment represented by the CBCF.

8. The necessary funds for the injection of CBCF Capital into local banks will be drawn from the Exchange Fund. The Financial Secretary, after consultation with the Exchange Fund Advisory Committee, has given approval to the establishment of the CBCF.

9. These two measures have been introduced in response to exceptional and very serious circumstances brought about by a crisis in international finance. The measures are temporary and time limited, and consistent with efforts being taken globally and in our own region to restore and reinforce confidence in the banking system and stabilise the financial markets. They have not been triggered by problems in Hong Kong, where the banking sector remains strong, but are precautions against a further deterioration in the international situation affecting Hong Kong. The measures are consistent with the statutory purpose of the Exchange Fund to maintain the stability and integrity of the monetary and financial systems of Hong

Kong.

10. In introducing these measures, the Government has taken into account two issues: the possibility of large claims on the Exchange Fund if the deposit guarantee is triggered or locally incorporated banks decide to seek capital injections under the CBCF, and the possibility that the deposit guarantee might lead to moral hazard affecting incentives in the banking sector and banks' management of risk.

11. With regard to the first point, the banking system in Hong Kong remains strong and robust, with capitalisation well above international standards. We therefore do not expect that the new measures would need to be triggered. They are intended as necessary precautions to reinforce confidence at a time of continuing stress in the global financial system. With the Contingent Bank Capital Facility (CBCF), we will be able to make available additional capital to locally incorporated banks should they find it necessary to replenish their capital base, thus providing the assurance to depositors that the banks will remain viable. The possibility of large claims on the Exchange Fund is therefore remote. On the contrary, if we do not take these pre-emptive measures to forestall potential trouble, the possibility of banks running into difficulties could increase, which might result in even larger financial implications for the government in handling the situation in order to maintain monetary and financial stability.

12. With regard to the second point, while the severity of the current crisis in international finance has made moral hazard a secondary consideration for the time being, the deposit guarantee announced on 14 October is temporary and time limited to guard against this possibility. At the end of 2010 deposit protection arrangements in Hong Kong will revert to those under the Deposit Protection Scheme, subject to any changes introduced following the review outlined in paragraph 5. In the meantime, increased supervisory attention by the HKMA under the current risk-based supervisory framework will help to ensure that AIs do not take on excessive risk while relying on the deposit guarantee.

Hong Kong Monetary Authority
17 October 2008