

LEGISLATIVE COUNCIL BRIEF

The Hong Kong Banking Sector Consultancy Study:

Hong Kong Banking into the New Millennium

INTRODUCTION

This paper briefs Members on the findings of the Hong Kong Banking Sector Consultancy Study.

BACKGROUND

Banking Sector Consultancy Study

2. At the beginning of this year, the Hong Kong Monetary Authority (HKMA) commissioned a consultancy study on the future development of the Hong Kong banking sector (the Study). The main objective of the Study was to evaluate the strategic outlook for the banking sector in Hong Kong over the next 5 years and to consider the effectiveness of the HKMA's approach to banking supervision. KPMG and Barents were subsequently appointed as the consultants to carry out the Study which commenced in March 1998.

3. The consultants have now completed the Study and produced a report which contains their findings and recommendations for changes to be made to some of the existing regulatory features as well as steps to advance the HKMA's supervisory regime. The main findings and recommendations of the consultants are contained in the attached Executive Summary. The main points of the Executive Summary are listed below.

THE FINDINGS

The Consultants' Overall Assessment

4. The consultants consider that Hong Kong has a sound, safe and dynamic banking sector. Overall, Hong Kong banks compare favourably with international standards in terms of profitability, efficiency and transparency. The supporting banking sector infrastructure compares favourably by all measures with other countries that were benchmarked. The key success factors of the Hong Kong banking sector include-

- a well developed financial infrastructure;
- a conducive regulatory environment and sound supervisory process (reflecting internationally accepted principles);
- a free and open market;
- a modern and effective legal system; and
- a high degree of transparency.

Within this environment, the Hong Kong banking sector has been able to grow and maintain high safety and sound standards.

An Evolving Banking Sector

5. The consultants identify a number of global forces and trends in financial services which will shape the development of the Hong Kong banking sector. The end-result is likely to be increased competition leading to advances in efficiency, innovation and customer service. At the same time, the global trends will introduce a number of new challenges and increase overall complexity and the level of risk to which banks and the sector will be exposed. Therefore the challenge for Hong Kong lies in how to exploit future opportunities while containing the risks.

Four Suggested Strategic Mandates for HKMA

6. Given the new emerging environment, the consultants have suggested *four strategic mandates* for the HKMA:

- ***Regulatory and supervisory framework*** - to ensure that the regulatory and supervisory framework for Hong Kong remains appropriate for the evolving financial markets.
- ***Development of a competitive banking sector*** - to improve the competitive environment to ensure the positive benefits of global and local trends are developed in the Hong Kong market, and Hong Kong remains an attractive international financial centre.
- ***Safety and stability of the banking system*** - to ensure that increasing levels of risk associated with global and local trends are prudently managed and that Hong Kong's exposure to systemic risk is mitigated.
- ***Efficiency and integrity of the financial system*** - to increase the level of transparency, both within the banking sector and across financial and capital markets, to allow the forces of market discipline to work more effectively.

The Consultants' Main Recommendations

7. The consultants have made a number of recommendations in pursuit of these mandates. The overall package aims to improve the competitiveness of the Hong Kong banking market as well as to enhance the safety and soundness of the banking system as a whole. The consultants consider that this is a coherent package of proposals which should be introduced in parallel, using a phased approach. This takes into account the fact that opening up the market to increased competition in order to strengthen local banks' ability to compete will, at the same time, require improved supervisory processes to ensure that the banks are capable of dealing with such an environment.

(i) ***Phase 1 - enhanced risk-based supervision (1999)***

The focus of Phase 1 is to enhance the HKMA's supervisory approach, to better position the HKMA to address the risks and increased competition within the market place, prior to substantive changes to the regulatory system. The consultants recommend that the HKMA initiate the process

towards a more competitive sector by relaxing the one branch policy to allow foreign banks to operate up to a maximum of three branches. The expected difficult operating environment in 1999 would likely prevent further deregulation of interest rate rules (“IRR”) during Phase 1. However, a programme to monitor key stability indicators should be undertaken during this phase in preparation for deregulation to take place during the second phase.

(ii) **Phase 2 - market restructuring (2000 to mid 2001)**

During Phase 2, the emphasis would shift from the supervisory approach towards implementing a revised market structure, although implementation of the recommendations in the enhanced supervisory approach would continue. The consultants recommend that the HKMA raise the minimum level of capital required for local institutions and begin a study to enhance depositor protection. Both are intended to enhance the safety and stability of the sector. Competitiveness would be further enhanced through measures such as simplifying the three-tier licensing system and implementing the first two stages of interest rate deregulation (subject to continued monitoring of stability indicators).

(iii) **Phase 3 market liberalisation (mid 2001 to end 2002)**

Phase 3 deals with the recommendations concerning the remaining barriers to a free and open market. These should be implemented once the improved supervisory approach is in place and the market structure is revised. Should the study concerning the need for enhancing explicit depositor protection (to be completed during Phase 2) requires changes to existing arrangements (e.g. the introduction of deposit insurance or other forms of enhanced protection schemes), then it would be appropriate to begin implementation of this prior to further liberalisation of the market. The final stage of interest rate deregulation would take place during this period.

8. The key recommendations to be implemented in each phase are summarised in the table at Annex.

PUBLIC CONSULTATION

9. It is our intention to publish the full details of consultants' recommendations, followed by a three-month public consultation. The HKMA will brief the LegCo Panel on Financial Affairs, the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee on the consultants' recommendations.

PUBLICITY

10. The HKMA will issue a press release on 18 December 1998 and is intended to publish the full details of the consultants' recommendations in the near future.

ENQUIRY

11. Enquiries on the Study can be directed to Mr Eddie Cheung, Assistant Secretary for Financial Services (tel:2527 3974) or Mr Peter Li, Senior Manager, Hong Kong Monetary Authority (tel:2878 1847).

Financial Services Bureau

18 December 1998

Phases	Regulatory recommendations	Supervisory recommendations
<p>Phases 1 - enhanced risk-based supervision</p>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> ➤ Introduce financial disclosure by foreign branch banks (limited disclosure introduction in progress). ➤ Clarify the HKMA’s role as lender of last resort. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> ➤ Relax the one-building condition to allow three branches for foreign banks. ➤ Begin monitoring process prior to start of deregulation of IRRs. 	<ul style="list-style-type: none"> ➤ Develop a formal strategic planning process. ➤ Develop a formalised risk assessment framework and quality assurance programme. ➤ Integrate risk management principles into the off-site surveillance activities. ➤ Revise on-site surveillance activities to more explicitly evaluate institutions’ risk management capabilities. ➤ Develop guidelines as to types and degrees of supervisory responses. ➤ Define core capabilities, revise job descriptions and the performance management process, develop a formalised career development programme, perform a training needs assessment and expand the current training curriculum. ➤ Create additional specialist teams. ➤ Enhance the supervisory database and management information systems. ➤ Assess risks associated with longer term economic integration with Mainland China.
<p>Phase 2 - market restructuring</p>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> ➤ Raise minimum capital requirements for local authorized institutions. ➤ Study of alternatives to enhance explicit depositor protection. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> ➤ Simplify the three-tier system. ➤ Reassess access criteria for RTGS. ➤ Stage 1 of deregulation of the IRRs (time deposits up to 6-days). ➤ Stage 2 of deregulation of the IRRs (current accounts). 	<ul style="list-style-type: none"> ➤ Assess supervisory gaps and/or overlaps and options to address.
<p>Phase 3 - market liberalisation</p>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> ➤ Implementation of enhanced explicit depositor protection scheme. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> ➤ Stage 3 of deregulation of the IRRs (remove all remaining interest rate caps). ➤ Reduce the time period and relax the association with Hong Kong entry criteria. 	