Press release

LCQ15: Regulation of banks

Wednesday, May 18, 2011

Following is a question by the Hon Frederick Fung and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (May 18):

Question:

It has been reported that the Federal Reserve of the United States (US) earlier decided to keep the interest rates unchanged, while the Chief Executive of the Hong Kong Monetary Authority (CE/HKMA) responded afterwards that Hong Kong's interest rates may increase without the need to wait for the US's interest rates to rise first, he thus urged the public to be vigilant and carefully manage the risk of interest rate increases; he also revealed that the loan-to-deposit ratio of local banks had risen from 71% at the beginning of last year to 81% in February this year. In this connection, will the Government inform this Council:

(a) whether the authorities have conducted any assessment of the risks which my be brought by the short to medium term interest rate trends, including the possible impact on the stability as well as credit and bad debt situations of the banking system, the flow of funds in the capital market, inflation and the overall economic environment, as well as the possible scenarios arising from the rise of US's interest rates in the future, etc; if they have, of the results; and given that Hong Kong dollar is pegged to the US dollar, how CE/HKMA arrived at the conclusion that Hong Kong's interest rates may increase without the need to wait for the US's interest rates to rise first;

(b) of the monthly loan-to-deposit ratios of local banks in the past five years, and the historical highest and lowest levels of the ratio; how the current loan-to-deposit ratio (81%) of local banks compares with those of the banks in other economies; how the authorities will regulate local banks to avoid the risks which may arise due to excessive lending; and

(c) given that the financial tsunami in 2008 had prompted various countries to enhance regulation of their banking industry, including splitting the high-risk banking businesses and adjusting the remunerations of the senior staff of banks, of the proposals and items introduced by the authorities on the reform for and new regulations of the local banking industry after the financial tsunami, as well as the relevant contents and current implementation details; and how such proposals and items compare with the reforms of the banking industry in European and American countries?

Reply:

President,

The Administration's reply to the question is as follows:

(a) The US Federal Reserve's recent indication that Quantitative Easing 2 will be completed as planned by the end of June 2011 represents its first move towards "normalising" monetary conditions and one further step closer to exiting from its intervention measures. Looking ahead, market expectation for US interest rate movements and global capital flows may change, increasing volatility and risk in the financial markets. That said, as long as the low-interest-rate environment remains unchanged, there would still be risk of an asset price bubble induced by abundant liquidity in Hong Kong, which would indirectly lead to higher inflation. However, once the interest rates start to rise after staying at low levels for a prolonged period, local asset prices would come under pressure and shifting in the macroeconomic conditions would be unavoidable.

The Hong Kong Monetary Authority (HKMA) has been monitoring the potential risks of interest rate trends to the banking sector. If interest rates start to rise, individual banks are expected to be affected to different degrees depending on their balance sheet structures. Higher interest rates would generally increase the debt burden of borrowers, which may drive up banks' bad debts. On the other hand, some banks may benefit if higher interest rates result in a widening of the spread between lending and deposit rates. Overall speaking, the capital adequacy ratio and liquidity of banks in Hong Kong remain robust. The HKMA will continue to monitor closely, among others, the developments in the businesses and risk management systems of banks.

Under the Linked Exchange Rate System, the Hong Kong interbank offer rates (HIBOR) will move in line with their US counterparts. However, the HIBOR levels are not the only factor affecting local deposit and lending rates applicable to bank customers. Other factors, such as the level of Hong Kong dollar deposits in the local banking system and the supply and demand conditions in the loan market, are at force too. With the growth in Hong Kong dollar loans persistently outpacing that of Hong Kong dollar deposits since 2010, the loan-to-deposit ratio of local banks increased rapidly from 71% in early 2010 to 82% as at March 2011. Many banks have raised their Hong Kong dollar deposit and lending rates. For example, a higher spread over HIBOR is now charged for new mortgage loans. With the loan demand for Hong Kong dollars remaining strong in the short term, Hong Kong dollar deposit and lending rates of local banks will continue to face upward pressure.

(b) A summary of the Hong Kong dollar loan-to-deposit ratios of authorised institutions (AIs) in the past five years together with their record high and low levels is at Annex. We do not consider it appropriate to directly compare banks' loan-to-deposit ratios between Hong Kong and other economies, since the level of the ratio depends on a number of factors, including the economic cycle that they are in, whether there are other channels for banks to invest their funds (e.g. whether there exist sizable debt markets for investments), etc. In view of the rapid expansion in bank loans recently, the HKMA issued a circular to the chief executives of all banks on April 11, 2011, requiring them to review their business plans and funding strategies for the rest of 2011. The HKMA will follow up with the banks to ensure that they apply prudent lending standards, review their lending plans and effectively manage concentration risk and liquidity. The HKMA will also discuss with selected individual banks on increasing their levels of regulatory reserve to better absorb the impact of bad debts, etc.

(c) In the light of lessons learned from the global financial crisis, international banking supervision and standard-setting bodies have put forward various proposals to strengthen the resilience of the global banking system. These include (i) a set of Principles for Sound Compensation Practices and their Implementation Standards announced by the Financial Stability Board (FSB) in 2009 to ensure that banks' remuneration systems are consistent with and promote effective risk management; (ii) enhancements to Basel II proposed by the Basel Committee on Banking Supervision (BCBS) in July 2009 to raise banks' capital requirements for trading book and securitisation exposures; and (iii) Basel III subsequently published by the BCBS in December 2010 to enhance the quality and level of banks' capital and liquidity.

The HKMA has issued guideline reflecting the proposal on remuneration systems made by the FSB to AIs. The enhancements to Basel II and the various measures set out in Basel III are expected to be implemented in Hong Kong by the end of this year and in phases starting from 2013 respectively. As always, we have put much emphasis on banks' ability to absorb losses by ensuring that they maintain high quality and level of capital. In this regard, some of the requirements under the definition of regulatory capital currently effective in Hong Kong are already consistent with or even more stringent than those of Basel III. We will brief the Legislative Council Panel on Financial Affairs on June 9 in relation to the implementation details of the new Basel requirements.

In addition to the measures proposed by the BCBS, some financial markets in the US and Europe have also considered other measures in the light of the issues they encountered in the financial crisis. Some of these measures have become part of the agenda under the international supervisory standards of "how to reduce the possibility and consequences of failure of systemically important banks". However, there has not been any international consensus reached on these issues yet. Although Hong Kong has not been seriously affected by the global financial crisis, the HKMA will continue to monitor the international developments on enhancing banking supervisory measures and implement additional measures in Hong Kong if necessary.

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