HONG KONG - BANKING SUPERVISION - PRELIMINARY CONSULTATION PAPER *

COMMISSIONER OF BANKING
HONG KONG

香 港
銀 行 業 監 理 處

27th March, 1985

Dear Sir,

As you know the Financial Secretary in his recent budget statement announced that I would consult with the banking community about modifications to the system of supervision in Hong Kong.

Consultation with some 500 banks and deposit-takers is a major task and it has seemed sensible to break it into a number of parts. We started by holding two seminars with some 40 banks and deposit-takers, chosen to be a cross-section of the community. To prompt and focus the discussion we circulated some discussion papers.

At the seminars a number of comments and ideas were generated. We have included them in a paper which I now enclose, and on which I invite your comments by at the latest the end of April. This paper is being circulated widely in the banking community and because of the number of people involved we would prefer to receive comments in writing rather than verbally.

I emphasise that we do not wish to be held to the views in the paper as representing our firm proposals for the future. However, if we cannot obtain better ideas from you and other people, it is likely they would become the basis for recommendations for development of firm and workable proposals. On such matters as statistics and capital and liquidity ratios there would clearly have to be more detailed discussion and a period of gradual implementation.

I look forward to hearing from you.

Yours faithfully,

(Robert Fell)
Commissioner of Banking
Commissioner of Deposit-taking Companies

To: The Chief Executive

1604 HANG CHONG BUILDING, 5 QUEEN'S ROAD CENTRAL, HONG KONG. TEL: 5-242141/2 TELEX 64282 COFB HX

* (This paper was provided by Mr Robert Fell, Commissioner of Banking, Commissioner of Deposit-taking Companies, Hong Kong).

Preliminary Consultation Paper

Introduction

1) The Financial Secretary announced in his recent budget speech that the Government is examining various options for improving the system of supervision of banks and DTC's (henceforth collectively referred to as "banks".) This would take account of local views. As a first step in obtaining the views of the banking community, the Commission recently held two discussions with a number of banks on five papers it had prepared for the purpose. This paper summarises those papers, the comments of bankers so far, and the Commission's reaction to those comments. It should be stressed that this paper is a preliminary step towards the formulation of definite proposals by the Commission, following consideration of the comments and ideas it expects to receive on the paper.

2) It should also be stressed that examining more appropriate methods of prudential supervision does not carry any implication that banks in Hongkong are vulnerable or badly managed. In fact, the state of the industry suggests remarkable resilience after the recent economic difficulties.

The general framework for supervision

3) There seems to be general agreement that the object of the Commission activities should be the protection of the interests of depositors and the promotion of a secure banking system. Its role is seen as having become more important as Hongkong has become more important as an international financial centre.

4) The Commission has so far found no disagreement with the view that the existing statutory framework for supervision has become inadequate, having regard to the development of banking in Hongkong, the experiences of the last three years and the present phase of expansion following the Agreement with China. The Commission's function up to now has been limited mainly to ensuring that certain statutory requirements on liquidity and lending are met. The bankers with whom it has consulted agree that the requirements on their own have over time become ineffective as a means of ensuring that the interests of depositors are protected.

5) The Commission put to bankers the proposition that there is a real doubt whether a system which is solely rule-based remains the best way of reconciling the need to have a watchdog for the depositor's interest with the desire strongly felt in Hongkong for a free and competitive market place for banks. It put forward as an alternative the idea that the Commission should operate on a more discretionary basis, relying more on its judgements about the capacity of management in each bank to cope with the challenges it faces. In so far as the judgement is that the management is capable, the Commission

would leave it free within the law to pursue its business. It would insist on minimum requirements of capital and liquidity against unexpected misjudgements or just bad luck but as far as possible avoid other constraints. In so far as the judgement is that management is weak, the Commission would endeavour to promote improvements, insist on larger safety margins of capital and liquidity, in more serious cases use its powers to enforce management restraint, and in extreme cases revoke the authority of the bank to pursue a banking or deposit-taking business.

6) In answer to the question how the Commission would go about judging management, it noted that there are a number of "objective" indicators, such as the ability to earn consistently high profits and to avoid unexpected sudden losses on assets or trading; the ability to adapt quickly to changed market conditions; the existence of management in sufficient depth to enable continuity in the face of sudden loss of one or more persons; and the existence of cost effective administrative systems to ensure proper control and adequate knowledge of the bank's business. Equally important are the subjective factors of the supervisor's confidence in the personal and profit motivation, intelligence, adaptability and practicality of the senior personnel. These judgements would naturally interact with the supervisor's view of the management's policy towards levels of capital adequacy, risk taking or risk aversion, quality of assets, liquidity and other matters which are the supervisor's traditional daily stock-in-trade.

7) So far no banker has fundamentally disagreed with these ideas, but a number have doubted the capacity of the Commissioner's staff to make competent judgements in respect of each of the 500 or so institutions for which he is at present responsible. The Commission's view is that the capacity to make the required judgements and act on them could be generated over a period of time. The Commission would undoubtedly rely on the fact that at any one time the number of major problem cases will be a small proportion of the total number of institutions. This has been the case in the past and there seems no reason not to expect it to continue. Moreover, the Commission has over the years through its examinations built up a considerable body of professional expertise and knowledge.

8) Nevertheless, the ability of the Commission to cover the field adequately is a legitimate concern. To prevent too arbitrary a use of the Commissioner's discretion, it seems desirable to place statutory limits on his ability to dictate or permit management policies in the banks. At the least he must be accountable for his actions; but more than that his ability to enforce unduly lenient or restrictive balance sheet relationships should, perhaps, be curtailed.

9) The Commission's view that the ultimate "safety nets" against managerial deficiency and/or bad luck are adequate capital and liquidity seems shared by the banks with whom it has so far consulted. It seems therefore that it is in the setting of these basic balance sheet relationships that the Commission's freedom of action should be curtailed.

/ Capital .....

Capital adequacy

10) From the supervisory viewpoint the primary purpose of capital is to enable losses to be sustained without threatening the closure of the bank or otherwise prejudicing the interests of depositors. Its subsidiary purpose is to provide a pool of finance the servicing of which is at the discretion of the directors. This allows an increase in non-income generating assets (e.g. premises, other fixed assets or non-performing loans) to be sustained without undue stress. Of course, the providers of the capital have different priorities.

11) The Commission put forward a suggestion for a common measure of capital adequacy, offering as its chief merit simplicity without too much distortion of reality. This was to compare capital with the total* of assets and contingent liabilities, but taking liquid assets at, say, 1/5 of their balance sheet value, in recognition of the markedly lower than average risk attaching to this substantial proportion of banks' total assets. An example appears in Appendix 1.

12) It was suggested that included in capital should be paid-up capital and undistributed reserves, including hidden reserves and genuine and stable unrealised accretions of value to assets which could be realised if necessary. Deducted from capital would be investments in subsidiaries, and loans with a similar character, in order to avoid double counting of the same capital in the hands of a bank and its subsidiary.

13) Although a number of questions on details have been asked, no fundamental objection has been made against this proposal, nor a better idea put forward. The detail which seems to have been of most concern so far relates to the inclusion of contingent liabilities of all varieties in the ratio. Some of these are undeniably of very low risk. However, whether they are a sufficient large amount to be of material importance to the result of the calculation remains in doubt.

14) The Commission went on to suggest that it would be possible to substitute for the present statutory limits on certain loans the deduction of the excessive part of them from capital in the calculation of the above ratio. It itself this idea seemed to be favourably received. However, the effect of deducting those parts of loans in excess of 25% of capital is very substantial for a number of foreign bank owned institutions relying on parental comfort letters. The ratio correctly identifies the fact that the Hongkong subsidiary taken by itself would be overtrading, and is dependent on its parent's capital. The possible lack of

/ clarity .....

* Deducted from the total of assets would be provisions made against diminution in their value, and investments in subsidiaries and other loans of a capital nature, which it is proposed would be deducted from capital.

clarity in lines of managerial and financial responsibility inherent in this situation are worrying. At the least, the Commission needs assurance that the parent knows what its subsidiary is doing, controls it adequately, accepts full responsibility for it, and has the means of ensuring its subsidiary remains adequately capitalised if something goes wrong. The simplest way to clarify the lines of responsibility would be to request that foreign bank parents wishing to support overtrading in their Hongkong subsidiaries should demonstrate their wish by transforming the subsidiaries into unlimited liability companies. The question would then become largely one of ensuring that the parent was capable of supporting its subsidiary. Other ideas would be very welcome.

15) The Commission suggested that this measure of capital adequacy could be the basis for a statutory requirement. If this set a standard minimum legal requirement for all banks, it would be necessary to establish a level which provided a reasonable safety margin for indifferently managed or highly exposed banks, notwithstanding that this was unnecessary for well managed banks with a better spread of risks. The Commission suggested 10% capital cover of the total of "risk assets".

16) It is clear that a number of banks regard this as too onerous for them, believing they are well managed and have a good spread of risks. They therefore naturally preferred the Commission's alternative proposal that 10% should be the reference level for exercise of the Commission's discretion, if the Commission were to be allowed to exercise discretion. However, it should be clear that the Commission's present view of the desirable range of its discretion is from about 8% to possibly 20%. Very few banks should in present circumstances expect the Commission happily to contemplate a ratio of less than 10%.

<u>Liquidity</u>

17) The Commission's view is that liquidity is much more difficult then capital adequacy to measure in a standard manner. The liquidity of a portfolio is so dependent on its quality, and the need for liquidity in a bank so dependent on its particular circumstances at the time. The Commission put forward for discussion an idea based on measuring future cash flows. Although it outlined a possible basis for setting a statutory standard requirement based on this method of measurement, it also questioned if any standard requirement would serve much real purpose.

18) There appears to be quite a strong feeling amongst banks that, although there is no simple standard requirement that is fair to all, something should exist as a discipline against wild excess, but that it should be accompanied by separate assessment by the Commission of each bank's liquidity policies and adherence to them, which would give full weight to the particular circumstances of that bank.

/ 19) .....

19) The Commission would propose that a simple standard requirement applied to all should be assessed by reference to all current liabilities callable or maturing within three months. Against a proportion of these liabilities should be held a wider range of assets regarded as liquid than is presently the case. However, the less liquid assets specified as liquid should be included at a discount on their balance sheet value. Included within this category of liquid assets subject to a discount might be certain types of small ticket loans which can be assembled into saleable or refinanceable packages quickly; e.g. residential mortgage or instalment credit loans, but this would have to be determined on a case-by-case basis by the Commission. The most obvious loophole in this proposal is the ability to generate illusory liquidity by lending and borrowing interbank at identical maturity. To counter this, while still giving due weight to the liquidity of short-term deposits with banks, it is suggested that interbank claims should be netted off against interbank liabilities rather than treated as a liquid asset. If a net interbank claim position resulted, it would be set off against other liabilities attracting a liquidity requirement. The ratio is illustrated in Appendix 2.

20) It is too early to predict what the requirement if based on this measure would be, but in the Commission's view it should be set at a level which is broadly equivalent in terms of liquidity held to that of the present liquidity ratio.

21) The Commission has little confidence that this ratio, or something like it, will have much more than cosmetic effect. Its only virtue as an across-the-board requirement is that in its coverage of interbank liabilities it is better than the present statutory liquidity ratio. Interbank liabilities have proved to be a major cause of liquidity problems in the recent past. But it is not proof against avoidance, it takes no account of the particular circumstances of each bank, and in particular it does not cover the fundamental aspect of the underlying liquidity inherent in a high quality loan portfolio. It will need to be accompanied by careful monitoring of the quality and maturity of a bank's assets and liabilities and their assessment in a more flexible manner through regular statistical returns as well as examination. In forming its view about the adequacy of each bank's liquidity, the Commission would not undertake to place any reliance on the proposed standard ratio.

22) The Commission also suggested that insufficient weight had been given in the past in the monitoring of liquidity to a bank's ability to borrow or sell non-liquid assets. It noted that in practice these were often the first resort of bankers when faced with a liquidity problem. It suggested that an important safeguard was the availability of unhypothecated assets which could be used as security for a loan, or sold. It therefore seemed sensible for the giving of charges by a bank over its assets to be brought within the ambit of control by the Commission, so that it would be alerted at an early stage to a possible deterioration of that bank's liquidity, and be in a position to influence the form of remedial action.

/ 23) .....

23) The logic of this suggestion was generally supported by the banks, but a number of practical difficulties were foreseen Some smaller banks have a sound business based on borrowing on the security of their assets. Banks are also obliged to put up margin deposits in respect of securities, futures, commodities and other market transactions. The Commission must not unreasonably withhold its consent to the giving of charges if the policy is to be a success. Equally the Commission would need to be very cautious about permitting so many assets to be charged that there remained insufficient unhypothecated assets to cover depositors' claims.

The role and content of the monthly statistical return

24) At present the monthly statistical return is a rudimentary balance sheet cast in a particular form to facilitate the working out of the liquid assets ratio. It is not wellsuited to keeping track of business developments, and is useless as a means of monitoring profitability, larger single risk exposures and possible future cash flows.

25) The inadequacies of the statistical return mean that reliance is placed on the Commission's examinations of each bank to track its business. This is time consuming and expensive both for the Commission and the banks, and is not likely to give early warning of adverse trends. The Commission believes the regular statistical returns should have a greater role in the supervisory process.

26) The Commission proposed a wider ranging replacement for the present monthly statistical return, a mock-up of which appears as Appendix 3. The proposal was that the return should be submitted quarterly by most banks, but with the possibility of greater or lesser frequency of parts or all of it, at the Commission's discretion.

27) Banker's opinions as to the scope of the proposed return have varied from a feeling that it does not go far enough, to a view that the contents are too sensitive for regular submission to the Commission. However, so far the Commission has not received any opinions which seriously undermine either the objectives behind the proposed changes or the changes themselves.

28) Before introducing a new return the Commission would seek to establish a working party of bankers to study technical detail and definitional problems. Adequate time will need to be allowed for the development within each bank of systems enabling it to complete the return. It would also seem sensible to stagger its introduction, starting with Part V (large items).

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Examinations and audits

29) The introduction of a better statistical return should enable the Commission to become more discriminating in determining the frequency of examination of each bank. From the Commission's point of view less frequent examinations will increase the importance of external audit of annual accounts, which is the only other periodic assessment independent of management of the business of each bank.

30) The Commission expressed a desire for a form of contact with auditors that is known to and approved by the client bank. It proposed enlarging the present arrangements (which seem to have proved satisfactory) for the audit of one monthly statistical return per year to cover the operational area of management control and accounting systems. Each bank might be required to have audited the accuracy of its answers to standard questions put by the Commission on these subjects.

31) The main fears so far expressed by bankers, and they seem quite strongly felt, is that this would be an expensive and probably unproductive process. However, no objection was expressed to the idea of more direct informal contact between auditors and the Commission provided the clients were generally aware such discussions were taking place. In light of these views, the Commission has begun discussions with the Hongkong Society of Accountants as to how the matter should be taken forward.

Other issues

32) There are a number of other issues, not covered in this paper, which have been raised. These have included revisions to the form of deposit-taking authority available under the Banking and Deposit-taking Ordinances, powers of the Commissioner to approve controllers of banks, deposit insurance, and a discount window. Any proposals for change in these areas would be the subject of separate consideration.

Appendix 1

Risk Asset Ratio

Balance Sheet

Paid up capital and reserves	150	Liquid assets	300
Current liabilities	1000	Loans & advances (net of provisions)	835
		Investments in subsidiaries	10
Contingent liabilities	250	Goodwill	5
		Contingent assets	250
	1400		1400

Capital and reserves			150
Less	investments in subsidiaries	(10)	
	goodwill	(5)	(15)
=	CAPITAL BASE		135

	Book value	x	Weight	=	Total
Liquid assets	300	x	0.2	=	60
Loans and advances (net)	835	x	1.0	=	835
Contingent liabilities	250	x	1.0	=	250
= Risk assets					1145

$$\text{Ratio} = \frac{135}{1145} \times 100 = 11.8\%$$

Appendix 2

Revised Liquidity Ratio

Liability base

	Interbank liabilities	callable or maturing within 3 months	
LESS	Interbank assets		
ADD	Other liabilities		
	= Total liability base for ratio		= A

Liquefiable assets

	Liquid assets (as presently defined, but excluding interbank assets)	
ADD	Say, 75% of lower of book or market value of other unhypothecated marketable securities held as short term or portfolio investments	
ADD	Say, 60% of unhypothecated performing term loans repayable by instalment, specified by Commissioner as marketable or refinanceable	
	= Total liquefiable assets	= B

$$\text{Ratio} = \frac{B}{A}\ \%$$

Appendix 3

PART I · BALANCE SHEET

LIABILITIES

H.K.'000

1.1	Paid up capital and reserves			
1.2	Current year's profits			
1	= SHAREHOLDER's FUNDS			
2	DEPOSITS FROM PUBLIC (as defined in subsection 18(5))			
3.1	(Borrowings from authorised) - in Hong Kong			
3.2	(banks and deposit-takers) - elsewhere			
3	= BORROWINGS FROM FINANCIAL INSTITUTIONS			
4	NOTES IN CIRCULATION			
5	OTHER LIABILITIES			
9 (=19)	TOTAL LIABILITIES			

ASSETS

		Market value	Book value	
10.1	Cash and marketable gold) Approved as specified liquid assets			
10.2	Claims on banks at call and short notice) Approved as specified liquid assets			
10.3	Treasury bills CD's & other money market instruments) Approved as specified liquid assets			
10.4	Bills of Exchange) Approved as specified liquid assets			
10	= SPECIFIED LIQUID ASSETS			
11.1	Other claims on authorised) - in H.K.			
11.2	banks & deposit-takers) - elsewhere			
11	= OTHER CLAIMS ON FINANCIAL INSTITUTIONS			
12.1	(Exposures(gross) to subsidiaries,) - loans & advances			
12.2	(associates and other connected (parties by way of) - investments			
12.3	LESS Provisions made		( )	
12	= CONNECTED DIRECT EXPOSURES			
13.1	Other loans & advances - to H.K. residents			
13.2	- to foreign residents			
13.3	LESS Provisions made		( )	
13	= LENDING TO PUBLIC			
14.1	Other investments - quoted equities			
14.2	- quoted debt			
14.3	- property including premises			
14.4	- fixtures and equipment used in the business			
14.5	- goodwill and other intangible assets			
14.6	- Other			
14	OTHER INVESTMENTS			
15	OTHER ASSETS			
19 (=9)	TOTAL ASSETS			

CONTINGENT LIABILITIES

20.1	Liabilities of and guarantees in respect of subsidiaries, associat s and other connected parties		
20.2	Other guarantees		
20.3	Oth r liabiliti s of customers		
20	CONTINGENT LIABILITIES		

PART II PROFIT AND LOSS ACCOUNT

As at ______________; covering period of _____ months since _______(last annual accounts)

INCOME

100.1	Interest received and receivable		
100.2	Interest paid and payable		
100	= NET INTEREST INCOME		
101	INCOME FROM FOREIGN EXCHANGE OPERATIONS		
102	INCOME FROM INVESTMENTS		
103	OTHER INCOME		
109	TOTAL INCOME		

EXPENSE

	OPERATING EXPENSES		
110.1	Provisions against) New provisions made		
110.2	bad & doubtful debts) LESS Provisions released or recovered	( )	
	MEMORANDUM ITEM: Amounts written off from provisions		
110	= NET CHARGE FOR DEBT PROVISIONS		
111	NET CHARGE FOR OTHER PROVISIONS		
112	AMOUNTS WRITTEN OFF FROM INCOME		
113	OTHER EXPENSES		
119	TOTAL EXPENSE		
120	EXTRAORDINARY INCOME/EXPENSE		
1.2 (=109-119+/-120)	Current year's profit		

PART III FOREIGN CURRENCY POSITIONS

[same as present Part IV of monthly r turn, except reported in HK$'000]

PART V LARGE ITEMS HK$'000

1) Liabilities

List below deposits from public and borrowings from financial institutions which exceed 10% of total liabilities (item 9 of Part I). Different deposits/borrowings from the same depositor/lender should be separately listed under the same depositor/lender. Depositors may be identified by account or client code numbers. Use of a different code from that applied to the same client in a previous return must be indicated and cross-referenced.

Creditor	Amount (in HK$)	Currency	Earliest Contractual Maturity	Has any security been given?

2) Assets and contingent liabilities

List below the 10 largest exposures (whether derived from loans, investments or customer's liability), and any other exposures in excess of 10% of paid-up capital and reserves (item 1.1 of Part I), to the credit worthiness of single parties and parties known to be financially connected or associated with them. Different claims on the same party should be separately listed under the same party.

Customer	Type of exposure	Amount (in HK$)	Currency	When an interest or capital (re-) payment last made	Wholly, partly or unsecured?

PART IV MATURITY POSITIONS

HK$'000

Part I ref.	Title	8 days	1 month	3 months	6 months	Over 6 months	Ov rdu
	LIABILITIES						
2	Deposits from public						
3	Borrowings from financial institutions						
A	Total						
	ASSETS						
10	Specified liquid assets	TOTAL					
11	Other claims on financial institutions						
13	Lending to public						
B	Total						
B-A	Net Asset position						

NOTE: Liabilities and assets should be classified on the basis of the earliest contractual call, repayment or maturity date. <u>If overdue, they should be reported in the "Overdue" column</u>.