Speech by the Financial Secretary John C. Tsang at the Asian Bankers Association Asian Banks: Ten Years After the Asian Financial Crisis and Beyond at the Island Shangri-La hotel Hong Kong (English only)

McKinney, David, Esteemed Guests, Ladies and Gentlemen,

Good morning.

It is a great pleasure for me to welcome the Asian Bankers Association back to Hong Kong. It has been 14 years since the ABA last held its Annual General Meeting here in this city, and how things have changed since then. I hope it won't take another 14 years before you come back again to Hong Kong. Come back next year.

Hong Kong is an appropriate host for this year's AGM given its theme: “Ten years after the Asian financial crisis and beyond”. I say ‘appropriate’ not just because Hong Kong was caught up in the financial crisis like the rest of Asia, but also because we are celebrating the 10th Anniversary of Hong Kong's Reunification with the Mainland of China.

Reunification alone posed the biggest political, legal and social challenge our city has ever faced. So, believe me when I say, a region-wide financial crash was the last thing that we needed back in 1997!

When you throw into the mix the SARS epidemic, not one but two outbreaks of avian flu, the fallout from the 9-11 attacks in the US and the bursting of the housing and dotcom bubbles, you have a clearer picture of what we were up against. Some would even call that the perfect storm, and few societies would have the resilience to withstand this sort of onslaught.

Every economy in Asia has its own unique tale to tell of the decade since the financial crisis took hold. I am sure you will agree that we have all emerged stronger and wiser from the experience. And certainly a little greyer! At least for me.

Today, I want to talk about how Hong Kong stood up to these testing times, and what we have been doing to strengthen our financial infrastructure, in particular the banking sector, in the past decade.

I firmly believe our unswerving commitment to Hong Kong's long-established fundamental values enabled us to weather the financial storm back in the late 1990s.

These values include the rule of law, zero tolerance towards corruption, a level playing field for business, clean and efficient government and the free flow of money as well as freedom of information, speech and the media.

These provided the foundation on which we built our financial recovery.

Our other big advantage is, of course, the Mainland. Hong Kong is no longer an island on the doorstep of the world's fastest-growing large economy, we are an integral part of this great nation. The unique concept of “One Country, Two Systems” for our reunification with the Mainland in 1997 ensures that our way of life, including our capitalist system, common law legal system and a raft of freedoms, will remain unchanged for 50 years, until at least 2047. The concept of “One Country, Two Systems” has helped ensure a strong element of consistency and confidence that proved to be vital over the past 10 years.

More about the China-factor a little later. First, I want to talk in more detail about our banking sector and the shape it is in today. Simply put, it is a leaner, fitter and more competitive banking system.

The evolution of the sector has followed Charles Darwin's “survival of the fittest” theory. Of the 31 local banks that existed at the end of 1997, more than half of them, in fact 19 of them, have been taken over or merged in the past ten years.

Stronger owners have increased their presence in the sector by acquiring weaker institutions. The overall result is a more robust banking sector.

Although the Government was keen to see some consolidation among lenders, there has been no “match making” among regulators. The mergers and acquisitions of banks has been market driven.

Hong Kong has earned a reputation for free market policies over the years. This is thanks partly to our open investment model, minimal restrictions on foreign capital and transparent regulation of the banking sector. Throughout the financial turmoil of the past decade, Hong Kong has retained its spot as the world's freest economy, according to the Heritage Foundation and the CATO Institute. We have come out number one 13 years in a row.

This commitment to free market principles and constant deregulation of markets has reinforced Hong Kong's status as a prime location in Asia for foreign capital.

The United Nations' World Investment Report, released last month, placed Hong Kong second in the region for both inward and outward foreign direct investment. Hong Kong attracted some US$43 billion worth of FDI last year. Only the Mainland ranked higher with FDI valued at US$69 billion. The report also noted that merger and acquisition (M&A) activities in the first half of this year was up 54 per cent year-on-year at US$581 billion. The report also predicted that M&A activities would continue to drive cross-boundary investment.

This brings me back to the China-factor.

Our bankers have a wealth of expertise in relation to the Mainland's financial sector, and local banks continue to expand their operations across the boundary.

At the same time, the Hong Kong Government, together with our provincial neighbours and the central authorities, are also continuing to work on interweaving the financial infrastructure of our two jurisdictions to create a quicker, safer and more efficient inflow and outflow of capital in future.

By working more closely with the Mainland we have been able to carve out some unique opportunities for the local banking sector. An obvious example is Renminbi business. Since Renminbi transactions began in Hong Kong in 2004, some 40 banks have become eligible to offer Renminbi services. By the middle of this year Renminbi deposits amounted to some 28 billion yuan.

And in June this year Hong Kong became the first centre outside of the Mainland to launch a Renminbi bond market. So far three Mainland banks have issued Renminbi bonds totalling 10 billion yuan.

Another opportunity that has emerged from our cross-boundary linkages is a scheme to facilitate the outflow of capital known as the Qualified Domestic Institutional Investor scheme, or QDII. This has recently been expanded to allow more Mainland banks, as well as securities and insurance companies that meet the criteria, to invest in Hong Kong.

The privilege enjoyed by Hong Kong based companies in entering the Mainland market will be expanded further from January 1 when the latest supplement to our unique free trade agreement with the Mainland comes into effect.

This free trade pact between Hong Kong and the Mainland is known as the Closer Economic Partnership Arrangement, or CEPA. In a nutshell, CEPA gives Hong Kong companies and overseas enterprises based in Hong Kong preferential access to Mainland markets ahead of WTO obligations. CEPA currently covers 27 service sectors with another 11 to be added from January 1 next year. These include banking, insurance, legal, logistics, tourism and other service sectors.

Here's one example of how the banking sector will benefit further from CEPA IV. This new round of liberalisation measures will, from January 1, lower the asset requirement threshold for Hong Kong banks acquiring a share of a Mainland bank from US$10 billion to US$6 billion. It will also fast-track applications to set up branches in Guangdong province and other designated areas.

You may wish to know that CEPA is nationality neutral. It is applicable to institutions registered in Hong Kong, regardless of their countries of origin.

Ladies and Gentlemen, I have highlighted a few of the areas where our banking sector is seeking out new opportunities.

Now I want to tell you what we are doing to boost the sector's resilience to the shocks that we will inevitably face in the future.

Strengthening of risk management has been a top priority since the Asian financial crisis. Recently we got a reminder of just how important this is. The credit crunch related to the sub-prime problem in the US has highlighted the importance and urgency of this work.

Implementing Basel II has been an important part of our risk management strategy. In fact, Hong Kong was among the first jurisdictions in the world to implement Basel II, making us very much a leader in the region. Importantly, it provides a more risk-sensitive approach towards capital planning. And it encourages lending to more credit-worthy counterparties. There are also more sophisticated credit ratings for both the borrower and each exposure in the process. Basel II requires a larger capital cushion for a range of high-risk exposures, like market risk or operational risk. The implementation process has been long and painstaking, but the end result is much greater confidence in the banking sector.

In addition to Basel II, stress testing has also become an important part of our financial infrastructure in recent years. Since 2003, all authorised institutions have been required to have a stress-testing programme in place to make sure that they are healthy enough to bear the risks that they are taking.

Techniques for stress-testing are also being constantly upgraded to meet the needs of the industry. They not only take into account the direct exposure to risk, but also the knock-on effects from second and third round exposures.

A strong regulatory regime and prudent risk management has helped shield Hong Kong from any significant impact from the sub-prime problem in the US.

36. It was, of course, a very different story 10 years ago when Hong Kong felt the full force of the financial crisis. One particularly painful chapter was the collapse

of the property market. Many people couldn't afford to pay their mortgages, and at one stage, more than 100,000 people were saddled with negative equity.

It became a long-term burden for many of our residents. However, the Hong Kong Mortgage Corporation, which was set up in 1997, did come up with a solution to help mortgage borrowers in negative equity. Under the market-driven plan, they were able to refinance at a lower mortgage rate. It also helped banks to manage the credit risk of their mortgage portfolios.

At the time, this initiative helped maintain stability of the banking system. The Corporation has achieved a solid performance over the past decade, and continues to add stability to the mortgage lending of banks by reducing their concentration to liquidity risk.

Another relatively high-risk borrower has traditionally been the small company. In Hong Kong, there are in the region of 275,000 small and medium-sized enterprises (SMEs) which account for about 98 per cent of all private sector businesses, and employ more than one million people. So it is important to get this part of the puzzle right.

Since 2004, the Commercial Credit Reference Agency (CCRA) has provided lenders with information about the credit history of SMEs to enhance the soundness of the financial system. Under the system, SMEs with a sound credit history can obtain loans faster and at better rates. It also helps to strengthen the credit risk management of banks.

I hope this has given you some idea of the work we are doing in Hong Kong to further strengthen our financial architecture and the banking sector.

But in this era of globalisation, we need global solutions to potential problems.

One such issue on our radar screens is international money laundering. Another is terrorist financing. In both cases, we are heightening awareness within our financial sector as well as the general community about these activities.

We are also implementing the recommendations of the inter-governmental Financial Action Task Force (FATF) on anti-money laundering (AML) and combating the financing of terrorist funding (CFT). These include customer due diligence, heightened surveillance and encouraging the reporting of suspicious transactions.

I believe regional financial stability also requires regional cooperation.

It is important for us to play a part in sharing ideas and promoting understanding within the region. Other groupings include EMEAP, the Executives' Meeting of East Asia-Pacific Central Banks, and SEANZA, the South East Asia, New Zealand and Australia Forum of Banking Supervisors. They are all playing an increasingly big part in helping to ensure regional financial stability.

Real Time Gross Settlements systems are an obvious way of reducing the risk for international fund transactions.

Hong Kong launched the RTGS more than a decade ago, and we are continuing to improve the system by building a multi-currency, multi-product payment mechanism. As financial markets across Asia become more mature and, more liquid, these services will become even more important to our financial services.

In fact, just this week we implemented a cross-boundary delivery-versus-payment (DvP) link with Malaysia. This follows the success of the payment-versus-payment (PvP) link between Hong Kong's US dollar RTGS system and Malaysia's Ringgit RTGS system that was established last year.

The DvP settlement services provide the necessary infrastructure to support potential issuance of US dollar bonds in Malaysia. This is part of the initiatives to promote Malaysia as an Islamic financial centre and strengthen our role as a global financial centre.

You may be aware that Hong Kong also aspires to become a centre for Islamic finance. The Monetary Authorities has been working on the initiatives with the Treasury Market Association for months. We have invited experts from Bank Negara Malaysia to come over to Hong Kong in January to share their experience with people in our financial sector on this subject.

Ladies and Gentlemen, banking systems in different parts of this region are at different stages of development. We are all seeking new and better ways to deal with our own unique issues. But we can also move in the same broad direction together. Meeting international standards, such as Basel II, is one way of achieving our common goal.

We have all come a long way since the Asian financial crisis threw our markets into a massive tail spin. I believe there is no better time than the present, a time of relative economic stability, to prepare for likely bumps in the road ahead. If there is one lesson to be learned from the past decade, it is that some of the biggest challenges come when we are least expecting them. So always be prepared.

Thank you.

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