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Self-Governance and State Regulation

Code of Banking Practice

In addition to a code of conduct proclaimed by individual banks, Hong Kong and Australia each have a code of banking practice issued by the respective banking associations. In order to appreciate the banking situation in Hong Kong, it is worthwhile to look at the Hong Kong Association of Banks (HKAB) and to examine its role and its relationship with the Hong Kong Monetary Authority (HKMA), which has the exclusive power to approve the establishment of licensed banks, restricted banks and deposit-taking companies, but the focus in this monograph is only on licensed banks. Once a bank receives a license to operate, it has a statutory obligation to become a member of the HKAB, which has traditionally had a pivotal role in the establishment of banking practices and guidelines. The locally established banks are entitled to select their own representatives, whereas the foreign banks have to choose representatives according to their geographical grouping. The HKAB has three permanent members, namely the Hong Kong Bank (HSBC), the Standard Chartered Bank and the Bank of China, each of which rotates annually as chair of the HKAB. These three are not only the largest banks in Hong Kong but also have a notable statutory function, namely as officially designated note issuers of the Hong Kong currency, which is a unique privilege held only by central banks in other countries.

Until the relatively recent establishment of the HKMA, which subsumed the previous Commissioner of Banking, the HKAB had a much broader unofficial role. Not only did the three permanent members issue the currency, but they also effectively established the interest rates, and thus the HKAB was referred to as a banking cartel. The HKMA has endeavoured to break up the interest-setting cartel by stipulating that market forces must determine interest rates. Despite this measure, the three permanent members remain the largest banks, continue to be the

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official note issuers and dominate monetary trading, so they exert considerable influence on interest rate movements and are effectively the market makers.

These permanent members perform another key role, which is normally carried out by the central bank of the country, namely as the official clearing banks: HSBC and HKMA for US dollars, HSBC for HK dollars and Bank of China for PRC RMB (Chinese renminbi). In its role of US dollar clearing, HSBC cooperates closely with the Federal Reserve Bank of the United States.

Together with the Deposit Taking Companies Association, the HKAB has also issued the Code of Banking Practice (COBP), which is intended:

(a) to promote good banking practices by setting out the minimum standards which institutions should follow in their dealings with personal customers;
(b) to increase transparency in the provision of banking services so as to enhance the understanding of customers of what they can reasonably expect of the services provided by the institutions;
(c) to promote a fair and cordial relationship between institutions and their customers;
(d) through the above, to foster customer confidence in the banking system.[1]

The HKMA fully endorses the COBP-recommended practices and standards and expects all banks to take active steps to ensure full compliance with the COBP, which some senior bankers believe actually emanates from the Authority. It believes that the COBP will help to further enhance the transparency and quality of banking services in Hong Kong as well as Hong Kong's status as an international financial centre. As part of its regular supervision and to set up the monitoring of banks' compliance with the COBP, the HKMA has required all banks to commission their internal audit departments or other equivalent units to conduct an annual self-assessment of their compliance with the COBP. The self-assessment results are required to be submitted in the standard template to the HKMA by the timeline as imposed by the HKMA. The self-assessment aims to encourage banks to rectify any weaknesses identified at an early stage. Where non-compliance areas are identified during the self-assessment process, banks should specifically provide the details, remedial plan and target completion date. The HKMA closely monitors banks' progress in implementing the rectification plans. The self-assessment results also enable the HKMA to analyse the compliance

position of individual banks, with a view to identifying common issues within the banking industry and developing supervisory guidance over the longer term. Although no penalties are specified for failure to submit reports, a non-cooperative manner would adversely affect the HKMA's outlook on the bank's practices in providing services to its personal customers. From one perspective, even if the COBP is voluntary for banks, the mandatory self-assessment of compliance for all banks is a clear signal that it is an instrument of banking supervision. The HKMA may undertake more frequent and stringent on-site examination to supplement its supervisory function.

During the course of the Hong Kong research, interviews were granted by the current and the previous chairperson of the HKAB, both of whom were chief executives of their own major global banks but were able to speak about the entire industry and also to comment on the occasional tension between the banks and the regulators, because of their position as industry spokespeople.

Looking at Australia, the Australian Bankers' Association (ABA) works with its members to provide analysis, advice and advocacy and contributes to the development of public policy on banking and other financial services. The ABA claims that it tries to ensure the banking system can continue to deliver the benefits of competition to Australian banking customers.

In practice the ABA works to ensure that the banking industry views are put forward when governments determine policy or legislation. Many areas of commonwealth and state law, and in some cases international law, impact upon the commercial interests of Australian banks. The Australian Competition and Consumer Commission (ACCC), the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA) regulate banks.

With the active participation of the member banks, the ABA works to foster an environment in which financial services are properly appreciated and allowed to prosper. In conveying the industry's views, the ABA works with the commonwealth, state and territory governments, the regulators, other industry associations, the community, community groups and the media.

The ABA has issued the Code of Banking Practice, which is a voluntary code of conduct that sets standards of good banking practice for banks to follow when dealing with persons who are, or who may become, individual and small-business customers and their guarantors. This COBP is reviewed periodically and updated by a professional external

consultant. The code establishes the banking industry's key commitments and obligations to customers on standards of practice, disclosure and principles of conduct for banking services. When a bank adopts the code, it becomes a binding agreement between the individual customer and the bank.

Although the Australian Bankers' Association instituted the code, an independent body administers compliance. The Code Compliance Monitoring Committee (CCMC) was established to ensure that banks that have adopted the COBP meet the standards of good practice set out in it. The committee investigates complaints that the code has been breached. CCMC also monitors bank compliance with the code through compliance activities such as mystery shopping, surveys and compliance visits.

However, CCMC does not get involved in financial loss. If a complaint against a bank includes a claim for financial loss, the Banking and Financial Services Division of the Financial Services Ombudsman (FOS) would consider the complaint. The FOS may also be able to consider other complaints that the CCMC cannot look at, for example, where the bank being complained about has not adopted the code. The Financial Services Ombudsman endeavours to independently and impartially resolve disputes between consumers, including some small businesses, and participating financial services providers. The FOS independent dispute resolution processes cover complaints about financial services including banking, credit, loans, general insurance, life insurance, financial planning, investments, stock broking, managed funds and pooled superannuation trusts.

The CCMC can look at serious and systemic breaches of the code. Such complaints can also be reported to the Australian Securities and Investments Commission (ASIC), whose role will be discussed in the section on regulators.

Though both the HKAB and the ABA are industry associations representing their member banks, the ABA is portrayed as very different from the HKAB, which takes active business decisions. In the past, the HKAB fixed interest rates and, though market forces now set the rates, it continues to carry significant influence. Moreover, the three permanent members of the HKAB are the official issuers of the currency and the official note-clearing banks. The ABA confines itself to formulating bank industry policy particularly in relation to regulations and compliance thereof. It avoids matters involving competition among the banks because it acts as an advocate for the entire industry.[2] In certain ways there is a commonality because Australia is characterized by four major

trading banks that are clearly larger than any other bank in the country, whereas Hong Kong is dominated by three leading banks, but the key difference is that the latter banks conduct specific monetary roles on behalf of the government treasury in addition to their commercial functions, and they maintain positions as rotating permanent chairpersons of the HKAB. One would therefore consider that the HKAB and the HKMA have a symbiotic relationship, whereas the ABA functions more as an industry advocate vis-à-vis the RBA.

Regulation in Hong Kong

Financial Crises in Retrospect

In order to understand the attitudes and practices of banks and regulators, it is especially useful to comprehend the environment in which they have operated and to recall the highly significant events that have made their imprint on Hong Kong. Without delving into the original history of the establishment of the colony by entrepreneurial traders from the British Empire, one only needs to recall historical episodes such as the successful revolution leading to the establishment of the People's Republic of China in 1949 and the Mao-inspired Cultural Revolution of the 1960s. But for the banks and the people living in the territories, the initial modern premonition of the turbulence that would soon test the resilience of Hong Kong was the Thatcher declaration of 19 December 1984 when British Prime Minister Margaret Thatcher announced that Great Britain would be handing Hong Kong over to China in 1997 as part of its mutual agreement.[3] This was the impetus behind the frenetic panic-driven foreign exchange trading immediately after that announcement that saw the HK dollar falling to its historical low and resulting in the establishment of a linked exchange system with the US dollar.

Why was there such a panic? Many residents had fled the centrally planned communist regime in China for the laissez-faire milieu of Hong Kong, some of them becoming very prosperous, many attaining respectable, comfortable professional status, with the average folk relishing the newly gained freedom. They feared all their affluence and independence would be lost once Hong Kong was returned to China, from which they and their parents had struggled to flee.

Therefore the initial reaction was to sell the local currency in order to buy foreign currency. The second and more long-lasting consequence was that residents applied for, and received in many cases, permission to migrate to foreign countries such as Canada, Australia and Britain.

When the handover eventually came in 1997, there was also a mad rush to sell property because these migrants wished to dispose of their assets so they could buy new homes in their new countries. A city that had experienced spectacular growth in property prices saw the real estate sector collapse by 70 per cent over the next several years. Such a dramatic downturn was due to a loss of trust by the people of Hong Kong in the sustainability of the institutions and the rule of law that had safeguarded the freedom to which they had grown accustomed. China had given assurance of having one country but maintaining two systems, that is, allowing the capitalistic money-oriented economy to continue unfettered within the communist state, but the Hong Kong residents had misgivings about this promise. The succeeding years would prove to be the true test.

The free fall in property prices and the loss of trust by the residents wrought severe repercussions on the banks and the financial stability of the former colony, thus necessitating institutional restructuring and upgrading of the regulatory framework in order to cope with the unprecedented systemic stresses.

Just as the former colony struggled to recover from this crisis of confidence, Hong Kong was afflicted in early 2003 by an unexpected SARS (Severe Acute Respiratory Syndrome) epidemic, which was transported from mainland China because of the extensive trade and commerce. SARS was a rare form of pneumonia caused by a coronavirus resembling that responsible for the common cold, but it was different because it was deadly, originated from contact with contaminated animals and was not spread in the air but through contact with infected persons. This was a blow to all segments of the economy as factories and commercial offices sent workers home whenever employees were diagnosed with the disease. The impact was ferocious on tourism as all travel dried up overnight, and unemployment in the tourism, air transport, hospitality, restaurant and retail sectors soared to an all-time high of 7.8 per cent in the period of February–April 2003. All business enterprises suffered because production, sales and profitability plummeted as the disease spread like bush fires.

The banking system had to struggle anew with this menacing onslaught, which struck at the whole corporate establishment as well as the working classes, the professionals and the business elite. An entire branch of one bank had to close down when it was discovered that one employee was infected with the deadly virus. The story of that decade reveals the amazing crucible that has shaped the ethos of the present-day banks of that city. The banking edifice of any other country might easily have collapsed under these circumstances.

The Hong Kong Monetary Authority

In response to the numerous financial crises and in preparation for the handover, the Hong Kong Monetary Authority was established on 1 April 1993 as Hong Kong's central banking institution by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. This was made possible by legislative amendments to the Exchange Fund Ordinance in 1992 empowering the financial secretary to appoint a monetary authority. What makes this institution unique is that the Exchange Fund Ordinance – Section 5A specifically states that 'The Financial Secretary shall appoint a *person*[4] to be the Monetary Authority on such terms and conditions as he thinks fit'.[5] Thus the office of the monetary authority is known as the HKMA and the monetary authority as the chief executive of the HKMA.

The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and maintaining and developing Hong Kong's financial infrastructure.[6] The banking ordinance provides the Monetary Authority with the responsibility and powers for regulating and supervising banking business and the business of taking deposits. The HKMA's supervisory policy manual states that:

> The HKMA's primary function under the Banking Ordinance is to promote stability within the Hong Kong banking system. Good and ethical banking practices are essential for safeguarding depositors' interests, maintaining the stability of the banking system and preserving Hong Kong's reputation as an international financial centre.
>
> The HKMA believes that it is consistent with these functions to require AIs (approved institutions) to promote a sound moral culture within their organisations and to develop a set of ethical standards and values to which their staff are expected to adhere. This can be done by means of establishing a Code of Conduct and having a system in place to enforce it.[7]

It is significant that the Monetary Authority explicitly declares the need for morality and ethical conduct in the banking system because this has elicited a positive response from the banks. Considering that countless individuals maintain deposits with banks, the protection of those depositors can only be ensured through principled and fair treatment by the banks. One could infer that the previous crises that afflicted Hong Kong provided the incentive for this affirmation of morality.

The chief executive appears particularly concerned about integrity as he wrote: 'The integrity of the financial system is too important for us to allow it to be undermined: effective regulation and robust systems are essential.'[8] One interprets this to unequivocally mean that the chief executive considers regulation as necessary for maintaining integrity, which is indispensable for financial intermediation to effectively support economic growth especially in an international financial centre like Hong Kong with its global ramifications on investors and fundraising issuers worldwide.

The Authority rightly expressed apprehension about the 'deep-rooted dilemma between the public interest in ensuring effective financial intermediation that promotes the general well-being of the community, and the private interest of financial intermediaries in maximising profits'.[9] He sees the key role of a financial system as that of a conduit between sources and users of funds, with providers or depositors accepting the credit risk of the banks and the latter exposed to the credit risk of the borrowers. As remuneration for their services and the risks of intermediation, the banks earn a net interest margin, or the difference between what they pay depositors and what they charge borrowers.

An effective financial system is one that gives a high rate of return to those saving or investing money and a low cost of funds for those raising money. But clearly for the intermediaries to play their specialized role effectively, they need to have the correct incentive to do so, and this means a reasonable level of remuneration for them in terms of profits for the financial institutions and pay for those working in them. The HKMA said: '*To ensure reasonableness, policymakers often, and rightly, rely on the competitive forces of the market.*'[10]

The HKMA realizes that a totally free market is not always feasible because the role of intermediation can only be entrusted to institutions with high integrity, thus necessitating banking supervision and regulations. At this point in time there was already ethical concern with selfish interests in compensation that needed to be curbed.

A free market also implies a somewhat protected mandate for the intermediaries that may be further strengthened through the advocacy of industry associations. Banks vigorously pursue self-interested, profit-maximizing objectives. Therefore the more successful the banks are in their corporate role, which is measured by the profits they make, one can argue, the less effective is the financial system in financial intermediation. According to the Hong Kong Monetary Authority, this is the deep-rooted dilemma often faced by policymakers.[11]

While the HKMA leaves the relationships between banks and customers in the hands of the banks as befits a free market, it upholds the ethical value of transparency and disclosure in order to grant an adequate degree of protection for individual clients and lessen the need for supervisors and regulators to get involved. The HKMA sets the standards and occasionally promulgates statutory guidelines. It expects its constituent banks to comport themselves according to 'best practice' norms.

Although not a consumer rights advocate per se, the Authority in actively promoting greater competition within the banking system, had started to curb the powers of the HKAB cartel in the 1990s and after seven years successfully eliminated interest rate fixing, which brought benefits to both depositors and borrowers alike. During the cartel regime the net interest margin had ranged from 2 to 3 per cent, which in 2006 fell to 1.4 to 1.5 per cent, which was evidence of the high efficiency of the banking system.

While subscribing to the belief that competition stimulates efficiency, the Authority says that regulators must ensure that competition does not reach the point of eroding profitability to such an extent that it pushes financial intermediaries into irresponsible behaviour that eventually undermines the stability and integrity of the financial system. The chief executive of the HKMA stated: '*improper behaviour . . . is categorically unacceptable*.'[12]

The Authority is of the opinion that regulators cannot prevent all crime or unethical behaviour; it promulgates guidelines and rules, statutory or otherwise, but expects the private sector to act without the supervisors reviewing every transaction. The Authority thus encourages transparency and investor education. Where necessary, it promotes investor protection measures, such as the requirement for deposit insurance introduced in 2006. The motive behind deposit insurance could be interpreted as a Kantian categorical imperative of treating all bank depositors as persons, but it could also be perceived as utilitarian in the sense that it sought to protect as many small depositors as possible and implant confidence among them in the banking system.

Credit Cards

The proliferation of credit cards was due to competition, and in the HKMA's view is possibly good for cardholders who obtain rebates and are able to earn rewards with their usage, but the worry is about the potentially reckless issuance of cards to individuals who are not in a position to borrow or service their liabilities, for instance students. The Authority's concern is that all banks conduct business prudently,

otherwise it could intervene. But non-bank institutions, which are beyond the scope of banking regulation, also issue credit cards, so the HKMA normally prefers to allow the market to instil discipline. Its main anxiety is over risk management, that banks are issuing credit cards to the right people.[13]

The Monetary Authority has witnessed scores of problems that surfaced during the period of economic crises and the devastating SARS epidemic. In the worst-case scenarios, credit card borrowers amassed debt exceeding 40 times their net income, leading to an extraordinary bankruptcy rate. The HKMA identified the need for sharing credit information so that every lender could be aware of the overall level of indebtedness of each potential borrower or credit card applicant. In its role as supervisor, the HKMA wished to ensure that banks take prudent risk and therefore encouraged the establishment of a credit bureau, which is owned by the private sector.[14] Since then, loan losses have dropped to comfortable levels. Credit cards are a profitable source of income but not a big part of overall earnings.

Housing Loans

The mortgage loan segment has been a major concern for the HKMA because it is the largest component of banking assets. The Authority is therefore particularly keen to make certain that banks proceed cautiously with granting mortgage loans – for both commercial and residential purposes. It has therefore deemed it necessary to promote prudent practices, such as setting a loan-to-value ratio of 70 per cent, a debt-service ratio of 50 per cent and the enactment of non-performing loan classification. These guidelines are far more stringent than those observed in America over at least the last ten years.

The Authority does not feel that banks were responsible for driving up housing prices because banks are in the business of taking risk and providing financing to whoever is creditworthy. In arriving at decisions, banks have to evaluate the creditworthiness of prospective borrowers and the quality of underlying assets. Banks can choose to act countercyclically and help to dampen speculation. As displayed at the height of the property boom, banks voluntarily reduced their loan valuations ratios to 60 per cent, even 50 per cent in some instances, especially for luxury housing that tended to be more volatile.

Negative Equity Problem

There are two sides to this problem, the first one relating to the anguish of individuals who suddenly become aware of their negative equity

position, that the current value of their property has plunged vis-à-vis the amount of the loan they still have to repay. This situation, which is upsetting by itself, could be aggravated if the interest rates soar or the borrowers lose their jobs, which could impair their capacity to repay their obligations. The other side corresponds to the position of the lenders who discover that the collateral assigned to them has deteriorated. As Chapter 6 will point out, this is precisely what occurred in the subprime crisis that erupted in America in 2007. 'As banking supervisor, the HKMA's concern has to be the likely significance of negative-equity mortgages for the quality of the loan book of the banks.'[15]

It is due to this apprehension that the Authority prescribed a loan-to-value ratio of 70 per cent for residential mortgage financing. Adherence to this guideline made it possible for banks to weather the storm. It was also not a common practice for banks to demand additional collateral on performing mortgage loans of owner-occupiers who were making regular timely repayments.[16]

A look at the actual levels of valuation of residential mortgage loans (RML) reveals a peak of 105,697 cases in negative equity amounting to HK$165 billion representing 22 per cent of all RMLs but 31 per cent of total value, yet resulting in a delinquency ratio of only 2.28 per cent. By December 2006 the circumstances were substantially improved with 8,444 cases with HK$14 billion outstanding or 3 per cent of all RMLs. The delinquency ratio was down to a low level of 1.26 per cent. What is extraordinary is that even at the height of the negative equity problem the delinquency ratio always remained at a respectable level. These levels of negative equity and delinquencies are depicted in the Table 1.

Table 1 Hong Kong Negative Equity and Delinquency in Residential Mortgage Loans 2001–06

Negative equity RMLs (end of period figures)	**Cases (per cent of total RMLs)**	**Value (per cent of total RMLs)**	**Delinquency ratio**
Sept. 2001 (1st available position)	65,000 (14 per cent)	$127 billion (23 per cent)	Not available
June 2002 (peak of delinquency ratio)	68,252 (14 per cent)		
June 2003 (peak cases & value)	105,697 (22 per cent)	$165 billion (31 per cent)	2.28 per cent
Dec. 2006 (latest available position)	8,444 (2 per cent)	$14 billion (3 per cent)	1.26 per cent

Supervisory Stance

The Hong Kong Monetary Authority prefers the term 'supervision' to 'regulation' in describing its role. The HKMA has progressed from a posture of prudential supervision to one where it defines a policy framework within which financial intermediaries operate and are encouraged to adopt sensible risk management tools. In carrying out corporate finance, foreign exchange trading and securities dealing, the banks are expected to utilize appropriate risk management tools to guard against credit risk, operational risk, market risk, interest rate risk, exchange risk, legal risk and reputational risk. In the view of the HKMA, the reputation of an institution would be damaged if it provided financing to a project or a borrower that destroyed the environment or harmed the community, so it would be unwise to back such a scheme. Likewise the HKMA expects banks to adopt best market practices and institute codes of conduct and procedures that discourage fraudulent trading among dealers. The Authority does not discourage banks from taking risks, but they must have effective mechanisms in place to manage these risks.

Rather than acting as a consumer advocate, the HKMA adopts the stance that fees and charges are commercial decisions of banks. It defines its role as one of 'ensuring transparency and sufficient competition in the market so that consumers can make their own decisions'.[17] This comment encapsulates the laissez-faire character of the Hong Kong banking environment

Attitude of Banks Towards HKMA

The bankers expressed the sentiment that the banking industry in Hong Kong is over-regulated with the HKMA imposing too many detailed guidelines that require banks to submit excessive quantities of returns, which are a cost burden. The banks would prefer a risk-based[18] approach that attempts to avert or mitigate risks and ensures a level playing field for all market players rather than the current system in which the HKMA is perceived as regulating all activities. Moreover, since many banks in Hong Kong are engaged in securities activities, they are also subject to the supervision of the Securities and Futures Commission, which is allegedly very tough on banks.

There is a feeling among financial institutions that industry self-regulation through the Hong Kong Association of Banks is quite effective and that good banking practices are in place, but there is also an impression that the regulators do not have a sufficiently comfortable level of trust in the banks. While comments from bankers abound that much pressure is imposed by the HKMA in the form of costly compliance and

additional reporting, bankers nevertheless acknowledge that the HKMA has performed well, engaged in dialogue with the banks, and through the HKAB encouraged self-regulation with the espousal of the Code of Banking Practice.

There is the observation that unlike former days, the HKMA has become much more proactive as a result of several major directives emanating from international regulators such as Basel II relating to bank risk, Sarbanes-Oxley on corrupt practices, and anti-money-laundering decrees. The latter, for instance, necessitated the acquisition by banks of expensive software which was not previously utilized.

It has been remarked that the Hong Kong Monetary Authority is one of the most enlightened regulators in the world, with strong leadership at the top. There has been reference to the HKMA as more similar to the UK and European models than the American one, the latter having an approach of 'comply or perish', and the HKMA a technique of 'comply or explain'. In other words, the HKMA is prepared to listen to a bank's explanation for non-compliance and will not automatically impose penalties; it might well accept the clarification. There is therefore a view that the HKMA is a 'world-class' regulator.[19]

There is general agreement that the regulatory, compliance and legal environment of the banking system has become much more rigorous over the past five years. Banks have to ensure that they operate soundly, are well capitalized, take the right risks and manage them well in order to protect the customers and depositors. The costs have been enormous for banks, but the institutions are more robust and risk-free than five to ten years ago.

Nevertheless, professionals in the field maintain that even in the absence of regulations the banking history of Hong Kong has demonstrated that banks have typically acted in a very responsible manner and have displayed a high level of natural integrity. There is a belief that the business environment here is good where people operate on the basis of trust. There is a claim for a high level of ethics among banks in Hong Kong. Reference was made to only one instance of serious misconduct that occurred in a major foreign-owned bank in the past decade.[20]

There is the view that the cooperation between the HKMA and the banks is one of the main factors that explain why Hong Kong did not collapse despite all the catastrophes that battered it. Communication between the HKMA and the banks is deemed very good and has engendered a sound banking system. Similarly the HKAB is regarded as performing an important role in coordinating with the HKMA on behalf of all the banks. An example cited is the synchronization of deposit insurance fees for the different levels of banks.

Top bankers accept that regulations are enacted in order to foster discipline but believe more self-regulation should be encouraged with reliance on guidelines in lieu of austere regulations. The Dragon CEO argues that the better-managed banks should be granted more flexibility based on their own self-assessment.[21] The leading banks believe they would behave the same way even in the absence of regulations because their internal standards exceed those required in regulations.

They contrast the situation in China, where corruption is rife, with that in Hong Kong, where it is avoided. The Hong Kong bankers attribute this to several factors that are positive in Hong Kong, namely a high level of education, a well-defined legal system to which people adhere, a high standard of living and a well-paid and disciplined police force. They allude to a lack of checks and balances in China, unlike Hong Kong, where the establishment of the Independent Commission against Corruption more than 30 years ago is regarded as a highly effective measure that provides equal recourse to the law for everyone. The free press is another essential ingredient.

Some top bankers remark that regulations are probably necessary in developing areas such as Latin America in order to instil discipline, but their own global institutions have performed very well in emerging markets. Because of their experience in such markets, one leading bank avers it has taken the initiative towards more self-regulation, that is, of setting standards according to its moral values.

Regulation in Australia

Deregulation, Banking Crisis and Recession

The Australian financial system has undergone several major adjustments over the past 60 years, with the period from the Second World War until the late 1970s characterized by stringent regulations on trading and savings banks, such as interest rate ceilings and asset ratio requirements. As Fitzgibbons wrote, a new breed of financial institutions developed during the 1950s and 1960s, non-bank financial institutions (NBFIs), which developed outside the regulated banking sector, comprising finance companies, merchant banks, building societies and credit unions, and these competed with the banks.[22] These NBFIs were not subject to the same degree of controls affecting the banks and hence offered a new challenge. These new institutions arose in response to increased demand for financial services driven by economic growth.

Although the two-tier financial structure meant that banks had to operate under strict rules, they enjoyed numerous benefits. As Amanda Fitzgibbons explains, the financial regulations offered distinct advantages to the banks. Privileged access to lender-of-last-resort facilities and an implicit warranty in the event of failure conferred on the banks an unrivalled stature for soundness and security that attracted many customers. Regulations granted the banks exclusive monopoly over cheque payment services and foreign exchange transactions: the latter function was particularly valuable as it was highly lucrative and the Reserve Bank carried all the risks. Barriers to entry staved off competition from foreign banks and protected the domestic banks' virtual oligopoly. The cost of controlled interest rates on loans was counterbalanced by controls on deposit interest rates and the banning of interest payments on current accounts, which provided the banks with a large source of low-cost funds.[23] The banking sector therefore preferred to live under a regulatory regime rather than admit the entry of new and stronger bank competitors. Yet the forces of economic progress and international markets started to clamour for change and deregulation, and in January 1979 the Campbell Committee was established to conduct an enquiry into the conditions of the Australian financial system. Submissions were requested from the Australian Bankers' Association, which acted as the banking industry's advocate and, at that time, was staffed by economists who backed ideas of economic liberalism and free markets and who therefore argued in favour of deregulation; bank economists who came from a similar academic training were likewise highly supportive.[24]

However, the bankers themselves did not share this view and were resistant to change. They were especially fearful of the entry of foreign banks that might come to Australia once deregulation was enacted. In countering such sentiments, the bank economists argued that if the banks wanted to expand overseas, they had to accept the principle of reciprocity and allow foreign banks to operate in Australia. Even while desiring international expansion, the bankers wanted foreign bank entry to be delayed in order to be better prepared.

The NBFIs were lukewarm towards deregulation because the current restrictive regime created a niche for them. As pragmatists, they acknowledged that deregulation was unavoidable and so they sought equality with the banks, which in turn attempted to exclude foreign institutions and retain their oligopolistic powers over the payments system and foreign exchange.[25]

The banking sector and the NBFIs submitted their respective recommendations to the Campbell Committee with each group seeking partial

and selective deregulation to suit its own respective vested interests. For instance, credit unions and building societies resisted foreign bank entry but insurance companies were favourably disposed.

While the enquiry was underway, the financial institutions embarked on stratagems to prepare for the inevitable onset of deregulation, which they viewed with trepidation. The banks believed that they needed to grow bigger in order to meet foreign competition, so a spate of mergers ensued. In June 1981 the Bank of New South Wales, the oldest bank in the country, merged with the Victoria-based Commercial Bank of Australia to form Westpac. During the same timeframe, the National Bank of Australasia merged with the Commercial Banking Company of Sydney with the resulting entity named National Bank of Australia. In addition to mergers, these enlarged banks went on an expansion programme to acquire other financial subsidiaries such as merchant banks and finance companies.

In November 1981 the Campbell Committee submitted its final recommendations to the Parliament; these included abolishment of interest rate restraints, floating of the Australian dollar and allowing entry of new foreign and domestic institutions into the Australian banking system. Westpac faced these new challenges with heightened vigour.[26]

In her book on Westpac, Carew narrates how Australia's oldest bank endeavoured to pursue growth through aggressive lending, acquisition of new businesses and establishment of a global network.[27] During a period of less than six years, Westpac transformed itself from the leading Australian bank to the epitome of financial disaster. It launched finance companies and merchant banks, which had scant central control and sometimes competed with each other and provided loans to the same corporate customers; it invested heavily in property financing and development and its various subsidiaries wound up becoming substantial property owners. For the first time in its long history, the bank hired outsiders in senior management positions to propel the growth in global markets and in new financial product areas, such as foreign exchange trading and treasury products. The incumbent bankers who had spent their entire careers in Westpac unsurprisingly resented these newcomers, and this cultural clash prevented integration that could have fostered genuine dialogue.

In January 1983 the Australian treasurer declared that the government would allow the establishment of ten new banks, including foreign-owned ones. The newly elected Labour government in March of that year formed the Martin Group to review the Campbell recommendations; in February 1984 the Martin Review Group gave its support to

maintaining deregulation as well as entry of new, including foreign, banks.[28] The government followed the recommendations and in 1985 approved the licensing of 16 new foreign banks, far more than initially proposed by the Campbell Committee.

The over-reaction to deregulation by the existing banks as well as the onslaught of the new entrants in the 1980s created the circumstances that would lead to the worst losses in the Australian banking industry in nearly a century. Deregulation in the mid-1980s escalated competition and the yearning by financial institutions for rapid expansion. This occurred in circumstances when asset prices, especially commercial property prices, were briskly shooting up, and credit evaluation processes in many institutions had not yet adapted to the new liberalized conditions. Consequently loans skyrocketed with collateral in the form of progressively overvalued commercial property. By 1989, the conjunction of soaring interest rates and declining commercial property prices revealed the substandard calibre of the riskiest credit. As recession hit the economy and property prices went into free fall, loan difficulties surfaced across the board.[29]

Westpac suffered heavy losses, but as a group the banks owned by state governments and foreign banks lost the most because they were the most relentless in the pursuit of market share. Supervision of the state banks was made difficult by the technicality that the Reserve Bank of Australia (RBA) did not have formal legal powers over licensing, 'even though the state institutions had given formal voluntary undertakings to meet the Reserve Bank's prudential standards'.[30]

While public trust in financial institutions was shaken by the huge losses and runs on smaller entities, overall confidence was not eroded because of public-sector intervention. The state governments ensured that no depositors lost their deposits while the foreign banks replenished the capital of their Australian subsidiaries. The depositors of the Big Four banks were never in danger of losing their deposits in the 1990s.

While the 1980s could be described as the era of corporate financing extravagance, the 1990s ushered in a significant financial development, the escalation of Australian *household indebtedness*. As RBA economists noted in a conference paper, the proportion of household debt to household disposable income nearly doubled over the decade, 'rising from 54 per cent in 1990 to almost 100 per cent at the end of 1999 . . . Most of the additional debt was used to purchase residential estate'.[31] A key reason for the emergence of households as a major market segment was the breathing space needed by corporations to wind down their excessive loans and acquisitions. The loan losses of banks from corporate finance propelled them into retail banking.

Accompanying the increase in household debt was the shift of household savings away from traditional bank deposits to market-oriented investments. This had a profound effect in the restructuring of the balance sheets of banks. The fusion of robust loan expansion and sluggish build-up in domestic deposits had prompted financial institutions to depend on financial markets for funding, primarily through debt securities, many of which were acquired by non-residents.[32] This dependence on international funding would subsequently impact Australian banks adversely as liquidity tightened during the global financial crisis.

Deregulation brought competition to the market for residential mortgages, where the RBA reported 'the margin between the standard mortgage rate and the cash rate fell from a historically high 4-1/4 percentage points in 1992/93 to around 1-3/4 percentage points in 1999'.[33] Although the mortgage brokers relied on banks for initial funding, they later turned to securitization of mortgage assets and were able to lower margins on their loans without worrying about the profitability of existing loans.

In the financial product of credit cards, competition was also fierce, but the strategy was a vigorous attempt on the part of credit card issuers to stimulate card usage through various loyalty reward programmes rather than a cut in lending margins, which succeeded in driving a 'five-fold increase in the number of credit card transactions over the decade, and a trebling since 1995'.[34] Competition in this case did not offer card customers financial benefits but creative inducement schemes to earn frequent flyer mileage or loyalty points with other service providers.

Despite competition, banking business became more concentrated among the top five banks, and their average return on equity remained unchanged. A noteworthy contributor to profitability was the growth of non-interest income, which was primarily *fee income* on services provided to households. According to RBA economist Gizycki, 'the most notable examples are the introduction of mortgage fees and account-servicing fees . . . whereas in 1990 such fees rarely existed'.[35]

There are several observations one can make about financial liberalization in Australia during the 1980s. Firstly, many new financial institutions were established, with some of the largest international groups setting up branches or subsidiaries. Secondly, the push to lower interest rate margins came from newcomers rather than from the major local banks that had the biggest market shares. Thirdly, zealous speculation created a property bubble that caused financial losses at numerous banks, thus resulting in the failure of several institutions and concentration of assets among the leading five banks. Fourthly, household debt emerged

as a significant growth factor. Fifthly, banks became progressively more reliant on funding through asset-backed securities and the use of derivatives in international financial markets. Finally, the structure of prudential supervision and regulation required adjustment and strengthening to cope with the sea change brought about by deregulation.

New Regulatory Model

The crisis suffered by the financial sector in the late 1980s to the early 1990s resulted from deficiencies in the risk management systems of the financial players and the prevailing regulatory structure. The immediate response in the initial half of the 1990s was the compulsion on financial institutions to upgrade their risk-management techniques, while in the latter half of the decade there was an emphasis on regulations that encouraged competition, protection of individual customers, responsiveness to financial innovation and firmness to ensure a stable financial system.

The new measures included regular on-site bank inspections by the Reserve Bank, the enactment of guidelines on the determination of non-performing loans, assumption of responsibility by the RBA of regulation of state-owned banks and the creation in 1992 of the Australian Financial Institutions Commission (AFIC) to supervise building societies and credit unions.[36] AFIC brought disjointed state systems under unified national regulation.

After instigating much of the necessary enhancement to address the earlier problems, the commonwealth government created the Wallis Inquiry in 1996 to undertake the first comprehensive assessment of the Australian financial system since the Campbell Inquiry in the late 1970s. The Wallis Committee was tasked with evaluating the results of deregulation since the 1980s, examining the elements of transformation in the industry and proposing a regulatory structure ideally suited for efficiency, flexibility and competition in the financial system.[37] In its final report of March 1997, the Wallis Inquiry recommended a significant reorganization of financial regulation:

> Responsibility for the prudential supervision of banks, building societies, credit unions, insurance and superannuation funds was assigned to the Australian Prudential Regulation Authority (APRA), which commenced operations in July 1998. This brought to an end the Reserve Bank's role in bank supervision. Responsibility for market conduct and disclosure in the financial sector was assigned to the Australian Securities and Investments Commission (ASIC), which was also given responsibility for the enforcement and administration of

> the Corporations Law and consumer protection across the financial system. The Reserve Bank retained responsibility for monetary policy and the maintenance of financial system stability. In addition, a Payments System Board was established within the Reserve Bank with responsibility to promote safety, competition and efficiency within the payments system.[38]

The remarks in a speech of the inaugural chairperson of APRA, Jeffrey Carmichael, are worth noting:

> It is universally agreed that the primary rationale for regulation is market failure.
>
> There is a widely held myth that Western economies are built on unfettered free markets – on laissez faire. The reality is that all markets fail, and they fail for a variety of reasons: Private enterprise only works where regulation corrects market failure.[39]

Regulations, of course, are simply rules of behaviour. As a totality, regulation attempts to establish a legal and ethical framework within which commerce can flourish to the mutual benefit of all involved. The ideal regulatory system encourages competition but does so in a way that also encourages honesty and fairness.[40] According to this view, market failures can result from a number of factors, which include monopolistic or anti-competitive behaviour, consumer exploitation and market manipulation, the lack of prudence in the structure of financial products and the breakdown of trust in and among financial institutions. As pointed out earlier, the advent of deregulation motivated the existing banks to attempt to strengthen their bastions through pre-emptive acquisitions and unbridled expansion. They also sought to manipulate markets without concern for individual customers. In the process they extended huge loans, funding a property bubble that eventually burst and inflicted sizeable losses on several institutions. Bank runs were a natural consequence. Such were the conclusions reached by the Wallis Inquiry, which effected the rearrangement of financial regulations in Australia. One would agree this coordinated approach was the appropriate step in addressing the multi-fold risks that could cause market failures.

Attitude of Australian Banks Towards Regulators

The attitude among banks appears to be one of resignation and forbearance. Though they claim to have good relations with regulators, credit unions contend that regulations are burdensome because they are much

smaller than banks and do not have as many support staff to maintain compliance. Among banks there is a sentiment that regulations stifle innovation.

Bankers feel that there is a need for a balance between protection of the community and efficient functioning of business enterprises. They decry the unintended consequences of regulations created by the Financial Services Reform (FSR), such as a directive enacted in reaction to the fraud and eventual collapse of a well-known insurance company. There were good intentions behind the desire to establish common licensing procedures for banks and insurance companies, but the implementation has proven to be a bureaucratic nightmare because banking and insurance are extremely dissimilar businesses. Banks complain that (a) clients are now inundated with 50–60 page documents for each product because of the huge disclosure requirements, (b) banking efficiency is impaired and (c) overzealous regulators make compliance more costly.[41]

The underlying principle is to provide disclosure and transparency so that when a customer walks into a bank he is expected to understand everything about a product and that it should be appropriate for what he needs. But the way this has been given form under the FSR is that the bank employee hands the customer an advisory service guide and then a products disclosure statement. Those steps discharge the bank from its legal obligation, so from a compliance viewpoint it has done what it has to do. But it is questionable if the client is any wiser about what he applied for. The substance of the law is that the customer should be aware of what he is being offered. But because regulation is by nature bureaucratic and procedural, bankers argue that they end up going through the motions sometimes at the expense of the essence of the intent.

One of the difficulties under the law is that banks must have numerous disclaimers, so when a client rings a call centre (and most people usually only have simple queries), by the time all the disclaimers are announced the client wants to hang up. Many individuals claim to have this experience and find it annoying and a waste of their time. The good intent is harmed by the manner of delivery.

A number of senior executives have opined that some regulations are good, such as the Basel II Rules on capital adequacy and the anti-money-laundering directives, which have instilled a measure of discipline in banks so they now ensure they know their customers well and their intended use for the products. However, as Chapter 7 will show, the capital position of the world's largest banks would prove to be inadequate in the wake of the global financial crisis because innovative funding

techniques allowed them to circumvent strict capital provisions in the situation of mortgage-backed securities.

There is a well-founded belief that regulators have an important role to play because trust is important. It is accepted that members of the community generally trust banks to protect their money and not embark on risky loans that jeopardize their deposits, so it is deemed appropriate to have regulations in place to make sure that the financial system is sound and serves the community. But some bankers worry that, after the Enron scandal, the manner pursued by regulators appears to be more about covering one's rear, not so much about genuinely identifying risks and dealing with them. From the perspective of banks, the requisite paperwork is burdensome and distracting. The banking attitude is that well-run institutions should not have to be subjected to all these rules.

A few accept that not all banks have the proper values and contend that regulations should be directed at the firms operating at the edge of permissible conduct. They grumble that regulators spend an inordinate amount of time with the big banks and not enough time with the sub-prime lenders. They maintain that the financial operators catering to clients at the margin are committing most of the egregious violations against individuals. They admit that the large banks might occasionally get things wrong but do not mind being reprimanded, and they spend tens of millions of dollars a year in compliance. But they protest that mortgage brokers, financial planners, sub-prime lenders and investment advisors are not regulated.[42] When this book subsequently turns to the story of the American sub-prime crisis, it will become evident how the situation there is especially exacerbated.

From the perspective of compliance officers, it almost seems 'redundant that the *government has to constantly legislate matters that are absolutely common sense*'.[43] Yet two major regulations from ASIC caused great uproar among financial institutions during the 12 months prior to the interview: conflict of interest legislation and dollar disclosure.

Dollar disclosure means that if a bank teller is recommending, for example, a term deposit product for which she may receive a financial reward, she should inform the customer that she would be entitled to extra pay as a result of closing the sale. Some banks did not want customers to know that individual sales personnel were being remunerated on a volume basis. They should have been disclosing this anyway but did not, so the legislation had to be passed, and this has caused much concern.[44]

More troubling to banks is the *conflict of interest legislation* that requires financial institutions to maintain a register of conflicts of interest, which is not really a harsh demand, and to strengthen their functional

segregation through more robust Chinese walls. The Bandicoot senior compliance officer said that a large bank typically owns half a dozen financial planning firms not carrying the bank's name. The bank instructs the financial planners to sell the products that it creates and also competes with them in the open market to sell the same products. When the same entity is involved in the development, distribution and sales of the products, there is a genuine conflict. It is ethically wrong to recommend something in which one has a pecuniary interest, unless one discloses this up front. But in Australia there has been considerable resistance.

It was alleged that in the years prior to 2003, mores were especially bad. Managers supposedly looked at compliance from a selfish standpoint; they would ask how much the penalty would be for non-compliance and, if told that it might cost, say A$500,000 and the cost of implementation was A$1 million, they would enquire how many firms had been caught. The managers then chose to defer implementation.[45]

Some chief executives stated that their banks do not willingly break the rules and no longer operate according to a risk and reward equation because that is unethical. Yet there remain many people in some banks who continue to think in terms of balancing that equation. The ethical strife thrives because the banker is not really considering the customers; she is only thinking about herself. Bank managers are only thinking about how products translate into profitable returns for shareholders because their career orientation is towards this goal.

Every large bank says it puts the customer first, but there are those who disagree and argue that each institution is shareholder-focused. According to a compliance officer, it is absolutely paramount in large organizations to win the confidence of investment analysts and commentators.[46] After announcing their annual results, the banks undertake a two-week road show speaking to analysts at major investment houses. Superannuation funds amounted to a total of A$1 trillion in 2006, and investors desirous of good returns look for shares that show promise. Therefore the investors' questions relate to profitability and not whether the banks are dealing with customers in a fair and honest way. Nonetheless in 2005 one investment report commented on the poor EOS score of one large bank and questioned the long-term sustainability of the bank if employees did not like working there. It would seem this bank had to make genuine strides to listen to stakeholders other than shareholders and the investment houses.

However, one bank, which regards compliance seriously, maintains that the *focus of compliance has to be on the customers for two reasons: regulations and the reputation of the bank.*[47] The staff members have to

establish the needs of customers and offer them products that best meet those needs. The bank employees should provide either general advice in terms of the range of products and their features or personal advice based on a detailed analysis of the customer's needs.

The policies set at the top fall into two principal categories: know your customer as an overall corporate thrust, and manage conflicts of interest so that employees do not put remuneration objectives ahead of customer needs. Every branch is subjected to testing for quality assurance and compliance risk. The frequency of testing depends on the risk score of the particular branch. One that had previous compliance deficiency would be visited more frequently than one that performed well. They also employ shadow shoppers pretending to be customers to check if the advice given to customers is appropriate.[48]

Two regulatory areas that banks consider highly challenging, because they are extremely difficult to detect wrongdoing, are money laundering and bribery payments. They conduct training for all employees, tailored to those with customer contact and those in operational roles. Many locations have an anti-money-laundering reporting officer.

The anti-bribery policy for well-managed banks *prohibits acceptance of bribes and facilitation payments (even if permitted by law) for reputational reasons*.[49] This is naturally difficult to enforce in countries that have acknowledged rampant corruption where Australian banks might have joint venture investments or partnerships. Australian corporate bankers state that the anti-bribery and anti-corruption policies apply in all segments of business and partnerships *over which they have control*. If one were to assume that corruption is part of a specific local culture, the challenge is to influence the behaviour of decision makers in the other culture in situations where a bank is a minority shareholder. Since a bank might typically be a minority partner in overseas ventures, one would strongly suggest that extra due diligence be conducted to guarantee effective ethical conduct.

In summary, after reviewing the circumstances that led to deregulation and the consequent reaction and behaviour of banks, followed by the Wallis Inquiry, one has to conclude that the revamping of financial regulation was necessary in order to preserve the integrity of financial markets, protect consumers and ensure the stability of the financial system. With the introduction of new regulations, one finds that there is general compliance even if some bankers express frustration. Compliance in itself does not necessarily denote ethical conduct but rather action taken to avoid punishment and maintain reputation or public trust. One could describe compliance by banks as utilitarian.