

Data Requirements For Assessing the Health of Systemically Important Financial Institutions (SIFIs): A Perspective from Hong Kong.*

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In my presentation I will discuss the data requirements for assessing the health of systemically important financial institutions, mainly from the perspective of Hong Kong SAR. I will proceed in three steps. I will start by asking how one would determine whether a financial institution is systemically important. I will argue that the answer depends at least in part on the characteristics of the economy we are interested in. Second, I will provide a summary of the data we traditionally collect from banks in Hong Kong SAR and the new data requirements introduced against the backdrop of the recent global crisis. Finally, I will explore what additional data could potentially improve the risk assessment of our financial institutions.

Characteristics of Systemically Important Financial Institutions

A financial institution may be deemed systemically important if it can potentially pose significant risks to financial stability, where risks to financial stability can be defined as the risks of severe disruptions to the smooth functioning of the financial system. It is generally agreed that size is the single most important characteristic of a systemically important institution – the larger a financial institution is, the greater will be its potential systemic consequences. Exactly how to measure size may however matter not only because some aspects of size may be more significant than others, but also because financial institutions may adjust their business model in response to regulators' definitions.

In addition to size, two other characteristics of financial institutions warrant particular attention. The **first** is whether an institution tends systematically to affect others by affecting confidence in the system as a whole, resulting in a domino effect in the financial system. These institutions are often those that take deposits or those that are heavily involved in financial markets. Deposit-taking financial institutions tend to have a greater impact on the confidence of the general public, while major financial market players tend to have a large number of counterparties. Hence, sometimes even an unfounded rumour about the weakness of a small institution can have significant systemic repercussions.¹ Therefore, in practice, the HKMA treats all financial institutions under its supervision the same in terms of setting data requirements, making no distinction between large banks and small banks.

The **second** type of a systemically important financial institution is one whose profitability tends to be positively correlated with financial market volatility. It includes notably the hedge funds and other highly leveraged financial institutions. As volatility often provides greater profitable opportunities for these institutions, there are strong incentives for them to manipulate or drive price movements in markets where they enjoy monopolistic power. Their activities can result in undesirable large

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¹ To mitigate the impact, the deposit insurance coverage – HK\$100,000 (or about US\$12,900) per bank account – is currently under review. This coverage excludes the temporary blanket guarantee committed by the Hong Kong SAR Government to all deposits until the end of 2010.

swings in financial markets that can threaten financial stability, since increased volatility may lead to herding and rush-to-exit behaviour of other investors in panic markets. Sometimes they also devise trading strategies to take advantage of existing institutional arrangements, an example being the so-called double-market play during the Asian financial crisis. In that episode some speculators sold Hong Kong dollars for US dollars, causing interest rates to increase sharply under the Linked Exchange Rate system. At the same time the speculators took short positions in the equity market on the expectation that the high interest rates would lead to a precipitous decline in share prices. In the current crisis, double-market play was rumoured to have taken place in the CDS and equity markets. The activities of this type of financial institutions are difficult to monitor, because financial regulators often do not have mandate to supervise them under existing laws. In the case of Hong Kong SAR, the credit lines of most of these institutions are provided by banks overseas and currently there is no international framework for central banks or financial regulators to exchange information.

Increased Data Requirements amid the Recent Global Crisis

Through a number of monthly and quarterly returns, the key data traditionally collected by the HKMA from banks in Hong Kong SAR include assets and liabilities, profit and loss account, large exposures, purposes and classification of loans and advances, capital adequacy, interest rate risk, market risk and liquidity,. Balance sheet items such as loans and deposits, profitability, asset quality, liquidity, and capital adequacy, are published regularly in conjunction with our analysis of the banking sector performance.

The HKMA also monitors the asset quality of the key lending portfolios of banks. Regular surveys have been conducted on residential mortgages and credit card lending for many years. In view of the increasing economic integration between Hong Kong SAR and Mainland China, the HKMA has also collected banks' exposure to the Mainland, including exposures to red-chip companies, H-share companies and provincial/municipal government-owned entities. Since 2007 this framework has been expanded to cover the exposures of Hong Kong incorporated banks' banking subsidiaries in Mainland China as some banks have transformed their branches on the Mainland into subsidiaries.

In view of the recent global crisis, the HKMA has introduced two new half-yearly surveys on off-balance sheet exposures and debt securities portfolios to strengthen the oversight of institutions' holdings of debt securities and their exposures to structured credit products or related off-balanced sheet entities. In addition, banks are encouraged to disclose information in accordance with the *Leading Practice Disclosures for Selected Exposures* compiled by the Senior Supervisors Group. This applies in particular to:

- their sub-prime related exposures (with respect to which they are encouraged to adopt a prudent approach to valuation) or making impairment charges in their announcement of financial results); and
- their risk exposures to complex financial instruments such as CDOs, RMBS CMBS and structured financial products.

Potentially Useful Data

With the additional data requirements just mentioned, there appear no significant data gaps given the current international standards. Nevertheless, there are two areas in which data, if available, could improve the assessment of systemic risk when conducting our stress testing analysis:

First, the breakdown of undrawn irrevocable credit commitments by types of customers. Such data are important for assessing contingent liquidity risk, which has not been covered in sufficient detail in most stress tests, a major weakness in banks' current stress testing practices identified by the Basle Committee on Banking Supervision.² As evidenced in the sub-prime crisis, some banks were exposed to significant contingent liquidity risk due to considerable drawdowns on irrevocable credit commitments by special investment vehicles that suffered substantial losses from sub-prime mortgage-related securities. In fact, similar contingent liquidity risk could arise if a bank's irrevocable credit commitments are unduly concentrated in a single customer or in a group of similar customers (e.g. customers in a same sector). The extent to which a bank is exposed to the contingent liquidity risk can be identified if breakdowns of the data are available.

Second, the creditworthiness of debt securities other than credit ratings. One of the important triggers of the recent crisis was the low quality of credit ratings with regard to structured products.³ While this problem is less acute for standard debt securities, the through-the-cycle rating methodology by credit rating agencies could lead to excessively low sensitivity of credit ratings to prevailing market risks. Hence, additional data regarding the creditworthiness of debt securities, such as current market yields or internal model default risk estimates of banks' holdings of debt securities, could help improve the assessment of risk. This is particularly important in assessing risk for systemically important financial institutions, since they generally hold larger investment portfolios that would expose them to significant market risk.

Finally, apart from these additional data for stress testing enhancement, we of course look forward to working with other central banks and financial regulators around the world in increasing the transparency of financial institutions central banks do not traditionally collect data from, such as hedge funds and other highly leveraged financial institutions, and insurance companies. Some sort of international framework for information exchange could enhance the monitoring process. For instance, through the Financial Stability Board, central banks can regularly exchange information about the activities – especially unusual ones – of large hedge funds and insurance companies on a confidence basis. If this is difficult to achieve in the near term, a useful first step would be for central banks and financial regulators to collect and publish data on the activities of these institutions at an aggregate level. Examples are the aggregate cross-border exposures of various types of non-bank financial institutions and their aggregate positions taken in different financial markets (e.g., equity, CDS).

² See page 6 of Basel Committee on Banking Supervision (2009) *Principles for sound stress testing practices and supervision*.

³ See Section IV "Changes in the role and uses of credit ratings" of Financial Stability Forum (2008) *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*.