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Contingent Bank Capital Facility

The second precautionary measure.

In the last few weeks many measures have been taken by authorities around the world to safeguard banking stability. In the United States and Europe, these were introduced in response to a banking crisis, whereas in Hong Kong they were introduced as pre-emptive and precautionary measures. Whatever the circumstances, the measures invariably address two important aspects of banking: liquidity and capital adequacy.

Liquidity is crucial for individual banks and the banking system as a whole. It is important to address both issues if the banks are to continue to provide funding to finance economic activities and sustain economic growth. Individual banks facing a shortage of liquidity would not be able to lend to homebuyers and industries. Under stressful conditions, individual banks may adopt a defensive strategy of hoarding liquidity. As a result liquidity for the whole of the banking system will dry up, while the price of liquidity, measured in, for example, interbank interest rates, will rise, possibly to prohibitively high levels.

All central banks should have standing arrangements to cope with liquidity tightness, in the systemic sense or for individual banks. This is one of the basic functions of central banks, and the operational means, at least those for influencing systemic liquidity, should be well established. Obviously, while the provision of liquidity for individual banks needs to take account of the special circumstances of the banks concerned, central banks, in order to protect the public purse, will normally lend only on a fully secured basis. Some jurisdictions, including Hong Kong, have transparent and established lender-of-last-resort arrangements. Others adopt the policy of handling matters case by case. But under the unusually stressful conditions prevailing in this financial crisis, which has been described as a once-in-a-century event, many of these established measures in many jurisdictions have become inadequate, and temporary arrangements are needed, or indeed have already been made. In Hong Kong, we introduced the five temporary measures for providing liquidity assistance to licensed banks in Hong Kong on 30 September, and announced the amendment to the formula for the determination of the Base Rate of the Discount Window on 8 October.

On capital adequacy, with the capital-adequacy ratio of locally incorporated banks, at around 14%, which is substantially higher than the minimum of 8% under Basel II, the capital cushion against adverse and stressful developments that may affect asset quality is very comfortable, as confirmed by the stress tests we periodically conduct for the banking system. This is in contrast to the situation in the developed markets, where asset quality has deteriorated to such an extent as to threaten the solvency of financial institutions, let alone meeting minimum capital adequacy requirements. But as I said last week, robust facts and figures might not be enough to sustain confidence in a situation of fear and uncertainty. There is therefore a need to ensure that the banking system is both well capitalised and seen to be so, hence the temporary Contingent Bank Capital Facility (CBCF).

I believe it is unlikely that the capital cushions of the local banks will, in the next two years, be eroded to such an extent as to require drawing on the CBCF, although some erosion may be possible, either directly as a result of the impairment of financial assets induced by the financial crisis or indirectly as deteriorating economic conditions affect the repayment ability of borrowers. I expect such erosion, should it occur, to be small. But I obviously cannot exclude the possibility of individual banks finding themselves in a position of having to raise additional capital to replenish their cushions. I certainly hope that, should this happen, it will be when the worst of the financial crisis is over and the global financial system has started to function properly again, so that it will be easier to raise capital in the market. This would of course be preferable to using the CBCF considering the necessary supervisory conditions and restrictions attached to it. But the existence of the CBCF provides comfort to all on the availability of additional capital. This comfort is particularly important now.

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