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ASSET QUALITY IN HKSAR'S REAL ESTATE MARKETS: A PUBLIC POLICY AND LEGAL ANALYSIS

Berry F.C. Hsu*

I. INTRODUCTION

The real estate sector is a crucial part of the Hong Kong Special Administrative Region (HKSAR) economy. It has played a major role in terms of relative size, inter-linkages with almost all macro-economic variables, competitiveness, and as a determinant of banking sector and stock market performance.¹ Real estate related industries account for over twenty-five percent of the GDP in the HKSAR.² It has been a dominant outlet of the disposable income of most of the region's residents. On June 30, 2001, the real estate sector's share of the Stock Exchange of Hong Kong in terms of market capitalization was approximately fourteen percent (twenty-one percent in 1998), versus the industrial sector's eleven percent (eight percent in 1998).³ Therefore, real estate assets form the core of all assets in the economy notwithstanding the real estate sector's decreased market capitalization due to the sharp drop of property prices. The HKSAR economy is fundamentally affected by real estate finance and real estate activities, and these activities rely on public policy, corporate governance, and the regulatory framework of banking institutions.

This paper discusses the factors determining the efficiency and stability of the real estate sector in the HKSAR from a pub-

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1. SAUJAY KALRA, DUBRAUKO MIHALJEK & CHRISTOPHER DUENWALD, PROPERTY PRICES AND SPECULATIVE BUBBLES 3 (Int'l Monetary Fund Working paper No. 0012 2000).

2. *Id.*

3. SEC. & FUTURES COMM'N OF H.K., MARKET CAPITALIZATION BY SECTOR (Dec. 31, 2001) available at <http://www.hksfc.org.hk/eng/statistics/html/index.html>

lic policy and legal perspective. The public policy framework of the HKSAR is addressed first. Although the HKSAR ostensibly has a laissez faire economy, the government tightly regulates the supply of land. This gives rise to two public policy concerns. First, government intervention may stabilize or destabilize any or all segments of the real estate market, with serious consequences in the banking and financial sector. Second, while the tax legislation of the HKSAR is favorable to land speculation, such legislation is difficult to amend because it is subject to constitutional constraints. Next, the legal framework regarding the financing of land in the HKSAR is discussed. A sound banking and financial framework is required to provide a level playing field in the real estate markets so that real estate financing is made more efficient. The corporate governance practices in the HKSAR, as an important aspect of legal infrastructure supporting the banking and financial framework, should be improved by providing more transparency and accountability in the real estate sector. Moreover, the regulatory framework of banking in relation to this sector warrants special consideration given the special nature of real estate as an illiquid and irreplaceable asset. The recent bursting of the real estate bubble in the HKSAR may be attributed to inappropriate banking practices such as the aggressive behavior of banking institutions, inadequate risk management, and weak regulatory control mechanisms.

II. PUBLIC POLICY

Public policy is a major force in the HKSAR real estate markets. The HKSAR is a densely populated city with 6.8 million residents concentrated in only sixteen percent of the region's 1,096 square kilometers of land.⁴ As a result of the limited supply of land, successive Hong Kong (as it was then called) governments regulated the real estate markets, and have moderated or accentuated the real estate boom-bust cycle.⁵ Successive Hong Kong governments have been said to follow a "high land price policy," a policy to reap huge rents from land sales in a monopoly market. This *de facto* policy weakens the financial stability of the HKSAR, as the value of the loans made to the real estate sector is artificially high. This policy decision, together with the pegged exchange rate and a low tax policy, has created a financial bubble leading to a speculative attack on the Hong Kong dollar during the Asian Financial Crisis of 1998. In this context, the HKSAR

4. GOVERNMENT INFO. SERVICES, HONG KONG: THE FACTS (2001).

5. KOICHI MERA & BERTRAND RENAUD, ASIA'S FINANCIAL CRISIS AND THE ROLE OF REAL ESTATE 20-21 (2000).

has become a classic example of moral hazards and "overheating."⁶

High Land Price Policy

Historically, it has been unusual for the Hong Kong government to grant "freehold" land.⁷ Most of the tracts of land granted by successive Hong Kong governments are leasehold estates.⁸ St. John's Cathedral has a freehold tenure in the HKSAR, and is likely to be the only one.⁹ The leasehold grant of land by the colonial administration was a device of control. In the New Territories, however, it was simply not legally possible for the former Hong Kong government to grant freeholds, as the government only had a leasehold for ninety-nine years granted by the Ching Emperor in 1898.¹⁰ The HKSAR government has continued this practice notwithstanding that it is now empowered by the *Basic Law of the Hong Kong Special Administrative Region* (the *Basic Law*) to grant freehold land. However, in reality, there is a conflict of law preventing the HKSAR government from granting freehold land as the *Basic Law* only guarantees the capitalist way of life in the HKSAR will remain unchanged for fifty years and granting freehold is not consistent with China's socialist legal system.¹¹

The state has a monopoly as the landlord of all real estate to be developed in the HKSAR. While the government retains the freehold title, the land is granted to the private sector by way of leasehold. Under the system of public auction and tender, normally the highest bidder would win the bid.¹² However, studies have shown that the auctioning policy does not affect the supply of land and has nothing to do with the high real estate prices, as there is a lag between land sales and housing competitions.¹³ However, the auction price of land should undoubtedly affect the present value of land.

6. B. HSU, *LAW OF BANKING AND FINANCE IN THE HKSAR* 158-60 (1998).

7. Freehold refers to an estate of an uncertain maximum duration. It simply means the right of the holder of the land to own the land freely, i.e. not subject to any lease. In feudal England, most land was held on leasehold, and only the noblemen could hold land freely.

8. Estate is the period of time in which a tenant is entitled to hold the land.

9. This is a cathedral of the Anglican Church, which enjoyed special privilege during the colonial era.

10. Under the Convention of 1898 this area was leased to Great Britain for 99 years, i.e. up until June 30, 1997.

11. THE BASIC LAW OF THE H.K. ADMIN. REGION OF THE P.R.C., art. 5.

12. LANDS ADMIN. OFFICE, THE LANDS DEP'T OF THE GOV'T OF THE H.K. SPECIAL ADMIN. REGION, *PROCEDURE FOR LAND SALE UNDER THE APPLICATION SYSTEM*, PRACTICE NOTE NO. 1/2001 (2001).

13. KALRA, MIHALJEK, & DUENWALD, *supra* note 1, at 8.

The supply of land had been artificially restricted, and this was reinforced by legal constraint. Annex III (Land Leases) of the 1984 *Sino-British Joint Declaration* provides that only 50 hectares of land could be granted by the then Hong Kong government each year until June 30, 1997.¹⁴ Land granted to the Hong Kong Housing Authority for public rental housing was excluded in order to encourage the then administration to release more land for public housing. This transitional agreement operated until June 30, 1997 when the HKSAR government was formed. During the transition period from 1984 to 1997, the inflow of overseas capital, which took advantage of the linkage of the Hong Kong Dollar to the U.S. dollar, transformed the economy of Hong Kong into a bubble. The reason for this is that by pegging the Hong Kong Dollar to the U.S. Dollar, the territory had to offer the same interest rate as the U.S. Federal Reserve, a rate that was relatively low during the 1980s to the mid-1990s.

An International Monetary Fund (IMF) study concluded that in mid-1997, the level of property prices in the HKSAR was forty to forty-five percent above the levels suggested by developments in fundamentals, reducing its economic competitiveness.¹⁵ It further suggested that the Hong Kong property markets between 1980 and 1998 were subject to speculative bubbles.¹⁶ Prior to the Asian financial crisis, HKSAR banks had rapidly expanded their lending and financed imprudent investments, such as speculation in taxi licenses, securities and real estate, which resulted in highly inflated asset prices.¹⁷ As the HKSAR is now essentially a service-based economy, its continued success very much depends on the inflow of international capital and income. However, rental cost is one of the considerations of operating a business, and a high rental cost will deter such inflows. Thus by adjusting and stabilizing real estate prices, the HKSAR is improving its competitiveness as a value-added service based economy.

In February 1998, the Chief Executive of the new administration, Mr. Tung Chee-Hwa, acknowledged that the HKSAR had inherited an economy from the colonial administration plagued by soaring real estate prices, high inflation, and negative

14. JOINT DECLARATION OF THE GOV'T OF THE U.K. OF GR. BRIT. AND N. IR. AND THE GOV'T OF THE P. R. C. ON THE QUESTION OF H.K., Annex III (Dec. 19, 1984) available at <http://www.info.gov.hk/trans/jd/>

15. KALRA, MIHALJEK, & DUENWALD, *supra* note 1, at 1.

16.

17. H.K. MONETARY AUTH., H.K. BANKING INTO THE NEW MILLENNIUM 91-92 (Dec. 1998).

interest rates and he promised to address these problems.¹⁸ The long-term plan of providing adequate housing to all HKSAR residents was announced on the very first day of formation of the HKSAR government.¹⁹ As a result of the efforts of the HKSAR government to provide adequate housing to its residents and, more importantly, as a result of the Asian financial crisis, real estate prices fell fifty-five percent in January 1998 from the peak in June 1997.²⁰ This is a conservative estimate, as real estate prices increased by fifty percent between February 1996 and September 1997.²¹ At the end of the day, the local banks may lose their mortgage cushion.

In the meantime, banking institutions were counting on government intervention, as any further drop in real estate prices would continue to destabilize the financial system.²² The HKSAR government has taken a series of measures which might cushion the steep drop in real estate prices, including designating prime land for government offices,²³ providing greater flexibility in the land sale program by providing 85,000 flats each year,²⁴ implementing mortgage relief in the tax system,²⁵ and introducing fixed-rate mortgages.²⁶ Although these measures were not intended to drive up real estate prices, they would keep the collapse in real estate prices under close monitoring.²⁷ Mr. Tung admitted that any further abrupt drop in real estate prices might adversely affect the banking system.²⁸ Finally, in June 2000, Mr. Tung stated that the target of providing adequate housing had never existed in substance but only in name.²⁹

18. Angela Li, *Tung Outlines Tactics to Keep Home Prices Stable*, S. CHINA MORNING POST, Feb. 15, 1998, at 1.

19. *Speech by the Chief Executive*, DAILY INFORMATION BULLETIN (HKSAR Gov't Info. Serv.), Jul. 1, 1997, at <http://www.info.gov.hk/isd/news>

20. *H.K. Property Issues Falling to Attractive Level*, WALL ST. J., Jan. 27, 1998.

21. H.K. MONETARY AUTHORITY, SURVEY ON RESIDENTIAL MORTGAGES IN H.K. (Feb. 25, 1998).

22. Li, *supra* note 18, at 1.

23. Kenneth Ko, *Tamar Selected for Government Offices Complex*, S. CHINA MORNING POST, Jan. 17, 1998, at 1.

24. *Exco Backs 'Flexible' Land Sale*, S. CHINA MORNING POST, Feb. 11, 1998, at 6.

25. HKSAR Gov't, *The 1998-99 Budget*, at <http://www.info.gov.hk/fb/bdgt98/english/eindex.htm>

26. *HK Mortgage Corp. To Proceed With Fixed-Rate Mortgage Plans*, WALL ST. J., Feb. 26, 1998.

27. *H.K. Keeps Options Open For Supporting Property Sector*, WALL ST. J., Feb. 10, 1998.

28. *CE's Letter from H.K.*, DAILY INFORMATION BULLETIN (HKSAR Gov't Info. Serv.), Feb. 14, 1998, at <http://www/info.gov.hk/isd/news>

29. Chris Yeung, *Tung Accused of Housing Cover-up Chief Executive Admits He Scrapped Key Property Policy in 1998*, S. CHINA MORNING POST, July 1, 2000, at 1.

As the real estate bubble burst, the effects of the high land price policy are clearly seen. Economists argue that this policy contributed to and continues to contribute to economic inefficiency.³⁰ This policy inflates the cost of capital for real estate development, raises credit constraints for private homeowners, and results in large-scale public housing.³¹ The latter of these is a form of public welfare that distorts the economy. It was argued that this policy is "high, arbitrary, and uncertain taxation on the private sector."³² The following section demonstrates the unfairness of the property tax policy in the HKSAR and how it distorts resource allocation.

B. REVENUE POLICY

One of the most important ingredients in support of banking and financial stability is a sound tax policy.³³ A sound tax policy should minimize distortions to incentives, be stable, and predictable.³⁴ Furthermore, the distorting effects of the tax provisions should not be magnified by inflation.³⁵

The structure of HKSAR taxation has been influenced to a large extent by constitutional constraints.³⁶ In reinforcing the free market economy and minimal government intervention in the private sector, the *Basic Law* provides that "the HKSAR shall practice an independent taxation system."³⁷ It further states "the HKSAR shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning taxes, tax rates, tax reductions, allowances, and exemptions, and other matters of taxation."³⁸ The HKSAR government is bound to practice a tax policy that favors the rich and the middle-income taxpayers because of this "low tax policy." The *Basic Law* also requires the HKSAR government to "follow the principle of keeping expenditures within the limits of revenues" and to achieve a fiscal balance and avoid deficits."³⁹ Thus, this low tax policy is feasible insofar as the public revenues are not less than the public expenditures.

30. Y. Fu, *H.K.: Overcoming Financial Risks of Growing Real Estate Credit*, in MERA & RENAUD, *supra* note 5, at 154.

31. *Id.*

32. *Id.*

33. BANK FOR INT'L SETTLEMENTS, FINANCIAL STABILITY IN EMERGING MARKET ECONOMIES: REPORT OF THE WORKING PARTY ON FINANCIAL STABILITY IN EMERGING MARKET ECONOMIES (1997).

34. *Id.*

35. *Id.*

36. B. Hsu, *The Legal Infrastructure of the H.K. Special Administrative Region: A Global Challenge*, 157 CHINA REV. 166-67 (2000).

37. THE BASIC LAW OF THE H.K. ADMIN. REGION OF THE P.R.C., art. 108.

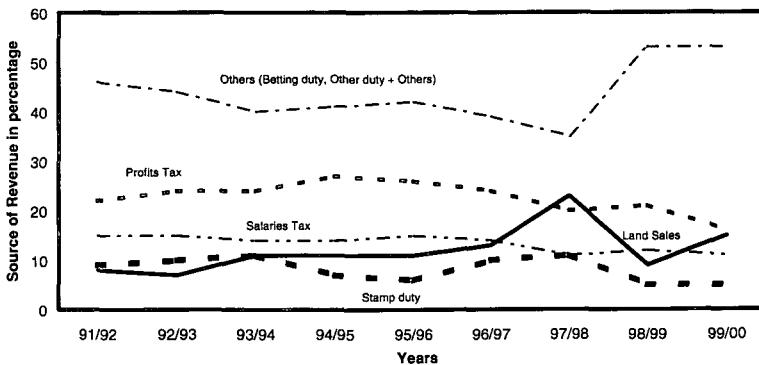
38. *Id.*

39. *Id.*, art. 107.

A progressive rate tax is necessary to discourage the accumulation of property and the concentration of power in the hands of a few.⁴⁰ Accumulation of property would distort the fair market value of property. Currently, the tax rate for assessable profits of an individual and for property in the HKSAR is at a standard rate of fifteen percent. In achieving vertical equity, the higher the property income bracket, the higher the tax that should be imposed. The question is whether or not efficiency would be the result. Although property investors might leave the jurisdiction if a progressive rate is introduced, this may be a healthy solution for the HKSAR as the existing low proportional rate structure is actually an incentive to risk-taking activities in the property markets. One objective therefore could be to dilute the power of the rich.

Land sales income is a very lucrative source of revenue if it is supported by a "high land price policy." Up until the Asian Financial Crisis of 1997, land sales income in Hong Kong had long been an important source of public revenue. In the 1997/1998 income tax year, it accounted for twenty-three percent of revenue.⁴¹ Since the former Hong Kong government was restricted by the 1984 *Sino-British Joint Declaration* in granting land leases, it was obliged to deposit half of the net proceeds from the leases granted (land sales) into a land fund.⁴² The sharp rise in land sales proceeds in 1997/1998 income tax year illustrates this. As it is the end purchaser who has to carry the cost of the high price of the land, the high price policy is in effect a form of indirect taxation. The following table illustrates the source of revenue in the HKSAR:

Chart 1: Source of Revenue⁴³



40. J. RAWLS, A THEORY OF JUSTICE 279 (1972).

41. H.K. 1998 (HKSAR Gov't Info. Serv.), available at <http://www.info.gov.hk/isd/hk99/ewww/index.htm>

42. *Supra* note 14, Annex III, para. 6.

43. HKSAR GOV'T, H.K. ANNUAL REPORTS 1991-01.(1992-98).

As the low tax policy subsidizes the risk taking activities in the real estate markets, the rich are encouraged to purchase more property in the hope that its value will increase rapidly. In the meantime, they can collect high rents to cover their expenditure. This activity is further supported by the absence of a capital gains tax in the HKSAR. The *Inland Revenue Ordinance* provides that profits tax shall be charged, but it expressly excludes profits arising from the sale of capital assets.⁴⁴ A property owner may avoid profits tax liability from selling his property if he keeps the property for a reasonable period of time and such transactions are infrequent. Even if profits tax liability is incurred, the owner pays a proportional tax. This again is said to subsidize risk-taking as losses incurred for producing income is profits tax deductible.⁴⁵

The speculative nature of the property market is not conducive to the HKSAR banking and financial system because of its heavy exposure. High rental value is associated with high property prices. This artificially increases the costs to businesses, trades and professions, and, as a consequence, has led the HKSAR to be uncompetitive in the global markets. Nevertheless, a proportional rate structure is simple to administer. Taxpayers can save the transaction costs of seeking tax-planning advice. It also benefits retirees or others who genuinely depend on rental incomes for their livelihood. Studies have shown that a proportional rate structure, or sometimes even a regressive rate structure, may narrow inequitable income distribution provided a reasonable system of deductions and exemptions is implemented.⁴⁶ However, the present standard tax rate of fifteen percent is too low to deter the rich from accumulating property. At the same time, the statutory "no questions asked" deduction of twenty percent does not give any incentive for a landlord to incur expenses to maintain his property, so that its asset quality would not depreciate.⁴⁷ Older properties have higher maintenance costs, while brand new properties may have minimal maintenance costs.

The home loan interest deduction provided by the *Inland Revenue Ordinance* further aggravates such inequity.⁴⁸ The deduction of interest available to homeowners is a form of subsidy provided to the better off by society as a whole. This naturally violates the principle of horizontal equity. Most renters are not

44. INLAND REV. ORDINANCE Ch. 112 § 14(1) (H.K.).

45. RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 500 (1992).

46. C. J. Berger, *In Behalf of A Single-rate Flat Tax*, 29 ST. LOUIS U.L.J. 993,1001-03.

47. INLAND REV. ORDINANCE Ch. 112 § 5(1A)(b)(ii) (H.K.).

48. *Id.* at § 26E.

among the better off. However, there is no provision in the *Inland Revenue Ordinance* that allows rental payments for domestic purposes to be deducted from income in computing tax liability. If the HKSAR does not adopt a more equitable tax base, it can hardly emerge as a socially just community.

If the HKSAR wishes to increase its competitiveness in the global markets, a lower level of rent is necessary. A higher tax on property income would not be counterproductive to economic growth as lower taxes on other types of income may also follow as a result. On the contrary, it would more likely tend to increase production, as it would discourage speculative rent practices.⁴⁹ The economic recession of the HKSAR, which began in late 1997, was partly a result of rampant speculation in the property markets. The bubble economy of the time paralyzed the industrial, trade and commercial sectors as costs were high and quick money could easily be made in the property and securities markets. However, any change in tax rates may offend the *Basic Law*, which provides for a low tax policy. The full implementation of the *Basic Law*, which protects property rights, indirectly supports the high land prices.⁵⁰ The appreciation of property values as a result of constitutional protection, however, is not taxable. Owning property other than for domestic purposes, nevertheless, is a symbol of wealth and power. A progressive tax policy on property not only promotes a more equitable form of property ownership, it also promotes economic growth. When people own property to collect rent or for speculation, they have no incentive to invest in industry, trade or commerce, and this is counterproductive to the economic development of the HKSAR.

In the new millennium, globalization is inevitable. Property is and continues to be an important source of revenue despite the free movement of capital that is characteristic of globalization. The consequence is that most enterprises will become more transnational. With the increasing number of HKSAR residents owning properties across the boarder in other parts of China, land is no longer a scarcity. Relying on the high land price policy to raise public revenue would be otiose. Traditional taxing activities will be more difficult to implement, as talented people and businesses become more mobile. The reality is that land is the only immovable and tangible taxing unit that is not vulnerable to globalization. Taxing activities on the use of land, whether this is capital gains or rental income, have always provided a reliable source of public revenue. Such tax is highly inelastic, so that substitution effects of the tax are minimal and it is inexpensive to

49. H. GEORGE, *PROGRESS AND POVERTY* 371. (1884).

50. THE BASIC LAW OF THE H.K. ADMIN. REGION OF THE P.R.C. art 105.

administer.⁵¹ Therefore, the property tax policy of the HKSAR demands serious consideration. Unfortunately, the report of the government-appointed Advisory Committee on New Broad-Based Taxes released in August 2001 has failed to consider these issues.⁵²

III. CORPORATE GOVERNANCE AND LEGAL INFRASTRUCTURE OF THE REAL ESTATE SECTOR

One of the fundamental problems leading to the Asian Financial Crisis was the risk management of assets. The efficient operation of the real estate markets very much depends on the legal infrastructure of corporate governance. Real Estate and buildings are the largest class of assets in the HKSAR economy, and they should be traded and financed with due diligence.⁵³ The transparency and accountability of the real estate markets can enhance their performance.⁵⁴ This would provide a more level playing field in the real estate sector and enable the banking and financial decision-makers to make prudent decisions. An effective insolvency law would also be important in limiting the effects of bankruptcy and nursing back an insolvent corporation to health.

Inadequate corporate governance regulation is one of the problematic legislative areas in the HKSAR. The present version of the *Companies Ordinance* is archaic.⁵⁵ It is still modeled upon the 1948 version of the British *Companies Act*.⁵⁶ In March 1997, the HKSAR government released a consultancy report on the corporate law.⁵⁷ This report addressed the problems of financial disclosure,⁵⁸ standard of care of directors,⁵⁹ as well as the conflicts of interest in corporate governance.⁶⁰ According to this report, the information required in books of account under the present corporate law is outdated and no longer consistent with

51. POSNER, *supra* note 45, at 488.

52. ADVISORY COMM. ON NEW BROAD-BASED TAXES, A BROADER-BASED TAX SYSTEM FOR H.K.? (Aug. 2001).

53. MERA & BERTRAND, *supra* note 5, at 283.

54. INT'L MONETARY FUND G-22, THE WORKING GROUP ON TRANSPARENCY AND ACCOUNTABILITY, REPORTS ON THE INT'L FIN. ARCHITECTURE (Oct. 1998) available at <http://www.imf.org/external/np/g22/index/htm>.

55. COMPANIES ORDINANCE ch. 32 (H.K.).

56. Hsu, *supra* note 36, at 163.

57. H.K.: THE GOV'T PRINTER, REVIEW OF THE H.K. COMPANIES ORDINANCE: CONSULTANCY REPORT (1997).

58. *Id.* at 99-105.

59. *Id.* at 121-23

60. *Id.* at 129.

accounting practice.⁶¹ In February 1998, the IMF recommended that the HKSAR should broaden the disclosure requirements further to help reduce market uncertainty and limit the risk of unwarranted contagion.⁶² Unfortunately, most of these recommendations were shelved.

As the accounting standards of the HKSAR have yet to meet international standards, the limited transparency of small and medium businesses has made risk-based lending more difficult.⁶³ Even most respectable corporations, e.g. banking institutions, may adopt their own accounting practices and methodologies in collusion with auditors to provide a rosy outlook and this is entirely legitimate in the HKSAR.⁶⁴ An example of this is that had The Hongkong and Shanghai Banking Corporation adopted the "benchmark treatment" (as some banking institutions have adopted) instead of the "alternative treatment" (in which investments are carried at fair market value at the date of the balance sheet), then its two interim reports on profits would have been higher by seventy-two percent and ninety-three percent respectively.⁶⁵ Consequently, banking institutions in the HKSAR shift their lending to safer mortgage loans or require mortgages to back up business loans.⁶⁶ Naturally, this partly contributes to an inflationary real estate market, as real estate is an important source of security.

As land prices in the HKSAR have been extremely expensive, high-rise apartment estates with high population density have been developed in utilizing the available useable land space.⁶⁷ The process in developing these high-rise estates would be costly as it includes high land acquisition costs through auction, financing, detailed planning and development, construction,

61. *Id.* at 100-01.

62. INT'L MONETARY FUND, PUB. INFO. NOTICE NO. 98/5, IMF ARTICLE IV CONSULTATION DISCUSSIONS HELD IN 1997 WITH THE PEOPLE'S REPUBLIC OF CHINA IN RESPECT OF THE H.K. SPECIAL ADMINISTRATIVE REGION (Feb. 16, 1998) at 3, at <http://www.imf.org/external/np/sec/pn/1998/pn9805.htm>.

63. INT'L MONETARY FUND, PUB. INFO. NOTICE 01/16, IMF CONCLUDES ARTICLE IV CONSULTATION WITH PEOPLE'S REPUBLIC OF CHINA IN RESPECT OF THE H.K. SPECIAL ADMINISTRATIVE REGION (Mar. 2, 2001) at 14, at <http://www.imf.org/external/np/sec/pn/2001/pn0116.htm>.

64. THE H.K. AND SHANGHAI BANKING CORPORATION LIMITED, H.K. 1999 INTERIM CONSOLIDATED RESULTS - HIGHLIGHTS (Aug. 2, 1999), note 16. "If adopted the same accounting treatment as the Bank of East Asia, H.K. and Shanghai Banking Corporation's interim profits would have risen by 72%." MING PAO DAILY, Aug. 3, 1999.

65. *Id.*

66. INT'L MONETARY FUND, *supra* note 63.

67. One may take judicial notice of this fact of life, i.e. the development of high-rise apartment estates, in the H.K. Special Administrative Region. An example can be found in the website of ERA Realty Limited (H.K.) available at <http://www.era.com/International/HongKong.html>.

and sales.⁶⁸ Therefore, only large corporations may be able to develop these huge land projects under the economy of scale.⁶⁹ The result is that the real estate industry is concentrated in relatively few large property developing corporations with seventy percent of total new private housing supplied by seven of these corporations.⁷⁰ During the booming economy and, even in recession, homebuyers of new apartment units do not have any bargaining power in making their consumer choice.⁷¹ They just have to accept the standard forms offered by these property developing corporations. The structure of the property market in the HKSAR enables property developing corporations to command great market power.⁷² In March 2001, the IMF released a report criticizing the lack of competition in the HKSAR weakens the non-interventionist ethos of the HKSAR.⁷³ Therefore, corporate governance of these property developing corporations should extend beyond the director-shareholder relationship.

From the outset, there is no level playing field in the real estate market. All things being equal, the property developers possess an edge over the quality of the real estate. It is a common practice for property developers to form a subsidiary for each and every project. They will wind up the subsidiary upon completion of the sales of apartment units in the project. However, it normally takes more than three years to discover any latent defects. As each company is an independent legal entity, by the time the defects are discovered, no one can be held accountable. There is no statutory duty of care owed by company directors in the HKSAR. At common law, the duty of care for company directors was "such care as is reasonably to be expected from him, having regard to his knowledge and experience."⁷⁴ Therefore, it is essential to enact legislation to make directors

68. H.K. CONSUMER COUNCIL, HOW COMPETITIVE IS THE PRIVATE RESIDENTIAL MARKET? (1996) available at http://www.consumer.org.hk/HSE9607/HSE_E.HTM. This is dated 1996. However, there have been very few changes, if any, since then.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* It has been suggested that the market power of property developing corporations derives not from their monopoly in the market for building space, but from their monopsony in the market for developable property. See Y. Fu and S. Ching, *Examining Competition in Land Market: An Application of Event Study to Land Auction in H.K.*, Paper presented in AUEURA conference (New Orleans, 2001). http://www.hiebs.hku.hk/working_paper_updates/pdf/WP1018.pdf.

73. INT'L MONETARY FUND, PUB. INFO. NOTICE 01/16, IMF CONCLUDES ARTICLE IV CONSULTATION WITH PEOPLE'S REPUBLIC OF CHINA IN RESPECT OF THE H.K. SPECIAL ADMINISTRATIVE REGION (Mar. 2, 2001) at 11, available at <http://www.imf.org/external/np/sec/pn/2001/pn0116.htm>.

74. *In re Brazilian Rubber Plantations and Estates, Ltd.* [1911] 1 ch. 425.

and other corporate officers liable to the stakeholders, e.g. purchasers of the apartment units of the incumbent company. This will ensure that they will not skirt their responsibility under the veil of corporation.

One of the roots of the Asian Financial Crisis was the lack of transparency and accountability.⁷⁵ In the real estate market, information about existing conditions, decisions, and actions taken, should be made available and properly presented.⁷⁶ Market participants, e.g. bankers, financiers, and purchasers, should have adequate information in identifying the risks in the real estate market. Once the information is available, the decision-makers, e.g. bankers, should be held responsible for their actions taken. The financial risks in funding a real estate project should be calculated properly. Not only must all the relevant information be made available, but also the market participants must process them competently. A lack of transparency and accountability in the real estate market weakens the financial stability of the HKSAR. Therefore, decision-makers in banking institutions have a responsibility to ensure that property valuations meet international standards. They should be held liable for accepting these professional reports at face value.

IV. BANKING FRAMEWORK IN RELATION TO REAL ESTATE

The latest version of the *Banking Ordinance* enacted in 1986 brought the regulatory framework of banking in the HKSAR closer to international standards for the first time since 1842.⁷⁷ The Ordinance has 151 sections and six schedules, retaining most of the provisions of the *Banking Ordinance 1964*, as well as the *Deposit-Taking Companies Ordinance*. The preamble of this new ordinance states that its intention is "to promote the general stability and effective working of the banking system." The ordinance now requires banking institutions in the HKSAR to observe certain international standards under the Capital Accord agreed to in Basle, Switzerland, in July 1988.⁷⁸ However, these measures proved to be inadequate for the HKSAR during the Asian Financial Crisis of 1997.

In June 1998, Standard and Poor's expressed its concern about the ability of the HKSAR's Government to maintain its

75. Int'l Monetary Fund G-22, *supra* note 54.

76. *Id.*

77. BANKING ORDINANCE, ch 155 (H.K.).

78. BASLE COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS, (July 1988).

prudent fiscal policies.⁷⁹ It also placed the foreign currency ratings of the leading bank in the HKSAR on credit watch with negative implications.⁸⁰ In December 1998, Moody's Investors Service cited weakness in domestic demand and high property prices, even after the adjustments following the Asian financial crisis in 1997, as reasons for downgrading the financial strength ratings of two leading HKSAR banks.⁸¹ The concerns expressed by the ratings related to their concerns that the HKSAR economy was still vulnerable to external shocks.⁸² The lending behavior of banking institutions in the HKSAR is very aggressive. Moody's rating confirmed another leading bank rating agency, Capital Intelligence, which also gave a negative report for the HKSAR banks.⁸³ Standard & Poor's had stated only that the volatile nature of the real estate and stock markets in the HKSAR would strain bank earnings and asset quality.⁸⁴ Inadequate risk management and weak mechanism in imposing regulatory control are the root of the problems.

A. INADEQUATE RISK MANAGEMENT

The high land price policy naturally resulted in a high book value for assets in the form of share prices and mortgages. This problem was aggravated by banking institutions in the HKSAR, which were lending up to 90% of real estate values for mortgages, until the Hong Kong Monetary Authority (HKMA), the regulatory agency of the banking industry, issued non-statutory guidelines restricting the upper ceiling to 70% of the value of a piece of real estate.⁸⁵ The following chart illustrates the price fluctuations in the real estate market exceeding the 30% cushion.⁸⁶

79. STANDARD AND POOR'S, H.K. RATINGS ON S & P WATCH NEGATIVE, (June 23, 1998).

80. *Id.*

81. MOODY'S INVESTORS SERVICES, MOODY'S CONCLUDES REVIEW OF H.K. BANKS (Dec. 17, 1998)

82. *Id.*

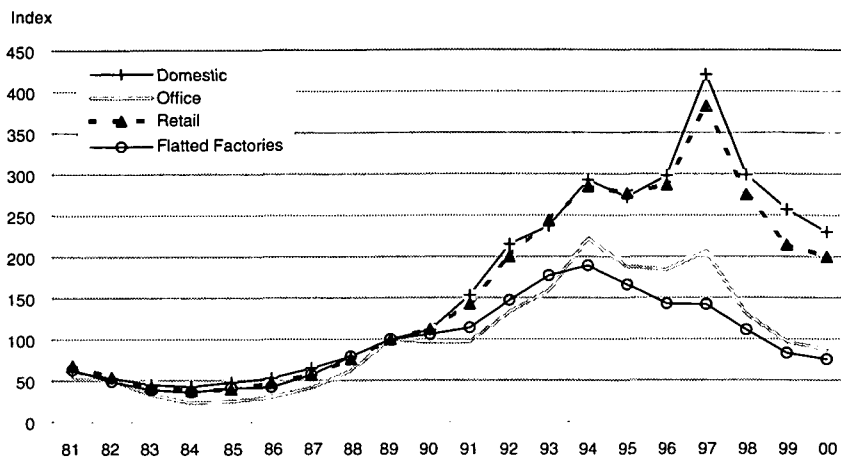
83. *Capital Follows in Moody's Negative-rating Footsteps*, S. CHINA MORNING POST, Nov. 2, 1997.

84. *Id.* See also *Market Turmoil Taking Toll on Global Financial Institutions*, CREDIT WEEK NOV. 12, 1997.

85. Enoch Yiu, *HKMA Gives Stern Warning on Mortgage Rules*, S. CHINA MORNING POST, July 29, 1997, at 14.

86. If a mortgagor borrows up to 70% of his mortgaged property value, once the property price drops by 30%, his mortgaged property becomes negative equity.

**Chart 2: Price Indices for HKSAR Property Markets
(1999=100)⁸⁷**



Banking institutions have been granting mortgage loans on real estate without considering the economic fundamentals. They simply evaluate the property value on the basis of the reports of professional surveyors who rely heavily on comparative pricing. There is no regulatory control over the procedures adopted by professional surveyors. These comparative prices only reflect the prevailing spot prices of property. Research has shown that public policy and the structure of the real estate industry may be important determinants of price levels.⁸⁸ Such price changes are related to rental price changes, GDP growth, exchange rates, and interest rates.⁸⁹ As the HKSAR property markets tend to create speculative bubbles, these economic fundamentals should be taken account of in valuing property prices.⁹⁰

In September 1997, the average outstanding principal for a property mortgage was US\$166,667 and the average loan-to-property value ratio was 52%.⁹¹ In February 2001, the average size of new loans was US\$176,923 and this ratio increased upwards to 57.3%.⁹² In September 1997, property acquired for investment purposes accounted for only 7% of the market, but in

87. RATING AND VALUATION DEP'T, H.K. PROP. REVIEW (2001).

88. KALRA, MIHALJEK & DUENWALD, *supra* note 1, at 23.

89. *Id.*

90. *Id.*

91. H.K. MONETARY AUTH., SURVEY ON RESIDENTIAL MORTGAGES IN H.K. (Feb. 25, 1998), available at <http://www.info.gov.hk/hkma/eng/press/index.htm>.

92. H.K. MONETARY AUTH., RESIDENTIAL MORTGAGES SURVEY RESULTS FOR FEB. 2001 (Mar. 27, 2001), available at <http://www.info.gov.hk/hkma/eng/press/index.htm>.

February 2001, this dropped to 0.8%. In September 1997, the delinquency ratio of all mortgage loans, i.e. loans overdue for more than 90 days, was 0.1%, but by February 2001, this was increased to 1.34%.⁹³ This is very alarming even for a risk-lover, even though the banking sector reports profits. On June 30, 2000, the total number of repossessed properties held or repossessing real properties were 5,846, valued at US\$2.43 billion.⁹⁴ During the same month, the total number of transactions in real property was 6,683.⁹⁵

B. WEAK MECHANISMS FOR IMPOSING REGULATORY CONTROL

The weak mechanisms for imposing regulatory control include inadequate enforcement of prudential rules and poor supervision. They are major factors contributing to the failure of a financial system.⁹⁶ According to an assessment by the HKMA, all the issues incorporated in the *Core Principles* have been addressed in the regulatory framework of banking in the HKSAR.⁹⁷ The real question is how well they are framed and enforced. HKMA's assessment appears to be more imaginary than real, as the framework was not implemented in the HKSAR through changes in banking legislation, but by non-statutory guidelines issued by the HKMA. Only when it has supervised banks with international operations could the HKMA claim that it has followed international practice as embodied in the *Core Principles*.⁹⁸

There are several requirements for the financial management of banking institutions. They include the parameters of the loans advanced, i.e. the limitations on loans advanced and interest held, and the qualities of these loans, i.e. how the adequacy and liquidity ratios should be maintained. The provisions in the *Banking Ordinance* serve to minimize defaults and reduce risk. As such, these banking institutions must also maintain adequate levels of capital and reserve funds. The risks are higher in the fluctuating property and equity markets of the HKSAR. In com-

93. *Id.*

94. HKSAR GOV'T, SURVEY ON REPOSSESSED PROP. (Nov. 28, 2000), available at <http://www.info.gov.hk/hkma/eng/press/index.htm>.

95. RATING AND VALUATION DEP'T OF H.K., NUMBER OF SALES TRANSACTIONS BY PROPERTY TYPE, H.K. PROP. REV. - MONTHLY SUPPLEMENT (Mar. 2002), available at <http://www.info.gov.hk/rvd/property/index.htm>.

96. Int'l Monetary Fund, *The Asian Crisis: Causes and Cures*, 35 FIN. & DEV. 2 (June 1998), available at <http://www.imf.org/external/pubs/ft/fandd/1998/06/>.

97. H.K. MONETARY AUTH., CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION: AN ASSESSMENT OF THE POSITION IN H.K. (Dec. 1997).

98. H.K. MONETARY AUTH., REGULATORY FRAMEWORK (Jan. 11, 1999), at <http://www.info.gov.hk/hkma/eng/bank/index.htm>.

puting these ratios, the natures of the assets are very much relevant. Therefore, these ratios set the standards of the lending practices of the banking institutions. One frequent cause of previous bank crises in the HKSAR was the underestimation of risks. Typically, illiquid banks lent or invested too much money in a few potentially high-risk areas, notably the real estate market, which has been highly speculative most of the time.

The HKMA has prided itself on the high-consolidated capital adequacy of local banking institutions at 18.8%, which exceeds the minimum international standard of eight percent.⁹⁹ This ratio requires banking institutions to maintain capital against credit risk, i.e. the risk of default by borrowers, and investment risk, and the risk of fluctuations of asset prices. The accuracy of this figure, however, relies on soundness of the accounting system in the HKSAR. The risk weight for residential mortgages under the *Banking Ordinance* is 50%.¹⁰⁰ This is not a suitable measure in the HKSAR environment as real estate prices have been unrealistically high, and the real estate market in the HKSAR has been quite speculative. Moreover, there is no uniform standard on the valuation of real estate. The experiences from the periodic Asian financial crises have shown that the adequacy ratio in most countries affected was largely illusory.¹⁰¹ In October 2001, an HKMA survey from a sample of banks revealed that the total value of mortgage loans in negative equity was around 23% of total outstanding mortgage loans and the number of such loans was around 14% of total mortgage loans.¹⁰² No account, however, was given to second mortgages and the figures might be far worse had these second mortgages been considered. The mortgages in the survey were assigned the same arbitrary risk weight of 50% in computing the capital adequacy ratio. The following table illustrates the concern.

99. H.K. MONETARY AUTH., ANNUAL REPORT 1999 34 (2000).

100. BANKING ORDINANCE, ch. 155, 3rd Schedule, Category V, Table A (H.K.).

101. INT'L MONETARY FUND, NEW CAPITAL ACCORD/BASEL COMMITTEE PRESENTS PROPOSALS FOR NEW CAPITAL ADEQUACY STANDARDS FOR BANKS, 30 IMF SURVEY (Feb. 5, 2001), available at <http://www.imf.org/external/pubs/ft/survey/survey01.htm>.

102. H.K. MONETARY AUTH., SURVEY ON RESIDENTIAL MORTGAGE LOANS IN NEGATIVE EQUITY (Oct. 16, 2001), available at: <http://www.info.gov.hk/hkma/eng/press/index.htm>.

Table 1: Capital Adequacy Ratio versus Financial Strength¹⁰³

Banking Institutions	Year of Annual Report	Capital Adequacy Ratio	Moody's Rating: Financial Strength
Nanyang Commercial Bank	1999	27.4%	C
The Bank of East Asia	2000	16.2%	D+
CITIC Ka Wah Bank	2000	17.1%	D
Dah Sing Bank	2000	14.3%	D+
Dao Heng Bank	2000	22.6%	C
Wing Hang Bank	1999	16.0%	D+
Wing Lung Bank	2000	20.7%	C
Hang Seng Bank	2000	15.3%	B
HSBC	2000	13.2%	B

The Bank Financial Strength Rating by Moody's Investors Service is recognized as a "qualifying credit rating" under the *Banking Ordinance*.¹⁰⁴ Moody's Bank Financial Strength Rating measures intrinsic safety and soundness of banking institutions and excludes certain external credit risks and credit support elements.¹⁰⁵ It is a measure of the likelihood that a banking institution will require assistance from third parties such as its owners, its industry group, or official institutions.¹⁰⁶ It does not take into account the probability that the bank will receive such external support, nor does it address risks arising from sovereign actions that may interfere with a banking institution's ability to honor its domestic or foreign currency obligations.¹⁰⁷ Factors considered in the assignment of financial strength include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification.¹⁰⁸ It also takes into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the

103. MOODY'S INVESTORS SERVICE, BANK RATING LIST (Apr. 2001), at <http://www.moodys.com/moodys/cust/RatingAction/rList.asp?busLineId=6&mode=RL>.

104. BANKING ORDINANCE ch. 155, 4th Schedule (H.K.).

105. MOODY'S INVESTORS SERVICE, BANK FINANCIAL STRENGTH RATINGS, (2001), at <http://www.moodys.com/moodys/cust/staticcontent/2000200000265803.asp?section=rdef>.

106. *Id.*

107. *Id.*

108. *Id.*

quality of banking regulation and supervision.¹⁰⁹ The above table sampled banking institutions in the HKSAR.¹¹⁰

In ensuring sound financial management and control of banking institutions, the *Banking Ordinance* imposes conditions on how banking institutions can lend and invest their money. However, it is rarely possible to make any profit without taking risks. The *Banking Ordinance*, therefore, imposes conditions on all banking institutions in achieving a financially safe and sound system of banking when they take risks. It restricts banking institutions with respect to the amount of money they can lend to their customers, and they must also operate at arm's length. Such restrictions are intended to prevent banking institutions from taking an undue risk by lending too much money to one favored customer or group of customers. The unsecured financial exposure of a banking institution incorporated in the HKSAR to a single customer or a group of closely connected companies cannot exceed 25% of its capital base, i.e. its share capital, reserves, and subordinated debt.¹¹¹ There is also a 25% limit on the amount of shares of other companies a banking institution may hold.¹¹² However, the ordinance is not concerned with the sectors, including the real estate sector that such borrowers belong to.

Banking institutions in the HKSAR are required to spread the risks by diversifying certain investments, i.e. their asset portfolios, which might otherwise be too volatile. Accordingly, banking institutions incorporated in the HKSAR cannot hold interests in land in or outside of the HKSAR in excess of 25% of its capital base.¹¹³ In view of the fluctuations in the real estate markets in the HKSAR, this is a sensible provision. This provision, however, does not extend to interests in land held as a result of defaulted mortgages, provided that the banking institution disposes of the excess amount at the earliest opportunity, and no later than eighteen months after it is acquired, unless the HKMA ex-

109. *Id.*

110. According to Moody's, C represents adequate intrinsic financial strength. Banks rated D display modest intrinsic financial strength, potentially requiring some outside support at times. Such institutions may be limited by one or more of the following factors: a weak business franchise; financial fundamentals that are deficient in one or more respects; or an unpredictable and unstable operating environment. Banks rated E display very modest intrinsic financial strength, with a higher likelihood of periodic outside support or an eventual need for outside assistance. Such institutions may be limited by one or more of the following factors: a weak and limited business franchise; financial fundamentals that are materially deficient in one or more respects; or a highly unpredictable or unstable operating environment.

111. BANKING ORDINANCE, ch. 155, §§ 79, 81, 91 (H.K.).

112. *Id.* at § 87(1).

113. *Id.* at § 88.

tends the time limit in writing.¹¹⁴ Interests in land held for conducting business and for staffing are not taken into account if the HKMA agrees, as they are not viewed as investments in the strict sense.¹¹⁵ All the investments in securities, holdings over all interests in land, and facilities granted under the above provision cannot exceed 80% of the capital base of a banking institution.

Save the above statutory restrictions, a banking institution in the HKSAR is at liberty to make any advances, loans, or credit facilities to the real estate sector. The *Banking Ordinance* does not set out to prohibit a banking institution from lending to a particular class of business or person, i.e. there is no limit on sectoral lending. The regulatory framework of banking in the HKSAR relies to a greater extent on the issuance of guidelines by the HKMA to banking institutions operating within its jurisdiction. Although the guidelines do not have the force of law, they are part of the regulatory framework.¹¹⁶ Breach of the guidelines may invoke a toothless condemnation by the HKMA. The HKMA is empowered to issue guidelines relating to certain business practices of banking institutions, and the contravention of these guidelines may result in the suspension of authorization.¹¹⁷ The scope of this power is, however, very narrow, as it relates only to such business practices that may cause the soundness of the financial position of banking institutions to be dependent upon the soundness of the financial position of a single party.¹¹⁸ The HKMA must consult the Financial Secretary and must publish these guidelines in the *Gazette*.¹¹⁹ It has issued guidelines regarding the exemption of financial exposures.¹²⁰

In regulating the quality of real estate assets, the HKMA has issued a set of guidelines imposing a 30% down payment and a no higher than 50% Debt Servicing Ratio¹²¹ on real estate mortgages.¹²² It has also required all banking institutions to maintain

114. *Id.* at § 88(5).

115. *Id.* at § 88(2).

116. *Id.* at § 7(3).

117. *Id.* at §§ 82, 22(1), 24(1), 25(1).

118. *Id.* at § 82(1).

119. BANKING ORDINANCE Ch. 155 § 82(1) (H.K.).

120. H.K. MONETARY AUTH., EXEMPTION OF FINANCIAL EXPOSURES WHICH ARE SECURED BY CASH DEPOSITS, GOVERNMENT SECURITIES, GUARANTEES, OR GUARANTEES UNDER SECTION 81, GUIDELINE No. 5.2.2 (July 1992) (superseded by CR-L-2 of the Supervisory Policy Manual); H.K. MONETARY AUTH., LETTERS OF COMFORT: SECTION 81, GUIDELINE No. 5.2.3 (July 1993) (superseded by CR-L-3 of the Supervisory Manual).

121. Debt Servicing Ratio stands for monthly repayment obligations as a percentage of monthly income.

122. H.K. MONETARY AUTH., PROPERTY LENDING, GUIDELINE No. 5.9.1. (Sept. 1995); H.K. MONETARY AUTH., PROPERTY LENDING, GUIDELINE No. 5.9.4. (July 1997).

property exposure under the overall industry average of forty percent of all loans.¹²³ However, this is merely a guideline without force of law except when it relates to a business practice causing the financial position of the banking institution to be dependent upon a single party.¹²⁴ This guideline was subsequently abolished to rescue the real estate sector.¹²⁵ The Hong Kong Mortgage Corporation (HKMC) now insures mortgage loans with loan-to-value ratios of up to eighty-five percent.¹²⁶ Due to the lack of a proper regulatory framework, some banking institutions use personal loans to compete for residential mortgages. The HKMA has to issue new guidelines to redress the abuse.¹²⁷ Moreover, the wording "exercise additional restraint" is unclear and ambiguous. The HKMA could at best threaten the non-compliant banking institutions with administrative harassment, but this tactic offends the rule of law. The following table illustrates the real estate exposure of banking institutions in the HKSAR.

**Table 2: Percentage of Real Estate Related Loans¹²⁸
(In HK\$ million – US\$1=HK\$7.8)**

Years	Building, construction, property development and investment	Percent as loans and advances for use in HKSAR	Professional and private individuals to purchase residential properties	Percent as loans and advances for use in HKSAR	Total real estate exposure	Percent as loans and advances for use in HKSAR
1991	125,704	15%	199,190	24%	324,894	40%
1992	144,533	16%	224,258	25%	368,791	41%
1993	180,439	17%	268,031	25%	448,470	42%
1994	249,112	20%	298,496	24%	547,608	44%
1995	262,199	19%	349,209	25%	611,408	44%
1996	333,032	20%	421,890	26%	754,922	46%
1997	440,296	22%	540,800	27%	981,096	48%
1998	416,226	21%	589,658	30%	1,005,884	51%
1999	384,127	21%	608,559	33%	992,686	55%
2000	398,341	21%	626,262	34%	1,024,603	55%

Although the statistics show the high exposure of banking institutions in the real estate related sector, they do not include

123. *Id.*

124. BANKING ORDINANCE Ch. 155 § 22(1) (H.K.).

125. H.K. MONETARY AUTH., THE USE OF PERSONAL LOANS TO COMPETE FOR RESIDENTIAL MORTGAGE BUSINESS, Guideline No. 5.9.2. (Sept. 1996).

126. H.K. MONETARY AUTH., THE H.K. MORTGAGE CORPORATION LIMITED MORTGAGE INSURANCE PROGRAMME (Apr. 26, 2001), available at <http://www.info.gov.hk/hkma/eng/press/index.htm>.

127. H.K. MONETARY AUTH., *supra* note 125.

128. H.K. MONETARY AUTH., MONTHLY STAT. BULL. (Apr. 2001), available at <http://www.info.gov.hk/hkma/eng/public/index.htm>.

funds injected into secondary mortgage markets under the mortgage-backed securities underwritten by the HKMC. As the risks are guaranteed by the HKMC, the soundness of the banking institutions is not affected.¹²⁹ Rather, the purchase of mortgages from banking institutions would provide more liquidity in the banking sectors. This might alleviate the sectoral risk of lending heavily to the real estate sector.

V. CONCLUSION

The HKSAR may have survived the Asian Financial Crisis of 1997, but it will not be immune from future crises unless it takes corrective measures to address systemic defects. The HKSAR enters this new millennium with the third successive year of budget deficits and the budget deficits are unlikely to improve until 2005.¹³⁰ This is the price the region has to pay for relying on a high land price policy to raise public revenue. The historical lessons for bank failure have never been learnt in the HKSAR. The foray of banking institutions into the volatile real estate markets has always been one of the main reasons that the HKSAR was left financially vulnerable. Real estate pricing only reflects underlying economic performance and can never be a driving force of economic success. Instead of finding a long-term solution to this historical problem, the HKSAR government bows to the pressure of the powerful alliance of the bankers and property developers by limiting the supply of land. This is not only counter-productive to service-based industries, it adds social costs by polarizing the "have's" and "have-not's."

The roots of the problem lie in the weak mechanisms for imposing regulatory control of the banking institutions, unsound public policy, and poor corporate governance. Consequently banking institutions' compliance to the non-compulsory HKMA guidelines is reluctant at best. Despite numerous warnings from international financial studies, the heavy-reliance of real estate finance by the banking institutions, as its major source of income, still haunts the region. Other inherent problems that weaken the financial stability of the HKSAR include overheating pressures, the pegged exchange rate, and the lack of transparency.

The HKSAR's failure to meet international accounting standards means that it is difficult to estimate the soundness of the banking system. The over-reliance on real estate loans by banking institutions inevitably concentrates the risk. As the financial

129. H.K. MORTGAGE CORP., MORTGAGE BUS. (2001), at <http://www.hkmc.com.hk>.

130. HKSAR GOV'T, THE 2001-02 BUDGET, available at <http://www.info.gov.hk/budget01-02/index.html>.

power in the HKSAR is concentrated in a coalition of bankers and property developers, they have ample opportunities to resist legislative reforms. Consequently, the real estate markets in the HKSAR are still structurally impaired. Due to the prevalent corruption and malpractice in the real estate industry, the real estate pricing does not actually reflect the construction costs and land value. Such discrepancy would inevitably affect the asset quality on the books of banking institutions. If the HKSAR is to market itself as an international center of banking and finance, its level of prudential banking and legal infrastructure should match international standards.

