HONG KONG MONETARY AUTHORITY
香港金融管理局

Supervisory Policy Manual		
IC-3	**Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance**	V.~~1~~ 2 – ~~06.11.03~~Consultation

This module should be read in conjunction with the Introduction and with the Glossary, which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To provide guidance in respect of the reporting obligations of AIs' external auditors under the Banking Ordinance

Classification

A non-statutory guideline issued by the MA as a guidance note

Previous guidelines superseded

Guideline 9.1 "Banking Ordinance: Auditors and Reporting under Section 61 to the Commissioner of Banking" dated 31.12.90; Guideline 9.2 "Auditors' Certificates on Statistical Returns" dated 23.07.91; and Guideline 9.3 "Internal Control Systems" dated 15.08.92; and IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance" (V.1) dated 06.11.2003

Application

To all AIs (parts applicable only to locally incorporated AIs are stated as such)

Structure

1. Introduction
   - 1.1 Background
   - 1.2 Role of the auditors
   - 1.3 Role of AIs' audit committees

~~B~~C: Controls relating to compliance with statutory provisions in the Banking Ordinance

~~C~~D: Controls relating to the maintenance of adequate provisions

1. Introduction

1.1 Background

1.1.1 External auditors (hereinafter referred to as "the auditors") play an important role in the supervisory process. The Basel Committee on Banking Supervision recognises the importance of the use of auditors in its Core Principles for Effective Banking Supervision. Principles ~~19~~ 10 and ~~21~~ 27 relate to the use of auditors to:

- help ensure that each bank maintains adequate and reliable records ~~drawn up~~ as well as prepares financial statements in accordance with ~~consistent~~ accounting policies and practices that are widely accepted internationally. This enables the supervisors to obtain a true and fair view of the banks' financial condition and ~~profitability~~performance; and
- perform independent checking to ensure the validity and integrity of the supervisory information.

1.2 Role of the auditors

1.2.1 The key responsibility of a bank's auditors is to express an opinion as to whether the bank's financial statements give a true and fair view and have been prepared in accordance with generally accepted accounting principles. In Hong Kong, the auditors are required to conduct the audit in accordance with applicable ~~Statements of Auditing Standards~~Standards on Auditing issued by the Hong Kong ~~Society of Accountants~~Institute of Certified Public Accountants ("~~HKSA~~HKICPA"), including adequate planning and supervision. The auditors are also required to observe the ethical standards promulgated by the ~~HKSA~~HKICPA, including those calling for independence, objectivity, professional competence and due care.

~~1.2.1~~1.2.2 In particular, AIs' auditors should comply with the partner rotation requirements applicable to the audits of public interest entities as set out in the HKICPA's Code of Ethics for Public Accountants ("COE"). In respect of the audit of an AI (including financial statements audit and auditors' reporting for prudential purposes), an individual shall not act in any of the key audit partner[1] roles, or a combination of such roles, for a period of more than seven cumulative years. The individual should also abide by the COE's requirements on the cooling-off period and the activities restrictions during the cooling-off period.[2]

~~1.2.2~~1.2.3 Apart from ~~this~~ the responsibility to express an opinion on the bank's financial statements, the auditors may communicate with those charged with governance[3] of the bank (e.g. through a management letter) any material weaknesses identified in its internal control system during the course of the audit and provide recommendations for improvement.

1.2.4 The auditors may also be required to report on certain specified events or make regular reports to the supervisors in addition to the audit report on the bank's financial statements. Generally, the scope of such reports will be agreed by the regulator, the bank concerned and its auditors before the commencement of the review.

~~1.2.3~~1.2.5 See Annex A for other supervisory expectations relevant to the external audits (including financial statements audits and auditors' reporting for prudential purposes) and the auditors.

[1] Key audit partner is defined in the HKICPA's COE as the engagement partner, the individual responsible for the engagement quality control review, and other audit partners, if any, on the engagement team who make key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion. Depending upon the circumstances and the role of the individuals on the audit, "other audit partners" might include, for example, audit partners responsible for significant subsidiaries or divisions.

[2] The partner rotation requirements are expected to be adopted for financial years ending on or after 1 January 2021 if they are not currently applied by the AIs' auditors.

[3] For the purposes of this module, the term "those charged with governance" refers to the audit committee and/or relevant governing body of the AI as appropriate.

1.3 Role of AIs' audit committees

1.3.1 The overall roles and responsibilities of an AI's audit committee with respect to the external audits and the auditors have been set out in CG-1 "Corporate governance of locally incorporated authorized institutions" and IC-2 "Internal audit function". Further guidance is provided below on the audit committee's responsibilities in relation to the oversight of as well as its relationship with the auditors.[4]

1.3.2 The audit committee should seek from the auditors, at least on an annual basis, information about the audit firm's policies and processes for maintaining independence and monitoring compliance with the relevant requirements.

1.3.3 The audit committee of an AI should develop a formal policy which governs the engagement of auditors for non-audit services[5] provided by auditors within the applicable ethical standards and regulatory requirements for auditors. Amongst other provisions, the policy should include criteria for the types of non-audit services that the auditors may provide or are prohibited from providing, and rules stipulating when advance approval by the audit committee is required for the engagement of auditors for non-audit services. The policy should be reviewed periodically and compliance should be monitored.

1.3.4 The audit committee of an AI should discuss with the auditors any significant issues identified in the course of the audits as well as the areas which could be relevant to future financial statements to promote early discussion and planning. These include upcoming changes in accounting standards or regulations and the implications of material transactions for the financial reporting processes and performance of the bank.

[4] In the case of an overseas incorporated AI which does not have an audit committee at the branch level, there should be a process for monitoring and assessing the effectiveness of the external audits as well as the independence of the auditors. Certain oversight function might be centralised at the group or regional level.

[5] Non-audit services include those services provided by the consultancy or advisory set-ups associated with the auditors.

1.3.5 The audit committee should also communicate to the auditors matters that are likely to be of significant relevance to the conduct of the audits. Such matters may encompass subjects that the audit committee believes warrant particular attention or may influence the audits, including significant communications with the supervisor.

1.3.6 In order to reinforce the audit committee's effectiveness and enhance the quality of the external audits, the audit committee should consider

- inviting the auditors to attend audit committee meetings (except when discussing matters in relation to the assessment of the auditors), even if there are no items explicitly relevant to the external audits on the agenda. The auditors' attendance should facilitate the exchange of views on the bank's business performance, risk and other topics; and

- assisting the auditors, if necessary, to gain access to any other committee meetings that the auditors determine to be relevant for the auditors' work.

1.3.7 To enable the audit committee to understand and discuss all issues that may have arisen between the auditors and bank management in the course of the external audits and how these issues have been resolved, the audit committee should consider meeting regularly with the auditors in the absence of executive management. In addition, these meetings should address any other matters that the auditors believe the audit committee should be aware of in order to exercise its responsibilities.

~~1.3~~1.4 Legal framework

~~1.3.1~~1.4.1 Companies incorporated under the Companies Ordinance (including locally incorporated AIs) are required to appoint auditors at each annual general meeting of the company. Pursuant to §~~141~~ 406 of the Companies Ordinance, the auditors are required to examine the ~~accounts~~ financial statements of the company and to report to the shareholders of the company on whether, in their opinion, the ~~accounts~~ financial statements give a true and fair view of the ~~company's~~ financial position and financial performance of the company and have been properly prepared in accordance with the provisions of the Companies Ordinance.

1.4.2 Under §59(1) of the Banking Ordinance, every AI and its auditors[6]~~[1]~~ shall comply with the Companies Ordinance with respect to the audit of a company's ~~accounts~~financial statements, whether or not the AI is incorporated under that Ordinance~~[2]~~.[7] Locally incorporated AIs should submit their annual report (including ~~—~~a set of audited annual ~~accounts~~financial statements, an auditors' report and a directors' report) to the MA within four months after the close of each financial year (for overseas incorporated AIs the time limit is six months).

~~1.3.2~~1.4.3 Set out below is a summary of the auditors' major duties and responsibilities in relation to prudential supervision under the Banking Ordinance:

- **Reporting on banking returns**
  - Pursuant to §63(3) of the Banking Ordinance, AIs can be required to appoint auditors to report, normally once a year, on whether a return or information submitted by them is correctly compiled, in all material respects, from their books and records and, if not, the nature and extent of the incorrectness (see section 3 below).
  - Under §50(1)(c) of the Banking Ordinance, locally incorporated AIs which maintain an overseas branch may need to appoint auditors, if the MA so requires, to report on whether a

[6] Under §2 of the Banking Ordinance, an "auditor" means a certified public accountant (practising) as defined in the Professional Accountants Ordinance.

[7] Under §60(6) of the Banking Ordinance, the MA may by notice in writing exempt an AI to comply with §59(1). Normally this exemption will be granted on an annual basis and only to overseas incorporated AIs.

return or information submitted by them in respect of their overseas branch(es) is correctly compiled, in all material respects, from the books and records of the branch(es).

- **Reporting on systems of control over the compilation of returns**

  §63(3A) of the Banking Ordinance allows the MA to require AIs to appoint auditors to report, normally once a year, on the adequacy of their systems of control over the compilation of banking returns or other information, compliance with certain statutory provisions in the Ordinance and, in the case of locally incorporated AIs, the maintenance of adequate provisions (see subsection 4.2 below).

- **Reporting on specific systems of control**

  Under §59(2) of the Banking Ordinance, AIs may be required to appoint the auditors, normally on a needs basis, to report on (see subsection 4.3 below):

  - their state of affairs or profit and loss or both; or
  - the adequacy of specific systems of control.

- **Reporting of qualification or adverse statement**

  Under §59A(2)(c) of the Banking Ordinance, AIs' auditors appointed under §~~131~~ 395, 396, 397 or 398 of the Companies Ordinance are required to provide immediate written notice to the MA if they decide to include in their report on an AI's ~~accounts~~ financial statements any qualification or adverse statement as to a matter mentioned in §~~141~~ 406 or 407 of the Companies Ordinance.

- **Reporting of significant adverse matters and non-compliance cases**

  §§63A and 63B of the Banking Ordinance require AIs' auditors to submit a report to the MA if, in the course of performing their duties as auditors, they become aware of any matter that in their opinion:

- adversely affects an AI's financial position to a material extent (see subsection 5.1 below); or
- constitutes on the part of a registered AI[8~~3~~] a failure to comply with certain provisions or rules made under the Securities and Futures Ordinance ("SFO") (see subsection 5.2 below).

~~1.3.3~~1.4.4 To facilitate a direct dialogue between AIs' auditors and the MA, there are protection clauses in the Banking Ordinance:

- §61 of the Banking Ordinance protects the auditors, despite any duty which they may owe to their clients (e.g. confidentiality), where they communicate to the MA in good faith any information or opinion on a matter of which they become aware in their capacity as auditors and which is relevant to any function of the MA under the Ordinance (see subsection 6.1 below); and
- §120(5)(g) of the Banking Ordinance allows the disclosure of information by the MA to the auditors of an AI or former AI, or to the former auditors, for the purpose of enabling or assisting the MA to discharge his functions under the Ordinance (see subsection 6.3 below).

2. Appointment, removal and resignation of auditors

2.1 Appointment

[8] A "registered AI" means an AI that is a registered institution under the SFO.

2.1.1 Reports under §§50(1)(c), 59(2), 63(3) and 63(3A) should be submitted by a firm of auditors appointed by an AI and approved by the MA. The auditors so appointed should be:

- the auditors appointed by the AI prior to the report being so required and approved by the MA for the purpose of preparing the report; or
- the auditors approved or nominated by the MA for the purpose of preparing the report after consultation with the AI.

2.1.2 The auditors referred to under §§63A and 63B of the Banking Ordinance (see section 5 below) are persons appointed:

- by shareholders of a locally incorporated AI, under §~~131~~ 395, 396, 397 or 398 of the Companies Ordinance, to report on whether the AI's ~~accounts~~ financial statements show a true and fair view and have been properly drawn up in accordance with the provisions of that Ordinance; or
- by the AI to submit a report to the MA under §§59(2), 63(3) or 63(3A) of the Banking Ordinance.

2.1.3 Accordingly the auditors for the various purposes under the Banking Ordinance (except §59(2) ¬– see para. 2.1.4 below) will normally be an AI's existing auditors. The MA has the right, however, to commission reports from another firm of auditors where:

- he considers that this arrangement can better utilise the knowledge and expertise of different auditors which may be beneficial to the AI; or
- he has reason to believe that the existing auditors would not be capable of producing an adequate report. In reaching this judgement, he will take into account:
  - the reputation of the existing auditors;
  - the quality of the reports previously submitted

to him;

- the expertise, knowledge and resources of the existing auditors; and
- any potential conflict of interest[9] on the part of the existing auditors.

2.1.4 Even where there are no doubts about the capability of the existing auditors, the MA may require that a report under §59(2) of the Banking Ordinance should be obtained from another firm of auditors, in particular if there may be any potential conflict of interest relating to the existing auditors. This would be to obtain a fresh and independent perspective on the matters which are the subject of the review.

2.1.5 If the MA is not intending to approve the existing auditors, he will first consult the AI concerned. Usually the MA will request the AI to propose another firm of auditors for his approval. If the AI fails to propose a satisfactory firm within a specified timeframe, he will nominate a selection of suitable firms from which the AI will be required to choose~~.~~.

2.1.6 An audit firm may be appointed by AIs to carry out a variety of assignments and these may be carried out by different departments of the audit firm. Auditors may therefore wish to consider whether reporting lines should be established within the firm so as to enable any important matters concerning clients to be brought to the attention of the auditors in the firm responsible for the annual audit or any review performed under the Banking Ordinance.

2.1.7 The appointed auditors should meet the ethical and independence requirements set out by the internationally accepted ethical and independence standards (such as the

[9] For the purposes of this module, a potential conflict of interest situation exists if, with all relevant facts and circumstances, a reasonable person would consider that the auditors may not be able to exercise unbiased judgement in respect of the work undertaken for prudential purposes. For example, independence concern may arise if the auditors are engaged to provide an assurance report on the effectiveness of the internal controls over certain IT systems of the AI which they were previously involved in the design and implementation of the systems. Overall, whether a potential conflict of interest situation exists would need to be assessed on a case-by-case basis.

Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants) and any additional requirements by the HKMA in relation to the relevant engagement.

2.1.8 In respect of partner rotation, auditors should comply with the rotation requirements as mentioned in para. 1.2.2 above.

~~2.1.7~~2.1.9 Where an AI appoints a third party (i.e. other than the existing auditors) to review any matters relating to its assets, internal controls and accounting records, the MA would expect the AI to inform its auditors of such an appointment. The AI should also make available to its auditors without delay the reports of any such reviews.

2.2 Removal

2.2.1 §59A(1) of the Banking Ordinance requires a locally incorporated AI to notify the MA immediately if:

- the AI proposes to give notice to its members of an ordinary resolution removing its auditors before the expiration of the term of office;
- the AI gives notice to its members of an ordinary resolution replacing its auditors at the expiration of the term of office; or
- a person ceases to be an auditor of the AI otherwise than in consequence of such a resolution.

2.3 Resignation

2.3.1 Under §59A(2) of the Banking Ordinance, an AI's auditors appointed under §395, 396, 397 or 398~~131~~ of the Companies Ordinance shall immediately provide a written notice to the MA if they:

- resign before the expiration of the term of office; or
- do not seek to be re-appointed.

2.3.2 If the auditors resign or communicate an intention to resign, those charged with governance of the AI should follow up on the reasons or explanations giving rise to such resignation and consider any need to take actions in response to those reasons.

3. Auditors' reporting on banking returns

3.1 Purpose and coverage

3.1.1 The HKMA monitors AIs' financial condition and profitability through data collected via banking returns and other means on a regular basis.

3.1.2 The arrangements whereby the auditors report on banking returns under §63(3) of the Banking Ordinance are intended to check, on a sample basis, the accuracy and reliability of the data submitted by AIs in the returns.

3.1.3 Under §63(3) of the Banking Ordinance an AI will normally be required by the MA to commission a report from its auditors each year on whether certain returns or information submitted to the MA have been correctly compiled in all material respects from its books and records. Normally the scope of the §63(3) report does not cover surveys (e.g. on credit card lending and residential mortgage lending).

3.1.4 The returns to be reviewed will normally be:

- for locally incorporated AIs:
  - Capital adequacy ~~(All parts)~~;
  - Large exposures (~~Columns 1 - 5 of Parts I and II~~selected parts)[4];
  - Liquidity position (selected parts, depending on whether the AI is a "category 1 institution" or "category 2 institution")~~(Part I)~~;[10]
  - Loans and advances (selected parts);

[10] Category 1 institution means an AI designated under rule 3(1) of the Banking (Liquidity) Rules ("BLR") as a category 1 institution. Category 2 institution means an AI that is not a category 1 institution.

- Mainland activities; and
- Compliance (~~Parts I - III~~selected parts).

- for overseas incorporated AIs:
  - Large exposures (~~Columns 1 - 5 of Parts I and II~~selected parts)[5];
  - Liquidity position (selected parts, depending on whether the AI is a "category 1 institution" or "category 2 institution") ~~(Part I)~~;[11]
  - Loans and advances (selected parts);
  - Mainland activities; and
  - Compliance.[12]

However, the MA reserves the right to require a report on other returns or information submitted under §§50(1)(a) & (b) and 63(1) & (2).

3.1.5 The returns to be checked should be the most comprehensive in the series. Thus where an AI completes a consolidated return it should be that return which is checked. Where it has overseas branches but no subsidiaries the combined return should be checked, and so on. The returns only apply, in the case of overseas incorporated AIs, to their Hong Kong offices.

3.2 Reporting frequency and timing

3.2.1 The returns are normally to be checked annually. The frequency may, however, be increased if there are particular grounds for concern.

3.2.2 The returns to be checked should all relate to one date or period. Normally returns with a common reporting date will be chosen for review on a random basis, i.e. as at end-March, end-June, end-September or end-December. The date or period will not necessarily be coterminous with the end of an AI's financial year.

[11] See footnote 10.
[12] The exact scope of review will be indicated in the HKMA's notification letter to respective AIs.

3.2.3 The particular reporting date will be chosen retrospectively and notified in writing to the AI concerned shortly after the returns have been submitted. This notification letter will be copied to the auditors directly. AIs should therefore retain the necessary information, including the working papers, for a sufficient time to ensure that this work can be done.

3.2.4 Notwithstanding the foregoing, the MA reserves the right to add other reporting dates into the process if he is not satisfied with the quality of an AI's data complied.

3.2.5 The auditors' report should be submitted by the AI to the MA, with any comment the AI wishes to make, not later than two months from the date of the MA's notification letter. Prior consent from the HKMA may be sought for an extension of the deadline for submission, if there is good justification.

3.3 Criteria for reporting errors

3.3.1 The MA requires only errors which are material in amount or indicative of weaknesses in the compilation process to be drawn to his attention. The intention is for the auditors to focus on the quality of the statistics provided rather than on identifying minor reporting errors. What constitutes material will need to be judged by the auditors on a case-by-case basis. ~~For example, an error should normally be considered material if it exceeds 5% of the applicable item in the return to which it relates.~~ Auditors should focus on the impact of errors on the return that is subject to examination and relevant items in other returns that are within the scope of section 63(3) reporting.

3.3.2 Auditors should evaluate whether an error is material in the context of quantitative factors as well as qualitative factors. A deviation of 5% or more in a particular line item in a return is a general quantitative reference. Nevertheless, an error that affects compliance with the law or regulation (e.g. failure to meet the minimum regulatory capital adequacy or liquidity requirements) is considered as material even if it is within 5% of the applicable item in the return. The materiality threshold should be adjusted downward when the actual prudential ratios of the AI are close to the regulatory limits or the AI's internal triggers.

3.3.3 Additionally, auditors should consider whether the errors identified are material individually or in aggregate as well as the qualitative aspects of the errors. In the case of multiple exceptions where each individual exception has an impact of less than 5% for a specific line item, materiality should be assessed by looking at the aggregate impact of the identified exceptions taking in consideration the nature of line items and the activities of the AI concerned. Material errors, regardless of their causal factors, should be reported to the HKMA.

~~3.3.1~~3.3.4 Auditors should prepare the report based on the findings identified in the latest returns ~~originally~~ submitted to the MA before the commencement of auditors' work, unless the MA specifies otherwise. Any subsequent amendments to the returns to correct the reporting errors identified after the submission or during the course of the review should not be considered. Auditors should specify in their reports the submission dates of the returns that have been reviewed by them.

~~3.3.2~~3.3.5 AIs and their auditors should bear in mind the penal provisions of §§50(6) and 63(7) of the Banking Ordinance relating to the knowing or reckless provision of false or misleading information.

4. Auditors' reporting on various internal control systems

4.1 General

4.1.1 The Banking Ordinance splits the reporting requirement on internal controls into two broad categories:

- AIs are required to submit reports by auditors on certain internal control systems on a recurring annual basis; and
- reports on other internal control systems are to be

commissioned on an ad hoc basis as needed.

4.2 Annual reviews

4.2.1 The MA is empowered under §63(3A)(a) of the Banking Ordinance to require an AI to submit an auditors' report on whether, during a specified period, the internal control systems of the AI were such as to enable, as far as practicable:

- the correct compilation of returns or information from the books and records of the AI (see Annex ~~A~~B);

- compliance by the AI with the provisions under Parts XII, XV, ~~XVII~~[~~6~~] XVIA[13] and ~~XVIII~~ XVIB of the Ordinance (see Annex ~~B~~C); and

- in the case of locally incorporated AIs, adequate provision for depreciation or diminution in the value of assets (including provision for bad and doubtful debts) and for actual or potential liabilities and losses (see Annex ~~C~~D).

4.2.2 Having completed this work, the auditors should also report under §63(3A)(b) of the Banking Ordinance in respect of the same period on:

- any material contravention of the provisions under Parts XII, XV, XVIA~~I~~[14] [~~7~~] and ~~XVIII~~ XVIB of the Ordinance by the AI; and

- in the case of locally incorporated AIs, any failure to maintain adequate provisions.

4.2.3 Only one report is to be submitted under §63(3A) and it will normally be required annually.

~~4.2.3~~4.2.4 The report submitted under §63(3A) should cover all the matters set out in paras. 4.2.1 and 4.2.2 above. Pursuant to

[13] Part XVIA of the Banking Ordinance does not apply to overseas incorporated AIs.
[14] See footnote 13.

§63(3D), a report will not be required on a matter referred to in §63(3A)(b) unless the requirement also relates to a matter referred to in §63(3A)(a). Thus a report under §63(3A)(b) will not be commissioned in isolation.

4.2.5 In reporting under §63(3A)(b), the auditors will draw particularly on their work performed under §63(3A)(a) but they will also be expected to take into account any other relevant information[~~8~~15] which comes to their attention in their capacity as auditors of the AI, including in the normal course of their audit work and in their review of returns under §63(3). They will not, however, be expected to change the scope of their audit work nor the frequency or timing of their audit visits. In cases where the audit work has not been completed, the auditors can refer to that fact in their report.

~~4.2.4~~4.2.6 For overseas incorporated AIs which are exempt from local statutory audits, the auditors are expected to set the scope and extent of tests to facilitate their reporting in accordance with the requirements of §63(3A)(a) and (b).

4.2.7 The period to be covered by a report under §63(3A) will not normally be more than 12 months unless the MA is satisfied that a longer period is required in the interest of the depositors or the public. Usually it will be the financial year of the AI so as to coincide with the work on the annual audit. In the case of an overseas incorporated AI, a different period for review may be agreed if that is mutually convenient to the AI, its auditors and the MA. Once determined for the initial report, the review period will normally be the same for subsequent reports.

~~4.2.5~~4.2.8 The scope and period to be covered by the report required under §63(3A) will normally be notified in writing to AIs three months before the end of the period to be reviewed. The notification letter will be copied to the auditors directly. The AI should in turn issue a letter of

[15] It is recognised that such information may already have given rise during the period under review to a report under §§61, 63A ~~and~~ or 63B. In such cases the auditors will not be required to report again on the matter under §63(3A)(b) unless there had been further developments which materially affected the position.

instruction~~16~~9 to its auditors with a copy to the MA.

~~4.2.6~~4.2.9 The report should be submitted to the AI by the auditors not later than three months from the end of the review period and should be forwarded to the MA with the comments of the AI, if any, within a further month.

~~4.2.7~~4.2.10 In making a report on internal controls under §63(3A)(a), the auditors will be asked to report on both the existence of controls and whether they have operated effectively during the review period. In drawing attention to any weaknesses or failures in the control system, they will be asked to report only those which, in their judgement, are material. Where weaknesses or failures in controls have been identified, the auditors should, if possible, make recommendations for improvement. It is not, however, the responsibility of the auditors to ensure that such recommendations are implemented by the AI.

~~4.2.8~~4.2.11 A materiality test should also be applied in reporting any matters under §63(3A)(b). What constitutes material or adequate will need to be judged by the auditors on a case- by-case basis. In the case of an overseas incorporated AI, ~~–~~it is adverse matters which are material in the context of the ~~–~~AI's operations in Hong Kong which should be reported.

4.3 Ad hoc reviews

4.3.1 The MA also has a discretionary power under §59(2) of the Banking Ordinance to require an AI, after consultation with the AI, to provide an auditors' report on such matters as he may specify for the performance of his functions under the Ordinance. This power will, among other things, enable the MA to require an AI to appoint auditors to conduct a review on its internal control systems in specific areas of operations.

4.3.2 Major areas of control which may be covered in ~~such a~~ad-hoc reviews include but are not limited to:

[16] The letter of instruction can remain effective ~~from~~ after ~~one~~ an accounting period ~~to another~~ until it is replaced.

- corporate governance (CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions");
- risk management system (IC-1 "~~General~~ Risk Management ~~Controls~~Framework");
- controls relating to specific operational areas (e.g. lending or trading activities);
- loan classification system~~ (CR-G-4 "Loan Classification and Provisioning"[10])~~;[17]
- information technology (TM-G-1 "General Principles for Technology Risk Management");
- business continuity planning (TM-G-2 "Business Continuity Planning");
- prevention of money laundering (AML-~~1~~ 2 "Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Authorized Institutions)~~Prevention of Money Laundering~~"~~[11]~~); and
- internal audit function (IC-2 "Internal Audit~~, Legal and Compliance~~ Function"~~[12]~~).

In determining the audit procedures of a review, the auditors may refer to the ~~above~~ relevant Supervisory Policy ~~m~~ Manual module(s) as well as circulars and guidelines to AIs for guidance.

4.3.3 This type of report will be commissioned where an independent review is required in particular areas. The circumstances which may lead to a decision to commission a report include:

- a management letter[18]~~[13]~~ from the AI's auditors which revealed significant weaknesses in internal controls;

[17] See "Guideline on loan classification system" and "Guidelines on overdue and rescheduled assets" as set out in Appendices 2 and 2.1 of the completion instructions for the banking return MA(BS)2A (Quarterly Analysis of Loans and Advances and Provisions) as well as other relevant circulars issued to AIs.

[18] AIs are required to provide a copy of the auditors' management letter to the HKMA for review (see subsection 11.1.2 of CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions").

- particular issues arising from the HKMA's on-site and off-site examinations, prudential interviews, tripartite meetings, internal auditors' reports, external auditors' reports on annual ~~accounts~~ financial statements and ad hoc reports made by the auditors under §61 of the Banking Ordinance;
- frequent errors detected in returns submitted to the MA or other indications of irregularities in the returns;
- material adverse events or transactions which affect the business operations or financial position of the AI. These will include matters reported by the auditors under §§63(3), 63(3A), 63A or 63B; and
- significant exposure to business activities or new product lines which require strong systems support as part of the risk management process. An example is dealing in derivative instruments with a high degree of price volatility.

4.3.4 The MA may also use his powers under §59(2) to commission reports on other matters which are relevant to the exercise of his functions under the Banking Ordinance, e.g. in relation to review of particular transactions. A report may also be commissioned on the financial affairs of the AI, based on an audit of its ~~accounts~~financial statements. Such a report will only be commissioned where the MA has reason to believe that the normal audit by the AI's auditors was, or was likely to be, seriously deficient.

4.3.5 The period to be covered by a report under §59(2) will vary depending on the circumstances but it will not normally exceed 12 months. A report will be commissioned after prior consultation with the AI and its scope (i.e. terms of reference) will be agreed in advance with the AI and its auditors.

4.3.6 The scope of the review, the period to be covered and the due date for submission will be notified in writing to the AI. The AI should in turn issue a letter of instruction to its auditors with a copy to the MA.

4.3.7 The auditors' report should normally be submitted to the AI not later than three months from the end of the review period and forwarded with the comments of the AI, if any, to the MA within a further month. The MA reserves the right to require a shorter deadline in special circumstances, after consultation with the AI and the auditors concerned.

4.3.8 The auditors' report should also be communicated to those charged with governance of the AI. For an AI incorporated outside Hong Kong, it should inform its head office of the reviews conducted at the branch and provide the head office with the auditors' report.

~~4.3.7~~4.3.9 Apart from the reviews commissioned under §59(2) of the Banking Ordinance, the HKMA may also require the AI to appoint an auditor to examine and report upon specific subject matters or transactions undertaken by the AI that would be appropriate for the purpose of the HKMA's supervisory functions under the Ordinance. Guidance provided in this module is applicable to these reviews, unless otherwise determined by the HKMA and notified to the AI.

5. Auditors' reporting on certain specified matters

5.1 Reporting of significant adverse matters

5.1.1 Under §63A of the Banking Ordinance, the auditors of an AI are required to submit a report in writing, as soon as is reasonably practicable, to the MA if they, in the course of performing their duties as auditors, become aware of a matter which, in their opinion, adversely affects the AI's financial position to a material extent. The report should cover the nature of the matter and the reason(s) why they are of that opinion.

5.1.2 In determining whether a matter should be reported to the MA under §63A, an AI's auditors should consider, among other things, the following issues:

- whether the AI's status as a going concern is questionable (e.g. a material loss that may threaten the financial condition of the AI);
- whether the AI's capital adequacy ratio has dropped, or will drop, significantly to a level which may be detrimental to depositors; or
- whether the liquidity position of the AI has deteriorated or will deteriorate to a level which is likely to threaten the interests of depositors.

5.1.3 For locally incorporated AIs, the auditors should look at the matter in the context of the AI as a whole. If the AI concerned is incorporated outside Hong Kong, the auditors should consider any such matter in the context of its principal place of business in Hong Kong and its local branches as if that principal place of business and those branches were collectively a separate AI.

5.1.4 It is also an AI's responsibility to report to the MA if it becomes aware of such matters affecting its financial position. The AI should bring such matters to the attention of the MA as soon as it has reason to believe that they could have a material adverse effect on the AI or on the interests of depositors. Specifically, an AI is required to notify the MA under §67 of the Banking Ordinance if it is, or is about to become, unable to meet its obligations, and under §§~~99~~ 97D and 97I~~103~~ of the Ordinance, where it fails to keep its capital adequacy or liquidity ratios at or above the prescribed levels.

5.2 Reporting of non-compliance with the SFO

5.2.1 Under §63B of the Banking Ordinance, the auditors of an AI are required to submit a report in writing, as soon as is reasonably practicable, to the MA if they, in the course of performing their duties as auditors, become aware of any matter that, in their opinion, constitutes on the part of a registered AI a failure to comply with any prescribed requirements within the meaning of §157 of the SFO.

5.2.2 Under §157 of the SFO, "prescribed requirements" refer to the requirements of any rules made under §§148, 149, 151, 152 or 397 of the SFO. These requirements generally relate to the management of client securities and collateral, holding of client monies, keeping of accounts and records, provision of contract notes, receipts, statement of account and notifications, etc.~~.~~

5.2.3 Given the nature of AIs' deposit taking business, the requirements relating to the holding of clients' monies under §149 of the SFO are specifically excluded for purposes of §63B of the Banking Ordinance.

5.2.4 Auditors of registered AIs should therefore familiarise themselves with the relevant regulations and requirements issued by the SFC in order to fulfil their duties under §63B of the Banking Ordinance. Nevertheless §63B does not of itself require auditors to change the scope, nature and depth of their audit work[19]~~[14]~~. They are not required actively to seek out grounds for making a report under this section. It is only when they become aware, in the ordinary course of their work, of a matter of the kind described in para. 5.2.2 above that they should make a report to the MA.

6. Communication between the auditors and the HKMA

6.1 Protection

6.1.1 §61 of the Banking Ordinance permits auditors, notwithstanding any duty which they may owe to their clients (e.g. confidentiality), to communicate with the MA, provided that:

- the communication, whether or not in response to a request by the MA, is in good faith; and

[19] It is acknowledged that the scope and extent of audit work on the securities dealing operations of an AI may vary from institution to institution, depending on the size of ~~the~~ its operation.

- the information so disclosed relates to information or opinion on a matter of which they become aware in the capacity of auditors and which is relevant to any function of the MA under the Ordinance.

6.1.2 The protection covers not only auditors appointed under §395, 396, 397 or 398~~131~~ of the Companies Ordinance but also auditors appointed for the purpose of §§50(1)(c), 59(2), 63(3) and 63(3A) of the Banking Ordinance. It also covers auditors who make a report to the MA as required under §§63A and 63B of the Banking Ordinance.

6.1.3 The protection afforded by §61 of the Banking Ordinance is general and not restricted by the circumstances in which the information is obtained or by its sources. Provided the information becomes known to the auditors in the capacity as the auditors of an AI, they may communicate that information to the MA notwithstanding that:

- the information does not relate to the auditing work undertaken by them; or
- the source of the information was not the AI.

6.1.4 §61 of the Banking Ordinance does not of itself require auditors to change the scope, nature and depth of their audit work. They are not required to actively seek out grounds for making a report under this section. It is only when they become aware, in the ordinary course of their work, of any situation as described in para. 6.2.3 below that they should make detailed enquiries with §61 in mind.

6.2 Direct reporting to the HKMA

6.2.1 For matters required to be reported under §§63A and 63B of the Banking Ordinance, it is the auditors' obligation to report them directly (i.e. not via the AI) to the MA. The auditors should also consider providing a copy of the report to the AI concerned at the same time.

6.2.2 Apart from matters required to be reported directly by the auditors under §§63A and 63B of the Banking Ordinance, the MA recognises that it is important for auditors to act in a manner that will preserve their professional relationship with their client AIs. It is therefore expected that the auditors will normally discuss with their AI any matter about which they are concerned, and request the AI to draw the matter to the attention of the MA (or obtain evidence that shows that the matter has been reported to the MA).

6.2.3 Where an AI declines to report to the MA or the matter has not been brought to the attention of the MA within a reasonable period of time, the auditors should consider making a report directly to the MA in respect of any matter (other than those already required to be reported under §§63A and 63B of the Banking Ordinance) where they consider that depositors' interests might be better protected if the MA was made aware of it. Examples of such matters include:

- when there appears to the auditors to be a material contravention of one or more of the requirements of the Banking Ordinance;
- where the auditors have evidence of an occurrence which has led or is likely to lead to a material diminution of the AI's assets;
- when the auditors form the opinion that there has been a significant failure of, or that there is a significant weakness in, the AI's accounting and other records or internal control systems; or
- when the auditors form the opinion that management has reported financial information to the MA which is materially misleading or become aware that management has failed or does not intend to report something and the failure to report is, or would be, materially misleading.

6.2.4 In exceptional circumstances, where it is in the interest of protecting depositors that the management of the AI should not be informed in advance, the auditors should report directly to the HKMA having first considered independent legal advice, as is deemed necessary. Examples of these circumstances are:

- where there has been an occurrence which causes the auditors no longer to have confidence in the integrity of the directors or senior management, e.g.:
  - where they believe that a fraud or other misappropriation has been committed by the directors or senior management of the AI; or
  - where they have evidence of the intention of directors or senior management to commit a fraud or misappropriation;
- where there has been an occurrence which causes the auditors no longer to have confidence in the competence of the directors or senior management to conduct the business of the AI in a prudent manner so as to protect the interests of depositors, e.g.:
  - where they have discovered that the directors or senior management are acting in an irresponsible or reckless manner with respect to the AI's affairs; or
  - where they have evidence of an intention so to act; and
- where the AI refuses or fails to inform the HKMA of a matter within the specified time period, having been advised to do so by its auditors, or where there is evidence that the AI has not adequately and properly reported the matter in question.

6.2.5 In these exceptional circumstances the auditors may wish to consider whether the matter should be reported at an appropriate senior level in the AI (e.g. audit committee) and whether an appropriate representative of the AI (e.g. an independent director) should be invited to attend a meeting with the HKMA. Decisions should be made in the light of the circumstances of each case.

6.2.6 Speed of reporting may be important for the protection of depositors. Therefore, while the auditors may wish to take legal advice, they should also consider the possible impact on depositors' interest arising from a delay in reporting the matter to the HKMA.

6.3 Sharing of information with auditors

6.3.1 The MA is permitted under §120(5)(g) of the Banking Ordinance to disclose confidential information to an auditor of an AI or former AI or to a former auditor for the purpose of enabling or assisting the MA to discharge his functions under the Ordinance.

6.3.2 With this authority, the MA will take the initiative, normally by calling a tripartite meeting, in bringing a matter to the attention of an AI and its auditors when:

- he considers the matter of such importance that the auditors' knowledge of it could significantly affect the form of their audit or other report or the way in which they carry out their reporting responsibilities; and
- the disclosure is for the purpose of enabling or assisting the MA to discharge his functions under the Banking Ordinance or will otherwise be in the interests of depositors.

6.3.3 Information so disclosed to the auditors remains confidential and should not therefore be further disclosed unless the MA consents.

6.4 Tripartite meeting

6.4.1 Meetings involving the HKMA, an AI and its auditors may be called by any of these parties and convened at any time. Such meetings can be held on an ad hoc basis but for locally incorporated banks, they are normally convened on a yearly basis following the annual audit.

6.4.2 Matters discussed in the tripartite meeting typically include the results of the annual audit, presentation and content of the annual ~~accounts~~financial statements and the work performed under §§50, 59(2), 63(3) and 63(3A) (such as identified weaknesses in internal controls, adequacy of provisions and compliance with legal and other prudential requirements).

6.4.3 Depending on individual circumstances, there would be a tripartite discussion to confirm expectations as to the scope, nature and extent of work to be performed prior to commencement of a §59(2) engagement. If changes need to be made to the scope, nature and/or extent of work subsequent to the commencement of engagement, such changes should be communicated and agreed by the auditors with the AI and the HKMA on a timely basis. In addition, for any material issues identified by the auditors during the course of their work, there should be timely communication with the AI and the HKMA.

~~6.4.3~~6.4.4 The HKMA will usually prepare an agenda for the tripartite meeting and include items at the request of the AI or its auditors. The auditors should forward any such request via the AI. An item may be included on the agenda even if the AI has not agreed. It may therefore be necessary for there to be direct communication between the auditors and the HKMA.

~~6.4.4~~6.4.5 Auditors should be aware of the MA's functions under the Banking Ordinance and his responsibilities for the protection of depositors. They will be expected to participate fully in tripartite meetings. This will involve discussing matters relating to their client's affairs, including information about the customers of their clients, arising from the statutory audit and from work required under the Ordinance.

~~6.4.5~~6.4.6 The HKMA recognises that it would not be appropriate for auditors to report to it any information about the AI obtained through their professional relationship with another client which is not the AI in question.

7. Industry guidance

7.1 AIs should read the Practice Note issued by the ~~HKSA~~ HKICPA in relation to the auditors' reporting responsibilities under the Banking Ordinance in conjunction with this module.

Annex A: Supervisory expectations relevant to the external audits and the auditors

The supervisory expectations set out in this Annex with respect to the external audits and the auditors are based on the Guidelines "External audits of banks" published by the Basel Committee on Banking Supervision in March 2014. These expectations would assist AIs' audit committees in carrying out their responsibilities for monitoring and assessing external audits.

1. The auditors of an AI should have banking industry knowledge and competence sufficient to respond appropriately to the risks of material misstatement in the AI's financial statements and to properly meet any additional regulatory requirements.

2. The HKMA expects that the audit engagement team, as a whole, has:

   - proficient knowledge and understanding of, and practical experience with, the banking sector, associated banking industry and bank-specific risks, and the operations and activities of banks and bank audits. The audit engagement team may acquire this knowledge through specific training, participation in bank audits or work in the banking sector;

   - proficient knowledge and understanding of applicable accounting, assurance and ethical standards, industry practice and relevant guidance;

   - proficient knowledge of relevant regulatory requirements, and a general understanding of the legal and regulatory framework applicable to banks; and

   - proficient knowledge and understanding of IT relevant to bank audits.

3. In some instances, expertise in a field other than accounting or auditing may be required to support the audit engagement team. Examples of such areas are certain complex valuations that may affect accounting estimates (e.g. valuation of complex financial instruments, commercial property valuations), regulatory matters and the evaluation of complex IT environments, particularly in areas subject to significant risks of material misstatement. Audit engagement teams should use expertise as appropriate.

4. In addition to being knowledgeable and competent in bank audits, the auditors of an AI should be objective and independent in both fact and appearance with respect to the bank.

5. When assessing whether any relationship or circumstance poses a threat to auditors' independence, the auditors evaluate not just the specific rules on independence, but also the substance of the threat to independence, and how a reasonably informed third party would perceive the threat and its effect on the auditors' objectivity. The provision of non-assurance services by the audit firm and, when applicable, network audit firms to the AI being audited may particularly affect a third party's perception of the auditors' independence. Such situations should be evaluated for threats to the auditors' objectivity and perceived independence.

6. The auditors of an AI should exercise professional scepticism when planning and performing the audit, having due regard to the specific challenges in auditing the AI.

7. It is of particular importance that professional scepticism is exercised by the auditors in the following areas: impairment calculations, fair value measurements and going concern assessments, including assessments of solvency and liquidity. Other examples are complex transactions lacking substance or a sound business purpose that management has structured to achieve a particular accounting treatment and/or regulatory outcome where audit engagement partner has or ought to have reasonable doubt that the proposed accounting treatment and/or regulatory outcome is consistent with the relevant financial reporting framework or regulatory requirements. In this context, auditors are expected to challenge management's inputs and assumptions and form independent views. This includes challenging evidence obtained from management that corroborates management's view.

8. The evidence of the extent of professional scepticism exercised should be demonstrable and understandable through audit documentation that describes what conclusions were reached by the auditors and how.

9. Audit firms should also comply with the applicable standards on quality control. Systems of control should be in place to emphasise quality and consultation and to create a culture of compliance with auditing and ethical standards as well as applicable legal and regulatory requirements.

10. Certain financial statement items are used in the calculation of key metrics used by a wide range of users of the financial statements. For example, regulatory ratios such as the leverage ratio, liquidity ratio and capital adequacy ratio are calculated based on account balances reported in the financial statements or are derived from the financial statements. The auditors of an AI are expected to consider these ratios as an input to the determination of materiality thresholds for the audit.

Annex ~~A~~B: Controls relating to the compilation of banking returns

1. Objective

AIs should have adequate systems and controls to permit the submission of reliable statistics and information to the HKMA. The statistics and information submitted should be complete, accurate and prepared in accordance with the HKMA's completion instructions.

2. Key controls and procedures

Auditors should develop audit procedures to assess whether the AI has controls in place to satisfy the above objective, taking into account the nature, size and complexity of an AI's business. In developing the audit procedures, they may have regard to the following:

- Roles and responsibilities with regard to compilation and review of banking returns and other information are clearly defined;
- A procedures manual is established, setting out the timing of reports, their compilation method, information sources used and other information gathering techniques which are necessary to ensure the complete, timely and accurate compilation of returns and other information;
- Clear, concise and organised working papers for the compilation of returns and other information are maintained to provide traceable links between the accounting records and completed returns. Any material discrepancies between the records and the returns are investigated and explained;
- The approach and procedures used in the compilation of returns and other information are clearly understood by the officers responsible for the preparation and checking. The various guidelines and instructions issued by the HKMA relating to the completion of returns are properly filed and kept up-to-date to facilitate future reference;
- The approach and procedures used in the compilation of returns and other information are timely updated for changes in regulatory reporting requirements and changes in business or operations. The updated procedures and reporting treatments are reviewed by an appropriate level of the AI's management;
- Where the calculations involve the use of internal models, governance and controls are in place to ensure consistent application of the established methodologies and assumptions as well as proper

management of subsequent changes.

- Where computer-based tools or systems are used for compiling returns and other information (whether maintained by the AI itself, its head office or third party vendor(s)), relevant procedures are put in place to ensure the reliability of outputs generated from such computer-based tools or systems;
- Reconciliations are prepared to summarise adjustments made between the originally submitted returns and subsequent returns. Root causes of the adjustments are identified and relevant controls and procedures are enhanced to rectify the issues;
- Any questions or clarification regarding the compilation process are referred to the HKMA. A note of any discussions is made for future reference;
- Prior to submission, returns and other information are checked by a designated officer who takes no part in the actual preparation work; ~~and~~
- Procedures are adopted to ensure that staffing changes do not affect the quality of returns and other information; and
- For a locally incorporated AI, the above controls should also take into account the data and information from the AI's overseas branches and/or its non-bank subsidiaries that are within the scope of regulatory consolidation.

Annex ~~B~~C: Controls relating to compliance with statutory provisions in the Banking Ordinance

1. Objective

AIs should have effective monitoring and reporting systems to enable compliance with their statutory duties under the Banking Ordinance at all times.

2. Key controls and procedures

Auditors should develop audit procedures to assess whether the AI has controls in place to satisfy the above objective, taking into account the nature, size and complexity of an AI's business. In developing the audit procedures, they may have regard to the following:

General controls

- Management are fully aware of the relevant statutory provisions and regulatory requirements in relation to the AI's operations;
- There is central filing of the Banking Ordinance, guidelines and circular letters issued by the HKMA (whether by mail or through electronic delivery), relevant communications with the HKMA and amendments to all these documents. There are also established procedures to ensure that such information are communicated effectively within the AI to those who need to be aware of it;
- A procedures manual is established and maintained to ensure compliance with statutory and regulatory requirements in all aspects of the AI's operations;
- Procedures are in place to ensure compliance with statutory and regulatory requirements. They deal not only with day-to-day operations ~~before introduction~~but also the process of introducing ~~of~~ new products and ~~engagement~~ engaging in new business activities;
- An officer (e.g. compliance officer) has been designated with the responsibility to monitor and ensure compliance with statutory and regulatory requirements;
- Adequate management reports on compliance with statutory and regulatory requirements are produced and reviewed by relevant management members and the compliance officer in a timely manner;

- Procedures are in place to ensure that any failure to comply with statutory or regulatory requirements is reported to the HKMA as well as to the AI's senior management and those charged with governance as soon as practicable; and
- Clear, concise and organised ~~working papers~~documentation for monitoring compliance are maintained to provide audit trails for subsequent verification.
- For a locally incorporated AI, the above controls should also take into account the AI's overseas branches and/or its non-bank subsidiaries that are within the scope of regulatory consolidation.

Compliance with ~~§§81 and 83~~Part XV of the Banking Ordinance – Limitations on exposures and interests of AIs

- There is a written policy on concentration of exposures particularly large exposures and exposures~~advances~~ to connected parties which sets out, among other things, the AI's strategy to prevent undue concentration of risks and, specifically, the systems and procedures to ensure compliance with statutory and regulatory requirements;
- Limits are established for individual counterparties,~~customers or~~ group of linked counterparties, connected parties~~related customers~~, equity exposures and interests in land to prevent any potential breach of the Banking (Exposure Limits) Rules ("BELR") made under Part XV of the Banking Ordinance. Where appropriate, sub-limits should be allocated to, and observed by, business units, branches or subsidiaries. The limits and sub-limits should be set at levels lower than the statutory limits under ~~§§81 and 83 of the Ordinance~~the BELR so as to ensure compliance on a continuous basis;
- Systems and processes are in place to support (1) the accurate valuation of individual exposures by taking into account the effect of applicable credit risk mitigation and (2) the accurate calculation of aggregate exposures;
- The internal reporting and monitoring system is able to provide timely information for management's attention or action and enable any breaches or exceptions to be identified and reported to the senior management immediately;
- A central liability record to ensure compliance with ~~§§81 and 83 of~~ the BELR ~~Ordinance~~ is maintained to capture all ~~financial~~ exposures to relevant customers, including those extended through branches or

subsidiaries, and that record is kept up-to-date at all times;

- Procedures are in place for effective control of exposures including facilities approved at a branch or subsidiary level and to ensure that such ~~facilities~~ exposures are captured in the central liability record in a timely manner; and
- ~~Financial e~~Exposures which are exempt from ~~§§81 and 83 of the Ordinance~~the BELR are adequately monitored to ensure that the terms and conditions for exemptions are complied with at all times.

(See also CR-G-8 "Large Exposures and Risk Concentrations" and CR-G-9 "~~Connected Lending~~Exposures to Connected Parties" for detailed guidance.)

Compliance with ~~§98~~Part XVIA of the Banking Ordinance – Capital ~~Adequacy~~requirements

- A written policy is established to set out the AI's strategy on capital adequacy and leverage ratio requirement and how it intends to maintain adequate capital to support its various business activities and to meet statutory and regulatory requirements;
- Target capital adequacy ~~ratios~~ and leverage ratios are set at a level above the ~~trigger~~ minimum ~~ratios~~ regulatory requirements and any higher limits imposed by the HKMA to ensure continuous compliance;
- ~~Capital adequacy b~~Budgets (on solo and consolidated basis where appropriate) are prepared at least annually for capital adequacy and leverage ratio requirements, taking into account the projected asset mix, expected balance sheet growth and capital resources. Where appropriate, limits on balance sheet growth are imposed on business units, branches and subsidiaries;
- Systems and procedures are in place to enable the management to monitor its capital adequacy and leverage ratios (on solo and consolidated basis where appropriate) on a continuous basis; and that any adverse variance against the target ratio(s) and, particularly, any ~~breach of~~failure to meet the trigger or minimum ratios, should be reported to the ~~chief executive~~senior management immediately;
- The impact of large loans, major investments and other significant transactions on capital adequacy and leverage ratio requirements is assessed in advance; and
- Stress-testing on capital adequacy ratio is performed on a regular basis (see IC-5 "Stress-testing" for further details).

Compliance with ~~§102~~Part XVIB of the Banking Ordinance – Liquidity requirements

- A written policy on liquidity is established to set out the AI's strategy and procedures for maintaining adequate liquidity at all times and, specifically, to meet statutory and regulatory requirements;
- Category 1 institutions should have systems and procedures in place to ensure:
  - assets included as high quality liquid assets ("HQLAs") for the purpose of calculating the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR") continuously satisfy all requirements relating to asset class, characteristics and operational requirements as specified in the BLR;
  - the institution's HQLAs and related risks (including foreign exchange risk and concentration risk) are managed on an ongoing basis;
  - methodologies (including key management assumptions) are properly established, reviewed and applied to determine the amounts of certain expected cash flow items (such as "operational deposits", potential drawdown on undrawn committed facilities and non-contractual contingent funding obligations) for the calculation of the LCR and the NSFR;
- Category 2 institutions should have systems and procedures in place to ensure:
  - assessment and management of liquefiable assets and related risks are conducted on an ongoing basis, and each asset included in the liquefiable assets satisfies all the applicable requirements as specified in the BLR;
  - assessment and management of Core Funding Ratio ("CFR") and related risks are conducted on an ongoing basis (applicable to "category 2A institutions");
- Systems, controls and procedures are in place to ensure that the valuation of any asset, liability, off-balance sheet item or cash flow measured at fair value is prudent and reliable for the purposes of calculating the LCR, Liquidity Maintenance Ratio ("LMR"), NSFR or CFR;
- Target liquidity ~~and maturity mismatch~~ ratios (LCR, LMR, NSFR and/or CFR) are set at a level above the ~~statutory~~ minimum regulatory ~~ratio~~

requirements and any higher limits imposed by the HKMA to ensure continuous compliance;

- Systems and procedures are in place to enable ~~the management to monitor the~~ actual liquidity ~~and maturity mismatch~~ ratios to be reported and monitored on a continuous basis and, specifically, any breach ~~of the target ratios~~es or exceptions to be identified and ~~is~~ reported to the senior management~~chief executive~~ immediately;
- The impact of large loans, major investments and other significant transactions on liquidity is assessed in advance; ~~and~~
- Contingency plans are in place for coping with various types of liquidity crisis; and
- Stress-testing on the liquidity position is performed on a regular basis.

(See LM-~~1~~ 2 "~~Liquidity Risk Management~~Sound Systems and Controls for Liquidity Risk Management" for detailed guidance.)

Annex ~~C~~D: Controls relating to the maintenance of adequate provisions

1. Objective

AIs should have adequate ~~policies and procedures~~systems of control for assessing the quality of their assets regularly and for establishing adequate provisions for depreciation or diminution in the value of their assets (including provision for bad and doubtful debts).

2. Key controls and procedures

Auditors should develop audit procedures to assess whether the AI has controls in place to satisfy the above objective, taking into account the nature, size and complexity of an AI's business.[20] In developing the audit procedures, they may have regard to the following:

- Policies and procedures are established to set out the frequency, methodology and level of ~~general and specific~~ provisions (including country risk provisions as appropriate) to be maintained for each type of assets and off-balance sheet exposures, and contingent liabilities;
- A multiple-grade loan classification system is established to monitor asset quality on a regular basis. The sophistication of the system should be in line with the nature, size and complexity of the AI's business. It should have a clear definition for each loan grade and respective classification criteria that consist of both qualitative and quantitative factors;
- Adequate provisions should be maintained. In general, these will be determined on a loan-by-loan basis, with full provision made for the likely loss. In the case of loans managed on a portfolio basis (e.g. credit cards) or where the AI is unable to determine the likely loss reliably on a loan-by-loan basis, minimum levels of provision may be set for each loan grade under the loan classification system[21~~15~~];
- Procedures are established for reviewing and setting aside ~~general and specific~~ provisions on a regular basis;

[20] Auditors can generally rely on the testing of controls performed during the audits of the financial statements of AIs. In case the auditors' tests conducted during the financial statements audits are mostly substantive in nature, they should conduct additional testing procedures that enable them to provide reasonable assurance on the AIs' internal control systems relating to the maintenance of adequate provisions.

[21] For further details, see "Guideline on loan classification system" as set out in Appendix 2 of the completion instructions for the banking return MA(BS)2A (Quarterly Analysis of Loans and Advances and Provisions).

- Specific officers or committees are charged with the responsibility for approving and reviewing ~~general and specific~~ provisions;
- Procedures are in place to ensure that the provisioning decisions and the basis for these decisions are recorded and reported to senior management or a relevant committee (e.g. credit committee) on a regular basis. Where appropriate, such information should also be reported to the Board;~~ and~~
- Procedures are in place for:
  - the monitoring of asset quality and loan concentration by country and sector;
  - the monitoring of adverse economic or political factors which might affect the quality of the loan portfolio or particular types of borrowers;
  - the monitoring of overdue and rescheduled assets;
  - the review of irregularities in individual credit exposures;
  - the review of borrowers' and guarantors' financial positions;
  - the review of and updating of value of collateral on a regular basis; and
  - the suspension or cessation of interest accrual for classified assets; and
- With the implementation of expected credit loss ("ECL") required under HKFRS 9 "Financial Instruments" auditors are expected to consider the following elements in developing the audit procedures over ECL on top of the controls and procedures discussed above:
  - For each class of on- and off-balance sheet exposures, policies and procedures detailing the ECL methodologies, the key assumptions and the rationale for the choices made, the roles and responsibilities of the personnel involved, as well as the frequency and approach for the review and recalibration of models;
  - Review and challenge by the AI's management and those charged with governance take place on a regular basis with respect to the appropriateness of forward-looking information used in the ECL estimation (e.g. the choice of forward-looking scenarios, the probabilities assigned to these scenarios, key assumptions and judgement applied) as well as the adequacy of ECL allowances;
  - Periodic validations of ECL models are conducted by independent

parties (internal or external), with the findings of model validation and the remedial actions (if any) reported to the appropriate level of management and board committee(s) in a timely manner;

- Controls are put in place to ensure the completeness and accuracy of data used in the ECL estimation, including the quality of externally sourced data or information;

- There are general IT controls and other application controls (automated or manual) over the data transfers between systems and the ECL calculation process, in particular reconciliation controls over data obtained from different systems;

- Periodic review and approval of the criteria and thresholds (both quantitative and qualitative ones) are established for the assessment of significant increase in credit risk ("SICR") including transfer into or out of the SICR categories to ensure appropriate determination of changes in credit risk;

- Systems and controls are put in place to ensure exposures are properly assessed for SICR (whether transfer into or out of the SICR categories) in accordance with the defined criteria and thresholds. Override cases should be infrequent. If they occur, they should be supported by sound justification, and reviewed and approved by the appropriate level of authority; and

- Regular reviews are conducted by the AI's management on the determination of asset quality under HKFRS 9 and that under the HKMA's five-grade loan classification system to ensure no bias in the conclusions about the AI's asset quality and the level of ECL allowances made.

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