

# **Process Review Committee**

## **Annual Report to the Financial Secretary 2007-2008**

### **I. GENERAL INFORMATION**

#### **Background of establishment**

1.1 The Clearing and Settlement Systems Ordinance (CSSO), which became effective on 4 November 2004, empowers the Monetary Authority (MA) to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre. The purpose of the CSSO is to promote the general safety and efficiency of designated clearing and settlement systems.

1.2 Since enactment of the CSSO, six clearing and settlement systems have been designated. They are:

- (a) the Central Moneymarkets Unit (CMU)
- (b) the Hong Kong Dollar Clearing House Automated Transfer System (HKD CHATS)
- (c) the Continuous Linked Settlement (CLS) System
- (d) the Euro Clearing House Automated Transfer System (EUR CHATS)
- (e) the US Dollar Clearing House Automated Transfer System (USD CHATS)
- (f) the Renminbi Clearing House Automated Transfer System (RMB CHATS)

1.3 The system operator (SO) and settlement institution (SI) of each designated system are set out in the following table:

**Table 1:**

	<b>Designated System</b>					
	<b>CLS System</b>	<b>CMU</b>	<b>HKD CHATS</b>	<b>USD CHATS</b>	<b>EUR CHATS</b>	<b>RMB CHATS</b>
<b>System operator</b>	CLS Bank	HKMA	HKICL*	HKICL*	HKICL*	HKICL*
<b>Settlement institution</b>	CLS Bank	Nil	HKMA	HSBC	Standard Chartered Bank (Hong Kong) Ltd	Bank of China (Hong Kong) Ltd

\* The Hong Kong Monetary Authority (HKMA) and the Hong Kong Association of Banks each owns 50% of the Hong Kong Interbank Clearing Limited (HKICL)

1.4 Of the six designated systems, the CLS system is the only one in which the HKMA does not have any interest. The CLS system is subject to the supervision of the U.S. Federal Reserve and is exempted under section 11 of the CSSO from the HKMA's oversight. In other words, the HKMA exercises ongoing oversight of the remaining five designated systems, namely, the CMU, HKD CHATS, USD CHATS, EUR CHATS and RMB CHATS, all of which the HKMA has an interest in one way or another. Some of these designated systems have established linkages with overseas payment or securities settlement systems to facilitate cross-border transactions, for example, the RENTAS-USD CHATS payment-versus-payment and delivery-versus-payment link. Although these overseas systems are not overseen by the HKMA, the HKMA oversees these external linkages in coordination with their home overseers.

1.5 To address the potential or perceived conflict of roles thus arising, the HKMA has implemented a number of measures. These included a clear segregation of duties within the HKMA and the promotion of transparency in the designation and oversight processes. In addition, the Process Review Committee (PRC), an

independent, non-statutory committee, was established by the Chief Executive of the Hong Kong Special Administrative Region in December 2004 to review the processes and procedures adopted by the HKMA in applying oversight standards. It seeks to, among other things, ensure that the same set of standards is applied to all designated systems, whether or not the HKMA has an interest in them.

### **Scope of work and terms of reference**

1.6 The terms of reference of the PRC are:

- (a) to review and advise the HKMA upon the adequacy of the HKMA's internal operational procedures and guidelines for applying the standards set under the CSSO to those designated systems in which the HKMA has a legal or beneficial interest;
- (b) to receive and consider periodic reports from the HKMA on all completed or discontinued files in respect of alleged non-compliance of the CSSO by those designated systems in which the HKMA has a legal or beneficial interest; and
- (c) to submit annual reports and, if appropriate, special reports on designated systems in which the HKMA has a legal or beneficial interest, to the Financial Secretary.

1.7 The PRC agreed that, in discharging its functions, the Committee would focus on whether there were any discrepancies in the HKMA's oversight of systems in which the HKMA has an interest, as compared with other systems. In other words, the PRC would review the processes and procedures adopted by the HKMA to ensure that the same set of oversight standards was applied to all designated systems. This was consistent with the policy intention of the establishment of the PRC.

1.8 The PRC is required to submit annual reports and, if appropriate, special reports to the Financial Secretary. The Financial Secretary may cause the reports to be published subject to relevant confidentiality requirements.

## **Membership of the PRC**

1.9 The PRC is in its second term of service. Members of the PRC are appointed by the Chief Executive of the Hong Kong Special Administrative Region in their personal capacity on a three-year term from 1 December 2007 to 30 November 2010. The membership of the PRC as at 30 November 2008 was:

### Chairman

**Dr Eric KC Li, GBS, JP**

Senior Partner

Li, Tang, Chen & Co

### Members

**Mr Nicholas Peter Etches**

Certified Public Accountant

**Mr Mervyn Robert John Jacob**

Financial Services Leader, Hong Kong and China

PricewaterhouseCoopers

**Mr Ling Chung Yan**

Chief Operating Officer

Citic Ka Wah Bank

**Professor Tsang Shu Ki**

Department of Economics

Hong Kong Baptist University

**Ms Maria Xuereb**

Financial Services Partner

Deloitte Touche Tohmatsu

## **II. HIGHLIGHTS OF THE WORK OF THE PRC**

2.1 This is the fourth Annual Report of the PRC, which covers the work of the Committee from 1 December 2007 to 30 November 2008. This is also the first annual report for the second term of the PRC.

### **Meetings held and major deliberations of the PRC**

2.2 The PRC held two meetings during 2008. At the first meeting in May, Members reviewed the regular report covering the oversight activities of the HKMA from December 2007 to March 2008. In particular, Members discussed how the HKMA handled the abnormal events encountered by the designated systems. Members were also updated on the progress of the designation of the RMB CHATS and on the intention to update the Internal Operating Manual after the designation process was completed.

2.3 The designation of RMB CHATS was completed on 11 July 2008 and Members were notified of the designation on the same day. The Internal Operating Manual was thus revised subsequently, together with other minor changes.

2.4 At the second meeting held in November, Members reviewed the regular report covering the period from July to September 2008. In particular, they discussed how to ensure consistency in the HKMA's oversight activities over the five local designated systems and the Committee's fourth Annual Report to the Financial Secretary.

2.5 As agreed by Members, regular reports covering the HKMA's oversight activities would be sent to Members for review by circulation in between meetings. If Members had questions about the reports, Members would raise them with the Secretary of the Committee. Subject to the agreement of the Chairman, the questions would be discussed at the next meeting or, if needed, a special meeting would be held.

2.6 A total of four regular reports were circulated to Members for review in 2008 and Members noted that the performance benchmarks were met by the HKMA.

### **Comments and recommendations of the PRC**

2.7 The format of the regular report and the accompanying oversight activities management reports was designed based on the suggestions from Members. During the year, Members reviewed 4 regular reports and 22 accompanying oversight activities management reports covering the period December 2007 to November 2008. The number of oversight activities contained in each regular report under the review of the PRC are summarised below:

**Table 2: Oversight activities of HKMA under the review of PRC from Dec 2007 to Nov 2008**

<b>HKMA's oversight activities conducted during the quarter</b>	<b>1<sup>st</sup> Regular Report (Dec- Mar)</b>	<b>2<sup>nd</sup> Regular Report (Apr-Jun)</b>	<b>3<sup>rd</sup> Regular Report (Jul-Sep)</b>	<b>4<sup>th</sup> Regular Report (Oct-Nov)</b>
Processing of monthly return submitted by SO/SI	28	21	25	18
Vetting of change in particulars of SO/SI	13	8	1	4
Reviewing of ad-hoc information submitted by SO/SI	50	21	27	38
Granting approval to change in operating rules	6	1	4	13
Conducting on-site examination	0	0	0	0
Handling of abnormal event/production incident	7	3	5	1
Handling of contravention case	0	0	0	0
Holding of meeting with management of SO/SI	3	0	0	3

2.8 At the meetings of May and November 2008, Members discussed the handling of a number of abnormal events and production incidents. In the May meeting, they discussed whether the remedial measures taken by the HKICL regarding an incident involving a double hardware failure was appropriate. It was explained to Members that, while it was impossible to eliminate the risk of multiple hardware failures, making available additional back-up hardware would help mitigate such a risk. The remedial measures taken by the HKICL were also explained to Members.

2.9 Members also discussed ways to ensure that CHATS member banks would arrange sufficient funding for their cheque settlement run obligation before the scheduled start time of the run. Members were briefed on the cheque clearing and settlement process and schedule. They noted that normally there would be enough time for member banks to arrange sufficient funding for their cheque settlement run. In exceptional cases where banks might be caught off guard of a late change in the settlement amount (e.g. due to the bouncing of a large-value cheque), repo transactions using Exchange Fund papers could be used to meet their short term liquidity needs.

2.10 The Internal Operating Manual was amended during the year to include report forms for the newly designated RMB CHATS and to reflect other minor changes. The revised Manual was sent to Members in September.

2.11 Members were updated on the progress of the designation of RMB CHATS in the May meeting. They were told that once the system was designated, it would be subject to the oversight of the HKMA according to the same oversight standards applicable to other designated systems and was therefore under the purview of the PRC. Members were informed of the designation of RMB CHATS in July 2008.

2.12 In the November meeting, Members discussed the impact of the financial crisis on the designated payment and settlement systems. The HKMA reported that the designated systems were robust and operated smoothly during the crisis period in September to November. Transaction statistics of the designated systems revealed no significant pressure so far on the systems as a result of the financial crisis.

2.13 Members also discussed ways to ensure consistency over the HKMA's oversight activities on the five designated systems. As agreed among Members when the PRC was first set up, standard procedures were to be established for HKMA staff to follow when they conduct their oversight activities. These standard procedures, set out in the Internal Operating Manual, were commented and endorsed by PRC Members at the time. By ensuring HKMA staff's adherence to the established procedures when they conduct oversight activities on all five designated systems, consistency of oversight standard would be achieved. To monitor the HKMA's adherence to the established procedures, PRC Members agreed, when the Committee was first set up, that the HKMA should submit regular reports to the PRC on its oversight activities in the agreed format. In the November meeting, PRC Members discussed and the HKMA agreed that the HKMA would share its internal audit report on the work of its Payment System Oversight Section with PRC Members to assist in ascertaining whether the HKMA had been adhering to the established procedures set out in the Internal Operating Manual in conducting their oversight activities.

2.14 A draft of the annual report was discussed at the second meeting in November 2008. Members made some suggestions on the content of the report and the report was revised accordingly. Members agreed to adopt the same publication approach as for the previous annual reports. The PRC proposed to the Financial Secretary that the annual report be published in its entirety and be posted on the website of the HKMA for the wider circulation to the public in the interest of promoting transparency and accountability.

### **III. CONCLUSION AND WAY FORWARD**

3.1 During the period, the PRC reviewed 4 regular reports and 22 accompanying oversight activities management reports covering the period December 2007 to November 2008. There was no complaint received from the SOs and the SIs and no alleged contravention event during the period. The review covered, among other things, the submission by the HKMA on its processing of 92 monthly returns and 26 cases of changes in particulars, granting approval to 24 changes in operating



rules, handling of 16 abnormal events and production incidents, reviewing of 136 submissions of ad-hoc information and holding of 6 meetings with the management of the SOs and the SIs.

3.2 The PRC was not aware of any cases where the HKMA had not followed duly the internal operational procedures, or where the HKMA had not been procedurally fair in carrying out its oversight activities across different designated systems.

3.3 The PRC will continue to review the processes and procedures adopted by the HKMA in overseeing the existing designated systems and, where appropriate, additional systems that will be overseen by the HKMA under the CSSO in the coming year.