

Banking Stability

One of the HKMA's main tasks is to promote the safety and stability of Hong Kong's banking system. In 1998 this took on a crucial importance as the banking sector felt the full effects of the Asian financial crisis. Priority tasks during the year included increased supervisory attention to local banks' asset quality and a more intensive monitoring of efforts towards Year 2000 compliance.

Objectives

The HKMA's primary objectives in banking supervision are to provide a measure of protection to depositors and to promote the stability and effective working of the banking system. At the same time, the HKMA seeks to maintain an environment in which authorised institutions retain the ability to operate on a competitive and commercial basis. To achieve these objectives, the HKMA maintains a regulatory framework for prudential supervision that is fully in line with best international standards, particularly those recommended by the Basle Committee on Banking Supervision.

Achievements

Operational supervision

Nineteen-ninety-eight was a challenging year for the Banking Supervision Department. As the banking sector felt the effects of the Asian financial crisis, monitoring the impact of the crisis on the sector as a whole and on individual authorised institutions was a

major priority. In particular, greatly increased attention was paid to local banks' asset quality and provisioning. Another priority task was the monitoring of authorised institutions' efforts in Year 2000 compliance.

Adapting to these changing demands required flexibility in the allocation of resources and in work procedures. A number of new regular and ad-hoc returns and surveys were introduced to enable developments to be monitored closely. Close attention was paid to reviewing returns with the aim of identifying possible problems as early as possible. Close contact was maintained with key participants in each market sector, and with authorised institutions identified as meriting close attention.

The number of on-site examinations increased sharply (Table 9). This was attributable mainly to more than a hundred examinations of authorised institutions' Year 2000 compliance carried out by special examination teams. Otherwise, the number of examinations remained broadly unchanged over

1997. In 1998 examinations continued to be risk based, in that they focused on key risk areas for key authorised institutions. In practice, this meant that the examination effort focused heavily on the local banks, and in particular on their asset quality and provisioning. Two full rounds of examinations of local banks were carried out.

The number of off-site reviews fell slightly, partly because of the fall in the number of authorised institutions. The number of routine tripartite meetings also declined, but there continued to be a great deal of contact with authorised institutions' external auditors, particularly on provisioning issues.

Over 500 applications to become Controllers, Directors, Chief Executives or Alternate Chief Executives of authorised institutions were processed during the course of the year. In addition, nine merger cases involving transfer of authorisation were dealt with, as well as applications for revocation. In order to enhance efficiency, some restructuring was effected to centralise licensing-related activities, and further restructuring is in mind.

The Banking Supervision Review Committee considered a total of 21 cases during the course of the year. Most related to licensing, either of authorised institutions or of money brokers. The Committee also considered fitness and propriety issues.

During 1998 five authorised institutions, including three foreign bank branches and two deposit-taking companies, breached the requirements of the Banking Ordinance relating to the liquidity ratio, and one deposit-taking company breached the requirements relating to the capital ratio. There were also eight breaches of the requirements relating to large exposures under section 81 of the Ordinance and four breaches of the requirements relating to connected lending under section 83. These breaches were largely of a technical nature. Appropriate remedial action was taken and the breaches were promptly rectified. The interests of depositors and other creditors were not put at risk.

Table 9 : Operational supervision	1997	1998
1. On-site examinations (of which Year 2000 examinations)	215 (-)	303 (105)
2. Off-site reviews and prudential interviews	340	292
3. Tripartite meetings	150	94
4. Treasury visits	19	4
5. Applications to become Controllers, Directors, Chief Executives or Alternate Chief Executives of Authorised Institutions	519	530
6. Reports commissioned under Section 59(2) of the Banking Ordinance	15	9
7. Cases considered by the Banking Supervision Review Committee	18	21

The Monetary Authority exercised his formal powers under Section 52 of the Banking Ordinance in two cases (one restricted licence bank and one deposit-taking company) in 1998. In both cases the authorised institution had ceased to meet certain authorisation criteria, and restrictions were imposed to protect depositors and other creditors. In neither case did depositors or other creditors suffer any loss.

Share margin financing

The HKMA continued to be vigilant in the supervision of authorised institutions' share margin financing activities throughout the year. Following the review of the related lending policies and risk management systems of authorised institutions in 1997, the HKMA required institutions that were active in share margin financing business to report their positions on a more frequent basis. Institutions were also required to take proper actions to deal with a small number of accounts on which the loan-to-value ratio exceeded 60%.

Given the prevailing economic environment, the volume of share margin financing conducted by authorised institutions declined substantially, and the outstanding balance of such lending fell by about 75% over the year. Since institutions had adopted prudent lending policies in the provision of share margin financing, the sharp fall in share prices did not cause them any major problems.

In January, CA Pacific Securities, a medium-sized brokerage house, collapsed after it failed to settle about \$39 mn with the Central Clearing and Settlement System. Before that, one of the banks of its money lender subsidiary, CA Pacific Finance, had refused to honour a cheque of \$83 mn drawn by the company. A few other brokerage houses also encountered difficulties during the year. The HKMA responded by deploying examination teams to conduct special visits to selected authorised institutions to review their exposures to brokerage houses and affiliated finance companies. The results

of these examinations were generally satisfactory, and institutions have not suffered any major loss from their lending to brokerage houses and affiliated finance companies.

The CA Pacific case highlighted some important issues in share margin financing activities conducted through affiliated finance companies of brokerage houses. The HKMA participated in an inter-agency working group formed to study possible enhancements to the prudential regulation of share margin financing activities of such affiliates. The proposals of the working group have been published and legislative changes are expected in 1999. The HKMA will closely monitor developments and will consider if it is necessary to adjust its approach to supervision of the share margin financing activities of authorised institutions in the light of these changes.

In May 1998 the Companies Registry published a Gazette Notice granting a standing exemption from certain provisions of the Money Lenders Ordinance to money lenders who offer share margin financing to customers subject to certain conditions being met. The HKMA subsequently issued a circular to authorised institutions advising that they should seek legal advice on the extent to which they should satisfy themselves regarding compliance by their money lender customers with the Money Lenders Ordinance and the exemption notice. A follow up survey on selected authorised institutions was also conducted towards the end of the year: the survey indicated that institutions had generally made satisfactory progress in implementing the necessary policies and procedures.

Taxi loans

The taxi industry was severely affected by the slowdown in the economy in 1998. The income of taxi drivers declined substantially and the value of taxi licences fell sharply from the peak of \$3.5 mn in mid-1997 to about \$2 mn at the end of 1998. The quality of taxi loans accordingly deteriorated. According to the HKMA's monthly survey of the 16 authorised institutions most active in the taxi loan business, at the end of December 1998 taxi loans overdue for more than three months and rescheduled taxi loans were respectively 5.63% and 6.97% of the total taxi loans of these institutions.

The increased level of rescheduled loans reflects the preparedness of authorised institutions to negotiate with individual borrowers to temporarily reduce monthly repayments to a more manageable level, pending the recovery of taxi driver incomes. In some cases taxi dealers have taken up the liabilities of borrowers encountering repayment difficulties, or have assisted borrowers in other ways.

The HKMA is monitoring the situation closely, in particular to check that adequate provisions are made against these loans and that authorised institutions engaging in taxi financing continue to follow prudent lending policies.

Relationship with other supervisors

The HKMA has continued to develop closer working relationships with other supervisors both in Hong Kong and abroad. The regular meetings held with the Securities and Futures Commission (SFC) have proved to be particularly useful in enhancing understanding

and in ensuring that supervisory issues are dealt with in a co-ordinated manner. Similarly, regular meetings have been held with the People's Bank of China (PBoC) and with other supervisors in the region and elsewhere to discuss matters of common interest.



Executive Director, Y. K. Choi, addressing central bankers at a seminar on financial supervision on 1 June 1998.

Given the regional situation, contacts with other central banks in the region have gained in importance, and the HKMA has played an active role in encouraging co-operation, co-ordination, and the sharing of ideas. The HKMA continues to chair the EMEAP Working Group on Banking Supervision, which provides a useful forum for sharing knowledge and experience of banking supervisory matters.

The closure of GITIC

On 6 October, the People's Bank of China ordered the closure of the Guangdong International Trust and Investment Corporation (GITIC) because of its financial problems. Following this, GITIC's two subsidiaries in Hong Kong - Guangdong International Trust and Investment Corporation Hong Kong (Holdings) Ltd and Guang Xin Enterprises Ltd - went into liquidation on 12 October. The decision to apply

for the liquidation of GITIC was announced at a creditors' meeting on 10 January 1999.

The closure of GITIC illustrates the determination of the Mainland authorities to deal decisively with ailing financial institutions as a part of the process of reforming the Mainland's financial sector. Nevertheless, it has also triggered worries in the Hong Kong banking sector about the risk of lending to other international trust and investment companies (ITICs) and to Mainland enterprises more generally. Authorised institutions have therefore been taking a more cautious attitude towards granting new facilities or rolling over existing facilities to other ITICs and Mainland enterprises. While recognising the banks' concerns, the HKMA has advised that they should be as supportive as possible to try to mitigate the effects of the liquidity crunch.

To assess the impact of the closure of GITIC on the banking sector, the HKMA conducted a survey in October of the sector's direct and contingent exposures to all non-bank Mainland entities, including GITIC, other ITICs, red chips, H shares, entities owned by the State, provincial or municipal governments, and other companies owned or controlled by Mainland interests. The results of the survey showed that the aggregate exposure to all non-bank Mainland entities amounted to \$325 billion, or 4.5% of the sector's total assets, of which \$47 billion was to GITIC and other ITICs. Overall, the exposures are spread among a wide range of Mainland borrowers, many of which are financially sound.

The exposure is also widely spread among the lending institutions.

The HKMA will satisfy itself that banks make adequate provisions for their exposures to GITIC and its subsidiaries, having regard to the estimated debt recovery rates disclosed. While the HKMA is confident that the banking sector will be able to absorb the impact of the closure of GITIC, there is a need to continue to monitor the effect on lending to other ITICs and Mainland enterprises. In this respect, the HKMA will continue to maintain regular contact with banks and to liaise closely with the PBoC.

The Hong Kong approach

In April the Hong Kong Association of Banks (HKAB) issued a circular to members containing formal but non-statutory guidelines about how institutions should deal with corporate customers in difficulties where the customer is dealing with multiple banks. This approach to workouts mirrors closely the "London approach" adopted in the UK, in which lenders and borrowers co-operate with each other to try to find a mutually beneficial way forward.

The HKMA has expressed its support for these guidelines and has indicated its willingness to try to help resolve differences of views that threaten the achievement of a compromise. The HKMA has been invited to participate in this way on several occasions since the guidelines were released. In each case the HKMA's role has been to act as an "honest broker" to help bring the parties together and to try to get an

agreement. With the co-operation and understanding of the institutions involved in these cases, the HKMA has successfully helped to resolve differences between individual institutions. The aim is to try to ensure that viable companies can continue in business and to produce a better result for the banks than would be achieved in a liquidation.

Supervision of institutions' securities business

Pursuant to the Memorandum of Understanding between the HKMA and the SFC, the HKMA is responsible for the supervision of the securities business of authorised institutions which are exempt dealers. In general, these exempt dealers are expected to comply with all relevant legislation and regulations applicable to securities dealers and to conduct their business in a responsible, honest and business-like manner.

The HKMA has monitored compliance in its regular on-site examinations of exempt dealers. In addition, the HKMA has formed a specialised securities team to conduct on-site examinations of institutions that are more active in the securities business or where there are potential causes for concern in the compliance and control of these activities. The specialised team conducted ten securities examinations during the year.

Hong Kong Banking Sector Consultancy Study

Early in 1998 the HKMA commissioned a consultancy study on the Hong Kong banking sector. The aim of the study was to develop an appropriate strategy to effectively supervise and regulate the banking sector for the next five years. The study was completed in December.

The study found that Hong Kong's success as an international financial centre is attributable to its free and open markets, its conducive regulatory environment, and its well-developed physical, financial and legal infrastructures. In the evolving global financial landscape, Hong Kong's attractiveness in the future will lie in its ability to embrace and manage changes brought about by global trends such as deregulation, technological innovation, changing customer needs and developments in the financial markets.

The central message from the study was that Hong Kong should take proactive steps in managing the impact of these changes on the Hong Kong banking sector. The recommended approach is to remove the remaining competitive barriers while, at the same time, ensuring that safety and soundness standards are enhanced. An open and competitive market should encourage more efficient behaviour and product innovation, strengthen local banks' ability to compete, and raise Hong Kong's profile as an international financial centre. The study recognises

the need to achieve these objectives in a safe and sound manner. This will require institutions to upgrade their risk management capabilities. It will also require the HKMA to enhance its supervisory process to ensure its effectiveness in maintaining stability in the banking system.

Given the emerging new financial environment, the consultancy study suggested four strategic mandates for the HKMA in promoting future developments in the banking sector. These are:

- To ensure that the regulatory and supervisory framework for Hong Kong remains appropriate.

Table 10 : Banking Sector Consultancy Study: suggested phased approach to implementation

Phases	Regulatory recommendations	Supervisory recommendations
<p>Phase 1 – Enhanced risk-based supervision</p>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> • Introduce financial disclosure by foreign branch banks (limited disclosure introduction in progress). • Clarify the HKMA's role as lender of last resort. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> • Relax the one-building condition to allow three branches for foreign banks. • Begin monitoring process prior to start of deregulation of Interest Rate Rules (IRRs). 	<ul style="list-style-type: none"> • Develop a formal strategic planning process. • Develop a formalised risk assessment framework and quality assurance programme. • Integrate risk management principles into the off-site surveillance activities. • Revise on-site surveillance activities to more explicitly evaluate institutions' risk management capabilities. • Develop guidelines as to types and degrees of supervisory responses. • Define core capabilities, revise job descriptions and the performance management process, develop a formalised career development programme, perform a training needs assessment and expand the current training curriculum. • Create additional specialist teams. • Enhance the supervisory database and management information systems. • Assess risks associated with longer term economic integration with Mainland China.
<p>Phase 2 – Market restructuring</p>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> • Raise minimum capital requirements for local authorised institutions. • Study of alternatives to enhance explicit depositor protection. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> • Simplify the three-tier system. • Reassess access criteria for RTGS. • Stage 1 of deregulation of the IRRs (time deposits up to 6 days). • Stage 2 of deregulation of the IRRs (current accounts). 	<ul style="list-style-type: none"> • Assess supervisory gaps and/or overlaps and options to address.
<p>Phase 3 – Market liberalisation</p>	<p><i>To enhance safety and stability:</i></p> <ul style="list-style-type: none"> • Implementation of enhanced explicit depositor protection scheme. <p><i>To enhance competitiveness:</i></p> <ul style="list-style-type: none"> • Stage 3 of deregulation of the IRRs (remove all remaining interest rate caps). • Reduce the time period and relax the association with Hong Kong entry criteria. 	

- To improve the competitive environment to ensure the positive benefits of global and local trends are developed in the Hong Kong market.
- To ensure increasing levels of risk associated with global and local trends are prudently managed.
- To increase the level of transparency allowing the forces of market discipline to work more effectively.

The study also produced a number of recommendations and a suggested road map for implementing these strategic mandates. The study suggested a phased approach in which the recommendations aimed at increasing the level of competition would be implemented in parallel with those aimed at raising the level of safety and soundness in the system (Table 10). The recommendations were released in December for a period of public consultation ending on 31 March 1999. The HKMA will decide the way forward in terms of implementation in the light of comments received.

Legislative changes

Introduction of the Euro Ordinance

The euro was introduced on 1 January 1999. In anticipation of the introduction of this new currency, the banking industry in Hong Kong requested the SAR Government to introduce specific legislation to provide for continuity of contracts denominated in ECU and in the participating national currencies upon the introduction of the euro.

In view of the number and size of operations of foreign banks in Hong Kong (which ranks only after New York and London), the changeover to the euro was expected to be a significant event for financial institutions in Hong Kong, particularly for those providing services (such as deposit taking, trade financing and foreign exchange trading) involving any participating national currency or the ECU. The Government therefore accepted the banking industry's proposal that it should follow the practice in the European Union and other financial centres, such as New York, and introduce specific legislation to provide for continuity of legal obligations on the introduction of the euro. An Introduction of the Euro Bill was thus prepared: the Euro Ordinance passed into law and took effect on 31 December 1998. Like the legislation in the European Union and New York, the new legislation in Hong Kong not only deals with the ECU/euro conversion but also removes any doubt about the general continuity of legal obligations arising from the introduction of the euro.



Staff in the HKMA's Legal Office carry out preparatory research for changes in banking legislation.

The new legislation in Hong Kong:

- (i) provides for references in any legal obligation to the ECU (as officially defined in the relevant EC Regulation) to be replaced by references to the euro at the rate of one euro to one ECU. The official definition of the ECU shall be presumed to apply unless it is otherwise expressly agreed or provided; and
- (ii) provides for continuity of legal obligations while respecting freedom of contract, i.e. subject to any agreement or provision to the contrary, the introduction of the euro and the changes consequential upon its introduction shall not discharge or excuse any performance under a legal obligation nor give the obligor or obligee to the obligation the right to unilaterally alter or terminate the obligation.

The legislation has been well received by the financial community and should help to strengthen Hong Kong's status as an international financial centre.

Liquidity

The HKMA amended the Fourth Schedule to the Banking Ordinance to recognise residential mortgage loans covered by the Hong Kong Mortgage Corporation Limited's (HKMC) forward commitment facility as liquefiable assets for the purpose of calculating the liquidity ratio. The HKMA considers that mortgage loans covered by the facility have the characteristic of liquefiable assets given that they are capable of generating cash or cash equivalent within

one month and the commitment is irrevocable as long as the mortgages conform with the HKMC's purchasing criteria. The recognition of mortgage loans covered by the facility as liquefiable assets should help enhance the banks' liquidity position.

Year 2000 problem

The HKMA intensified its supervisory efforts with regard to the Year 2000 compliance of authorised institutions during the year. The HKMA had previously established 31 December 1998 as the deadline by which all institutions should achieve Year 2000 compliance in accordance with the following definition: "A Year 2000 compliant system should perform, function and manage data involving dates without being abnormally affected by dates spanning the period prior to, during and after the year 2000." This means that institutions should have completed the modification and testing of individual systems and tested the interaction of the modified systems with



Raymond Li, the Executive Director in charge of banking policy, speaking at the Symposium on Year 2000 Compliance Progress in Hong Kong organised by the Information Technology and Broadcasting Bureau on 15 December 1998.

other internal systems with which they interface directly by the end-1998 deadline. The intention was to leave them with sufficient time to conduct testing with external parties in 1999.

Since May 1998, the HKMA has required the chief executives of authorised institutions to provide it with a formal statement of Year 2000 compliance progress on a bimonthly basis. The institutions were also required to be subject to some form of independent assessment of their compliance process. These measures are intended to reinforce the responsibility of the institutions' management to take all reasonable and prudent steps to address the Year 2000 problem and to monitor progress in achieving compliance. Further, the HKMA has established dedicated Year 2000 teams to conduct on-site examinations on the progress of individual institutions. During the year, the teams visited a total of 105 institutions and their subsidiaries as part of the independent assessment process.

According to the confirmations provided by the chief executives in January 1999, 85% of the institutions had achieved Year 2000 compliance (as defined above) for their critical systems by the end of 1998. The HKMA is closely following up with those non-compliant institutions and is pressing them to achieve compliance in respect of at least their critical systems by the end of March 1999.

During the year, the HKMA also issued a number of guidelines, including guidelines on counterparty assessment and contingency planning, to assist institutions to prepare for the Year 2000 transition. As part of the HKMA's efforts to promote public awareness of and transparency on this issue, institutions have been required under the financial disclosure package to disclose information about their Year 2000 progress in their financial statements. The HKMA also publishes a Year 2000 Bulletin and maintains a dedicated page on its Internet website to disseminate information and promote the sharing of sound practices in addressing this problem.

The HKMA recognises that the appropriate response to the Year 2000 issue involves the close co-operation of both public and private sector entities at the international and domestic level. The HKMA has sought active co-operation with local and overseas authorities on the Year 2000 issue on the basis of the principles endorsed by the Basle Committee in relation to the Year 2000 supervision of cross-border banking institutions. The HKMA is also a member of the Steering Committee on Year 2000 Compliance in the Financial Services Sector convened by the Financial Services Bureau, which aims at co-ordinating resources and actions in the areas of industry-wide testing and contingency planning for the financial sector in Hong Kong as a whole. The Committee also acts as the contact point for the Hong Kong Special Administrative Region in the Joint Year 2000 Council.

Financial disclosure

Further steps were taken by the HKMA in 1998 to increase the transparency of the financial position of authorised institutions and hence to encourage greater market discipline among these institutions. In May, the HKMA issued a guideline on recognition of interest to promote greater uniformity in the interest recognition policies of authorised institutions in Hong Kong. The guideline sets out the principles and criteria for determining when interest should be placed in suspense or cease to be accrued, including the treatment of collateral. This guideline should be adopted by all authorised institutions for the purposes of reporting to the HKMA and by locally incorporated institutions for the purposes of disclosure in their published financial statements.

In June, the HKMA issued a guideline recommending that listed authorised institutions and listed banking groups in Hong Kong should disclose additional information in their interim reports for the half-year ending on or after 30 June 1998. The additional disclosure items for inclusion in interim reports mainly pertain to information about the institutions' loan portfolios. In particular, listed institutions are expected to provide a detailed and standardised analysis of overdue and rescheduled loans by maturity breakdown.

The disclosure requirements on overdue and rescheduled assets outlined in the guideline on interim reporting by listed institutions were subsequently incorporated into the 1998 disclosure package for all locally incorporated authorised institutions in



Staff at the HKMA's Public Registry provide information on Hong Kong's banking industry to a member of the public

November. The disclosure requirements for the Year 2000 problem have also been enhanced to provide more detailed information on how the problem is being addressed, consistent with the requirements of the Stock Exchange of Hong Kong for listed companies. The 1998 disclosure package is applicable to local institutions in respect of their annual accounts for financial years ending on or after 31 December 1998. The HKMA's Best Practice Guide on Financial Disclosure by Authorised Institutions (BPG) has been updated to take into account these changes.

As a further step towards increasing the transparency of the banking sector as a whole, in December the HKMA issued a package of proposals on financial disclosure by overseas incorporated authorised institutions. The disclosure package is applicable to the larger overseas incorporated authorised institutions with total assets of \$10 billion or more or total customer deposits of \$2 billion or more, for

their financial periods ending on or after 31 December 1998. Such institutions are expected to disclose on a half-yearly basis selected key financial information drawn from the BPG, which aims at giving an indication of the size and nature of their operations in Hong Kong and the quality of their assets. In addition, certain basic financial information (such as capital, assets, loans and deposits) of the overseas institution as a whole should also be disclosed to help place the operation of the local branch within the context of the whole institution.

Market risks

Following the implementation in 1998 of a market risk capital adequacy regime based on the Basle Committee Capital Accord, the HKMA conducted several model recognition visits to institutions which sought the HKMA's approval to adopt their internal risk management models to generate value-at-risk figures for calculating market risk capital charges. In these visits the HKMA sought to ascertain that both the qualitative and quantitative criteria for the models approach as proposed by the Basle Committee were met, taking into account the current practices of other banking supervisors as well as industry-wide developments in this area. The number of institutions that have applied to the HKMA and received the consent to use the internal models approach remains small.

In view of the volatile market environment in 1998, the HKMA closely monitored the market risk exposures of institutions and their capital adequacy in this respect.

The specialist team of the Banking Supervision Department continued to conduct regular treasury visits to examine the derivatives and trading activities of institutions and their risk management systems.

Code of Banking Practice

The HKMA conducted two compliance surveys in 1998 to assess compliance by authorised institutions with the Code of Banking Practice. These compliance surveys were carried out in February and August. The August survey showed that the compliance progress of authorised institutions was satisfactory, with 91% of the surveyed institutions claiming to have complied with more than 90% of the Code. There were, however, certain important areas of non-compliance that will need to be addressed. For example, many institutions have yet to provide the terms and conditions of their services to customers in both Chinese and English and to include fees and charges in the calculation of Annualised Percentage Rate. The HKMA will continue to monitor compliance with the Code as part of its regular supervision and will follow up with individual institutions that fail to report full compliance, especially in the areas described above.

Money laundering

The Financial Action Task Force's (FATF) second mutual evaluation of Hong Kong was successfully completed in April. The final report by the examiners generally gave a positive assessment of the efforts made by Hong Kong since the last evaluation in 1994. It acknowledged that Hong Kong had made significant progress in complying with the FATF's forty recommendations, notably through the adoption

of a more effective and comprehensive legal framework to combat money laundering and to encourage suspicious transactions reporting. It commended the efforts of the HKMA in promoting the vigilance of authorised institutions in filing suspicious transaction reports. The FATF suggested, however, that further improvements could be made in the quality of the reports and that the industry associations could play a more active role in raising the awareness of institutions of this matter. Both the Government and the HKMA agree that more can be done in these respects. An inter-agency working group has been established by the Government comprising representatives from the Police, Security Bureau, Financial Services Bureau, the HKMA, the HKAB and the DTC Association to recommend ways of improving communication between the law enforcement authorities and the financial sector and enhancing the quality of reports made to the Joint Financial Intelligence Unit.

On the international front, the HKMA has also contributed to other typology and self-assessment exercises by the FATF, and has taken part in the Asia Pacific Group on Money Laundering, a regional group recently formed to promote the adoption of the best anti-money laundering practices by Asian countries. Domestically, the HKMA participated actively in seminars, workshops and various forums to promote a general awareness in the banking sector of money laundering and of the HKMA's policy guidelines on the subject.

Money brokers

Following the introduction of the new regulatory regime for money brokers in late 1997, the HKMA received 14 applications to become approved money brokers in Hong Kong: 12 of these were from operators in existence before the introduction of the new regime and two were from new operators overseas. Since then, two applications from existing operators have been withdrawn as a result of merger and group reorganisation. Up to now, the HKMA has granted approvals to eight voice brokers and two electronic brokers. The two outstanding applications from overseas operators are being processed.

Electronic transmission of returns

Since the launch of the Submission Through Electronic Transmission (STET) system in December 1997 to further automate the submission of banking returns, 77% of all authorised institutions had, by the end of December 1998, either commenced using or were preparing to use the STET system to submit returns. Another 16% of authorised institutions had committed to use the STET system in early 1999. The STET system has also been used to facilitate and improve the efficiency of some of the HKMA's surveys of authorised institutions in respect of certain specific prudential information, for example, on credit card asset quality.

BIS survey of foreign exchange and derivatives activities

In April, the Bank for International Settlements (BIS) invited 43 central banks and monetary authorities,

including the HKMA, to participate in a triennial survey of the foreign exchange and derivatives markets. This was the fourth time that Hong Kong had participated in this international survey.

The survey covered spot deals, forward contracts and OTC foreign exchange and interest rate derivatives. As in the 1995 survey, the survey comprised two separate sections, on turnover and on amounts outstanding of foreign exchange and derivatives contracts. Participating countries released the results of the turnover section of the survey in September, while the BIS released the preliminary global turnover results in October. Final reports covering both sections will be published by the BIS in the spring of 1999.

In relation to Hong Kong, the main results of the survey are summarised in Table 11 -

Types of transactions	Average net daily turnover		
	April 1995 (US\$ mn)	April 1998 (US\$ mn)	% change over 1995
Foreign exchange transactions:			
Spot	34,525	30,985	-10.3%
Forward	55,673	47,570	-14.6%
Subtotal	90,198	78,555	-12.9%
Derivatives transactions:			
Foreign exchange	718	1,378	92.0%
Interest rate	3,531	2,438	-31.0%
Subtotal	4,248	3,815	-10.2%
Total	94,446	82,370	-12.8%

Foreign exchange and derivatives trading in Hong Kong has declined owing to a number of factors. These include the depreciation of major currencies against the US dollar, the scaling down of operations by some foreign authorised institutions, and the adverse effects of the Asian financial crisis. Nevertheless, Hong Kong remains one of the leading foreign exchange and derivatives centres in the world.

Electronic banking

The Study Group on Electronic Banking established by the HKMA conducted a study in late 1997 of the security issues arising from banking transactions conducted over the Internet in Hong Kong. The Study Group considered that an effective way of addressing these issues would be to encourage the development of a proper public key infrastructure and to enhance legal certainty in the conduct of electronic transactions in Hong Kong. The HKMA reflected these views to the Government in 1998. It is understood that the Government is of the same mind and will take the lead in the development of a public key infrastructure in Hong Kong. The Government is also considering the introduction of specific legislation in Hong Kong to give legal recognition to electronic transactions and digital signatures in Hong Kong.

Meanwhile, the HKMA held discussions with a number of banks that were planning to deliver banking services over the Internet. In these discussions, banks were requested to demonstrate that they had properly addressed the security issues and the allocation of liability between bank and customer in relation to the provision of internet banking services. A number of banks are now offering Internet

banking services of various kinds. The HKMA will continue to keep abreast of technological developments and will adopt an appropriate policy framework to provide a sound and secure basis for the development of electronic banking in Hong Kong.

Property lending

With the property market in a subdued state for much of the year, 1998 saw the rate of growth of authorised institutions' property lending moderate considerably after the sharp growth in 1997. Most institutions were cautious about new lending. As before, the HKMA continued to monitor authorised institutions' exposure with a view to ensuring that development of their property lending portfolio took place in a controlled manner, consistent with the institutions' policies.

Late in the year there were signs of a revival in residential mortgage lending, and of the re-emergence of stronger competition for business, reflected in the downward trend in interest rate spreads.

Withdrawal of the 40% guideline

In July the HKMA withdrew its "40% guideline" on the property exposure of authorised institutions in Hong Kong. The withdrawal of this guideline did not represent a change in the HKMA's policy that institutions should diversify their risks and avoid concentration in property lending. The guideline was withdrawn because it was no longer considered to be relevant to the more subdued market conditions. In addition, disclosure by authorised institutions of their property exposure has improved significantly since the introduction of the guideline in 1994, and their

capacity for managing the risks of the portfolio has been increased through the ability to sell residential mortgages to the HKMC. Despite the withdrawal of the guideline, institutions are still required to observe the 70% loan-to-value ratio (LVR) ceiling, which was introduced in 1991, and to apply a prudent debt-servicing ratio for residential mortgages. The HKMA will continue to discuss with individual institutions at the beginning of each year their budgets for property lending to satisfy itself that they are expanding their lending at a prudent rate.

Quality of residential mortgage loans

The HKMA conducts a monthly survey of the residential mortgage lending of 33 authorised institutions. In order to enable the HKMA to monitor more closely the quality of these loans, the scope of the survey was expanded in 1998 to cover more information about the underlying quality of institutions' mortgage loan portfolios, such as loans overdue, and the average LVR. The survey indicated that the loan delinquency ratio (measured by the ratio of mortgage loans overdue for more than three months to total outstanding mortgage loans) rose from 0.29% in June to 0.84% at the end of 1998. The delinquency ratio on mortgage loans remains low on average when compared with other types of loans. Nevertheless, the continued increase in the delinquency ratio in 1998 prompted the HKMA to advise institutions to remain prudent in their new lending. In particular, authorised institutions were reminded that revived competition for residential mortgage loans should not lead to a lowering of credit standards.

Mortgage insurance by the HKMC

In December 1998 the HKMC approved a Mortgage Insurance Programme to provide insurance to lending institutions for an additional 15% of a mortgage loan on top of the usual 70% LVR. The HKMC will hedge the exposure arising from the insurance by taking out reinsurance with third party mortgage reinsurers. The Programme is expected to be launched in the first quarter of 1999.

The HKMA considers that the Programme is acceptable from the regulatory point of view. The extra amount of loan granted would be fully secured by the HKMC, which is a Public Sector Entity wholly owned by the Government through the Exchange Fund. In addition, in return for giving the mortgage, the HKMC will require that banks strictly observe a debt servicing ratio of 50%. On this basis, it is not felt that the mortgage Programme undermines the 70% LVR.

Challenges

Two items are at the top of the HKMA's supervisory agenda in 1999: the Year 2000 issue and the continuing focus on asset quality. To some extent the two issues are linked, in that institutions will need to monitor closely the Year 2000 readiness of their counterparties and take action to control their credit exposure to companies whose business may be disrupted as a result of Year 2000 problems.

Asset quality

Reflecting the weak economic situation, bad debts are likely to continue on a rising trend during the first part of 1999 at least. The HKMA will therefore continue to monitor closely the asset quality of institutions and check that they have in place adequate systems and controls for early identification and recovery of problem accounts. As in 1998, the HKMA will conduct two rounds of on-site examinations of the asset quality of the local banks during 1999 to satisfy itself that they are making adequate amounts of provisions against bad debts.



Deputy Chief Executive David Carse outlines some of the challenges facing the banking sector in his end-of-year briefing on 15 January 1999.

The aftermath of the GITIC closure has led many banks to reassess their policy on Mainland-related lending and to attempt to reduce their exposure in this area. The resultant liquidity crunch is causing debt servicing problems for a number of Mainland enterprises. The HKMA will continue to act as a focal point for channelling the views and suggestions of authorised institutions to the Mainland, and will work closely with the various parties to try to reduce the impact on the banking sector as far as possible.

More generally, the HKMA will continue to offer assistance in corporate workouts to help ensure that HKAB's guidelines on Corporate Difficulties can be successfully applied.

Year 2000 problem

It is anticipated that all institutions should have largely achieved compliance (as defined earlier) in respect of their critical internal systems by the end of March. The HKMA will continue to monitor institutions' efforts in this respect and will conduct further on-site examinations as part of this process.

The main focus will then shift to the need for institutions to have adequate contingency plans to deal with unexpected Year 2000 problems should they arise. As noted earlier, institutions will also need to make every effort to assess the Year 2000 readiness of their customers and other counterparties. Such steps by individual institutions should reduce the risks of Year 2000 problems of a systemic nature. Nevertheless, prudence requires that contingency plans should also be put in place to deal with risks that might arise for the banking sector, and indeed the financial sector, as a whole. The HKMA is in the process of preparing its own sector-wide contingency plan and will work with the Government and other financial sector regulators and participants to identify appropriate measures that could guard against and mitigate the risks. A key element will be a communication strategy to promote public awareness of, and confidence in, such measures.

Hong Kong Banking Sector Consultancy Study

The HKMA recognises the importance of the consultants' findings and recommendations to the banking sector and has released the details of the recommendations for a full public consultation exercise. Some of the recommendations would involve substantial changes to what have been key features of the regulatory structure in Hong Kong for many years. The proposed changes include relaxation of the one branch policy for foreign banks, simplification of the three-tier system of authorisation, the removal of the remaining interest rate rules and the relaxation of the means of entry by foreign banks. There is also the suggestion that the HKMA should look again at the issue of deposit insurance. These are all major policy issues which require careful consideration. The HKMA will need to take full account of the comments received during the consultation exercise before deciding precisely how to proceed on the consultants' recommendations. However, it is planned that the process of implementation will begin during 1999.

In the area of banking supervision, the consultants' report commends the efforts already made by the HKMA to refine its risk-based supervisory approach while suggesting that further enhancements should be put in place to take the process further in that direction. These include a more systematic risk assessment framework and organisational changes designed to increase staff capabilities and provide

more comprehensive career development. The HKMA has initiated work on mapping out a plan for implementing the recommendations in this respect. This would enable the HKMA to focus more clearly its attention on risk areas of individual institutions as well as the sector as a whole.

Banking (Amendment) Bill 1999

Plans are in hand to amend the Banking Ordinance, principally in order to bring Hong Kong's framework of banking supervision fully in line with the Basle Committee's Core Principles for Effective Banking Supervision adopted by supervisory authorities around the world and to allow greater flexibility in the provisions governing the publication of annual accounts by authorised institutions.

In September 1997, the Basle Committee on Banking Supervision published the Core Principles, which were endorsed by the central banks of the G10 countries. The Core Principles serve as a basic reference for supervisory authorities to review their existing supervisory arrangements and to initiate a programme designed to address any deficiencies as quickly as practical within their legal authority.

As part of such a review, the HKMA has prepared an assessment of Hong Kong's position in relation to each of the Core Principles. This assessment reveals that the Hong Kong framework substantially complies with the Core Principles except in a few areas. The new legislation is intended to fill these gaps and to make other improvements to the working of the Ordinance.

Transparency of the banking sector

The HKMA will continue the process of enhancing the disclosure framework currently in place in Hong Kong to ensure that the transparency of the Hong Kong banking sector, which is already among the highest in Asia, is in line with international best practices and developments. Consideration will be given to requiring non-listed local authorised institutions to make disclosures at the half-year similar to the requirements for local listed institutions and overseas incorporated institutions.

Exposure to highly leveraged institutions

With the increasing magnitude and complexity of the activities of highly leveraged institutions (HLIs) and the much expanded scope of interactions between HLIs and financial institutions, such as banks and securities houses, international regulators have recognised the need to fully understand and control the risks associated with these activities, both in terms of credit risk and systemic financial risk. The current focus is on identifying appropriate solutions to the problem, including increasing the transparency of HLIs' activities.

The HKMA will continue to monitor closely the latest international developments in this area and to participate actively in the various international and regional forums which are considering the issue. The HKMA will also consider the need to formulate appropriate banking and disclosure regulations in Hong Kong that are consistent with international standards in relation to the activities of HLIs. To be effective, however, this process will require international effort and co-operation.

Code of Banking Practice

Pursuant to the results of the compliance surveys conducted in 1998, the HKMA will continue to discuss with individual authorised institutions that failed to report full compliance with the Code how they intend to rectify the deficiencies. It will also collaborate with the industry associations to resolve specific issues such as the calculation of Annualised Percentage Rates and the appropriate loss limit for credit cards.

The Code will be due for review in July 1999, by which time it will have been in operation for two years. The results of the compliance surveys will form the basis of the review to be conducted in 1999.

Submission Through Electronic Transmission

The HKMA is planning to extend the uses of STET for improving communications between the HKMA and authorised institutions. This will involve the development of a website for information dissemination, receipt and storage. It is expected that the initial phase of the service will be available in the first quarter of 1999 and will enable the dissemination of circulars and guidelines, application forms, and other information, such as address and telephone lists of relevant organisations. The next phase of development will include the establishment of a discussion forum between specific groups (e.g. specified executives of the HKMA and authorised institutions), communication of confidential information through the website with appropriate security features, and permitting access to the site by other regulatory and government bodies.