

Banking Stability

One of the HKMA's key responsibilities is to promote the safety and stability of Hong Kong's banking system. In 1999 two issues required special attention: local banks' asset quality in the light of the regional situation and the continuing unfavourable economic environment; and the preparations by the banking sector for the Year 2000. During the year, the HKMA also formulated a three-year reform programme to assist the banking sector to meet the challenges ahead.

Objectives

The HKMA's primary objectives in the area of 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 Basel Committee on Banking Supervision.

Achievements

Operational supervision

During 1999 the Banking Supervision Department concentrated on two major issues: asset quality and the Year 2000 issue.

With most institutions experiencing sharply higher bad debts as a result of the regional downturn, close attention to local banks' asset quality and



provisioning continued. As in 1998, two rounds of on-site examinations were conducted of each local bank's asset quality in order to verify that assets were being classified appropriately in accordance with the HKMA's guidelines on loan classification, and that adequate provisions were being made. In all, over 260 on-site examinations were conducted in 1999, including more than seventy Year 2000-related examinations (see the Chapter on the Year 2000 issue for more information on this subject).

The number of off-site reviews and tripartite meetings was broadly the same as in 1998, taking into account the reduction in the number of authorised institutions.

More than 430 applications to become Controllers, Directors, Chief Executives or Alternate Chief Executives of authorised institutions were processed during the course of the year. In addition, a number of merger cases and applications for revocation were handled. To increase efficiency, all such licensing-related activities have been centralised in a newly-created Licensing and Compliance Division.

The Banking Supervision Review Committee considered a total of ten cases during the course of the year. Most cases related to the licensing of authorised institutions or money brokers.

No authorised institution breached the requirements of the Banking Ordinance relating to the liquidity ratio or capital ratio during the year. However, there were eight breaches of the requirements relating to

large exposures under Section 81 of the Ordinance and twelve breaches of the requirements relating to connected lending under Section 83. These breaches were 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.

The Monetary Authority exercised his formal powers under Section 52 of the Banking Ordinance in respect of a deposit-taking company that had ceased to meet certain authorisation criteria. Restrictions were imposed on the company and depositors and other creditors did not suffer any loss.

Table 1 Operational supervision

	1998	1999
1 On-site examinations (of which, Year 2000 examinations)	303 (105)	262 (77)
2 Off-site reviews and prudential interviews	292	283
3 Tripartite meetings	94	93
4 Treasury visits	4	5
5 Securities examinations	10	10
6 Applications to become Controllers, Directors, Chief Executives or Alternate Chief Executives of Authorised Institutions	530	435
7 Reports commissioned under Section 59(2) of the Banking Ordinance	9	7
8 Cases considered by the Banking Supervision Review Committee	21	10



Risk-based supervisory framework

As recommended in the Hong Kong Banking Sector Consultancy Study Report, the HKMA has embarked on the process of making its supervision more risk based.

The risk-based supervisory framework provides a formal process for the development of comprehensive, well-defined risk profiles of authorised institutions and the preparation of a supervisory plan, which focuses attention on the areas of greatest risk.

The risk-based process includes an evaluation of the quality of the institution's risk management practices and internal controls, which results in a risk management rating being assigned and formally incorporated into the CAMEL* rating of the institution.

With the assistance of a consultant from the U. S. Federal Reserve, the following achievements were realised during 1999:

- An Overview Paper describing the risk-based supervision approach and methodology was issued to banking supervision staff.
- Briefing sessions covering the Overview Paper were conducted for the entire banking supervision staff.
- Pilot risk-focused examinations were conducted at two local banks.

* An internationally recognised framework for assessing the Capital Adequacy, Asset quality, Management, Earnings and Liquidity of banks. The primary purpose of CAMEL is to help identify institutions whose weakness requires special supervisory attention.

- Risk profiles were developed for the small to medium sized local banks.
- Comprehensive guidance notes for staff, covering the documentation aspects of the process, were prepared.

This risk-based supervisory framework is expected to be largely implemented by the end of 2000.

Loan recovery

In June the HKMA issued for information a working paper on loan recovery. The paper noted that, historically, local banks have generally experienced a very low level of problem loans compared with banks in other centres. Consequently, in the past there has been less of a need to develop elaborate loan recovery policies and procedures. However, as local banks have over the last two years begun to experience sharply higher problem loans as a result of the regional situation, a need has arisen for them to sharpen their loan recovery efforts with the objective of maximising recoveries. The paper noted that, in order to achieve this, banks need to identify problem loans as soon as possible, and then to manage them quickly and efficiently. Banks should also have effective loan recovery procedures, including dedicated resources for problem loan management and restructuring and for collateral recovery and collection. The HKMA will have regard to this issue during its on-site examinations.



Loan classification & provisioning

During the year, the HKMA broadened the scope of its loan classification framework to include investment debt securities. The loan classification framework, which was introduced in 1994, was embodied in a guideline to enhance the transparency of the framework (previously the framework was part of the completion instructions of the relevant banking return). In addition, taking account of the views expressed in the Basel Committee's paper "Sound Practices for Loan Accounting and Disclosure", the HKMA issued guidance notes on rescheduled assets and recognition of interest to standardise the treatment of these items.

Over the last two years the HKMA has carried out regular half-yearly examinations of local banks' loan classification and provisioning. In November an article was published in the *HKMA Quarterly Bulletin* drawing on the experience gained in the course of these examinations to offer practical advice to institutions on how to improve their loan classification system and how to ensure that their provisioning is adequate.

The article stressed that, while the HKMA will continue to address the issues of loan classification and provisioning in its supervisory work, it is the responsibility of the Board of each institution, through its management, to ensure that appropriate policies and procedures are in place and are operating effectively. As far as loan classification is concerned, institutions should take into account not only quantitative factors, but qualitative factors as well. While the HKMA will continue to review institutions'

provisioning (including by reference to "benchmark" provisioning levels), the appropriate level of provisions on individual accounts and in aggregate is primarily a matter for the bank itself to determine, in consultation with its auditors.

Share margin financing

The HKMA continued to monitor closely institutions' share margin financing activities throughout the year. Institutions that were active in share margin financing business were required to report their positions to the HKMA on a more frequent basis and to pay particular attention to those accounts on which the loan-to-value ratio exceeded 60%.

Against the backdrop of a revitalised stock market, the volume of share margin financing conducted by authorised institutions increased significantly in the last quarter. Consistent with the increase in the Hang Seng Index, the outstanding balance of such lending expanded by about 40% over the year. Despite the strong growth, there were no signs that authorised institutions had relaxed their lending policies in order to achieve this growth.

The proposals of the inter-agency working group (in which the HKMA participated) formed in 1998 to study possible enhancements to the prudential regulation of share margin financing activities conducted through affiliated finance companies of brokerage houses have been published and legislative changes are expected. The HKMA will continue to monitor developments closely 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.



Taxi loans

The taxi industry continued to suffer in 1999 with the slowdown in the economy. Total taxi loans have declined from over \$20 billion to less than \$18 billion since the HKMA started, in 1998, to collect statistics from the sixteen authorised institutions most active in the taxi loan business. The decline reflects institutions' caution towards lending to the industry during this difficult period. The situation, however, stabilised in the second half of the year with the value of taxi licences increasing from about \$2 million at the end of 1998 to \$2.2 million in December 1999.

In terms of the quality of institutions' taxi loan portfolio, according to the HKMA's survey, loans overdue for more than three months decreased to 3.4% at the end of 1999 compared to 5.7% at the end of 1998. This, however, was primarily due to the large amount of such loans that have been rescheduled. Rescheduled loans rose to 11.6% at the end of December 1999 from 6.9% at the end of 1998, reflecting the fact that institutions have increasingly adopted the practice of agreeing reduced monthly repayments pending recovery of the industry.

The HKMA will continue to monitor the situation, in particular to ensure that adequate provisions are made against these loans and that authorised institutions engaging in taxi financing continue to follow prudent lending policies. During the year the HKMA undertook a full review of the taxi lending policies of the major taxi lenders to ensure that their policies are prudent and cover areas such as loan-to-value ratio, ceilings on the maximum amount of each loan, debt servicing ratio and maximum maturity of loans, and classification and provisioning.

Exposures to Mainland non-bank entities

In January 1999 the Guangdong Provincial Government (GPG) announced a debt restructuring proposal for Guangdong Enterprises (Holdings) Ltd. and related companies (GDE). With more than one hundred and twenty creditor banks and debts amounting to \$33 billion, this was the largest and most complex debt restructuring ever attempted in Hong Kong.

In view of the important ramifications for banks' provisioning and profitability and banks' attitudes towards lending to Mainland-related entities, the HKMA monitored the situation closely. While not itself participating in the negotiations, the HKMA kept in close contact with the parties concerned to understand the progress of the negotiations.

The HKMA also acted as a communication channel in passing banks' views and concerns about the restructuring to relevant Mainland authorities. At the same time, the HKMA encouraged banks, in their own interests, to adopt a constructive and realistic approach in order to achieve a mutually satisfactory outcome of the restructuring.

After months of negotiation, it was announced on 16 December 1999 that the GPG and the working group of the steering committee of bank creditors had reached an agreement-in-principle on a debt restructuring package for GDE. While the agreement still needs to be approved by all financial creditors, the agreement-in-principle clearly represents a significant step towards resolving this important and difficult issue. This should help pave the way for other restructurings of Mainland-related borrowers which



are encountering financial difficulties and should encourage banks to regain confidence in granting credit facilities to Mainland-related entities.

Given the debt problems surrounding certain Mainland-related entities, banks continued to take a cautious attitude towards lending to these entities, with new lending remaining subdued. According to the HKMA survey of the banking sector's direct and contingent exposures to Mainland-related entities, aggregate exposures of all authorised institutions to these entities have fallen from \$325.4 billion or 4.5% of the sector's total assets at 30 September 1998 (that is, before the announcement of the closure of Guangdong International Trust and Investment Corporation in October 1998), to \$233.6 billion or 3.4% of the sector's total assets at 31 December 1999. Loan repayment was a main reason for the reduction.

Profits of local banks have been affected to varying degrees by the debt problems of Mainland-related entities depending on the amount of provisions they have had to make against their exposures to these entities. The HKMA's practice is to discuss with individual banks the level of provisions they intend to make and assess whether this is reasonable. In deciding whether the provisions of an individual bank are reasonable, the HKMA will take into account its own assessment of the bank's exposures, the views of the bank's auditors and the provisions of other banks for similar exposures.

The Hong Kong Approach

Following the issue in April 1998 by the Hong Kong Association of Banks (HKAB) of guidelines on corporate workouts, a working group was formed in June 1999 to review the guidelines. The revised guidelines were issued jointly by HKAB and the HKMA in November 1999 as the "Hong Kong Approach to Corporate Difficulties". A joint HKAB/HKMA seminar on the guidelines was held, which attracted an attendance of more than three hundred and fifty.

The guidelines, which have a formal but non-statutory status, stress the fact that it is usually to the benefit of all the parties involved, including the lending banks, if there can be a restructuring of a problem borrower's operations and financial position rather than putting the borrower into liquidation. Integral to this workout process is a recognition of shared interests and a willingness to co-operate with the borrower and with other banks and other creditors.

The HKMA is a strong supporter of the workout concept and of the guidelines. It is prepared to try to help resolve differences of views that would threaten a workout by meeting with the parties involved to see if a compromise can be reached. While the HKMA may try to encourage banks in the minority to accept the majority view, if this seems justified, it is not the HKMA's practice to try to force banks to take decisions on workouts that are against their commercial judgement.



The HKMA has so far been asked to help in more than a dozen major workouts covering debts of some \$20 billion.

Connected lending

Section 83 of the Banking Ordinance limits the unsecured advances of locally incorporated authorised institutions to connected parties. The HKMA has come across a number of cases which indicate either a lack of understanding on the part of some institutions about the provisions of Section 83 or deficiencies in their systems and procedures for monitoring compliance with that section (for example, a failure to monitor the current market value of the collateral held for the connected advances).

The HKMA issued a circular letter in November 1999 requiring all locally incorporated authorised institutions to strengthen their systems and procedures for monitoring compliance with Section 83 of the Ordinance. To protect against the risk of a breach of the requirements under that Section of the Ordinance and to ensure that their financial soundness is not put at risk by imprudent connected lending, all locally incorporated authorised institutions are required to establish, if they have not already done so, a policy statement on connected lending. The policy statement should be approved by the Board and should set out the institution's policy on connected lending, including the types of lending that are considered to be "connected" in nature; the maximum limits that apply to individual connected loans and connected loans in aggregate, on a secured and on an unsecured basis; the

authority and procedures for approving connected loans; and the arrangements for ensuring the accuracy of reporting to the HKMA. Institutions are required to submit the policy statement on connected lending to the HKMA.

In addition to compliance with Section 83, the HKMA also reminded locally incorporated institutions in the November circular of the requirement to deduct lending and exposure to connected companies specified in Clause 3(B) of the Third Schedule to the Banking Ordinance from the capital base, if such lending or exposure, in the opinion of the HKMA, has been made or incurred other than in the ordinary course of business. The HKMA will review the connected exposure of locally incorporated institutions in future on-site examinations to ensure compliance with Section 83 and the Third Schedule.

Relationships with other supervisors

The HKMA has continued to maintain a close working relationship with other supervisors both in



Executive Director Mr YK Choi (right) meets with senior banking supervisors in the region during the Asia-Pacific Conference of Bank Supervisors in Kuala Lumpur from 29 November to 10 December 1999.



Hong Kong and abroad. It also participates actively in a number of regional and international forums of banking supervisors. These include the Core Principles Liaison Group set up by the Basel Committee on Banking Supervision, the EMEAP Working Group on Banking Supervision, the Offshore Group of Banking Supervisors and the SEANZA Forum of Banking Supervisors. The HKMA has chaired the meetings of the EMEAP Working Group on Banking Supervision since its establishment in 1996.



Mr Raymond Li, Executive Director in charge of banking policy, attends the Hong Kong Financial Conference "Hong Kong and Japan: Building a New Financial Partnership" organised by the Hong Kong Trade Development Council in Japan on 16-17 November 1999.

Regular meetings with the Securities and Futures Commission (SFC) to discuss issues and cases of common interest have continued to be held. These meetings are useful 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 to discuss matters of common interest.

Additionally, regular contact has been maintained with key overseas regulators, including those of Macau, the USA, the UK, Japan and South Korea. Memoranda of Understanding (MOUs) with regulators in Canada and Denmark were concluded during the year.

Supervision of institutions' Mandatory Provident Fund business

During 1999 the HKMA participated actively in the work of the Mandatory Provident Fund Schemes Authority (MPFA) in developing a supervisory regime for Mandatory Provident Fund (MPF) intermediaries. MPF intermediaries refer to those persons who are involved in selling MPF schemes or advising clients on constituent funds or underlying pooled investment funds of MPF schemes. MPF intermediaries must be registered with the MPFA and subject to the supervision of the SFC, Insurance Authority (IA) or HKMA.

To ensure conformity in regulatory approach, to minimise mis-selling by MPF intermediaries and to maximise protection for MPF scheme participants, in October 1999 the MPFA, SFC, IA and HKMA entered into an MOU in respect of the regulation of MPF intermediaries. Under the MOU, the MPF Intermediaries Regulation Co-ordinating Committee was established to co-ordinate the regulation of MPF intermediaries among the four regulators. With the contribution of the Committee, the MPFA issued the Code of Conduct for MPF Intermediaries to provide guidance in respect of the minimum standards of conduct applicable to MPF intermediaries.



Supervision of institutions' securities business
Pursuant to the MOU between the HKMA and the SFC, the HKMA is responsible for the supervision of the securities business of authorised institutions which are exempt dealers. As a general rule, the standards expected of exempt AIs will be equivalent to those set out in the SFC's Code of Conduct and Guidelines. Adherence to these standards is monitored by on-site examinations of the securities operations of these institutions.

Market risks

Following the implementation in 1998 of a market risk capital adequacy regime based on the Basel Committee Capital Accord, in 1999 the HKMA approved three institutions in their use of internal risk management models to generate value-at-risk measures for calculating market risk capital charges. In the approval process, the HKMA sought to ascertain that both qualitative and quantitative criteria for the institutions' in-house models met the standards proposed by the Basel Committee.

Residential mortgage lending

In 1999, total outstanding residential mortgage lending grew by only 3.7% to \$478 billion. Negative month-on-month growth rates were recorded in August and November, reflecting pockets of subdued market activity in the second half of the year.

The proportion of loans to refinance existing mortgages, as a percentage of new loans approved, increased sharply from 4.5% in January 1999 to 51.1% in December. This was attributable to the

abundance of liquidity in the banking sector and the proven resilience of this type of lending in a recessionary environment. In view of this, the HKMA issued a circular to all authorised institutions in September to express its concerns about this trend. The HKMA believes that while it is a commercial decision for banks to compete for mortgage business, they should consider the rationale of their strategy and the reactions of their competitors, which might simply result in the banks' exchanging customers at less favourable terms without generating new business for the whole sector. Authorised institutions were also reminded that they should not relax the prudent lending standards, including strict adherence to 70% loan-to-value ratio in granting mortgage loans, irrespective of whether these were new or refinancing loans.

Credit derivatives

In response to the rapid development of credit derivatives and banks' increasing involvement in the credit derivatives market, the HKMA devised a supervisory approach to these instruments, which was published on 26 November 1999, covering aspects relating to risk management, capital requirements and the impact on large exposures. The HKMA will continue to monitor the degree of use and the risk of credit derivatives in the market. The supervisory approach will be kept under review and new guidelines will be issued when appropriate.

Money laundering

The Financial Action Task Force (FATF) formally adopted the Report of the Second Mutual Evaluation



of Hong Kong at the Plenary Meeting in February 1999. The report commended Hong Kong's anti-money laundering regime and the efforts made by the authorities to improve the deficiencies identified in the First Mutual Evaluation. The report also pointed out that the effectiveness of the system could be further improved in certain areas, including those relating to money changers and remittance agents.

Legislative changes have been made to address some of the FATF's concerns. In particular, the Organised and Serious Crimes (Amendment) Bill was introduced in April 1999 and enacted in January 2000 to require, among other things, money changers and remittance agents to be registered and to keep records of transactions exceeding \$20,000 or an equivalent amount in any other currency.

In response to the recommendation of the FATF to improve the quality of suspicious transaction reports, the Police have set up a Working Group on suspicious transaction reporting to increase the quantity and improve the quality of these reports. Membership of the Working Group includes representatives from the Police, Customs and Excise, Security Bureau, Financial Services Bureau, financial regulators and the banking industry. The HKMA participates actively in this inter-agency working group in conjunction with the industry associations.

Money brokers

In 1999, the HKMA approved two money brokers and revoked the approval of one money broker at its own request.

To achieve continuous supervision of approved money brokers, on-going off-site analysis of the financial condition of individual money brokers and assessment of their compliance with the relevant provisions of the Banking Ordinance and Code of Conduct on Money Broking Business are conducted. Money brokers are required to submit returns on their financial positions on a quarterly basis. After the completion of the annual off-site reviews, prudential interviews are conducted with the senior management to enable the HKMA to discuss performance, internal control issues and future business outlook. On-site examinations of selected money brokers will be conducted in 2000.

Banking sector reform

In 1998 the HKMA commissioned a Consultancy Study on the further development of the Hong Kong banking sector. The full details of the consultants' findings and recommendations were published in early 1999 for a three-month public consultation, which ended in March 1999. The consultants proposed two sets of recommendations to assist the future development of the banking sector. The first related to market reforms targeted at promoting competition in the banking sector by removing incompatible regulatory features. The second set of recommendations aimed at enhancing the infrastructure supporting bank safety and soundness in an increasingly volatile and competitive environment. The consultants considered this to be a coherent package of recommendations, which should be introduced in parallel, using a phased approach.



From the responses received during the public consultation, it appeared that there was a large measure of support from the banking industry and other sectors of the community for the general direction as well as for most of the specific recommendations identified by the consultants. Having carefully evaluated the consultants' recommendations and the public response, in July 1999, with the endorsement of the Chief Executive in Council, the HKMA announced a three-year reform programme to further develop the banking sector to meet the challenges in the years ahead. The objectives of the reform programme are two-fold: first, to encourage market liberalisation and enhance competitiveness in the banking sector; and, secondly, to strengthen banking infrastructure with the objective of enhancing the safety and soundness of the sector. Details including the timetable for the implementation of this reform programme are in Table 2.

The HKMA considers that a carefully planned liberalisation of the banking markets is necessary if Hong Kong is to maintain and consolidate its position as an international financial centre. This reform programme should strike an appropriate balance between competitiveness issues and safety and soundness considerations.

Since the reform programme was announced, a number of the policy initiatives have already been implemented according to the programme schedule. In June 1999, the HKMA issued a policy statement on its role as lender of last resort to the banking sector. The policy statement clarified the circumstances in which the HKMA would provide emergency funding

support to banks with short-term liquidity problems and the types of funding support that would be available to them.

The HKMA has also taken measures to promote greater competition in the banking sector. The twenty-year-old "one branch" policy for foreign banks has been relaxed and foreign banks are now allowed to operate from three separate buildings rather than one. This measure has provided foreign banks with greater flexibility in doing business and will further enhance Hong Kong's reputation as a free and open financial centre.

Until December 1999 access to Real Time Gross Settlement (RTGS) system had been restricted to licensed banks. However, the HKMA has obtained agreement-in-principle from HKAB and Hong Kong Interbank Clearing Ltd (HKICL) to allow restricted licence banks (RLBs) access to the RTGS system. Details of the arrangements were announced in December 1999. This measure should raise the level of competitiveness in the banking industry and reduce the settlement risk of RLBs.



Deputy Chief Executive Mr David Carse (centre) at the press conference on the Banking Consultancy Study on 14 July 1999.



Table 2 Hong Kong Banking Sector Reform Programme

Measures	Status and reform timetable	
Market reform and liberalisation measures:		
<ul style="list-style-type: none"> Deregulate the remaining Interest Rate Rules (IRRs) in two phases, subject to the prevailing financial and economic conditions 	First phase (for time deposits with maturity of less than 7 days)	July 2000
	Second phase (for savings and current account deposits)	July 2001
<ul style="list-style-type: none"> Relax the one branch policy to allow foreign banks to establish up to a maximum of three branches (further relaxation will be considered in the first quarter of 2001) 	Implemented Revisit	September 1999 1 st Quarter 2001
<ul style="list-style-type: none"> Allow access to Real Time Gross Settlement by restricted licence banks 	In progress	1 st Quarter 2000
<ul style="list-style-type: none"> Simplify the three-tier licensing system into a two-tier system 	Review	2 nd Half 2000
<ul style="list-style-type: none"> Relax the market entry criteria for obtaining a local banking licence 	Review	2 nd Half 2001
Safety and soundness enhancement measures:		
<ul style="list-style-type: none"> Conduct a detailed study to enhance deposit protection 	Review	1 st Half 2000
<ul style="list-style-type: none"> Clarify the HKMA's role as lender of last resort 	Policy statement issued	June 1999
<ul style="list-style-type: none"> Improve the financial disclosure framework 	Continuing effort	
<ul style="list-style-type: none"> Develop a more formal risk-based supervisory regime 	Continuing effort	
<ul style="list-style-type: none"> Conduct a feasibility study on establishing a credit register for commercial enterprises in Hong Kong 	Feasibility study	1 st Half 2000
<ul style="list-style-type: none"> Promote high standards of corporate governance within the banking sector 	In progress	1 st Half 2000

Financial disclosure

In June 1999 the HKMA took further steps to promote greater transparency of the banking sector with the introduction of the Interim Financial Disclosure package. Prior to this, only listed authorised institutions and listed banking groups were expected to disclose financial information at the interim period. The package recommends all locally incorporated authorised institutions that meet the size

criteria to disclose information on their profit and loss statement, loan quality and off-balance sheet exposures. The information expected to be disclosed includes key components of the profit and loss statement, segmental information on loans, standardised analysis of overdue and rescheduled loans, and the contractual and notional amounts of off-balance sheet exposures.



In December 1999 the HKMA updated the disclosure recommendations for foreign incorporated institutions. The update requires such institutions to disclose at the year-end and interim period information on their non-accrual, overdue and rescheduled loans in line with the Interim Financial Disclosure package issued for locally incorporated institutions in June. At the end of the year, the HKMA also issued a guideline entitled Financial Disclosure by Locally Incorporated Authorised Institutions under section 16(10) of the Banking Ordinance. The Guideline converts the previous “Best Practice Guide” into a more formal set of minimum standards for disclosure by local institutions in their annual reports. The HKMA took this opportunity to update the disclosure standards to bring them into line with the Statement of Standard Accounting Practice (SSAP) No.24 on accounting for investments in securities issued by the Hong Kong Society of Accountants.

The Banking (Amendment) Ordinance 1999

The Banking (Amendment) Ordinance 1999 was passed by the Legislative Council on 7 July and was published in the Gazette on 16 July 1999. The primary purpose of these legislative changes was to bring the existing supervisory framework in Hong Kong in line with the Basel Committee’s Core Principles for Effective Banking Supervision.

The main provisions of the Banking Amendment Ordinance are:

- (a) the introduction of a new provision to require a locally incorporated authorised institution to seek the Monetary Authority’s prior approval for any major acquisition or investment in a company (including establishment of a company) which constitutes 5% or more of the capital base of the authorised institution. This new requirement may be applied to an institution on a solo or consolidated basis or on both bases (section 87A);
- (b) the removal of the restriction on disclosure of individual customers’ information to overseas supervisory authorities. In addition, the Monetary Authority is empowered to attach a condition to any disclosure of information made under section 121 requiring the recipient authority to seek his prior consent for any onward transmission of the information. Such a condition is mandatory in the case of any disclosure of individual customers’ information (section 121(3));
- (c) the right for the Monetary Authority to attend a court hearing on a winding-up petition in respect of an authorised institution and to support or oppose such a petition. This is to address the concern that the Monetary Authority’s supervisory power to bring about timely corrective actions on a problem authorised institution may be disrupted by a winding-up petition against the authorised institution presented by creditors (section 122(7)); and
- (d) the removal of the requirement for local authorised institutions to publish their annual accounts in newspapers (section 60(1)); and the granting to the Monetary Authority of the power to require all authorised institutions (both foreign and local) to publish or disclose information relating to their



financial affairs, and to specify the disclosure requirements and the manner and timing of disclosure by way of subsidiary legislation (section 60A). This is to allow greater flexibility in the provisions governing the publication of annual accounts by authorised institutions and to provide a clear legal backing for the financial disclosure requirements for both local and foreign authorised institutions.

The majority of the provisions, except those in relation to section 60A of the Ordinance, have already commenced operation. The remaining section will come into effect subject to the enactment of the relevant subsidiary legislation. The new legislation will further enhance the effectiveness of the HKMA's supervisory framework.

Capital adequacy ratio

In December 1999, the HKMA amended the Third Schedule to the Banking Ordinance to revise the treatment of two types of asset revaluation reserves for the purposes of calculating the capital adequacy ratio of an authorised institution. First, reserves arising from the revaluation of securities which are not held for trading purposes under the alternative treatment of SSAP 24 are now included in Supplementary Capital at a discount of 30%. Secondly, the amount of property revaluation reserves which can be included in Supplementary Capital is now capped at the level at the end of 1998. The amendments are intended to limit the impact of a sudden diminution in value of such asset revaluation reserves on an institution's capital adequacy ratio in a volatile market environment.

Challenges

Continued attention to asset quality

While the worst may be over in terms of new problem loans coming to light, new provisions are likely to be required for existing problem loans if they show no improvement and if the overdue period increases. Consequently, asset quality will continue to be a major preoccupation in 2000.

Review of local banks' lending policies and credit risk management

While institutions will have to continue to devote resources to managing their problem loans, at the same time, with the economy and consequently loan demand recovering, banks will be looking to resume growth in their balance sheets. The HKMA is keen to ensure that there are no unnecessary regulatory impediments to banks in fulfilling the important role of financing the growth of the economy. However, the HKMA has an interest in ensuring that growth in institutions' balance sheets is achieved in a safe and sound manner. To ensure that this is so the HKMA will closely review institutions' lending policies and credit risk management with a view to ensuring that institutions' lending is prudent and that appropriate systems of control are in place.

In February 2000 the HKMA published a set of 18 basic principles underlying prudent credit control by authorised institutions. Institutions were encouraged to review their lending policies, procedures and controls in the light of these principles.



Risk-based supervision

In 2000 full implementation of the risk-based supervisory framework will require the HKMA to:

- conduct additional risk-focused on-site examinations
- issue a supervisory framework document to the banks, which will describe how the risk assessment approach has been integrated into the supervisory process of the HKMA
- develop and conduct a formal training programme on risk-based supervision with assistance from training specialists
- develop a new risk-focused examination manual to supplement the current on-site examination manual
- develop and consolidate supervisory guidelines to form a Policy Manual to support risk-based supervision
- consider structural and process changes in bank supervision to better accommodate the risk-based supervisory approach

As noted, it is intended that the implementation of the risk-based approach should be largely completed by the end of 2000.

Enhanced supervision of institutions' securities business

The HKMA has agreed with the SFC and the Financial Services Bureau on the framework for the regulation and supervision of the securities business of authorised institutions exempt under the Securities and Futures Composite Bill. The agreed framework

builds on existing supervisory arrangements as enshrined in the MOU signed between the HKMA and the SFC, and seeks to have in place a regulatory mechanism that will avoid unnecessary regulatory burden on such exempt institutions and minimise regulatory overlaps between the HKMA and SFC, subject to the principle that there should be an equivalence of regulatory requirements and standards applied to exempt institutions and SFC licensees.

In line with this objective, the agreed framework provides for the HKMA to be the front-line regulator in respect of exempt institutions' activities that are regulated under the Bill. Exempt institutions will also be subject to certain statutory requirements that are specific to securities and futures operations. To ensure that exempt institutions manage their regulated activities properly, they will be required to nominate executive officers who will be responsible for directly supervising the conduct of such activities and seek the HKMA's approval of such persons. In order to fulfil this commitment, the HKMA will increase the number of specialist securities examination teams from one to three. These resources will be supplemented, where appropriate, by the use of the HKMA's existing examination teams which monitor compliance with the Banking Ordinance. The HKMA will also establish a system for conducting off-site surveillance of exempt institutions' securities business.

The arrangement for the regulation of exempt institutions under the Bill will be the subject of consultation with the market as part of the wider consultation on the Bill which will take place



in the period from April to June 2000. The MOU between the HKMA and the SFC will also be revised to reflect the proposed regulatory and supervisory framework for exempt institutions under the Bill. At the same time, some changes will need to be made to the Banking Ordinance to make it more explicit that the HKMA's powers under the Ordinance are exercisable in relation to exempt institutions' regulated activities.

Supervision of institutions' MPF business

The commencement of the MPF Schemes in Hong Kong creates new business opportunities for the banking, insurance and investment industries. The involvement of authorised institutions in this business is mainly in acting as MPF intermediaries in the selling of, and advising on, MPF schemes and products starting from February 2000. This market is expected to be highly competitive. The HKMA is responsible for the supervision of MPF intermediaries that are authorised institutions and the employees of these institutions engaged in MPF business. The HKMA expects all institutions which are MPF intermediaries, and their employees, to comply with the Code of Conduct for MPF Intermediaries issued by the MPFA. The HKMA will establish a special supervisory team to monitor institutions' involvement in the MPF business, particularly in their compliance with the Code of Conduct for MPF Intermediaries.

Banking sector reform

During 2000, a priority of the HKMA will be to ensure that the banking sector reform programme progresses smoothly. The bulk of the work involved in the reform programme will take place in 2000.

The outcome may entail significant changes to the regulatory structure in Hong Kong. The focus in 2000 will be on deregulation of the remaining Interest Rate Rules, conducting a full study on deposit protection, evaluating the feasibility of establishing a credit register for commercial enterprises in Hong Kong, and implementing a formalised risk-based supervisory approach. These measures encompass the twin objectives of enhancing the safety and soundness of the banking sector and promoting competition in the sector.

Corporate Governance

In 1991, the HKMA issued a Best Practice Guide describing how the Board of Directors and individual directors of an authorised institution are expected to discharge their responsibilities. As part of the banking sector reform programme, the HKMA has completed a review of the Guide with a view to issuing more specific guidelines to authorised institutions on corporate governance. The review raises a number of difficult issues about how far the HKMA should prescribe the Board's responsibilities in this area. The HKMA nonetheless believes that the Asian financial crisis has reinforced the need for leadership and control by the Board of Directors if authorised institutions are to steer their way safely through difficult conditions. The HKMA has consulted the banking industry on a draft guideline setting out the minimum standards on corporate governance of locally incorporated authorised institutions. The intention is to issue the guideline in 2000, under section 7(3) of the Banking Ordinance, after taking into account the views of the industry.



Interest Rate Deregulation

Providing that the prevailing economic and financial conditions are not unfavourable, HKAB's Rules on Interest Rates and Deposit Charges (IRRs) covering time deposits with a maturity of less than seven days will be deregulated in the middle of 2000 while IRRs on savings and current accounts will be removed in July 2001. The HKMA believes that deregulation should help to promote greater efficiency and encourage innovation in new deposit products. The HKMA has devised a set of specific and objective indicators for the purpose of evaluating the conditions for deregulation and will consult the relevant advisory committees fully before a final decision is made on deregulation.

Enhancing deposit protection

Deposit protection was last publicly debated in 1992 following the failure of BCCHK Limited and a number of contagious bank runs in 1991. At that time, the proposal for establishing a deposit protection scheme was rejected mainly on grounds of cost, and because of concerns about fairness and effectiveness. The consultants in the Banking Sector Consultancy Study identified "a strong need for an enhanced deposit protection scheme to improve consumer confidence, and to enhance the general stability of the banking sector". An enhanced form of explicit deposit protection would also help bring Hong Kong into line with international practices, including the Second Banking Directive adopted by the European Union in 1994 and the recommendations of the G22 Working Party on Strengthening Financial Systems.

In response to these developments, the HKMA has undertaken to revisit this subject and to consider the options available by way of a more detailed study on the various forms of explicit deposit protection in the first half of 2000. The HKMA intends to commission a full consultancy study on this issue, which is expected to be completed by the end of June 2000. The findings of the study together with any recommended options will be subject to full public consultation before any decision is made on this important matter.

Feasibility study on establishing a credit register

The increase in corporate failures in Hong Kong as a consequence of the downturn in the economy has highlighted the need for banks to have better information about their customers and, in particular, about their levels of indebtedness. As part of the reform programme, the HKMA has undertaken to look into the feasibility of establishing a credit register for commercial enterprises in Hong Kong. This will involve detailed study on a number of practical issues, such as the range of collectible information, existing confidentiality agreements between banks and their customers, impact on Hong Kong's attractiveness as a financial centre and other legal and implementation issues. The results of this study will be subject to consultation with the banking industry and other relevant parties before further steps are taken to implement any new measure in this regard.



Review of the three-tier licensing system

The consultants in the Banking Sector Consultancy Study noted that the existing three-tier structure is somewhat complex and that there is significant duplication of licences within banking groups. The HKMA will therefore conduct a study in the second half of 2000 with a view to simplifying the three-tier system into a two-tier system. By the end of 2000, the HKMA aims to devise proposals for changes to the current structure for consideration by the industry. Any changes to the three-tier system would entail substantial changes to the Banking Ordinance and could only be implemented in 2001 at the earliest.

Electronic banking

The HKMA recognises that electronic banking is one of the key strategic challenges facing the Hong Kong banking sector. It is apparent that there is a massive acceleration of the pace of development of electronic banking activities in Hong Kong in a variety of electronic channels such as the Internet and cellular phone networks. A number of banks have already launched transactional websites or mobile phone banking in Hong Kong, and many others are at an advanced stage of planning and development. These initiatives are facilitated by developments in the community at large which help promote electronic banking in Hong Kong. The recently enacted Electronic Transactions Ordinance grants legal recognition to digital signatures and electronic

records. In addition, Hongkong Post has launched its public certification authority service in Hong Kong. These will help to promote public acceptance of electronic transactions in Hong Kong.

The HKMA's role is to provide a regulatory environment in which banks will properly manage the risks arising from electronic banking, so that the potential benefits can be safely realised. Given the pace of development in this area, the HKMA will step up its efforts to ensure that it understands the latest developments in the industry and maintain the expertise to supervise banks' activities in this field. It will keep its policy framework for regulating electronic banking under review. The HKMA intends to produce specific guidelines on issues such as authorisation of virtual banks and information security in relation to electronic banking activities. It will also consider the issues that arise in relation to offshore banking activities conducted over the Internet, including the need to cooperate with other supervisors to ensure that such activities are properly monitored and regulated. The HKMA will also establish a specialist team of examiners with the necessary skills and information technology knowledge to conduct more focused examinations on the electronic banking activities and electronic data processing controls of banks.



New Capital Accord

A new capital adequacy framework (“New Accord”) was proposed by the Basel Committee on Banking Supervision in June 1999. The proposed New Accord aims to refine the risk weighting system and broaden the scope of application of the 1988 Accord. The relatively crude risk weighting system in the existing framework is widely considered to be incapable of adequately differentiating between the default risks of borrowers. It also fails to provide proper incentives for risk mitigation techniques. The Basel Committee recognises that the Accord must evolve along with the changes in the market and is therefore working towards a more broad-based and flexible capital adequacy framework. In addition, the Committee proposes to incorporate into the New Accord major categories of risk, such as interest rate risk and operational risk.

The New Accord proposes major changes in the risk weighting system. For example, the existing OECD-based approach would be replaced by a modified standardised approach that uses external credit assessments. In addition, the Basel Committee is examining the possibility of basing risk weightings on banks’ internal ratings.

The changes in the New Accord will affect banks’ capital adequacy ratios and funding costs. In view of this, the new framework will affect the future development and competitiveness of the Hong Kong banking sector. The HKMA is playing an active role in the process by consulting the local banking industry and passing on comments on the proposals to the Basel Committee. In addition, the HKMA is participating directly in the process of formulating the proposals through its membership of the Basel Committee’s Core Principles Liaison Group, which provides a forum for both G-10 and non-G10 Supervisors to consider and discuss the proposals.

Code of Banking Practice

In view of the high priority given to the preparation for the Year 2000 problem, the HKMA agreed with the industry associations to defer a review of the Code of Banking Practice to 2000. In conducting the review in 2000, the HKMA will work together with the industry associations on the basis of the compliance surveys conducted in 1998, subsequent examinations on the compliance of authorised institutions, and specific issues of concern, such as the calculation of annualised percentage rates and the appropriate loss limits for credit cards. Given the importance of customer confidence in the development of electronic banking, the HKMA expects that the review will also cover electronic banking services, in particular the issue of allocation of liability between banks and customers in relation to the provision of electronic banking services.



Consumer credit information

As a result of the downturn in the economy the number of individual borrowers with multiple delinquencies has been increasing. This issue was recently raised by a Hong Kong-based credit reference agency, which suggested an expansion in the scope of collectible information by credit reference agencies to include a certain amount of positive credit exposure information. This proposal raises a number of important issues, including in relation to data privacy, and it will need to be discussed fully with all interested parties before any decision is made to proceed.

Financial disclosure

Keeping the disclosure framework in line with international best practice remains an important objective of the HKMA. In 2000, the disclosure framework will be reviewed to take into account disclosure practices and developments in Hong Kong and other major financial centres.

