Banking Stability

One of the HKMA's main tasks is to promote the safety and stability of Hong Kong's banking system. In 2000, a year of improved performance for Hong Kong's banking sector, progress was made in developing a risk-based supervisory framework and in strengthening the corporate governance of locally incorporated authorized institutions. As part of the banking sector reform programme, the first phase of the deregulation of the remaining Interest Rate Rules took place in July. The HKMA also conducted consultation on two major proposals: the introduction of a deposit insurance scheme and the establishment of a commercial credit reference agency in Hong Kong.

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 authorized institutions retain the ability to operate on a competitive and commercial basis. To achieve these objectives, the HKMA aims to maintain 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.

Progress and achievements in 2000

Operational supervision

Hong Kong's banking sector recorded a noticeable improvement in performance in 2000. In particular, owing to improved asset quality and debt recovery, banks generally saw a sharp reduction in bad debt charges. As a result, most local banks enjoyed a significant increase in their pre-tax profits over the same period of the previous year.

The overall improvement in asset quality among local banks has enabled the HKMA to focus its supervisory attention on developing policies aimed at promoting sound and prudent business practices in the banking sector. A number of guidelines and circular letters on subjects such as corporate governance, credit control, electronic banking, authorization of virtual banks, share financing and taxi financing were issued during the year. The HKMA monitored compliance with the required standards through its ongoing supervision of authorized institutions.

A total of 282 on-site examinations of authorized institutions were conducted in 2000, including 17 risk-focused examinations of local banks, 44 money laundering examinations and 58 special examinations of the treasury, securities and Mandatory Provident Fund-related activities of selected institutions. The number of off-site reviews and tripartite meetings was slightly less than in 1999 owing partly to the reduced number of institutions. This reduction reflected retrenchment by some foreign banks of their overseas presences (including in Hong Kong) and the impact of mergers and acquisitions, notably among banks incorporated in the United States, Europe and Japan.

Despite this, the HKMA received a larger number of applications for authorization in 2000 than in the previous year. The Banking Supervision Review Committee considered a total of 16 cases during 2000 (ten in 1999) relating to the licensing of authorized institutions and money brokers. In addition, more than 400 applications to become Controllers, Directors, Chief Executives or Alternate Chief Executives of authorized institutions were processed during the year.

No authorized institution breached the requirements of the Banking Ordinance relating to liquidity ratio or capital adequacy ratio during the year. There were, however, seven breaches of the requirements relating to large exposures under Section 81 of the Ordinance and 14 breaches of the requirements relating to connected lending under Section 83. Appropriate remedial actions were taken by the institutions concerned and the breaches were promptly rectified. The interests of depositors and other creditors were not put at risk. No use was made of the formal powers of the Monetary Authority under Section 52 of the Ordinance.

Table 1 Operational supervision

		1999	2000
1.	On-site examinations	185	224[1]
2.	Year 2000 examinations	77	–
3.	Treasury examinations	5	10
4.	Mandatory Provident Fund examinations	–	23
5.	Securities examinations	10	25
6.	Examinations of money brokers	–	2
7.	Off-site reviews and prudential interviews	283	257
8.	Tripartite meetings	93	87
9.	Meetings with Boards of Directors of authorized institutions	1	6
10.	Applications to become Controllers, Directors, Chief Executives or Alternate Chief Executives of authorized institutions	435	418
11.	Reports commissioned under Section 59(2) of the Banking Ordinance	7	1
12.	Cases considered by the Banking Supervision Review Committee	10	16

[1] Including 44 money laundering examinations

Industry consolidation

A number of acquisitions took place among banks in Hong Kong during the year. These included the acquisition of ICBC (Asia) Ltd (formerly known as Union Bank of Hong Kong Ltd) by the Industrial and Commercial Bank of China and the acquisition of First Pacific Bank Ltd by the Bank of East Asia Ltd. In addition, it has been announced that the Bank of China Group will consolidate the Hong Kong operations of ten of its member banks into a single locally incorporated entity.

Risk-based supervisory approach

Considerable progress was made during 2000 in further developing and implementing the risk-based supervisory framework.

The risk-based supervisory framework is a structured approach to supervision designed to establish a forward-looking view of the risk profile of an authorized institution. The introduction of the risk-based approach has helped the HKMA to develop a tailored supervisory plan for each institution, focusing its resources on areas of greatest risk to the institution concerned.

Risk-based supervision progressed in the following ways during 2000:

- risk-focused on-site examinations were conducted at 17 small to medium sized local banks;
- a formal staff training programme on risk-based supervision was organised and conducted for supervisory staff; and
- comprehensive guidance notes and briefing sessions on all aspects of the risk-based supervisory process were provided to supervisory staff.

Capital adequacy

In 1998 the HKMA reviewed the minimum Capital Adequacy Ratio (CAR) to be observed by locally incorporated banks and their authorized subsidiaries. Following this review, these institutions have been required to observe a minimum CAR of 10% or above. In 2000 the HKMA conducted a similar review for other locally incorporated authorized institutions, and raised the minimum CAR to be observed by these institutions to 10% or above, consistent with the minimum CAR applicable to locally incorporated banks.

Competition and asset quality

Although the Hong Kong economy recovered strongly in 2000, loan demand remained subdued. As a result, competition among banks for lending business continued to be intense, particularly in traditional lending products such as residential mortgages, personal loans, credit cards and tax loans. Lending rates for mortgages continued to fall during the year, and the market norm reached prime minus 2.25% in the last quarter. Borrowers were also offered incentives in the form of cash rebates. While the HKMA does not intervene in commercial lending decisions, the erosion of margins raises some prudential concerns, since it may expose lending institutions to increased interest rate risk, particularly on long-term assets such as mortgages. There is also the risk that competitive pressures may cause credit standards to slip. In the light of these concerns, the HKMA held discussions during the year with institutions adopting a more aggressive strategy in their mortgage business, in order to satisfy itself that prudent lending policies had not been compromised and that proper account had been taken of the interest rate risk in the pricing policies of the institutions concerned.

Taxi loans

Economic recovery and lower operating costs through conversion to Liquid Petroleum Gas taxis helped raise the licence value of taxis in 2000. As a result, the overall quality of taxi loans improved during the year, although the non-performing ratio was still generally higher than for other types of loans. Overdue and re-scheduled urban taxi loans remained high, at 7.6% at the end of 2000, although this was well below the 15% recorded at the end of 1999.

In December, following consultation with the Hong Kong Association of Banks (HKAB), DTC Association (DTCA) and Finance Houses Association of Hong Kong Limited, the HKMA issued a *Guidance Note on Taxi Financing* to all authorized institutions. The Guidance Note is non-statutory. It nevertheless sets out prudent lending practices to be followed by authorized institutions in their taxi loan business. The Guidance Note recommends, among other things, that the maximum amount of a loan against the value of a taxi licence should not exceed $2.15 million and that the lending against the car body should not exceed 80% of the value of a used car or 90% for a new car. The Guidance Note is subject to quarterly review. For this purpose, the HKMA has established a panel comprising ten lending institutions and two taxi dealers' associations. Panel members will provide the HKMA with the income level of the taxi operators and the value of taxi licences on a quarterly basis.

Credit policies

It became apparent during the financial crisis that basic credit control principles had not always been fully observed. The HKMA therefore issued to all authorized institutions in February 2000 a set of basic principles underlying prudent credit controls. Institutions were asked to conduct self-assessments of their compliance with these principles. The HKMA monitored compliance with these principles during its on-site examinations.

Initial public offerings (IPOs)

Investor interest in the IPOs for Internet and technology-related stocks surged in the first half of 2000, and heavy over-subscription in one case raised public concern about whether the arrangements for collecting applications by the receiving banks were sufficiently robust. In May 2000 the HKMA issued a guideline on various aspects of the role of receiving banks in IPOs. The guideline emphasises that authorized institutions should only act as receiving banks in IPOs if they have the operational and capital resources to do so. The guideline further requires the receiving bank to agree in advance with the sponsor of the IPO a formal contingency plan for coping with any unexpected level of interest in the IPO.

Share financing

During the year, the HKMA continued to collect regular information on exposure to share margin loans from a number of institutions active in this business. The HKMA was satisfied that institutions continued to exercise prudence in their share margin financing activities.

In the light of investors' strong enthusiasm for Internet-related stocks, the HKMA issued a circular in February 2000 drawing institutions' attention to the need to exercise caution in their involvement in financing such stocks. Specifically, institutions were reminded to establish and observe counter-party limits, maintain their normal credit standards, and limit their total lending for individual Internet-related IPOs to an amount well within their ability to obtain funding to meet their obligations on the day of settlement.

As regards share margin financing, the circular reminded institutions that they should have in place, among other things, a list of stocks which are acceptable as collateral. In view of the volatility in the price and trading of some of the Internet-related stocks, institutions should also assess the position of these companies carefully before a decision was made to include them in their lists of acceptable stocks and a conservative loan-to-value ratio should be set for such stocks.

In June 2000, the HKMA issued another circular to all authorized institutions drawing their attention to the addition of a new Part XA to the Securities Ordinance relating to the regulation of securities margin financing business. Authorized institutions that are exempt dealers were reminded that they should take appropriate steps to ensure compliance with the relevant requirements, such as those relating to the provision of trading records to clients, the handling of clients' securities collateral and claims and liens over securities.

Exposure to Mainland non-bank entities

The HKMA continued to keep in close touch with banks and other parties to monitor progress in the restructuring of the debts of individual Mainland borrowers that had experienced financial difficulties. It also acted as a communication channel for conveying banks' views and concerns about individual restructuring exercises to the relevant Mainland authorities.

In December 2000, agreement was finally reached on the complex debt restructuring of the Guangdong Enterprise Group (GDE). Compared with the alternative of liquidation, the successful restructuring of GDE reduced the lending institutions' potential loss on their exposure to the Group. During the year, several other Mainland institutions also reached agreements with creditor banks to restructure or repay their debts, with varying degrees of "haircut".

Given the debt problems surrounding Mainland-related entities generally, banks continued to take a cautious attitude towards lending to these entities. The aggregate exposure of all authorized institutions to Mainland non-bank entities fell from $233.6 billion, or 3.4% of the banking sector's total assets at 31 December 1999 to $194.3 billion, or 2.9% of the sector's total assets at 31 December 2000.

The Hong Kong Approach

As set out in the *Hong Kong Approach to Corporate Difficulties* issued in November 1999, the HKMA is prepared, on request, to help to resolve differences in views that might threaten the successful conclusion of a corporate workout. In line with this, the HKMA mediated in seven corporate workouts covering debts amounting to some $33 billion during the year.

Corporate governance

Following consultation with the banking industry, the HKMA issued a *Guideline on Corporate Governance of Locally Incorporated Authorized Institutions* in May 2000. In addition to describing the responsibilities and obligations of the board of directors, the Guideline sets out a number of specific requirements to which the HKMA expects the boards of all locally incorporated authorized institutions to adhere. The main requirements include:

(a) the board should ensure that the institution establishes policies, procedures and controls to manage the various types of risk with which it is faced;

(b) the board should maintain an appropriate level of checks and balances against the influence of the management and/or the shareholder controllers in order to ensure that decisions are taken with the institution's best interests in mind. To this end, it is recommended, in the case of banks, that the board should include at least three independent non-executive directors;

(c) the board should establish an audit committee which should be made up of non-executive directors, the majority of whom should be independent;

(d) board meetings should be held preferably on a monthly basis but in any event no less than once every quarter; and

(e) individual directors should attend at least half of board meetings held in each financial year.

The HKMA considers it important to establish a formal and direct channel of communication with the board of directors of banks, and proposes to meet the board of directors of each locally incorporated bank every year. During 2000, the HKMA conducted meetings of this kind with the boards of directors of six local banks.

Outsourcing

Outsourcing has become increasingly popular among authorized institutions as a means of saving costs and increasing efficiency. While the HKMA does not in principle object to outsourcing, the practice raises a number of concerns. During the year, the HKMA further developed its approach towards outsourcing in dealing with a number of particular cases. The main areas that were addressed included the following:

(a) the adequacy of systems, controls, and contingency planning, which should not be compromised through outsourcing services to another party;

(b) the implementation of satisfactory arrangements for compliance with data privacy requirements and for safeguarding customer confidentiality, particularly in the case of cross-border outsourcing;

(c) the adequacy of disclosure of information to customers about the outsourcing arrangement;

(d) the question of whether outsourcing would undermine the HKMA's ability to access data and supervise the institution concerned.

Supervision of authorized institutions' securities business

In February 2000, the HKMA increased the number of specialist securities examination teams from one to three. They conducted on-site examinations of the securities business of authorized institutions that are "exempt dealers". Such institutions are exempt from the need to be registered under the Securities Ordinance and are not subject to the supervision of the Securities and Futures Commission (SFC). The HKMA, in supervising the securities business of these exempt dealers, applies standards that are equivalent to those imposed by the SFC on registered dealers. To facilitate this process, the HKMA and the SFC co-operate closely, pursuant to the Memorandum of Understanding entered into by the two regulators in 1995. In addition to carrying out on-site examinations, the HKMA introduced a new "Return of Securities Related Activities" in late 2000 to facilitate its off-site review of the securities business of institutions that are exempt dealers.

In November 2000, the Securities and Futures Bill was introduced into the Legislative Council to consolidate and revamp the existing statutes for the securities and futures industries. The Banking (Amendment) Bill 2000 was introduced into the Legislative Council at the same time, proposing parallel changes relating to the supervision of exempt authorized institutions (i.e. exempt dealers under the current legislation). The objective is to achieve consistency with the supervisory regime for securities firms proposed under the Securities and Futures Bill.

The Legislative Council Bills Committee began to vet the two bills in December 2000. The HKMA continues to work closely with the Administration and the Bills Committee to seek the early enactment of these bills.

Supervision of institutions' mandatory provident fund business

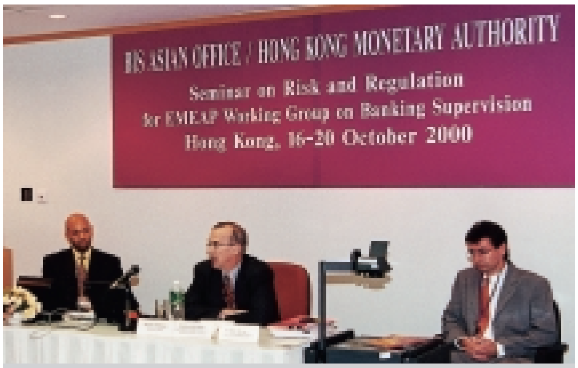
Under the Memorandum of Understanding entered into with the Mandatory Provident Fund Schemes Authority (MPFA), the SFC and the Insurance Authority, the HKMA is responsible for supervising the MPF-related activities of authorized institutions. During 2000, a special team was established for this purpose. A total of 23 on-site examinations were conducted to assess whether the internal control systems of the institutions examined were adequate to meet the standards prescribed in the Code of Conduct for MPF Intermediaries issued by the MPFA. A new "Return of Mandatory Provident Fund Related Activities" was also introduced to collect information on the MPF-related activities of authorized institutions on a half-yearly basis.

Relationships with other supervisors

The HKMA continued to maintain a close working relationship with other supervisors both in Hong Kong and abroad. During the year, overseas visits or bilateral meetings were arranged with regulators in the USA, the UK, Belgium, Germany, Singapore, Japan, Taiwan, Indonesia and Macau. Regular meetings were also held with the People's Bank of China to discuss matters of common interest.

The HKMA also continued its participation in a number of regional and international forums for banking supervisors. These include the Core Principles Liaison Group and the Electronic Banking Group established by the Basel Committee on Banking Supervision, the EMEAP Working Group on Banking Supervision, the Offshore Group of Banking Supervisors, the APEC Financial Regulators' Training Advisory Group 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.

In October 2000, the HKMA and the BIS Asian Office jointly organised a seminar on risk and regulation for members of the EMEAP Working Group on Banking Supervision in Hong Kong. This seminar, which was conducted by the BIS Financial Stability Institute, attracted 20 representatives from 13 supervisory authorities in the EMEAP economies.



Deputy Chief Executive David Carse (centre) chairs an HKMA/ BIS Asian Office joint seminar on risk and regulation for the EMEAP Working Group on Banking Supervision.

Banking reform

Since the HKMA embarked on the banking reform programme announced in July 1999 following the Banking Sector Consultancy Study, a number of policy initiatives have been carried out as planned. These initiatives are aimed at promoting market liberalisation and competitiveness in the banking sector and strengthening banking infrastructure with the objective of enhancing the safety and soundness of the sector.

Measures to enhance competitiveness

(a) Access to Real Time Gross Settlement

In May 2000, the legal arrangements were finalised to allow restricted licence banks with a clear business need to join the Real Time Gross Settlement (RTGS) interbank payment system.

(b) Interest rate deregulation

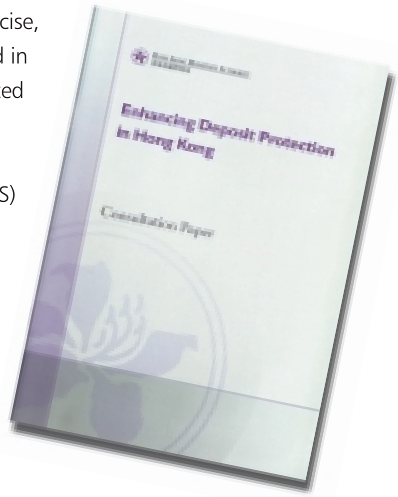
The first phase of deregulation of the remaining Interest Rate Rules (IRRs) took effect on 3 July 2000. This involved the removal of the interest rate cap on time deposits with a maturity of less than seven days, thereby completely deregulating the interest rates on time deposits.

The first phase of deregulation of the remaining IRRs produced a calm response. Some banks introduced new overnight deposit accounts that pay interest above the savings account rate. But there was no large-scale migration of funds from savings to overnight call accounts. This was not unexpected given that the newly deregulated time deposits constituted only a small fraction of total Hong Kong dollar deposits. Moreover, banks have had a reduced incentive to bid actively for deposits, given the ample liquidity in the banking system during the period. According to the self-assessments conducted by 44 major banks earlier in 2000, the final phase of deregulation, which is expected to take place in July 2001 and involves the removal of the IRRs on savings and current accounts, may have a more significant impact.

Measures to enhance safety and soundness

(a) Enhancing deposit protection

One of the key measures aimed at promoting the safety and soundness of the banking system was to re-examine the possibility of enhancing deposit protection in Hong Kong. The HKMA commissioned Arthur Andersen to carry out a Consultancy Study, and then issued a consultation paper for public consultation in October 2000. The consultation paper examined various options for deposit protection: maintaining the current system under which small depositors have priority claims in a liquidation of a failed bank; enhancing the priority claims system; or introducing an explicit deposit insurance scheme. Explicit insurance schemes are increasingly being introduced around the world and are advocated by a number of international bodies.



The consultation exercise, which was completed in January 2001, indicated broad support for introducing a deposit insurance scheme (DIS) in Hong Kong, although some large banks have expressed opposition. In addition, a motion supporting the introduction of a DIS was debated and passed in the Legislative Council in December 2000. There is general consensus that, if a DIS is to be implemented, issues of moral hazard, fairness, cost and effectiveness should be thoroughly addressed: the HKMA has received various suggestions in this regard.

(b) Commercial credit reference agency

Another major initiative arising out of the reform programme was to study the case for the establishment of a commercial credit reference agency (CCRA), which would gather and collate information from participating institutions about the indebtedness and credit records of their corporate customers. This would enable lenders to obtain a more complete picture of the credit worthiness of their customers, and thus improve their credit assessment. Public consultation on the subject was carried out between July and September 2000. The results indicated broad support from the banking industry and other sectors of the community for establishing a CCRA. There was also general agreement that the scheme would benefit small and medium sized enterprises in terms of improving their transparency, which could facilitate greater access to funding. Accordingly, the HKMA has convened a Working Group comprising representatives of the banking and corporate sectors as well as other relevant public organisations to pursue further the detailed arrangements for the establishment of a CCRA in Hong Kong.

Code of Banking Practice

In July 2000, the HKMA convened an Informal Working Group comprising representatives of HKAB and the DTCA to undertake a review of the Code of Banking Practice, which was first promulgated by the two associations with endorsement by the HKMA in July 1997. The scope of the review includes credit card services, the use of debt collection agencies, e-banking and the provision of account and loan services.

One of the first issues reviewed by the Working Group was the practices of authorized institutions in relation to credit card services. After a detailed review and consultation with the banking industry and the Consumer Council, the Working Group produced a set of recommended practices aimed at enhancing the fairness and transparency of the terms and conditions of credit card agreements, which became effective on 15 January 2001. Authorized institutions have been asked to implement these practices as quickly as practicable.

Financial disclosure

During the year the HKMA continued its efforts to improve the standards of financial disclosure by authorized institutions. In June, the recommendations on interim financial disclosure by locally incorporated institutions were updated to include the disclosure of balance sheet information. The disclosure of credit risk weighted amounts and replacement costs of contingent liabilities and commitments, exchange rate contracts, interest rate contracts and other derivatives was also introduced.

In December 2000, the HKMA issued an updated *Guideline on Financial Disclosure by Locally Incorporated Authorized Institutions*. Among the changes, authorized institutions have been required to disclose in their annual accounts concentration risks including geographical concentration of income, profit/loss, assets, liabilities and contingent liabilities and commitments; geographical concentration of loans and advances; and foreign currency exposures. Similar updates were incorporated into the disclosure recommendations for overseas incorporated authorized institutions.

Electronic banking

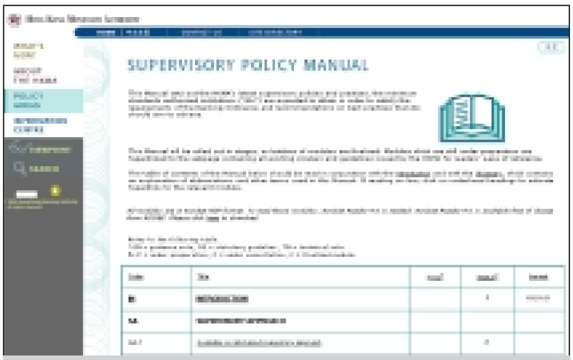
Over twenty banks and banking groups in Hong Kong have now introduced Internet banking services. The HKMA aims to keep the regulatory framework up-to-date with the rapid developments in this area. During the year, a specialist team of e-banking examiners was established and a series of technical briefings was arranged for supervisory staff. The HKMA also appointed an external consultant to develop an on-site examination programme focusing on e-banking activities and electronic data processing controls.

In May, the HKMA issued a *Guideline on Authorization of Virtual Banks*, aimed at banks that deliver banking services wholly or primarily through the Internet or other electronic delivery channels. The main principle is that the HKMA does not object to the establishment of virtual banks in Hong Kong provided that they can satisfy the same prudential criteria that apply to conventional banks.

Management of security risks in e-banking services is essential to protect personal information and the assets of customers, as well as to safeguard the financial position and reputation of banks that provide such services. In this regard, the HKMA issued Guidance Notes on *Management of Security Risks in Electronic Banking Services* and *Independent Assessment of Security Aspects of Transactional e-banking Services* in July and September 2000 respectively. The second of these Guidance Notes further clarifies the requirement for authorized institutions to commission periodic independent assessments of the security aspects of their e-banking services.

Supervisory Policy Manual

In July 2000 the HKMA commenced development of a Supervisory Policy Manual to reflect its latest banking supervisory standards and practices. This project is intended to support the risk-based supervisory approach being implemented by the HKMA. In order to enhance the transparency of the HKMA's supervisory policies, readers are able to access the Manual on-line through the HKMA's website.



The HKMA's Supervisory Policy Manual is available on the HKMA's website.

In developing the Manual, the HKMA is drawing on its existing guidelines, circulars, examiners' manuals and the supervisory experience of its staff. In addition, reference is being made to international standards, particularly those promulgated by the Basel Committee on Banking Supervision, guidelines of overseas banking regulatory authorities and suggestions from the banking industry.

Prevention of money laundering

The Organised and Serious Crimes (Amendment) Ordinance 2000 came into operation on 1 June 2000. Among other things, the Ordinance requires remittance agents and money changers to keep records of customers' identity and particulars of remittance and exchange transactions of $20,000 or more or of an equivalent amount in any other currency. To reflect this legislative amendment, the HKMA revised its *Guideline on Prevention of Money Laundering* to require authorized institutions to adopt the $20,000 threshold for remittance and currency exchange transactions undertaken for non-account-holders. This is to ensure that the anti-money laundering standards of the banking sector are in line with overall Government policy to combat money laundering activities.

A comprehensive review and revision of the guideline is planned for 2001.

Banking Amendment Bills

Two Banking Amendment Bills were prepared in 2000. As noted above, the first Bill – the Banking (Amendment) Bill 2000 – proposes changes to the Banking Ordinance corresponding to the new licensing regime for securities firms being introduced under the Securities and Futures Bill.

The second Bill – the Banking (Amendment) Bill 2001 – proposes to amend the Banking Ordinance in order to keep the HKMA's supervisory regime abreast of recent developments. The main legislative proposals aim to update and strengthen the supervisory regime in relation to authorized institutions' places of business, appointment of senior management and advertisements for deposits through the Internet.

The Bills are currently being examined by the Legislative Council.

Plans for 2001 and beyond

Banking reform

During 2001, the HKMA will mainly focus on following up the reform measures initiated in 2000. This will include deregulation of the remaining Interest Rate Rules, a review of the three-building condition that applies to foreign banks licensed after 1978 and further consideration of the DIS and the CCRA.


Deputy Chief Executive David Carse speaks at the Asian Banker Summit 2000 held in Hong Kong on "Recreating the Financial Services Industry for the New Economy: A Regulator's Perspective".

(a) *Interest rate deregulation*

In the final phase of deregulation of the IRRs, the interest rate cap on savings accounts and the prohibition of interest on current accounts are due to be removed at the beginning of July 2001, providing that the prevailing economic and financial conditions are not unfavourable. As the HKMA has emphasised on a number of occasions, the deregulation of interest rates will entail not only opportunities but also challenges for the Hong Kong banking industry. Banking competition may intensify after the change and the net interest margin could be affected by a rise in funding costs. Banks will attempt to offset this impact by increasing fees and charges and introducing tiered interest rates. The actual impact will however depend on the prevailing market conditions: if the supply of deposits remains ample, banks will have less incentive to bid aggressively for deposits. Despite this, some banks may use deregulation as an opportunity to try to gain market share and to attract new customers by offering new deposit products with an attractive interest rate. Since competition may increase and the risk profile of banks may change after the deregulation, the HKMA has implemented a risk-based supervisory regime that takes a proactive approach to assessing whether banks have taken account of the various risks in formulating their business strategies.

(b) *Three-building condition*

During the year the opportunity will be taken to consider a further relaxation of the restriction on the number of buildings from which foreign banks licensed since 1978 may operate. In September 1999 the restriction was relaxed from one to three buildings. No banks have so far availed themselves of this opportunity. This raises the question of whether the restriction continues to serve a useful purpose. Further relaxation of the restriction, or its complete removal, will therefore be considered.

(c) *Establishment of a deposit insurance scheme*

Further consideration will be given to the establishment of a DIS. If the Government decides that, in principle, a DIS should be established, the HKMA will carry out further study and consultation on the detailed design of the scheme, covering, inter alia, the assessment of insurance premia, the appropriate size of the insurance fund and the organisational arrangements of the scheme. Given the detailed work that would be required and the need to enact supporting legislation, it is expected that the earliest time for the introduction of a DIS in Hong Kong would be 2002.

(d) *Commercial credit reference agency*

The Working Group will consider a number of issues concerning the detailed design of a possible scheme, including the ownership structure of the CCRA, whether participation by authorized institutions should be mandatory or voluntary, what type of information the CCRA should collect and how it should be regulated. As with the DIS, it is likely that legislation will be needed to set up the arrangements for the CCRA.

Electronic banking

The HKMA will continue to enhance its supervisory framework on e-banking in line with the international sound practices, including those being developed by the Basel Committee on Banking Supervision. Particular attention will continue to be focused on the security aspects of banking services offered through electronic delivery channels particularly the Internet. During 2001, the HKMA will also prepare a guideline on the use of the Internet to advertise for deposits subject to the passage of the relevant provisions in the Banking (Amendment) Bill 2001. It will also commence its on-site examination of e-banking activities and electronic data processing controls of authorized institutions.

Consumer protection

As already noted, deregulation of interest rates is likely to lead banks to increase fees and charges for banking services. This is part of a global trend, as banks try to increase non-interest income. While the HKMA does not regulate fees and charges, we have a strong interest in ensuring that the pricing structure of banks is transparent and that customers are given sufficient notice of any fee adjustments. The relevant provisions in the Code of Banking Practice will therefore be strengthened to this effect. The HKMA also considers that, while banks are free to determine their charging policy, they should be sensitive to the impact of increases in charges on small account holders and the disproportionate effect that such charges can have on the more vulnerable members of the community. In a number of other economies, this issue has been addressed through the provision by banks of a basic banking service on which the fees are low or non-existent. Such a solution may also be appropriate for Hong Kong, although whether any official action is required to implement it will depend on the actual impact of deregulation and initiatives taken by the banks themselves.

The changing competitive environment and the growing involvement of the banking industry in a broader range of financial products and services raises the question of the HKMA's involvement in consumer issues. Although the HKMA already plays a role in this area, as witnessed by its involvement in the preparation of the Code of Banking Practice, it is still predominantly a prudential regulator. Nor does the Banking Ordinance give a clear mandate to the HKMA to function as a "consumer watchdog". As a result of the developments referred to above, the HKMA intends to review during the course of 2001 whether it should play a more explicit role in regulating the way in which authorized institutions conduct business with consumers. In doing so, it will work closely with the Financial Services Bureau. In considering the way forward on this issue, the HKMA will need to take into account the resource implications and whether an enlarged role in consumer issues might conflict with the HKMA's responsibilities for prudential supervision of banks.

New Capital Accord

The Basel Committee released the second consultative package on the New Accord in January 2001. The consultation period on the latest proposals will last until the end of May 2001, with a view to finalisation by the end of the year. The current package has modified and substantially expanded the contents of the first consultative paper issued in June 1999.

The New Accord is intended to align regulatory capital requirements more closely with the key elements of banking risks and to provide incentives for banks to enhance their risk measurement and management capabilities. This will involve major changes to the existing 1988 Accord. For example, the OECD-based risk-weighting system will be replaced by a standardised approach that uses external credit assessments. In addition, there will be explicit capital requirements for operational risk. Sophisticated banks will have the option of developing an internal ratings-based (IRB) approach as an alternative to the standardised approach.

The proposed capital framework will have implications for banks in terms of their capital adequacy ratio, competitive position and funding costs. The HKMA will assess these implications in detail and ensure that the views of the local banking industry are fully taken into account before passing on comments to the Basel Committee at the end of the consultation. Apart from seeking the views of the two industry Associations, the HKMA will re-activate the joint industry-HKMA working party on the New Accord to discuss specific aspects of the latest proposals and conduct impact analysis on a number of local banks to determine the possible impact of the New Accord on their capital requirements.

In line with its policy of adopting international best practices and standards, the HKMA will aim to implement the New Accord in Hong Kong according to the timetable set by the Basel Committee (i.e. in 2004). While it is expected that most locally incorporated institutions in Hong Kong will, initially at least, use the standardised approach to calculate capital requirements, some may wish to use the IRB approach. The HKMA's intention would be to allow for this option in the revised capital adequacy framework. Implementation of the New Accord will require extensive work on the part of both the HKMA and authorized institutions in the period leading up to 2004.

Supervisory Policy Manual

The work on developing the Supervisory Policy Manual will continue throughout 2001. In the course of preparing the Manual, the HKMA will take into account any new supervisory standards or practices promulgated by the Basel Committee on Banking Supervision. To cater for this, the HKMA will be flexible about the completion timetable and may, where necessary, introduce new modules or revise existing modules to enhance its regulatory framework or approach on a continuing basis.

Risk-based supervision

The risk-based supervisory approach pursued in 2000 focused mainly on the local banks. The HKMA intends to extend this to foreign bank branches in 2001. Risk-focused examinations will continue to be conducted in conjunction with other efforts to enhance the existing supervisory process. This will include, among others things, revision of the existing on-site examination manual to incorporate the risk-focused examination approach and the development of a new supervisory policy manual. A feasibility study will also be carried out to consider whether a computerised on-site examination programme should be developed to further standardise the examination approach and enhance efficiency. In addition, more training will be provided to staff to equip them with the necessary supervisory knowledge and skills.

Overseas examinations

The economic recovery and improvement in the financial position of the local banking sector will enable the HKMA to refocus part of its resources to overseas on-site examinations of the branches of locally incorporated authorized institutions in 2001. Altogether, 17 examinations involving some ten overseas markets have been scheduled for the year.

Asset quality of banks

While the profitability of banks improved in 2000, continuing vigilance over banks' asset quality is still needed. This is particularly so given the slowdown in the US economy and its impact on borrowers whose businesses depend heavily on the US market. Further supervisory effort will be devoted to ensuring that banks' underwriting standards for loans are not compromised through intense competition for business and the subdued demand for loans. Consequently, asset quality will continue to be a main supervisory focus for 2001.

Enhanced supervision of institutions' securities business

Depending on the outcome of the legislative process, the HKMA will make detailed preparations for implementing the new regulatory regime set out in the Securities and Futures Bill and the Banking (Amendment) Bill 2000.

For its on-going supervision, the HKMA will continue to conduct specialised on-site examinations of the securities business of exempt institutions. In addition to ensuring regulatory compliance and adequacy of operational controls, the HKMA will focus on the systems and controls relating to the on-line securities trading systems of institutions.

Supervision of institutions' MPF business

The commencement of Mandatory Provident Fund Schemes in Hong Kong has created new business opportunities for the banking, insurance and investment industries. Since the market is highly competitive, some service providers may not be able to achieve the necessary business volume to sustain profitability. Apart from MPF intermediary activities, some authorized institutions are involved in the provision of guarantees on the investment return of MPF products. The HKMA has issued guidelines on the provisioning and capital charge requirements in respect of such guarantees issued by individual institutions. The HKMA will continue to monitor the MPF business of individual institutions to determine that the code of conduct and guidelines issued by the MPFA and the HKMA have been followed.

Industry consolidation

The challenges posed by increased competition, globalisation, technological change and greater demand for sophisticated services by customers are likely to increase the pressure for structural change in the Hong Kong banking system. As has been the case with other banking systems, smaller banks will need to consider whether they have a viable future as stand-alone entities or whether they should try to combine with one another to achieve economies of scale and broaden income sources. A further option is to be taken over by a larger institution. While this process has been slow to develop in Hong Kong, there were signs of a quickening pace of industry consolidation in 2000. This trend can be expected to continue. While this is primarily a commercial decision for individual institutions, the HKMA will do what it can to facilitate the process. In particular, it will keep the regulatory regime under review to ensure that it is appropriate to market conditions and does not stand in the way of industry consolidation. The HKMA will also try to ensure that applications for bank mergers or acquisitions are handled in an expeditious manner.