

Banking Stability



One of the main policy objectives of the HKMA is to promote the safety and stability of the banking system through the regulation of banking and deposit-taking business and the supervision of authorized institutions. A key issue in 2002 was the sharp increase in the number of personal bankruptcies. In response to this problem, the HKMA stepped up its supervision of consumer lending, particularly in the credit card business, with a view to mitigating the credit risk faced by authorized institutions. The HKMA worked closely with the banking industry and the Privacy Commissioner to reach agreement on the sharing of positive consumer credit data. Good progress was also made on finalising the detailed features of the deposit protection scheme.

OBJECTIVES

Responsibility for promoting the safety and soundness of the banking system is shared among three departments within the HKMA:

- The *Banking Supervision Department* handles the day-to-day supervision of authorized institutions (AIs)¹
- The *Banking Policy Department* formulates supervisory policies to promote the safety and soundness of the banking sector
- The *Banking Development Department* formulates policies to promote the development of the banking industry.

PROGRESS AND ACHIEVEMENTS IN 2002

Operational supervision

The HKMA conducted 285 on-site examinations of AIs' operations in 2002, including 62 risk-focused, 32 tier-two money laundering, 11 treasury and ten securities examinations. The increase in on-site examinations (up from 232 in 2001) reflected the additional resources required to conduct 34 short but focused examinations of AIs' credit card and personal loan operations in the light of the worsening personal bankruptcies situation. Furthermore, with e-banking services becoming more popular, the HKMA established two specialised examination teams, which conducted 30 e-banking and IT related examinations and 20 on-site reviews of AIs' business continuity planning during the year.

In 2002, the HKMA strengthened its supervision of the anti-money laundering procedures of AIs by establishing two levels of examinations. Tier-one examinations conducted by the regular teams cover high-level reviews of controls, while

two specialist money laundering teams handle tier-two examinations covering more thorough checking of the actual implementation and effectiveness of the laid down procedures. In 2002, the teams conducted 32 tier-two money laundering examinations and 73 tier-one examinations as part of general examinations.

The number of tripartite meetings conducted in 2002 remained the same as in 2001, but the number of off-site reviews was slightly lower owing to the reduced number of institutions resulting from mergers and acquisitions.

In order to strengthen communication with the boards of directors of locally incorporated AIs, the HKMA met the boards of 16 banks and five deposit-taking companies during 2002. Both the HKMA and the boards concerned found this arrangement very useful in improving their understanding of the financial position, state of affairs, and strategic direction of the AIs.

The Banking Supervision Review Committee considered ten cases during 2002 relating to the licensing of AIs and money brokers. In addition, 318 applications to become controllers, directors, chief executives, and alternate chief executives of AIs were approved. Details of the operational supervisory work performed in 2002 are set out in Table 1.

During 2002 no AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio. One foreign bank branch breached the requirements relating to the liquidity ratio because of a technical mistake, but the breach was rectified immediately upon discovery of the problem. In addition, there were six breaches of the requirements relating to large exposures under Section 81 and eight breaches of the requirements relating to connected lending under Section 83. All these

¹ Institutions authorized under the Banking Ordinance to carry on banking business or the business of taking deposits. Authorized institutions are divided into three tiers: licensed banks, restricted licence banks (RLBs) and deposit-taking companies (DTCs).

TABLE 1 Operational supervision*

	2001	2002
1. On-site examinations including those on:	232	285
- money laundering (tier-two exams for 2002)	(58)	(32)
- treasury	(10)	(11)
- securities	(17)	(10)
- e-banking	0	(30)
- review of business continuity plans	0	(20)
- overseas examinations	(11)	(12)
2. Off-site reviews and prudential interviews	238	215
3. Tripartite meetings	78	78
4. Meetings with boards of directors of AIs	19	21
5. Approval of applications to become controllers, directors, chief executives, alternative chief executives of AIs	440	318
6. Reports commissioned under Section 59(2) of the Banking Ordinance	5	0
7. Cases considered by the Banking Supervision Review Committee	9	10

* Further details on the banking supervisory approach of the HKMA are given in *HKMA Background Brief No.2 - Banking Supervision in Hong Kong*.

breaches, which were technical and unintentional in nature, were promptly rectified and did not result in any risk to the interests of depositors or creditors. No use was made of powers under Section 52 of the Banking Ordinance during the year.

Risk-based supervision

During 2002, the HKMA made significant progress in its on-going efforts to develop and implement a risk-based supervisory approach. Major accomplishments for the year included

- (a) the implementation of an automated examination work programme to improve the quality and efficiency of on-site examinations;

- (b) the creation of a Quality Assurance Unit to ensure a high level of work standardisation and consistency; and

- (c) revisions to an internal guidance note on the CAMEL rating system² to incorporate changes resulting from the implementation of risk-based supervision.

Industry consolidation

In line with global trends, the banking industry in Hong Kong continued to consolidate in 2002. The mergers of the Bank of East Asia with First Pacific Bank and the Hongkong Chinese Bank with Citic Ka Wah Bank were completed during the year. As a result of these mergers, the number of locally incorporated banks dropped to 26 at the end of the year, comprising four large and 15 small or medium-sized banks/banking groups.

Taxi loans

During 2002 the HKMA continued to monitor closely the quality of AIs' taxi loan portfolio. Quarterly surveys were conducted of a group of active lenders and two taxi associations regarding the licence value, income level of taxi operators, and problem loan level. Although the operating income of taxi operators edged down by about 10% during the year, the licence value remained stable and the servicing capability of the operators held up quite well, owing to the low interest rate level. The proportion of overdue and rescheduled taxi loans (for both urban and New Territories taxis) improved from 2.88% to 1.68% during the year. The HKMA will continue to keep a close eye on the situation, since the income level of taxi operators is likely to remain low in the current economic conditions.

² An internationally recognised framework for assessing the Capital adequacy, Asset quality, Management, Earnings and Liquidity of banks.

Asset quality

With the low level of interest rates and actions taken by banks proactively to manage their problem loans, their average classified loan ratio declined from 6.53% to 5.05% during the year, helping to boost the overall asset quality of the retail banks in 2002. The quality of the corporate loan and residential mortgage loan portfolios continued to hold up well, although the quality of the credit card portfolio deteriorated sharply.

Credit card business and personal bankruptcies

Rising unemployment and the slow economy caused the bankruptcy situation to worsen sharply in 2002. The number of petitions for bankruptcies doubled from 13,186 in 2001 to 26,922 in 2002. This had a significant impact on the quality of the personal loan and credit card portfolios of AIs. In response to this problem, the HKMA requested AIs to exercise greater caution in conducting their credit card business.

According to the HKMA's survey on credit card lending, total credit card receivables and the total number of credit card accounts declined by 4.5% and 1.3% respectively during the year.

Banks also adopted more conservative accounting policies by charging off credit card receivables at the time when a borrower filed a bankruptcy petition rather than waiting until the granting of a bankruptcy order. Reflecting the more difficult operating environment, the annualised charge-off ratio on credit card receivables rose sharply during the year to 13.25%, compared with 5.46% for 2001. At the end of 2002, the delinquency ratio (i.e. the value of credit card receivables overdue for more than 90 days as a percentage of total credit card receivables) remained unchanged at 1.28% compared with end 2001.

In view of the deteriorating quality of credit card receivables, the HKMA issued a circular in February 2002 setting out best practices on

credit card lending to be adopted by AIs. The HKMA also conducted two rounds of special on-site examinations of 23 card-issuing AIs to ensure these institutions adopted prudent policies and procedures in credit card lending. Meanwhile, the HKMA continued to work with the banking industry and the Privacy Commissioner on measures to allow greater sharing of positive credit data among AIs.

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Residential mortgage lending

According to the HKMA's Residential Mortgage Survey, growth of AIs' residential mortgage loans (RMLs) was modest in 2002. At the end of 2002, total outstanding RMLs stood at \$533.7 billion, an increase of 0.96% compared with the end of 2001. The market norm for the mortgage rate remained at about best lending rate minus 2.6 percentage points. In terms of asset quality, there was no sign of any material deterioration in the RML portfolios. At the end of 2002, the mortgage delinquency ratio and rescheduled loan ratio remained at the relatively low levels of 1.06% and 0.46% respectively. The low interest rate environment has helped reduce the pressure on mortgage borrowers.

The number of mortgage loans in negative equity (i.e. where a mortgaged property is worth less than the level of the outstanding mortgage loan from an AI) remained an issue of concern. The results of the HKMA's survey showed that about 78,000 cases or 16% of the total number of RMLs were in negative equity at the end of 2002. With an average loan-to-value ratio of about 127%, the unsecured portion of these loans was estimated to be about \$28 billion or about 5% of the total RMLs of the banking sector. In October 2001 the HKMA announced that it would not object if institutions, should they judge it commercially desirable, were to refinance RMLs in negative equity up to 100% of the current market value of the mortgaged

properties. During 2002 the Hong Kong Mortgage Corporation (HKMC) and a private-sector company each launched schemes to enable homeowners in negative equity to refinance their mortgages up to 140% of the current market value of the mortgaged property. This has been helpful in alleviating the financial burden of eligible homeowners. During its discussions with individual AIs, the HKMA also encouraged AIs to adopt a sympathetic approach towards negative equity homeowners seeking loan restructuring.

During the year there were calls for the 70% loan-to-value guideline on RMLs to be relaxed. The HKMA issued a circular in December 2002 to make it clear that the 70% guideline was intended to limit the risk exposure of AIs rather than to restrict the amount that home buyers could borrow. In fact, various schemes in the market, such as the HKMC's Mortgage Insurance Programme and co-financing schemes offered by developers enable home buyers to borrow more than 70% of the value of the property. Separately, in view of the high level of cash rebates offered by individual developers to home buyers, the circular also made it clear that AIs were generally expected to use the discounted price (i.e. after deducting the cash rebate or other discount offered by the property developer) to determine their risk exposure for the purpose of the 70% guideline.

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Outsourcing

In line with the international trend, many AIs in Hong Kong have outsourced their data processing and back office functions, primarily to save costs. The HKMA does not object in principle to such outsourcing arrangements and has set out in its *Supervisory Policy Manual* the relevant supervisory issues to be addressed by AIs before outsourcing. In 2002 the HKMA indicated no objection to 42 institutions outsourcing their data processing and back

office functions to service providers in Hong Kong and/or overseas.

[» Policy Areas » Supervisory Policy Manual](#)

Relationship with other supervisors

The HKMA maintains a close working relationship with other regulators in Hong Kong, including the Securities and Futures Commission (SFC), the Insurance Authority and the Mandatory Provident Fund Authority. A new Memorandum of Understanding (MoU) between the HKMA and the SFC was signed in December 2002 to reflect the need for further co-operation under the new regime for supervising AIs' securities activities as enshrined in the Securities and Futures Ordinance (SFO) and the Banking (Amendment) Ordinance 2002. The MoU replaced the previous one, signed in October 1995, and took effect on 1 April 2003. The HKMA also opened discussions with the Insurance Authority in late 2002 about the possibility of entering into an MoU to enhance supervisory co-operation in respect of the insurance business of AIs and their insurance subsidiaries.

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The HKMA meets regularly with the Police Commercial Crime Bureau to discuss commercial crimes relating to the banking industry and to consider measures that can help AIs prevent such crimes. In March 2002 the HKMA circulated to AIs a set of general guidelines prepared by the Hong Kong Police to assist them in improving their security arrangements.

The HKMA also maintains a close working relationship with supervisors outside Hong Kong. During the year meetings were held in Hong Kong and overseas with regulators of the USA, the UK, Indonesia, Japan, Taiwan, Bahrain, Malaysia and Macau to discuss supervisory issues of common interest. Regular meetings were also held with the People's Bank of China to discuss supervisory and other issues relating to the development of the financial markets in Hong Kong and on the Mainland.

Banking reform

During the year the HKMA continued to implement the remaining policy initiatives contained in the banking sector reform programme announced in July 1999. These initiatives are aimed at promoting market liberalisation and competitiveness in the banking sector and strengthening banking infrastructure with a view to enhancing the safety and soundness of the sector.

Measures to enhance competitiveness

(a) Relaxation of market entry criteria

In May 2002 the existing market entry criteria for licensed banks were relaxed. The asset and deposit size criteria applicable to local bank applicants (currently set at HK\$4 billion and HK\$3 billion respectively) were extended to foreign bank applicants in place of a US\$16 billion asset size criterion. The requisite period of operation as an RLB or DTC before upgrading to licensed bank was reduced from ten to three years and the “association with Hong Kong” requirement for locally incorporated RLBs and DTCs was also dispensed with.

The *Guide to Authorization* was updated to reflect these changes. The objective of the changes is to attract a broader range of domestic and international institutions to carry on banking business in Hong Kong, which is conducive to maintaining Hong Kong’s status as a leading international financial centre. Since the relaxation, nine foreign banks that did not meet the former criteria have indicated an interest in applying for a bank licence, and three of them have already submitted an application. At the same time, three RLBs have taken advantage of the relaxed criteria to apply for a full banking licence.

 » [Policy Areas](#) » [Guide to Authorization](#)

(b) Review of three-tier authorization system

In conjunction with the review of the market entry criteria, the HKMA evaluated the case for simplifying the three-tier authorization system into a two-tier system. The review concluded that the relaxation of the market entry criteria would enable more RLBs to upgrade themselves to licensed banks and eventually lead to a natural simplification of the three-tier system. Taking this into account, it was decided that the current three-tier authorization regime should be maintained while the effects of the changes to the market entry criteria worked through the system.

All the market liberalisation measures contained in the banking sector reform programme have now been implemented.

Measures to enhance safety and soundness

(a) Deposit protection scheme (DPS)

Following the Chief Executive-in-Council's approval in principle for the establishment of a DPS in Hong Kong, the HKMA has undertaken detailed studies of how the DPS should be structured. In March 2002 a second consultation paper setting out the HKMA's detailed proposals was released. Responses received during the consultation were generally supportive of these proposals.

Taking into account the recommendations of the HKMA's studies and comments received during the consultation exercise, it is proposed that the DPS for Hong Kong should have the following major features:

- (i) the scheme would be managed by an independent Deposit Protection Board whose functions would be confined to the assessment and collection of contributions, investment of funds and making payouts to depositors in the event of bank failures;

- (ii) to keep costs down, the Board would appoint the HKMA as an agent to carry out the day-to-day administration of the scheme;
- (iii) participation by licensed banks in the scheme would be mandatory;
- (iv) the coverage limit would be set at HK\$100,000 per depositor per bank;
- (v) the scheme would be funded by the banks; and
- (vi) a differential rate system based on the CAMEL ratings of individual banks would be used to assess contributions.

In collaboration with the Department of Justice and the Financial Services and the Treasury Bureau, the HKMA has produced a draft Bill for implementing the proposed DPS. The draft Bill was issued to the industry and other interested parties for consultation in December 2002.

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(b) Commercial credit reference agency (CCRA)

The Working Group convened by the HKMA recommended a CCRA scheme targeted at small and medium size enterprises (SMEs) based on voluntary participation by AIs. Following this recommendation, the industry associations formed a working party in May 2002, with participation from the HKMA, to consider how to take the scheme forward. The working party has since reached consensus on a number of important issues, including the scope of data sharing, the definition of SMEs, and the ground rules for obtaining customer consent. The working party will continue to work on the remaining details, such as selection of a vendor and a

strategy for explaining the scheme to SMEs.

Consumer credit data sharing and bankruptcy related issues

A common feature of many bankruptcies is that the person involved has often borrowed large amounts from multiple institutions. To help borrowers who are in a multiple borrowing situation, the Hong Kong Association of Banks (HKAB), the DTC Association, the Finance Houses Association and the HKSAR Licensed Money Lenders Association issued the "Hong Kong Approach to Consumer Debt Difficulties" in October 2002, which sets out formal but non-statutory guidelines on how members of the associations should deal with personal customers who have genuine difficulty in repaying consumer loans granted by financial creditors. Specifically, the Approach urges financial creditors to follow the framework and procedures laid down in the Agreement on Debt Relief Plan, endorsed by the Associations in June 2002, as a co-operative mechanism to assist borrowers in financial difficulties. The HKMA fully supports this initiative and will monitor AIs' compliance with the standards and principles recommended in the Approach.

The problem of multiple indebtedness also points to the pressing need for financial creditors to share a wider range of consumer credit data so that they can more accurately assess the overall indebtedness of borrowers. During the course of the year the HKMA worked closely with the banking industry and the Privacy Commissioner on the industry's proposal for the sharing of positive credit data. In response to the industry's proposal, the Privacy Commissioner released on 28 August 2002 a consultation paper proposing revisions to the Code of Practice on Consumer Credit Data to extend the scope of consumer credit data to be shared through credit reference agencies. Taking into account the results of the

consultation, the Privacy Commissioner issued a report on the results of the consultation in January 2003 and recommended a number of changes to the Code to effect the sharing of positive consumer credit data. The HKMA welcomes the decision of the Privacy Commissioner to allow greater sharing of credit data and believes that this will increase the transparency of credit information and contribute to the creation of a fairer and healthier credit environment. The HKMA will issue an industry guideline to require AIs that engage in consumer lending to participate in the sharing of positive consumer credit data and to have in place adequate controls to safeguard customer data privacy.

 » [Sharing Positive Consumer Credit Data](#)

Legal and regulatory framework

The Banking (Amendment) Ordinance 2001 came into operation in May 2002. The Ordinance strengthened the HKMA's supervisory regime in relation to the appointment of senior management by AIs, control over AIs' places of business and regulation of advertisements for deposits disseminated through the Internet or other new technological means.

Consumer protection

During the year, the HKMA continued to work closely with the industry associations to strengthen the mechanism for handling customer complaints and to promote AIs' compliance with the *Code of Banking Practice*.

(a) *Code of Banking Practice*

To promote self-regulation of market conduct, the HKMA has actively participated in the Code of Banking Practice Committee. The Committee, established by the industry associations, provides guidance on the interpretation of the Code and recommendations on how to improve the standard of business practices. Over the past year, the Committee has recommended that

the industry improve business practices by enhancing the transparency of charges on foreign currency credit card transactions, strengthening AIs' debt collection practices, enabling guarantors to have a choice of limited or unlimited guarantee, and improving standards of advertising tactics adopted by institutions.

To supplement the industry's efforts in self-regulation, the HKMA stepped up its monitoring of AIs' compliance with the Code by introducing a new annual self-assessment framework in 2002. The results of the first self-assessment indicated that the industry's progress towards full compliance was satisfactory. The majority (90%) of AIs achieved full, or almost full, compliance with all sections of the Code. Most AIs also reported that they had adequate internal procedures and management oversight to ensure on-going compliance with the Code. Where AIs identified non-compliance with the Code, the HKMA required them to take prompt remedial action to rectify the problem.

(b) *Efforts to tackle customer complaints*

Given that a large proportion of complaints received by the HKMA are attributable to misconduct by debt collection agencies (DCAs), the HKMA has since March 2002 required all AIs to submit a quarterly return on the number of complaints received against the DCAs that they employ. The objective of the survey is to encourage AIs to tighten up their monitoring of DCAs to ensure that they comply with the *Code of Banking Practice*. Since the survey was introduced, the number of DCA-related complaints has been on a downward trend, indicating that AIs have strengthened their oversight of DCAs' conduct.

The HKMA's Guideline on Complaint Handling Procedures came into full effect in July 2002. The HKMA has also streamlined its own complaint handling procedures and complainants are encouraged to resolve their disputes through AIs' internal procedures first before reporting to the HKMA. These procedures have resulted in a decrease in the number of complaints received by the HKMA from 976 in the first half of 2002 to 235 in the second half of the year. This seems to suggest that AIs' procedures are effective in resolving the majority of complaints. To improve customer access, contact details of AIs' complaints officers have been made available at HKMA's website.

To promote customer awareness, the HKMA has published a leaflet to advise customers on what to do if they have a complaint against a bank. This leaflet aims at helping bridge the gap between the expectations of complainants and what the HKMA can deliver under the existing consumer protection framework.

[www » Consumer Information](#)

Regulatory regime for authorized institutions' securities and Mandatory Provident Fund activities

The Securities and Futures Ordinance (SFO) and the accompanying Banking (Amendment) Ordinance 2002 were enacted in March 2002. To ensure that AIs are well prepared for the impending commencement of the two Ordinances, the HKMA issued a series of circulars to AIs providing specific guidance on individual areas and reminding AIs to make early preparation. These cover the salient features of the new regime; the key features of the register of AIs' securities staff to be maintained by the HKMA; and the subsidiary legislation and other regulatory requirements that will be applicable to AIs in respect of their conduct of securities

activities. In addition, the *Supervisory Policy Manual* module on the HKMA's supervisory approach towards AIs' securities business under the new regime was released for industry consultation in November 2002.

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Throughout the year the HKMA and the SFC co-operated closely to prepare for the new regime. In addition to the revised MoU, the HKMA and the SFC also formed a working group to discuss the procedures for the implementation of the primary and subsidiary legislation as well as the codes and guidelines applicable to AIs' securities business. Within the HKMA, the main preparatory work for the new regime during the year was the development of the electronic register of AIs' securities staff. An external consultant was hired for the purpose and the system development work was substantially completed in 2002.

During the year the HKMA continued to conduct close supervision of AIs' securities business. In view of the first retail launch of hedge funds and the growing involvement of AIs in the retail marketing of collective investment schemes, the HKMA issued a circular in November 2002 reminding AIs of the expected marketing practices. During the examinations performed by the specialist securities examination teams, the HKMA has placed emphasis on the quality and conduct of institutions' staff in selling various investment products.

The HKMA is also responsible for supervising the Mandatory Provident Fund (MPF)-related activities of AIs. During securities examinations, the HKMA ascertains the adequacy of AIs' internal control systems for compliance with regulatory requirements and ensuring the fitness and propriety of those staff carrying out MPF intermediary activities. The HKMA also

monitors AIs' on-going adherence to provisioning and capital charge requirements in respect of the guarantees they provide for the investment return of MPF products.

Electronic banking and technology risk management

Recognising the growing acceptance of e-banking and the increasing dependence of AIs on the use of technology, the HKMA strengthened its supervisory framework in this area in 2002. To assist supervisory staff in assessing the level of technology-related risk of AIs, the HKMA compiled technology risk profiles of over 60 AIs.

In response to the HKMA's recommendation, HKAB established in December 2002 an Electronic Banking Working Group, which comprises representatives of the HKMA, the Hong Kong Police Force and the banking industry, to consider a number of industry-level initiatives in promoting consumer awareness of e-banking and Internet security.

During 2002 the HKMA continued to share its experience in supervision of e-banking and technology risk management with overseas counterparts through various international or regional forums, including the e-banking Group of the Basel Committee, the Committee on Trade in Financial Services of the World Trade Organisation, and the 2002 Asian Roundtable of the Internet Project Team of the International Organisation of Securities Commissions.

Business continuity planning

The HKMA reviewed the business continuity plans (BCPs) of 20 AIs in 2002. Having regard to the results of these reviews and the BCP guidance developed by the international regulatory community, the HKMA issued a comprehensive and detailed guidance note on BCPs to AIs in December 2002. The guidance note sets out the HKMA's supervisory approach to BCP and the sound practices that AIs should adopt in this area.

Prevention of terrorist financing and money laundering

The HKMA stepped up its supervisory efforts in combating terrorist financing and money laundering during the year. A two-tier on-site examination approach was adopted in the second quarter. In June 2002 briefing sessions were held for the senior management, compliance and internal audit officers of all AIs with the objective of raising awareness. In September the HKMA issued a letter to all AIs requiring a report on their efforts in combating terrorist financing. Follow-up discussions were held with AIs where appropriate.

The HKMA issued a proposed Supplement to the Guideline on Prevention of Money Laundering for industry consultation in October 2002. The Supplement mainly incorporates the recommendations of the Basel Committee paper on "Customer Due Diligence for Banks" and also reflects recent developments and international initiatives in this area.

The United Nations (Anti-Terrorism Measures) Ordinance was enacted during the year and a substantial portion came into operation in August 2002. The Ordinance prohibits, among other things, the supply or collection of funds for terrorists or terrorist associates, and makes it a statutory requirement for any person to report knowledge or suspicion that any property is terrorist property. Meanwhile, the United Nations Sanctions (Afghanistan) Regulation was also amended in July 2002. The HKMA issued a number of circulars informing AIs of these legislative changes as well as the various lists of terrorist suspects published in the Gazette and designated under the US President's Executive Order.

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Development of supervisory policies

Major policy guidelines developed during the year as modules of the *Supervisory Policy Manual* include the following:

General risk management controls

This statutory guideline specifies the essential controls that the HKMA expects AIs to have in place in respect of risk management systems. It provides the basic framework upon which other guidelines on the management of particular types of risks are built.

Interest rate risk management

This guidance note sets out the HKMA's supervisory approach to interest rate risk and principles and sound practices relating to interest rate risk management. In particular, it provides guidance to AIs on effective systems for measuring, monitoring and controlling interest rate risk in the banking book. To facilitate the HKMA's monitoring of AIs' interest rate risk exposures, the Return on Interest Rate Risk Exposures was revised (to be implemented in December 2003).

Stress testing

In the light of the increasing importance of stress testing as a risk management tool, this guidance note illustrates the use of stress tests for risk management purposes and describes the HKMA's approach to evaluating the appropriateness and effectiveness of stress tests conducted by AIs. AIs are expected to take steps to develop their stress-testing capabilities having regard to the nature and complexity of their business activities.

Perpetual subordinated debt and paid-up irredeemable cumulative preference shares for inclusion in supplementary capital

This statutory guideline specifies the HKMA's approach to recognising perpetual subordinated debt and paid-up irredeemable cumulative preference shares as supplementary capital, including instruments that carry special features such as call options and step-ups. Relevant amendments to the Third Schedule to the Banking Ordinance were gazetted in December 2002.

Supervision of regulated activities of SFC-registered authorized institutions

This statutory guideline describes the HKMA's approach to supervising the regulated activities of AIs that are registered, or deemed to be registered, with the SFC under the SFO. The general approach is to require registered institutions to comply with standards equivalent to those applied by the SFC to licensed corporations in their regulated activities.

Leveraged foreign exchange trading

The HKMA's approach to supervising AIs' conduct in the making of unsolicited calls for the purpose of leveraged foreign exchange trading as well as appraisal of customers in this regard is set out in this statutory guideline.

Business continuity planning


This guidance note was developed in consultation with a discussion forum of banks following the incident of 11 September 2001. The note, which was drawn up on the basis of lessons learnt from the incident, sets out the HKMA's supervisory approach to business continuity planning and the sound practices which the HKMA expects AIs to take into consideration.

Complaint handling procedures

This guidance note on the operation of AIs' internal complaint handling procedures requires AIs to put in place effective procedures for the proper handling of customer complaints. AIs should investigate and deal with complaints in a fair, thorough and prompt manner.

Regulation of advertising material for deposits issued over the Internet

The purpose of this statutory guideline is to regulate Internet advertising materials for deposits. It specifies the factors the HKMA will consider when determining whether Internet advertising material for deposits is advertising material targeted at members of the public in Hong Kong and to which Section 92(1) of the Banking Ordinance applies.

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Review of financial disclosure and regulatory reporting

Financial disclosure

In continuation of efforts to improve the standards of financial disclosure by AIs, the guidelines for locally and overseas incorporated AIs were brought up to date in November with reference to international best practices and recent papers issued by the Basel Committee. The revisions in 2002 focused mainly on disclosures relating to corporate governance, and to derivatives and hedging strategies and policies. Enhancements to the disclosures on asset quality, profitability and segmental information were also introduced.

Regulatory reporting

The Working Group on Regulatory Reporting, which included representatives from the industry associations and accountancy profession, completed a comprehensive review of the regulatory returns submitted by AIs, taking into account latest policy developments and reporting requirements of the Bank for International Settlements (BIS) and the International Monetary Fund (IMF). The review resulted in a reduction in AIs' reporting burden while improving the accuracy, consistency and usefulness of reporting. The revised returns will be effective for the reporting of positions at end-March 2004 with the exception of certain deletions of returns and reductions in reporting frequency that took immediate effect upon issuance of the package in November.

Core Principles assessment

In 2002 the HKMA completed a self-assessment of the current supervisory regime against the *Core Principles for Effective Banking Supervision* based on the detailed criteria issued by the Basel Committee in 1999 (the first self-assessment was conducted in 1997 after the *Core Principles* were published by the Committee). The *Core Principles* represent an important set of international standards for prudential regulation and supervision of banks.

The results of the HKMA's self-assessment, which were reviewed by the IMF mission as part of the Financial Sector Assessment Programme on Hong Kong in late 2002, confirm that the banking regulatory system and supervisory practices in Hong Kong are strong, with a high degree of observance of the *Core Principles*.

International supervisory developments

New Capital Accord

During 2002 the HKMA continued to monitor developments relating to the Basel New Capital Accord and to participate in international and regional forums (such as the Core Principles Liaison Group and the Executives' Meeting of East-Asia Pacific Central Banks (EMEAP)) to discuss issues relating to the calibration of the New Accord and potential problems arising from cross-border implementation. The HKMA also reviewed and consulted the industry on several papers released by the committee in the year. In October 2002 the Basel Committee launched a third Quantitative Impact Study (QIS 3) to assess the potential impact of the latest calibration on banks' capital requirements before finalising the proposals. The HKMA invited a representative

sample of banks to participate in QIS 3, and attended various workshops and meetings organised by the Basel Committee to facilitate the process. Data submitted by the participating banks will form the basis for a detailed assessment of the implications of the latest proposals for the Hong Kong banking sector.

Revision of loan classification system

As part of its study of how the New Accord should be implemented in Hong Kong, the HKMA issued a consultative document in September 2002 to seek the views of the two industry associations on preliminary ideas to revise the loan classification system. These ideas reflect the HKMA's policy intentions to: (i) enhance the existing loan classification system so as to bring it more into line with the requirements for internal rating systems under the New Accord; and (ii) encourage AIs to develop or modify their internal rating systems for the purpose of improving credit risk management.

In response to the industry associations' feedback on the proposals, the HKMA confirmed that it would further consult the industry on the detailed proposals in due course, taking into account the industry's comments and subsequent changes in the Basel requirements for internal rating systems under the New Accord. The HKMA also indicated that it would determine the implementation timetable in close collaboration with the industry, recognising that some AIs might need more time to develop their internal rating systems for implementing the proposed framework.

International co-operation

The HKMA continues to participate in various regional and international forums for banking supervisors. These include the Core Principles Liaison Group and the associated Working Group on Capital established by the Basel Committee, the EMEAP Working Group on Banking Supervision, the Offshore Group of Banking Supervisors and the South East Asia, New Zealand and Australia (SEANZA) Forum of Banking Supervisors. The HKMA assumed the chairmanship of the SEANZA Forum of Banking Supervisors in January 2002 for a two-year term. The HKMA also participates in supervisory seminars organised by the BIS Financial Stability Institute (FSI). In November the HKMA, in association with the FSI, hosted a SEANZA workshop on the New Capital Accord and risk-focused supervision, which attracted 28 representatives from 15 supervisory authorities in the SEANZA economies.



Deputy Chief Executive David Carse reviews the performance of the banking sector in 2002 and outlines the HKMA's job priorities in 2003.

PLANS FOR 2003 AND BEYOND

Risk-based supervision

The HKMA will continue to develop the risk-based supervisory process to keep pace with changes in the banking industry and capture the different types of risks arising from new activities undertaken by AIs. In view of the increasing involvement of AIs in wealth management business, the HKMA will allocate resources in 2003 to enhance its supervision of these activities by developing new supervisory guidance and examination procedures for its supervisory staff. Guidelines will also be issued to AIs as and when necessary.

Insofar as insurance activities are concerned, the HKMA will seek to develop a framework to enhance its ability to supervise such activities conducted by AIs and assess the potential financial impact, if any, on the AIs brought about by their insurance subsidiaries. The HKMA will also seek to finalise its discussions with the Insurance Authority on the establishment of a MoU between the two authorities within 2003.

The Quality Assurance Unit will complete its review of the work done by the supervisory staff in the whole process of the risk-based approach. The purpose of the review is to ascertain whether the standardised documents and procedures laid down for each of the six phases of the risk-based approach have been followed by staff and whether there is any need to revise the documents and procedures to further

enhance the quality and efficiency of the risk-based approach. Further guidance will be provided to staff where necessary upon completion of the review to help the risk-based approach to bed down more firmly and ensure that the quality of work done by staff is of a high standard.

Asset quality

With the outlook of the local economy and personal bankruptcy situation remaining uncertain, the quality of consumer lending portfolios will continue to be a major supervisory focus in 2003. Specifically, focused examinations will be conducted in early 2003 to ensure that AIs involved in credit card business continue to adopt prudent card issuing policies and effective portfolio management tools to manage the risk of the portfolio. The HKMA will also monitor carefully the trend of the delinquency ratio for the residential mortgage portfolio.

Industry consolidation

With an increasing number of locally incorporated banks involved in mergers and acquisitions during the past few years, the number of local banks has decreased. The merged institutions have posed a greater competitive pressure on the small- and medium-sized banks. It is important for these smaller institutions to assess carefully the way forward for their business strategies and to explore the potential for merger and acquisition as a means to safeguard their long term growth and market positioning. The HKMA will continue to encourage and facilitate the industry consolidation process, and will process merger and acquisition cases expeditiously.

Banking reform

During 2003, the HKMA will continue to focus on the establishment of the DPS and the CCRA.

(a) Deposit protection scheme

Taking into account comments received during the consultation exercise, the HKMA will refine the draft Bill for implementing the DPS. The intention is to introduce the Bill to the Legislative Council in the first half of 2003. If the Bill is enacted by the end of 2003, the Deposit Protection Board will be established in the first half of 2004 for the scheme to be in operation in 2005.

(b) Commercial credit reference agency

The HKMA will continue to participate in the industry working party to finalise the implementation of the scheme and solicit participation in the scheme by AIs and SMEs. Major tasks ahead include identification of an appropriate service provider and systems development to support the sharing of commercial credit data. The HKMA will issue a formal supervisory guideline to AIs on the use and protection of commercial credit data. It is envisaged that the scheme could be rolled out in the latter part of 2003 and be in full operation around mid-2004.

Consumer credit data sharing

A key focus of the HKMA in 2003 will be to ensure comprehensive participation by AIs active in consumer lending in contributing and making use of positive consumer credit data and the maintenance of sufficient controls by these AIs to safeguard the privacy of customers' data. This will be achieved by issuing industry guidelines to AIs and enforcing compliance by ongoing supervision and monitoring.

As suggested by the Consumer Council, the HKMA will also monitor certain indicators to assess the benefits arising from the sharing of positive consumer credit data, including more differentiation in interest rates, reduction in default rates, and reduced level of over-indebtedness.

Consumer protection

Through the Code of Banking Practice Committee, the HKMA will continue to promote self-regulation and improvement in the standard of banking practices. In terms of monitoring compliance with the Code, the second annual self-assessment will be conducted in the third quarter of 2003. The HKMA will evaluate the effectiveness of the self-assessment regime and keep under review whether it is necessary to further strengthen the monitoring framework or the supervision of individual AIs.

The HKMA will continue to play a role in handling complaints against AIs. It will closely monitor the trend in customer complaints, in particular those in relation to debt collection, and assess the effectiveness of the Guideline on Complaint Handling Procedures. Follow-up actions will be conducted with AIs concerned in the case of weaknesses in their complaint handling procedures. A review of the HKMA's complaint handling procedures will also be conducted to tie in with the new regime under the Securities and Futures Ordinance.

Supervision of authorized institutions' securities and MPF activities

In the light of the commencement of the new regulatory regime for the securities industry on 1 April 2003, the HKMA will deploy additional resources to perform its new statutory duties. The new functions will include advising the SFC on the fitness and propriety of AIs applying for registration with the SFC, giving consent to AIs' executive officers who are responsible for directly supervising securities business, maintaining the public register of AIs' securities staff, and exercising disciplinary sanctions.

The performance of these functions will be supported by continued close co-operation with the SFC to ensure that there is essentially uniform regulation of brokers and banks in the conduct of securities activities.

To ensure proper enforcement of the new regulatory regime, the HKMA's specialised on-site examinations of the securities business of AIs will continue to focus on the quality of securities staff, the marketing and dealing practices in respect of securities, as well as compliance with the new legal and regulatory requirements. The HKMA will also collect regular information from AIs on their securities-related activities by means of a revised prudential return.

With regard to the MPF business of AIs, the HKMA will maintain its current supervisory efforts. The HKMA will also keep in view any new legal and regulatory requirements to be introduced by the Mandatory Provident Fund Schemes Authority and ensure that these will be observed by AIs in their conduct of MPF activities.

Electronic banking and technology risk management

The HKMA will develop and update its existing guidance notes on technology risk management and supervision of e-banking, taking into consideration common issues identified during on-site examinations and industry best practices. As regards supervisory activities, the HKMA plans to conduct approximately 20 on-site examinations on e-banking and general IT controls. The HKMA will also introduce an automated mechanism for AIs to conduct a self-assessment of their e-banking and technology risk management to facilitate prioritisation of the HKMA's supervisory resources.

Through the Electronic Banking Working Group of HKAB, the HKMA will continue to work with the banking industry on ways to promote consumer awareness of e-banking and Internet security.

Business continuity planning

The HKMA will continue to review the BCPs of AIs as part of its on-site examinations. To help the HKMA cover a wider range of AIs, the automated self-assessment mechanism will be used to assess AIs' BCP readiness. The HKMA will continue to participate in relevant international discussion meetings to keep abreast of the latest developments on this subject.

Prevention of terrorist financing and money laundering

The HKMA will continue to strengthen its supervisory efforts in the prevention of money laundering and terrorist financing through the two-tier on-site examination approach and the issue of specific guidance.

The proposed Supplement to the existing Guideline will be finalised and issued in spring 2003. A forum will be established for the HKMA and industry representatives to discuss practical issues in the application of the new requirements. In addition, upon completion of the Financial Action Task Force's review of the Forty Recommendations, a comprehensive revision of the Guideline will be undertaken.

Development of supervisory policies

Key policies and guidelines to be developed in 2003 will include the following areas:

- auditors' reporting requirements under the Banking Ordinance
- credit cards
- foreign exchange risk management
- management of trading in derivatives and other instruments
- liquidity risk management
- general principles for technology risk management
- general approach to supervision of e-banking.

Financial disclosure

The HKMA will continue to keep abreast of accounting and disclosure developments. Major changes or updates are not expected in 2003 pending the finalisation of Pillar 3 of the New Basel Capital Accord and the adoption of international accounting standards on financial instruments in Hong Kong, both of which would entail significant changes in disclosure requirements.

Review of liquidity regime

Since the existing liquidity regime was introduced in 1994, there have been various developments in international standards and practices relating to the liquidity risk management of banks. An objective for 2003 is to enhance the existing liquidity regime with a view to incorporating the latest international standards and best practices on liquidity risk management. In considering the revised framework for supervising liquidity risk, the HKMA will have regard to the standards set by the Basel Committee and the current risk management practices of international banks. It is expected that the revised liquidity regime will place more supervisory focus on AIs' liquidity risk management systems and controls, including their ability to conduct cash flow management and scenario analysis.

International supervisory developments

New Capital Accord

The Basel Committee announced in October 2002 that, following QIS 3, a third consultation on the revised proposals of the New Accord will be conducted in the second quarter of 2003. The Committee will then finalise the New Accord for release later in the year, allowing for its implementation by the end of 2006. In the light of the revised Basel timetable, the HKMA will further develop and consult the industry on its plan for implementing the New Accord in Hong Kong. This plan will take into account the detailed analysis of the results of QIS 3 and the implications for the Hong Kong banking sector, as well as the views of the participating banks on the latest QIS 3 proposals. The HKMA will also participate in the third consultation on the New Accord and continue to maintain active dialogue with the Basel Committee and supervisors in other countries through international and regional forums to reflect the views of the industry on issues arising from the New Accord.

International co-operation

To help promote Hong Kong's status as an international financial centre, the HKMA will continue to take an active role in international and regional supervisory forums. Apart from participating in such forums as the Core Principles Liaison Group and the EMEAP Working Group on Banking Supervision, the HKMA will continue to chair the SEANZA Forum of Banking Supervisors and will host a meeting of its members in 2003. A supervisory workshop to be jointly hosted by the HKMA and the FSI will also be held in Hong Kong in late 2003 for members of the SEANZA Forum.

