One of the largest of the mangrove trees, the *Heritiera littoralis* (or looking-glass mangrove) can withstand submergence in the sea for several hours a day and yet still grow to the height of a three-storey building. Its strong buttress roots enable it to remain upright in loose soil and strong winds. It is found throughout South-East Asia and among the islands and coastlines of the Indian Ocean and the South Pacific.

BANKING STABILITY

One of the HKMA's main policy objectives is to promote the safety and stability of Hong Kong's banking system through the regulation of banking and deposit-taking business and the supervision of authorized institutions. In 2004 the HKMA continued to prepare for the implementation of Basel II and to improve the supervisory framework for preventing money laundering and terrorist financing. Progress was made in the establishment of a Deposit Protection Scheme. The first phase of the Commercial Credit Reference Agency was successfully launched in Hong Kong. In view of banks' increasing reliance on information technology and the growing popularity of Internet banking services, the HKMA developed further its Internet banking and technology risk management supervisory framework and worked closely with the banking industry to counter Internet banking fraud.

OBJECTIVES

Responsibility for promoting the safety and soundness of Hong Kong's 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 and pursues initiatives to promote the development of the banking industry.

[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).

REVIEW OF 2004

Operational supervision

The full implementation of the risk-based supervisory approach in 2004 enabled the HKMA to deploy its supervisory resources more effectively in accordance with the assessment of the specific risk areas to which individual AIs are exposed. This has enabled the HKMA to reduce the frequency of on-site examinations of AIs that are less risky, and to devote its resources to more intensive examinations of AIs with a higher level of inherent risk. During 2004 the HKMA conducted a total of 247 on-site examinations, which included 78 risk-focused, 11 treasury, and seven securities examinations. The on-site examinations also included 36 focused examinations to assess AIs' compliance with the restrictions on personal renminbi business, which was launched in February 2004. The HKMA carried out 17 focused examinations of residential mortgage loans and 16 focused examinations of credit card operations.

The HKMA also conducted examinations of three AIs active in insurance-related activities to check their compliance with the codes of conduct governing the sale of insurance products to their customers. In view of AIs' increasing reliance on information technology (IT) and the growing popularity of Internet banking services, the HKMA's specialised examination teams conducted 24 Internet banking and IT-related examinations, of which 17 examinations also covered a review of the AIs' business continuity planning.

The implementation of the revised *Supplement to the Guideline on Prevention of Money Laundering* took effect on 31 December 2004. During 2004 the HKMA continued to focus primarily on high-level reviews of AIs' controls over preventing money laundering, and conducted 53 money laundering examinations as part of its routine examinations.

TABLE 1 **Operational supervision**

	2003	2004
1. On-site examinations	247	**247**
Including those on:		
- treasury	9	**11**
- securities	18	**7**
- e-banking	28	**24**
- review of business continuity plan	20	**17**
- review of personal renminbi business	-	**36**
- overseas examinations	9	**20**
2. Off-site reviews and prudential interviews	216	**183**
3. Tripartite meetings	77	**66**
4. Meetings with boards of directors or board-level committees of AIs	16	**8**
5. Approvals of applications to become controllers, directors, chief executives, alternative chief executives of AIs	310	**376**
6. Reports commissioned under Section 59(2) of the Banking Ordinance	5	**1**
7. Cases considered by the Banking Supervision Review Committee	12	**9**

The number of off-site reviews and tripartite meetings conducted in 2004 was slightly lower than in 2003 because the HKMA lengthened the off-site review cycle of AIs with smaller and simpler operations and redeployed the resources to handle other ad hoc duties, which included the approval of bank mergers and restructuring, and processing migration applications under the Securities and Futures Ordinance (SFO).

The HKMA continued to maintain regular contact with the boards of directors of locally incorporated AIs. HKMA staff met the boards of five banks and one restricted licence bank, and the chairpersons of the audit committees of one bank and one deposit-taking company during 2004. The HKMA and the boards concerned found this arrangement useful in strengthening communication and improving understanding of the state of affairs, financial position and strategic direction of the AIs.

The Banking Supervision Review Committee considered nine cases during 2004 relating to the licensing of AIs and approval of controllers. In addition, 376 applications to become controllers, directors, chief executives and alternate chief executives of AIs were approved. Details of the operational supervisory work performed in 2004 are set out in Table 1.

In 2004 the HKMA used the powers under Section 59(2) of the Banking Ordinance to require one AI to commission external auditors to review internal control issues and report their findings to the HKMA.

During 2004 no AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio and liquidity ratio. There were two breaches of the requirements relating to large exposures under Section 81 and two breaches of the requirements relating to connected lending under Section 83. All these 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 the powers under Section 52 of the Banking Ordinance during the year.

Special examinations

In the second half of 2004 the HKMA conducted a special examination of a bank in relation to the unauthorised distribution of funds by certain of its senior executives. The aim of the special examination was to establish the full details surrounding the incident, assess the effectiveness of the bank's risk management and control systems at the time of the incident and the improvements made since, and determine the lessons learnt. The bank's audit committee and independent non-executive directors also conducted an investigation into the incident: the results confirmed that the funds involved were not assets of the bank, its subsidiaries or any of their customers, but were beneficially owned by the bank's parent company. Throughout the examination, the HKMA maintained close contact with the parent company of the bank and its home authority. At the request of the HKMA, the bank initiated an open, global recruitment process to identify suitable replacements for the positions vacated by various senior executives following the incident. The relevant appointments were announced by the bank before the end of the year.

In the light of this incident the HKMA carried out examinations of several other AIs to assess the effectiveness of their controls of similar accounts maintained by the head offices or parent banks. We identified certain weaknesses in the controls exercised by these AIs and required them to take appropriate remedial measures. Some of these examinations were still in progress at the end of the year.

During the year the HKMA received information from certain overseas and local authorities which suggested potential weaknesses in certain AIs' anti-money laundering procedures. In the light of this information, the HKMA conducted special reviews of the control procedures of some of these AIs and required them to take appropriate improvement measures.

Safeguarding customer assets and information

In October 2004, 83 rented safe deposit boxes at the Mei Foo branch of DBS Bank (Hong Kong) Limited were mistakenly destroyed during branch renovation work. A lesson learnt from the incident is that AIs should never underestimate the need for adequate supervisory oversight and control over outsourced operations. These operations, even though they may seem straight-forward and simple, can pose serious operational and reputation risks to AIs if they are not handled properly.

In the light of the incident, the HKMA issued a circular on 22 December 2004 requiring AIs to adhere to sound internal control principles when undertaking operations that involve customer assets. These should include ensuring sufficient planning for the operations, adequate supervisory oversight and control throughout the whole process, detailed records of customer assets (or items containing customer assets) being handled, and independent verification of the accuracy of these records.

Separately, the HKMA noticed that it was common for AIs' marketing or customer service staff to meet customers at open-plan customer service desks or in cubicles where confidential customer information might be collected and retained in hard copy form or electronic form in computers or portable computers. To safeguard the confidentiality of customer information, the HKMA also took the opportunity of the circular to remind AIs that they should have adequate data security procedures, such as computer log-on and application-specific access passwords and data encryption technology, to protect against theft and unauthorised access of computer equipment or information in open-plan areas. AIs should also have appropriate security measures, such as surveillance cameras and security guards, to monitor any unauthorised access to unattended service desks and meeting rooms.

Asset quality

The asset quality of AIs improved markedly alongside the recovery of the economy and the rise in property prices. The number of petitions for bankruptcies continued to fall, from 22,092 in 2003 to 12,489 in 2004. The delinquency ratio for residential mortgage loans improved steadily throughout the year, dropping from 0.86% at the end of 2003 to 0.38% at the end of 2004. The number of residential mortgages in negative equity fell to less than one-fifth of the peak level reached in second quarter of 2003, the lowest level since the start of the survey of mortgages in negative equity in 2001. The quality of credit card portfolios of AIs also improved substantially in 2004: the delinquency ratio dropped from 0.92% in 2003 to 0.44% in 2004, the lowest level since the start of the credit card lending survey in 1996. The annualised charge-off ratio also declined from 10.02% in 2003 to 4.73% in 2004.

> Information Centre > Press Releases > Residential Mortgage Survey

> Information Centre > Press Releases > Credit Card Lending Survey Results

Focused examinations of residential mortgage loans

In view of the considerable increase in new residential mortgage loans by AIs and renewed competition in this business, the HKMA conducted focused on-site examinations of 17 AIs that were active in mortgage loans to assess whether they were following prudent lending practices in this business. The examinations reviewed the AIs' compliance with the applicable guidelines issued by the HKMA, the adequacy of controls over equitable mortgages, and the extent of use of consumer credit data in assessing residential mortgage applications. The results of these examinations indicated that AIs generally had effective risk management procedures for their residential mortgage loan business. However, there were isolated cases of AIs breaching the 70% loan-to-value ratio guideline, and weaknesses were noted in the way in which some AIs assessed borrowers' repayment ability. Following these examinations, the HKMA issued a circular to AIs, drawing their attention to the findings and recommendations of these examinations. In particular, the circular reminded AIs to adhere to the 70% guideline.

Focused examinations of credit card business

The HKMA carried out focused examinations of AIs that were active in credit card business to review their underwriting criteria, risk management practices and use of consumer credit data in assessing credit card applications. The results of the examinations indicated that the AIs had generally put in place effective risk management systems. In the light of the findings of the examinations, the HKMA issued a circular to AIs in September 2004 asking them to continue to adhere to the relevant guidelines issued by the HKMA and the Code of Banking Practice, including the need to act responsibly in issuing and marketing credit cards.

Seminar on bankruptcy, mortgage and letter of credit frauds

There were a number of court cases in 2004 relating to bankruptcy, mortgage and letter-of-credit frauds committed against AIs. To help AIs to have a better understanding of the usual modus operandi of these types of frauds, the HKMA organised a seminar in August and invited speakers from the Department of Justice and Commercial Crime Bureau of the Hong Kong Police Force to advise AIs on what they should do to improve their documentation standards and control procedures to guard against these types of frauds, and increase the chance of a successful prosecution if AIs became a victim of such frauds.

Taxi loans and public light bus loans

The HKMA continued to monitor the market situation and asset quality of AIs' taxi loan portfolios. With the recovery of the economy, the taxi licence value increased considerably in 2004 and was close to the 1997 level towards the end of the year. The operating income of taxi operators also recorded a mild increase in the year. As a result, the overdue and rescheduled loan ratio of the taxi loan portfolio (covering both urban and New Territories taxis) of the institutions surveyed by the HKMA improved significantly to 0.28% at the end of 2004 (2003: 3.18%[2]).

In 2004 the HKMA completed the review of the Guidance Note on Taxi Financing, which had been in place since December 2000. After consultation with the industry, and taking into account developments in the taxi finance market, the HKMA issued a circular in March 2004 to map out a new set of arrangements for the monitoring of taxi financing, which also covers public light bus financing business. Under the new arrangements, individual AIs are required to put in place their own internal policies for taxi and public light bus financing. The internal policies should set out, at a minimum, the maximum permissible loan-to-value ratio, which should normally not exceed 85%, and the debt servicing ratio, the maximum loan tenor, the limit on the portfolio size, and the cash rebate arrangements. The regular survey on taxi loans was revised to facilitate the HKMA's monitoring of AIs' compliance with the new arrangements.

Personal renminbi banking business

Personal renminbi banking business has grown steadily in Hong Kong since its introduction in February 2004 (the chapter, International Financial Centre, has more details on this). Thirty-eight licensed banks in Hong Kong were offering renminbi services to their customers at the end of 2004. During the year the HKMA carried out on-site examinations of the personal renminbi business of 36 Participating Banks. The overall findings indicated a high degree of compliance with the business restrictions set out in the Agreement for Settlement of Personal Renminbi Business in Hong Kong and control effectiveness in the prevention of money laundering among the Participating Banks. Nevertheless, there was room for improvement for some Participating Banks relating to staff training on the various business restrictions, system automation for the processing of transactions, and preparation of more timely and comprehensive management information system reports on breaches of the business restrictions and suspected money-laundering transactions. Participating Banks were required to take appropriate measures to improve their systems.

[2] Adjusted from 3.30% after including the data of the lending institution added to the survey sample since January 2004.

CEPA

Since taking effect on 1 January 2004, the Closer Economic Partnership Arrangement (CEPA) has provided Hong Kong-incorporated banks with greater market access and flexibility to conduct business in Mainland China. Seven Hong Kong-incorporated banks have benefited from the lowering of the asset size requirement from US$20 billion to US$6 billion and have become eligible to establish branch operations on the Mainland. By the end of 2004, five of these banks applied, and four were given approval, to open branches on the Mainland. The relaxation of the criteria for Hong Kong-incorporated banks to conduct renminbi business has also been helpful to these banks' operations on the Mainland. By the end of 2004, two of these banks had already received the approval to conduct such business.

Following the introduction of CEPA II, the Mainland branches of Hong Kong-incorporated banks have since November 2004 been allowed to conduct insurance agent business with the approval of the relevant Mainland authorities. It is expected that this arrangement will help improve business and fee-income opportunities of the Mainland branches of Hong Kong-incorporated banks.

Supervision of AIs' securities activities

The HKMA has been working closely with the Securities and Futures Commission (SFC) in the supervision of AIs' securities activities. During the year the HKMA and the SFC held five bilateral meetings to discuss matters of common interest under the established mechanism of the Memorandum of Understanding. The HKMA also assisted the SFC in seeking views of the industry associations on the SFC's guidelines on disclosure of fees and charges relating to securities services. To strengthen supervisory co-operation and to ensure a consistent enforcement approach between the two regulators, reciprocal secondment of staff was arranged during the year. Close liaison with the SFC was also maintained at the operational level to improve understanding about each other's practices. These arrangements have facilitated skill transfer and sharing of experience at various levels in the two organisations.

During the year, 58 incidents with potential grounds for discipline were reviewed by the Event Review Committee (the committee responsible for deciding whether to open cases for disciplinary investigation) and 12 cases were opened for investigation. The Disciplinary Committee (the committee responsible for making recommendations on the exercise of disciplinary powers) considered one case on completion of the investigation during the year. Since no disciplinary grounds could be established, the case was formally closed with no further action considered necessary.

In an effort to improve the workings of the Banking Ordinance, proposed amendments have been incorporated in the Banking (Amendment) Bill 2005 to put beyond doubt the MA's power to publish the relevant facts and findings surrounding cases subject to disciplinary actions under sections 58A and 71C of the Ordinance.

> HKMA Register of Securities Staff of Authorized Institutions

Supervision of AIs' insurance-related and Mandatory Provident Fund activities

Following the signing of a Memorandum of Understanding with the Insurance Authority in late 2003, the first bilateral meeting between the two authorities was held in June 2004 to discuss current and evolving supervisory issues. To facilitate the HKMA's supervision of insurance-related activities, AIs were required to submit halfyearly returns to the HKMA on their insurance-related activities. On-site examinations were also conducted on AIs active in insurance-related business. The objectives of the examinations were to ensure the institutions' compliance with the codes of conduct governing the sale of insurance products issued by the Hong Kong Federation of Insurers and the adequacy of their risk management controls in this regard.

Following the implementation of the SFO, a revised Memorandum of Understanding was signed by the HKMA, the Mandatory Provident Fund Schemes Authority, the SFC and the Insurance Authority in 2004. The four regulators held a meeting in December 2004 to exchange views on regulatory requirements in relation to Mandatory Provident Fund intermediary activities.

Co-operation with overseas supervisors

The HKMA continued to maintain close working relationship with regulators outside Hong Kong. The Bundesanstalt fur Finanzdienstleistungsaufsicht of Germany and the HKMA signed a Memorandum of Understanding on 5 January 2004, which established a formal framework for supervisory co-operation and sharing of supervisory information. The HKMA has also been discussing with a number of overseas supervisory authorities the establishment of similar arrangements. During the year, meetings were held in Hong Kong and overseas with regulators from the Mainland, the US, the UK, Australia, Indonesia, Japan, Macau, Singapore, Switzerland, Germany and Taiwan to discuss supervisory issues of common interest.

Initial public offerings

In early 2004 some fraud cases involving the theft of initial public offering (IPO) refund cheques aroused public concern about the security of the IPO refund process. The HKMA, the SFC, the Hong Kong Police Force and the Federation of Share Registrars responded to the issue immediately and developed a number of measures to guard against similar frauds from happening. Following this, the HKMA issued a circular to all AIs in March 2004 informing them of the new measures. One of the new measures was to print part of the subscriber's identity card number on IPO refund cheques to facilitate checking by banks. The HKMA issued a circular to all AIs in July 2004 drawing their attention to the new arrangements and requiring them to ensure that their staff conduct proper verification of the payee's identity before accepting the deposit of an IPO refund cheque.

In the light of enormous public interest in the IPO of the Link Real Estate Investment Trust by the Housing Authority, the HKMA issued a circular in November 2004 drawing all AIs' attention to the supervisory requirements in relation to the IPO. Throughout the entire IPO process, the HKMA maintained close contact with the receiving banks and the SFC to ensure the smooth operation of the process.

AIs' migration applications under the SFO

Under the transitional arrangements of the SFO, AIs with deemed registration status (deemed RIs) will lose this status if they do not lodge migration applications to become Registered Institutions (RIs) by 31 March 2005. The HKMA wrote to the deemed RIs in October 2004 reminding them of the migration application requirements and deadline. By the end of 2004, 21 of a total of 90 deemed RIs had already migrated to RI status and 42 had submitted applications. The HKMA granted consent to 84 executive officers (responsible for supervising securities activities) of the RIs under the Banking Ordinance within the year.

Banking frauds through electronic channels

In view of the suspected automatic teller machine (ATM) skimming fraud cases reported in 2003, the HKMA recommended a set of precautionary measures to the banking industry and worked with the Hong Kong Police Force to tackle this form of crime. By mid-2004, all ATMs in Hong Kong were protected by appropriate measures, such as anti-skimming devices, closed-circuit television, and more frequent patrols of ATMs during and after office hours. All reported ATM skimming fraud cases were satisfactorily settled in the first quarter of 2004 and no newly reported cases have been received since November 2003. The HKMA worked with the banking industry and the Hong Kong Police Force to set up an ATM Fraud Prevention Task Force in 2004, which developed and launched a consumer education programme (including production of radio segments and posters) to heighten public awareness of ATM security.

The number of reported fake bank websites surged from eight in 2003 to 34 in 2004. The HKMA issued press statements on cases drawn to its attention to remind the public to be careful. A circular was issued in June 2004, after consultation with the banking industry, requiring AIs to introduce two-factor authentication for high-risk retail Internet banking transactions by June 2005.

Despite these actions, the HKMA received for the first time in September 2004 reports that certain customers of a bank had fallen victim to Internet banking fraud and had suffered financial losses. In the light of this, the HKMA issued a circular to the banking industry making a number of proposals to improve the security of AIs' Internet banking services, including lowering the maximum limit for unregistered third-party transfers through Internet banking. In addition, the HKMA continued to work with the banking industry and the Hong Kong Police Force to promote customer awareness of Internet banking fraud through a multi-channel consumer education programme. The programme included the issue of educational leaflets, the production of a series of TV episodes and radio segments, and the installation of an interactive educational computer programme about Internet security on the HKMA's website and at its Information Centre.

> Consumer Information > Internet Banking Safety

Supervision of Internet banking and business continuity planning

The level of public use of Internet banking continued to rise in Hong Kong in 2004. At the end of 2004 Hong Kong had around 2.5 million personal Internet banking accounts (a 39% increase from 2003) and 87,000 business or corporate Internet banking accounts (an 89% increase from 2003). In addition, the first 3G mobile banking service was launched in June 2004.

In view of the growing acceptance of Internet banking services and AIs' increasing dependence on the use of technology, the HKMA further developed its Internet banking and technology risk management supervisory framework in 2004. A module of the Supervisory Policy Manual on

Supervision of e-Banking was issued in February 2004, advising AIs to implement a number of security and control measures in relation to Internet banking. In addition, 24 on-site examinations of Internet banking and IT-related controls were conducted during the year: of these, 17 covered business continuity planning. The automated control self-assessment process was extended to 50 AIs. The AIs generally reported that their risk management controls had improved in 2004.

The HKMA continued to share its experience in the supervision of Internet banking and technology risk management with overseas bank regulators through the Electronic Banking Group of the Basel Committee.

Banking reform

During the year the HKMA continued to implement the two remaining policy initiatives contained in the banking sector reform programme: the establishment of a Deposit Protection Scheme and a Commercial Credit Reference Agency (CCRA) in Hong Kong.

(a) Deposit Protection Scheme

Following the enactment of the Deposit Protection Scheme Ordinance in May, the Hong Kong Deposit Protection Board was formed in July to oversee the project for establishing the Deposit Protection Scheme. With the assistance of the HKMA, the Board has developed a detailed project plan to implement the Scheme. In November, the draft of a return to be completed by banks for the assessment of contributions under the Scheme was issued to the industry for consultation. Work on other preparatory tasks including the development of a payout system and the specification of a set of rules governing the operation of the Scheme also began. To keep the industry informed of the progress of the project and to facilitate the exchange of views between the industry and the Board on issues of common interest, a Consultative Committee on Deposit Protection Scheme was formed in November.

(b) Commercial Credit Reference Agency

On 26 October the Hong Kong Association of Banks, the DTC Association and the HKMA held a joint press conference to announce the launch of the CCRA. The scheme, which in the first stage covers credit data of non-listed companies with an annual turnover not exceeding $50 million, has been operating smoothly since its inception on 1 November. The CCRA is an important addition to Hong Kong's banking infrastructure. It will help strengthen the credit risk management of AIs, and assist small and medium-sized enterprises with good credit history to secure bank financing.

Executive Director (Banking Development) Arthur Yuen (second from left) joins the industry associations at a press conference to launch the commercial credit reference agency.

With the enactment of the Deposit Protection Scheme Ordinance and the establishment of the CCRA, the banking sector reform programme announced in 1999 has now been fully completed (Table 2).

TABLE 2 **Hong Kong banking sector reform programme**

Measures	Details of implementation
Market reform and liberalisation measures:	
• Deregulate the remaining Interest Rate Rules in two phases, subject to the prevailing financial and economic conditions.	The first phase (for time deposits with maturity of less than 7 days) was introduced in July 2000. The second phase (for savings and current account deposits) was introduced in July 2001.
• Relax the one branch policy imposed on foreign banks.	The policy was completely relaxed in November 2001.
• Allow access to Real Time Gross Settlement (RTGS) system by restricted licence banks (RLBs).	Legal arrangements were finalised in May 2000 to allow RLBs to access the RTGS system.
• Relax the market entry criteria for obtaining a banking licence.	In May 2002 the asset and deposit size criteria applicable to local bank applicants set at $4 billion and $3 billion respectively were extended to foreign bank applicants in place of a US$16 billion asset size criterion. In addition, the requisite period of operation as an RLB or deposit-taking company (DTC) before upgrading to licensed bank was reduced from ten to three years. The "association with Hong Kong" requirement for locally incorporated RLBs and DTCs was also dispensed with.
• Consider the need for simplifying the three-tier licensing system into a two-tier system.	A review was conducted in 2001. Since 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, it was considered unnecessary to introduce any changes to the current system.
Safety and soundness enhancement measures:	
• Conduct a detailed study to enhance deposit protection.	The study was conducted in 2000. Pursuant to the enactment of the Deposit Protection Scheme Ordinance in May 2004, the HKMA is assisting the Hong Kong Deposit Protection Board to implement the Scheme.
• Clarify the HKMA's role as lender of last resort.	A policy statement was issued in June 1999.
• Improve the financial disclosure framework.	The framework was improved in 2002 and will be subject to continuous refinement.
• Develop a more formal risk-based supervisory regime.	The regime was fully implemented in 2003.
• Conduct a feasibility study on establishing a credit register for commercial enterprises in Hong Kong.	The feasibility study conducted in 2000 indicated that it was desirable to establish a CCRA in Hong Kong. The scheme was successfully launched in November 2004.
• Promote high standards of corporate governance within the banking sector.	A Guideline on Corporate Governance of Locally Incorporated Authorized Institutions was issued in May 2000 and will be subject to continuous refinement.

Consumer credit data sharing

In the first quarter of 2004 the HKMA conducted a round of special on-site examinations covering 37 AIs active in consumer lending to check if they had established appropriate controls to protect customer data privacy. Later in the year, AIs were asked to conduct a self-assessment of their compliance with SPM-IC6, which sets out the minimum standards that should be observed by AIs in sharing and using consumer credit data. The results of both exercises showed that AIs had generally established effective systems to safeguard customer data privacy, although there was room for improvement in the case of several AIs.

Consumer protection

(a) Code of Banking Practice

The HKMA noted during the year that AIs had included a general exemption of liability clause in their terms and conditions for safe deposit box services. Such clauses mainly attempted to exclude or limit AIs' liability, even in any circumstances where the damage may have been caused by the AIs' own negligence. The HKMA considered these clauses to be unfair and inconsistent with the Code of Banking Practice and required AIs to undertake a comprehensive review of their terms and conditions of banking services. The part of the review covering safe deposit box agreements was completed in November. Taking into account the results of the review, the HKMA issued a circular to AIs, requiring them to make appropriate changes to their safe deposit box agreements by 31 March 2005. In parallel, the Code of Banking Practice Committee, of which the HKMA is a member, amended the Code to make it clear that AIs should have due regard to the Control of Exemption Clauses Ordinance, the Unconscionable Contracts Ordinance and the Supply of Services (Implied Terms) Ordinance in drawing up terms and conditions of banking services. AIs are also required to keep their terms and conditions under review to ensure compliance with the Code.

Apart from these changes, the Code of Banking Practice Committee also introduced new provisions into the Code to improve the protection of co-borrowers. At the request of the Committee, the Hong Kong Association of Banks issued a circular advising its members to provide ATM cardholders with a choice of whether their cards should have the function of purchasing cash vouchers through the Easy Payment System.

The overall level of compliance with the Code remained high, as reflected by the results of the annual self-assessments conducted by AIs covering the period between June 2003 and May 2004. In the past two years, 99% of AIs reported either full or largely full compliance (that is, fewer than five instances of non-compliance) with the Code. Where non-compliant areas were identified, AIs were required to take prompt action to rectify the situation.

(b) Customer complaints

In 2004 the HKMA received a total of 383 complaints, compared with 536 complaints in 2003 (Chart 1). The decrease was attributable mainly to a reduction in the number of complaints relating to the practices of debt

CHART 1 Customer complaints received by the HKMA

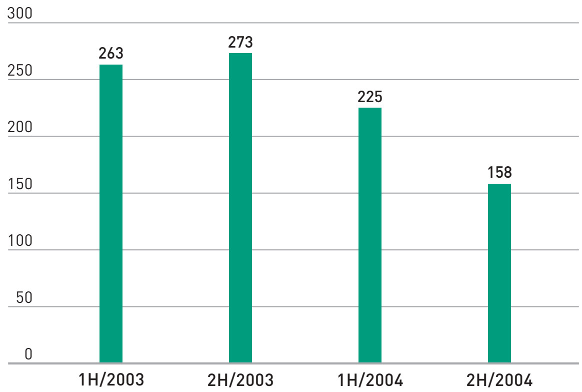
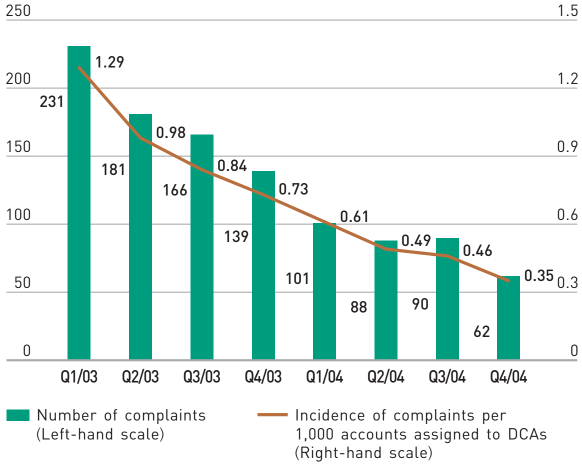


CHART 2 **Debt collection agency complaints received by AIs**



collection agencies (DCAs). Commencing in March 2002, the HKMA has required all AIs to submit a quarterly return on the number of complaints received against DCAs employed by them. The number of such complaints reported by AIs fell further to 341 cases in 2004, from 717 cases in 2003 (Chart 2). The declining number of complaints indicates that AIs have generally been more diligent in monitoring the performance of their DCAs.

> Consumer Information

Basel II

In June 2004 the Basel Committee finalised and issued the revised framework on capital adequacy standards for banks (commonly referred to as "Basel II"). Implementation of the revised framework in the member jurisdictions of the Committee is scheduled for the end of 2006 in general, and the end of 2007 for the most advanced approaches. In line with its policy of adhering closely to international supervisory standards, the HKMA will implement the requirements of Basel II in Hong Kong in line with the Basel timetable.

The HKMA has undertaken extensive public consultation in developing the implementation plan for Basel II. A Basel II Consultation Group, which comprises representatives from the HKMA, the banking industry, the accounting profession and other interested groups, has been established to meet regularly to discuss implementation proposals. The Legislative Council Panel on Financial Affairs was also briefed on the HKMA's plans to implement the revised capital framework in Hong Kong. During August and September, the HKMA released for public consultation a detailed package of implementation proposals, which cover, among other things, technical requirements on key areas of Basel II, the implementation process, the exercise of national discretions, and the rule-making approach the HKMA proposes to adopt in putting the revised framework into legislation. The parties consulted endorsed the proposals as a pragmatic means of implementing the revised framework in Hong Kong. The comments received were mostly to seek clarification on a number of technical issues, which the HKMA will take into consideration when finalising rules and requirements under the revised framework.

The HKMA has also maintained close contact with individual banks, particularly those intending to adopt the more advanced approaches for capital measurement, to understand their readiness to meet the revised framework's requirements. Close co-operation among regulators also plays a key role in the smooth implementation of Basel II, especially for banks active in cross-border operations. The HKMA has co-operated with its supervisory counterparts through the exchange of views and experience on relevant practical issues in the implementation process. During the year, the HKMA participated in meetings with supervisors of two large international banks to discuss supervisory co-operation in the implementation of Basel II.

Banking (Amendment) Bill 2005

Basel II involves a more sophisticated approach to the calculation of capital adequacy ratio than the present regime in the Banking Ordinance. This necessitates amendments to the Ordinance to provide for a revised legal framework to incorporate the new requirements. During the year the HKMA collaborated with the Department of Justice and the Financial Services and the Treasury Bureau to produce a draft of the Banking (Amendment) Bill 2005 to implement the Basel II regime.

The draft Bill relates to two main areas. First, in view of the complexity of the calculations under Basel II and the need to keep the capital regime up to date, the Banking Ordinance will be amended to provide for the introduction of a revised capital framework, which will operate in accordance with capital rules promulgated by the Monetary Authority. Secondly, section 60A of the Ordinance will be extended to empower the Monetary Authority to prescribe the information to be disclosed to the general public by AIs.

The draft Bill also covers amendments that limit the liability of a manager of an AI to circumstances where a contravention was caused or contributed to by the manager himself or a person under his control, and other amendments which seek to improve the working of the Ordinance in the light of experience.

Impact of new accounting standards on capital requirements and regulatory reporting

In the course of 2004 the Hong Kong Institute of Certified Public Accountants adopted several new accounting standards modelled on the corresponding International Accounting Standards (IAS). These include Hong Kong Accounting Standards (HKAS): HKAS 32, *Financial Instruments: Disclosure and Presentation, and* HKAS 39 *Financial Instruments: Recognition and Measurement*.

IAS 39, which HKAS 39 closely follows, has been particularly controversial in the banking industry because it significantly extends the use of fair-value accounting. Many bank assets are difficult to value on a fair-value basis. There has also been concern that more extensive use of fair-value accounting will introduce greater volatility into banks' financial statements. Discussions between regulators, the banking industry and the accounting profession are continuing in a number of countries: by having already adopted this standard, Hong Kong has pre-empted the outcome of this process.

The Basel Committee has offered some guidance on the application of the new international accounting standards in calculating capital requirements and in regulatory reporting. The basic principle has been to minimise changes to the existing capital adequacy framework, including the definition of capital, arising from the implementation of the new accounting standards.

In line with the Committee's recommendations, and to avoid a significant increase in banks' reporting burden, the HKMA's aim has been to minimise the impact of the new accounting standards on its capital adequacy framework. However, the implementation date for the new HKAS of 1 January 2005 has provided a relatively short period for assessing the potential impact of the changes, consulting the accounting profession and the banking industry, and providing guidance to AIs.

The HKMA conducted a preliminary assessment of the changes in the second half of 2004 and, on the basis of this, was able to offer guidance on some urgent topics, such as the treatment of provisioning. Nonetheless, to achieve a complete assessment of the implications of the new HKAS, substantial work remains to be done. Further consultations with the accounting profession and the banking industry will need to continue through the first half of 2005. The HKMA will also continue to monitor international developments, in particular the additional guidance of the Basel Committee.

Financial reporting and disclosure

No revisions were made in 2004 to the financial disclosure guidelines issued by the HKMA. The implementation of the new accounting standards (see major changes in Box) and of Pillar 3 of Basel II may nevertheless entail major changes in the existing financial disclosure regime.

BOX

Major accounting changes

Existing requirements	New requirements
Measurement of financial assets and liabilities	
Most financial assets and liabilities are measured at either historic cost ("book value") or are marked to market. Loans and advances and securities held for investment rather than trading purposes are valued at historic cost. Securities held for trading are marked to market.	HKAS 39 provides scope for institutions to select specific classifications for financial assets (i.e. held for trading, held to maturity, available for sale, loans originated) and financial liabilities. Each classification has different accounting rules for measurement and reporting, including fair value and amortised cost. The available-for-sale classification generally requires fair-value measurement, with unrealised gains and losses included directly in equity and transferred to profit or loss when realised.
Provisioning and interest recognition	
In the absence of any explicit accounting standards, the HKMA drew up guidelines that required banks to make provisions based on likely (expected) losses. Specific provisions are made on an individual-loan basis, while general provisions are made on a portfolio basis. Benchmark provisioning percentages are provided as a reference point.	HKAS 39 adopts an incurred loss approach to impairment. Assets or groups of assets that are individually / collectively identified as having objective evidence of impairment are individually / collectively assessed. Impairment is the difference between the carrying amount and the recoverable amount, which is the present value of the expected future cash flows discounted at the original effective interest rate or the current rate of return for a similar financial asset, as appropriate. No benchmark provisioning percentages are provided.
Interest for classified loans should cease to be accrued or be credited to a suspense account.	Interest income for impaired loans should continue to be recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.
Cash flow hedges	
Derivatives are normally accounted for at notional amount off balance sheet with gains or losses recognised in Profit or Loss.	Under HKAS 39, the effective portion of gains and losses on the hedging instrument of a qualified cash flow hedge should be recognised directly in equity, which would thereafter be recognised in Profit or Loss in the same period or periods during which the hedged instrument affects Profit or Loss. The ineffective portion of gains and losses on the hedging instrument should be recognised in Profit or Loss.
Investment properties and leasehold land	
Revaluation changes of investment properties are accounted for in Investment Property Revaluation Reserve under HKSSAP 13.	Fair value changes of investment properties are accounted for in Profit or Loss under HKAS 40.
Leasehold land is accounted for as an asset item in balance sheet under HKSSAP 14. Revaluation is permitted.	Leasehold land is no longer regarded as an asset item and should be accounted for as prepaid lease payments under HKAS 17. Revaluation is not allowed.

Prevention of money laundering and terrorist financing

In 2004 the HKMA continued its efforts to develop the supervisory framework for the prevention of money laundering and terrorist financing. After industry consultation, the HKMA issued in June 2004 a revised version of the *Supplement to the Guideline on Prevention of Money Laundering*, together with a set of *Interpretative Notes*. The *Supplement* was revised to take account of the revised *Forty Recommendations* issued by the Financial Action Task Force on Money Laundering (FATF) in June 2003. The *Interpretative Notes* were produced in collaboration with the banking industry to provide practical guidance to AIs on implementing the requirements of the revised *Supplement* and to explain the risk-based approach to be adopted. AIs were expected to review their policies and procedures on the prevention of money laundering and terrorist financing and take necessary actions to comply with the revised requirements before the end of 2004.

Following the release of the revised *Supplement* and the *Interpretative Notes*, the HKMA has started to develop a structured self-assessment framework to facilitate AIs' regular assessment of the extent of their compliance with the relevant regulatory requirements. This will also help the HKMA identify risk indicators and further improve supervisory guidance in the longer term.

To promote public awareness of the issues relating to money laundering and terrorist financing, the HKMA and the two industry associations jointly produced an information leaflet entitled *Fighting Crime and Terrorism: How You Can Help*. This leaflet, which was released in March 2004, explains to customers of AIs why they may be required to provide identification documents and how, in line with the latest international practices, this can help prevent money laundering and combat terrorist financing.

During the year the HKMA continued to issue circulars to inform AIs of changes to the list of Non-cooperative Countries and Territories and to alert them to the new lists of terrorist suspects published in the Gazette under the relevant local legislation, as well as those designated under the US President's Executive Order.

Review of Core Principles

At its June 2004 meeting, the Basel Committee decided to initiate work to revise the *Basel Core Principles for Effective Banking Supervision* in the light of new regulatory issues and standards, as well as experience with the implementation of the *Core Principles* gained over the years through compliance assessments of various economies by the International Monetary Fund and the World Bank.

Early in the year the Basel Committee appointed experienced supervisors from a number of economies, including Hong Kong, to take part in the preparatory work for the project, including proposing to the Committee on the scope and mandate for the project. These supervisors were later appointed by the Committee to a steering group to co-ordinate and oversee the project. Hong Kong is one of the three economies whose representatives in the steering group are given a leading role in the drafting process.

Development of supervisory policies

A key focus during the year was on the development of detailed supervisory guidance on various important areas under Basel II, some of which were incorporated in the August and September consultation proposals. Supervisory policies in other areas developed during the year included:

Liquidity risk management

This statutory guideline sets out the key elements of effective liquidity risk management, taking into account latest international standards and practices adopted by some international banks, and explains the enhanced approach that the HKMA will adopt towards ensuring the adequacy of AIs' liquidity risk management. In addition to restating the need for AIs to comply with the statutory liquidity ratio requirements, the revised liquidity regime provides more guidance on the development of an effective liquidity risk management framework; cash flow management and reporting for liquidity management under normal and stressed situations; and contingency planning for dealing with a liquidity crisis. It will replace the guideline issued in 1994 and will take effect in August 2005.

Foreign exchange risk management

This guidance note is aimed at improving the existing supervisory approach on foreign exchange risk and providing more guidance to AIs on the key elements of effective foreign exchange risk management. In developing the guidance note, the HKMA has made reference to international standards, the range of practices currently adopted by AIs, relevant recommendations made by the IMF during the last FSAP assessment, and the experience of the 1997-98 Asian financial crisis.

The sharing and use of commercial credit data through a commercial credit reference agency

This statutory guideline sets out the minimum standards that the HKMA expects AIs to observe in sharing and using commercial credit data through a commercial credit reference agency. It requires AIs involved in SME lending to participate in the sharing and use of commercial credit data and to maintain adequate controls to safeguard customer data confidentiality.

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International co-operation

The HKMA continues to participate in various regional and international forums for banking supervisors, including the Core Principles Liaison Group 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. In October 2004, in association with the Financial Stability Institute, the HKMA hosted a seminar on *Problem Bank Resolution* in which 31 participants from 16 supervisory authorities in the SEANZA economies attended.

In April 2004 the HKMA co-operated with the Bank for International Settlements and 51 other economies in the *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity*. The results of the survey showed that Hong Kong advanced one place to be the sixth largest foreign exchange market in the world and seventh largest taking into account over-the-counter derivative transactions.

Deputy Chief Executive William Ryback (left) talks with representatives from the SEANZA economies in the Seminar on Problem Bank Resolution.

PLANS FOR 2005 AND BEYOND

Focused examinations

The HKMA plans to conduct a series of focused examinations in 2005 on AIs' key business activities, covering residential mortgage loans, trade finance, wealth management and personal renminbi business. The purpose of these examinations is to ensure that AIs follow prudent business practices and comply with relevant codes of conduct or business restrictions. Using the findings of these examinations, the HKMA will identify and recommend best practices to AIs that are engaging in these activities.

CAMEL rating

In anticipation of the introduction of the Deposit Protection Scheme, the HKMA plans to refine the mechanism and criteria for assessing AIs' CAMEL[3] rating in 2005. This will include the setting up of a review committee within the HKMA to consider appeals against the rating from AIs.

Internet banking and business continuity planning

The HKMA will continue to improve its Internet banking and technology risk management supervisory framework to ensure that it keeps pace with the developments in these areas. In particular, the HKMA plans to increase the number of AIs to be subject to the automated control self-assessment process to 55 (50 in 2004), which will cover all retail banks and AIs with significant IT operations. The HKMA will also continue its on-site specialist examination programme in 2005.

The HKMA will continue to monitor Internet banking frauds and ensure the implementation of two-factor authentication by relevant AIs for high-risk retail Internet banking transactions by June 2005. Through the Electronic Banking Working Group of the Hong Kong Association of Banks, the HKMA will work with the banking industry and the Hong Kong Police Force on suitable education programmes to increase consumer awareness of Internet banking security.

The HKMA will continue to share its experience in supervision of Internet banking and technology risk management with overseas bank regulators both directly and through the Electronic Banking Group of the Basel Committee.

Supervision of AIs' securities activities

The HKMA gives high priority to handling deemed Registered Institutions' migration applications under the Securities and Futures Ordinance in 2005. In view of the growth in securities-related business conducted by AIs, the HKMA will step up its supervisory efforts for these activities. In particular, the HKMA plans to implement an automated control self-assessment process to cover major AIs' securities-related activities.

As part of its continuing efforts to develop the supervisory framework applicable to the securities business of AIs, the HKMA will take appropriate measures to cater for the expected growing need for investigation work and the exercise of its disciplinary powers under the Banking Ordinance. Procedural enhancements and, where necessary, legislative changes will be introduced to improve the securities regulatory regime for AIs in the light of experience with administering the current regime. The HKMA will continue to maintain a close working relationship with the SFC in accordance with the framework set out in the Memorandum of Understanding signed between the two regulators in order to maintain a consistent enforcement approach.

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

Improvement of banking sector infrastructure

The HKMA will focus on the establishment of the Deposit Protection Scheme and the further development of the Commercial Credit Reference Agency in 2005.

Deposit Protection Scheme

According to the project plan laid out by the Hong Kong Deposit Protection Board, the Deposit Protection Scheme will be ready for launch in the second half of 2006 if the external environment (such as interest rate levels) prevailing at that time is considered appropriate. Most of the preparatory work, including the development of a payout system and the specification of a set of rules governing the operation of the Scheme, should therefore be substantially completed by the end of 2005. The HKMA will continue to assist the Board to prepare for the launch of the Scheme. The Board and the HKMA will keep the industry abreast of the development of the project through the Consultative Committee on Deposit Protection Scheme.

Commercial Credit Reference Agency

In 2005 the HKMA will, in collaboration with the Industry Working Group on the Commercial Credit Reference Agency, consider methods to expand the coverage of the scheme to include sole proprietorships and partnerships, and evaluate the adequacy of information contained in the Commercial Credit Reference Agency database. The HKMA will also monitor AIs' compliance with SPM-IC7, which sets out the minimum standards that should be observed by AIs in the sharing and use of commercial credit data.

Consumer credit data sharing

The HKMA will continue to monitor a set of indicators to assess the benefits arising from the sharing of positive consumer credit data, including greater differentiation in interest rates, reduction in default rates and reduced level of indebtedness. With the two-year moratorium on access to credit data for the purpose of credit review coming to an end in June 2005, the HKMA will also monitor whether AIs have made greater use of the consumer credit database in assessing the creditworthiness of their customers.

Consumer protection

The HKMA will continue to promote improvements in the standard of banking practices through active participation in the work of the Code of Banking Practice Committee. We will complete the comprehensive review of AIs' terms and conditions to ensure compliance with the Code and the relevant consumer protection legislation. We will also monitor AIs' compliance with the Code through the annual self-assessments and the handling of relevant complaints against AIs.

Basel II

The draft Banking (Amendment) Bill 2005 was circulated for public consultation in December 2004 and is expected to be introduced in the Legislative Council in the second quarter of 2005. With the legislative process underway, the HKMA, in consultation with the industry, will continue to develop the specific technical and qualitative requirements of the revised capital regime. The proposed requirements will then form the basis of the capital and disclosure rules to be made for the implementation of Basel II. New banking returns for reporting regulatory capital requirements will also be developed and issued for industry consultation in 2005.

The HKMA will start the validation process for AIs intending to adopt the Internal Ratings-based Approaches during 2005. Where applicable, this will involve liaising with relevant home supervisors of the Hong Kong operations of international banking groups about the recognition arrangements to avoid unnecessary duplication of work among supervisors.

The HKMA is keen to ensure that, while meeting the international standards required of banks under Basel II, the revised regime is tailored to Hong Kong's needs. We will continue to consult with the industry regarding relevant rules and guidelines being developed, and monitor closely AIs' Basel II implementation progress, particularly in the case of AIs intending to adopt the more advanced approaches.

Prevention of money laundering and terrorist financing

The HKMA will continue to monitor the latest international developments in combating money laundering and terrorist financing, and to further improve our supervisory efforts in this area in line with the international standards.

In view of the new requirements stipulated in the revised *Supplement to the Guideline on Prevention of Money Laundering*, the HKMA will conduct on-site examinations on AIs' systems of controls over the prevention of money laundering and terrorist financing based on the revised requirements. In addition, the HKMA will carry on with the work of developing a structured self-assessment framework for AIs' on-going assessment of their compliance with the relevant requirements. We intend to consult AIs on the details of this framework by the end of the first quarter of 2005.

In order to ensure Hong Kong's compliance with the Financial Action Task Force on Money Laundering's revised *Forty Recommendations*, the Government is planning to introduce an omnibus bill that will put the basic obligations relating to customer due diligence and record-keeping into law. The HKMA will work closely with government departments and other financial regulators regarding the drafting of the bill, and will seek comments from the banking industry on the proposed legislation whenever necessary.

Review of Core Principles

The HKMA sees the Basel Committee's updating of the *Core Principles* as very important in maintaining them as a set of widely applied international standards that continue to address current banking supervisory issues. Drawing from its experience in the last Financial Sector Assessment Programme in 2002, the HKMA will continue to contribute to the process of drafting the relevant updates and assist the Committee in regional consultation.

Development of supervisory policies

Operational risk management

In view of the release of the *Sound Practices for the Management and Supervision of Operational Risk* by the Basel Committee in February 2003 and the increasing importance of operational risk in AIs, the HKMA is in the process of developing a new module on operational risk management under the Supervisory Policy Manual. The module will model on the Basel paper and provide additional, detailed guidance to AIs on the key elements of a sound operational risk management framework for identifying, assessing, monitoring, and controlling or mitigating operational risks. It will also highlight current practices and approaches of the industry in managing operational risk as a distinct risk similar to credit and market risks. The HKMA intends to release the module for industry consultation in the first quarter of 2005.

Other guidelines

Other guidelines to be developed in 2005 will cover the following areas:

- credit cards
- new share subscriptions and share margin financing
- internal audit, legal and compliance functions.

Accounting and financial disclosure

The HKMA will continue to keep abreast of accounting and disclosure developments. In addition, the HKMA will work, in collaboration with the industry associations and the accounting profession, to understand the impact of the new accounting standards, Pillar 3 of Basel II and the Basel Committee's recommendations on the treatment of various items for capital adequacy purposes on the banking industry.

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