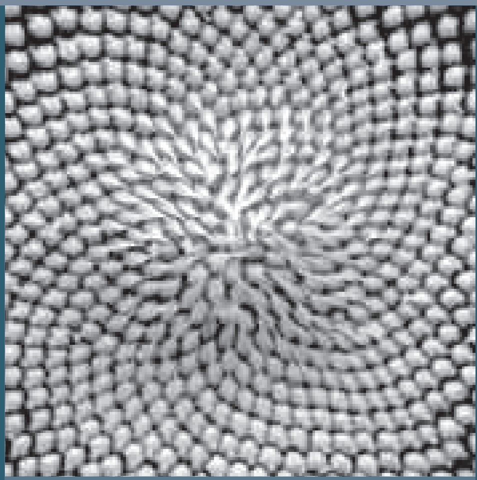

BANKING STABILITY

One of the main objectives of the HKMA is to promote the safety and stability of the banking system through the regulation of banking and deposit-taking businesses and the supervision of authorized institutions. A major priority in 2005 was to ensure they had adequate policies and risk management procedures to combat money laundering and terrorist financing activities. On the policy front, the enactment of the Banking (Amendment) Ordinance 2005 helped to advance the necessary preparations for the implementation of Basel II.

OBJECTIVES

The 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 polices 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 and deposit-taking companies.

REVIEW OF 2005

Risk-based supervision

To ensure more effective implementation of the risk-based approach to banking supervision, the Banking Supervision Department was reorganised into five divisions focusing on large and complex institutions, foreign institutions, local institutions, China-related institutions and technical supervision. This has enabled the HKMA to utilise better its supervisory resources and more effectively develop expertise to identify and tackle different types of risk faced by the banking industry over the next few years. The reorganisation has resulted in cost savings, while allowing the upgrading of some posts to ensure that personnel of the right calibre are available to meet the increased challenges.

During 2005, the HKMA conducted a total of 228 on-site examinations, which included 92 risk-based and eight treasury examinations. The on-site examinations included 64 focused examinations: 18 to assess AIs' compliance with the restrictions on personal renminbi business, 24 on residential mortgage loans and 22 on trade-financing business. With AIs' continuing reliance on information technology and the increasing popularity of Internet banking services, the HKMA's specialised teams conducted 17 special examinations of Internet banking services and IT-related controls, and another 17 examinations of AIs' business continuity planning. The

HKMA also carried out five tier-2[2] examinations of the securities business of AIs. In view of the growing demand for retail investment products, the HKMA conducted 14 focused examinations of AIs' retail wealth management operations, including a review of their policies and procedures on client-suitability assessment.

The HKMA carried out 14 more risk-based on-site examinations during 2005 than in 2004. As these risk-based examinations cover a wider scope of issues, they require more resources than focused examinations. As a result, the total number of on-site examinations declined.

The reorganisation of the Banking Supervision Department enabled slightly more off-site reviews and tripartite meetings (among the HKMA, an AI, and its external auditors) to be conducted in 2005 than in 2004. This was achieved despite resources being used to deal with ad hoc duties, such as approving bank mergers and restructuring and processing migration applications under the Securities and Futures Ordinance. A total of 187 off-site reviews and 71 tripartite meetings were held during the year.

The HKMA continued to maintain regular contacts with the boards of directors of locally incorporated AIs. These contacts help strengthen communication and improve understanding of the AIs' state of affairs, financial position and strategic direction. During the year, HKMA staff met the boards of four licensed banks and one restricted licence bank, and the board-level committees (in particular the audit committees) of 13 banks.

The Banking Supervision Review Committee considered seven cases relating to the licensing of AIs and the fitness and propriety of controllers. In addition, 332 applications to become controllers, directors, chief executives and alternate chief executives of AIs were approved. Details of the operational supervisory work performed in 2005 are shown in Table 1.

Table 1 Operational supervision

	2004	2005
1. On-site examinations	247	**228**
Including		
– risk-based	78	**92**
– treasury	11	**8**
– securities	7	**5**
– e-banking	24	**17**
– review of business continuity plan	17	**17**
– review of renminbi business	36	**18**
– overseas examinations	20	**11**
– retail wealth management	–	**14**
– trade financing	–	**22**
– residential mortgage	17	**24**
2. Off-site reviews and prudential interviews	183	**187**
3. Tripartite meetings	66	**71**
4. Meetings with boards of directors or board-level committee of AIs	8	**18**
5. Approval of applications to become controllers, directors, chief executives, alternate chief executives of AIs	376	**332**
6. Reports commissioned under Section 59(2) of the Banking Ordinance	1	**4**
7. Cases considered by the Banking Supervision Review Committee	9	**7**

In 2005, the Monetary Authority used the powers under Section 59(2) of the Banking Ordinance to require four AIs to commission external auditors to review internal control issues and report their findings to the HKMA.

During the year, no AI breached the Banking Ordinance relating to the capital adequacy ratio, liquidity ratio and the large exposures under Section 81. There were three breaches of the requirements relating to connected lending under Section 83. These breaches, which were technical and unintentional in nature, were promptly rectified and they did not affect the interests of depositors or creditors.

[2] Tier-1 examinations are high-level examinations which assess the adequacy of AIs' general management controls over the areas being examined. Tier-2 examinations are more in-depth and focused assessments, including detailed testing and verification as warranted by the risks involved, of the effectiveness of the AIs' relevant controls.

CAMEL[3] rating review

In the second half of 2005, the CAMEL Approval Committee met on a number of occasions to consider the CAMEL ratings of all licensed banks and most restricted licence banks and deposit-taking companies. As all licensed banks are members of the Deposit Protection Scheme, it was necessary to provide their CAMEL ratings (relating to their positions on 20 October 2005) to the Hong Kong Deposit Protection Board before the end of the year. The banks involved were given an opportunity to request a review of their ratings. Four banks requested such a review, and meetings of the independent CAMEL Approval Review Committee formed by members not involved in the original rating decisions were convened to consider the requests.

Appointment of Manager

On the advice of the Financial Secretary, the Monetary Authority used the powers under Section 52(1) of the Banking Ordinance to appoint, on 16 September, a Manager to manage the affairs, business and property of Delta Asia Credit Limited (DAC), a deposit-taking company. The action was taken in the light of serious allegations made by an overseas authority relating to the parent bank of DAC in Macau. The assets of DAC were also ring-fenced. These steps were intended to protect the interests of DAC's depositors and to safeguard the integrity of the banking system. The HKMA has since been liaising closely with the relevant overseas authorities to monitor developments and assess the implications for DAC and its parent bank.

Focused examinations

Treasury activities

The growing involvement of the banking sector in dealing with complex structured products and the uncertainties surrounding interest rate movements have increased the risks faced by AIs' treasury operations. Through the redeployment of internal resources, the HKMA has set up a second treasury examination team to monitor and examine the effectiveness of AIs' systems for managing their interest rate risk and the risks arising from transactions involving complex structured and derivatives products. The main duty of the second team is to benchmark relevant risk management practices and, where appropriate, develop a set of best practices on critical treasury functions that AIs are encouraged to follow. In December, the HKMA discussed with AIs involved in derivatives and structured products the need to examine the latest market trends and risk-management practices. This has helped the HKMA to set its supervisory priorities for 2006.

Wealth management activities

Driven by the narrowing return from lending activities and investor demand for more comprehensive financial products and services, banks in Hong Kong have become increasingly active in offering wealth management products to retail customers. In 2005, the HKMA conducted on-site examinations of the retail wealth management business of 14 AIs, focusing on their compliance with the relevant Code of Conduct, including risk disclosure and customer suitability checking. The overall findings indicated that banks generally had effective procedures to ensure compliance with the requirements. Nevertheless, a number of banks have identified ways to improve their client suitability procedures.

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[3] An internationally recognised framework for assessing the quality of banks based on **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity.

Residential mortgage and trade financing business

In view of the growing trend in early 2005 for AIs to use large cash rebates to compete for new residential mortgage business, the HKMA issued a circular in February setting out the treatment of these rebates for residential mortgage business within the context of the 70% loan-to-value ratio guideline. The circular stated that cash rebates exceeding 1% of the residential mortgage loan amount should be treated as part of the loan amount for the purpose of calculating the loan-to-value ratio, and that any cash rebate offered by a developer, directly or indirectly, should be deducted from the purchase price before determining the value of the property concerned.

The HKMA also carried out focused examinations on the residential mortgage business of 25 AIs to assess their compliance with the 70% guideline, their risk-management systems, underwriting criteria and business practices. During these residential mortgage loan examinations, the HKMA took the opportunity to examine 21 AIs' procedures for preventing and detecting trade financing fraud and controls over the use of trade finance facilities. The results indicated that the AIs concerned had satisfactory controls and risk management systems.

Securities business

In addition to on-site securities examinations, the HKMA implemented an automated compliance self-assessment process to cover 30 AIs that are active in securities business. The outcome of the assessment will help the HKMA to improve its supervisory effectiveness. It will also foster a culture of compliance reviews among AIs. The outcome of the first assessment highlighted some control and compliance issues requiring remedial action, which is expected to be completed by the end of March 2006.

Internet banking services, IT-controls & business continuity planning

The HKMA conducted 34 on-site examinations of Internet banking, technology-risk management and business continuity planning. To help AIs better plan their resources for managing technology-related risk, the HKMA has shared the common findings from these on-site examinations with the Hong Kong Association of Banks (HKAB). The HKMA also extended the coverage of the automated control self-assessment process for Internet banking, technology-risk management and business continuity planning from 50 to 54 AIs. The results of the self-assessments indicated a marked improvement in the overall information technology control environment of AIs since self-assessment began in 2003.

Prevention of money laundering and terrorist financing

The revised *Supplement to the Guideline on Prevention of Money Laundering* took effect on 31 December 2004. The HKMA conducted 62 anti-money laundering examinations as part of its risk-based on-site examinations in 2005. To help AIs better understand common anti-money laundering issues and prioritise their resources for managing their reputation risk, the HKMA shared with HKAB the findings and observations from these examinations. The areas identified for further improvement by some AIs, include

- regular updates of anti-money laundering policies and procedures to incorporate the HKMA's latest requirements
- more effective monitoring of the activities of high-risk accounts and timely reporting of suspicious transactions to the relevant authorities
- continuing training of staff to maintain a high level of awareness and vigilance in the prevention of money laundering and terrorist financing.

In November, the HKMA issued a circular to the industry reiterating and clarifying the supervisory standards and approach towards combating money laundering and terrorist financing activities. AIs were reminded of the potential legal and reputation risks involved.

Safeguarding customer information

The leak of credit card data in the US in June had the potential to affect some 12,000 credit cards issued by AIs in Hong Kong. The AIs concerned promptly arranged to replace these cards before the end of July. The incident resulted in no financial loss for holders of cards issued by AIs. However, the HKMA took steps to minimise the chance of such an incident happening in Hong Kong. All AIs were requested to re-assess and submit a formal report on the adequacy and effectiveness of controls over customer data security, retention and confidentiality (covering the AIs and their service providers). The overall results were satisfactory.

As the US incident involved inadequate security controls of a third-party service provider, the HKMA also conducted three special on-site examinations in October and November focusing on the controls over data input and the management of processes outsourced to service providers in Singapore and Mainland China.

Personal renminbi business

Personal renminbi business recorded significant growth in Hong Kong in 2005. Total deposits stood at RMB22.6 billion yuan at the end of the year, an increase of 86% from 2004.

The development of this business entered a new phase in November with the People's Bank of China announcing the expansion of the scope of the clearing arrangements. Participating banks in Hong Kong can benefit from the change by providing renminbi exchange and remittance services with increased transaction limits. They can also determine, on their own, the credit limit on renminbi credit cards, and take renminbi deposits from designated merchants, the definition of which has been expanded to cover more business categories. Banks can also begin offering renminbi current accounts to individual customers after the requisite system development is completed by Hong Kong Interbank Clearing Limited.

The HKMA conducted on-site examinations of the personal renminbi business of 18 banks, as opposed to examining all participating banks in 2004 when the business was first introduced. In 2005, a risk-based approach was adopted, which showed that the compliance of banks with the business restrictions was satisfactory. Nevertheless, there was room for improvement in the internal systems of some banks to guard against non-compliance with the relevant business restrictions and detect irregular transactions. These banks were required to improve promptly their systems and controls.

As the business expands, the HKMA will continue to supervise closely personal renminbi business activities in 2006 through on-site examinations and a revised prudential return to collect more information from banks.

CEPA

Since its introduction in January 2004, the Closer Economic Partnership Arrangement has helped promote the expansion of Hong Kong-incorporated banks in Mainland China. The arrangement was further revised in October 2005, and subsequently refined in January 2006. Under CEPA III, the level of operating funds required of Mainland branches of Hong Kong-incorporated banks offering renminbi and foreign currency businesses to local customers is assessed on the basis of all the Mainland branches of a bank rather than each individual branch. Where the average level of operating funds of all Mainland branches is over RMB400 million yuan per branch, the operating funds allocated to an individual branch can be lowered to RMB300 million yuan. Through CEPA, eight Hong Kong-incorporated banks have become eligible to establish branches on the Mainland. Among these, five banks had opened six new Mainland branches by the end of 2005.

Non-bank China exposures

The HKMA considers it prudent to gather more comprehensive data on AIs' aggregate exposures to Mainland China borrowers with the ever-increasing economic integration between Hong Kong and the Mainland. After consultations with the industry, the HKMA introduced in December 2005 a revised reporting framework for non-bank China exposures. The major change is the new requirement to capture exposures to non-Mainland Chinese entities where the credit is for use on the Mainland. The revised reporting framework will take effect in the third quarter of 2006, with the first reporting to cover the position at the end of September 2006.

Supervision of technology and operational risks

Two-factor authentication for Internet banking

Two-factor authentication for high-risk transactions conducted through Internet banking in Hong Kong was launched on 30 May at a joint press conference held by the HKMA, HKAB and the Hong Kong Police Force. Hong Kong is one of the first jurisdictions among developed financial markets to establish this regulatory requirement, which contributes to the safety of Internet banking. The HKMA, together with the banking industry and the Police, launched a consumer education programme in late May to promote public awareness of the new system. By the end of the year, 21 AIs had introduced two-factor authentication and around 940,000 customers (a 276% increase from mid-2005) had registered for the service.

The major retail banks have worked with IT vendors and customers to ensure that two-factor authentication can cater for the needs of the visually impaired. A number of solutions have been identified, including security tokens with voice output and one-time passwords delivered through a dedicated phone-banking hotline. The banks plan to test and implement the proposed solutions in the first half of 2006.

> Consumer Information > Internet Banking Safety

Business continuity planning

The HKMA undertook a number of initiatives during the year to help the banking industry to address potential risks posed by mass demonstrations and cyber attacks when the World Trade Organization Sixth Ministerial Conference was held in Hong Kong in December. The HKMA, the Government's Co-ordination Office and the Police held a joint briefing session for the banking industry in September to discuss the anticipated disruptions during the Conference period and the recommended measures to address such incidents. The HKMA also issued a circular to AIs in October on the recommended measures regarding event management and business continuity planning around the time of the Conference. To effectively monitor and manage potential problems, the HKMA established an Event Management Centre at its office and required AIs to submit periodic status reports during the conference. Apart from the temporary closure of some bank branches and ATM services due to nearby demonstrations, no major disruptions were reported by AIs. The smooth operation of the Centre confirmed that there is an effective and secure communication framework between the HKMA and all AIs, which will provide a solid foundation for handling future emergencies.

The HKMA invited the Department of Health to brief the banking industry on 7 November 2005 on precautions against a possible influenza pandemic. Some 250 participants from over 130 AIs attended the briefing. The HKMA also issued a circular to all AIs in November setting out recommended measures. An industry task force has been established by the HKMA and HKAB to monitor developments and review applicable business continuity practices for the banking sector.

Supervision of ancillary activities

Securities business

The HKMA continued to maintain close supervisory co-operation with the Securities and Futures Commission (SFC). Two bilateral meetings were held in 2005 to discuss matters related to the supervision of AIs' securities activities, in addition to the normal communication on day-to-day supervisory matters. To draw the attention of registered institutions (RIs) to important regulatory requirements and recommended practices, the HKMA issued a number of circulars, including

- a circular in February to recommend a number of control measures to help ensure proper registration of securities staff and maintenance of these individuals' particulars in the HKMA register

- a circular in March to draw the attention of RIs to the findings and regulatory requirements set out in the SFC's *Report on Selling Practices of Licensed Investment Advisers*

- a circular in November to remind AIs of the relevant supervisory requirements for ensuring the smooth operation of the subscription and refund processes of the initial public offer of the Link REIT.

Under the transitional arrangements of the Securities and Futures Ordinance, 74 AIs with deemed registration status (deemed RIs) lodged their migration applications before the expiry of the transitional period on 31 March 2005. By the end of 2005, the HKMA had completed assessment of the majority of the applications, resulting in 53 deemed RIs being registered with the SFC and two having revoked their status as AIs (and thus deemed RIs).

During the year, the HKMA granted consent to 172 executive officers, who are responsible for supervising the securities activities of RIs.

> HKMA Register of Securities Staff of Authorized Institutions

In response to the recommendation of the Working Group on the Business Environment of the Stockbroking

Industry, the HKMA presented a proposal for discussion with the SFC on the revision of fees for AIs' regulated activities under the Securities and Futures Ordinance. The intention is to replace the current flat fee rate with a sliding-scale fee structure.

Sections 58A and 71C of the Banking Ordinance have been amended to improve the securities regulatory regime by empowering the Monetary Authority to disclose relevant details of disciplinary action taken against securities staff of AIs. Procedural improvements have also been made in the light of experience gained in administering the enforcement regime. Necessary steps are also being taken to increase the resources of the Securities Enforcement Team to handle the rising number of investigation cases and reported incidents with potential for disciplinary action.

During the year, investigations continued into 16 cases opened in 2003-2004. Another 10 cases were opened for investigation by the Event Review Committee, which is responsible for deciding whether to open cases for disciplinary investigation. At the end of 2005, the investigation of 17 cases was in progress and will continue into 2006.

The Disciplinary Committee, which is responsible for making recommendations on the exercise of disciplinary powers, considered nine cases on the completion of the investigations. Among these, one case involved short-selling, but no disciplinary action was taken under the Banking Ordinance as the individual concerned had left the banking industry to join the securities sector. Nevertheless, the individual was disciplined by the SFC. In another case concerning suspected malpractice of a former "relevant individual" of a registered institution when selling investment products, the individual had also left the banking industry and Hong Kong. Again, disciplinary action under the Ordinance could not be taken, although the person was put on a watch list designed to alert the HKMA's authorization team and other relevant licensing authorities should the individual apply again to perform regulated activities, whether in registered institutions or in licensed corporations.

Another case considered by the Disciplinary Committee involved the supervisory failure of a "relevant individual" that occurred prior to the commencement of the Securities and Futures Ordinance when the person was with his former employer. The investigation concluded there were insufficient grounds to find the individual not fit and proper under the new securities regime. The case was closed, but a warning letter was issued to the person concerned.

The other six cases were closed as there were insufficient grounds for disciplinary action. The cases included suspected lack of due care and diligence in order taking, suspected contravention of an honesty and fairness provision of the SFC's Code of Conduct, suspected failings in internal control systems, and suspected involvement in an overseas dealing malpractice.

Insurance and Mandatory Provident Fund businesses

The HKMA and the Insurance Authority held the second bilateral meeting in July to discuss current and evolving supervisory issues in the insurance activities of AIs, and streamlined the procedures for handling insurance-related complaints received by the HKMA from bank customers. To improve the supervision of AIs' insurance activities, the HKMA continued to collect half-yearly returns and conduct on-site examinations of AIs active in insurance business.

The HKMA also worked with the Mandatory Provident Fund Schemes Authority, the SFC and the Insurance Authority on the revision of MPF intermediaries' registration and reporting requirements, which became effective on 1 October 2005. The changes included substituting MPF certificates for MPF cards, waiving the return of expired MPF cards and certificates to the MPFA, aligning the registration expiry dates of individual intermediaries with their sponsoring corporate intermediaries and stipulating compliance with the Continuing Professional Development requirement as a criterion in assessing the fitness and propriety of applicants and registrants.

Development of the banking sector infrastructure

The HKMA continued to provide assistance to the Hong Kong Deposit Protection Board in preparing for the launch of the Deposit Protection Scheme and to the banking industry for the further development of the Commercial Credit Reference Agency (CCRA).

(a) Deposit Protection Scheme

The Board is making good progress towards the launch of the Deposit Protection Scheme. The draft rules and guidelines governing the operation of the Scheme have been substantially completed after consultations with the industry associations and other interested parties. The payout system for assessing and paying compensation to depositors has been developed and is now undergoing a user acceptance test. Other preparatory tasks including the development of the payout policy and procedures and the engagement of professionals such as accounting and IT firms to assist the Board when a payout occurs are also close to completion.

(b) Commercial Credit Reference Agency

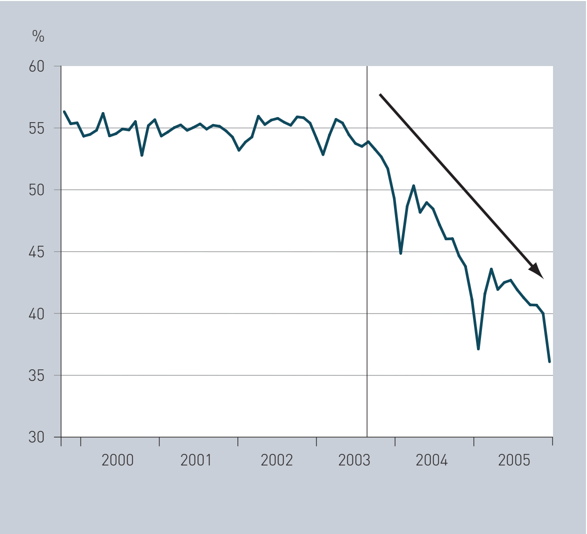
The Agency has been operating smoothly since its inception in November 2004. The scheme currently covers credit data of over 39,000 small and medium-sized enterprises defined as non-listed limited companies with an annual turnover not exceeding $50 million. Over 120 AIs are sharing commercial credit data through the CCRA.

The Industry Working Group on the CCRA has considered different ways to expand the scheme's coverage to include sole proprietorships and partnerships. It has agreed in principle to follow the Code of Practice on Consumer Credit Data in sharing the credit data of sole proprietorships and partnerships. Detailed arrangements are being worked out.

Consumer credit data sharing

Using a set of indicators agreed with the Consumer Council, the HKMA conducted the first review of the benefits of positive credit data sharing. This followed the expiry, in June 2005, of the two-year moratorium on access to credit data for the purpose of credit review. The review showed clear benefits to both financial institutions and consumers. Specifically, the average indebtedness of bankrupts had declined from over 35 times their monthly income in June 2003 to 25 times in August 2005. This shows that with positive data sharing it is now more difficult for borrowers on the verge of bankruptcy to accumulate unreasonably large amounts of debt. Financial institutions also have better tools to avoid lending to these borrowers. After the introduction of positive data sharing, a significant amount of credit card rollover balances was substituted by lower-cost credit such as instalment loans and revolving credit facilities (Chart 1). This resulted in substantial interest savings on the part of consumers. Market practitioners believe this development might not have been possible without positive data sharing. Now the moratorium is over, it is expected financial institutions will make fuller use of positive data in their credit assessments, which could further benefit consumers.

Chart 1. Rollover ratio of credit card receivables



Source: HKMA.

During the year, AIs conducted a self-assessment of compliance with SPM IC-6, one of the modules in the *Supervisory Policy Manual*, which sets out the minimum standards that should be observed by AIs in sharing and using consumer credit data. The assessment results showed that participating AIs had further improved their systems to safeguard customer data privacy.

Consumer protection

Code of Banking Practice

The banking industry has completed the annual self-assessment of compliance with the Code of Banking Practice covering the period from June 2004 to May 2005. A total of 177 AIs providing personal banking services conducted the self-assessment, 151 of which reported full compliance with the Code. The rest of the AIs had five or fewer instances of non-compliance. The main area of non-compliance related to the terms and conditions of banking services. In a separate review conducted in early 2005, 98 AIs' terms and conditions of banking services (other than safe deposit box services) were found to contain exemption of liability clauses which were inconsistent with the Code. As for systems of control for monitoring compliance with the Code, all AIs reported they had adequate internal procedures and management oversight to ensure compliance. New products were reviewed to ensure compliance with the Code before they were launched. The results of the review were broadly in line with the previous year.

> Consumer Information > Code of Banking Practice

Customer complaints

In 2005, the HKMA received 328 complaints, compared with 383 the previous year (Chart 2). The decrease was due mainly to a reduction in the number of complaints relating to the practices of debt collection agencies (DCAs). This was in line with the continuing decline in the number of complaints received by AIs against the DCAs employed by them. According to the quarterly returns submitted by AIs since March 2002, the number of DCA-related complaints received by AIs further declined to 171 in 2005 from 348 in 2004, indicating that AIs have been vigilant in monitoring the performance of their DCAs (Chart 3).

> Consumer Information > Complaints about Banks

Chart 2. Complaints received by the HKMA

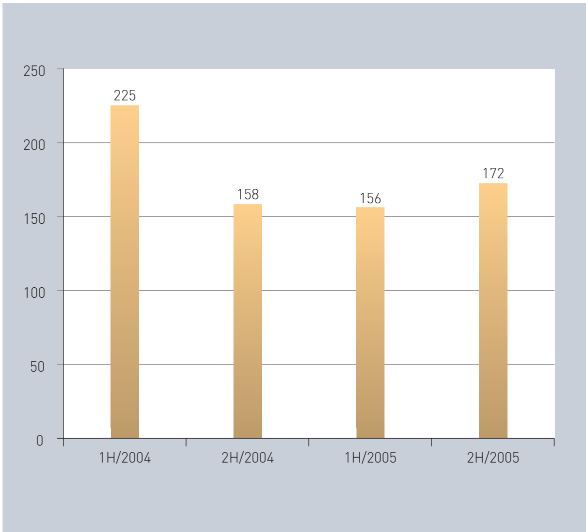
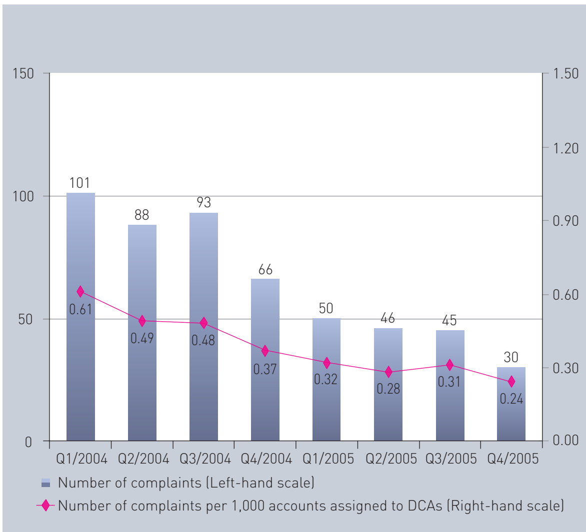


Chart 3. DCA complaints received by AIs



Basel II implementation

The HKMA, in consultation with the banking industry, continued to develop proposals and draft rules for implementing the revised capital adequacy standards under Basel II in Hong Kong in January 2007. The HKMA collaborated with the Department of Justice and the Financial Services and the Treasury Bureau to secure the passage of the Banking (Amendment) Bill 2005.

Banking (Amendment) Ordinance 2005

The Banking (Amendment) Ordinance 2005 was enacted on 6 July giving express statutory backing for the implementation of Basel II in Hong Kong. It provides for the new capital adequacy requirements to be operated in accordance with "Capital Rules" and "Disclosure Rules" issued by the Monetary Authority. The Third Schedule to the Banking Ordinance, which sets out how the minimum capital requirement should be calculated under the existing framework, will be repealed when the Capital Rules are made.

There are clear checks and balances in the Banking (Amendment) Ordinance 2005 relating to the Monetary Authority's power to make Capital Rules and Disclosure Rules. First, the Rules will be developed in full consultation with the banking industry. Secondly, they will have the status of subsidiary legislation and will be subject to negative vetting by the Legislative Council. Thirdly, if an AI is aggrieved by certain decisions of the Monetary Authority made under the Capital Rules, it can apply to the Capital Adequacy Review Tribunal – an independent appellate body to be established in 2006 – for a review.

Following enactment of the Ordinance, the HKMA began to develop, in co-operation with the Department of Justice and the Financial Services and the Treasury Bureau, the Capital Rules and Disclosure Rules. Because of the length and complexity of the Basel II requirements, the banking industry will be consulted in stages in formulating the draft Rules. The first batch was circulated for public comment in December 2005.

New capital adequacy standards under Basel II

During the year, the HKMA continued to develop the standards for implementing the revised framework in relation to each of its three mutually reinforcing components: minimum capital requirement (Pillar 1); supervisory review process (Pillar 2) and market discipline (Pillar 3).

Pillar 1

Since August 2004, the HKMA has issued five detailed consultation packages. These proposals, which have been developed with the support of the industry, cover the core parts of the weighting framework under Basel II, as well as changes to the determination of the capital base to incorporate the latest accounting standards and Basel requirements. To facilitate adoption of the revised framework, AIs are being issued in stages with different parts of a new Capital Adequacy Ratio (CAR) return to assist them in assessing the reporting system changes necessary to ensure compliance. The policy-setting stage was largely completed in 2005.

For AIs intending to adopt the Internal Ratings-based Approach (IRB) for credit risk, the HKMA issued in October a draft guidance note for industry consultation on *Validating Risk-rating Systems under the IRB Approaches*. This received broad support from the banking industry and from other experts in the field, including leading consulting firms. A set of self-assessment questionnaires was also issued to help AIs comply with the relevant IRB requirements of the HKMA.

In monitoring the progress of AIs' implementation plans and to develop a more detailed understanding of their rating system, the HKMA is liaising closely with individual AIs planning to adopt the IRB Approach between 2007 and 2009. The recognition process has already started in the form of a review of the completed self-assessment questionnaires and supplementary information on the rating systems for those AIs aiming to adopt the IRB Approach in 2007.

On operational risk, AIs intending to adopt the Standardised Approach must be able to demonstrate to the HKMA's satisfaction that they meet the specific qualifying criteria set out in Basel II. A guidance note on *Operational Risk Management* was issued by the HKMA in November to assist AIs in meeting the qualifying criteria. The note sets out the key elements for identifying, assessing, monitoring and controlling operational risk. It also explains the HKMA's approach to the supervision of AIs' operational risk.

On market risk, the HKMA reviewed the existing capital framework by incorporating the new standards laid down by the Basel Committee on matters relating to trading-book and internal model recognition. The criteria for granting *de minimis* exemption to AIs with minimal market risk were also simplified. The revised regime, which was set out in a consultative paper on *Capital Framework for Market Risk* and supplemented by a revised version of the technical note on *Use of Internal Models to Measure Market Risk*, was issued for industry consultation in December 2005.

The HKMA also reviewed its policy on items eligible for inclusion in regulatory capital, taking into account the adoption of the new Hong Kong Accounting Standards (HKAS) on 1 January 2005 and the latest Basel guidance. After an extensive consultation with the industry, a comprehensive review of the policies of other regulators and an impact analysis to assess the effect of the proposed policy changes on the largest AIs, the HKMA issued a discussion paper, *Determination of Capital Base*, in December. It proposes

– standardising the "haircut" for the revaluation reserve on properties and securities holdings at 55%;

– permitting the inclusion of fair-value gains on securities in core capital, subject to an AI being able to demonstrate the adequacy of relevant prudential controls;

– including collective impairment allowance in supplementary capital; and

– deducting all intangible items from core capital.

The proposed changes will closely align the definition of capital base used by the HKMA with the Basel standards and enable the HKMA to respond quickly to future recommendations of the Basel Committee. Further guidance is expected from the Committee relating to the impact on capital of the International Financial Reporting Standards. The Committee has also announced its intention to review the definition of capital base by 2009 to take account of market developments and innovations.

Pillar 2

The main elements of Pillar 2 are already embedded in the HKMA's existing supervisory approach, which provides a good basis for conducting the supervisory review process. Instead of a radical change to existing practices, the implementation of Pillar 2 in Hong Kong will focus on elaboration and refinement. While the HKMA will continue to set the minimum CAR for individual AIs under Pillar 2, the decision will be based on a more detailed and rigorous assessment. To facilitate the conduct of the supervisory review, the HKMA developed a new assessment framework based on its existing risk-based supervisory system. This takes into account an AI's overall risk profile and risk management systems, the extent of the AI's exposure to risks not covered under Pillar 1, and its approach to conducting internal capital assessments. The results of the review will determine the minimum CAR and supervisory priorities for individual AIs. The HKMA will issue details of the proposed assessment framework for industry consultation in the first half of 2006.

Pillar 3

To supplement supervision through improved transparency and market discipline, the recommended disclosures under Pillar 3 will cover the state of affairs of an AI including the profit and loss, capital structure and capital adequacy, risk exposures and risk assessment (qualitative and quantitative). To avoid unnecessary duplication with requirements under other disclosure standards in Hong Kong, the recommended disclosures under Pillar 3 will also take account of the *Hong Kong Financial Reporting Standards 7 Financial Instruments: Disclosures,* and *HKAS 1 Presentation of Financial Statements: Capital Disclosures*. In the case of AIs that are subsidiaries of banks incorporated overseas, the HKMA will take into account disclosures made by the overseas parent in considering whether the disclosure requirements have been met. AIs adopting more sophisticated approaches under the revised framework for calculating capital requirements will generally be subject to higher levels of disclosure. The HKMA intends to issue a consultation paper on the proposed disclosure of information under Pillar 3 in the first quarter of 2006.

Impact of new accounting standards on capital requirements and regulatory reporting

The adoption of International Accounting Standards in Hong Kong on 1 January 2005 has had considerable impact on prudential reporting, interim financial disclosure, and AIs' capital base. After conducting a review of the implications for the Hong Kong banking sector and its supervisory framework, the HKMA issued two guidance notes to AIs in 2005 – *Impact of the New HKAS on AIs' Capital Base and Regulatory Reporting* dated 12 April, and *New HKAS: Impact on Interim Financial Disclosure* dated 11 July.

Initial indications are that the new accounting standards resulted in a significant increase in volatility of earnings for individual AIs, although the net effect on a system-wide basis appears to have been relatively modest. However, as the new standards apply to accounting periods beginning on or after 1 January 2005, more time is needed to assess their impact over the longer term.

Prevention of money laundering and terrorist financing

In June 2005, the HKMA launched a structured self-assessment framework to gauge the banking sector's compliance with anti-money laundering and counter-terrorist financing requirements, and to facilitate supervisory monitoring of the compliance position of individual AIs. The framework, developed in consultation with the banking industry, was designed to encourage AIs to rectify any identified weaknesses as early as possible. An initial review of the self-assessment reports showed a high level of compliance within the banking industry. After a full analysis of the results, the industry will be informed of the overall findings, and any compliance issues requiring closer attention will be highlighted.

The HKMA has also taken steps to improve the conduct of on-site examinations of AIs' anti-money laundering and counter-terrorist financing systems and controls. The examination manual has been revised to incorporate a risk-based approach to conducting examinations including drawing examiners' attention to high-risk products and transactions.

International co-operation

International and regional forums

The HKMA participates in various regional and international forums for banking supervisors, including the Basel Committee's Core Principles Liaison Group, 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 is involved in the working group formed under the Basel Committee to review and propose changes to the *Basel Core Principles for Effective Banking Supervision* in the light of new regulatory issues and standards, and the experience gained from the implementation of the *Core Principles* since their publication in 1997. In June, the HKMA hosted a Core Principles Liaison Group meeting in Hong Kong for banking supervisors of more than 20 economies to exchange views on the proposed changes. The meeting provided useful input to the initial drafts of the revised *Core Principles*.

Chief Executive Joseph Yam and Mr Ryozo Himino, Chairman of the Core Principles Liaison Group.

Cross-border implementation of IRB under Basel II

Most Hong Kong-incorporated AIs planning to adopt the IRB Approach are subsidiaries of foreign banking groups. The cross-border implementation of Basel II by these AIs presents challenges to the home supervisors and the HKMA as the host supervisor. The challenges include collaboration over the necessary IRB system validation and dealing with potential differences in the application of IRB requirements and the implementation timetable.

As a member of the Basel Committee Accord Implementation Group's Validation Sub-group, the HKMA took part in its quarterly meetings and contributed to its work across a broad range of issues, including several of the specialised working groups. Participation in the Sub-group also enabled the HKMA to exchange views on IRB system-related validation issues with other leading regulators.

During 2005, the HKMA met the supervisors of large international banks with subsidiary operations in different jurisdictions, including Hong Kong, to review co-ordination in the IRB recognition process. The aims are to avoid supervisory overlap and to reduce the regulatory burden on these banking groups.

Co-operation with overseas supervisors

The HKMA maintains a close working relationship with regulators outside Hong Kong. In 2005, it exchanged letters with the Banking, Finance and Insurance Commission of Belgium, and signed Memorandums of Understanding with the Australian Prudential Regulation Authority and the State Bank of Pakistan to improve supervisory co-operation and the sharing of information with these authorities. 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 banking supervisors from the Mainland, Macau, Taiwan, the US, the UK, the Netherlands, Belgium, France, Germany, Switzerland, Japan, South Korea, Indonesia and Malaysia to discuss supervisory issues of common interest.

PLANS FOR 2006 AND BEYOND

Focused examinations

Apart from continuing risk-based on-site examinations of specific institutions, the HKMA plans to carry out a series of focused examinations targeting certain identified macro risks. The scope of these examinations will include detailed checking of the interest rate risk management capability of selected AIs, treasury risk management, wealth management operations and branch operations in Mainland China. The HKMA aims to ensure that AIs have adequate systems and skills to manage the risks and comply with the relevant supervisory requirements. Based on the findings of the examinations, the HKMA will identify and recommend best practices to AIs engaged in these activities.

On anti-money laundering and terrorist financing controls, the HKMA will establish a specialist team of examiners to step up its anti-money laundering supervisory work. The team will conduct tier-2 examinations and benchmarking of selected high-risk areas. Common issues revealed from AIs' self-assessment reports will form the basis for the HKMA to develop longer-term supervisory guidance. Appropriate local and overseas training will be arranged for team members during the year.

Supervision of technology and operational risks

The HKMA will continue to improve its supervision of Internet banking, technology-risk management and business continuity management to keep abreast of the latest developments in these areas. The results of the automated control self-assessments reported by participating AIs in 2005 have highlighted two areas for improvement: data security controls and a comprehensive business continuity plan for dealing with prolonged disruption of banking operations. Two rounds of examinations will be conducted in 2006 focusing on customer data security and business continuity preparedness of AIs for the possible outbreak of an influenza pandemic.

Regular specialist examinations and the automated control self-assessment exercises will also be conducted by the HKMA on Internet banking, technology-risk management and business continuity planning. The HKMA will host the Conference for International Supervisors on Information Technology in 2006, which provides a forum for banking supervisors from 15 major financial markets to share their experiences.

Supervision of ancillary activities

Securities business

The HKMA plans to increase the number of tier-2 securities examinations and to extend the compliance self-assessment process from 30 to 40 registered institutions. In view of the significant growth in the investment advisory activities of registered institutions, the HKMA will also perform theme inspections of their activities, and continue its co-operation with the SFC on the review of regulatory standards on the selling practices of securities intermediaries.

Consultation with the SFC and the banking industry will continue on the proposed revision of the fee structure for AIs' regulated activities under the Securities and Futures Ordinance.

The main aim of the HKMA's securities enforcement function is to protect investors by ensuring that prompt action is taken against those acting improperly in carrying out regulated activities; and that disciplinary action is taken to impose a penalty for wrongdoings and to deter others from engaging in similar conduct. The HKMA plans to complete the upgrading of procedures and resources, which began in 2005, to cope with the growing number of investigation cases. These improvements are expected to lead to a reduction in the time taken to investigate cases and improve operational efficiency. Regular communications with the SFC will continue within the framework set out in the Memorandum of Understanding between the two regulators to promote consistency in enforcement.

Insurance & Mandatory Provident Fund businesses

In 2006, the HKMA plans to conduct examinations focusing on the adequacy of AIs' client suitability assessment when selling insurance and structured products to ensure they are effectively managing the risk of mis-selling. The HKMA will also conduct regular on-site examinations and review half-yearly returns from AIs on insurance-related activities, and maintain a close working relationship with the Insurance Authority.

Developing 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 2006.

Deposit Protection Scheme

The HKMA will assist the Deposit Protection Board in completing the remaining preparatory tasks for the launch of the Scheme. Assuming no unforseen developments, the Deposit Protection Scheme will begin collecting contributions from banks and providing deposit protection in the second half of 2006. A publicity campaign will be launched to raise the public's awareness of the Scheme and the protection it provides.

Commercial Credit Reference Agency

In 2006, the HKMA in collaboration with the CCRA Industry Working Group will complete the inclusion of sole proprietorships and partnerships in the Agency's database.

Consumer credit data sharing

The HKMA will continue to monitor the benefits of positive credit data sharing according to a set of indicators agreed with the Consumer Council.

Consumer protection

The HKMA will continue to promote improvements in the standard of banking practices through participation in the work of the Code of Banking Practice Committee. It will also monitor AIs' compliance with the Code through the annual self-assessments and handling complaints about banking services.

Basel II implementation

Developing Capital and Disclosure Rules

The HKMA will continue to work in consultation with relevant parties to develop the Capital and Disclosure Rules. There will be two consultative rounds to consider the draft Rules, preliminary discussions with industry associations on the first draft and subsequent statutory consultations on the second draft with the industry associations as well as the Banking Advisory Committee, the Deposit-Taking Companies Advisory Committee and the Financial Secretary. The Rules will then be finalised for submission to the Legislative Council for negative vetting in the third quarter of 2006.

Establishment of Capital Adequacy Review Tribunal

Under the Banking (Amendment) Ordinance 2005, the HKMA plans to establish the Capital Adequacy Review Tribunal and the appeal procedures in 2006. AIs aggrieved by certain decisions made by the Monetary Authority under the Capital Rules can seek a review by the Tribunal. Decisions to be reviewed by the Tribunal are expected to be fundamental issues such as the choice of approach for calculating the CAR, which may have a material impact on the AI's minimum capital requirement.

New capital adequacy standards under Basel II

The HKMA will work closely with the industry to prepare for the implementation of the revised framework in January 2007. Some of the key tasks to be undertaken by the HKMA during 2006 include:

Pillar 1

Finalise the new capital adequacy ratio return and its completion instructions in consultation with the banking industry. Introduce a temporary parallel reporting system using the new return and the existing return to familiarise AIs with the new return and assist them in assessing the impact of the new capital standards.

Finalise the guidance note on validating the risk-rating system under the IRB Approach for issue in early 2006, taking into account comments received and any further international development. On-site examinations will also be conducted in early 2006 on AIs planning to adopt the IRB Approach in 2007. The recognition process for AIs intending to adopt the IRB Approach in 2008 will begin in 2006. Where necessary, discussions will be arranged with AIs to ensure a smooth transition and recognition process.

Pillar 2

The new Pillar 2 assessment framework will be further developed in 2006 to ensure that the assessment criteria and methodology are appropriate and to take into consideration comments received during the consultation. A more formal mechanism will be established to ensure the quality, objectivity and consistency of assessments for determining individual AIs' minimum CARs, and to improve supervisory transparency and accountability. In future, after completion of a Pillar 2 assessment, the HKMA will discuss with the AI concerned the results of its assessment, particularly any areas of concern.

The HKMA will review the methodology for assessing the CAMEL rating of AIs to harmonise the system with the Pillar 2 process.

Pillar 3

The HKMA plans to issue a consultation paper on financial disclosure in the first quarter of 2006, and to convene meetings of the Working Party on Financial Disclosure and Joint Technical Working Group on Financial Disclosure. Disclosure Rules will then be developed under Section 60A of the Banking (Amendment) Ordinance 2005, to replace the relevant modules of the *Supervisory Policy Manual* relating to financial disclosure by AIs, incorporated both locally and overseas.

Executive briefing

To ensure AIs take appropriate steps for implementing Basel II, the HKMA has organised a briefing session for the senior executives of institutions to assist them in understanding the underlying objectives, key changes and implications of the revised framework.

> Basel II

Accounting standards

Developments in accounting standards will be kept under review to assess their potential impact on the banking sector and the HKMA's supervisory framework. This will include liaison with the accounting professions, industry associations and other regulatory bodies. At an international level, initiatives are underway to improve co-ordination between banking supervisors and accounting standard setters. In particular, the Basel Committee intends to work with the International Accounting Standards Board in reviewing *International Accounting Standard 39 Financial Instruments: Recognition and Measurement*. Further guidance is expected from the Basel Committee on addressing the impact of the new accounting standards on various prudential requirements.

Prevention of money laundering and terrorist financing

The HKMA will strengthen the supervisory framework and monitoring of AIs' compliance with the relevant requirements, particularly with regard to deficiencies identified in AIs' self-assessment reports. Common issues revealed from the self-assessment results will form the basis for the HKMA to further develop supervisory guidance. To help accomplish this, the HKMA will put more resources into its anti-money laundering efforts, including providing further training to on-site examination staff.

The HKMA also plans to co-ordinate the establishment of specific industry user groups to address anti-money laundering and terrorist financing issues with a higher priority of concern. The aim is to strengthen the banking industry's preparedness to meet new challenges in this area.

To help keep Hong Kong's anti-money laundering framework in line with the latest standards issued by the Financial Action Task Force, the Administration is considering a bill to put the basic obligations relating to customer due diligence and record-keeping into law. The HKMA will work with the Government and financial regulators in drafting the bill, and will seek comments from the banking industry on the proposed legislation when necessary.