



# Banking Stability

**A major objective 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. In 2006 the HKMA continued to improve its banking supervisory approach by using more benchmarking reviews to identify the best risk management and internal control practices for selected businesses of the banking industry. With increasing competition in the industry, particular attention was paid to the ability of AIs to properly manage the risks arising from aggressive pricing strategies for their residential mortgage business. Preparations were completed for the implementation of Basel II in January 2007.**

## 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.

## REVIEW OF 2006

### Risk-based supervision

During the year the HKMA further developed its risk-based supervisory approach, allocating more resources to thematic examinations of selected AIs. These examinations allowed the HKMA to benchmark AIs' risk management and internal control practices on important business lines and major risk areas. They also helped identify emerging risks common to the examined AIs and enabled the HKMA to issue guidance on sound industry practices in these areas.

A total of 247 on-site examinations were performed in 2006. Of these, 111 were thematic examinations: 25 to assess AIs' compliance with the business restrictions on renminbi business; 17 on AIs' implementation of the standardized (credit risk) aproach and the Internal Ratings-Based (IRB) approach under Basel II; 22 on AIs' anti-money-laundering and counter-terrorist-financing (AML/CFT) controls over correspondent banking activities and private banking business; 15 on AIs' controls for protecting customer data; 22 on AIs' retail wealth management activities, focusing on the selling of insurance and structured products; and 10 to review AIs' investment advisory activities under co-ordinated efforts with the Securities and Futures Commission (SFC).

[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.

The HKMA conducted 86 risk-based and 10 overseas examinations, including reviews of selected AIs' operations in Mainland China. Specialist teams carried out detailed examinations of risk management controls in specific areas, including nine examinations of AIs' treasury and derivatives activities, seven tier-2[2] examinations of the securities business of AIs, 15 reviews of selected AIs' business continuity planning for a possible pandemic, and five examinations of AIs' Internet banking activities and technology risk management practices. The HKMA also began tier-2 examinations of the effectiveness of selected AIs' procedures to combat money laundering and terrorist financing.

In addition to on-site examinations, the HKMA conducted 185 off-site reviews and held 51 tripartite meetings, while resources were also devoted to other duties including the approval of acquisitions of local AIs and handling non-compliance with guidelines or statutory requirements. Regular contact was made with the boards of directors of locally incorporated AIs or important committees under the boards. The supervisory teams met the boards of six banks and members of board-level committees, in particular the audit committees, of 13 other banks and two restricted licence banks.

The Banking Supervision Review Committee considered 14 cases relating to the licensing of AIs and money brokers and a case concerning an AI's possible breach of the Banking Ordinance. In addition, 278 applications to become controllers, directors, chief executives and alternate chief executives of AIs were approved. Details of the operational supervisory work performed in 2006 are set out in Table 1.

**Table 1. Operational Supervision**

| | 2005 | 2006 |
|---|---|---|
| 1. On-site examinations | 228 | **247** |
| *Regular examinations* | | |
| – risk-based | 92 | **86** |
| – overseas | 11 | **10** |
| *Specialised examinations* | | |
| – treasury and derivatives activities | 8 | **9** |
| – securities (tier-2) | 5 | **7** |
| – e-banking activities and technology risk management | 17 | **5** |
| – AML/CFT controls (tier-2) | – | **4** |
| – business continuity plan | 17 | **15[3]** |
| *Thematic examinations* | | |
| – renminbi banking business | 18 | **25** |
| – implementation of the standardized (credit risk) approach and the IRB approach under Basel II | – | **17** |
| – AML/CFT controls over correspondent banking and private banking | – | **22** |
| – controls for protecting customer data | – | **15** |
| – retail wealth management | 14 | **22** |
| – investment advisory activities | – | **10** |
| – trade financing | 22 | **–** |
| – residential mortgage | 24 | **–** |
| 2. Off-site reviews and prudential interviews | 187 | **185** |
| 3. Tripartite meetings | 71 | **51** |
| 4. Meetings with boards of directors or board-level committees of AIs | 18 | **21** |
| 5. Approval of applications to become controllers, directors, chief executives, alternate chief executives of AIs | 332 | **278** |
| 6. Reports commissioned under Section 59(2) of the Banking Ordinance | 4 | **1** |
| 7. Cases considered by the Banking Supervision Review Committee | 7 | **15** |

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

[3] In 2006, the examinations focused on assessing AIs' preparedness for a possible pandemic.

The HKMA used its powers under Section 59(2) of the Banking Ordinance to require one AI to commission external auditors to review its treasury and derivatives business and report their findings to the HKMA. Seven AIs voluntarily appointed external auditors to review their controls on selected areas identified by the HKMA as cause for concern. Improvements were subsequently implemented.

No AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio, the liquidity ratio, large exposures under Section 81 and connected lending under Section 83 of the Ordinance. However, there were two technical breaches of the requirements for the holding and acquisition of share capital of companies under Section 87 and Section 87A. These breaches, which were determined to be unintentional, were promptly rectified and did not affect the interests of depositors.

## CAMEL[4] rating review

The CAMEL Approval Committee met nine times during the year to determine the CAMEL ratings of individual AIs. The AIs were notified of the ratings and were given the opportunity to request a review of their ratings, although none did so. These ratings of licensed banks were used as the supervisory ratings provided to the Hong Kong Deposit Protection Board before the end of the year to help it determine the contributions to be paid by the banks in 2007 under the Deposit Protection Scheme.

## Appointment of Manager

The appointment of a Manager, on 16 September 2005, under section 52(1) of the Banking Ordinance to manage the affairs, business and property of Delta Asia Credit Limited (DAC), a deposit-taking company, continued during 2006. The HKMA continued to communicate with the relevant overseas authorities to monitor developments related to DAC and its parent bank in Macao, and review regularly the supervisory measures to safeguard the interests of DAC's depositors and the integrity of the banking system.

## Prevention of money laundering and terrorist financing

One of the major supervisory focuses of the HKMA in 2006 was to further strengthen the oversight of AIs' controls for combating money laundering and terrorist financing, and to ensure the supervisory framework's compliance with international standards. A specialist team was established through the internal redeployment of resources to conduct tier-2 examinations of AIs and thematic examinations on selected high-risk areas. To help prioritise the HKMA's supervisory efforts, the specialist team implemented a risk-profiling process for assessing the inherent money laundering and terrorist financing risks and the effectiveness of the risk mitigation processes adopted by AIs.

With the results of the risk-profiling exercise, the team conducted four tier-2 and 22 thematic examinations covering various risk areas including AIs' controls over correspondent banking and private banking businesses. The HKMA identified and shared with the industry improvements recommended for the oversight of transaction-based intermediary businesses. In addition, 55 high-level (tier-1) examinations were conducted as part of the risk-based examinations of individual AIs in 2006.

In March, the HKMA issued a report to the banking industry summarising the results of an industry-wide self-assessment on compliance with the regulations. The results, while suggesting a high level of compliance, also reflected some issues and challenges faced by the industry. As a result, the HKMA co-ordinated the establishment of an Industry Working Group and three User Sub-groups in June to further improve the banking industry's ability to guard against improper activities, and to promote industry standards and best practices. The Working Group chaired by the HKMA meets quarterly.

[4] 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.

In October, a circular was issued setting out the HKMA's approach to formalise the use of supervisory measures for addressing serious money-laundering or terrorist-financing concerns identified in individual AIs. This approach aims to provide a more structured framework for the HKMA to differentiate the seriousness of AIs' deficiencies, determine the supervisory measures to be taken, and encourage AIs to quickly address concerns.

The HKMA revised the AML guidelines on wire transfers in November to implement *Special Recommendation VII* issued by the Financial Action Task Force (FATF) on Money Laundering. Under the revised requirements, an ordering AI must include some additional basic information about the originating customer in the message of a cross-border remittance transaction of $8,000 or more, with effect from 2 January 2007. To align with amendments to the Organised and Serious Crimes Ordinance, a circular was also issued in December requiring AIs to lower the threshold for customer identification and record-keeping requirements from $20,000 to $8,000 for remittance or money-changing transactions executed for non-account holders.

The HKMA consulted the industry in April on whether Hong Kong should adopt a threshold-based transaction reporting system (reporting to a central agency by banks and other financial institutions and intermediaries of all transactions in any currency above a fixed amount) pursuant to *FATF Recommendation 19*. The consultation helped the Government assess the proposal. The industry was not attracted to the idea because of the significant costs associated with developing and operating the system and the fact that it would not help AIs detect suspicious transactions. The industry comments were passed to the Government for consideration.

The Narcotics Division of the Security Bureau, the Joint Financial Intelligence Unit and the HKMA jointly held an anti-money-laundering seminar for the banking industry in September to brief the compliance officers of AIs on key issues relating to customer due diligence and suspicious transaction reporting. Two briefing sessions were conducted for the chief executives of AIs on 27 September, providing them with an update on major anti-money-laundering issues and challenges affecting the industry and the role they are expected to play in combating money laundering and terrorist financing.

## China-related businesses

### *Renminbi banking business*

At the end of 2006, 39 licensed banks were eligible to conduct renminbi business while the total amount of renminbi deposits reached RMB23.4 billion yuan. From March 2006, Participating Banks are allowed to open current accounts for Hong Kong residents to use renminbi cheques to pay for personal consumption in Guangdong Province (including Shenzhen). To facilitate the cross-border clearing and settlement of renminbi cheques, the Clearing Bank for renminbi banking business co-operated with Hong Kong Interbank Clearing Limited to establish a new Renminbi Settlement System in the first quarter of 2006, which was subsequently upgraded for the settlement of other renminbi transactions.

The HKMA continued to monitor the renminbi business. To cope with the expanded services, the HKMA revised the related prudential returns in the first quarter of 2006. Results of thematic examinations covering 25 AIs offering renminbi banking services indicated that their internal control systems were sufficient to ensure compliance with the applicable business restrictions and detect irregular transactions. There was scope for some AIs to improve their controls and the HKMA issued a circular to share with the industry the common issues and good practices identified during the examinations.

### Non-bank China exposures

The HKMA has required AIs to report their exposures to specified non-bank Mainland entities since December 1998. With the increasing economic integration between Hong Kong and the Mainland, the HKMA revised its reporting framework in December 2005 to include exposures arising from credit facilities granted by AIs to non-Chinese entities but for use on the Mainland. Reporting of the new data series commenced with the September 2006 position. At the end of 2006, the industry's aggregate on-balance sheet non-bank China exposures amounted to HK$430.5 billion, or 4.7% of all AIs' total assets.

### Mainland's relaxation of controls over foreign investments

Mainland authorities announced a series of rules and notices in the second quarter of 2006 allowing commercial banks, fund management and securities companies, and insurance companies to provide wealth management services for Mainland individuals and entities to invest outside Mainland China. Among these institutions, commercial banks operating on the Mainland, including foreign banks' Mainland operations, are allowed to start the new business after obtaining approval from the China Banking Regulatory Commission (CBRC) and the foreign exchange quota from the State Administration of Foreign Exchange (SAFE). At the end of 2006, four banks incorporated in Hong Kong had been given approval by the CBRC to conduct the new business. To ensure the scheme is properly implemented, the CBRC, SAFE, the HKMA and the SFC have formed a joint working group to improve cross-border supervisory co-operation.

### Mainland banking market opens up

Monday 11 December 2006 marked the opening up of the Mainland banking market under the Regulations on the Administration of Foreign-funded Banks, which were announced by the State Council in November, honouring the commitment given by China on accession to the World Trade Organization. The CBRC also subsequently announced the Implementation Rules to supplement the new regulations.

Under the Regulations, foreign-funded banks incorporated on the Mainland are entitled to "national treatment", which allows them to conduct banking business on a level playing field with domestic banks. This includes full-scope renminbi banking business targeting all customers (including Mainland residents) in Mainland China, provided they fulfil the prudential requirements equally applicable to domestic banks. Foreign banks operating branches on the Mainland are allowed to take renminbi time deposits from Mainland residents of not less than RMB1 million yuan.

The HKMA has maintained close contact with individual banks to understand their business strategy in Mainland China in light of the new framework. There is also regular dialogue with the CBRC to improve cross-border supervisory co-operation and co-ordination for the expected increasing presence of Hong Kong banks on the Mainland. At the end of 2006, the CBRC had approved three Hong Kong-incorporated banks to restructure their existing Mainland branches to Mainland-incorporated banking subsidiaries.

### CEPA

Since the implementation of the Closer Economic Partnership Arrangement in 2004, Hong Kong banks have gained greater access to the Mainland market. At the end of 2006, 8 banks were entitled to establish a Mainland presence under CEPA. Of these, 5 had opened a total of 8 branches. In response to the opening up of the banking market in December, CEPA may be further refined to improve the competitive edge of Hong Kong banks on the Mainland.

## Residential mortgage loans

Competition among AIs for residential mortgage business intensified in 2006. This prompted the HKMA to closely monitor how well AIs were managing the risks, particularly whether they were taking on excessive risks (especially interest rate risk) that they were not in a position to manage, and whether AIs had adopted prudent risk management and complied with the prudential guidelines. The results of the assessment did not indicate, at this stage, any serious supervisory concerns. Nevertheless, the HKMA reminded individual AIs of the need to be alert to the management of interest rate risk since the flexibility for AIs to raise their prime rates could, at times, be limited by market competition. During its regular on-site examinations, the HKMA also reviewed the residential mortgage business of 20 AIs, which showed they continued to adopt prudent underwriting criteria and practices.

## Treasury activities

In addition to its specialised on-site examinations of AIs' treasury operations, the HKMA conducted a benchmarking review on the stress-testing practices of selected AIs on market and interest rate risks associated with treasury activities. This follows the growing involvement of the banking sector in dealing with complex structured products and the uncertainties surrounding interest rate movements, which have increased the risks faced by AIs' treasury operations. After the review, the HKMA issued a circular to all AIs in November to highlight the good industry practices identified in the exercise.

## Co-operation with overseas supervisors

The HKMA continued to maintain a close working relationship with overseas regulators, signing Memoranda of Understanding with the Financial Supervisory Commission of Korea, the Swiss Federal Banking Commission and the South African Reserve Bank during the year to provide a formal framework for supervisory co-operation and the sharing of information. The establishment of similar arrangements was discussed with a number of other overseas supervisory authorities. Meetings to discuss supervisory issues of common interest were also held in Hong Kong and overseas with banking supervisors from the Mainland, Macau, Taiwan, the US, the UK, Australia, France, Germany, India, Indonesia, Italy, Japan, Pakistan, the Philippines, South Korea, Switzerland, Thailand and Vietnam.

*Mr Yoon Jeung-Hyun (left), Chairman of the Financial Supervisory Commission of Korea, and Joseph Yam, Chief Executive of the HKMA, sign the Memorandum of Understanding.*

## Supervision of technology and operational risks

### *Internet banking and technology risk management*

The HKMA has established a supervisory framework to promote a safe and sound environment for Internet banking, which continued to grow during the year. By the end of 2006, Hong Kong had some 3.8 million personal Internet banking accounts, 15% higher than a year earlier; and 234,000 business or corporate Internet banking accounts, up 44%. In May 2005, Hong Kong launched two-factor authentication for high-risk transactions conducted through Internet banking, becoming one of the first jurisdictions among developed financial markets to mandate the system. Since its launch, 30 AIs have implemented the additional safeguards and around 1.4 million customers (up 49%) have registered for the service.

The HKMA extended the coverage of the automated control self-assessment process for Internet banking and technology risk management to 60 AIs. The results of the self-assessments indicated a marked improvement in the overall IT control of AIs since the process began in 2003.

Following a leak of credit card data in the US in 2005, the HKMA requested all AIs to perform a detailed self-assessment of their security controls over customer data. To ensure there were adequate controls to protect customer data and the issues identified in the self-assessment had been satisfactorily addressed, the HKMA reviewed the controls of 15 AIs. The overall level of control was found to be acceptable. However, improvements were needed in safeguarding sensitive customer data stored in peripheral devices, such as notebook computers and memory devices, and on hard-copy documents, or data processed and maintained by outside service providers. A circular was issued to all AIs on the common issues identified.

### *Business continuity management*

Since November 2005, the HKMA has worked with the banking industry to ensure a high degree of preparedness for a possible pandemic and to minimise any systemic risk. An industry task force involving eight major banks was established by the HKMA to monitor avian flu developments and to review applicable good business continuity planning practices for the banking sector. An article published in the June 2006 *HKMA Quarterly Bulletin* included a discussion of the possible supervisory response and regulatory forbearance to be considered by the HKMA in the event of a pandemic. The HKMA also carried out specialised examinations of 15 AIs' business continuity plans, which showed they had largely completed their preparation, verification and testing by mid-2006, and had drawn on their experience and lessons learned during the 2003 SARS outbreak and preparations for the World Trade Organization's Sixth Ministerial Conference in December 2005.

## Supervision of ancillary activities

### *Securities and insurance businesses*

The HKMA and the SFC liaise closely on matters of common supervisory interest, and two meetings were held in 2006 to discuss the supervision of securities business of Registered Institutions (RIs). Under the transitional arrangements of the Securities and Futures Ordinance, the HKMA has been working with the SFC to process migration applications of AIs with deemed "Registered Institutions" status to become RIs. At the end of 2006, 74 deemed RIs had lodged their migration applications. Of these, three revoked their status as AIs (and thus their deemed RI status). The HKMA had assessed most of the applications, resulting in 64 deemed RIs being registered with the SFC. It also granted consents to 86 executive officers, who are responsible for supervising the securities activities of RIs.

To gradually extend the coverage of self-assessment compliance, the HKMA increased the number of participating RIs by 10, to 40, in 2006. A circular was issued in September to highlight important regulatory requirements and recommend sound practices concerning the self assessment system to ensure the fitness and propriety of staff engaged in securities activities and other related duties.

The results of joint HKMA and SFC thematic examinations on securities business during the year indicated that the product due diligence process was acceptable and the controls were generally in place. Thematic examinations on the retail wealth management business of AIs and their compliance with codes and guidelines on the sale of investment-linked insurance and structured products to retail customers showed the banks' procedures were effective. However, some AIs were required to further improve their client and product suitability procedures.

### *Securities enforcement*

Procedural improvements were completed and, together with the expansion of the Securities Enforcement Team, these led to notable benefits in the efficiency and effectiveness of investigations and disciplinary reviews. In the final quarter of 2006, a Securities Enforcement Division was established to handle enforcement issues and related complaints.

Investigation of 17 cases opened previously continued in 2006. Another 12 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 2006, the investigation of 19 cases was in progress.

The Disciplinary Committee, which makes recommendations on the exercise of disciplinary powers, considered three cases following the completion of the investigation and disciplinary review.

The HKMA and the SFC jointly disciplined three existing and former "relevant individuals" of a Registered Institution for unlicensed dealing and supervision failure. This was the first time for the two regulators to take joint disciplinary action under the Securities and Futures Ordinance.

The investigation into another case of suspected unlicensed dealing by an authorized institution was completed and referred to the SFC to consider prosecution and further investigation. A suspected breach of the Banking Ordinance uncovered in the case was referred to, and followed up by, the Banking Supervision Department. The Disciplinary Committee also reviewed a case involving the acceptance of pre-signed blank Investment Funds Dealing Order Forms from a client. The Monetary Authority, on the advice of the Committee, decided to impose disciplinary sanctions on the current "relevant individual" and recommend the SFC take disciplinary action against the former "relevant individual".

Investigations into another seven cases found there were insufficient grounds for disciplinary action. These cases included suspected misrepresentation and other improper acts in soliciting investment funds and securities, suspected failure to provide adequate fund-switching advice and suspected failure to exercise due diligence when acting as a sponsor.

## Banking sector infrastructure

The Deposit Protection Scheme was launched on 25 September 2006, and good progress was made in expanding the coverage of the Commercial Credit Reference Agency to include sole proprietorships and partnerships.

### *Deposit Protection Scheme*

Final preparations for the launch of the Scheme were completed by the Hong Kong Deposit Protection Board, with the assistance of the HKMA. These included formulation of all rules and guidelines governing the Scheme's operation, the amendment of Schedule 1 to the Deposit Protection Scheme Ordinance to clarify the treatment of structured products, and the development of a payout system and procedures for promptly compensating depositors. Starting from 25 September, eligible depositors are entitled to compensation of up to $100,000 in the event of a bank failure. The Board also launched an extensive publicity programme on the key features of the Scheme.

### *Commercial Credit Reference Agency*

The CCRA has been operating smoothly since its establishment in November 2004. It covers more than 48,000 small and medium-sized enterprises defined as non-listed companies with an annual turnover not exceeding $50 million. More than 120 AIs are sharing commercial credit data through the CCRA.


*Executive Director (Banking Development), also Chief Executive Officer of the Hong Kong Deposit Protection Board, Raymond Li (left) and Chairman of the Board Professor Andrew Chan at a press conference to announce the launch of the Scheme.*

The HKMA participated in the Industry Working Group on the CCRA. During the year the Group devised the implementation details for expanding the coverage of the CCRA to include sole proprietorships and partnerships.

## Consumer credit data sharing

The HKMA completed the second review of the benefits of positive consumer credit data sharing, based on a set of indicators agreed with the Consumer Council. The review reaffirmed that benefits were being shared between consumers and financial institutions. With improved access to positive data after the moratorium, financial institutions are capable of offering more personalised interest rates to their customers taking into account the credit ratings assigned by the credit reference agency. Consumers benefit by maintaining a good credit record.

## Consumer protection

### *Code of Banking Practice*

The banking industry completed the annual self-assessment of compliance with the Code of Banking Practice covering the period from June 2005 to May 2006. One hundred and seventy-two AIs providing personal banking services conducted the self-assessment. One hundred and fifty AIs reported full compliance with the Code, 19 identified five or fewer instances of non-compliance and three identified more than five. The main areas of non-compliance related to the advance of loans and overdrafts, and terms and conditions of banking services. Most AIs reported they had adequate systems of control and management oversight to ensure compliance with the Code. As soon as AIs identified non-compliance, the HKMA required them to take prompt remedial action.

› Consumer Information › Code of Banking Practice

### *Customer complaints*

The HKMA received 292 customer complaints about banking services provided by AIs, compared with 328 the previous year (Chart 1). The decline was noted across all types of banking services, including the number of complaints against debt collection agencies (DCAs) appointed by AIs. The quarterly returns submitted by AIs since March 2002 show the number of DCA-related complaints further decreased to 129 in 2006 from 171 in 2005, indicating that AIs have been vigilant in monitoring the performance of their DCAs (Chart 2).

› Consumer Information › Complaints about Banks

## Consolidation of bank branches

Increased competition in the banking sector, together with the introduction of new technology, has led some banks to consolidate their branches. At the request of the HKMA, the Hong Kong Association of Banks established a special task force in January 2006 to identify ways to minimise the impact of branch closures on the public. In June, after detailed discussions, the Task Force announced, and has begun implementing, a series of recommendations. These include simplifying the operating procedures of ATMs to facilitate their use by senior citizens, developing community-wide education programmes on the use of ATMs, encouraging banks to give priority to setting up ATMs or self-service banking centres in public housing estates where the establishment of a bank branch is not feasible, and exploring with EPS the feasibility of cash withdrawals independent of any purchase of goods at selected retailers.

**Chart 1. Complaints on banking services of AIs received by the HKMA**

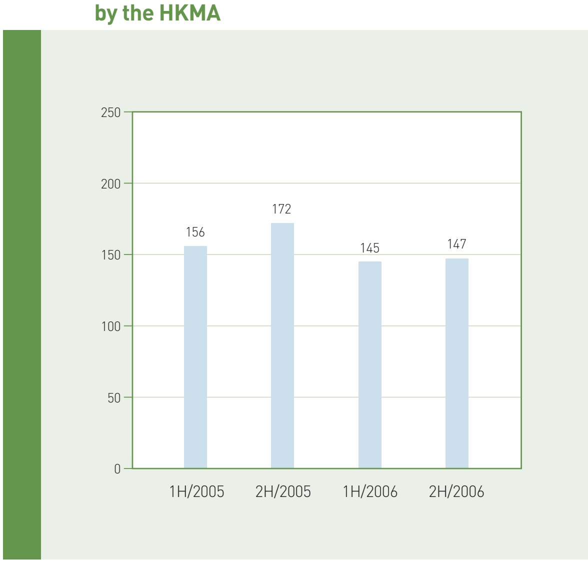
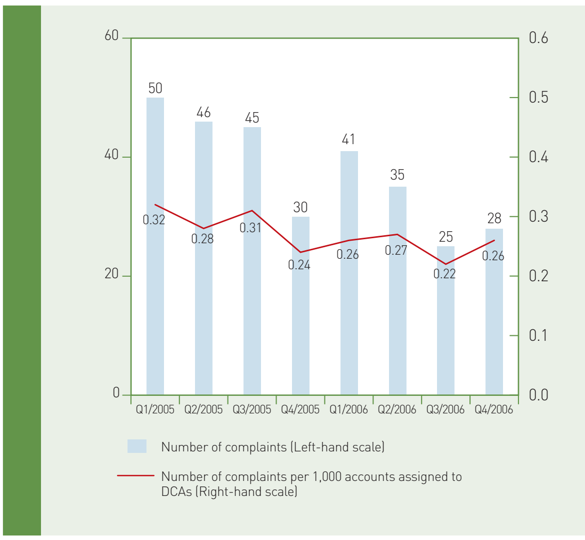



**Chart 2. DCA complaints received by AIs**



## Basel II Implementation

The HKMA, together with the banking industry and the Government, completed the preparatory work for the implementation of Basel II in Hong Kong on 1 January 2007. The HKMA also continued to provide assistance to the industry in their preparation for compliance with the requirements under the new capital adequacy framework.

### Legislation

#### *Banking (Capital) Rules and Banking (Disclosure) Rules*

Following extensive consultation on earlier implementation proposals on the new capital requirements and disclosure standards under Basel II, rules were developed during the year for implementing the minimum capital requirements (Pillar 1) and market discipline requirements (Pillar 3). The Banking (Capital) Rules and the Banking (Disclosure) Rules under the Banking Ordinance came into effect on 1 January 2007. They prescribe how the capital adequacy ratio (CAR) of Hong Kong-incorporated AIs is to be calculated and what information on the state of affairs, profit and loss, and CAR is to be publicly disclosed by AIs. The Rules were made following consultation with the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks, the DTC Association and the Financial Secretary as required under the Banking Ordinance, as well as a wide range of stakeholders in the community.

#### *Appeal mechanism*

The Capital Adequacy Review Tribunal was established by the Government, as required under the Ordinance, with the appointment of a chairman and four members for a three-year term also with effect from 1 January 2007. This independent body will review, on application of an aggrieved institution, decisions made by the Monetary Authority under the Banking (Capital) Rules on the choice of approaches for the calculation of credit, market and operational risks.

### Pillar 1

#### *New CAR returns and parallel reporting*

A new CAR return was developed for AIs to report their CAR calculations under the new framework, starting from their positions at the end of March 2007. An exercise requiring AIs to report their CARs based on both the previous CAR return and the new return was conducted for the positions at the end of September and December 2006. The aim of this "parallel reporting" was to familiarise AIs with the reporting requirements, and to facilitate their compliance and impact assessment. Data submitted for the two reporting positions in 2006 indicated the overall impact on the capital adequacy ratio of the banking sector was as expected — the average CAR of Hong Kong-incorporated AIs recorded a slight drop mainly because of the additional operational risk capital charge.

#### *Recognition of ratings assigned by external credit assessment institutions*

The new framework allows the use of credit ratings assigned by recognised external credit assessment institutions (ECAIs) for determining risk-weights of credit exposures. These include the standardized (credit risk) approach for general credit exposures and the standardized (securitisation) approach for securitisation exposures. The HKMA issued a policy paper setting out its approach to recognising ECAIs for Basel II in June 2006 and subsequently announced the recognition of ratings assigned by Standard & Poor's Ratings Services, Moody's Investors Service, Fitch Ratings, and Rating and Investment Information, Inc.

### *Revised market risk framework*

The HKMA incorporated into the Banking (Capital) Rules the existing capital framework for market risk together with new standards laid down by the Basel Committee on Banking Supervision (Basel Committee) for trading book definition, prudent valuation, alignment of capital treatment for exposures held in the trading book and the banking book, and specific risk modelling. The Rules are supplemented by a supervisory policy manual (SPM) module on *Use of Internal Models Approach to Calculate Market Risk*. This technical note incorporated additional guidance on the minimum requirements for using the internal-models approach and replaced the previous technical note on *Use of Internal Models to Measure Market Risk*.

### *Assessment of AIs' readiness for Basel II*

Preparations for the adoption of the IRB approaches by AIs continued to make good progress in 2006 and placed Hong Kong at the forefront of jurisdictions offering the advanced approaches under Basel II.

At the start of 2006, the HKMA finalised the guidance note on the validation of risk rating systems under the IRB approach after incorporating industry comments on the draft issued in 2005. The guidance note sets out the HKMA approach to the validation of AIs' internal rating systems and the requirements the HKMA expects AIs to meet in order to use the IRB approach. It was issued as an SPM module in February 2006.

Regulatory approaches to IRB validation continue to evolve rapidly and, following clarification of the use test by a number of leading regulatory agencies, the HKMA revised its own requirements on the use test in the second half of 2006. The changes were made to ensure the HKMA's requirements are consistent with those of jurisdictions with which it has close home/host co-operation, and to ensure a level playing field among the IRB applicant AIs in Hong Kong, which are predominantly subsidiaries of foreign banking groups. The changes were set out in a feature article in the December 2006 issue of the *HKMA Quarterly Bulletin*.

As individual AIs planning to adopt the IRB approach between 2007 and 2009 moved closer to their target implementation dates, the HKMA engaged them in more frequent dialogue in 2006 to monitor their progress, develop a more detailed understanding of their rating systems, and provide guidance on emerging implementation issues at the AIs' request.

The HKMA has undertaken assessments including on-site examinations of AIs planning to adopt the foundation IRB approach in 2007. The on-site examinations of several AIs intending to adopt the IRB approach in 2008 have also begun.

In relation to the implementation of the standardized (credit risk) approach, the HKMA conducted a number of high-level examinations focusing on the board and senior management oversight and overall project management of 14 AIs. The results indicated that AIs generally had adequate oversight of the Basel II implementation efforts.

### *Home/host co-operation*

As the majority of Hong Kong-incorporated AIs planning to adopt the IRB approach are subsidiaries of foreign banking groups, the HKMA, as host supervisor, intensified its communication with the home supervisors of these banking groups. The aim was to keep home and host authorities updated on the IRB implementation progress of individual banking groups, discuss issues of mutual concern including the allocation of responsibilities for IRB system validation, avoid supervisory overlap, and reduce the regulatory burden on the banks.

### Pillar 2 framework

The HKMA has developed a detailed and rigorous assessment framework based on its existing risk-based supervisory system to help conduct the supervisory review process recommended under Pillar 2. This framework, which takes into account an AI's overall risk profile and management systems, the extent of its exposure to risks not covered under Pillar 1, and its approach to conducting internal capital assessments, will be used by the Monetary Authority to evaluate and monitor the capital adequacy of individual AIs, and to determine their minimum CAR under the Banking Ordinance. The assessments will also help the Monetary Authority to set the supervisory priorities for individual AIs and facilitate an industry-wide analysis of banking risks. Details of the framework, including the procedures for ensuring the quality, objectivity and consistency of the assessments, were, after industry consultation, set out in an SPM module *Supervisory Review Process* issued as a statutory guideline in November 2006.

### Pillar 3 requirements

The Banking (Disclosure) Rules apply to AIs' first financial year commencing on or after 1 January 2007. For AIs whose financial year commences on 1 January, their first disclosures under the new regime will be the interim disclosures relating to 30 June 2007. However, the Rules will not apply to a minority of AIs with a financial year commencing on a date other than 1 January until their 2006/2007 financial years end. For AIs in this category, the HKMA has provided guidance on the disclosure requirements during the transition period until the start of their 2007/2008 financial years. These institutions are required to continue to apply the appropriate SPM modules on financial disclosures and follow the changes in certain disclosure items as a result of the replacement of the Third Schedule to the Banking Ordinance by the Banking (Capital) Rules.

› Basel II

## Developing supervisory policies

### *Credit card business*

In January 2006, the HKMA issued an SPM module on *Credit Card Business* to provide AIs with guidance on the management of risks associated with credit card business. The module also advocates the development of risk-based pricing using information obtained from external credit reference agencies and taking a constructive view of restructuring and debt relief plans to help cardholders with repayment problems.

### *Use of fair value option for financial instruments*

Section 40(2) of the Banking (Capital) Rules provides that an AI may, with the prior consent of the MA, include fair value gains arising from its holdings of equities and debt securities designated at fair value through profit or loss in its core capital to determine capital base. The consent is conditional on the MA being satisfied that the AI's controls over the use of the fair value option (FVO) meet certain minimum prudential standards. An SPM module on *Use of the Fair Value Option for Financial Instruments* was issued by the HKMA on 7 November 2006 to set out the minimum risk management and control standards an AI should meet in its use of the FVO. The guideline also provides information on how the HKMA will assess an AI's risk management and controls in using the FVO.

### *New share subscription and share margin financing*

An SPM module on new share subscription and share-margin financing was issued as a statutory guideline in January 2007. This sets out the minimum business and control standards expected of AIs financing their clients' subscription for new share issues, acting as a receiving bank in an initial public offering (IPO), or providing share-margin financing to clients (including stockbrokers). The module also analyses the risks associated with these activities, draws AIs' attention to the security measures they should observe in handling IPO refund monies, and specifies precautions AIs should take to mitigate the risk of unauthorised pledging of shares related to their lending to stockbrokers.

## International co-operation

The HKMA participates in various regional and international forums for bank supervisors, including the Basel Committee's International Liaison Group, the EMEAP Working Group on Banking Supervision, the Offshore Group of Banking Supervisors and the South East Asia, New Zealand and Australia Forum of Banking Supervisors. The HKMA chairs the EMEAP Working Group on Banking Supervision, which meets twice a year to promote information sharing and regional co-operation on banking supervision.

In December, the Working Group and the Financial Stability Institute jointly organised a high-level meeting on the implementation of Basel II and other regional supervisory priorities. The two-day meeting enabled banks and bank regulators to exchange knowledge and concerns in promoting the common goal of prudent risk measurement and management under Basel II. Hosted by the HKMA, the meeting attracted 70 representatives from 23 central banks and supervisory authorities and 21 leading commercial banks. Distinguished speakers included Mr Nout Wellink, Chairman of the Basel Committee and Mr Josef Tosovsky, Chairman of the Financial Stability Institute, and senior executives from major international banks in the region.

As a member of the Basel Committee Accord Implementation Group's Validation Sub-group, the HKMA participated in the quarterly meetings to expedite the exchange of views on IRB system-related validation issues with other leading regulators. The HKMA also shared its experience in implementing specific areas of Basel II with regional supervisors at technical workshops or briefing sessions.

The HKMA hosted the Conference for International Supervisors on Information Technology in April 2006, for banking supervisors from 15 major financial markets to share their experiences in the supervision of Internet banking and technology risk management.

The HKMA and the International Monetary Fund jointly hosted a regional conference in Hong Kong in July to share experiences in helping other markets in the Asia Pacific region to prepare for a possible pandemic. The framework for effective cross-border communications with banking supervisors of major financial markets in emergencies continued to improve.

### Accounting and disclosure

#### *Impact of new standards on capital requirements and regulatory reporting*

Since January 2005, Hong Kong-incorporated AIs have been required to prepare financial statements according to new Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards. These are broadly equivalent to the International Financial Reporting Standards.

To assess their overall impact on the banking system, the HKMA conducted a study of AIs' first full-year financial results. This covered 16 licensed banks, representing about 97% of the total assets less provisions, or 98% of the total customer deposits, of all Hong Kong-incorporated AIs.

The study showed that the increased use of fair values in the preparation of financial accounts under the new Standards is likely to lead to greater volatility in the banks' reported earnings. While the overall effect was slightly positive on the banks' reported profit (+2.9%), the impact varied considerably from bank to bank, ranging from +29% to -9%. The primary impact on the banks' balance sheets was an overall reduction in accounting equity both at transition and at the end of the 2005 financial year (-5%). This was mainly due to the reclassification of preference shares from equity to liabilities in accordance with *HKAS 32, Financial Instruments: Disclosure and Presentation. HKAS 17, Leases* had a larger effect than anticipated. It not only had an adverse impact on banks' equity, but also reduced certain banks' CAR modestly by 0.1 to 1.4 percentage points. The study confirmed the HKMA's policy of requiring AIs to maintain a regulatory reserve, in addition to their accounting provisions, was useful in maintaining the overall level of provisions in the banking system at a broadly similar level to that before the implementation of the new Standards.

The study also identified two issues that require further improvement: the adequacy of the models used by AIs for the determination of provisioning levels; and the method for setting an appropriate level of regulatory reserve.

The HKMA will continue to keep abreast of accounting and disclosure developments, particularly in the implementation of the Banking (Disclosure) Rules and *HKFRS 7, Financial Instruments: Disclosure*.

## PLANS FOR 2007 AND BEYOND

### Risk-based supervision

A review of the further development of the risk-based supervisory approach, started in 2006, will continue. The preliminary conclusion is that the supervisory process will benefit from further specialisation, focusing on selected risks and business areas of the banking sector to ensure the approach remains effective given the growing complexity in banking operations and the regulatory environment. The HKMA will complete the review in 2007 and implement the recommendations as appropriate. The HKMA will fine-tune its CAMEL rating assessment of AIs to harmonise the system with the supervisory review process under Pillar 2 of Basel II. The revised CAMEL rating system will provide a more detailed assessment of the risk of individual AIs.

## Lending businesses

Through on-site examinations and off-site surveillance, the HKMA will continue to monitor AIs' management of the risks related to their lending businesses. Focus will be placed on whether there is an observable relaxation in underwriting criteria among AIs amid the intense competition in the banking industry. In particular, the HKMA will monitor closely AIs' residential mortgage loans and personal lending businesses, and assess their compliance with the prudential guidelines and their ability to manage the interest rate risk. The HKMA will also review individual AIs' share financing and related businesses and their ability to withstand the impact of any significant market fluctuation, in view of the significant volatility in the stock market during the latter half of 2006.

## China-related businesses

### *Renminbi banking business*

On 10 January 2007, the State Council announced a further expansion of renminbi business in Hong Kong by allowing qualified Mainland financial institutions to issue debt securities in Hong Kong. The HKMA is considering the relevant supervisory requirements for this development, and new supervisory circulars and revised prudential returns will be issued where necessary. Thematic examinations will also be conducted on the expanded scope of renminbi banking services.

### *AIs' operations on the Mainland*

With the growing importance of Mainland business to Hong Kong-incorporated AIs, and the plans of some of them to turn their Mainland operations into Mainland-incorporated banking subsidiaries, the HKMA will closely monitor AIs' Mainland operations in 2007. In addition to conducting on-site examinations under the MoU between the HKMA and the CBRC, the HKMA will assess the adequacy of AIs' oversight of their Mainland operations during off-site reviews and regular risk-based examinations. Thematic examinations will also look at the investment and related services provided by AIs under the scheme for relaxed foreign investments by Mainland residents.

## Supervision of technology and operational risks

### *Internet banking, technology risk management and business continuity management*

With the growing acceptance of Internet banking services and AIs' increasing dependence on technology, the HKMA will conduct more thematic examinations on related subjects. These will include IT systems and infrastructure management, and systems support for Basel II implementation. AIs will be asked to perform supervisory control self-assessments on Internet banking, technology risk management and business continuity planning. The HKMA will maintain close contact with the banking industry and the Police to promote sound control practices and awareness of emerging fraud techniques, and to develop effective customer education programmes.

The HKMA will participate in the International IT Supervisors Group, which comprises 20 banking supervisors from developed markets, to discuss issues of common concern.

### *Operational risk management*

As a result of the increasing importance of AIs' operational risk management, the HKMA will establish a specialist team for supervising this risk area. The team will be responsible for implementing a supervisory framework and developing a system for assessing individual AIs' operational risk profiles. Thematic examinations of selected high-risk areas in operational risk management will also be conducted in 2007.

## Securities and insurance businesses

The HKMA will continue to co-operate with the SFC and the Insurance Authority on the supervision of AIs' securities and insurance-related businesses. This includes working with the SFC on the review of regulatory standards for the selling of investment products to retail customers and the implementation of the new regime on IPO sponsors. Thematic examinations of RIs' controls for ensuring the fitness and propriety of staff involved in the securities business will be conducted in 2007. There will also be follow-up examinations on the implementation of the recommendations arising from previous examinations on retail wealth management business.

Steps will be taken to further streamline communications between the HKMA and the SFC under the MoU between them. The reciprocal secondment programme between their enforcement functions will continue to improve staff training and to ensure better understanding of each other's practices to promote consistency in enforcement.

## Developing banking sector infrastructure

The HKMA will assist the Hong Kong Deposit Protection Board in maintaining an effective Deposit Protection Scheme, and support the industry in further developing the Commercial Credit Reference Agency.

### *Deposit Protection Scheme*

In the first year of the Scheme's operation, the Hong Kong Deposit Protection Board will focus on consolidating and improving the various newly established systems and monitoring the effectiveness of the systems. Simulations and payout rehearsals will be conducted. Increasing public awareness and understanding of the Scheme will also be a focus of the work in 2007.

### *Commercial Credit Reference Agency*

The HKMA will collaborate with the CCRA Industry Working Group to complete the remaining preparatory tasks for the inclusion of sole proprietorships and partnerships in the Agency.

## Consumer protection

Promoting industry self-regulation and improving the standards of banking practices through participation in the Code of Banking Practice Committee will be maintained during the year. The HKMA will also monitor AIs' compliance with the Code through the self-assessments and handling of complaints about banking services.

## Basel II implementation

### *Monitoring and assessment of impact*

The commencement of the Banking (Capital) Rules and Banking (Disclosure) Rules on 1 January 2007 for the implementation of Basel II did not end the HKMA's role in this project. Work on the new framework will continue on a number of fronts throughout 2007 and beyond to improve the risk management practices of banks, including the development of supervisory guidance on the application of the Rules and updating relevant SPM modules to align with the Basel II requirements. The HKMA will continue to monitor the impact of the new framework on AIs' capital adequacy ratios through the development of detailed internal management reports for analysing data reported under the new CAR return.

### *Supplementary guidelines*

To assist AIs in complying with the Rules, the HKMA will issue supplementary guidance, particularly on how some of the major requirements should be interpreted or applied. The guidance will also contain answers to some frequently asked questions arising from the consultation and rule-making processes. The HKMA released a draft guideline on the application of the Banking (Disclosure) Rules for industry consultation in the first quarter of 2007 to ensure that AIs have sufficient time to prepare for the first set of disclosures under the Banking (Disclosure) Rules.

### *Pillar 2 implementation*

Starting from 1 January 2007, the HKMA will conduct supervisory reviews on individual AIs as part of the risk-based supervisory process. The scope and extent of applying the assessment standards and criteria set out in the SPM module on *Supervisory Review Process* will be compatible with the nature, size and complexity of AIs' business operations. The results of the supervisory reviews will be used to assess the appropriateness of the minimum CAR and other supervisory priorities for individual AIs. In addition, the HKMA will monitor AIs' compliance with the capital adequacy and risk management standards set out in its supervisory guidelines. Where necessary, the HKMA will further refine its supervisory approach to focus on AIs' high-risk areas, and continue to issue supervisory guidance on the risk management standards to help AIs upgrade their existing systems and to meet the Basel II requirements.

### *IRB validation*

The recognition process for AIs intending to adopt the IRB approach will continue. Priority will be given to those AIs planning to adopt the approaches in 2007/2008. As home/host co-operation intensifies for the international banking groups, the HKMA will continue to participate in supervisors' meetings and in model review visits organised by home supervisors.

### *More advanced approaches*

In line with its plan for Basel II implementation, the HKMA will monitor international developments relating to the implementation of the more advanced approaches covering areas such as the measurement of operational risk and counterparty credit risk, and review the readiness of AIs for adopting them.

## Prevention of money laundering and terrorist financing

The HKMA restructured its policy and specialised examination teams in January 2007 to increase the effectiveness of its supervisory function, by centralising the teams under the same division responsible for overall co-ordination and monitoring of money laundering and terrorist financing activities. Additional resources and further training will be provided to the teams to enable more detailed and thematic examinations to be conducted in 2007.

Hong Kong's compliance with the latest FATF standards will be evaluated in the latter part of 2007 as part of the Task Force's third round of mutual evaluations on member jurisdictions. The HKMA will work with Government and the industry in preparing for the evaluations to ensure the banking sector complies, to the greatest extent possible, with the FATF standards.

## Basel Core Principles

In October 2006, the Basel Committee on Banking Supervision issued the revised *Basel Core Principles for Effective Banking Supervision*. The revisions further clarify and strengthen areas in the *Core Principles* to address innovations and developments in banking, the financial instruments and markets within which banks operate, and the methods and approaches used by supervisors. The HKMA, which was involved in the initial drafting process, recognises the importance and relevance of the revised *Core Principles* as a flexible, up-to-date and globally applicable standard. In line with its policy of conforming with international supervisory best practices, the HKMA is planning to conduct a high-level review in 2007 to assess its compliance with the revised *Core Principles* and identify areas for further improvement.

## Islamic finance

From relatively small beginnings 20 years ago, Islamic finance has grown into a market now estimated at US$700 billion to US$1 trillion. A number of financial centres outside the Middle East, such as London, Singapore and Malaysia, have encouraged the growth of Islamic finance business, and wholesale markets in Islamic financial products have been rapidly evolving. Although domestic demand for such products is likely to be modest, Hong Kong's position as an international financial centre creates an opportunity for it to develop wholesale markets in Shariah-compliant instruments as a complement to those in London and elsewhere in Asia. Hong Kong's legal system and regulatory structure is likely to be sufficiently flexible for the regulation of most Islamic capital products in the same way as other similar wholesale and retail financial products. The HKMA will work with the Government and other regulators to understand more about Islamic finance, and will develop policies to create the framework that would allow Islamic financial business to be transacted efficiently and to help maintain financial stability.

## International co-operation

The HKMA will continue to participate in regional and international forums for bank supervisors to improve regional financial stability through compatibility with international regulatory and supervisory standards.

The Bank for International Settlements has invited 54 central banks and monetary authorities, including the HKMA, to participate in the triennial survey of activity in the foreign exchange and derivatives markets in 2007. Selected AIs and some major securities houses will be invited to participate in the survey. Past surveys have been invaluable for both the public and private sectors in providing a snapshot of the size and composition of the foreign exchange and derivatives markets.

## Development of supervisory policies

Key policies to be reviewed in 2007 include:
the need for further guidance on setting a level of regulatory reserve for AIs; and a supervisory guideline on how consolidated supervision of AIs is practised by the HKMA and the laws, regulations, or prudential standards applicable to AIs on a consolidated basis, covering areas such as capital adequacy, large exposures and lending limits.