Banking Stability

Ensuring Hong Kong's authorized institutions were well capitalised and adequately liquid to face the challenges of the global financial crisis was a priority for the HKMA in 2008. Following the collapse of Lehman Brothers in mid-September, measures were introduced to provide liquidity assistance to banks and restore confidence in the banking system. The local banking sector remained resilient. Substantial resources were deployed to handle the alleged mis-selling of Lehman Brothers-related investment products by banks. A number of international initiatives are being implemented in Hong Kong to address the lessons from the current crisis.

OBJECTIVES

Promoting the safety and stability of the banking system through the regulation of banking and deposit-taking businesses and the supervision of authorized institutions (AIs) is a primary function of the HKMA. The responsibility is shared among three departments:

- the Banking Supervision Department handles the day-to-day supervision of AIs
- the Banking Policy Department formulates supervisory policies to promote the safety and soundness of the banking sector
- the Banking Development Department formulates policies to promote the development of the banking industry.

REVIEW OF 2008

Risk-based supervision

The HKMA's risk-based supervisory process was further strengthened to keep pace with developments in the banking industry. Substantial resources were devoted to conducting thematic and specialised examinations and issuing guidelines on industry best practices covering selected lines of business and major risk areas to assist AIs in improving their risk management and internal controls.

During the year, two specialist credit risk teams were established to carry out examinations reviewing AIs' best practices in commercial and consumer lending, with a particular focus on syndicated lending, residential mortgage loans, personal loans and share margin financing.

Because of the redeployment of considerable internal resources to investigate the alleged mis-selling of Lehman Brothers-related investment products by banks since mid-September, the HKMA conducted 161 on-site examinations in 2008, compared with 246 in 2007. As the financial crisis continued to unfold, the HKMA also deployed resources to conduct in-depth reviews of AIs' exposures to financial groups or banks in difficulty and financial instruments with significant diminution in value, and made sure that AIs actively monitored and managed those exposures, including marking to market appropriately. Furthermore, complaints triggered by losses on stock accumulators due to the stock market correction rose considerably in 2008 and the HKMA allocated more resources to conduct investigatory reviews on these complaints. As a result of the extra workload arising from these unexpected events, the number of regular and securities (tier-2)[1] on-site examinations conducted in 2008 was lower than that in 2007.

Out of the 161 on-site examinations, about one-third (50) were thematic examinations, including reviewing compliance in the use of credit facilities for intended purposes; compliance with the restrictions on renminbi business; controls over regulated activities including compliance and selling practice; controls over AIs' investment in structured financial instruments; system capacity and contingency planning for on-line securities trading service systems; operational risk management; and anti-money-laundering (AML) and counter-terrorist-financing (CFT) controls over trade financing activities.

The HKMA conducted 53 risk-based and four overseas examinations. Specialist teams also carried out detailed examinations of risk management controls in specific areas, including AIs' treasury and derivatives activities, interest rate risk management, commercial and consumer lending, business continuity planning, e-banking activities and technology risk management and practice, and the selling of accumulators; and tier-2 examinations of the securities business of AIs and their AML/CFT controls.

Specialised reviews were also performed on the qualitative and quantitative aspects of internal rating systems, and the relevant IT supporting systems to assess the readiness of AIs intending to implement either the foundation or advanced internal ratings-based (IRB) approach for credit risk under Basel II in 2009 (*see section on Basel II implementation for details*).

1 Tier-1 examinations are high-level examinations that 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 AIs' relevant controls, including detailed testing and verification.

In addition to on-site examinations, 188 off-site reviews were conducted and 39 tripartite meetings[2] held. Other duties included the approval of acquisitions of local AIs and the handling of non-compliance with guidelines or statutory requirements. The supervisory teams met the boards of two banks and members of board-level committees.

The Banking Supervision Review Committee considered 22 cases in 2008, with six relating to the licensing of AIs and approval of money brokers and the other 16 dealing with the imposition of conditions, revocation, and the exercise of the Monetary Authority's powers under section 52 of the Banking Ordinance. In addition, 301 applications to become controllers, directors, chief executives and alternate chief executives of AIs were approved. Details of the operational supervisory work performed in 2008 are set out in Table 1.

The Monetary Authority used his powers under section 59(2) of the Banking Ordinance to require five AIs to commission external auditors to review internal control issues and to report their findings to the HKMA. Another seven AIs voluntarily appointed external auditors to review their controls on selected areas identified by the HKMA.

In 2008 no AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio (CAR). One foreign bank branch was found to have breached the liquidity ratio requirement for a short period due to technical errors. It did not pose any threat to the safety and soundness of the institution or to the interests of depositors. There were two breaches of the requirements under section 81 relating to large exposures, six under section 83 on connected lending, eight under section 85 on lending to AI's employees, and one under section 87A relating to shareholdings by an AI. These breaches were assessed to be unintentional. They were rectified promptly by the AIs and did not affect the interests of depositors.

Table 1 Operational supervision

		2008	2007
1	On-site examinations	**161**	246
	Regular examinations	**57**	95
	– risk-based	**53**	86
	– overseas	**4**	9
	Basel II – IRB validation	**8**	15
	– qualitative and quantitative	**5**	10
	– IT aspects	**3**	5
	Specialised examinations	**46**	30
	– treasury and derivatives activities	**3**	10
	– interest rate risk management	**2**	–
	– commercial lending	**10**	–
	– consumer lending	**6**	–
	– securities (tier-2)	**1**	7
	– selling of accumulators	**5**	–
	– business continuity plan	**1**	5
	– e-banking activities and technology risk management	**2**	5
	– AML/CFT controls (tier-2)	**16**	3
	Thematic examinations	**50**	106
	– review compliance in use of credit facilities for intended purposes	**8**	–
	– renminbi banking business	**11**	22
	– QDII scheme	**–**	7
	– controls over regulated activities including compliance function and selling practice	**5**	29
	– controls over AIs' investment in structured financial instruments	**8**	–
	– IT problems and system change management	**–**	13
	– system capacity and contingency planning of AIs' on-line securities trading service systems	**11**	–
	– operational risk management	**4**	11
	– AML/CFT trade financing activities	**3**	–
	– AML/CFT customer due diligence	**–**	8
	– AML/CFT ongoing transaction monitoring	**–**	6
	– AML/CFT implementation of FATF special recommendation VII in remittance transactions	**–**	10
2	Off-site reviews and prudential interviews	**188**	193
3	Tripartite meetings	**39**	39
4	Meetings with boards of directors or board-level committees of AIs	**2**	18
5	Approval of applications to become controllers, directors, chief executives, alternate chief executives of AIs	**301**	296
6	Reports commissioned under section 59(2) of the Banking Ordinance	**5**	3
7	Cases considered by the Banking Supervision Review Committee	**22**	12
8	AIs that were subject to the exercise of powers under section 52 of the Banking Ordinance during the year	**5**	2

[2] An annual meeting between the HKMA, the AI and its auditors.

Powers under section 52 of the Banking Ordinance

Pursuant to section 53F of the Banking Ordinance, the Monetary Authority revoked the appointment of Mr Paul Jeremy Brough of KPMG as the Manager of Delta Asia Credit Limited (DAC) on 24 October 2008. On the same date, the Monetary Authority proposed the revocation of DAC's authorization as a deposit-taking company under the Banking Ordinance as he was satisfied that certain grounds for revocation as set out in the Eighth Schedule to the Banking Ordinance had been met. The revocation came into effect on 9 December 2008.

The appointment of an Advisor, on 16 February 2007, under section 52(1)(B) of the Banking Ordinance to advise the management of Octopus Cards Limited (OCL), a deposit-taking company, on matters relating to the protection of Octopus cardholders' interests remained in effect during 2008. The Advisor was actively involved in advising, and reviewing the progress of OCL in carrying out the remedial measures recommended in the independent auditors' report on OCL's operational risk control. He also oversaw the refund of money deducted for the failed Octopus EPS add-value transactions from the bank accounts of the affected Octopus cardholders.

Following the publication of a decision taken by the Council of the European Union to introduce financial sanctions against Melli Bank Plc and its parent bank in Iran, the Monetary Authority exercised his powers under section 52(1)(A) of the Banking Ordinance to impose restrictions on the affairs, business and property of the Hong Kong Branch of Melli Bank Plc on 25 June 2008 to protect its depositors.

In addition, the Monetary Authority exercised the powers under section 52(1)(C) of the Banking Ordinance to appoint a Manager to manage the affairs, business and property of Indover Asia Limited[3] (IAL), a restricted licence bank, on 13 November 2008, after its parent bank in Amsterdam went into administratorship on 6 October 2008. IAL's parent bank was subsequently declared bankrupt on 1 December by the District Court of Amsterdam and IAL's authorization as a restricted licence bank was revoked on 18 February 2009.

In the second half of 2008, the Monetary Authority exercised his powers under section 52(1)(A) of the Banking Ordinance to issue directions to restrict the business of a deposit-taking company (DTC) in the light of serious deficiencies in the controls and management of the institution. The HKMA also assigned an on-site examination team to monitor closely the AI's compliance with the directions. The DTC's authorization was subsequently revoked by the HKMA and none of its depositors suffered any losses.

CAMEL rating review

The CAMEL Approval Committee met nine times to determine the capital adequacy, asset quality, management, earnings and liquidity (CAMEL) ratings of individual AIs. The institutions were notified of the ratings and were given the opportunity to request a review, although none did so in 2008.

The CAMEL ratings of licensed banks on 20 October 2008 were used as the supervisory ratings provided to the Hong Kong Deposit Protection Board for the purpose of determining the contributions to be paid by banks in 2009 under the Deposit Protection Scheme.

[3] Previously known as Indover bank (Asia) Limited

Specialised supervisory work

Supervision of technology and operational risks

Internet banking, technology risk management and BCP

The utilisation of Internet banking services continued to grow in 2008. By the end of the year, Hong Kong had 5.7 million personal Internet banking accounts, 16% higher than a year earlier, and 401,000 business or corporate Internet banking accounts, up 31%. So far, 37 AIs have implemented a two-factor authentication mechanism for personal Internet banking and some 2.5 million account holders have registered for the service. In November the HKMA worked with the Hong Kong Police Force, the Hong Kong Association of Banks, the Office of the Government Chief Information Officer and the Hong Kong Computer Emergency Response Team Co-ordination Centre to organise a "Clean PC Day 2008" campaign to promote public awareness of Internet banking security.

In early 2008 there were a number of reported incidents involving the loss of personal data by several organisations. As a result, the HKMA issued a circular on 10 July to remind AIs of the importance of measures to protect customer data. In particular, AIs are required to designate an officer of sufficiently senior rank to oversee the handling of loss or leakage of customer data. AIs are also required to regularly review their control measures for reporting data leakage and emerging data security threats.

Following the issuance of a circular on supervisory measures for on-line securities trading systems in 2007, the HKMA completed a round of thematic examinations in 2008 of 11 AIs that were active in providing on-line securities trading services. The examinations reviewed the adequacy and effectiveness of the AIs' system capacity for on-line securities trading services and related contingency plans. A circular was issued to AIs on 4 September on good practices identified in the examinations.

The HKMA continued to participate in the International Information Technology Supervisors Conference to share supervisory experience and knowledge with overseas banking supervisors in e-banking, operational and technology risks, emerging fraudulent techniques and the implementation of Basel II.

Operational Risk Management

Following the establishment in 2007 of an operational risk management specialist team, the HKMA strengthened the supervisory framework in this area in 2008. Four examinations of selected AIs were conducted covering their operational risk management and ongoing compliance with the capital requirements for operational risk under the Banking (Capital) Rules. An annual self-assessment exercise on operational risk management was also launched for 23 locally incorporated licensed banks. The results indicated that the framework established by the selected AIs was in line with the supervisory requirements. The information gathered by the HKMA from the exercise was automatically scored in a risk profiling system to facilitate the continuing assessment and monitoring of individual AIs' operational risk profiles.

Supervision of securities and insurance business

In the light of adverse market conditions affecting the valuations of derivatives instruments, including credit-linked notes and collaterised debt obligations (CDOs), the HKMA recommended that banks distributing such investment products with CDOs as underlying collateral should apply a high risk rating to them by February 2008. Focused on-site examinations were also conducted on four registered institutions (RIs) to examine their dealings and advisory activities for credit-linked investment products.

Following receipt of investor complaints lodged against certain RIs concerning stock accumulators, the HKMA conducted focused on-site examinations of five RIs to ensure their selling activities and complaint handling procedures for stock accumulators and decumulators complied with the legal and regulatory requirements.

The securities-related on-site examinations in 2008 revealed that controls in product due diligence and the selling practices of some of the examined RIs needed to be improved. Those RIs were required to rectify the deficiencies within a reasonable time. Possible mis-selling cases and suspected breaches of regulatory requirements were referred to the HKMA's Securities Enforcement Division for further action.

The HKMA processed seven applications for registration to become RIs and eight applications from RIs to engage in additional regulated activities; and granted consents to 208 executive officers, who are responsible for supervising the regulated activities of RIs, and conducted background checks on 4,814 individuals whose information was submitted by RIs for registration.

The HKMA continued to co-operate with the Securities and Futures Commission (SFC) and the Insurance Authority (IA) on the supervision of AIs' securities and insurance-related businesses. Regular contacts were made in 2008 among the HKMA, the SFC and the IA to discuss supervisory issues and enforcement matters through various channels including under the auspices of the Financial Stability Committee and the Council of Financial Regulators.

Supervision of treasury activities

Since mid-2007, the HKMA specialist treasury examination team has given priority and resources to the unfolding US sub-prime mortgage crisis and the global financial crisis, and their combined impact on the banking sector in Hong Kong. As the crisis continued to widen and affect more asset classes and overseas institutions, the HKMA stepped up monitoring of the direct and indirect exposures of AIs to these developments, by obtaining regular reports from banks and maintaining close dialogue with their management. On-site visits and stress tests were performed to assess AIs' ability to weather additional shocks to such exposures. In November 2008 the HKMA launched two new half-yearly surveys on off-balance sheet exposures and debt securities portfolios to further strengthen the oversight of AIs' treasury activities. In the process, the annual survey on credit derivatives and securitisation activities was superseded.

Apart from monitoring the impact of the US sub-prime crisis and the expanding global downturn on banks, the specialist treasury examination team conducted 13 on-site examinations on selected AIs' treasury activities during 2008. Of these, eight were thematic examinations focusing on controls on investment in structured financial instruments. The remaining on-site examinations covered mainly AIs' control framework for managing interest rate risk and other risks arising from their treasury and derivatives activities.

China-related businesses

Renminbi banking business

At the end of 2008, 39 licensed banks were conducting renminbi banking business. The total amount of outstanding renminbi deposits reached RMB56.1 billion, representing a 67.9% increase over the previous year. The increase occurred mainly in the first half of the year with the continued rise in the value of the currency. In addition, there was demand for the one-stop service provided by the participating banks to facilitate the opening of renminbi deposit accounts with banks on the Mainland. The HKMA issued a circular to these banks in May reminding them of the compliance issues involved in providing cross-border one-stop renminbi services.

The amount of renminbi bonds issued in Hong Kong also increased substantially during the year as four Mainland banks launched new issues for a total of RMB12 billion. The over-subscription for these issues demonstrated the huge demand for renminbi bonds in the local market.

Tapping the Mainland market

At the end of 2008, 14 locally incorporated banks had business operations in Mainland China, including seven banks which have restructured their Mainland branches into Mainland-incorporated subsidiary banks (two of these banks completed the restructuring in 2008) and one bank which acquired a Mainland bank in 2005. Among the eight Mainland-incorporated subsidiary banks, seven can conduct full-scope renminbi business serving all types of customers on the Mainland (including Mainland residents). The 14 locally incorporated banks maintained over 200 Mainland branches or sub-branches at the end of the year, either directly or through subsidiary banks.

The industry's aggregate on-balance-sheet non-bank China exposures at the end of 2008 amounted to HK$732.2 billion equivalent, or 6% of total assets. These included exposures of HK$217.5 billion equivalent booked in the Mainland subsidiaries of Hong Kong banks. The HKMA maintains regular contact with the China Banking Regulatory Commission (CBRC) to improve cross-border supervisory co-operation and co-ordination.

Hong Kong banks' Mainland business is also assisted by the Closer Economic Partnership Arrangement (CEPA). The Fifth Supplement to the arrangement, which was signed on 29 July 2008 and became effective from January 2009, allows Mainland-incorporated banking subsidiaries established by Hong Kong banks to locate and operate their data centres in Hong Kong instead of the Mainland, subject to certain conditions. This helps reduce operating costs through economies of scale as well as mitigating operational and IT risks arising from split operations. The HKMA is establishing specific arrangements with the CBRC, including a framework for supervisory co-operation, to ensure the relevant data centres located in Hong Kong are adequately supervised.

Credit risk management and asset quality

In early 2008 the HKMA noticed a growing trend among AIs to provide residential mortgage loans (RMLs) to customers with a principal repayment holiday of two to three years. It was concerned that such a practice would expose AIs to considerably higher risk and issued a circular in March requiring AIs to stop the practice for new RMLs. During the year, a series of specialised examinations was conducted by the HKMA to assess whether AIs maintained effective credit risk management procedures to guard against emerging risks arising from the deteriorating economic conditions. The examinations revealed no material weaknesses in the controls.

Following worsening financial conditions in the second half of the year, the HKMA increased its monitoring of AIs' asset quality and conducted regular credit risk stress-testing on their loan portfolios. The AIs were also reminded to continue to follow the principles set out in the "Hong Kong Approach to Corporate Difficulties" in dealing with customers experiencing financial problems.

Co-operation with overseas supervisors

The exposure of banks around the world to emerging risks and the increased globalisation of banking activities has heightened the need for supervisors to co-operate with one another, both geographically and functionally. The HKMA has entered into Memorandums of Understanding or other formal arrangements with a number of overseas banking supervisory authorities to improve co-operation and the exchange of information. In 2008 Memorandums of Understanding were signed with the Bank of Mauritius and the State Bank of Vietnam. Meetings were held in Hong Kong and abroad with banking supervisory authorities from Australia, Belgium, Germany, Indonesia, Japan, Macau, the Mainland, Malaysia, the Philippines, Singapore, South Africa, South Korea, Switzerland, Thailand, the UK and the US to discuss issues of common interest. There were also regular exchanges of correspondence and communications with overseas banking supervisory authorities on developments in financial markets and their impact on individual banking institutions.

Response to the global financial crisis

The HKMA started close monitoring of the impact of the US sub-prime mortgage crisis on the Hong Kong banking system in mid-2007. Concerns about the holdings of sub-prime mortgage-related assets by individual financial institutions following the collapse of Lehman Brothers in September 2008 quickly developed into fear, and eroded the trust between financial institutions, which in turn significantly interrupted the operations of the interbank market. The confidence of depositors was undermined and resulted in a run on a local retail bank based on unfounded rumours about its financial condition. Since mid-2007, the HKMA has implemented the following measures:

- increased monitoring of AIs' direct and indirect exposures to the problem institutions, including monoline insurers and financial institutions which reported heavy losses due to US sub-prime mortgage-related assets
- performed regular stress tests to assess whether retail banks in Hong Kong had adequate capital to withstand significant losses should financial markets deteriorate further
- required banks to ensure transparency in their disclosure of sub-prime-related exposures and adopt a prudent approach in valuation or making impairment charges for these exposures in their 2007 financial results, although the exposures of the Hong Kong banking sector to sub-prime-related assets are immaterial
- increased monitoring of AIs' liquidity position and required individual AIs to have their own contingency liquidity plan in place from early 2008 for handling potential and actual liquidity problems

- stepped up the HKMA's internal readiness for triggering Lender-of-Last-Resort support in case of need, and took measures to ease the liquidity tightness in the Hong Kong interbank market

- established a new arrangement with the People's Bank of China (PBoC) whereby Hong Kong banks operating on the Mainland can obtain collateralised renminbi liquidity from the PBoC, with the collateral provided by the parent or headquarters in Hong Kong to the HKMA for safe keeping on behalf of the PBoC. This arrangement will ease any renminbi liquidity pressure of the Mainland branches and subsidiaries of Hong Kong banks.

In addition, a number of measures were adopted to restore public confidence and ensure the normal operation of the local banking system:

- the Financial Secretary announced the use of the Exchange Fund to guarantee the repayment of customer deposits held in Hong Kong with all AIs starting from 14 October 2008 until the end of 2010 following the principles of the existing Deposit Protection Scheme

- a Contingent Bank Capital Facility was established over the same period to provide locally incorporated licensed banks with access to additional capital should this become necessary. The HKMA also adopted a flexible approach towards the buffer above the statutory minimum CAR of 8% imposed on individual local AIs to ease the constraints of their capital for continuing the provision of credit

- provision of collateralised lending to individual banks in need of liquidity through or outside the Discount Window was made easier through a number of temporary measures

- issuance of Exchange Fund paper was increased to meet market demand from banks for liquidity management

- the HKMA issued a statutory guideline on 24 October 2008 explaining the approach being adopted in enhancing the monitoring of AIs' activities to pre-empt the emergence of any imprudent business practices and prevent any potential moral hazard arising from the introduction of the full deposit guarantee and Contingent Bank Capital Facility

- the frequency of collecting prudential data from AIs through ad-hoc surveys was increased to facilitate a closer supervisory surveillance over AIs' financial positions and business activities, particularly deposit movements and asset quality

- two new half-yearly surveys on off-balance sheet exposures and debt securities portfolios were introduced to strengthen the HKMA's oversight of AIs' holdings of debt securities and their exposures to structured credit products or related off-balance sheet entities which have been affected substantially by the global financial crisis

- monitoring of AIs' liquidity positions was increased to ensure they have adequate high-quality assets to exchange for liquidity in emergencies.

The HKMA will continue to work closely with the HKSAR Government, and Mainland and overseas authorities to preserve the stability of the local banking system. The enhanced supervisory efforts will continue for the time being, to ensure that AIs can weather the current global crisis.

Lehman-related investment products

On 14 September 2008 Lehman Brothers Holdings Inc. filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code. Subsequently, the HKMA received a large number of complaints from retail investors who purchased from banks structured investment products, including those known as Minibonds, related to Lehman Brothers.

To process these complaints as quickly as possible while ensuring due process, the HKMA deployed about 200 staff (including its own staff and others seconded from external auditing firms) to handle the complaints. The HKMA also agreed with the SFC a set of specifically designed procedures to deal with the large number of complaints.

Under these procedures, the HKMA reviews each complaint to ascertain whether there is prima facie evidence to open an investigation. If an investigation is opened and during the course of the investigation the HKMA finds sufficient justification, it refers the case to the SFC to facilitate its investigation at the institutional level, and to decide whether further action, including the imposition of sanctions, is warranted. (The SFC is the authority ultimately responsible for deciding whether a Registered Institution has been guilty of misconduct.) The HKMA will continue its review of individual cases, whether or not referred to the SFC, to investigate if there has been misconduct by individual staff members of the banks concerned.

In early October the Government proposed that banks involved in the sale of Minibonds should buy them back from the investors at their current market values. The proposal was accepted by the distributing banks and the Hong Kong Association of Banks set up a Task Force to pursue the matter. To ensure that the investors would receive fair treatment under the proposal, the HKMA appointed an independent financial adviser on behalf of the Government to review the valuation and strategy adopted by the Task Force in implementing the proposal. In November the trustee for the Minibonds received a letter from the legal advisers to Lehman Brothers in the US. The letter asserted that, according to the US Bankruptcy Code, the trustee's actions since 14 September 2008 might be invalid, and that the trustee might not lawfully realise the collateral and pay the money to Minibond investors, and should refrain from taking any further action. Having obtained advice from their legal advisers and, after consultation with the Government, the banks decided to continue the buy-back only after the legal issues had been clarified and addressed. The distributing banks have continued to liaise with the trustee regarding the proposed steps to be taken to protect the interests of the investors. On 17 December the distributing banks announced that they were prepared to provide finance to the trustee of up to $100 million to assist in the performance of its duties to protect the interests of the Minibond investors.

Separately, the HKMA announced on 31 October a mediation and arbitration scheme to help resolve questions of compensation between investors in Lehman-related investment products and the distributing banks. The service is provided by the Hong Kong International Arbitration Centre. The HKMA has agreed to co-ordinate referrals and pay the share of the fee for these services for investors whose complaints have been referred by the HKMA to the SFC, or whose complaints have resulted in a finding against relevant bank staff by either the HKMA or the SFC.

On 12 November the Legislative Council passed a motion to confer powers under the Legislative Council (Powers and Privileges) Ordinance to a Sub-committee to study issues arising from the Lehman Minibonds and related structured financial products. The HKMA has provided the Sub-committee with information and documents to assist in carrying out its review.

On 31 December the HKMA submitted a report to the Financial Secretary to provide observations and information on lessons learned and issues identified during the process of investigating the complaints about the sale of Lehman-related investment products. The report will be used by the Government in undertaking a comprehensive review of the present regulatory framework governing the sale of investment products to retail investors.

Review of the HKMA's work on banking stability

In late 2007 the HKMA appointed an independent consultant to undertake a review of how the HKMA could best discharge its functions in promoting the general stability and effective working of the banking system, taking into account recent and likely future developments in Hong Kong's banking system and the changing nature of the risks it faced.

The review was completed in July 2008, and the report was subsequently published for public consultation for three months until the end of October. In the report, the consultant acknowledged the robust condition of Hong Kong's banking sector and concluded there were no fundamental deficiencies in the HKMA's regulatory and supervisory framework or processes. Nevertheless, to provide the HKMA with a sounder foundation to cope with the challenges ahead, the report recommended a number of improvements to the present regulatory framework for the banking sector, addressing trends and issues such as business integration with the Mainland, the impact of the US sub-prime crisis on the banking sector, further development of Hong Kong as an international financial centre, increasing competition in the financial markets, and erosion of financial boundaries.

In all, 15 submissions were received during the public consultation period, including responses from the Hong Kong Association of Banks, the DTC Association and the Consumer Council.

Basel II implementation

Monitoring the effectiveness of the revised capital adequacy framework introduced by the Banking (Capital) Rules and Banking (Disclosure) Rules in January 2007 was a subject of special focus by the HKMA in 2008. Particular attention was paid to compliance with the relevant requirements by those Hong Kong-incorporated AIs that have adopted, or have applied for approval to adopt, the internal ratings-based (IRB) approach for regulatory capital reporting purposes. In the light of experience from the implementation of the framework, the HKMA refined its supervisory review process, under which AIs' capital adequacy and risks, as well as their progress in developing their own capital adequacy assessment processes, are assessed. The continuing global financial crisis also required the HKMA to consider the implications for Hong Kong of international developments affecting the Basel II framework.

Supervisory recognition and monitoring of AIs' adoption of the IRB approach

In 2008 the HKMA granted approval for three Hong Kong-incorporated AIs to adopt the foundation or advanced IRB approach to calculate credit risk under the Banking (Capital) Rules from January 2009. The approvals were granted after on-site examinations to assess the robustness of the AIs' internal rating systems and their compliance with the requirements set out in the Banking (Capital) Rules for the use of the IRB approach. The HKMA also conducted follow-up reviews of those AIs previously approved to use the IRB approach to ascertain that any issues identified in previous on-site examinations had been fully addressed, and to ensure their ongoing compliance with the relevant IRB requirements.

The HKMA developed an internal MIS report to facilitate credit risk analysis and monitoring of the IRB data submitted by AIs which had either adopted the IRB approach or applied to adopt the IRB approach and were undergoing the requisite parallel reporting during the year. Analyses across various types of credit risk parameters, exposures, obligors, and peer groups, as well as trend analyses, were conducted regularly to help monitor the level and trend of the credit risk of these AIs and the impact of using the IRB approach on their capital levels.

Home/host co-operation

In deciding whether to grant approval for subsidiaries of foreign banking groups to adopt the IRB approach in Hong Kong, the HKMA, as host supervisor, considered the assessments of their home supervisors. In particular, the HKMA relied on the home supervisors' reviews of group-developed internal rating systems proposed to be used by the subsidiaries in Hong Kong. The HKMA participated in supervisory meetings organised by the home supervisors for selected individual banking groups to keep itself informed of the IRB approval and implementation progress of these banking groups, and to discuss other issues of mutual interest.

Supervisory review process (SRP)

The approach developed by the HKMA for conducting the SRP has provided a comprehensive framework for assessing AIs' capital levels and risks, including various non-credit risks, such as interest rate risk in the banking book, liquidity risk, and reputation and strategic risks. The SRP was further refined in 2008 in the light of implementation experience and lessons drawn from the global financial crisis. The assessment of some risk factors relating to credit concentration risk, liquidity risk, corporate governance and systems and controls was enhanced.

During the year, the HKMA completed the second round of SRP on Hong Kong-incorporated AIs using the refined assessment framework. The SRP Approval Committee within the HKMA met regularly to review the assessment results for AIs for the purpose of considering their minimum CARs and other supervisory issues requiring attention. AIs were notified of the results, and were given the opportunity to request a review of their minimum CAR, although none did so in 2008.

Capital adequacy assessment process (CAAP)

CAAP is an internal process whereby AIs assess whether their overall capital adequacy is commensurate with the risk profile of their operations and formulate a strategy for maintaining adequate capital levels. Following the implementation of the SRP in 2007, Hong Kong-incorporated AIs were expected to have a firm plan for adopting a CAAP that meets supervisory standards. The HKMA continued to monitor AIs' progress in CAAP development in 2008, reviewing the project plans, status reports, and CAAP policies and methodologies they submitted and meeting with their management to exchange views on the subject. While noticeable progress was made by the AIs in developing or updating their CAAP, more time is needed in certain cases to complete the project given the evolving methodologies and techniques and the need to address various issues associated with the development process.

Disclosure

Hong Kong-incorporated AIs continued to make financial disclosures in accordance with the enhanced disclosure requirements under the Banking (Disclosure) Rules and the relevant accounting standards (*HKAS 1 Presentation of Financial Statements and HKFRS 7 Financial Instruments: Disclosures*). The HKMA also recommended that they should adopt the Leading-Practice Disclosures for Selected Exposures compiled by the Senior Supervisors Group (*see separate box on Improving the supervisory framework for details*).

Counterparty credit risk (CCR) [4]

The HKMA conducted a further survey in early 2008 on the CCR management practices of selected AIs, the results of which reinforced the need to develop CCR management guidance (which was released for industry consultation in December 2008), ahead of any plan to implement locally the more advanced CCR calculation methods available under the Basel II framework. The HKMA will review the approach and timetable for implementing these more advanced CCR calculation methods once AIs have had sufficient opportunity to implement the CCR guidance, so that a better picture of their CCR management systems and capabilities can be gathered. This will also enable the HKMA to take account of any CCR-related market developments when it determines the implementation strategy.

Recognition of external credit assessment institutions (ECAIs)

The use of credit ratings assigned by ECAIs recognised by the Monetary Authority is a typical feature of the standardised approach for calculating credit risk under the Banking (Capital) Rules. During the year, the HKMA reviewed applications for recognition of certain domestic ECAIs in India and Japan, based on the eligibility criteria specified by the Monetary Authority and the recognition granted to those institutions by their local supervisory authorities. The Banking (Capital) Rules will be amended to add these institutions to the list of recognised ECAIs under the Rules.

Basel II-related international developments

In addressing issues identified by the global financial crisis, the Basel Committee on Banking Supervision has developed proposals for strengthening the Basel II framework. In January 2009 the Committee released consultative documents on enhancements to the Basel II framework, including enhanced capital and disclosure requirements for structured credit and securitisation activities, supplemental Pillar 2 guidance to address the flaws in risk management practices revealed by the financial crisis, the introduction of an incremental risk charge for trading book positions, and other revisions to the market risk capital framework. The Committee is also considering improvements to other areas of the framework. The HKMA monitored these developments and provided its comments to the Basel Committee where appropriate. Amendments to the Banking (Capital) Rules will be required for the adoption of these measures in Hong Kong.

› Basel II

[4] Counterparty credit risk (CCR) is the risk that the counterparty to a transaction may default before the final settlement of the transaction's cash flows. However, an economic loss would only occur if the transaction with the counterparty has a positive economic value at the time of default. CCR thus involves a bilateral risk of loss to either counterparty to the transaction, depending on the market value of the transaction which may vary over time with the movement of underlying market factors.

Improving the supervisory framework

Lessons from the global financial crisis

The HKMA has been monitoring closely the international initiatives and developments arising from the US sub-prime crisis. In October 2007 the G7 Finance Ministers asked the Financial Stability Forum (FSF) to analyse the underlying causes of the global financial market turbulence triggered by the sub-prime crisis. The FSF presented its report, *Enhancing Market and Institutional Resilience*, to the G7 Finance Ministers in April 2008, among other international responses to the crisis such as those from the Senior Supervisors Group (SSG)[5] on improving risk management and disclosures, and the Report of the President's Working Group on Financial Markets.

The FSF's report contains detailed recommendations in five main areas:

- strengthening prudential oversight of capital, liquidity and risk management
- enhancing transparency and valuation
- changes in the role and uses of credit ratings
- strengthening the authorities' responsiveness to risks
- robust arrangements for dealing with stress in the financial system.

The HKMA, as a member of the FSF, strongly supports and participates in the development of the recommendations of the FSF, SSG and other relevant international organisations, and is taking steps to implement the recommendations as appropriate in Hong Kong. As a first step, the HKMA has encouraged AIs to improve their governance and risk management systems, drawing reference to the recommendations of the FSF and the SSG.

[5] The Senior Supervisors Group (SSG) is made up of seven participating supervisory agencies from France, Germany, Switzerland, the UK and the US.

The Declaration of the Leaders of the Group of Twenty (G20) in November 2008 is also of relevance. It sets out action required to implement reforms that will strengthen financial markets and regulatory regimes to avoid future crises. The measures falling within the supervisory remit of the HKMA, such as those relating to transparency and accountability, sound regulation, and international co-operation, are similar to the recommendations in the FSF report.

Accounting, disclosure and valuation issues flowing from the financial crisis

Recent market events have demonstrated the importance to market confidence of reliable valuations and relevant disclosure of financial institutions' exposures to, and the risks associated with, sub-prime-related or structured products. The HKMA has encouraged local banks to be prudent in valuing these exposures and to ensure that an adequate impairment charge is made for them. The HKMA met the Hong Kong Institute of Certified Public Accountants (HKICPA), major auditing firms and individual banks in the first quarter of 2008 to promote the adoption of an approach that ensured prudent valuation and transparency of disclosure of the banks' exposures in their 2007 financial results.

In the light of the FSF's recommendations concerning risk disclosure, the HKMA requested all Hong Kong-incorporated AIs in May 2008 to disclose their exposures to structured products in accordance with the *Leading-Practice Disclosures for Selected Exposures* compiled by the SSG. In line with the practices, large local banks have substantially expanded their interim 2008 disclosures for risk exposures (including those associated with complex financial instruments), valuations, off-balance sheet entities and related policies, although their exposures to sub-prime-related credits, structured investment vehicles and collateralised debt obligations were not material relative to their total assets.

In October the HKICPA adopted the amendments to IAS 39 for the equivalent Hong Kong Financial Reporting Standards, which permit institutions to reclassify their non-derivative financial assets out of the "held for trading" category to the "available for sale" or "held to maturity" category, in rare circumstances, dating back to their positions at 1 July 2008. Such reclassification was already permitted under US GAAP in rare circumstances. The HKMA has no objection to Hong Kong-incorporated AIs making use of such changes to IAS 39, in view of the unusual circumstances prevailing in the global financial markets. It is estimated that any reclassifications permitted under the revised IAS 39 are unlikely to have any material impact on AIs' equity or earnings for the second half of 2008.

Implementation of Basel Committee's revised liquidity guidance

The Basel Committee published the Principles for Sound Liquidity Risk Management and Supervision in September 2008. These Principles, which represent a substantial revision of the Basel Committee's previous liquidity guidance issued in 2000 and reflect lessons from the global financial crisis, were developed to raise international standards for the management and supervision of banks' liquidity risk.

In line with its policy of adopting international standards, the HKMA formulated an action plan to improve the supervisory framework for liquidity risk in Hong Kong to align it with the Basel Committee's revised liquidity guidance, and commenced a review of the existing framework in the fourth quarter of 2008 to identify potential areas for change. The review includes the methodology for the calculation of the statutory minimum liquidity ratio and the individual components included in that calculation.

In addition, the HKMA issued in November 2008 a standardised template to AIs requiring them to conduct a self-assessment of their compliance with the Basel Committee's revised liquidity guidance. The HKMA will use the results to gain a better understanding of AIs' current liquidity risk management practices and identify any major compliance gaps or implementation issues that may warrant more supervisory guidance or attention.

Group-wide approach to supervision of locally incorporated AIs

In view of the growth in financial groups, which include banking operations and their diversification across jurisdictions and financial sectors, as well as the increased emphasis internationally on the importance of consolidated supervision, the HKMA issued a Supervisory Policy Manual (SPM) module on the "Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions" in November 2008 following consultation with the industry. The module was developed to help AIs understand how an AI's exposure to risks within its corporate group is addressed in the HKMA's supervisory framework and practices.

Reputation risk management

In December 2008 after industry consultation, the HKMA issued an SPM module on "Reputation Risk Management" to give AIs a better understanding of its supervisory approach to reputation risk and fuller guidance on how such risk can be managed. The module was also designed to draw AIs' attention to the importance of reputation risk management and to promote a formalised and systematic approach to managing it, including any crisis that might be triggered by events adversely affecting their reputation.

Counterparty credit risk (CCR) management

The global financial crisis has underlined the importance of CCR, as concerns about the difficulties of some major financial institutions or counterparties have thrown markets into disarray. After completing a soft consultation with a selected group of AIs, the HKMA issued a draft SPM module on "Counterparty Credit Risk Management" for industry consultation in December. The module is intended to provide guidance that AIs can adopt in improving or developing their CCR management systems, and to describe the HKMA's supervisory approach to CCR. The guidance reflects the sound practices for CCR management set out in the Basel II framework, and incorporates, where appropriate, lessons and experiences from the global financial crisis.

Foreign exchange risk management

In December the HKMA also updated and issued for industry consultation the SPM module on "Foreign Exchange Risk Management", which incorporates the recommendations of the Bank for International Settlements for reducing foreign exchange settlement risk. The revised module was issued on 14 January 2009.

Stress testing

The HKMA conducts regular supervisory stress tests on selected AIs to assess the resilience of the banking sector to risks and vulnerabilities within the banking system. Following intensification of the global financial crisis and, in anticipation of the potential effects on the local economy and AIs' credit quality and profitability, the HKMA increased the scope and severity of its stress-testing scenarios to ensure they remain up to date and appropriate. For example, stress assumptions relating to rates of decline in property and stock prices and the profitability impact on AIs were tightened. The results showed that despite the more severe scenarios, the banking sector generally would be able to withstand the stress, although some AIs might experience a more significant impact. The HKMA will continue to monitor AIs' capital levels to ensure the adequacy of their capital buffers to withstand a possible worsening of the financial crisis.

Prevention of money laundering and terrorist financing

The main focus for the year was to assist the Government in completing the mutual evaluation of Hong Kong's regime for combating money laundering and terrorist financing, undertaken jointly by the Financial Action Task Force on Money Laundering (FATF) and the Asia/Pacific Group on Money Laundering (APG).

Following several rounds of discussions with the evaluation team, the mutual evaluation report on Hong Kong was adopted by the FATF at its Plenary Meeting in June and by the APG at its Annual Meeting in July. The report was subsequently published on the websites of the two organisations.

The report recognised the strengths of Hong Kong's anti-money laundering and counter-terrorist financing regime. It concluded that the AML/CFT supervisory frameworks for the banking, securities and insurance sectors were generally effective, with comprehensive obligations on financial institutions and a fairly broad range of sanctions available to the regulators. The report identified a number of issues for consideration, and the HKMA is reviewing those issues relating to the banking sector.

In March the HKMA, in collaboration with the Industry Working Group on Prevention of Money Laundering and Terrorist Financing, finalised two guidance papers to AIs, on "Customer Due Diligence Process for Offshore Companies" and "Address Proof for Personal Customers". In July the HKMA issued a further guidance paper on "Good Practices on Transaction Monitoring" to provide practical guidance to AIs on how to establish an effective monitoring system for identifying suspicious and unusual activities.

During the year, the AML/CFT specialist teams completed 19 examinations, including 16 tier-2 examinations and three thematic examinations focusing on preventive measures in relation to trade finance, an area identified by the FATF as of increasing concern.

International co-operation

The HKMA participates in various international and regional forums for banking supervisors. These include the Basel Committee's International Liaison Group, Policy Development Group and various sub-groups, the EMEAP Working Group on Banking Supervision, which the HKMA chairs, and the South East Asia, New Zealand and Australia Forum of Banking Supervisors.

Following the implementation of Basel II, the Basel Committee created two new policy sub-groups in 2007: the Capital Sub-group to explore issues surrounding the definition of regulatory capital, with a view to developing an agreed set of capital instruments that are available to absorb unanticipated losses on a going-concern basis, and the Liquidity Sub-group to analyse national liquidity regimes given the changing nature of liquidity risk due to rapid financial market innovation and integration in recent years. The HKMA is a member of both sub-groups. The work of these two sub-groups has grown in significance in view of the global financial crisis. Relating to the work of the Capital Sub-group, the G20 recommended that definitions of capital should be harmonised in order to achieve consistent measures of capital and capital adequacy. This is also in line with the initiatives being taken by the Basel Committee to enhance the quality of tier-1 capital as part of its strategy to address the lessons of the banking crisis. After completing the revision of the Basel Committee's liquidity guidance in September 2008, the Liquidity Sub-group is undertaking further work on formulating analytical frameworks for supervisory evaluation of liquidity risk, as well as providing practical guidance on cross-border and other technical issues associated with implementation of the revised liquidity guidance. The HKMA has participated in the discussions of these sub-groups and offered its views from the Hong Kong perspective.

Islamic banking

With Islamic finance growing rapidly worldwide in recent years, the HKSAR Chief Executive, in his 2007 Policy Address, identified the introduction of Islamic finance to Hong Kong and the development of an Islamic bond market as key government initiatives. In supporting them, the HKMA considered the appropriate supervisory treatment for AIs' exposures to Islamic bonds (also known as sukuk). It concluded that the existing legislative framework and approach for the supervision of AIs should be suitable for Islamic and conventional banking business. The HKMA's supervisory policy for holdings of sukuk will reflect the economic substance of these instruments and seek to ensure a level playing field with conventional financial instruments. The supervisory standards to be applied to AIs' exposures to sukuk will be the same as those applying to their conventional equivalents. The HKMA's current supervisory approach to Islamic finance in Hong Kong, covering the approval criteria for setting up an Islamic Banking Window[6] and the supervisory treatment for AIs' exposures to sukuk, was set out in detail in an article entitled "Islamic Finance in Hong Kong: Supervisory Issues", published in the December 2008 issue of the *HKMA Quarterly Bulletin*.

During the year, two Malaysian banks commenced Islamic banking business in Hong Kong through Islamic Banking Windows established within their local branches, and a few other AIs engaged in structuring or selling Islamic financial products. In considering any proposal to launch Islamic banking business in Hong Kong, the HKMA will take into account a number of factors, including:

- the AI's risk management process to ensure that the risks of the Islamic financial products to be offered are well understood, assessed, monitored and controlled
- the AI's policies, procedures and control systems for ensuring the products are Shariah-compliant
- proper disclosure of risk and return to depositors.

Credit data sharing

The Commercial Credit Reference Agency (CCRA) has been operating smoothly since its establishment in 2004. It initially covered small and medium-sized enterprises (SMEs) defined as non-listed limited companies with an annual turnover not exceeding $50 million.

[6] An Islamic Banking Window is a business unit within a conventional AI, enabling the AI to offer Islamic financial services that are consistent with Islamic law on Shariah using the AI's existing infrastructure and branches.

In March 2008 the CCRA coverage was expanded to include sole proprietorships and partnerships. At the end of December, over 120 AIs were sharing commercial credit data through the CCRA, and the scheme contained the credit data of more than 94,000 business enterprises, about 19% of which are sole proprietorships and partnerships. The continued development of the Agency has helped to further strengthen the credit risk management of AIs and improved SMEs' access to credit.

Consumer protection

Code of Banking Practice

The Code of Banking Practice Committee convened by the Hong Kong Association of Banks and on which the HKMA and the DTC Association are represented, completed a comprehensive review of the Code of Banking Practice in 2008. The aim was to improve the Code and to keep it up to date with recent developments in the banking sector. Major improvements include:

- the introduction of a new section requiring AIs to give reasonable notice to customers, normally not less than two months, before closing a branch
- the rewriting of provisions relating to guarantees and third-party securities to make them easier to understand
- the updating of the chapter on "Stored Value Cards (or Devices)" to better protect cardholders, including the introduction of new requirements on card issuers to provide channels to check previous transactions and to reimburse the cardholder, as soon as reasonably practicable, where a transaction cannot be completed successfully but the value has been deducted from the stored value card
- improving provisions relating to security advice for cards and e-banking services to provide more guidance to facilitate compliance by AIs, and to make it easier for customers to understand their obligations in not compromising the security of their card and e-banking transactions.

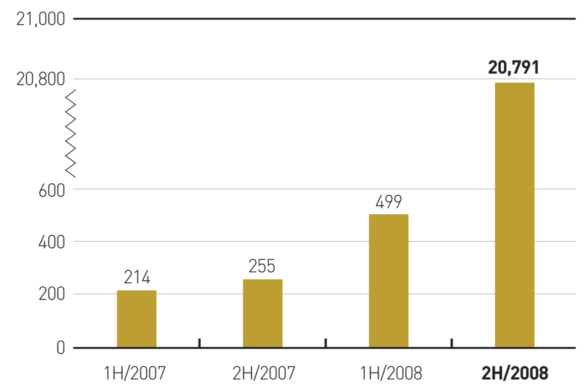
The revised Code became effective on 2 January 2009. AIs are expected to take steps to comply with the revised provisions as quickly as possible and achieve full compliance within six months. A further six-month grace period is allowed for compliance with the revised provisions requiring system changes.

> Consumer Information > Code of Banking Practice

Customer complaints

The HKMA received 21,290 complaints about services provided, or products sold, by AIs in 2008, compared with 469 the previous year (Chart 1). The substantial increase was due to the large number of complaints relating to investment products (including those related to Lehman Brothers) sold by AIs (*see separate box on Lehman-related investment products for details*).

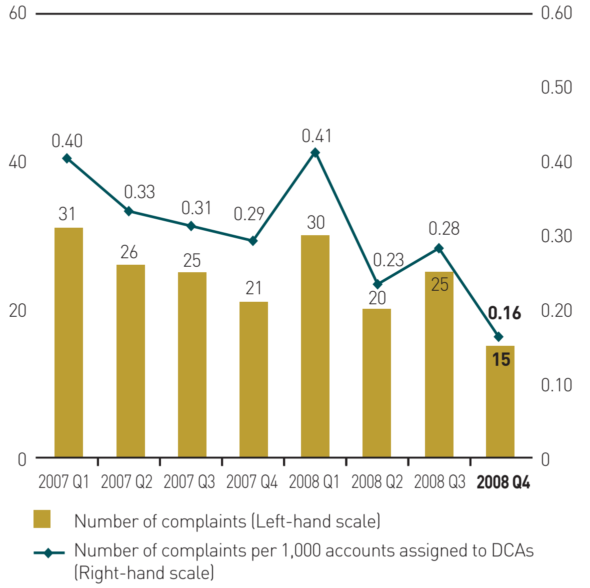
Chart 1 Complaints about services or products of AIs received by the HKMA



The number of complaints received by AIs relating to their debt collection agents decreased to 90 in 2008 from 103 in 2007 (Chart 2). The HKMA will continue to monitor the situation to ensure that AIs remain vigilant in overseeing the performance of their debt collection agents.

> Consumer Information > Complaints about Banks

Chart 2 **DCA complaints received by AIs**

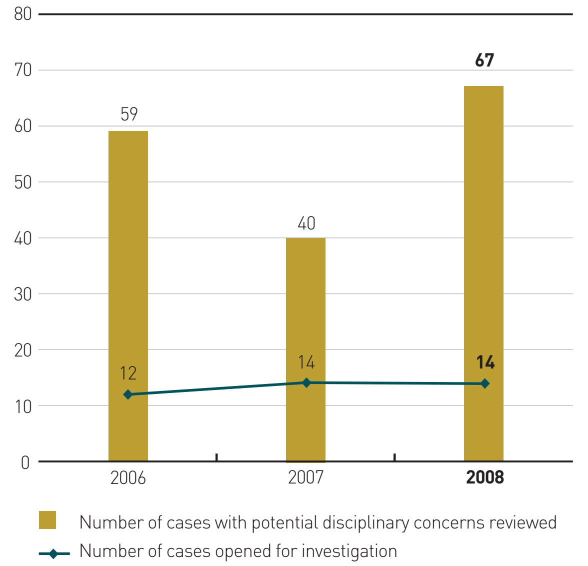


Securities enforcement

The HKMA has a shared responsibility with the SFC for enforcing the rules and regulations on RIs and their executive officers and relevant individuals in the conduct of regulated activities.

During the year, the HKMA reviewed 67 cases (other than those related to the bankruptcy of Lehman Brothers) with potential disciplinary concerns and opened investigations into 14 of them (Chart 3). Investigations of five cases were completed and disciplinary proceedings commenced in one case related to a relevant individual who had facilitated market manipulation. There were insufficient grounds for disciplinary action in the other four cases. The remaining nine investigations are continuing.

Chart 3 **Cases with potential disciplinary concerns reviewed by the HKMA**



As a result of recommendations made by the HKMA arising from earlier investigations commenced before 2008, the SFC disciplined an RI and two former relevant individuals by exercising its sanctioning power under the Securities and Futures Ordinance, including public reprimand, fine and prohibition order.

Deposit Protection Scheme

The Hong Kong Deposit Protection Board implemented a number of measures to strengthen the operation of the Deposit Protection Scheme. Scheme members were required to submit auditors' reports to certify the accuracy of the returns of relevant deposits submitted by them for contribution assessment purposes. A self-assessment mechanism was implemented to monitor members' compliance with the membership and product representation requirements under the Scheme. Compliance reviews were conducted to ensure that members' systems and data meet the standards specified by the Board and can support a prompt payout. The Board also conducted simulation tests and payout rehearsals, and enhanced the payout procedures and systems to further improve readiness to pay out. The Board's publicity effort helped maintain a high level of public awareness and understanding of the Scheme.

In the light of various international developments on reforming financial regulatory and deposit insurance regimes, and taking into consideration recommendations in the consultancy report on the HKMA's work on banking stability, the Board decided to conduct a review of the Scheme's coverage. The first phase, encompassing the protection limit and membership of the Scheme, commenced in the fourth quarter of 2008.

Following the announcement of the deposit guarantee provided by the Exchange Fund, the HKMA issued a letter to AIs that are not members of the Deposit Protection Scheme requiring them to give representations similar to those required under the Scheme, to inform their customers of the protection available under the guarantee. The representation regime applicable to all AIs was formalised in a statutory guideline issued in early December 2008. The Board also updated its publicity materials to explain the co-existence of the two deposit protection arrangements.

> Deposit Protection

Licensing

At the end of 2008, Hong Kong had 145 licensed banks, 27 restricted licence banks, 28 deposit-taking companies and 16 approved money brokers. During the year, the HKMA granted two bank licences and one restricted banking licence to three foreign banks, and upgraded two restricted licence banks to licensed banks. The HKMA also granted a certificate of approval to one money broker. One licensed bank, three restricted licence banks and one deposit-taking company revoked their authorization during the year.

PLANS FOR 2009 AND BEYOND

Supervisory focus

Credit risk, capital and liquidity management

The outlook for the global economy remains highly uncertain. The impact of the financial crisis may not have fully surfaced and customers of AIs are likely to face a difficult business environment in 2009 and the challenges for AIs in managing the associated credit risk will be considerably greater. The HKMA will continue to monitor closely the asset quality of individual AIs and assess the adequacy of their systems of internal controls for managing credit risk.

As the financial crisis continues to affect the banking industry, the HKMA will ensure that AIs have effective capital and liquidity management processes that are capable of withstanding severe market volatility.

China-related business

The HKMA will further improve its supervisory policies and practices in line with AIs' continuing business integration with the Mainland. In particular, the HKMA will seek to strengthen communication and co-operation with the Mainland regulatory authorities to ensure new risks arising from this development are well managed.

The HKMA will liaise with the CBRC to establish the framework to improve supervision of data centres following the signing of the Fifth Supplement to CEPA in 2008.

Supervision of technology and operational risks

Internet banking, technology risk management and BCP

In view of reported incidents of loss or leakage of personal data, the HKMA plans to conduct a round of thematic examinations to cover AIs' controls over customer data protection. Separately, a specialist review on the migration of the Real Time Gross Settlement and Central Moneymarkets Unit systems to the SWIFTNet infrastructure will be performed to ensure that the migration is done in a controlled manner and sufficient testing is conducted prior to the migration. To promote sound control practices and awareness of emerging fraudulent techniques, the HKMA also plans to work with the Hong Kong Association of Banks and the Hong Kong Police Force to develop an effective customer education programme.

The HKMA will share its experience in the supervision of Internet banking, technology risk management and business continuity management with overseas banking supervisors through the International IT Supervisors Group, which comprises some 20 banking supervisors from developed markets.

Operational risk management

The operational risk management specialist team will continue to identify and address emerging operational risks of AIs through on-site examinations and off-site reviews. The existing self-assessment on operational risk management will be extended to cover certain locally incorporated restricted licence banks and deposit-taking companies in addition to locally incorporated licensed banks.

Supervision of securities and insurance businesses

In addition to conducting regular examinations of AIs' securities, insurance and MPF activities to ensure the effectiveness of their compliance with relevant codes of conduct and regulatory requirements, the HKMA will work closely with the Government and the SFC to implement in phases a series of recommendations made in the HKMA's report on the Lehman Brothers incident. These recommendations include improvements to the regulation of the sale of investment products, enhancement to investor protection and review of the current regulatory framework, particularly with regard to the securities business conducted by AIs. The HKMA will review the supervisory approach, seek industry views on some of the longer-term recommendations, and monitor AIs' implementation of those recommendations that have already been introduced. In addition, the HKMA plans to allocate additional resources and step up the supervision of AIs' securities and insurance businesses, including the off-site surveillance work and on-site examinations of these activities.

Supervision of treasury activities

As part of its efforts to reinforce the oversight of AIs' treasury activities, the HKMA will strengthen the resources and expertise of its specialist treasury teams in 2009 by recruiting professionals with relevant knowledge and establishing a specialised division to supervise AIs' treasury and derivatives activities. The new division will also monitor market trends and developments, and identify emerging market risks so that prompt supervisory action can be taken.

Supervisory policy initiatives relating to the global financial crisis

The HKMA's major supervisory policy initiatives in 2009 and beyond will be driven, to a large extent, by international responses to the current global financial crisis by the Financial Stability Forum (FSF), the Senior Supervisors Group (SSG) and other international organisations to improve the resilience of financial markets and institutions. While the financial crisis has not posed any systemic risk to the Hong Kong banking sector, there is no room for complacency. The HKMA will seek to follow international best practices that contribute to the resilience of the Hong Kong system. In particular, the HKMA will aim to implement the recommendations of the FSF, SSG and other international organisations, having regard to the guidance of the Basel Committee and local circumstances by:

- strengthening the capital adequacy framework through amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules and further refinement of the supervisory review process

- revising the supervisory framework for liquidity risk in line with the *Principles for Sound Liquidity Risk Management and Supervision* issued by the Basel Committee in September 2008

- improving risk management guidance to AIs in areas including the management of credit, market, liquidity and counterparty credit risks; stress-testing for risk management and capital planning; management of the risks associated with securitisation and off-balance sheet exposures; management of firm-wide risks, including concentration risks; and governance and controls over valuation processes

- continuing participation in the Basel Committee's review of sound provisioning practices, including the impact of IAS 39 on the levels of provisions maintained by AIs, and monitoring of the work of the FSF in examining pro-cyclicality related to loan loss provisions, and considering their implications for the HKMA's supervisory policy

- reviewing the need to issue further guidance to enhance risk disclosure in light of the recommendations of the Basel Committee and the International Accounting Standards Board (IASB), as well as emerging disclosure practices in the industry and in other jurisdictions

- monitoring international developments in the regulation of ECAIs and the reforms of their rating processes, and considering amendments to the supervisory policy framework where necessary.

It is expected that these and other issues arising from the financial crisis will dominate the HKMA's policy agenda in the foreseeable future. Many of the issues are complex and the development of international standards is still in progress. The guidance issued by international organisations so far consists largely of high-level principles that will require significant further development before implementation. They will also need to be adapted to local circumstances. The guidance may be subject to change as the global financial crisis continues to evolve. The HKMA will remain vigilant to international developments in banking supervision, and will consider implementing the relevant international standards and practices after taking into account the circumstances of the local banking sector.

Lehman-related investment products

The HKMA is engaging additional contract staff to assist in the investigations of the complaints relating to the sale of Lehman-related investment products. This will enable existing staff, who have been deployed to handle the complaints, to return to their normal duties. The HKMA will also assist the Government in reviewing the present regulatory framework governing the sale of investment products to retail investors.

Review of the HKMA's work on banking stability

The HKMA is studying the comments received during public consultation on the consultant's report, and hopes to develop a policy response in the first half of 2009.

Basel II implementation

Supervisory recognition for use of the IRB approach

In 2009 the recognition process will focus on AIs applying to adopt the IRB approach in 2010 or 2011. On-site examinations of AIs intending to adopt the IRB approach in 2010 have been scheduled and the HKMA will maintain regular dialogue with those AIs planning to adopt the IRB approach in 2011 and beyond.

The HKMA will also conduct follow-up reviews of the AIs previously approved to ensure that they have properly implemented recommendations made by the HKMA previously, and that changes or refinements made to their internal rating systems are appropriate.

Amendments to Banking (Capital) Rules and Banking (Disclosure) Rules

The HKMA plans to incorporate the Basel Committee's proposals on enhancements to the Basel II framework relating to capital treatment for market risk and securitisation exposures by 2010 by amending the Banking (Capital) Rules and related supervisory guidance. The HKMA will also consider changes to the Banking (Disclosure) Rules, taking into account the proposal issued by the Basel Committee for strengthening disclosure requirements for securitisation and re-securitisation activities, as well as any enhanced disclosure standards proposed by the IASB for complex financial instruments and off-balance sheet entities. Minor refinements to the current Rules may also be necessary in the light of implementation experience since 2007.

Supervisory review process (SRP)

The HKMA will continue to identify areas where the SRP framework can be further improved in view of relevant guidance (including associated stress-testing requirements) issued by the Basel Committee. AIs' progress in developing their capital adequacy assessment process (CAAP) will also be closely monitored. In addition to reviewing their policies and methodologies, the HKMA will evaluate the effectiveness of their CAAP and how it is integrated into AIs' daily risk management process. Where necessary, more guidance will be provided to assist individual AIs in upgrading their existing systems to implement the CAAP standards.

Revision of liquidity supervisory framework

The HKMA will consider necessary changes to make the existing framework more effective, taking into account the approaches adopted by other overseas supervisors in implementing the Basel Committee's revised liquidity guidance, the specific circumstances of the Hong Kong banking sector, and the impact of any proposed changes on individual AIs. The HKMA will consult the banking industry once firm proposals are drawn up.

The HKMA will ensure that AIs have appropriate liquidity contingency measures to cope with potential market distress; and will continue its monitoring of AIs' liquidity risk management and funding positions and require prompt action to address any major deficiencies.

Prevention of money laundering and terrorist financing

In 2009 the HKMA will undertake further institution-specific and thematic examinations to ensure AIs remain vigilant against money laundering and terrorist financing, and commence an exercise to consolidate, and where necessary improve, its existing AML/CFT guidelines. This will include issues identified by the FATF and the Asia/Pacific Group on Money Laundering in their joint mutual evaluation of Hong Kong.

In April 2008 the Government established a Central Co-ordinating Committee on Anti-money Laundering and Counter Financing of Terrorism. Chaired by the Financial Secretary, the Committee will steer and co-ordinate the strategic development of Hong Kong's AML/CFT regime in line with internationally recognised standards. A major task for the HKMA in the coming years will be to assist the Committee in formulating appropriate and effective policy measures for the banking sector.

Accounting and disclosure

In addition to the work of the Basel Committee in developing guidance to banks and banking supervisors to strengthen fair valuation processes for financial instruments and risk disclosures under Basel II, steps have also been taken by the accounting standard setting bodies to address the various financial reporting issues highlighted by the global financial crisis. Work underway at the IASB includes improving guidance on valuing financial instruments when markets are no longer active, and the revision of the accounting standard for consolidation of off-balance sheet entities and related risk disclosures. The HKMA will monitor these developments and assess the implications for its supervisory policy framework.

Credit data sharing

The HKMA will work with the industry to promote credit data sharing and believes the continued development of the credit data sharing arrangements in Hong Kong will help to strengthen the credit risk management capacity of AIs. This, in turn, will be conducive to maintaining the stability of the financial system.

Consumer protection

The HKMA continues to promote improvements in banking practices through participation in the Code of Banking Practice Committee. It will also monitor AIs' compliance with the Code through regular self-assessments and the handling of complaints about services and products provided by AIs.

Deposit protection

The HKMA will assist the Hong Kong Deposit Protection Board in operating the Deposit Protection Scheme. While maintaining and improving the efficiency and effectiveness of the Scheme, due consideration will be given by the Board to aligning the Scheme's operation with that of the deposit guarantee provided by the Exchange Fund. The Board expects to complete the review of the protection limit and membership of the Scheme and formulate firm proposals in the first quarter of 2009 for public consultation. Any changes will be confirmed well ahead of the expiry of the guarantee by the end of 2010 to give AIs and the public ample time to prepare for the transition. In view of the heightened public awareness of the protection status of their deposits, the Board will increase its promotional and educational efforts to enhance public understanding of the deposit protection arrangements in force. The Board will also join with the HKMA in monitoring whether proper representations are being made by AIs of protection under the Scheme and the guarantee.