Banking Stability

The banking sector in Hong Kong remained sound and stable in 2016 despite increased risks and shocks in the global markets. During the year, the HKMA stepped up its supervisory efforts on the effectiveness of the risk governance framework, as well as the credit and liquidity risk management systems of authorized institutions. As cyber attacks became increasingly prevalent, the HKMA strengthened the supervision of authorized institutions' technology risk management. The effectiveness of authorized institutions' anti-money laundering and counter-terrorist financing controls remained a key supervisory focus of the HKMA as part of its effort to combat financial crime. On conduct supervision, the HKMA took concrete steps to promote a customer-centric culture and foster financial inclusion, and address the difficulties encountered by foreign small and medium-sized enterprises and start-up companies in opening and maintaining bank accounts in Hong Kong. More efforts were also made to supervise authorized institutions' selling practices for investment and insurance products to further enhance customer protection.

On the policy side, substantial progress was made on the preparatory work for the local implementation of international supervisory and accounting standards, including the Net Stable Funding Ratio, large exposure limits, International Financial Reporting Standard 9, and the resolution framework after the enactment of the Financial Institutions (Resolution) Ordinance.

REVIEW OF 2016

Overview of supervisory activities

In 2016, 188 off-site reviews were conducted covering a broad range of issues, including CAMEL ratings[1], corporate governance, business operations and risk management of authorized institutions (AIs). The HKMA stepped up its engagement with the boards of directors of AIs in order to strengthen risk governance and culture in the banking sector. Apart from meetings with boards of directors or board-level committees, separate meetings with the independent non-executive directors (INEDs) were held to exchange views on culture and risk governance issues. Tripartite meetings among the HKMA, AIs and their external auditors were also conducted. A review was undertaken to assess whether the remuneration systems of AIs are conducive to promoting effective risk management.

In respect of capital adequacy, the HKMA reviewed the capital plans of AIs, including their multi-year capital targets in preparation for the full implementation of Basel III capital buffers in 2019. The solvency stress testing programme was refined, having regard to the prevailing macroeconomic environment. The HKMA also critically assessed the recovery plans of major retail banks and provided feedback on areas requiring enhancement.

In addition to off-site activities, the HKMA continued to conduct regular on-site examinations supplemented with thematic reviews on areas assessed to be of higher risks. This approach has allowed the HKMA to prioritise its supervisory resources to focus on emerging and more significant risks faced by AIs. In 2016, the HKMA conducted 377 on-site examinations and thematic reviews. Credit risk management and controls, particularly those over Mainland-related business, continued to be the focus of these examinations and reviews. Another major focus was anti-money laundering and counter-terrorist financing (AML/CFT) controls. The HKMA also increased the number of on-site examinations and thematic reviews on liquidity, operational and technology risk management. AIs' activities in securities, investment products, insurance and Mandatory Provident Fund (MPF)-related businesses were also subject to on-site examinations by specialist teams during the year.

[1] Comprising the **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity components.

Table 1 contains an overall summary of the HKMA's supervisory activities in 2016.

Table 1 Summary of supervisory activities

		2016	2015
1	Off-site reviews and prudential interviews	**188**	196
2	Meetings with boards of directors or board-level committees of AIs	**30**	23
3	Tripartite meetings	**27**	20
4	On-site examinations	**164**	193
	Credit risk management and controls	**71**	71
	Technology risk and operational risk management	**20**	27
	AML/CFT controls	**17**	21
	Liquidity risk management	**8**	2
	Implementation of Basel capital adequacy framework	**6**	8
	Market risk, counterparty credit risk and treasury activities	**4**	23
	Securities, investment products, insurance and MPF-related businesses	**20**	22
	Deposit Protection Scheme-related representation	**12**	12
	Code of Banking Practice/Consumer Protection	**–**	1
	Overseas examinations	**6**	6
5	Thematic reviews	**213**	152
	Credit risk management and controls	**62**	69
	Technology risk and operational risk management	**64**	45
	AML/CFT controls	**30**	22
	Implementation of Basel capital adequacy framework	**4**	7
	Selling of investment products	**3**	3
	AIs' systems of control over sales agents and sales/marketing staff in relation to customer data protection	**50**	–
	New product reviews	**–**	6
Total number of off-site reviews and prudential interviews, meetings, on-site examinations and thematic reviews		**622**	584

Supervision of credit risk

Credit growth and asset quality

Bank lending increased moderately in 2016. Total outstanding loans grew by 6.5%, compared with a growth of 3.5% in 2015 (Table 2). As the increase in customer deposits outpaced the increase in bank lending, the overall loan-to-deposit ratio decreased to 68.4% at the end of 2016 from 70.1% a year earlier.

Banking Stability

Table 2	Growth in loans and advances	
% change	**2016**	2015
Total loans and advances	**6.5**	3.5
Of which:		
– for use in Hong Kong	**8.0**	6.3
– trade finance	**0.2**	–16.3
– for use outside Hong Kong	**4.5**	2.8

Mainland-related lending grew by 7% to HK$3,564 billion at the end of 2016 (Table 3). This included HK$545 billion of loans booked with Mainland subsidiaries of banks incorporated in Hong Kong.

Table 3	Growth in Mainland-related lending	
% change	**2016**	2015
Total Mainland-related lending	**7.0**	3.3
Of which:		
– Mainland-related lending excluding trade finance	**7.7**	6.5
– trade finance	**–1.1**	–22.3

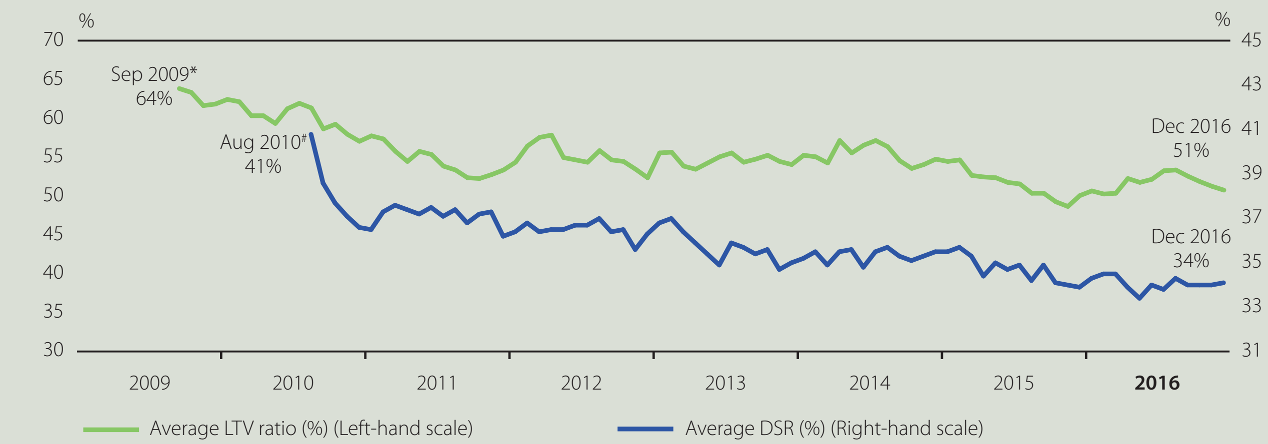
The asset quality of the banking sector remained healthy in 2016. Retail banks' classified loan ratio edged up from 0.69% at the end of 2015 to 0.72% at the end of the year, but well below the long-run historical average of 2.4% since 2000. For the banking sector as a whole, the classified loan ratio increased from 0.73% to 0.85%. The asset quality of the industry's Mainland-related lending showed a similar trend during the year. Retail banks' classified loan ratio of such lending edged up to 0.82% from 0.78% over the same period. For the banking sector as a whole, the ratio increased to 0.80% from 0.77% a year ago.

The HKMA devoted a significant amount of its supervisory effort to ensure that AIs continued to adopt prudent underwriting standards, and maintained effective loan classification and provisioning systems. Specifically, supervisory attention on credit risks associated with growing exposures to privately owned enterprises in Mainland China and investment in debt securities for yield enhancement purposes was intensified. Thematic reviews on credit risk management in relation to the distribution of high-risk investment products was undertaken.

Property mortgage lending

The HKMA continued to maintain a high degree of vigilance over AIs' property lending business. Following the correction in property prices beginning in September 2015, the prices of residential properties reverted to an upward trend in March and rose by 8% in 2016. In December 2016, the average loan-to-value (LTV) ratio for new residential mortgage loans (RMLs) approved reduced to 51%, compared to 64% in September 2009, before the HKMA first introduced countercyclical measures on property lending. The average debt servicing ratio (DSR) for new RMLs approved dropped to 34% in December 2016, from 41% in August 2010, when a cap on DSR was first applied (Chart 1).

Chart 1 Average LTV ratio and DSR of new RMLs



* Before the introduction of the first round of the HKMA's countercyclical measures on property lending
\# Introduction of a cap on DSR

As part of the seventh round of countercyclical measures introduced in February 2015, AIs using an Internal Ratings-Based (IRB) approach to calculate credit risk capital charge were required to extend the application of a risk-weight floor of 15% to their entire RML portfolios rather than only newly granted mortgage loans. This requirement came into effect in June 2016.

During the year, more property developers provided direct mortgage financing to property buyers. The LTV ratios of these mortgage facilities were often higher than that permitted under the prudential requirements applied by the HKMA on AIs. The HKMA monitored the development closely and maintained regular dialogue with AIs to assess whether banks continued to maintain effective risk management over their exposures to property developers. Separately, the Land Registry (LR), at the request of the HKMA, agreed to develop an "e-Alert" service for AIs. AIs that have subscribed to this service will receive electronic notifications when further mortgage documents in respect of properties mortgaged to them are registered with the LR. The introduction of this service will help address the issue of mortgagors seeking further mortgage financing without obtaining the mortgagee AIs' consent. The LR rolled out the e-Alert service in the first quarter of 2017.

Supervision of operational and technology risks

Similar to other global financial centres, Hong Kong faced growing cyber threats. In 2016, the HKMA received reports from AIs about cases of unauthorised online share trading transactions and attempts to compromise their payment systems. The HKMA took immediate action to address the risks posed by these attacks. The HKMA issued an e-banking alert to raise the public's awareness of online share trading frauds and advised them on the precautionary measures they should take. The HKMA also issued a circular to provide AIs with guidance on possible measures to further strengthen their security controls over internet banking services. On the attempts to compromise banks' payment systems, the HKMA alerted AIs to this type of fraud when these attempts were first detected in Hong Kong. With the help of the Police, the HKMA shared the modus operandi used in these frauds and required AIs to take them into account in strengthening their controls over payment operations.

To further enhance the cyber resilience of the banking sector, the HKMA rolled out a Cybersecurity Fortification Initiative (CFI) in May 2016. The CFI comprises three pillars, namely a Cyber Resilience Assessment Framework (C-RAF), a Professional Development Programme and a Cyber Intelligence Sharing Platform (see *Fintech Facilitation Office* in the chapter on *International Financial Centre* for more details). In December, the HKMA issued a circular to AIs setting out the C-RAF implementation timeline.

During 2016, the development of fintech gathered pace in the banking sector. Many AIs rolled out new fintech products, particularly in the areas of person-to-person (P2P) small-value payment services, contactless mobile payments and biometric authentication. In September, a Fintech Supervisory Sandbox (FSS) was introduced to enable AIs to conduct pilot trials of their fintech initiatives under a controlled environment without the need to achieve full compliance with the HKMA's supervisory requirements. The FSS arrangement enabled real-life data and user feedback to be gathered at an early stage so that refinements to the fintech initiatives could be made before the full launch. Up to the end of 2016, six requests for access to the FSS, in respect of new fintech products involving biometric authentication, securities trading and blockchain technology for use in mortgage valuation, were granted. In November, the HKMA also raised the maximum transaction limit for P2P small-value payment services conducted via internet banking without two-factor authentication to HK$5,000 per day per account, in a bid to meet growing demand for convenient P2P payment services.

A series of property-related frauds were reported in 2016 in which fraudsters impersonated property owners and attempted to obtain benefits by seeking mortgage financing or disposing of the properties. Although these cases did not involve AIs, the HKMA worked closely with the Police and the Hong Kong Association of Banks (HKAB) to provide guidance to AIs on ways to detect these frauds and stop them from occurring in the banking sector. Over the year, the HKMA published two issues of its *Operational Incidents Watch*, sharing with the industry lessons learned from past AIs' operational incidents. The HKMA also conducted on-site examinations and thematic reviews on AIs' operational risk management frameworks, fraud management practices, trustee/custodian operations, and risk management controls for guarding against rogue or unauthorised trading activities.

Banking Stability

Supervision of treasury activities and liquidity risk

Several major political events took place in 2016, causing significant volatilities in financial markets at various times during the year. Meanwhile, the interest rate normalisation process in the US continued to advance at a slow pace, with the Federal Open Market Committee deciding in December to raise the Federal Funds Rate for the second time since the global financial crisis. In preparation for these political events, the HKMA maintained a close dialogue with overseas regulators, assessed the implications for the banking sector in Hong Kong and required banks to stay alert and strengthen their risk management to cope with adverse market developments.

On liquidity risk management, the HKMA conducted additional liquidity stress tests to assess the resilience of the banking sector to cope with severe but plausible liquidity stress scenarios. Follow-up actions were taken to enhance the capability of AIs in coping with these scenarios. After a round of on-site examinations focused on interest rate risk management in 2015, the HKMA conducted additional on-site examinations to evaluate AIs' market risk management. AIs with identified control weaknesses were asked to take corrective actions.

Prevention of money laundering and terrorist financing (ML/TF)

The HKMA's risk-based AML supervision included on-site examinations and desk-based reviews (including event-driven supervisory engagement with AIs), which targeted areas presenting higher ML/TF risks. The examinations and reviews covered AIs' assessment of ML/TF risks, implementation of the risk-based approach, as well as systems and processes for transaction monitoring and sanctions compliance. In 2016, the HKMA's specialist supervisory resources undertook 17 on-site examinations and 30 desk-based reviews.

In terms of policy development, priority was given to addressing difficulties encountered by certain businesses and individuals when opening bank accounts; guidance and frequently asked questions were issued to clarify certain customer due diligence (CDD) requirements as well as the HKMA's supervisory expectations on the risk-based approach. Meanwhile, the HKMA continued to work closely with industry associations in issuing guidance to assist AIs to address risks in certain areas, such as trade-based money laundering.

To fully align our AML/CFT regime and risk-based supervision with the latest international standards and practices, the HKMA continued to be active in various international and regional AML/CFT forums and participated in the mutual evaluation of Thailand's AML/CFT regime led by the Asia/Pacific Group on Money Laundering. The HKMA also continued to work with both domestic and international partners to develop Hong Kong's first jurisdiction-wide ML/TF risk assessment, which is expected to be published in 2017.

Supervision of wealth management and MPF-related businesses

The HKMA co-operated closely with the other financial regulators in Hong Kong to provide guidance and supervise AIs' selling of securities, investment products, insurance products and MPF schemes. Regular contact was maintained with regulators through bilateral and multilateral meetings, as well as under the auspices of the Council of Financial Regulators, to ensure more co-ordinated and effective supervisory actions. In 2016, the HKMA and the Securities and Futures Commission (SFC) conducted a joint review of a financial group's controls and management over possible conflict of interest arising from the selling of in-house investment products.

During the year, the HKMA conducted 20 on-site examinations, 3 thematic reviews and 14 industry analyses of AIs. These covered the selling of investment products, settlement of securities transactions and the safe custody of client securities. It also covered the selling of non-investment-linked long-term insurance (NLTI) products and MPF-related products involving retail, private banking and corporate banking customers. The HKMA also maintained close communications with the banking industry in relaying and clarifying regulatory standards and its risk-based supervisory approach through meetings with management of AIs and joint workshop with the industry association.

In April, a circular was issued to share some key observations and good practices on the selling of investment products identified in the course of the HKMA's supervisory work, and to remind AIs to review their selling practices and promptly implement necessary enhancement measures. Following industry consultation, an updated Supervisory Policy Manual (SPM) module "Supervision of regulated activities of SFC-registered authorized institutions" was gazetted in May 2016. The revisions mainly include an elaboration of the HKMA's supervisory and enforcement approaches for enhanced transparency, and highlights of relevant major regulatory requirements. Guidance was also provided in the year to AIs regarding suitability obligations.

The HKMA processed six applications to become Registered Institutions (RIs) and three applications from RIs to engage in additional regulated activities. It granted consent to 203 executive officers responsible for supervising the securities activities of RIs, and conducted background checks on 8,557 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

Other supervisory activities

The Banking Supervision Review Committee considered six cases in 2016. Five of these cases concerned the authorization of AIs or the approval of money brokers. The remaining one was about the lifting of the restrictions imposed on an AI under section 52 of the Banking Ordinance (see Table 4 for details).

During the year, the HKMA commissioned two reports under section 59(2) of the Banking Ordinance. The AIs were required to appoint external auditors to report on the effectiveness of their controls over a specified area of operation. One of the reports covered credit risk management and the other was related to the distribution of financial products.

In 2016, no AIs breached the requirements of the Banking Ordinance relating to capital adequacy or liquidity ratio. There were, however, 23 breaches under various sections of the Banking Ordinance, but none affected the interests of depositors and these breaches were promptly rectified by AIs.

On 24 June 2016, the Monetary Authority lifted the restrictions imposed on the Hong Kong Branch of Melli Bank Plc under 52(1)(A) of the Banking Ordinance in respect of its affairs, business and property, as the circumstances and considerations leading to the imposition of the restrictions no longer existed.

As in past years, the CAMEL ratings of AIs were reviewed and determined by the CAMEL Approval Committee. AIs were notified of the ratings and given the opportunity to request a review. An AI requested for a review of its rating. The request is being considered by the CAMEL Approval Review Committee.

Table 4 Summary of other supervisory activities

		2016	2015
1	Cases considered by the Banking Supervision Review Committee	**6**	4
2	Reports commissioned under section 59(2) of the Banking Ordinance	**2**	6
3	AIs subject to the exercise of powers under section 52 of the Banking Ordinance	**–**	1
4	Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs	**193**	291
5	Reports commissioned under section 21(2)(b) of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance	**–**	1

International co-operation

Co-operation with overseas supervisors

The HKMA participated in 31 college-of-supervisors meetings organised by the home supervisors of 22 banking groups with significant operations in Hong Kong. A broad range of issues were discussed at these meetings, covering areas such as financial soundness, corporate governance, recovery and resolution planning and risk management controls. During the year, the HKMA assisted the home supervisors of three global systemically important banks (G-SIBs) in organising supervisory college meetings in Hong Kong.

Banking Stability

Bilateral meetings were held during the year with banking supervisors from Australia, the European Union, India, Indonesia, Japan, Mainland China, Malaysia, Switzerland, Taiwan, the UK and the US. There were also regular exchanges with overseas authorities on institution-specific issues and developments in financial markets.

Participation in international and regional forums

The HKMA continued to participate in a range of international and regional forums for banking supervisors. The HKMA is a member of the Basel Committee on Banking Supervision (Basel Committee) and its governing body, the Group of Governors and Heads of Supervision, and is represented on various Basel Committee working groups, including the Policy Development Group (PDG), the Macroprudential Supervision Group (MPG), the Supervision and Implementation Group (SIG) and the AML/CFT Expert Group. The HKMA is also a member of several sub-groups under (i) the PDG, including the Working Group on Capital (which the HKMA also co-chairs), the Trading Book Group, the Working Group on Liquidity, the Working Group on Disclosure, and the Task Force on Standardised Approaches; and (ii) the SIG, including the Working Group on Supervisory Colleges, the SIG Trading Book Task Force, the SIG Banking Book Task Force, the Task Force on Impact and Accountability, the Working Group on Stress Testing and the Workstream on Future Regulatory Consistency Assessment Programme (RCAP). The HKMA also chairs the Risk Data Network under the SIG to monitor the implementation progress of the *Principles for effective risk data aggregation and risk reporting* by G-SIBs. From 2017, the HKMA will also be a member of a new Market Risk Group (formed by the merger of the Trading Book Group and the SIG Trading Book Task Force) and a new Credit Risk Group (formed by the merger of the Task Force on Standardised Approaches, the SIG Banking Book Task Force and another Basel Committee working group – the Risk Measurement Group). In addition, the HKMA participates in the Joint Working Group on Margining Requirements formed by the Basel Committee and the International Organization of Securities Commissions (IOSCO).

The HKMA is a member of the Financial Stability Board (FSB) Plenary Meeting, FSB Standing Committee on Assessment of Vulnerabilities and FSB Standing Committee on Supervisory and Regulatory Co-operation. It also participates in several FSB working groups, including the Over-the-counter (OTC) Derivatives Working Group, the Compensation Monitoring Contact Group, the Working Group on Governance Frameworks, and the Workstream on Other Shadow Banking Entities. In the area of resolution, and addressing the problem of "Too Big To Fail", the HKMA is a member of the FSB's Resolution Steering Group and Cross-Border Crisis Management Working Group.

At the regional level, the HKMA is a member of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), the South East Asia, New Zealand and Australia Forum of Banking Supervisors and the South-East Asian Central Banks group. As part of its work in the EMEAP Working Group on Banking Supervision, the HKMA is the Champion of the Interest Group on Liquidity (IGL). During the year, the IGL conducted surveys and engaged in discussions regarding the implementation of the Basel III liquidity standards in the EMEAP jurisdictions.

Under the Basel Committee's RCAP, each of its member jurisdictions' capital and liquidity regulations are compared against the corresponding Basel standards. During the year, the HKMA participated in an RCAP review team evaluating assessments conducted by technical experts from other countries on both the implementation of the Basel III framework for systematically important banks in the European Union, Japan, Mainland China, Switzerland and the US, and the liquidity standards adopted in Japan and Singapore. The reports of these assessments were published in June and December respectively.

Implementation of Basel standards in Hong Kong

Capital standards

On 14 January 2016, the HKMA announced a jurisdictional Countercyclical Capital Buffer (CCyB) for Hong Kong at a rate of 1.25% (reflecting the Basel III phase-in provisions), effective from 1 January 2017. On 27 January 2017, the HKMA increased the CCyB rate for Hong Kong to 1.875% with effect from 1 January 2018. In line with the Basel Committee's framework for dealing with domestic systemically important banks (D-SIBs), the HKMA announced in December an updated list of D-SIBs for 2017, together with their corresponding higher loss absorbency capital requirements, to take effect from 1 January 2018.

The HKMA, together with the Department of Justice, worked on a set of amendments to the Banking (Capital) Rules (BCR) for the purpose of implementing the Basel Committee's: *Capital requirements for banks' equity investments in funds* (December 2013); *The standardised approach for measuring counterparty credit risk exposures* (April 2014); and *Capital requirements for bank exposures to central counterparties* (April 2014). The original intention was to implement these three standards on 1 January 2017 in accordance with the schedule set by the Basel Committee. However, the HKMA ultimately decided in September to defer implementation of these standards (tentatively to 1 January 2018) to better align with the progress made by other major markets.

During the year, the HKMA developed policy proposals for the local implementation of the *Revisions to the securitisation framework* issued by the Basel Committee in December 2014 (and updated in July 2016). An industry consultation paper was issued in January 2017. Reflecting the Basel implementation timeline, the HKMA has proposed to introduce the revised framework from 1 January 2018 through amendments to the BCR.

Disclosure standards

The Basel Committee's *Revised Pillar 3 disclosure requirements* issued in January 2015 were the outcome of the first phase of a review of the existing regulatory disclosure standards. The purpose of the review was to enhance user-relevance, consistency and comparability (between banks and across jurisdictions) of banks' public disclosures through, among other things, a greater use of standard templates and tables. The new requirements were implemented locally by the Banking (Disclosure) (Amendment) Rules 2016 which took effect on 31 March 2017, supplemented by a set of standard templates and tables specified by the Monetary Authority under the Rules.

Liquidity standards

In November, the HKMA consulted the banking industry on policy proposals for the local implementation of the Net Stable Funding Ratio (NSFR), which is the second of the two Basel III liquidity standards alongside the Liquidity Coverage Ratio (LCR). The HKMA has proposed that AIs designated as "category 1 institutions" under the Banking (Liquidity) Rules (BLR) should observe the NSFR requirements in addition to the LCR. Other AIs would be required to implement a modified version of the NSFR (referred to as "Core Funding Ratio" or "CFR") unless otherwise exempted on specified grounds. Both of these new stable funding requirements are intended to take effect from 1 January 2018.

Banking Stability

Improving Supervisory Policy Framework

Credit risk transfer

Following industry consultation, the HKMA issued a module for the SPM on "Credit Risk Transfer Activities" (CRT activities) in June, reflecting developments in risk management standards and best practices for CRT activities. The module superseded a former SPM module on "Credit Derivatives" and Guideline No. 4.6 on "Supervisory treatment on asset securitisation and mortgage backed securities".

Liquidity standards

The HKMA revised the guidance in the SPM module "Regulatory Framework for Supervision of Liquidity Risk" in July to provide further elaboration on the implementation of the LCR and the local Liquidity Maintenance Ratio. The guidance contained in the SPM module on "Sound Systems and Controls for Liquidity Risk Management" was also updated accordingly in November.

Corporate governance and risk controls

In August, the HKMA consulted the industry on revisions to three SPM modules relating to corporate governance and risk controls (namely "Corporate Governance of Locally Incorporated Authorized Institutions", "Risk Management Framework" and "Internal Audit Function") to reflect the latest international standards. The revised modules are expected to be issued in 2017.

Regulation of OTC derivatives transactions

The HKMA finalised a new SPM module on "Non-centrally Cleared OTC Derivatives Transactions — Margin and Other Risk Mitigation Standards" to adopt global margin and risk mitigation standards for AIs involved in non-centrally cleared OTC derivatives transactions. These standards, developed jointly by the Basel Committee and the IOSCO, are designed to reduce counterparty credit risk and limit contagion by ensuring collateral is available to offset losses following the default of a derivatives counterparty; promote legal certainty over the terms of derivatives contracts; and facilitate timely resolution of disputes. The new module was issued in January 2017 and took effect from 1 March 2017, with a 6-month transitional period.

To facilitate the implementation of the new margin and risk mitigation standards, the HKMA also revised the Banking (Specification of Class of Exempted Charges) Notice so that legal charges created over an AI's assets arising from the AI's provision of initial margin for OTC derivatives transactions would be exempted, to a specified limited extent, from the general restrictions imposed under the Banking Ordinance on the creation of charges over AIs' assets. This exemption took effect from 3 March 2017 to coincide with the start of the margin and risk mitigation standards.

Exposure limits

In March, the HKMA consulted the industry on proposed approaches to locally implement the Basel Committee's *"Supervisory framework for measuring and controlling large exposures"* (April 2014) and updating certain other exposure limits contained in the Banking Ordinance.

The Basel large exposures framework consists of a comprehensive minimum standard for internationally active banks, which is designed as a simple backstop to complement the Basel III risk-based capital standard. Aggregate exposures to single or linked counterparties will, for the most part, be limited to 25% of a bank's Tier 1 capital. A stricter 15% limit will apply to exposures between G-SIBs.

During the year, the HKMA conducted a quantitative impact study (QIS) to calibrate proposed revisions to the existing limits in section 87 (Limitation on shareholding by authorized institutions) of the Banking Ordinance.

Updating other supervisory policies and risk management guidelines

The HKMA updated and re-issued the SPM module on the "Supervisory Review Process" in April to reflect changes to the supervisory framework (such as the CCyB and its interaction with the Pillar 2 capital requirement).

Accounting standards

Following the release of International Financial Reporting Standard 9 (IFRS 9) *Financial Instruments* by the International Accounting Standards Board in July 2014, various initiatives have been undertaken by standard-setting bodies to promote the robust and consistent application of IFRS 9 (or of its counterpart, the expected credit loss accounting framework of the US Financial Accounting Standards Board) across jurisdictions. These include the issuance of supervisory guidance on credit risk and accounting for expected credit losses by the Basel Committee in December 2015, and two subsequent documents in October 2016 relating to the regulatory treatment of accounting provisions based on expected credit loss (i.e. the Consultative Document on *"Regulatory treatment of accounting provisions — interim approach and transitional arrangements"* and the Discussion Paper on *"Regulatory treatment of accounting provisions"*). Domestically, the HKMA conducted a survey in June 2016 to facilitate its assessment of locally incorporated AIs' progress in adopting the new IFRS 9 requirements and their potential impact on AIs' business operations. Discussions are ongoing with auditors on AIs' preparation for the implementation of IFRS 9.

During the year, the HKMA also continued its regular dialogue with the Banking Regulatory Liaison Group of the Hong Kong Institute of Certified Public Accountants (HKICPA) on topics of common interest. These included international and domestic developments in relation to new or revised accounting, auditing and financial reporting standards and their implications for banks, as well as major international and domestic banking regulatory developments.

Resolution

The Financial Institutions (Resolution) Ordinance (FIRO) was enacted by the Legislative Council on 22 June 2016 for the purpose of establishing a cross-sectoral resolution regime in Hong Kong reflecting the standards set out in the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*. The regime is designed to mitigate the risks which a failing financial institution may pose to the stability and effective working of the local financial system. It provides the authorities with a set of tools targeted at securing continuity of critical financial services whilst still imposing the cost of failure on the shareholders and creditors of the financial institution, thereby minimising the risks posed to public funds. The FIRO appoints the sectoral regulators in Hong Kong as resolution authorities for institutions under their respective purviews. Accordingly, once the FIRO comes into force, the Monetary Authority will be the resolution authority for AIs with responsibility for setting resolution strategies for individual AIs, conducting resolution planning, assessing whether the conditions for initiating resolution are met and, if so, applying the appropriate resolution tools to achieve the objectives of the regime.[2]

The FIRO will start operation on a date to be appointed by the Secretary for Financial Services and the Treasury. At the same time, a regulation is intended to be made as subsidiary legislation under the FIRO, designed to preserve the economic effect of certain structured finance, security, set-off, netting and title transfer arrangements and the operation of specified clearing and settlement systems when a resolution authority deploys selected resolution tools under the Ordinance. A public consultation on the proposed treatment of these arrangements was launched in November 2016 and concluded in January 2017.[3]

From an international and regional perspective, the HKMA actively participated during the course of the year in a range of forums focused on establishing international standards for resolution and developing operational cross-border resolution plans for systemically important banks. On resolution policy, as a FSB member, the HKMA contributed to the development of standards on bail-in execution, continuity of access to financial market infrastructures (FMIs) for entities in resolution and internal Total Loss-Absorbing Capacity (i-TLAC). On resolution planning, the HKMA attended the crisis management groups (CMGs) of 12 G-SIBs organised by the relevant home authorities to develop resolution strategies for individual banks, assess the resolvability of each banking group and identify any structural changes required to remove barriers to resolvability. The HKMA also took the lead in organising an annual regional CMG for a local banking subsidiary of a major international bank attended by the host regulators from the Asia Pacific region.

2 The Monetary Authority will also be the resolution authority for a small number of financial market infrastructures which are designated by the Monetary Authority as a designated clearing and settlement system under section 4(1) of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) (other than those which are wholly owned or operated by the Monetary Authority).

3 http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/Protected_Arrangements_Regulations_CP_eng.pdf

Banking Stability

Bank consumer protection

Code of Banking Practice

The HKMA followed up with AIs in the first quarter of 2016 to monitor their implementation of the revised code, which took effect on 6 February 2015, with full compliance expected by 5 February 2016. The HKMA will continue to monitor AIs' compliance as part of its ongoing supervisory process.

Financial inclusion

In line with the spirit of promoting a customer-centric culture and fostering financial inclusion, the banking industry responded positively to the HKMA's call for the provision of adequate basic banking services to the public. Several retail banks have leveraged on new technology while retaining human touch in customer interface, and launched initiatives, including mobile branches and video teller machines in remote areas and public housing estates, to enhance access to basic banking services.

HKMA Chief Executive, Mr Norman Chan, officiates at the opening ceremony of a mobile bank branch.

HKMA Chief Executive, Mr Norman Chan, officiates at the launching ceremony of a bank's video teller machine at Shui Chuen O Estate.

Opening and maintaining bank accounts

During the year, there were comments made through different sources that some corporate customers, most notably small and medium-sized enterprises (SMEs) and start-up companies from overseas, have experienced difficulties in opening and maintaining bank accounts in Hong Kong. While this problem does not appear to be an industry-wide issue but is pertinent among one or two AIs, the concern expressed by the business community was strong and the situation could affect the perception about Hong Kong as a welcoming financial and business hub.

It is recognised that the international community had tightened the requirements and standards for combating money laundering, tax evasion and terrorist financing over the past decade. Therefore, in line with the global trend, banks in Hong Kong have put in place more stringent controls in their account-opening and CDD procedures for existing and new customers. Apart from local requirements, some AIs in Hong Kong, for a variety of reasons, also need to comply with requirements or standards mandated by their head offices or overseas authorities.

The HKMA is concerned that SMEs and start-up companies which are planning to carry out bona fide businesses in Hong Kong – no matter established locally or in overseas jurisdictions – may be subject to overly stringent requirements and treatment when opening and maintaining bank accounts. A series of steps have therefore been taken to deal with the matter. The HKMA engaged various stakeholders to gather specific incidents of the problem and followed up with the AIs concerned. A list of about 20 AIs of different niches and a variety of local or foreign backgrounds, which indicated interests in exploring businesses with foreign SMEs and start-ups, has been provided to InvestHK for sharing with interested foreign companies that may wish to seek assistance to open bank accounts in Hong Kong. We also hosted several sharing sessions in August and September to facilitate direct exchange of views and foster co-operative relationships among the business community and AIs.

On 8 September, the HKMA issued a circular to AIs, explaining how the risk-based approach should be applied to CDD process at account opening and maintenance. The circular emphasised that the risk-based approach was not a "zero failure" regime and AIs were not required to implement overly stringent CDD processes with a view to eliminating, ex-ante, all risks. It also emphasised the importance of AIs' engaging with customers to ensure they were treated fairly, particularly with respect to transparency, reasonableness and efficiency. On 29 September, the HKMA further issued a circular to AIs to clarify some commonly misinterpreted CDD requirements.

In response to the HKMA's guidance, AIs have taken steps to improve the account opening process, for example, by shortening the turnaround time, providing interim updates about the progress of applications and establishing review mechanisms for unsuccessful applications. Some AIs also adjusted their practices to be more risk-based so that they would no longer request customers to provide decades-old information as proof of their source of wealth. At the same time, some local and international AIs have actively expanded their SME business in Hong Kong, providing greater convenience from account opening to business support. The HKMA has also requested the banking industry to explore opportunities to further co-operate with, and leverage on, the government platform to reach out to the SME community and provide SMEs with up-to-date information about banking services.

Based on the feedback received from different sources, customer experience is beginning to improve in some aspects. Execution issues and inconsistent application of information requirements by different bank staff were noted in some cases, and the banks concerned were required to scrutinise their policies, procedures and practices to identify gaps and make improvements to execution issues, e.g. review the design of letter templates for greater clarity and avoid mis-understanding on documentation requirements, and to step up staff training to enhance professional knowledge and effective customer communications. While there is no easy quick fix, the HKMA will continue to work with the banking industry, business community and relevant stakeholders to deal with this global and complex issue. Our aim is to maintain a robust AML/CFT regime in Hong Kong that does not undermine access by legitimate businesses and ordinary citizens to basic banking services.

Banking Stability

Engagement of intermediaries by AIs

Various policies and measures were introduced to help further protect the interests of bank consumers. In particular, following the HKMA's reminders to the public to stay alert to bogus phone calls, retail banks' hotlines have been widely and effectively used by the public to verify callers' identity, with 2,400 to 3,400 of such enquiries received by banks' hotlines each month. In addition to requiring all AIs to cease the use of intermediaries for sourcing customers for retail non-collateralised financial products or services, the HKMA introduced in November measures to further enhance customer protection. When proceeding with a loan application referred by a third party, AIs have to ensure that the third party concerned is appointed by the AIs and that the prospective borrowers are not charged any loan-related fees by that third party. AIs are also expected to join efforts to educate the public about responsible borrowing.

Enhancing customer communication regarding US Foreign Account Tax Compliance Act (FATCA) and Automatic Exchange of Information (AEoI)

In view of the developments in relation to global efforts on tax transparency, which also require co-operation with bank customers particularly in terms of information collection and updating, the HKMA has worked closely with the industry to improve customer communication. The HKMA has worked with HKAB to enhance the FATCA Fact Sheet previously developed by HKAB so as to better address the commonly asked questions by bank customers on what is required of them under FATCA. Regarding AEoI, the HKMA worked closely with the industry through the Joint Working Group under HKAB and the Private Wealth Management Association (PWMA) to set out high-level guiding principles for banks to take into account the customers' perspective when developing customer communication channels and materials for AEoI implementation. On 11 October, the HKMA issued a circular reminding AIs to adopt a balanced approach in meeting the statutory obligations under the AEoI regime, while treating customers fairly in the process. The HKMA also participated in three briefing sessions organised by HKAB and PWMA in October and December for their members, covering, among other topics, customer engagement principles that banks need to pay attention to when implementing AEoI.

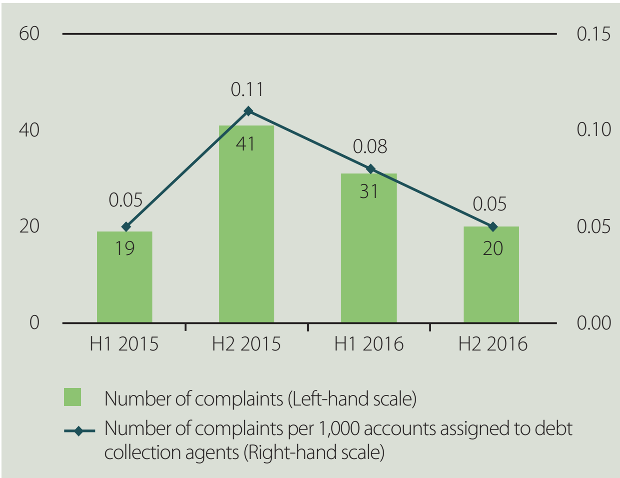
Credit data sharing

At the end of 2016, 110 AIs and AI subsidiaries shared commercial credit data through the Commercial Credit Reference Agency. The scheme contains the credit data of more than 121,300 business enterprises, about 15% of which were sole proprietorships and partnerships.

Customer complaints relating to debt collection agents employed by AIs

The number of complaints received by AIs about their debt collection agents decreased to 51 from 60 in 2015 (Chart 2). The HKMA will continue to monitor AIs' engagement with debt collection agents.

Chart 2 Complaints received by AIs about their debt collection agents



Deposit protection

The Deposit Protection Scheme (DPS) continued to provide protection to each depositor up to a limit of HK$500,000 per bank. The Deposit Protection Scheme (Amendment) Ordinance 2016 (Amendment Ordinance) was passed by the Legislative Council on 17 March and took effect on 24 March.

The Amendment Ordinance allows the adoption of a gross payout approach for determining compensation payments to speed up the process. Adjustments were conducted on the operations of the DPS, including updating payout policy and procedures, and revising the contribution assessment and reporting requirements, to improve efficiency. These improvements have resulted in the target payout time frame for making full compensation payments to depositors being significantly shortened from the previous six weeks to within seven days in most cases.

The efforts on publicity and community education continued during the year and helped maintain a high level of public awareness of the DPS. To tie in with the 10th anniversary of the DPS, a Deposit Story Competition was held and attracted overwhelming support from different walks of life. A new series of promotional videos was produced from the winning stories and aired at multifaceted channels from social media to out-of-home platforms to enhance the emotional connection with the value of DPS protection.

Licensing and director empowerment

At the end of 2016, Hong Kong had 156 licensed banks, 22 restricted licence banks, 17 deposit-taking companies and 16 approved money brokers (AMBs). During the year, the HKMA granted banking licences to three foreign banks and approved one money broker incorporated outside Hong Kong. Four licensed banks, two restricted licence banks and one deposit-taking company had their authorization revoked during the year.

As part of the wider efforts to promote board governance and help empower INEDs to play their important roles, the HKMA commissioned a small group of experts on corporate governance in July 2015 to undertake a study of the role of INEDs in the local banking sector and to provide with their observations and recommendations to ensure there are sufficient suitably qualified people willing to serve as INEDs on AI boards. After consultations with the banking industry and relevant stakeholders on recommendations by the expert group, a circular "Empowerment of independent non-executive directors in the banking industry in Hong Kong" was issued on 14 December. It set out guidance covering six areas, namely (i) constituting the board and its committees; (ii) INEDs of AIs: roles, qualities and background, time commitment; (iii) independence and tenure; (iv) remuneration of INEDs; (v) board practices in relation to INEDs; and (vi) training and development requirements for INEDs. AIs are expected to implement the guidance within one year of the date of the circular.

Enforcement

Banking complaints

The HKMA received 1,745 complaints against AIs and their staff members, a 9% increase from the previous year, and completed the handling of 1,729 cases in 2016. At the end of the year, the total number of outstanding cases was 555 (Table 5).

Table 5 Banking complaints received by the HKMA

	2016			2015
	Conduct-related issues	General banking services	**Total**	Total
In progress on 1 January	218	321	**539**	400
Received during the year	247	1,498	**1,745**	1,608
Completed during the year	(222)	(1,507)	**(1,729)**	(1,469)
In progress on 31 December	243	312	**555**	539

Complaints relating to the provision of banking services continued to rank highest in 2016 with a slight decrease of 3% to 231 cases. Complaints concerning AIs' refusal to open accounts dropped significantly by 47% to 48 cases in 2016. This was offset by a rise in complaints concerning freezing of accounts and closure of accounts. Changes in the mix of these complaints reflected that, in complying with the local and overseas regulatory requirements, AIs adopted stringent CDD measures in ongoing transaction monitoring and review of customer profiles to identify high-risk customers, particularly for corporate accounts.

Banking Stability

Complaints relating to mis-selling of investment, insurance and investment-linked assurance scheme (ILAS) products decreased by 6% to 164 cases due to a decrease in complaints relating to mis-selling of insurance and ILAS products. However, due to the continued depreciation of the renminbi, there were additional complaints relating to mis-selling of foreign exchange accumulators linked to renminbi from corporate customers.

Complaints concerning disputes over credit card transactions surged by 104% to 147 cases in 2016 mainly due to the closure of a fitness gymnasium chain in July.

Complaints concerning client agreements increased by 86% to 136 cases. These included termination of banking facilities or changes to or insufficient disclosure of the terms and conditions of existing contracts (Chart 3).

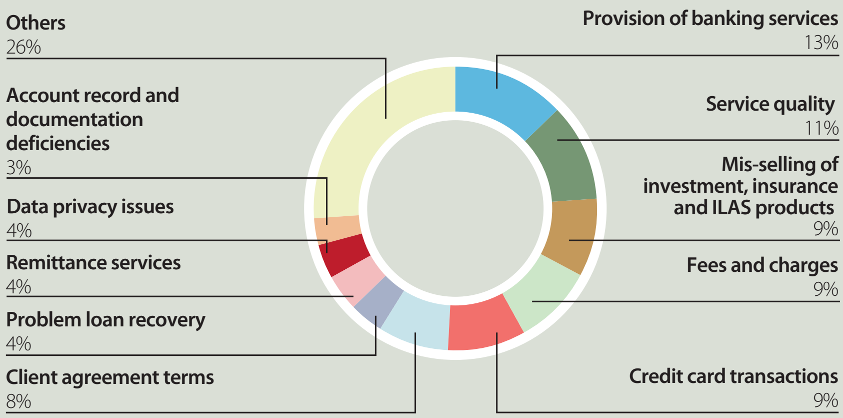
Enforcement action

The HKMA has continued to investigate or otherwise follow up issues arising from banking complaints or examinations during the year that raised possible concerns regarding compliance with laws and regulatory requirements and fitness and properness. This has resulted in referral of over 30 cases to relevant financial regulators for appropriate action, issuance of 48 compliance advice letters to AIs and their staff who were found not to have acted in full compliance with the relevant regulatory requirements, and other supervisory outcomes. Disciplinary sanctions, ranging from suspension to life ban, were imposed during the year by the SFC on seven former relevant individuals following referrals by the HKMA.

Complaints Watch

As a continuing initiative to promote proper standards of conduct and prudent business practices among AIs, three issues of *Complaints Watch* were published in 2016, drawing AIs' attention to trends in banking complaints and emerging topical issues. The topics covered in *Complaints Watch* included: selling of foreign exchange accumulators linked to renminbi; leakage of customers' personal data; verification of customer's permanent residency status based on Hong Kong Identity Card; effective handling of complaints related to SMS messages sent to unrelated third-parties; Automated Teller Machine/Cash Deposit Machine disputes; and imposition of Below Balance Fee.

Chart 3 Types of services or products concerned in banking complaints received by the HKMA



Oversight of financial market infrastructures

The HKMA issued a policy statement in 2013 setting out its approach to the oversight of FMIs under its purview. The policy objectives of the HKMA in overseeing these FMIs are to promote their general safety and efficiency, limit systemic risk and foster transparency. The aim is to make the FMIs more resilient to financial crises and protect the monetary and financial systems in Hong Kong from possible destabilising effects arising from disruption to the FMIs. The policy statement, which is available on the HKMA website, is updated from time to time to reflect changes to the oversight framework.

The Payment Systems and Stored Value Facilities Ordinance (PSSVFO) empowers the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial centre. The purposes of the PSSVFO include promoting the general safety and efficiency of the designated clearing and settlement systems: the Central Moneymarkets Unit (CMU), the Hong Kong dollar Clearing House Automated Transfer System (CHATS), the US dollar CHATS, the Euro CHATS, the Renminbi CHATS and the Continuous Linked Settlement (CLS) System.

The HKMA is also responsible for overseeing the OTC Derivatives Trade Repository (HKTR). Since it is not a clearing or settlement system, the HKTR is not designated as such under the PSSVFO. However, it is the policy intention of the HKMA to oversee the HKTR in the same way, and applying, where relevant, the same standards, as the other designated clearing and settlement systems under its purview. All the designated clearing and settlement systems and the HKTR are treated as FMIs in Hong Kong.

The HKMA adopts international standards in its oversight framework for FMIs. The Committee on Payments and Market Infrastructures (CPMI) of the Bank for International Settlements and the Technical Committee of the IOSCO published the Principles for Financial Market Infrastructures (PFMI) in 2012. The PFMI constitutes the latest international standards for the oversight of FMIs, including systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories. The HKMA and the SFC jointly issued a policy statement in March 2013 on the adoption of the PFMI for the systematically important FMIs in Hong Kong. To implement the requirements under the PFMI, the HKMA issued a new statutory guideline on "Application of Principles for Financial Market Infrastructures to Designated Clearing and Settlement Systems" under the PSSVFO and revised the guidelines on designated clearing and settlement systems and trade repository.

Except for the CLS System, the HKMA oversees other FMIs under its purview through off-site reviews, continuous monitoring, on-site examinations and meetings with management. All the FMIs continued to comply with relevant requirements.

During the year, the HKMA continued to work with FMIs under its purview to ensure observance of the PFMI. Substantive progress has been made by the FMIs to align with the PFMI requirements. The HKMA has completed PFMI assessments on FMIs under its oversight and published the assessment results on its website. All the FMIs have also published Disclosure Frameworks, which is a key requirement under the PFMI to improve transparency by disclosing system arrangements principle by principle.

International participation

The HKMA is a member of the CPMI and participates in meetings, working groups and forums on FMI oversight matters. It also participates in the CPMI-IOSCO Implementation Monitoring Standing Group, which is responsible for monitoring and assessing the implementation of the PFMI by different jurisdictions.

In addition to participating in the monitoring and assessment of other jurisdictions, the HKMA is also one of the parties being assessed. In 2016, the HKMA participated in the Level 2 assessment, which examined whether a regulatory authority had effectively implemented the principles for overseeing FMIs. The assessment found that the HKMA had duly implemented the PFMI into its oversight framework, and obtained the highest rating in all relevant principles for the FMIs under its purview. The assessment report will be published in the first half of 2017.

Banking Stability

The HKMA is also a member of the Oversight Forum of the global message carrier SWIFT, which discusses relevant oversight matters and shares SWIFT-related information. Hong Kong's AIs and FMIs use and rely on SWIFT's services and may be exposed to risks in the event of any disruption to its operations. During the year, the HKMA attended meetings and teleconferences to discuss matters of interest with other members of the Forum including cybersecurity.

The HKMA participates in the international co-operative oversight of the CLS System through the CLS Oversight Committee. The CLS System is a global clearing and settlement system operated by the CLS Bank for cross-border foreign exchange transactions. It enables foreign exchange transactions involving the CLS-eligible currencies, including the Hong Kong dollar, to be settled on a payment-versus-payment (PvP) basis. During the year, the HKMA attended various meetings and teleconferences of the CLS Oversight Committee to discuss operational and development matters as well as Hong Kong dollar-specific issues to ensure the CLS System continued to meet the safety and efficiency requirements under the PSSVFO.

The HKMA also held discussions with relevant overseas authorities to further strengthen the co-operative oversight of links between the FMIs in Hong Kong and those overseas. In particular, the HKMA has established co-operative oversight arrangements with overseas regulators for the PvP links between the US dollar CHATS and the Malaysian ringgit, Indonesian rupiah, and Thai baht Real Time Gross Settlement systems. The HKMA also held bilateral meetings with the National Bank of Belgium to discuss matters concerning the links between the CMU and the international central securities depository, Euroclear.

Independent tribunal and committee

An independent Payment Systems and Stored Value Facilities Appeals Tribunal has been established to hear appeals against decisions of the Monetary Authority on licensing and designation matters under the PSSVFO. There has been no appeal since the establishment of the tribunal. An independent Process Review Committee (Committee), whose members are appointed by the Chief Executive of the Hong Kong Special Administrative Region, reviews processes and procedures adopted by the HKMA in applying standards under the PSSVFO to systems in which the HKMA has a legal or beneficial interest. The Committee assesses whether the HKMA has applied the same procedures to all designated clearing and settlement systems. The Committee met twice in 2016 and reviewed four regular reports and 22 accompanying oversight activities management reports. The Committee concluded that it was not aware of any case where the HKMA had not duly followed the internal operational procedures, or where the HKMA had not been procedurally fair in carrying out its oversight activities. Under its terms of reference, the Committee submitted its annual report to the Financial Secretary, which is available on the HKMA website.

Compliance with the regulatory regime for OTC derivatives market

The HKMA monitors AIs' and AMBs' compliance with the mandatory reporting and related record keeping requirements on OTC derivatives transactions stipulated in the Securities and Futures Ordinance that came into effect in July 2015. Where necessary, the HKMA will follow up with AIs and AMBs on matters of compliance concern.

HKMA Deputy Chief Executive, Mr Arthur Yuen, speaks at the press conference on 2016 Year-end Review and Priorities for 2017 for the Hong Kong Banking Sector.

PLANS FOR 2017 AND BEYOND

Supervisory focus

Supervision of operational and technology risks

The HKMA will devote more resources to the supervision of technology risk to keep pace with the fintech initiatives of the banking industry and to cope with the growing threats posed by cyber attacks. In 2017, the HKMA will monitor the industry's implementation of the CFI. A round of thematic reviews focused on AIs' cybersecurity controls will be undertaken. In addition, the HKMA plans to conduct a review of its supervisory guidance on business continuity planning and outsourcing, having regard to technological advancement and industry development.

Supervision of treasury activities and liquidity risk

After the interest rate hike in the US in December 2016, the financial markets expect the pace of interest rate normalisation to pick up in 2017. The new US administration, which assumed office in January, is expected to make changes to its fiscal and trade policies. These have led to renewed volatilities in financial markets. Upcoming political events in Europe, including the Brexit negotiations and the presidential and parliamentary elections in other European countries, may present further challenges to the financial sector. The risk of fund outflow from Hong Kong should not be underestimated.

The HKMA will continue to be vigilant and further step up its supervision of liquidity risk. The HKMA will assess AIs' preparedness to cope with significant fund outflow more critically and enhance its liquidity stress testing. On-site examinations and thematic reviews will be conducted on AIs' liquidity risk management controls, as well as controls over interest rate risk and counterparty credit risk associated with AIs' debt securities portfolios.

Supervision of credit risk

The uncertain business environment in Hong Kong and Mainland China is expected to present continued challenges to AIs in managing their asset quality. The supervision of credit risk will therefore remain a key supervisory focus of the HKMA in 2017. Proactive steps will be taken to ensure that AIs have in place adequate and effective systems for managing credit risk. On-site examinations and thematic reviews will be undertaken to assess the robustness of AIs' loan classification and provisioning systems.

Prevention of money laundering and terrorist financing

The HKMA will continue its work in the implementation of the risk-based approach to ensure AIs focus on those customers and activities that genuinely present the highest risk of ML/TF. The HKMA's risk-based supervisory work will also include thematic reviews on AIs' sanctions compliance controls and quality assurance functions, including internal audit and compliance functions.

The HKMA will continue to support AML/CFT policy development and review Hong Kong's legal and regulatory requirements for AML/CFT purposes to ensure they are up to date and aligned with the latest international standards and practices. A collaborative partnership with the industry will continue to be maintained in various areas including, for example, developing industry guidance.

Supervision of wealth management and MPF-related businesses

The HKMA will:

- continue to communicate closely with other regulators and the banking industry to provide guidance on the regulatory standards in relation to the sale of investment and insurance products;
- continue to collaborate with the SFC on supervision of financial groups consisting of RIs and licensed corporations;
- continue to conduct on-site examinations and off-site surveillance of AIs' conduct in the selling of securities, MPF and other investment and insurance products, including accumulators, debt securities, investment funds and NLTI products, as well as AIs' compliance with new regulatory requirements;
- co-operate with the Government and the Insurance Authority on the preparatory work for implementing the new statutory regime for regulating insurance intermediaries; and
- maintain dialogue with, and provide guidance to, the industry to promote a customer-centric culture and good conduct of the banking sector.

Banking Stability

Implementation of Basel standards in Hong Kong

Capital standards

The HKMA intends to amend the BCR to incorporate a collection of the Basel Committee capital standards scheduled to take effect from 1 January 2018. These include:

- the revised securitisation framework;
- the Basel III leverage ratio (currently AIs are required to disclose their leverage ratio and it will become a binding minimum capital requirement from 2018); and
- the regulatory capital treatment of expected loss provisions required under the new (IFRS 9) accounting framework.

The amendments to the BCR should also, depending on the implementation schedules in other major markets, include those standards that were originally due for implementation in January 2017 but were deferred, tentatively, to January 2018 to better align with progress overseas (namely the capital standards on AIs' counterparty credit risk exposure and in respect of their exposure to central counterparties and equity investments in funds).

The final elements of the Basel Committee's post-crisis regulatory reform package were initially expected to be issued in January 2017. Ultimately, issuance was deferred pending further negotiations. The objectives of these final reforms are to reduce excessive variability in the risk-weighted asset (RWA) side of the regulatory capital ratios, enhance the risk-sensitivity of the capital framework for credit and operational risk and finalise the calibration of certain elements of the Basel III leverage ratio.

The proposed reforms include a revised standardised approach for credit risk with increased granularity and risk-sensitivity; a revised IRB approach for credit risk that reduces excessive RWA variability by further constraining the use of internal models in respect of exposure types or model parameters that are less amenable to being estimated sufficiently reliably; a streamlined operational risk framework removing the existing model-based Advanced Measurement Approaches and introducing a new standardised approach to replace the three existing non-model-based approaches; a capital output floor to replace the existing Basel I-based capital floor; and the finalised calibration of certain aspects of the Basel III leverage ratio designed to eventually replace those in the existing standard Basel III leverage ratio framework and disclosure requirements published by the Basel Committee in January 2014.

Once the final elements of the reform package are issued, the HKMA intends to consult the banking industry locally on their implementation in Hong Kong.

With regard to market risk, the Basel Committee issued revised standards on the minimum capital requirements for market risk in January 2016 following the completion of its fundamental review of the trading book. The HKMA's intention is to implement the revised market risk capital framework in accordance with the Basel Committee's timetable by 1 January 2019 with reporting by banks under the new standards from 31 December 2019. The HKMA expects to consult the industry on its implementation proposals for Hong Kong in 2017.

Implementation of Basel standards in Hong Kong (continued)

Interest rate risk in the banking book

In April 2016, the Basel Committee issued new standards on interest rate risk in the banking book, fundamentally updating its earlier 2004 principles on this important risk category. The new standards continue to follow an "outlier-based" Pillar 2 approach, but include a more sophisticated and more comprehensive set of measures to identify banks with significant exposures to interest rate risk in their banking books. The HKMA intends to consult the industry on its planned approach for local implementation of the standards in 2017. The standards are scheduled by the Basel Committee to be implemented by 1 January 2018.

Disclosure standards

The HKMA will, following industry consultation, revise the SPM module "Guideline on the Application of the Banking (Disclosure) Rules" to reflect the changes made to the Banking (Disclosure) Rules (BDR) by the Banking (Disclosure) (Amendment) Rules 2016.

In March 2017, the Basel Committee released the *Pillar 3 disclosure requirements — consolidated and enhanced framework* to consolidate the disclosure requirements associated with the existing Basel III capital and liquidity standards, and with those arising from the Committee's later policy development work relating, for instance, to the regulatory capital treatment of banks' holdings of other banks' TLAC instruments and to interest rate risk in the banking book. The HKMA will implement these requirements through appropriate amendment of the BDR, coupled with the release of additional templates and tables, following consultation with the industry.

Liquidity standards

The HKMA will develop a set of Banking (Liquidity) (Amendment) Rules 2017 to incorporate into the BLR the requirements for the calculation of the NSFR (for category 1 institutions) and the CFR (for certain category 2 institutions). New returns will be developed to facilitate the reporting of the NSFR and the CFR by different categories of AIs.

Banking Stability

Development of Supervisory Policies

Counterparty credit risk

The HKMA will update the SPM module on "Counterparty Credit Risk Management" with a view to conducting industry consultation during 2017. The primary objective of the revision is to bring the guidance into line with the latest capital treatment and risk management practices for counterparty credit risk arising from derivative contracts and securities financing transactions.

Exposure limits

Following the industry consultation on the proposed revisions to the exposure limits framework in March 2016, the HKMA is conducting local QIS in the first half of 2017 to test the impact of the policy proposals. A legislative bill will be prepared to amend Part XV of the Banking Ordinance to grant the Monetary Authority a power to make rules prescribing the proposed new exposure limits.

External audits of banks

In March 2014, the Basel Committee issued revised supervisory guidance on the *External audits of banks*. The guidance aims to improve audit quality by raising the bar in relation to what supervisors expect from banks' external auditors and audit committees. The HKMA intends to issue updated supervisory guidance for AIs reflecting the Basel Committee's revisions.

Updating other supervisory policies and risk management guidelines

In addition to the SPM modules specifically mentioned above, the HKMA also plans to update a selection of other modules to incorporate the latest guidance issued by the Basel Committee and other international standard-setters. These include the SPM module on the validation of risk-rating systems under the IRB approach for credit risk.

Accounting standards

With the impending application of IFRS 9 to banks, the HKMA will update its prudential framework for AIs as appropriate, taking into account the related standards and guidance issued by the Basel Committee. This will involve consideration of the allocation of expected credit losses pertaining to exposures that are classified under IFRS 9, as general or specific provisions for the purposes of the regulatory capital framework; as well as the interaction between the regulatory reserve requirement and the expected loss provisions to be made by AIs under the new accounting standard. The HKMA will maintain close contact with the HKICPA and the banking industry in preparation for the implementation of IFRS 9.

Resolution Office

The HKMA established a Resolution Office on 1 April 2017 that is operationally independent and reports directly to the Chief Executive of the HKMA.[4]

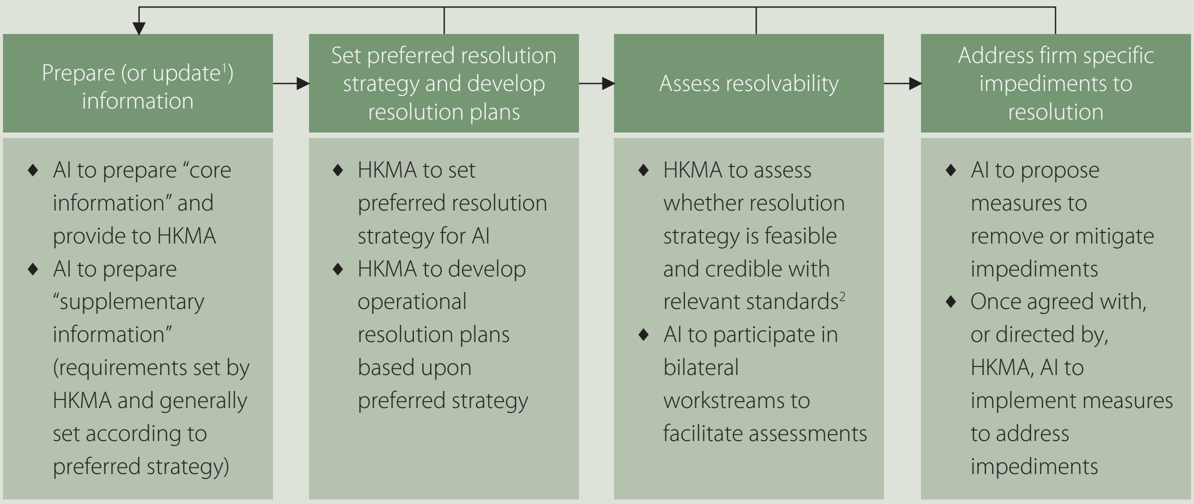
A key priority for the new Resolution Office in 2017 will be to begin the development of rules relating to the loss absorbing capacity (LAC) of AIs (see Table 6) and to the contractual recognition of the application of certain resolution actions as envisaged under the FIRO. The intention is to begin consultation on proposals for the former by the end of 2017.

Under the FIRO the resolution authorities may issue a code of practice relating to their functions under the Ordinance. A chapter of this code regarding the core information requirements underpinning resolution planning for AIs, is expected to be published once the FIRO comes into effect.

The Resolution Office will continue to advance resolution planning with individual AIs with a focus on those posing the greatest systemic risk in Hong Kong. Chart 4 sets out an overview of the HKMA's intended approach to resolution planning.

The Resolution Office will also focus on enhancing the HKMA's organisational readiness for resolution, including cross-border arrangements for co-operation in resolution and the practical operation of the resolution tools under the FIRO.

Chart 4 Resolution planning



1. Resolution planning is a continuous process and core information should be updated at least every two years.
2. Resolution standards will be defined in relation to matters that have been found to commonly result in impediments to resolution, for example: loss absorbing and recapitalisation capacity; operational services continuity in resolution; termination rights risk in financial contracts; resolution valuations capability; access to payment, settlement and clearing services; liquidity & collateral reporting capability; and post-stabilisation restructuring capability.

4 http://www.hkma.gov.hk/eng/key-information/press-releases/2017/20170317-3.shtml

Banking Stability

Table 6 Loss absorbing capacity

LAC requirements are intended to ensure that financial institutions are financed in such a way that, if they were to fail, a resolution authority could use the financial institution's financial resources contributed by its shareholders and certain creditors to absorb losses and recapitalise the institution, ultimately avoiding the cost of failure being borne by the public purse.

The FIRO provides for resolution authorities in Hong Kong to make rules prescribing minimum LAC requirements for institutions within the scope of the ordinance. The HKMA intends to issue LAC rules that align with international best practices but are tailored to the local context. The HKMA's objective will be to devise minimum LAC requirements such that AIs have in place sufficient LAC to support the execution of the HKMA's preferred resolution strategy for them.

Key LAC design considerations will include:

- Defining the scope of AIs required to meet a minimum LAC requirement;
- Defining minimum LAC requirements under different resolution strategies;
- Defining eligible instruments for the purposes of meeting LAC requirements, including the nature of LAC subordination requirements and any minimum debt (as opposed to equity) requirement within such instruments;
- Interaction between the LAC rules and the regulatory capital framework; and
- Treatment of AIs' holdings of other banks' LAC instruments to minimise contagion risk.

Recovery planning

The HKMA will continue with the implementation of the recovery planning requirements for AIs that were first introduced in June 2014. In 2017, the HKMA intends to roll out recovery planning requirements to AIs more widely, including foreign bank branches. The HKMA also intends to take the opportunity of a Banking (Amendment) Bill to incorporate more explicit recovery planning provisions into the Banking Ordinance.

Bank consumer protection

The HKMA will continue to promote good banking practices through participating in, and providing advice to, the Code of Banking Practice Committee of HKAB. It will continue to monitor AIs' compliance with the code through AIs' self-assessment, on-site examinations, mystery shopping programmes and handling relevant complaints on AIs. The HKMA has also started working with the industry associations in reviewing some of the code provisions, based on customer complaints and enquiries it has received, in order to further enhance protection for customers.

The HKMA will continue its effort to develop a customer-centric culture among AIs and foster financial inclusion by retail banks, especially securing reasonable access to basic banking services by the public. Recognising the importance of banks' corporate cultures in shaping the behaviour of their staff, the HKMA has provided in March 2017 further guidance to the industry and shared effective practices that help promote sound bank culture. The HKMA will also continue to participate in international efforts to drive better protection for financial consumers through participation in the Organisation for Economic Co-operation and Development Task Force on Financial Consumer Protection.

Opening and maintaining bank accounts

The HKMA plans to commission mystery shopping programmes in 2017 to monitor the effectiveness of banks' measures in improving customer experience in account opening. The HKMA is also working with the industry association and international standard setting bodies to seek to better manage some of the burden associated with CDD requirements through innovation and technology, including the use of Know-Your-Customer Utilities in account opening processes.

Credit data sharing

The HKMA will work with the industry to promote credit data sharing, as its continued development will help strengthen the credit risk management capacity of AIs.

Deposit protection

Continued efforts will be made to ensure and improve the payout readiness of the DPS. A full-scope payout rehearsal is planned to be conducted to test the capability of the Hong Kong Deposit Protection Board (the Board) and its network of service providers to meet the new target payout timeframe under the gross payout approach. Payout infrastructure will be upgraded with enhanced servers to further improve the resilience and performance of the payout system. The Board will continue to execute the compliance programme for monitoring DPS members' readiness in submitting the data and information in accordance with the Information System Guideline.

Annual self-assessments and on-site examinations will continue for monitoring the compliance of DPS members with the representation requirements on DPS membership and protection status of financial products. Publicity and community education campaigns will be undertaken to reinforce public understanding of the DPS.

Enforcement

In addition to focusing on mis-selling affecting the interests of the investing public and cases involving misconduct and dishonesty on the part of regulated persons, the HKMA will continue to deploy resources to enforce compliance with the AMLO, to pursue material contraventions of the OTC derivatives regime involving damage or potential damage to the integrity of the securities market or the financial stability of Hong Kong and to enforce the new statutory framework for stored value facilities. The HKMA will continue its close co-operation and dialogue with other local and overseas financial regulators to further strengthen the enforcement framework.

Oversight of financial market infrastructures

The HKMA will continue to promote the safety and efficiency of the FMIs under its oversight in accordance with the PSSVFO and the PFMI.

The HKMA will work with the FMIs on their observance of the PFMI. Assessments will be conducted and updated as required, and the HKMA will continue participating in the CPMI-IOSCO PFMI implementation monitoring and assessment exercise. Where appropriate, oversight requirements will be strengthened to reflect international practices or in response to market developments. The HKMA will continue to work with the relevant authorities to further strengthen co-operative oversight arrangements where appropriate.

Compliance with the regulatory regime for OTC derivatives market

The HKMA will continue to monitor AIs' and AMBs' compliance with the regulatory regime for OTC derivatives market in accordance with the statutory requirements.