

PRUDENTIAL SUPERVISION IN HONG KONG



HONG KONG MONETARY AUTHORITY
香港金融管理局

PREFACE

Under the Banking Ordinance (“the Ordinance”), Chapter 155 of the Laws of Hong Kong, the Monetary Authority (“the MA”) is charged with the responsibility for promoting the general stability and effective working of the banking system in Hong Kong. The Ordinance prohibits the carrying on of “banking business” except by a bank and the carrying on of a business of taking deposits except by an institution authorized under the Ordinance, namely, licensed banks, restricted licence banks and deposit-taking companies.

This book describes the prudential supervision framework and practices adopted by the MA in exercising the functions conferred or imposed by the Ordinance.

Similar to some other international financial centres, there are separate supervisory authorities for other financial businesses in Hong Kong, such as securities, commodities, leveraged foreign exchange trading and insurance. This book also covers briefly the supervisory frameworks of the non-bank financial businesses in Hong Kong.

Hong Kong Monetary Authority
April 2002

TABLE OF CONTENTS

	Page
<i>Chapter 1 - Introduction</i>	
(a) Structure of the banking system	1.1
(b) Structure of the non-bank financial system	1.2
(c) Objectives of banking supervision	1.5
(d) International banking establishments	1.6
<i>Chapter 2 - Legislation</i>	
(a) Banking legislation	2.1
(b) Legislation covering non-bank financial institutions	2.2
<i>Chapter 3 - Structure of the supervisory system</i>	
(a) Organisational structure of supervisory authority	3.1
(b) Number and distribution of staff	3.1
(c) Supervision of non-bank financial business	3.2
<i>Chapter 4 - Authorization process</i>	
(a) Licensing requirements	4.1
(b) “Fit and proper” tests on management of applicants	4.3
(c) Authorization of non-bank financial institutions	4.4
<i>Chapter 5 - Supervision of cross-border banking</i>	
(a) As home supervisor	5.1
(b) As host supervisor	5.3
<i>Chapter 6 - Supervisory methods</i>	
(a) Supervisory approach	6.1
(b) Collection of financial information	6.5
(c) Risk management systems	6.5
(d) Supervisory policies and practices	6.6
(e) Relationship with internal auditors	6.19
(f) Measures/actions to deal with problem banks	6.20
(g) Other supervisory methods	6.21
(h) Supervision of non-bank financial business	6.21

<i>Chapter 7 - Failure management</i>	7.1
<i>Chapter 8 - Contact with other domestic and overseas supervisory authorities</i>	
(a) Powers to share information with other supervisors	8.1
(b) Contacts with other supervisors	8.1
(c) Confidentiality of information received from other countries	8.2
(d) Restrictions on passing information by banks	8.2
(e) Ability of home supervisors to conduct on-site examinations	8.3
<i>Chapter 9 - Supervision of financial conglomerates</i>	9.1
<i>Chapter 10 - Supervision of electronic money and electronic banking</i>	
(a) Electronic money	10.1
(b) Electronic banking and technology risk management	10.2
<i>Chapter 11 - Deposit protection</i>	11.1
<i>Chapter 12 - Control of money laundering activities</i>	12.1
<i>Chapter 13 - Recent developments in the financial system and supervisory regime</i>	
(a) Banking reform	13.1
(b) Banking supervisory policies	13.5
(c) Consumer protection	13.6
(d) Business continuity planning	13.6
(e) US dollar clearing system	13.7

Annexes

- 1(a) Authorized institutions with overseas branches for which the Monetary Authority is the home supervisor
- 1(b) International banking groups for which the Monetary Authority is the home supervisor
- 2 Organisation chart of the Hong Kong Monetary Authority
- 3 Seventh Schedule to the Banking Ordinance
- 4 List of regulatory returns

Chapter 1 - Introduction

(a) Structure of the banking system

Hong Kong maintains a three-tier system¹ of deposit-taking institutions, namely, banks, restricted licence banks (“RLBs”) and deposit-taking companies (“DTCs”). These are collectively known as authorized institutions (“AIs”) under the Banking Ordinance. The Banking Ordinance prohibits the carrying on of “banking business” except by a bank authorized under the Ordinance and the carrying on of the business of taking deposits except by an AI.

“Banking business” is defined in Section 2 of the Banking Ordinance as the business of either or both of the following:

- receiving from the general public money on current, deposit, savings or other similar accounts repayable on demand or within less than three months or at call or notice of less than three months;
- paying or collecting cheques drawn by or paid in by customers.

Only banks may carry on “banking business” as defined above. RLBs may take call, notice or time deposits from the public in amounts of HK\$500,000 or above without restriction on maturity. RLBs are principally engaged in wholesale, merchant banking and capital market activities. DTCs are restricted to taking deposits of HK\$100,000 or above with an original term to maturity, or call or notice period, of at least three months. These companies are mostly owned or otherwise associated with banks and engage in a range of specialised activities, including consumer finance, trade finance and securities business.

Under the Banking Ordinance, it is an offence for any person, other than a bank authorized under the Ordinance or a central bank, to use the word “bank” in the description or name under which they conduct business in Hong Kong without the written consent of the Monetary Authority² (“MA”). There are certain exemptions from this restriction, for example, an RLB may use certain terms such as “restricted licence bank” or “merchant bank” in describing its business, and an RLB which is a branch of a bank incorporated outside Hong Kong may use the name of that bank, provided that it is used in conjunction with the term “restricted licence bank”.

An overseas applicant seeking a banking licence in Hong Kong can in practice enter only in the form of a branch. An RLB presence may be in the form of either a branch or a subsidiary. Since 1977, it has been the practice to grant DTC registrations only in respect

¹ A review of the three-tier system was completed in December 2001. Please see Chapter 13 on recent developments in the financial system and supervisory regime.

² Legally, the “Monetary Authority” (“MA”) is an individual appointed by the Financial Secretary under Section 5A of the Exchange Fund Ordinance. The powers under the Banking Ordinance are personally vested in the MA. In practice, the MA heads an office known as the “Hong Kong Monetary Authority” (“HKMA”) of which he is the Chief Executive.

of locally incorporated subsidiaries. At present, there are no restrictions on the number of offices that an overseas incorporated AI can maintain in Hong Kong³.

A bank incorporated outside Hong Kong may apply to the MA for approval for the establishment of a local representative office (“LRO”)⁴. The LRO is required to operate from only one business location and to confine its business to representational and liaison activities. It must not engage in any banking or deposit-taking business, including the receiving of deposits, granting of loans, establishing letters of credit, buying and selling of foreign exchange, or transacting remittance businesses.

At end-June 2001, there were 153 licensed banks, 48 RLBs and 58 DTCs in Hong Kong. Together they operated a network of 1,556 local branches. 31 of the licensed banks and 117 of the AIs in aggregate were locally incorporated whereas the rest were branches of foreign banks. In addition, 115 overseas banks had representative offices in Hong Kong. The total deposits and assets held by the three categories of AIs as at end-June 2001 were as follows:

	Total Deposits	Total Assets
Banks	3,396,317	6,303,738
RLBs	31,863	225,431
DTCS	5,681	56,522
Total	3,433,861	6,585,691

NB. All figures in HK\$ million

(b) Structure of the non-bank financial system

The non-bank financial system in Hong Kong comprises the following key sectors:

(i) Securities business⁵

Broadly speaking, any person (i.e. corporate or individual) who carries on a business in Hong Kong of dealing in securities or giving advice in connection with securities is required to be registered as a securities dealer or investment adviser respectively with the Securities and Futures Commission (“SFC”) under the Securities Ordinance. Fund managers, merchant banks or unit trust advisers are normally registered as investment advisers. Where they also engage in the business of dealing in securities, such as involvement in the marketing and distributing of securities and unit trust products, they will also need to be registered as securities dealers (but see the following paragraph regarding exempt dealers).

³ The three-building condition which restricted foreign banks licensed after 1978 to operate from not more than three buildings was completely relaxed in November 2001. Please see Chapter 13 for more details.

⁴ The MA’s policy that an overseas bank should generally maintain an LRO for a period, in order to acquire local banking experience, before it can be considered for authorization was lifted in April 2002. Please see Chapter 13 for more details.

⁵ The term “securities” is defined under the Securities Ordinance and includes any shares, stocks, debentures, loan stocks, funds, bonds, or notes.

In addition, any individual who performs dealing or advising functions on behalf of a registered dealer or registered investment adviser is required to be registered as a dealing director or investment adviser director (in the case of a director of a registered corporate dealer or investment adviser having direct supervisory functions for the dealing or investment advisory activities) or a dealer representative or investment adviser representative (for all other employees). Registration as a securities dealer is not required for persons who trade in securities on their own account through registered dealers.

The SFC may declare certain corporations to be exempt dealers if the main business of such corporations is something other than dealing in securities or their main business is securities dealing at a “wholesale level”, such as offering underwriting arrangements to issuers, offering government securities, or dealing with professional investors who act as principals. In addition, licensed banks have a specific eligibility to apply for exempt dealer status and many have been granted it. Licensed banks are also not required to be registered as investment advisers under the Securities Ordinance.

As at 31 March 2001, there were 725 registered dealers (of which 257 were corporations controlled by overseas interests), 1,421 dealing directors, 13,477 dealer representatives, 659 registered investment advisers, 1,140 investment adviser directors and 5,176 adviser representatives.

(ii) Securities margin financing

The Securities (Margin Financing) (Amendment) Ordinance came into operation on 12 June 2000. Under this Ordinance, a person who carries on a business of securities margin financing shall register as a securities margin financier or a securities margin financier’s representative. Exempt dealers and registered dealers are exempted. As at 31 March 2001, there were ten registered margin financiers and 268 margin financier’s representatives.

(iii) Commodities trading

Under the Commodities Trading Ordinance, a person (i.e. corporate or individual, but see next paragraph) is required to be registered respectively as a commodity dealer or commodity trading adviser with the SFC if he carries on a business in Hong Kong of trading in commodity futures contracts or giving advice with respect to trading in commodity futures contracts. The registration arrangements are similar to those set out in the Securities Ordinance for securities dealers and investment advisers. However, unlike the Securities Ordinance, there are no exemption provisions for the registration requirements under the Commodities Trading Ordinance.

The main lines of business of commodities dealers include trading in securities index futures contracts, securities index options contracts and currency futures contracts. As at 31 March 2001, there were 158 commodities dealers (all were corporations of which 74 were controlled by overseas interests), 316 dealing directors, 4,123 dealer representatives, 128 commodity trading advisers, 185 adviser directors and 224 adviser representatives.

(iv) Leveraged foreign exchange trading

Under the Leveraged Foreign Exchange Trading Ordinance (“LFETO”), any person who carries on a business of leveraged foreign exchange trading is required to be licensed by the SFC and such a licence will only be granted to a limited company. AIs are exempt from the licensing requirements of LFETO. Primarily, leveraged foreign exchange traders act either as principals or brokers for retail clients in margined spot foreign exchange trading. As at 31 March 2001, there were ten licensed traders and 817 trader’s representatives.

(v) Insurance business

Insurance activities include the writing of general and long term insurance business, reinsurance, and insurance agencies and brokerage. As at 31 May 2001, the number of authorized insurers was 207. Of these, 102 insurers were incorporated in Hong Kong and the remaining 105 were incorporated in 25 different countries. In addition, there were 2,765 corporate insurance agents, 28,936 individual insurance agents and 379 authorized insurance brokers as at 30 April 2001.

(vi) Mandatory Provident Fund

In December 2000, Hong Kong launched a Mandatory Provident Fund (“MPF”) System of contributory schemes for the workforce’s retirement protection. 20 corporate trustees have been authorized as approved trustees to operate registered MPF schemes. These MPF approved trustees have registered 47 master trust schemes and two industry schemes. Separately there are also two registered employer sponsored schemes. These schemes offer a total of 299 constituent funds. As at 31 July 2001, there were about 30,000 MPF intermediaries. Participation rates in MPF schemes have been satisfactory and as at end-July 2001 87% of employers, 94% of relevant employees and 90% of self-employed persons were enrolled in MPF schemes.

(vii) Money lenders

This includes all persons or companies (AIs being the main exception) involved in the business of making loans or who advertise or announce themselves or who hold themselves out in any way as carrying on that business. In this context, “loans” are defined as including any advance, discount or money paid, and any agreement which is in substance or effect a loan of money. For example, finance and leasing companies will typically operate as money lenders under this definition. Loans made by money lenders are usually financed privately or through related banks. As at 31 March 2001, there were 919 licensed money lenders, most of which are incorporated in Hong Kong.

(viii) Money brokers

At present, there are 13 approved money brokers in Hong Kong, including two electronic money brokers, providing broking services to the interbank foreign exchange and deposit markets. Money brokers in Hong Kong conduct both domestic and international business and deal only with wholesale money market counterparties such as banks or RLBs. The major products that money brokers deal with include traditional foreign exchange and money market products, swap and foreign currency swaps, derivatives and bonds.

The regulatory regime for money brokers introduced in 1997 provides that only persons who satisfy the fit and proper criteria set out in the Eleventh Schedule to the Banking Ordinance will be approved as money brokers. Since the number of money brokers in Hong Kong is small and they do not pose significant systemic risk to the interbank foreign exchange and deposit markets, the supervisory approach of the MA in respect of money brokers is relatively simple compared with that for AIs. Basically, money brokers are required to submit quarterly returns on their financial positions and audited financial statements for on-going monitoring. Periodic on-site examination and annual meeting with the senior management will also be conducted to ensure that money brokers comply with the relevant legal and prudential requirements.

(c) Objectives of banking supervision

The principal function of the MA as set out in Section 7(1) of the Banking Ordinance is to “promote the general stability and effective working of the banking system”.

Section 7(2) further provides that the MA shall:

- be responsible for supervising compliance with the provisions of the Banking Ordinance;
- take all reasonable steps to ensure that the principal places of business, local branches, overseas branches and overseas representative offices of all AIs and LROs are operated in a responsible, honest and business-like manner;
- promote and encourage proper standards of conduct and sound and prudent business practices among AIs and money brokers;
- suppress or aid in suppressing illegal, dishonourable or improper practices in relation to the business practices of AIs;
- co-operate with and assist recognised financial services supervisory authorities of Hong Kong or of any place outside Hong Kong, whenever appropriate, to the extent permitted by the Banking Ordinance or any other ordinance; and
- consider and propose reforms of the law relating to banking business and the business of taking deposits.

Protection of depositors is not explicitly mentioned in Section 7 as a statutory function of the MA. However, it is clearly in the interest of stability of the banking system if the risk of loss to depositors is reduced. The Banking Ordinance is however not intended to eliminate all risk of loss to depositors. This is acknowledged in the “long title” of the Ordinance where it states that one of the objectives of the Ordinance is to “provide a measure of protection” for depositors. In connection with this, the HKMA is in the process of developing a deposit insurance scheme in Hong Kong. Please refer to Chapter 11 for details.

(d) International banking establishments

As at 26 June 2001, the MA is the home supervisor of 21 banks with overseas branches as well as eight international banking groups, a full list of which is at [Annex 1](#). In addition, the MA supervises 83 locally incorporated AIs that form part of a banking group for which another supervisory authority is the home supervisor.

Chapter 2 - Legislation

(a) Banking legislation

The Banking Ordinance provides the legal framework for banking supervision in Hong Kong. In addition to setting out the functions of the MA (see section (c) of Chapter 1), the Banking Ordinance includes provisions relating to such matters as:

- authorization to carry on banking business or the taking of deposits;
- revocation or suspension of authorization;
- powers of control of the MA over problem AIs;
- approval by the MA of directors, controllers and chief executives of AIs;
- disclosure of information by AIs to the MA;
- large exposure limits;
- capital adequacy ratio;
- liquidity ratio; and
- use of banking names and descriptions.

The Banking Ordinance is regularly reviewed and updated to improve its working in the light of practical experience and to take account of developments in the banking industry. The Banking (Amendment) Ordinance 1995 enacted on 29 June 1995 established the MA as the licensing authority responsible for the authorization, suspension and revocation of all three types of AIs. It also strengthened the MA's ability to deal with a banking crisis by defining more clearly the scope, objective and powers of a Manager appointed under the Banking Ordinance to take control of a problem AI. The Banking (Amendment) Ordinance 1997, enacted on 8 January 1997, introduced a legal framework for the regulation of the issue of multi-purpose stored value cards and the approval and regulation of money brokers providing brokerage services in the interbank foreign exchange and deposit market. In July 1999, the Banking (Amendment) Ordinance 1999 was enacted to bring Hong Kong's supervisory framework more fully in line with the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision, and to improve the provisions governing the publication and submission of audited accounts by AIs.

The Banking (Amendment) Ordinance 2001 was enacted by the Legislative Council in December 2001. It aims to improve the general working of the Banking Ordinance in the light of recent market developments. The main amendments seek to update and strengthen the supervisory regime in relation to AIs' places of business, appointment of senior management and advertisements for deposits disseminated through the Internet. The Amendment Ordinance is expected to commence operation in May 2002.

On the other hand, the Banking (Amendment) Ordinance 2002 was also enacted by the Legislative Council in March 2002. It deals with amendments in response to the introduction of the Securities and Futures Ordinance. The objective is to enhance the MA's regulatory framework for AIs that conduct securities business and bring it more in line

with the approach adopted by the SFC in the regulation of securities dealers and investment advisers.

The legal framework under the Banking Ordinance is supplemented by statutory guidelines issued by the MA under the Ordinance, indicating the manner in which he proposes to exercise the functions conferred or imposed by the Ordinance upon him. This provides the MA with the authority to set prudential rules to promote sound and prudent management.

(b) Legislation covering non-bank financial institutions

(i) Securities, commodities, securities margin financing and leveraged foreign exchange trading

As mentioned earlier, the SFC is responsible for the regulation of persons who are carrying on a business of dealing in securities or commodities futures trading, giving advice with respect to securities or commodities futures trading, securities margin financing and leveraged foreign exchange trading. The legal basis for the SFC's power in respect of the regulation of these businesses is the Securities and Futures Commission Ordinance, Securities Ordinance, Commodities Trading Ordinance, Leveraged Foreign Exchange Trading Ordinance and the Securities (Margin Financing) (Amendment) Ordinance. In addition, the SFC administers the Protection of Investors Ordinance which regulates the issue of advertisements or documents inviting the public to invest in collective investment schemes⁶. Each of these Ordinances is described briefly in the following paragraphs.

Securities and Futures Commission Ordinance

This Ordinance sets out the constitution, functions and powers of the SFC. Together with the other Ordinances administered by the SFC (see preceding paragraph), the major statutory responsibilities of the SFC in respect of regulating securities, commodities futures trading and leveraged foreign exchange trading businesses, include:

- regulatory oversight of the Hong Kong Exchanges and Clearing Limited and its subsidiary exchanges and clearing houses;
- licensing securities and futures dealers and advisers and leveraged foreign exchange traders using a set of "fit and proper" criteria and monitoring their compliance with the relevant statutory requirements;
- vetting applications by persons wishing to distribute to the public collective investment schemes, including unit trusts and mutual funds, investment-linked assurance and pooled retirement funds;
- supervision and monitoring through, among other means, inspection visits; and
- enforcement of relevant regulatory requirements and monitoring of trading on the securities and futures markets to detect unusual

⁶ The Securities and Futures Ordinance which consolidates and rationalises the SFCO, SO, CTO, LFETO and PIO into one piece of legislation was enacted on 13 March 2002. The new legislation is expected to become effective in the second half of 2002.

movements in prices and volumes which may indicate possible trading malpractices.

Securities Ordinance

As stated earlier, the registration requirements for persons engaging in the business of dealing in securities or providing investment advice on securities are set out in the Securities Ordinance (see section (b) of Chapter 1). In addition, the Securities Ordinance provides a wide range of regulatory powers in respect of these businesses. They include:

- requirements for the establishment of stock markets;
- keeping of trading records by dealers;
- prevention of improper trade practices;
- keeping of accounts and audit of the books of dealers;
- administration of the Compensation Fund for losses arising from default of stockbrokers; and
- inspection and investigation.

Commodities Trading Ordinance

The Commodities Trading Ordinance sets out the regulatory framework for commodities dealers and commodity trading advisers. The structure of the Commodities Trading Ordinance is very similar to that of the Securities Ordinance in such aspects as establishment of the commodity exchange, registration, accounts and audits, prevention of improper practices, and the administration of the Compensation Fund. However, the Commodities Trading Ordinance has less extensive powers in respect of investigations.

Securities (Margin Financing) (Amendment) Ordinance

Under the Securities (Margin Financing) (Amendment) Ordinance, a person must not carry on a business of securities margin financing unless the person is registered as a securities margin financier. Applicants have to comply with such requirements as annual returns, notification requirements, fees, additional deposit requirements and the financial resources rules.

Leveraged Foreign Exchange Trading Ordinance

In addition to the licensing requirements for leveraged foreign exchange traders, the Ordinance provides for the investigation of suspected trading malpractice. The Ordinance is also supplemented by rules governing conduct of business, maintenance of financial resources, contract notes, accounts and audit, arbitration of disputes between traders and their customers, and appeal procedures. Again, the structure of the Ordinance is largely modelled after the Securities Ordinance.

Protection of Investors Ordinance

The Protection of Investors Ordinance prohibits the use of fraudulent or reckless means to induce investors to buy or sell securities, or to take part in any investment arrangement in respect of property other than securities. It also prohibits the issue of advertisements and documents which contain an invitation to the public to invest in collective investments schemes (such as unit trusts, mutual funds, investment linked insurance schemes, pooled retirement funds and investment-linked immigration schemes) unless such advertisements or documents are authorized by the SFC.

(ii) Insurance business

The Insurance Companies Ordinance brings all classes of insurance business under a comprehensive system of regulation and control by the Commissioner of Insurance (who is appointed as the Insurance Authority). The main objectives of the Ordinance are to ensure that the interests of policy holders or potential policy holders are protected; and to promote the general stability of the insurance industry. Apart from providing insurance legislation for the supervision of insurers in Hong Kong, the Ordinance also provides the legal backing for the self-regulation of insurance intermediaries, i.e. insurance agents and insurance brokers.

(iii) Mandatory Provident Fund

The Mandatory Provident Fund Schemes Ordinance, first enacted in August 1995, provides the framework for the establishment of a privately managed MPF System. The Ordinance was amended in March 1998 and supplemented by subsidiary legislation in April 1998 and May 1999 respectively, setting out detailed regulations governing the operation of MPF schemes. Further amendments have subsequently been introduced to the MPF legislation to improve the effectiveness of the MPF System.

(iv) Money lenders

The Money Lenders Ordinance sets out the legal framework under which the business of lending money is regulated in Hong Kong. In general companies which engage in a lending function and which are not AIs are required to be registered under this Ordinance. The purpose of the Money Lenders Ordinance is to provide protection and relief against excessive interest rates and extortionate stipulations in respect of loans. It provides penalties for a number of statutory offences, such as carrying on an unlicensed money-lending business. It also provides that any loan made by an unlicensed money lender shall not be recoverable by court action. With certain exceptions, any person, whether a licensed money lender or not, who lends or offers to lend money at an interest rate exceeding 60 per cent per annum commits an offence. Any agreement for the repayment of any such loan, or security given in respect of such a loan, is unenforceable. AIs are exempt from the provisions of the Ordinance.

(v) Money brokers

Please refer to section (b)(viii) of Chapter 1.

Chapter 3 - Structure of the supervisory system

(a) Organisational structure of supervisory authority

With effect from July 2001, the responsibility for the conduct of banking supervision is divided among three departments of the HKMA. The Banking Supervision Department (“BSD”) is responsible for the day-to-day supervision of AIs. The Banking Policy Department (“BPD”) is responsible for the development of supervisory policies and the compilation of banking statistics and management information reports. The Banking Development Department (“BDD”) is responsible for dealing with industry development issues such as banking sector reform, electronic banking, consumer protection issues and licensing-related matters.

The Banking Departments may draw on the expertise provided by the HKMA’s Legal Office when professional advice is required with respect to the legal interpretation of the banking legislation, and the Corporate Services Department to obtain the necessary IT support and advice on matters relating to public relations.

An organisation chart of the HKMA is attached at [Annex 2](#).

(b) Number and distribution of staff

One of the three Deputy Chief Executives of the HKMA is responsible for the three Banking Departments, each of which is headed by an Executive Director. As at July 2001, the three Departments had a total staff establishment of 232 (including secretarial and clerical support) of which 141 were in BSD, 30 in BPD and 61 in BDD.

To improve its efficiency and productivity, the BSD was restructured in mid-1997 to segregate the responsibilities for performing on-site and off-site supervisory functions. Following the restructuring in July 2001, there are currently four divisions, each comprising eight to 11 supervisory teams with staff establishment ranging from 31 to 39. The total number of supervisory teams in BSD is 40, comprising 18 on-site teams, 21 off-site teams and one specialised team. The on-site teams are mainly responsible for conducting on-site examinations. Each member of the off-site teams is assigned to supervise a portfolio of AIs as a case officer and to conduct all related off-site supervisory work. A specialised team is responsible for carrying out examinations of derivative activities of AIs.

In general, the standard team size is three, consisting of a Manager and two Assistant Managers. Each team is led by a Manager and reports to a Senior Manager. In each division, there are three to four Senior Managers reporting to the Division Head. A Senior Manager generally oversees the work of three supervisory teams.

The BPD comprises two divisions. One division takes the lead in developing prudential supervisory policies relating to such areas as capital adequacy, liquidity, market risk and financial models. The other division is responsible for development of the supervisory policy manual, financial disclosure issues and compilation of management information reports and analyses of financial trends in the local banking sector.

The BDD comprises three divisions. One division takes the lead in implementing the policy initiatives under the banking sector reform programme, and also has responsibilities in relation to banking legislation, credit reference agencies, review of the Code of Banking Practice and consumer protection. Another division is responsible for a range of banking issues including money laundering, securities and MPF businesses of AIs, and licensing-related matters of AIs. One of the teams also serves as secretary to the industry Advisory Committee chaired by the Financial Secretary. The third division is dedicated to issues relating to the development of supervisory framework for electronic banking and technology risk management. It has established a specialist team to conduct focused examinations on electronic banking activities of banks.

(c) Supervision of non-bank financial business

As in some other major financial centres such as the US, there are separate supervisors for banking, securities, commodities, insurance, MPF schemes and money lending in Hong Kong. The MA is responsible for supervising banking business and activities of money brokers; the SFC is responsible for supervising securities and futures business, securities margin financing and leveraged foreign exchange trading; the Office of the Commissioner of Insurance is responsible for prudential supervision over the insurance industry, and the Mandatory Provident Fund Schemes Authority (“MPFA”) is responsible for the prudential regulation and supervision of the MPF System. While the Registrar of Money Lenders is responsible for the registration of money lenders, he does not perform supervisory functions. The Police will handle complaints and conduct investigation if necessary regarding money lenders. Breaches of the statutory regulations could, however, lead to loss of a money lender’s licence or criminal penalties.

As explained in section (b) of Chapter 1, AIs which carry on securities business themselves (rather than in separate legal entities) are generally declared to be exempt dealers for the purposes of the Securities Ordinance. The Securities and Futures Ordinance, which was introduced to rationalise and consolidate the various Ordinances administered by the SFC, will become effective in the second half of 2002. Under the new regime, to formalise the consistent treatment of AIs and persons licensed by the SFC, AIs which carry on securities or futures business will need to be registered with the SFC. The MA will continue to be the front-line supervisor in respect of such activities of the registered AIs and will apply standards that are equivalent to those applied to persons licensed by the SFC.

It is not common for banks in Hong Kong to be engaged in insurance underwriting directly themselves. Such activities are usually conducted by related insurance companies which are regulated by the Insurance Authority. The role of the banks in such activities is generally confined to agency or marketing functions for insurance products offered by those related companies, and as such they are only required to register as insurance agents and comply with the Code of Practice for Administration of Insurance Agents as appropriate.

Corporations and individuals marketing MPF schemes are required to register as MPF intermediaries and comply with the Code of Conduct for MPF Intermediaries. Accordingly, AIs and their staff that are engaged in the selling and advising of MPF schemes must be registered with the MPFA as MPF intermediaries. Some AIs also provide guarantees

on the investment return of MPF products. The MA is responsible for monitoring the MPF-related activities of AIs, particularly in relation to compliance with the Code of Conduct and guidelines issued by the MPFA and the MA.

As already noted in section (b)(iv) of Chapter 2, the money lending activities of AIs are not governed by the Money Lenders Ordinance.

For supervision of money brokers, please refer to section (b)(viii) of Chapter 1.

Chapter 4 - Authorization process

(a) Licensing requirements

Under Section 16(1) of the Banking Ordinance, the MA has a general discretion to grant or refuse an application for authorization in Hong Kong. Under Section 16(2), the MA is required to refuse to authorize if any one or more of the criteria specified in the Seventh Schedule (“the Schedule”) to the Banking Ordinance are not fulfilled with respect to the applicant (please refer to [Annex 3](#)).

Normally, the MA will not refuse to authorize an applicant if all the criteria in the Schedule are satisfied with respect to it. However, the MA may exercise a discretionary power to refuse to grant authorization where the application in question gives rise to prudential concerns which are not covered in the existing criteria in the Schedule or where it is considered necessary, on prudential grounds, to limit entry into the banking sector (e.g. because the existing number of AIs is giving rise to destabilising competition).

A description of each of the criteria in the Schedule and the MA’s interpretation of them is set out in the Guide to Applicants for authorization under the Banking Ordinance published by the MA. The criteria in the Schedule are continuing in nature (i.e. they apply to AIs not only at the time of authorization but also thereafter); are forward looking (i.e. the MA has to assess whether the criteria will be met not only at the time of authorization but also in the future); and apply to the AI as a whole (i.e. not simply to its Hong Kong operations).

All three types of authorization are subject to the same criteria⁷, except that:

- the requirement for the aggregate amount of paid-up capital and the balance of share premium account in respect of licensed banks incorporated in Hong Kong is higher than for RLBs and DTCs (i.e. HK\$150 million against HK\$100 million and HK\$25 million respectively);
- applicants which apply for a banking licence in Hong Kong are subject to a minimum asset size criterion (i.e. HK\$4 billion for local applicants and US\$16 billion for foreign applicants) which does not apply to RLBs and DTCs; and
- for applicants incorporated in Hong Kong, they should also have a minimum deposit size of HK\$3 billion and have been a DTC or RLB (or any combination thereof) for not less than ten continuous years.

As noted in section (a) of Chapter 1, in practice, foreign banks seeking a banking licence in Hong Kong may enter only in the form of a branch. An RLB presence may be in the form of a branch or subsidiary, while DTCs may only be in the form of a subsidiary.

⁷ A review of these criteria for licensed banks was completed in December 2001. Please see Chapter 13 for details.

The authorization criteria are intended to be consistent with international standards promulgated by the Basel Committee on the supervision of international banking groups. In particular, in respect of applicants incorporated outside Hong Kong, the applicant must be a bank which, in the opinion of the MA, is adequately supervised in its home country. In assessing the adequacy of home supervision, the MA will have regard to the extent to which that supervisor has established, or is actively working to establish, the necessary capabilities to meet the Basel Committee's Core Principles for Effective Banking Supervision. Among other things, the Principles provide that all international banking groups and international banks should be supervised by a home supervisory authority that capably performs consolidated supervision.

The other criteria specified in the Schedule cover the generally accepted features of a prudent licensing system as set out in the Core Principles, including:

- whether the chief executive, directors and controllers of the applicant are "fit and proper";
- the financial soundness of the applicant in respect of capital adequacy, liquidity and asset quality;
- the adequacy of internal controls and accounting systems; and
- whether the business of the applicant is, and will continue to be, carried on with integrity, prudence and competence.

Applicants which are incorporated in Hong Kong are required to maintain a capital adequacy ratio ("CAR") (calculated in accordance with the Hong Kong application of the Basel Capital Accord) of at least 8%. Branches of foreign banks are not subject to this statutory capital adequacy requirement as the primary responsibility for supervising capital adequacy rests with the home supervisor. However, in practice, the MA will generally require any foreign bank which wishes to establish a branch in Hong Kong to have a CAR (in respect of the bank as a whole) of at least 8% measured in a way which is consistent with the Basel Capital Accord.

For an applicant incorporated outside Hong Kong, the MA will also seek assurances from the relevant banking supervisory authority about the ownership, management and financial standing of the applicant as part of the authorization process.

In addition to the above licensing requirements, an applicant seeking to establish a "virtual bank"⁸ in Hong Kong must satisfy the following requirements:

- maintenance of a physical presence in Hong Kong;
- maintenance of a level of security appropriate to their proposed business;
- establishment of appropriate policies and procedures to deal with the risks associated with virtual banking;

⁸ Virtual banks are defined as companies which deliver banking services primarily through the Internet or other electronic channels.

- development of a business plan which strikes an appropriate balance between the desire to build market share and the need to earn a reasonable return on assets and equity;
- clearly setting out in the terms and conditions for their services the rights and obligations of customers; and
- compliance with the MA's guidelines on outsourcing of computer operation.

In line with existing authorization policies, a locally incorporated virtual bank cannot be newly established other than through the conversion of an existing locally incorporated AI. Furthermore, local virtual banks should be at least 50% owned by a well established bank or other supervised financial institution. For applicants incorporated overseas, they must come from countries with an established regulatory framework for electronic banking.

(b) “Fit and proper” tests on management of applicants

One of the criteria for authorization of an institution incorporated in Hong Kong is that the MA must be satisfied that the chief executive and directors are “fit and proper”. A similar requirement applies in respect of the chief executive of the Hong Kong operations of an institution incorporated outside Hong Kong and the head office directors and the chief executive of such an institution (although in the case of head office officials, the MA will generally rely on the opinion of the home supervisor). The “fit and proper” criteria apply both at the time of authorization and thereafter.

In considering whether a person fulfils this criterion, the MA has regard to a number of general considerations, while also taking account of the circumstances of the particular position held and the institution concerned.

With regard to the appointment of a director or chief executive of an institution incorporated in Hong Kong (or the chief executive of the Hong Kong branch of a foreign bank), the relevant considerations include :

- whether the person has sufficient skills, knowledge, experience, and soundness of judgement properly to undertake and fulfil his particular duties and responsibilities;
- the diligence with which the person is fulfilling or is likely to fulfil those duties and responsibilities (i.e. whether he does or will devote sufficient time and attention to them);
- the integrity of the person including having regard to his reputation and character;
- whether the person has a record of non-compliance with various non-statutory codes, or has been reprimanded or disqualified by professional or regulatory bodies;
- whether the person has been a director of a company which has been wound up by the court on the application of creditors; and

- the person’s business record and other business interests, as well as his financial soundness and strength. This is to ensure that business decisions will be made on an arm’s length basis and there are no potential concerns over his personal dealings or financial situation that would undermine the confidence of depositors through “contagion”.

With a view to further enhancing corporate governance among AIs, the HKMA has proposed in the Banking (Amendment) Ordinance 2001 to add a new authorization criterion in the Banking Ordinance that AIs should maintain adequate systems of control to ensure that persons appointed to hold senior managerial positions within the organisation (referred to as “managers” under the Banking Ordinance) are fit and proper. This recognises that “managers” could play an important role in ensuring the safety and soundness of AIs. A guideline setting out the key elements of such systems, including the “fit and proper” criteria for managers, has been developed and will be issued upon the commencement of the Banking (Amendment) Ordinance 2001.

(c) Authorization of non-bank financial institutions

(i) Securities, commodities, securities margin financing and leveraged foreign exchange trading

As stated earlier in section (b) of Chapter 1, persons who engage in a business of dealing in or giving advice on securities, dealing in commodity futures or giving advice with respect to dealing in commodity futures, leveraged foreign exchange trading or securities margin financing are required to be registered or licensed by the SFC (registered persons). In addition, employees of these persons who perform dealing or advising functions on behalf of their employers are required to be registered as representatives (registered representatives).

Similar registration or licensing requirements (the fit and proper criteria) are applicable to all registered persons and, with some relaxation of the standards, the fit and proper criteria are also applicable to registered representatives. Under the respective legislation (see section (b) of Chapter 2), the SFC shall refuse to register or license anyone unless it is satisfied that the person is fit and proper to be registered or licensed.

The “fit and proper” test adopted by the SFC will take into account, among other things, the applicant’s financial status; educational or other qualifications and experience having regard to the nature of the functions which he will perform; ability to perform such functions efficiently, honestly and fairly; reputation, character, financial integrity and reliability. Where the applicant is a limited company, the “fit and proper” test will apply to the directors, substantial shareholders and related persons of the company concerned. Under some circumstances, the SFC may impose conditions on the registration or licence of an applicant (such as restricting an investment adviser to provide only investment advice on unit trust and mutual funds, that is, prohibiting him from providing discretionary portfolio management services to his clients).

(ii) Insurance business

Under the Insurance Companies Ordinance, the conduct of insurance business in or from Hong Kong is restricted to: companies authorized by the Insurance Authority, the society of underwriters known in the United Kingdom as Lloyd's, and associations of underwriters approved by the Insurance Authority. The statutory requirements for authorization cover share capital, solvency margin, fitness and propriety of directors and controllers, and adequacy of reinsurance arrangements. Insurance intermediaries are also subject to the provisions of the Insurance Companies Ordinance. The statutory requirements for authorization as an insurance broker include requirements on capital and net assets, qualification and experience, professional indemnity insurance, maintenance of separate client accounts and proper books and accounts. Insurance agents must be appointed and registered by an authorized insurer, and details of such registration and subsequent de-registration are required to be given to the Insurance Authority. With effect from 1 January 2000, all insurance intermediaries and their technical representatives are required to pass a publicly held Qualifying Examination under the Insurance Intermediaries Quality Assurance Scheme. They are also required to attend a Continuing Professional Development Programme as a condition for re-registration.

(iii) Mandatory Provident Fund

Under the Mandatory Provident Fund Schemes Ordinance, only trustees that meet the specified criteria are eligible to apply for approval as MPF trustees. The statutory requirements include capital adequacy and financial soundness; and the suitability of the company's controllers (including their reputation and character and their knowledge of, experience in and qualifications for administering provident funds), and in the case of applications by a natural person, the suitability of the applicant to be an approved trustee. MPF intermediaries will be eligible for registration if they pass the required examination.

(iv) Money lenders

Under the Money Lenders Ordinance, anyone wishing to carry on business as a money lender must apply to a licensing court for a licence (the main exemption being AIs). Applications must be submitted to the Registrar of Money Lenders. A copy is also sent to the Commissioner of Police, who may carry out investigations and object to the application. The application is advertised, and any members of the public who have an interest in the matter also have the right to object. A licensing court will hear and determine the application. The licensing court is empowered to grant, subject to such conditions as it may impose, applications for licences or reject them altogether in appropriate cases.

(v) Money brokers

Under the Banking Ordinance, anyone wishing to carry on business as a money broker must apply to the MA for approval. The statutory requirements for approval cover the known identity of shareholder controllers, the fitness and propriety of the controller(s) and applicant's management, adequacy of financial resources, accounting

systems and internal controls, and integrity and prudence and competence of the applicant in conducting its business. In approving an application, the MA may attach conditions to the certificate of approval generally or specifically in any particular case.

Chapter 5 - Supervision of cross-border banking

(a) As home supervisor

As part of the authorization process, the MA must be satisfied that the identity of all controllers of an applicant is known. The MA must be satisfied that all such controllers are “fit and proper”, taking into account the likely or actual impact on the interests of depositors of a person holding his particular position as a controller⁹.

In addition, changes of control of an AI incorporated in Hong Kong require the specific approval of the MA under Section 70 of the Banking Ordinance.

While each case is looked at on its own merits, it is generally the MA’s policy that a person who intends to hold more than 50% of the share capital of an AI incorporated in Hong Kong should be a well established bank (or, exceptionally, another financial institution of good standing and with appropriate experience) which is adequately supervised. There are, however, some instances where AIs are majority owned by non-banks. There are no restrictions on foreign ownership of locally incorporated AIs.

The MA has extensive powers to obtain information from AIs and if necessary from the holding company, a subsidiary or fellow subsidiary of such AIs. AIs would in any case be expected to notify the MA of any significant changes in their situation, including those relating to ownership. As noted above, the MA is required to be satisfied about the fitness and propriety of controllers of AIs on an on-going basis, and changes of control in AIs incorporated in Hong Kong need to be approved by the MA in advance.

The MA has various powers to prevent undesirable affiliations or structures. Apart from the general requirement that AIs conduct their business with integrity and prudence, the establishment of overseas branches, subsidiaries and representative offices by an AI incorporated in Hong Kong requires the prior approval of the MA. The MA’s powers to approve changes of control also provides additional protection. The HKMA monitors organisation structures through its on-going supervision of individual AIs, in particular through off-site reviews and prudential interviews with management.

In considering whether to give approval for the establishment of an overseas branch, subsidiary or representative office, the MA would take into account the AI’s business plan for the proposed operation, the financial implications, the AI’s ability to exercise adequate control over the operation, and the management and internal controls of the proposed operation. The economic and political situation of the country in which the AI proposes to operate would also be a relevant consideration, as would be the supervisory arrangements and the secrecy rules in the host country. The MA would wish to be satisfied that sufficient information can be obtained about the proposed operation, either by direct on-site examination or by other suitable means. The MA could object to an AI setting up an

⁹ “Controller” under the Banking Ordinance includes a majority shareholder controller who is able to control more than 50% of the voting rights of the AI, a minority shareholder controller (10% but not more than 50% of the voting rights) and an indirect controller, being a person in accordance with whose directions or instructions the directors of the AI are accustomed to act.

establishment in a country where the financial position and/or reputation of the AI might be put at risk, or where the secrecy laws prevent the passing of information to the MA and/or to the head office of the AI.

The MA supervises AIs incorporated in Hong Kong on a consolidated basis in respect of capital adequacy, concentration of exposures and liquidity. The main objective of consolidated supervision is to enable the MA to assess any weaknesses within a banking/financial group which may impact upon the AI itself and, if possible, to initiate defensive or remedial action.

The MA takes a flexible approach when considering the scope of consolidated supervision in order to accommodate different types of group structure. This may mean departing from the principles of accounting consolidation e.g. by looking at risks in parent and sister companies. As a general rule, however, quantitative consolidation for the purposes of capital adequacy etc. would cover the positions of an AI's banking activities carried out through its own offices in and outside Hong Kong and through its local and foreign financial subsidiaries. Non-bank companies are included in the consolidation if they undertake "financial" business (e.g. hire purchase, credit cards, leasing etc.). However, financial business conducted by non-bank subsidiaries such as securities companies, which are themselves adequately supervised, will not normally be subject to the consolidated quantitative requirements, but will be taken into account, qualitatively, during the course of consolidated supervision. The MA relies heavily on the co-operation of other supervisors, locally and abroad, to ensure effective consolidated supervision of such banking groups. Such co-operation falls into two areas - information sharing and sharing of supervisory responsibilities.

The Banking Ordinance empowers the MA to obtain information both on a regular and on a need basis from locally incorporated AIs concerning their operations in Hong Kong and overseas. Such information requirements apply also to activities carried out through subsidiaries, whether or not they are banking institutions and whether or not they are held through an intermediate non-bank holding company.

For locally incorporated AIs, the HKMA's statistical returns cover four separate levels of consolidation: an AI's local branch operations, the position in each country of the overseas branch operations, the combined position of the AI's local and overseas branch operations, and the consolidated banking group including subsidiaries.

Information relating to an AI's overseas operations may be verified by on-site examination of such operations (subject to the consent of the host supervisor). Account will also be taken of the work carried out by internal and external auditors and the host supervisory authority. In particular, the MA has the power to commission an external auditor to report on, inter alia, the accuracy of any return or information submitted by the AI (including, specifically, in relation to its overseas branches) and on the adequacy of the internal control system for producing the returns.

(b) As host supervisor

Assessment of the adequacy of home supervision applies both at the time of authorization and on an on-going basis. In considering the adequacy of supervision exercised by the home supervisor, the MA will consider the extent to which that supervisor has established, or is actively working to establish, the capabilities to meet the Basel Committee's Core Principles for Effective Banking Supervision. In forming the view, the MA takes into account:

- the legal and administrative powers of the home supervisor;
- the supervisory framework of the home supervisor;
- the method of supervision adopted by, and the resources available to the home supervisor; and
- past experience in dealings with the home supervisor.

The MA's approach to the supervision of branches of foreign banks is broadly in line with that applied to locally incorporated AIs except that capital-based supervisory requirements (e.g. relating to limits on large exposures) are not applied to such branches. This reflects the fact that branches of foreign banks are not required to hold capital in Hong Kong, although they are subject to the statutory liquidity ratio in the same way as locally incorporated banks. Branches of foreign banks are subject to on-site examinations by the HKMA and are required to submit returns in respect of their Hong Kong operations.

In addition, the MA welcomes the inspection of branches or subsidiaries in Hong Kong by the home supervisor of the parent bank, subject to his prior approval. This reflects the MA's view that supervision of foreign branches is the joint responsibility of the host and home supervisors, in line with the recommendations of the Basel Committee.

Chapter 6 - Supervisory methods

(a) Supervisory approach

The MA's supervisory approach, which is consistent with the Basel Committee's Core Principles, is based on a policy of "continuous supervision". This involves the on-going monitoring of AIs under the risk-based supervisory framework and the use of a variety of techniques which aim at detecting problems at an early stage. These techniques include on-site examinations, off-site reviews, prudential meetings, meetings with the board of directors, co-operation with external auditors and sharing information with other supervisors. Consolidated supervision is also exercised by the MA on a global basis in respect of AIs which are incorporated in Hong Kong (see section (a) of Chapter 5).

(i) Risk-based supervision

Given the evolving financial and economic environment, there is an on-going need for the HKMA to enhance the supervisory process to maintain the stability of the banking system. The HKMA introduced the risk-based supervisory framework during 1999. It is a structured approach to supervision designed to establish a forward-looking view on the risk profile of AIs. This results in a direct and specific supervisory focus on the areas of greatest risk to an AI.

The risk-based supervisory approach puts emphasis on the evaluation of the quality of risk management systems and internal controls of the various types of risks faced by AIs. The eight major types of inherent risks identified by the HKMA are:

- credit;
- interest rate;
- market;
- liquidity;
- operational;
- legal;
- reputation; and
- strategic risks.

The risk profile of an AI is ascertained by balancing the level of inherent risks with the quality of risk management systems at the AI. A risk management rating is then assigned and factored into the management and other relevant components of the CAMEL rating system (see section (d)(i) below). The key elements of the HKMA's risk-based supervisory approach are set out in a guidance note which was issued in October 2001 and incorporated into the HKMA's Supervisory Policy Manual¹⁰.

¹⁰ Please refer to section (b)(i) of Chapter 13 for details about the Supervisory Policy Manual.

The risk-based supervisory approach was first applied in 2000 to the small to medium sized local banks and was introduced to large local banks and branches of foreign banks in 2001.

(ii) On-site examinations

On-site examination is an essential part of the supervisory process undertaken by the HKMA. The examinations are conducted by the HKMA's own examination teams on all AIs irrespective of their place of incorporation. For locally incorporated AIs, on-site examinations may be extended to cover their overseas branches and subsidiaries.

On-site examination offers the opportunity to examine at first hand how an AI is managed and controlled, and is particularly useful for assessing asset quality and the adequacy of risk management systems and internal controls. The scope of on-site examinations will be based on the HKMA's assessment of AIs under the risk-based supervisory approach. It can take the form of either a comprehensive examination or a targeted examination. A comprehensive examination covers the full range of an AI's operations. Areas covered include adequacy of capital, quality of assets, treasury operations, high level controls, compliance with the Banking Ordinance, liquidity, controls against money laundering and other internal controls. A targeted examination focuses on specific areas of concern which the HKMA has identified during the course of its off-site supervision. For AIs engaging in derivatives, securities or MPF-related business, specialised examinations on these activities will be conducted to ensure that these activities are adequately managed and in compliance with relevant laws and regulations and codes of conduct.

The evaluation of the areas identified in the examination scope will normally be carried out through the review of documented policies and procedures, interview with various level of staff to ascertain adequate awareness of the policies and procedures and sound practices, and substantive test of transactions. At the end of the examination the Manager of the examination team will discuss the main findings and conclusions with senior management of the AI at an exit meeting. A formal examination report will be issued to the AI and the implementation by the AI of any recommendations for remedial action will be closely monitored. For AIs incorporated outside Hong Kong, the HKMA will send a copy of the examination report to the home supervisory authority provided that the latter is subject to adequate secrecy provisions in the AI's country of incorporation.

The frequency of examinations varies among AIs, depending on the size, financial standing and the internal control systems of the AI concerned. In the case of foreign-owned AIs, the extent and frequency of examination by the home supervisory authorities and head office will also be taken into account. At present the frequency of on-site examinations ranges from one to three years. The actual examination frequency of an AI will normally be determined by the CAMEL¹¹ rating assigned to the AI by the HKMA: AIs receiving a rating of 3 or worse will be subject to more frequent examinations.

The period of an examination varies according to its scope. A targeted examination normally takes about two to three weeks. For a full scope examination, the

¹¹ CAMEL is an internationally recognised framework for assessing Capital adequacy, Asset quality, Management, Earnings and Liquidity. The overall rating is expressed through the use of a numerical scale of 1 through 5 in ascending order of supervisory concern.

duration varies depending on the size and internal control systems of each AI, but will typically last for at least one month.

(iii) Off-site reviews

In order to achieve “continuous supervision”, on-site examination is supplemented by on-going off-site analysis of the financial condition of individual AIs and assessment of the quality of their management, including the systems for controlling exposures and limiting risks. These reviews help to monitor the financial position of AIs and detect emerging problems that can be explored in greater detail in on-site examinations or prudential meetings.

The scope of off-site reviews varies from regular (e.g. quarterly) analysis of statistical returns covering various aspects of the operations of AIs to a more extensive annual review of the performance and financial position of individual AIs. Analysis is made on an institutional, peer group and system-wide basis. There are three main sources of information - statistical returns, internal management accounts and other management information, and published financial information.

(iv) Prudential meetings

The annual off-site review is usually followed by a prudential meeting with senior management of the AI concerned. The HKMA attaches great importance to this regular dialogue with the senior management of AIs as it enables the HKMA to:

- understand how the AI’s management controls its operations, and views its business situation and prospects;
- clarify specific queries and discuss prudential concerns arising from off-site reviews or other sources; and
- as a result of the above, give a greater focus to on-site examinations.

For AIs which belong to a banking group, prudential meetings may be held both at group level and with individual subsidiaries of the group. In addition, the HKMA may hold discussions with AIs’ overseas head offices, either through the HKMA staff calling on them or during their visits to Hong Kong.

(v) Meetings with the board of directors

To promote a high standard of corporate governance within the banking sector in Hong Kong, the MA issued a Guideline on “Corporate Governance of Locally Incorporated Authorized Institutions” in May 2000. One of the initiatives set out in the Guideline is that representatives of the HKMA will meet the board of directors of each local bank every year. During these meetings, an assessment will be given to the board concerning the performance of the bank, the quality of its risk management and internal controls and issues requiring attention. Such meetings enable the HKMA to establish a formal and direct channel of communication with the board of directors.

(vi) Co-operation with external auditors

Co-operation with external auditors also plays an important role in the supervisory process. Section 61 of the Banking Ordinance provides the basis for the external auditors to be involved in the process of prudential supervision. It makes clear that an auditor may communicate in good faith to the HKMA, whether or not in response to a request made by it, any information or opinion on a matter of which he becomes aware in his capacity as an auditor and which is relevant to any function of the MA under the Banking Ordinance.

The HKMA's relationship with AIs' external auditors takes a number of forms:

- auditors are required under Section 63(3) of the Banking Ordinance to certify, usually once a year, whether an AI's banking returns have been compiled correctly. This is to give the HKMA an independent opinion on the reliability of prudential statistics submitted;
- auditors are also required under Section 63(3A), usually once a year, to report on the following areas :
 - controls relating to the compilation of prudential returns or other information;
 - controls which enable compliance with statutory provisions in the Banking Ordinance; and
 - for AIs incorporated in Hong Kong, controls to enable the maintenance of adequate provisions;
- auditors may be commissioned to review certain internal control systems of an AI under Section 59(2) on an ad-hoc basis;
- annual tripartite discussions are held with AIs and their auditors, normally following the annual audit. Matters discussed typically include any matter arising out of the annual audit (such as identified weaknesses in internal controls), adequacy of provisions and compliance with prudential standards and the various requirements of the Banking Ordinance; and
- the HKMA may ask to see the auditors' management letter to the AI. Any cause for prudential concern would be brought up for discussion in a tripartite or ad-hoc meeting.

(vii) Sharing information with other supervisors

Please refer to Chapter 8 for details.

(b) Collection of financial information

The MA's powers to collect prudential data on both a routine and ad-hoc basis are provided by Section 63 of the Banking Ordinance. Under Section 63(1) and (2), an AI is required to submit returns or other information to the MA on a regular basis. In addition, under Section 63(2A), the MA may require any holding company or subsidiary or sister company of an AI to submit such information as may be required for the exercise of his functions under the Banking Ordinance.

Regular statutory returns cover information on assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan classification, foreign exchange position, interest rate risk, market risk as well as securities and MPF-related activities. Returns are mostly submitted on a monthly or quarterly basis. Some of the returns are required to be completed on both a solo and consolidated basis. A full list of the returns, including the frequency of submission, is at [Annex 4](#).

Information requested on an ad-hoc basis is normally for the purpose of off-site reviews. This may include internal management information such as financial budgets and forecasts as well as bad and doubtful debt reports. Requests may also be made for non-financial information such as AIs' internal policy statements on particular areas of operations e.g. money laundering, and information on AIs' subsidiaries. For the purposes of policy development, the MA may also require information on the nature and extent of an AI's particular business activity and the relevant policies and practices adopted with respect to such business in order to assess the overall adequacy and appropriateness of market practices.

The accuracy of the information and the quality of the systems used to produce it are subject to regular examination by external auditors (see section (a)(vi) above). In addition, such matters may be verified by direct on-site examination by the HKMA.

(c) Risk management systems

The HKMA recognises that sound risk management is essential to promoting stability in both AIs and the banking system as a whole. The objective of the risk-based supervisory approach introduced in 1999 is to ensure that AIs have the necessary risk management systems in place to identify, measure, monitor and control risks inherent in their business operations (please refer to section (a)(i) above for the eight major types of risks identified under the approach). The approach enables potential problems to be detected and tackled at an early stage, thereby reducing the risk of bank failure.

The impact of the Asian financial crisis in the late 1990s on the asset quality of the banking system has served to highlight the importance of sound credit risk management systems within AIs. Asset quality has since remained a major focus of the HKMA in its regular on-site examination and on-going supervisory review of the AIs. General guidance on credit risk management has also been issued. This includes a detailed statutory guideline on "General Principles of Credit Risk Management" issued in January 2001 summarising the main principles AIs should follow in managing credit risk.

Moreover, there has been a growing interest among banks to use electronic banking as an alternative form of delivery channel, bringing with it new issues concerning operational risk management. To strengthen the existing regulatory framework in order to provide a sound and secure basis for the conduct of electronic banking business, a team of specialists was set up in 2000 to provide expertise and take up the monitoring function in this area. Guidelines on “Authorization of Virtual Banks” and on “Management of Security Risk in Electronic Banking Services” were issued in 2000. A number of meetings have been conducted with AIs intending to conduct electronic banking services to ensure that they have adequate systems and controls in place before launch. An on-site examination programme focussing on electronic banking and technology risk management has also been developed. Please refer to section (b) of Chapter 10 for more details.

The increasing risks in the rapidly changing operational environment (e.g. resulting from globalisation, technological advancements, financial innovations, mergers and acquisitions etc.) also call for high standards of corporate governance within banks to ensure that there is adequate board oversight of the risk management and control systems. Under the Guideline on “Corporate Governance of Locally Incorporated Authorized Institutions” issued by the MA in May 2000, AIs are required to review their current practices and make every effort to adopt the minimum standards stipulated in the Guideline. Please refer to section (a)(ii) of Chapter 13 for more details.

(d) Supervisory policies and practices

(i) CAMEL rating system

The HKMA uses the CAMEL rating system for evaluating the safety and soundness of AIs by reference to the AI’s Capital, Asset quality, Management, Earnings and Liquidity. Its primary purpose is to help the HKMA to identify those AIs whose weaknesses in the aforementioned areas require special supervisory attention and warrant a higher than normal level of supervisory attention.

Under the system, each AI is assigned a composite rating based on an evaluation of the individual CAMEL components. A set of qualitative factors and quantitative measurement yardsticks has been developed internally by the HKMA to facilitate the rating process. Upon the introduction of the risk-based supervisory approach in 1999, the CAMEL system was modified to factor the evaluation of an AI’s quality of risk management practices and internal controls into the rating of Management and other relevant components.

AIs rated 3 are considered to be less than satisfactory and those rated 4 or 5 are considered problem AIs. Supervisory actions are required for AIs in these categories, such as an increase in their minimum CAR or the imposition of formal supervisory conditions or requirements relating to the business of the AI.

The CAMEL rating system applies to both locally incorporated AIs and branches of foreign banks. The HKMA aims to review the CAMEL ratings of all AIs once a year. The composite rating will be disclosed to the board of directors (or the head office in the case of foreign bank branches) and senior management of an AI together, where necessary, with recommendations to strengthen its financial position or management. The

board is expected to take a close interest in management's efforts to rectify any problems underlying a composite rating of 3 or worse. The board and management of AIs are required to keep the composite rating confidential. This is to avoid the risk of possible misinterpretation of the composite rating assigned to individual AIs.

The supervisory policies on which the HKMA makes its CAMEL assessment are consistent with the Basel Committee's Core Principles.

(ii) Capital adequacy (credit and market risk¹²)

Capital adequacy is measured on a basis consistent with the Basel Capital Accord, which Hong Kong implemented on 31 December 1989. As at end-June 2001, the consolidated CAR of locally incorporated AIs was 18%.

Under the provisions of the Banking Ordinance, AIs incorporated in Hong Kong are required to maintain a minimum CAR of 8%. The MA is, however, empowered to specify a higher minimum CAR for any particular AI, which may be up to 12% in the case of a licensed bank and up to 16% in the case of a RLB or a DTC. At present, the minimum CAR to be observed by all locally incorporated AIs has been raised to 10% or above. In addition to the statutory minimum ratio, AIs are required to observe a trigger ratio which is normally set at 1% above the minimum ratio. The trigger ratio is intended to provide an early warning signal of deterioration in capital adequacy. Locally incorporated AIs will generally be required to meet the minimum and trigger ratio requirements on both a solo and consolidated basis.

The calculation of CAR is in line with the Basel Capital Accord. The definition of capital, among other things, includes property revaluation reserves and reserves relating to revaluation of securities. Inclusion of such reserves in AIs' capital base for calculation of CAR is subject to limits. In October 2000, the capital adequacy framework was revised, in line with the Basel Committee's policy on Tier 1 capital, to allow innovative capital instruments in the form of non-cumulative preference shares issued by an AI through a special purpose vehicle to be included as part of the AI's core capital. Inclusion of such instruments is subject to certain criteria, including the requirement that such instruments should not exceed a maximum of 15% of an AI's total core capital. Any excess over the 15% will be included as supplementary capital.

The HKMA has implemented a market risk framework in Hong Kong based on the Basel Committee's 1996 Amendment to the Capital Accord to incorporate market risk. In developing the framework the HKMA is mindful that most locally incorporated AIs are not heavily involved in the trading of securities and derivatives products. The HKMA therefore adopts a three-tier approach to the implementation of the market risk framework:

¹² Market risk is defined as the risk of losses in on- and off-balance-sheet positions in interest rate instruments, equities, commodities and foreign exchange arising from movements in market prices or rates.

- a model-based approach for active market participants who have developed sophisticated model-based systems for measuring market risk, subject to supervisory approval of the model;
- a standard approach based on the Basel standardised framework for less sophisticated AIs; and
- an exemption for AIs with market risk positions below a certain threshold.

The HKMA implemented a market risk reporting framework in December 1996. The market risk capital requirement was put into statutory effect at end-December 1997, in line with the Basel Committee's proposal. The Seventh Schedule was amended for this purpose and a guideline was issued by the MA in November 1997.

The Basel Committee is currently proposing a New Capital Accord which, inter alia, seeks to extend the scope of application and the risks covered under the existing Accord. The HKMA is presently considering how the proposals should be implemented in Hong Kong. Please refer to section (b)(ii) of Chapter 13 for details.

In addition to the requirements on CAR, AIs are required to maintain minimum absolute levels of the aggregate amount of paid-up share capital and the balance of share premium account. These are currently HK\$150 million for banks (applicable only to those incorporated in Hong Kong), HK\$100 million for RLBs and HK\$25 million for DTCs.¹³ (In the latter two cases the requirement is applicable to AIs incorporated both in and outside Hong Kong.)

(iii) Asset quality

It is an authorization criterion that each AI should maintain adequate provisions for bad and doubtful debts. The HKMA monitors asset quality and adequacy of provisions through its on-site examinations and off-site analysis, in particular by means of the loan classification system introduced in December 1994.

Under the HKMA's loan classification system, all AIs are required to report their loans¹⁴ according to five categories, i.e. Pass, Special Mention, Substandard, Doubtful and Loss. The three latter categories are collectively known as "classified loans". Locally incorporated AIs report in respect of their combined branch operations within and outside Hong Kong while branches of foreign banks report only on their Hong Kong operations.

The system serves three important objectives:

- to monitor regularly individual AIs' asset quality and the adequacy of their level of provisioning;

¹³ Please see Chapter 13 for proposed changes on requirements for minimum paid-up capital for banks.

¹⁴ Apart from loans and advances, the classification system also applies to other assets such as balances due from banks, acceptances and bills of exchange and investment debt securities.

- to identify outliers through peer group analysis made possible by the common classification system; and
- to detect deterioration of asset quality in specific sectors through monitoring the aggregate level of provisioning against lending to individual sectors.

The main characteristics of each of the five categories of the loan classification system are set out below:

Pass:	Loans where borrowers are current in meeting commitments and full repayment of interest and principal is not in doubt.
Special Mention:	Loans where borrowers are experiencing difficulties which may threaten the AI's position, although ultimate loss is not yet expected but could occur if adverse conditions persist.
Substandard:	Loans where borrowers are displaying a definable weakness which is likely to jeopardise repayment and where some loss of principal or interest is possible after taking account of the net realisable value ¹⁵ of collateral. Normally, rescheduled loans ¹⁶ are also included under this category.
Doubtful:	Loans where collection in full is improbable and the AI expects to sustain a loss of principal and/or interest, taking into account the net realisable value of collateral.
Loss:	Loans which are considered uncollectible after exhausting all collection efforts.

Under the guidelines issued by the MA, AIs are required to accrue interest to a suspense account in the balance sheet or cease to accrue it in respect of:

- loans where there is reasonable doubt about the ultimate collectibility of principal and/or interest;
- loans on which contractual repayments of principal and/or interest are more than three months in arrears and the net realisable value of collateral held is insufficient to cover the repayment of principal and accrued interest; or

¹⁵ Net realisable value is the current market value less any realisation costs.

¹⁶ Rescheduled loans refer to those that have been restructured or re-negotiated because of a deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule. This includes loans for which revised repayment terms render the loan non-commercial for the bank. Such loans may only be upgraded to "pass" or "special mention" if they have been satisfactorily serviced in accordance with the revised terms for at least six months where repayments are monthly or 12 months where repayments are other than monthly.

- loans on which principal and/or interest is more than 12 months in arrears, irrespective of the net realisable value of collateral.

AIs are expected to establish provisions in Hong Kong. In the case of foreign bank branches, however, it would be acceptable for provisions to be established in head office provided that confirmation to this effect has been given by the head office and that, where necessary, confirmation is obtained from the home supervisory authorities that adequate provisions have been maintained by head office.

The HKMA does not currently mandate minimum levels of provisions, either general or specific, in relation to the various categories of classified loans. It would, however, require an AI to increase provisions if it considered these to be inadequate following an on-site examination or taking into account the amount of provision made by other AIs in relation to the same credit.

Ideally, AIs should assess provisions on a loan-by-loan basis, with full provision made for the likely loss. If it is not possible for AIs to reliably estimate the loss of a loan, it may be acceptable for them to set up a provision against the unsecured portion of the loan using the following benchmarks:

- Substandard – 20%;
- Doubtful – 50% is acceptable initially, but this may have to be increased to 75% or even 100% over time if credit quality deteriorates further; and
- Loss – 100%.

The HKMA may also use the above benchmarks to cross-check whether the aggregate amount of an AI's provisions looks adequate. As a prerequisite for using this benchmark approach, AIs should have a reliable loan classification system. Equally important is that collateral should be properly valued. Otherwise, the unsecured proportion against which the provision is calculated may be understated.

(iv) Large exposure limits

AIs incorporated in Hong Kong are subject to a statutory limit of 25% of capital base on the credit exposure to any one person. For the purpose of this limit, the exposure to a group of related borrowers is treated as a single exposure. The limit may be applied to AIs on a solo and/or consolidated basis. There are various statutory exemptions including, for example, exposures to other AIs or banks abroad which are adequately supervised, governments and multinational development banks, and exposures which are appropriately secured or guaranteed by a third party.

There are also limits on unsecured lending to persons connected with a lending AI. Such persons include any director, controller or any employee who is responsible for approving loan applications, relatives of these persons and companies which are controlled by them. The maximum unsecured lending to such persons who are individuals should not exceed HK\$1 million per person and 5% of capital base in aggregate. The aggregate unsecured lending to all connected persons should not exceed 10% of the capital base of the lending AI.

In addition, locally incorporated AIs are required to seek the MA's prior approval for any major acquisition or investment in a company (including the establishment of a company) which constitutes 5% or more of the capital base of the AI concerned. It should be noted that this requirement may be applied to an AI on a solo and/or consolidated basis.

There is no statutory limitation on lending to any particular economic sector, although AIs' aggregate holdings of interests in land (excluding bank premises) or in shares are limited to a maximum of 25% of their capital base in each case. However, AIs are expected to have internal limits to control their exposure to different sectors (see next paragraph).

Apart from adhering to statutory limitations on exposures as mentioned above, locally incorporated AIs are required to maintain adequate controls over large exposures, the minimum standards and requirements for which are set out in a Guideline on "Large Exposures and Risk Concentrations" issued by the MA in August 2001. In particular, an AI is expected to establish a policy on large exposures and risk concentrations which should be approved by its board of directors and agreed with the HKMA. The policy should, among other things, prescribe maximum limits for different types of exposure (e.g. by counterparty, industry, sector or country etc.) and an internal clustering limit to control the aggregate amount of its large exposures which are not currently exempted from Section 81 of the Banking Ordinance.

(v) **Country risk**

With the withdrawal of the Bank of England's country risk provisioning matrix, the HKMA has modified its supervisory approach towards country risk management and provisioning. As the primary responsibility for establishing adequate country risk management systems and determining the appropriate level of country risk provisions rests with AIs' management, they are expected to ensure that:

- there are appropriate policies and procedures for the management of country risk;
- there is a robust system for assessing the country risk in their cross-border exposures;
- there are proper controls (e.g. through establishing and monitoring country exposure limits) in place to manage the concentration risk associated with such exposures;
- adequate resources are devoted to managing country risk; and
- adequate provisions for country risk are maintained.

The HKMA will review the effectiveness of AIs' country risk management and the adequacy of provisions in regular on-site examinations and off-site reviews (in particular through peer group comparisons in respect of country risk provisions). In addition, AIs are required to submit a half-yearly return to report their cross-border exposures broken down by counterparty type (bank, public sector and other) and country.

A guidance note setting out the HKMA's recommendations and best practices on how AIs should manage their country risk was issued in November 2001 and incorporated into the Supervisory Policy Manual.

(vi) Liquidity

The HKMA's approach to the supervision of liquidity aims to ensure, as far as possible, that AIs:

- can meet their obligations when they fall due in normal circumstances; and
- maintain an adequate stock of high quality liquid assets to provide them with breathing space in the event of a liquidity crisis.

The principal supervisory tool is the statutory liquidity ratio. All AIs in Hong Kong, irrespective of their place of incorporation, are required to maintain a statutory liquidity ratio of not less than 25% on average in each calendar month. In this regard they are required to submit liquidity ratio returns on a monthly basis. The ratio applies to the Hong Kong operations of AIs but the MA may require the consolidation of subsidiaries and overseas branches in the case of AIs incorporated in Hong Kong. The MA also has the power to vary the ratio for particular AIs.

Broadly, the liquidity ratio is expressed in terms of each AI's liquefiable assets which can be realised within one month as a percentage of its qualifying liabilities which will, or could, mature within one month. Liquefiable assets include cash, gold, net interbank placements, marketable debt securities, export bills, loan repayments and conforming residential mortgage loans. Conforming residential mortgage loans was added as a new type of liquefiable asset to the liquidity regime in 1999. Such loans should be covered by the irrevocable forward commitment facility issued by The Hong Kong Mortgage Corporation Limited ("HKMC"), which makes them immediately saleable to the HKMC. To qualify as liquefiable assets, these loans should conform to the HKMC's mortgage purchasing criteria and satisfy the conditions set out in the forward commitment facility approved by the MA. Qualifying liabilities include customer deposits, net interbank borrowings and other liabilities. Discounts (known as "liquidity conversion factors") ranging from 0% to 20% are applied to various types of liquefiable assets for the purposes of calculating the ratio.

There are no statutory requirements for AIs to observe a liquidity ratio in respect of any particular currency. However, AIs are required to set out their policy on managing their liquidity in different currencies. They are also required to establish an internal liquidity management policy which, for AIs incorporated in Hong Kong, should take into account the liquidity needs of foreign branches and subsidiaries in the event of a liquidity crisis. The HKMA would wish to be satisfied that effective contingency plans are in place to deal with such a situation.

In addition to the liquidity ratio, the HKMA will assess the adequacy of an AI's liquidity by reference to the following factors:

- maturity mismatch profile;
- ability to borrow in the interbank market;
- diversity and stability of the deposit base;
- loan to deposit ratio; and
- intra-group claims.

Apart from the liquidity ratio return, all AIs are required to submit a maturity profile return on a quarterly basis.

As host supervisor, the HKMA has the responsibility to monitor the liquidity of a foreign bank's branches in Hong Kong. However, it is also considered that the supervision of liquidity of branches is a joint responsibility between the host and the home supervisors. This means that the HKMA is prepared to adopt a more flexible approach to the supervision of the liquidity of overseas incorporated AIs, particularly in respect of intra-group transactions, provided the home supervisor takes account of the Hong Kong operation in its global supervision of liquidity.

(vii) Foreign exchange risk

All AIs are required to establish internal control systems to monitor their foreign exchange risks. They are required to report to the HKMA their foreign currency positions (including options) monthly.

Locally incorporated AIs are required to report their consolidated foreign currency positions. The aggregate net open position (calculated as the sum of net long/short positions of individual currencies) should normally not exceed 5% of the capital base of the AI and the net open position in any individual currency should not exceed 10% of capital base. In particular cases, if an AI has a high degree of market and system proficiency, the normal aggregate limit might be higher than 5%, but in any event it should not exceed 15% of its capital base. For subsidiaries of foreign banks, where the parent consolidates the foreign exchange risk on a global basis and there is adequate home supervision, the HKMA may accept limits at higher levels. For branches of foreign banks, the HKMA reviews and monitors their internal limits which are usually set by their head offices. If the figures are considered to be too large, the HKMA will discuss this with their head offices and home supervisory authorities, if necessary. All AIs (i.e. both local and overseas incorporated AIs) are required to report to the HKMA any breaches of the agreed limits on a monthly basis.

Because of the linked exchange rate mechanism, positions in the Hong Kong dollar against the US dollar are excluded from the guidelines on net open positions. AIs are, however, expected to have internal limits for such positions.

(viii) Derivatives and other off-balance sheet items

The HKMA has taken a number of initiatives to ensure that AIs take a prudent approach to managing their derivatives business. These steps include the issue of relevant guidelines on managing such risks and the conduct of internal control reviews and treasury visits. Any AI wishing to begin to trade in derivatives is expected to discuss its plans with the HKMA in advance.

Regarding the use of credit derivatives by AIs, the MA issued an expanded guideline in June 2001 to set out the supervisory approach to credit derivative instruments, covering aspects relating to risk management, capital requirements for the trading or banking book and the reporting treatment for large exposures.

For locally incorporated AIs, the HKMA takes into account their positions in derivatives and other off-balance sheet items in assessing capital adequacy and large exposures (credit risk), foreign currency risk, interest rate risk and liquidity risk. In addition, positions arising from such activities have been incorporated within the market risk reporting framework which was implemented in December 1996. For branches of foreign banks, the HKMA considers that, in general, it is more appropriate for the banks' home supervisor to monitor the impact on capital adequacy of their derivatives and other off-balance-sheet activities on a consolidated basis. However, these AIs are required to provide regular information on positions in such instruments.

AIs are required to provide the following information on a regular basis:

Credit risk: Locally incorporated AIs provide quarterly information on the notional principal, replacement cost and potential exposure of their OTC traded interest rate, exchange rate, gold, equity, precious metals and commodities related derivative contracts.

AIs incorporated outside Hong Kong are required to provide monthly information on the principal amount held in the above OTC traded contracts.

Liquidity risk: All AIs are required to provide a monthly liquidity return under which the irrevocable commitments to provide funds on a known date of drawdown within one month or irrevocable standby facilities which are at call or have a notice period within one month are regarded as qualifying liabilities for the purposes of calculating the liquidity ratio.

FX risk: All AIs are required to take foreign exchange derivatives into account in calculating their net open foreign currency positions. Options positions are reported separately.

Interest rate risk:	All AIs are required to provide quarterly information on the repricing risk of interest rate and foreign currency related derivatives.
Market risk:	With effect from end-1996, locally incorporated AIs have been required to provide quarterly information on their off-balance-sheet positions in interest rate, equities, commodities and foreign exchange derivatives as part of the overall calculation of AIs' market risk.
Profit & loss:	With effect from the second quarter of 1997, all AIs are required to provide quarterly information on earnings (realised and unrealised) arising from their derivatives activities.

As part of a wider assessment of the supervisory approach to derivatives, the HKMA has reviewed the joint Basel/IOSCO framework for supervisory information on banks' derivatives activities. Overall, the reporting requirements listed above cover the broad areas of risk identified in the Basel/IOSCO paper, namely, credit risk, liquidity risk, market risk and earnings. Whether further detailed information should be obtained will be reviewed in the light of market developments.

(ix) Accounting systems and internal control systems

One of the criteria for authorization is that all AIs should have in place adequate accounting and internal control systems. Every AI is subject to examination of the adequacy of such systems by the HKMA's own bank examiners and/or its external auditors. "Adequacy" of systems covers both their existence and whether they are working effectively. The use of external auditors to conduct both regular and ad-hoc reviews of internal controls is described in section (a)(vi) above.

The aspects of internal controls which may be subject to ad-hoc reports by external auditors under Section 59(2) of the Banking Ordinance include the following:

- high level controls;
- controls relating to the financial accounting and management reporting systems;
- specific controls relating to the financial accounting and management reporting systems;
- specific controls relating to functional areas of AIs' operations (such as loans and advances, electronic banking etc.);
- computer controls;
- contingency planning; and
- controls to prevent money laundering.

The HKMA's expectations regarding the general objectives and major components of internal control systems are set out in a Guideline on "Internal Control Systems" issued in August 1992. Other relevant guidelines are issued from time to time by the MA.

(x) Public disclosure of financial and prudential information

Accounting standards in Hong Kong are mainly embodied in the Statements of Standard Accounting Practices issued by the Hong Kong Society of Accountants ("HKSA"), which is responsible for regulating the accounting profession in Hong Kong. The Statements are largely based on similar statements issued by the accounting bodies in the United Kingdom. More recently, the new and revised statements are modelled closely on the International Accounting Standards.

The HKSA's approach to developing accounting standards is set out in the Framework for the Preparation and Presentation of Financial Statements. Under the framework, financial statements are prepared on two underlying assumptions, namely accrual basis and going concern. It requires that information provided in financial statements should possess the qualitative characteristics of being understandable, relevant, reliable and comparable. In general, where an item meets the following criteria, it should be recognised in the balance sheet or profit and loss account:

- it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- the item has a cost or value that can be measured with a degree of reliability.

The statutory framework relating to the requirement of issuance of annual accounts of companies in Hong Kong (including AIs) and the external audit of these is contained in the Companies Ordinance. The Tenth Schedule to the Companies Ordinance sets out the information which companies incorporated in Hong Kong are required to include in the balance sheet and profit and loss account in their audited annual accounts. Banks are, however, given a number of exemptions from the requirements which apply to companies in general.

Beginning with the 1994 accounts and following discussions with the SFC and the Stock Exchange, the HKMA has taken the lead in promulgating minimum standards for financial disclosure by AIs in their audited annual accounts. These standards were first set out in a "Best Practice Guide on Financial Disclosure" issued by the MA in 1994 which has since been periodically updated and revised. In 1999 the Best Practice Guide was converted into a formal set of minimum standards of disclosure in the Guideline on "Financial Disclosure by Locally Incorporated Authorized Institutions" which was issued under Section 16(10) of the Banking Ordinance. The requirement to comply with the Guideline by all AIs incorporated in Hong Kong (except for the smaller RLBs and DTCs¹⁷) is backed by an authorization criterion in the Banking Ordinance which requires AIs incorporated in Hong

¹⁷ These refer to RLBs and DTCs which have total assets and total customer deposits of below HK\$1 billion and HK\$300 million respectively.

Kong to make adequate disclosure of information in their audited annual accounts. The MA therefore has specific statutory powers to impose requirements in relation to such accounts.

As a result of the disclosures already made, the relevant AIs in Hong Kong now provide information on the following in their accounts:

- the nature and quality of earnings and cost structure: including breakdown of income, operating expenses, bad debt charges and taxation;
- profits;
- the nature and quality of assets: assets are grouped by type and maturity. General and specific provisions are separately disclosed. Securities are analysed according to the purpose for which they are held, and the market value of listed investment securities is disclosed. Maturity profile of all major assets and liabilities are disclosed. Counterparty analysis on securities and standardised disclosure of advances by industry sector is disclosed. There is also information on the overdue and non-accrual status of loans, the overdue status of other assets, the level of loan loss provisions analysed into specific and general and movements in provisions during the year.
- sources of funding: liabilities are analysed into various main constituents, namely, customer deposits, interbank deposits, and other accounts;
- cashflow statement;
- capital resources: analysed into loan capital, minority interests, share capital and various material types of reserves including general reserves and property revaluation reserves. Components of capital are split between core and eligible supplementary capital;
- off-balance sheet exposures: disclosure of purpose of holding (i.e. trading or hedging) and the current replacement costs and credit risk;
- principal accounting policies: the policies adopted in determining the profit and loss for the period and in stating the financial position; the policies, practices and methods adopted for credit risk exposures in particular for loans and advances which should include inter alia the basis of measurements at the time of acquisition and at subsequent periods, the recognition of interest income, and the determination of specific and general provisions and write-offs; the policies in respect of off-balance sheet exposures, valuation and income recognition; and voluntary disclosure on accounting treatment of related fees and expenses, including whether any incentives relating to residential mortgages or other advances have been written off or amortised;
- segmental reporting: forms part of the supplementary information to the audited accounts. Total assets and liabilities, total operating income and profit/loss before tax, and off-balance sheet exposures are analysed by geographical areas and classes of business. Advances to customers are

broken down by industry sectors and geographical areas and cross-border claims are analysed by geographical areas and the types of counterparties;

- other financial information: transactions with group companies, assets of the AI pledged as security, capital adequacy and liquidity ratios; and
- risk management: for qualitative information, AIs are required to provide a description of the main types of risk arising out of its business (including credit, liquidity, interest rate, foreign exchange and market risk) and the policies, procedures and controls used for measuring, monitoring and controlling those risks and for managing the capital required to support them. For quantitative information, AIs should disclose the amount and volatility of market risk if market risk is regarded as material, and foreign currency exposures.

A set of recommendations for the disclosure in interim accounts of listed AIs was issued in 1998. These disclosure standards were later extended to apply to all AIs incorporated in Hong Kong (except for the smaller RLBs and DTCs, and non-listed AIs which are wholly-owned subsidiaries of Hong Kong incorporated AIs) in June 1999. These recommendations have subsequently been updated and refined to incorporate disclosure of condensed balance sheet, profit and loss information, asset quality, foreign currency exposures, components of capital, liquidity position and off-balance sheet risk positions along-side with the development of the annual disclosure standards.

The MA also issued in 1998 recommendations for disclosure by foreign bank branches to bring their financial disclosures onto a more level playing field in relation to the locally incorporated AIs. The level of disclosure is broadly in line with that for the locally incorporated AIs. These AIs are required to disclose certain bank information on a consolidated basis which includes the size of capital, CAR, total assets, total liabilities, total advances, total customer deposits and pre-tax profits.

The MA requires AIs to include a statement of compliance in the directors' report, stating whether the Guideline for Financial Disclosure has been fully complied with and, if not, the reasons for any non-compliance. In addition, banks which are listed on the Stock Exchange are subject to its listing requirements. In general, these require disclosure of information in line with the MA's minimum standards on financial disclosure.

In November 2001, the full set of financial disclosure guidelines and recommendations was recast and incorporated into the Supervisory Policy Manual as follows:

- a statutory guideline on financial disclosure by locally incorporated AIs;
- a guidance note on interim financial disclosure by locally incorporated AIs ; and
- a guidance note on financial disclosure by overseas incorporated AIs.

(xi) External audit

Companies incorporated under the Companies Ordinance (including AIs) are required to appoint an external auditor at each annual general meeting of the company. The auditor is required to examine the accounts of the company and to report to the shareholders of the company on whether, in the auditor's opinion, the balance sheet and profit and loss account have been prepared in accordance with the provisions of the Companies Ordinance and whether they give a true and fair view of the company's financial position.

An AI incorporated outside Hong Kong is required, within six months after the close of each financial year, to submit to the MA a copy of its audited accounts, the auditors' report on the accounts and the directors' report prepared under the laws of the place in which the AI is incorporated.

An AI incorporated in Hong Kong is required under the Banking Ordinance immediately to give notice to the MA if it proposes to remove an auditor before or at the expiration of his normal term of office. Similarly, an auditor must give written notice to the MA if he:

- resigns before the expiration of his term of office;
- does not seek to be re-appointed; or
- decides to include in his report on the AI's accounts any qualification or adverse statement.

As already mentioned, the MA may require an AI to commission both regular and ad-hoc reports from its auditors on such matters as the quality of internal controls and the accuracy of its prudential returns. The MA may also require what amounts to a second audit of the AI's financial affairs to be conducted. Normally, such reports will be conducted by the AI's existing auditors. However, the MA reserves the right to require the report to be commissioned from a different firm of auditors where he has reason to believe that the AI's existing auditors would not be capable of producing an adequate report. In reaching this judgement, the MA will take into account the existing auditors' expertise, resources, competence, independence, integrity and other relevant attributes.

There is no legislation to prevent banking groups incorporated in Hong Kong appointing more than one auditor to audit their group companies. However, an auditing guideline "Group Financial Statements - Reliance on the work of other auditors" has been issued by the HKSA to clarify the duties, responsibilities and practices of the auditors when the financial statements of subsidiaries or of associated companies are audited by other auditors. In general, the MA considers it preferable if banking groups are audited by one firm of auditors.

(e) Relationship with internal auditors

It is the MA's policy to require AIs to maintain a proper internal audit function as part of an effective system of internal controls. AIs are also recommended to

establish an audit committee under the board of directors to oversee the operation of the internal auditors and to provide an independent reporting line.

The MA attaches particular importance to the role of internal auditors of AIs to ensure that the internal controls and operating procedures of AIs are adequate and functioning properly in accordance with board policies. During on-site examinations, the HKMA would normally review the audit programme of the internal auditors and the work conducted by them, and discuss with the internal auditors their major findings to ascertain the performance and adequacy of the AI's internal audit function. Internal auditors are normally invited to participate in tripartite meetings of the HKMA, the senior management of the AI and their external auditors.

Where control weaknesses have been identified in an AI, the HKMA may rely, initially at least, on an investigation and report by the AI's internal auditors. The HKMA's perception of the independence and effectiveness of the internal audit team, and the quality of the report produced, will influence whether the HKMA feels obliged to follow up with its own investigation.

In the case of foreign AIs (including subsidiaries of such AIs), the HKMA welcomes internal auditors from head offices or parent banks to review their operations in Hong Kong. They are entitled to have full access to the AIs' books, accounts, documents, securities and other information which they may require for their audit. While there are no statutory provisions in the Banking Ordinance to require such auditors to report their findings to the HKMA, most would normally voluntarily visit the HKMA to discuss the scope and results of their audit and to exchange views on the AI's strategies and operations.

(f) Measures/actions to deal with problem banks

Where an AI fails to comply with statutory requirements (e.g. capital adequacy, liquidity ratio, large exposures limits), the HKMA will normally enter into discussions with the AI to understand the circumstances leading to such contraventions, and to consider whether the AI is capable of taking remedial action which would resolve the problem in a satisfactory manner. To a large extent this will depend upon the quality of the AI's management and whether it is capable of initiating reforms. On occasions, a change of management may be required.

As already noted, the authorization criteria under the Banking Ordinance are continuing requirements and a breach of these means that the MA's powers of revocation of authorization become exercisable. In addition, there are other grounds for revocation, such as the provision of materially false, misleading or inaccurate information to the MA. Whether the MA chooses to exercise his powers to actually revoke an AI will depend on the scope for remedial measures (e.g. fresh injection of capital or change of management) as described above and whether revocation would be in the interests of the stability of the banking system and of depositors.

As an alternative, or prelude, to revocation, the MA may suspend the authorization of an AI. The grounds for suspension are the same as those for revocation.

The MA also has powers under Section 52 of the Banking Ordinance to:

- require an AI to take any action specified by the MA (which might include ceasing to take deposits);
- appoint an Adviser to advise the AI on the management of its affairs;
- appoint a Manager to take control of the AI's affairs; and
- make a report on the AI to the Chief Executive in Council (normally, this would be the first step in winding up the AI).

In general, the grounds for taking such measures are the same as those which trigger revocation or suspension. The Section 52 powers might well be used as a prelude to revocation, e.g. by imposing restrictions which would protect the interests of depositors prior to revocation.

In addition to supervisory action which might be taken by the MA, failure to comply with the requirements of the Banking Ordinance may give rise to criminal offences in respect of which specific penalties are laid down in the Ordinance. The decision on whether to prosecute such offences is, however, a matter for the Secretary for Justice.

(g) Other supervisory methods

Under the Banking Ordinance, locally incorporated AIs' aggregate holdings of shares and of interests in land must each not exceed 25% of capital base. Moreover, equity investments in subsidiaries or associated companies are required to be deducted from the capital base of the AI. There are no other statutory restrictions on the normal business of an AI. However, the MA has issued guidelines on various activities such as motor vehicle financing, lending to stockbrokers, financing of the subscription of new share issues etc. Depending on the circumstances, the MA may advise AIs to act prudently when lending to a particular sector.

(h) Supervision of non-bank financial business

(i) Securities, commodities business and securities margin financing

Corporations seeking SFC registration as securities dealers, investment advisers, securities margin financiers, commodity dealers or commodity trading advisers are subject to the following liquid capital/ net tangible assets requirements:

- Securities dealers and commodity dealers (excluding futures non-clearing dealer, introducing broker and trader)
 - (1) Liquid capital of HK\$3,000,000; or
 - (2) 5% of the aggregate of:
 - (i) his total liabilities;
 - (ii) the initial margin requirement in respect of open positions in futures or options contracts held by him on behalf of clients; and
 - (iii) the amount of margin required to be deposited in respect of open positions in futures and options contracts held

by him on behalf of clients to the extent that those futures or options contracts have not been subject to the initial margin requirement described in subparagraph (ii).

whichever is higher

- Investment advisers and commodity trading adviser Net tangible assets of not less than HK\$500,000
- Commodity dealers which is a futures non-clearing dealer
 - (1) Liquid capital of HK\$500,000; or
 - (2) 5% of the aggregate of-
 - (i) his total liabilities;
 - (ii) the initial margin requirement in respect of open positions in futures or options contracts held by him on behalf of clients; and
 - (iii) the amount of margin required to be deposited in respect of open positions in futures and options contracts held by him on behalf of clients to the extent that those futures or options contracts have not been subject to the initial margin requirement described in subparagraph (ii).

whichever is higher

- Securities dealer and commodity dealer which is an introducing broker or trader
 - (1) Liquid capital of HK\$500,000; or
 - (2) 5% of the aggregate of total liabilities;
- Securities margin financier
 - (1) Liquid capital of HK\$3,000,000; or
 - (2) 5% of total liabilities

whichever is higher

Once registered, persons and business entities are subject to a number of on-going obligations set out in the relevant Ordinances and the various codes (including the Code of Conduct) and rules issued by the SFC. As already noted, the Securities and Futures Ordinance which consolidates the various Ordinances administered by the SFC was enacted in March 2002 and will become effective in the second half of 2002. The relevant rules and codes issued by the SFC will also be subject to revision.

The supervisory methods adopted by the SFC include:

- review of returns;
- detection of unusual price and volume movements on both the Stock Exchange and the Futures Exchange;
- routine or special inspection visits; and
- investigation of cases referred by Licensing Department or Enforcement Division, communications from external auditors, public complaints or media reports.

(ii) Leveraged foreign exchange trading

The SFC has issued a set of ancillary rules and guidelines governing the operations of leveraged foreign exchange traders. In addition to the fit and proper requirements (noted in section (c) of Chapter 4), these rules and guidelines cover the following key areas:

- financial resources requirements to ensure that a licensed trader's risk is proportional to its resources. Licensed traders are required to maintain a minimum share capital of HK\$30 million and minimum liquid capital of HK\$25 million; or 1/60 of aggregate gross position for all foreign currencies, whichever is higher;
- conduct of business standards to ensure licensed traders adopt high standards of integrity, treat investors fairly and disclose relevant information to clients;
- a fair and efficient arbitration system to govern the resolution of disputes that arise between a licensed trader and its clients; and
- a range of investigatory and enforcement powers to promote fairness and integrity in the market.

(iii) Insurance business

The Insurance Companies Ordinance sets out specific minimum requirements in respect of the capital base and solvency for insurance businesses. The Insurance Authority may also impose additional requirements in respect of individual insurers. The minimum capital required for limited companies is HK\$10 million, or HK\$20 million for composite insurers and those wishing to carry on statutory classes of insurance (i.e. mainly employee compensation insurance and motor vehicle third party insurance). Under the solvency requirements, the value of an insurer's assets must exceed the value of its liabilities by a statutory margin of solvency. The Ordinance also requires general insurance companies, other than professional reinsurers, to maintain a minimum level of assets in Hong Kong of not less than 80% of their net liabilities attributable to their Hong Kong insurance business (i.e. liabilities arising from claims net of reinsurance) plus a margin based on the Hong Kong business premiums and claims.

In addition to the statutory requirements noted above, the Insurance Authority issues guidelines and circulars setting out the requirements with respect to the conduct and operations of insurers and insurance intermediaries. On-site examinations are conducted in

respect of insurers' observance of the guidance notes on money laundering issued by the Insurance Authority and compliance with the requirement to maintain assets in Hong Kong. The Insurance Companies Ordinance empowers the Insurance Authority to impose interventionary requirements on insurers or appoint joint managers to take over control of the insurer's affairs, business and property in Hong Kong in certain circumstances. The Insurance Authority also works closely with industry associations in the self-regulation of insurance intermediaries.

(iv) Mandatory Provident Fund

The Mandatory Provident Fund Schemes Ordinance prescribes the capital adequacy requirements to be complied with by a company that applies to be an approved trustee. The minimum requirements are that the company must have a paid-up share capital of HK\$150 million, own net assets of at least the same amount, and own assets held in Hong Kong to the value of at least HK\$15 million. The applicant must have sufficient presence and control in Hong Kong. A natural person applicant must ordinarily reside in Hong Kong and be a person of good reputation and character.

With a view to facilitating the enforcement of and compliance with the MPF requirements, the MPFA issues comprehensive guidelines for the guidance of approved trustees, other service providers, participating employers and their relevant employees, self-employed persons and other persons concerned with the MPF legislation.

(v) Money lenders

The supervisory approach to money lenders is simple compared to that adopted by the MA and SFC. As noted above, while a Registrar is responsible for the registration of money lenders, he does not perform supervisory functions. Public complaints on the conduct of money lenders may be investigated by the Police where there are causes for concern. The Administration has introduced a new regulatory regime to bring margin financing activities of securities-related finance companies under the supervision of the SFC.

(vi) Money brokers

Please refer to section (b)(viii) of Chapter 1.

Chapter 7 - Failure management

When an AI shows signs of failing (i.e. of being insolvent or unable to meet its obligations), the MA would activate the emergency procedures for dealing with such a situation. Internally, this would involve a group of high-level HKMA staff to manage the crisis and to co-ordinate the action to be taken. Among the first steps would be to hold urgent meetings with the management and auditors of the AI concerned and to commission an immediate on-site examination by the HKMA personnel to try to establish the scale of the problem and, in particular, whether the AI is facing a liquidity or a solvency crisis. In the case of AIs incorporated outside Hong Kong, there would be close liaison with the home supervisors.

It is likely that the MA would use one or more of the powers under Section 52 of the Banking Ordinance (see section (f) of Chapter 6). For example, the MA might require the AI to stop taking new deposits or making new loans (in order to stop the problem getting worse and to preserve liquidity). Taken to the extreme, the AI could be instructed to close its doors for normal business in order to protect its remaining assets. The MA might also appoint a Manager to take control of its affairs.

If it appears to the MA that the AI in difficulties is suffering a temporary liquidity problem but is still solvent, the MA will normally be prepared to act as lender of last resort in the interest of maintaining the stability of the system as a whole. Such liquidity assistance would be on a fully secured basis and on normal commercial terms. The MA would also expect significant shareholders of the AI to inject liquidity and/or capital as a demonstration of their own commitment.

Where the problem bank is insolvent, or probably so, the MA would normally appoint a Manager to assume control as mentioned above and require it to close for normal business.

In this case, the available options would include:

- helping to find a suitable buyer to acquire the problem AI;
- seeking to put the problem AI into liquidation (this can be done by the Financial Secretary presenting a winding-up petition to the High Court on the instructions of the Chief Executive in Council); and
- taking over the problem AI using public funds.

All of these options have been used in Hong Kong in the past. There is no undertaking by the Government that problem banks will automatically be rescued using public funds and each case is looked at on its merits. Having said that, the resources of the Exchange Fund (which holds the foreign exchange reserves of Hong Kong) could be used to mount a rescue at the discretion of the Financial Secretary. This would depend on whether the use of the Exchange Fund for this purpose is deemed necessary to protect the exchange rate of the Hong Kong dollar or to maintain the stability of the financial system.

Where problems such as fraud have arisen in an AI, the Financial Secretary is empowered to appoint a person to carry out an investigation of, and report to him on, the affairs of the AI in question.

Chapter 8 - Contact with other domestic and overseas supervisory authorities

(a) Powers to share information with other supervisors

The Banking Ordinance specifically allows the MA to disclose information to central banks and financial services supervisors outside Hong Kong to assist them to exercise their functions. This is subject to the proviso that the recipient authorities are subject to adequate secrecy provisions in their own countries. Locally, the MA may disclose information to other supervisors, namely, the Insurance Authority, the SFC and the MPFA. Such disclosures may include routine information such as examination reports, opinions on the fitness and probity of management, and details of banking transactions.

With the enactment of the Banking (Amendment) Ordinance 1999, Section 121(3) of the Banking Ordinance has been amended to allow the MA to disclose information relating to the affairs of individual customers of an AI or LRO to an overseas supervisory authority. A guideline has also been issued to set out the manner in which the MA would exercise his discretion to disclose information about individual customers and the criteria for such disclosure. The main principle is that disclosure of information relating to individual customers would be made only on a case-by-case and “need to know” basis, following either a specific request from the overseas authority concerned or on occasions at the initiative of the MA. The latter might occur, for example, where the MA wished to share information about a problem loan booked in Hong Kong with the relevant AI’s home supervisor.

(b) Contacts with other supervisors

The MA maintains regular contacts with other local and overseas supervisors to exchange views on supervisory matters. Locally, the MA and the SFC have signed a Memorandum of Understanding (“MOU”) which sets out the agreed framework for supervisory co-operation between the two regulatory bodies. The aim of the MOU is to strengthen co-operation between the two authorities in respect of supervision of entities or financial groups in which both parties have a mutual interest and, where possible, to minimise the effects of dual supervision. Following the introduction of new composite legislation on the activities regulated by the SFC, the MOU will be revised to enshrine the “co-operative supervision” scheme agreed between the two authorities. At present, regular meetings are held with the SFC to discuss issues of mutual concern or supervisory matters relating to AIs. The MA also communicates with the Insurance Authority as the need arises.

The MA has also signed a MOU jointly with the MPFA, the SFC and the Insurance Authority in respect of the regulation of MPF intermediaries. This MOU is to ensure conformity in regulatory approach, minimise duplication of regulatory efforts, close gaps in regulatory boundaries, minimise mis-selling by MPF intermediaries and maximise protection of MPF scheme participants. An MPF Intermediaries Regulation Co-ordinating Committee was established under this MOU to co-ordinate the regulation of MPF intermediaries among the four regulators.

In relation to AIs incorporated outside Hong Kong, contacts with overseas supervisors will start from the authorization process, during which the MA will seek assurances from the relevant banking supervisory authority about the management and

financial standing of the applicant, and also information about the scope of that supervisor's consolidated supervision. After AIs have been authorized, the MA will maintain on-going contacts with their home supervisors to exchange information relating to the operations of these AIs. Where locally incorporated AIs are proposing to establish or have established branches or subsidiaries overseas, the MA will also liaise with the relevant host supervisors.

The MA has reciprocal arrangements with many home supervisors to provide examination reports on overseas AIs' operations in Hong Kong. When parent supervisors carry out examinations of their AIs in Hong Kong, the HKMA staff will seek to hold discussions with the examiners before and after their inspection.

With a view to enhancing information sharing and supervision of cross-border banking operations, the MA has entered into agreements on supervisory co-operation with supervisors in Canada, Denmark, Indonesia, Macau, UK, the USA, Germany and the Netherlands.

(c) Confidentiality of information received from other countries

In general, information received in confidence from supervisors in other countries is protected by the secrecy provisions of the Banking Ordinance. Save for some exceptional circumstances, the MA is required to preserve secrecy with regard to all matters that may come to his knowledge in the exercise of any function under the Banking Ordinance. Any public officer who breaches the secrecy provision commits a criminal offence and is liable to imprisonment.

There are various "gateways" under the Banking Ordinance where the MA has the discretion to disclose information to third parties (such as other regulators in Hong Kong) where such information will assist the recipient to exercise his functions. In respect of information received from overseas supervisors, the MA would normally notify the provider of the information in advance and seek his views prior to making such disclosure. The MA may also in certain circumstances be obliged to make disclosure of information, for example for the purposes of criminal proceedings. While the legislature might also seek to require the MA to disclose confidential information, including that obtained from overseas supervisors, its ability to do so has not been tested.

(d) Restrictions on passing information by banks

There is no legislation which prevents a bank or banking group for which the MA is the host supervisor from passing information either to its parent bank or to its home supervisor. Neither is there any legislation which prohibits the internal auditors from the parent bank or head office from inspecting the books of their establishments in Hong Kong or prohibits them from learning the names of individual depositors and borrowers. However, in compliance with the Data Protection Principles contained in the Personal Data (Privacy) Ordinance, an AI is expected to inform the customer of the classes of person to whom disclosure of customer data may be made (including its home supervisor) and to obtain the prescribed consent of the customer before disclosing such information to other persons.

(e) Ability of home supervisors to conduct on-site examinations

Home supervisory authorities are entitled to conduct on-site examinations of branches, subsidiaries or representative offices in Hong Kong of banks from their countries provided that prior approval from the MA is obtained. So far, there has been no refusal of any such request. There is no restriction on access to information concerning the branch, subsidiary or representative office examined.

Chapter 9 - Supervision of financial conglomerates

In line with the trend in other major financial centres, it has become relatively common in Hong Kong for banking groups - so-called “financial conglomerates” - to provide services in several different financial sectors (primarily banking and securities but also, to a more limited extent, insurance). Where a variety of financial services are offered through a single legal entity (such as a bank), each of the financial regulators may have supervisory responsibilities in respect of the AI concerned (although, as explained in section (b) of Chapter 1, in the case of securities business conducted by AIs, they may be granted exempt dealer status by the SFC and thus not be subject to its supervision). However, where the financial services - banking, securities or insurance - are carried out in separate legal entities, each of these will be subject to direct regulation by the relevant supervisor.

In the case of a banking group which is locally incorporated, this entity-by-entity supervision is supplemented by consolidated supervision of the group by the MA in fulfilment of his responsibilities under the Banking Ordinance. However, where the other regulators apply their own capital adequacy requirements to financial services subsidiaries, the MA will normally exclude such subsidiaries from the scope of its calculation of the consolidated CAR. Instead, the investment in such subsidiaries will be deducted from group capital. At the same time, the MA also normally performs the role of “co-ordinator” of all the regulators with an interest in the banking group. While each supervisory authority would retain its statutory responsibilities, the co-ordinator’s role is to ensure that information is shared promptly among the regulators and that supervision is co-ordinated to avoid overlaps or underlaps. (In respect of certain AIs where business is mainly securities-related, the SFC may act as the co-ordinator.)

In the case of a banking group which is incorporated outside Hong Kong, there is no “country level consolidation” in Hong Kong, although, as with groups which are locally incorporated, there is close contact between the Hong Kong supervisors if an issue arises in relation to a legal entity supervised by one supervisor which may also affect another legal entity supervised by another supervisor. If the group’s major activity in Hong Kong is banking and its home supervisor is a banking supervisor, then the MA will act as co-ordinator of the Hong Kong supervisors, whereas if its major activity in Hong Kong is securities and its home supervisor is a securities supervisor, it will be the SFC which will act as co-ordinator.

Chapter 10 - Supervision of electronic money and electronic banking

(a) Electronic money

Legislative changes have been made to the Banking Ordinance to provide a legal framework for the regulation of the issue of multi-purpose stored value cards (“SVC”). The MA’s current policy stance is to restrict the issue of general multi-purpose cards to fully licensed banks, but to allow special purpose non-bank vehicles to issue more limited multi-purpose cards or to exempt certain even more limited multi-purpose cards.

The legal framework for the regulation of multi-purpose cards (“MPC”) provides that:

- only fully licensed banks may issue general purpose MPCs;
- special purpose vehicles whose principal business consists of the issue/facilitating the issue of MPCs may apply for authorization as a DTC for the principal purpose of issuing or facilitating the issue of MPCs¹⁸;
- the MA would be given a discretionary power to declare a SVC not to be a MPC for the purpose of the Banking Ordinance (thus effectively exempting them); and
- single-purpose SVCs which are effectively prepayments for specified goods and services are not subject to the legal framework.

Under the legal framework for the regulation of MPCs, the MA is the authority responsible for the authorization and exemption of electronic money schemes. Regulatory requirements relating to authorization, capital adequacy and liquidity will apply to the MPC issuers or facilitators by virtue of their status as AIs. Detailed regulatory requirements for MPC schemes are imposed through the power in the Ordinance to attach conditions to approval to issue/facilitate the issue of MPCs and through guidelines to be issued by the MA. This will include, for instance, the use of the funds received from cardholders and the separation of such funds from other funds maintained by the issuer/facilitator, the internal control and system requirements to guard against forgery and money laundering.

The MA has, so far, authorized one special purpose DTC with its principal activity for the issue of Octopus cards and the operation of the Octopus system. Octopus cards are “contactless” SVCs jointly developed by the major transport operators in Hong Kong for use in connection with transport and ancillary services.

Banks in Hong Kong introduced two general multi-purpose stored value cards namely, the Prime Visa Cash and the Mondex system, in 1996. However, due to changing market conditions, these cards were withdrawn from the market in early 2002.

¹⁸ In the case of a special purpose vehicle authorized as a DTC for the issue of MPCs, the MA may impose conditions on its authorization such that no deposits can be taken from the public other than the value of money stored on MPCs.

(b) Electronic banking and technology risk management

All major banks in Hong Kong have continued with the development of electronic banking (e-banking) services. Many are further extending such services to their corporate customers. Recognising these developments, the HKMA has implemented a comprehensive e-banking and technology risk management supervisory framework to ensure a secure and sound control environment for e-banking development in Hong Kong.

Under this framework, the HKMA developed an on-site examination programme focusing on e-banking and technology risk management, having regard to the practices of other bank supervisors in advanced economies and the guidance on e-banking risk management issued by the Basel Committee on Banking Supervision. Three pilot examinations were successfully conducted in 2001. The HKMA plans to complete approximately 40 such on-site examinations in 2002, focusing on all major banks and selected banks with higher risk exposure to technology. To facilitate the HKMA in prioritising its supervisory resources, the HKMA is compiling technology risk profiles of all banks and will implement a technology risk control self-assessment mechanism for banks.

The HKMA will also continue to enhance its guidelines on e-banking in line with international sound practices. To this end, the MA will issue a guideline on regulating advertising materials for deposits issued over the Internet.

Chapter 11 - Deposit protection

The failure of Bank of Credit and Commerce Hong Kong Ltd. in July 1991 prompted discussion on whether or not a deposit insurance scheme should be introduced in Hong Kong. A full scale public consultation was carried out in 1992 by the Government to gauge the support for such a scheme. This failed to produce clear support. Taking into account the result of the exercise, the Government decided that a deposit insurance scheme should not be introduced. Instead, it was decided that an alternative scheme, whereby small depositors would receive priority treatment in the event of a bank liquidation, should be put in place.

The “priority payment” scheme was embodied in the Companies Ordinance and commenced effect in 1995. Under that scheme, the first HK\$100,000 net deposits of eligible depositors (i.e. all depositors except persons connected with the bank being liquidated and other AIs) should receive priority payment in a liquidation of a licensed bank. The scheme applies to all eligible deposits, including resident and non-resident deposits, with terms to maturity of less than five years maintained with the local and overseas branches of a bank incorporated in Hong Kong and the local branches of a foreign bank. However, the scheme does not apply to RLBs and DTCs.

The Asian financial crisis highlighted the fact that external shocks and rumours may adversely affect confidence in individual banks and the system as a whole. The short and temporary run on a local bank in 1997 demonstrated the reaction that depositors can have to rumours even though these may be entirely unfounded. The occurrence of such events is not conducive to financial stability, particularly in times of crisis. In the Banking Sector Consultancy Study carried out in 1998, the consultants considered that the existing protection arrangements did not appear to have sufficiently raised the crisis of confidence threshold to avoid bank runs and that there was a strong case for enhancements to be made.

At the international level, there is a growing trend in favour of explicit forms of deposit protection. The G22 Working Party on Strengthening Financial Systems has recommended that each country should put in place explicit deposit protection arrangements, with clear specification of the nature of protection provided and the means of defraying costs. The IMF endorsed a limited form of deposit protection in its code of best practices. The Financial Stability Forum has created a Working Group to develop international guidance on deposit insurance in recognition of the crucial role of deposit insurance in contributing to confidence in the financial system.

In response to all these developments, the HKMA commissioned a Consultancy Study on enhancing deposit protection in Hong Kong in April 2000. The Study considered the relative costs and benefits of an explicit deposit insurance system, alternative means of deposit protection and the status quo, and considered that the best protection for small depositors would be achieved with a deposit insurance scheme (“DIS”). Based on the recommendations put forward, the HKMA issued a consultation paper in October 2000 to seek the public’s views on whether deposit protection should be enhanced and, if so, how. The consultation exercise indicated broad public support for the introduction of a DIS in Hong Kong. In the light of this, the Government approved in principle the proposal to introduce a DIS and requested the HKMA to undertake more detailed work with a view to

producing a set of final recommendations on how the scheme should be structured. This detailed design work has substantially been completed and a public consultation on how the scheme should be structured was initiated in March 2002.

In the consultation paper, the HKMA recommends that the DIS in Hong Kong should contain the following features:-

- An independent Deposit Insurance Board should be established to operate the scheme.
- The Board should operate with a lean structure. Its functions should be confined to collection of premiums, management of the funds of the DIS (DIS Fund), assessment of claims, making compensation payments and recovering payments from the estate of the failed bank.
- Participation should be compulsory for full licensed banks, but foreign bank branches in Hong Kong which are covered by a comparable scheme in their home jurisdiction may seek exemption.
- Coverage limit should be set at HK\$100,000 per depositor per bank.
- A differential premium system based on the CAMEL ratings of banks should be adopted by the scheme.
- The DIS should be funded by the industry. The target level of the DIS Fund should be set at 0.3% of the total balance of insured deposits of all banks (approximately HK\$1.5 billion based on the level of insured deposits at May 2001).
- The Exchange Fund would provide back-up liquidity to the DIS in the event that payout by the scheme is triggered.
- The scheme should adopt full netting. This means that a depositor's liabilities to the failed bank should be fully set off against his deposits before his entitlement is determined.

The consultation paper also contains proposals to deal with issues such as an appeal system for the scheme, protection of multi-beneficiary accounts, treatment of accrued interest, investment of the DIS Fund and co-ordination between the Board and the HKMA. The consultation period ends on 31 May 2002.

Chapter 12 - Control of money laundering activities

Legislation has been developed in Hong Kong to address the problems associated with the laundering of proceeds from drug trafficking and serious crimes. The Drug Trafficking (Recovery of Proceeds) Ordinance (“DTROP”) came into force in September 1989. It provides for the tracing, freezing and confiscation of the proceeds of drug trafficking and creates a criminal offence of money laundering in relation to such proceeds. The Organized and Serious Crimes Ordinance (“OSCO”), which was modelled on the DTROP, was brought into operation in December 1994. It extends the money laundering offence to cover the proceeds of indictable offences in addition to drug trafficking. With effect from 1 September 1995, both Ordinances were amended to impose a clear statutory obligation on a person (including AIs) to disclose knowledge or suspicion of money laundering transactions to the law enforcement agencies.

Based on the 1993 Money Laundering Guideline, the MA issued in October 1997 a revised industry Guideline on Prevention of Money Laundering (“the Guideline”) setting out in greater detail the standards and procedures expected of AIs in customer identification, record-keeping as well as recognition and reporting of suspicious transactions. The Guideline takes into account the relevant money laundering provisions in the DTROP and OSCO, as well as the results of the stock-taking review of the 40 recommendations of the Financial Action Task Force (“FATF”) on the combat against money laundering.

The Guideline specifically provides that AIs should have in place the following policies, procedures and controls:

- a clear statement of the AI’s policies in relation to money laundering which is communicated to all relevant staff and is reviewed on a regular basis;
- an instruction manual which sets out the AI’s procedures for account opening, customer identification, and record-keeping;
- a single reference point within the AI to which staff are instructed to report suspicious transactions promptly and which should have a clear means of liaison with the law enforcement agencies;
- education and training to staff on matters contained in the MA’s Guideline; and
- regular internal audit review on compliance with the AI’s policies, procedures and controls.

In addition, the Guideline sets out stringent customer identification requirements, particularly in respect of shell companies, trust and nominee accounts as well as other types of intermediaries. These requirements bring Hong Kong’s anti-money laundering supervisory framework in line with the latest recommendations of the FATF and the practices in other international financial centres.

The FATF formally adopted the Report of the Second Mutual Evaluation of Hong Kong at the Plenary Meeting in February 1999. The report commended Hong Kong’s anti-money laundering regime and the efforts made by the authorities to improve the

deficiencies identified in the First Mutual Evaluation. The report also pointed out that the effectiveness of the system could be further improved in certain areas, including those relating to money changers and remittance agents.

Legislative changes have been made to address some of the FATF's concerns. The Organized and Serious Crimes (Amendment) Ordinance 2000, which came into effect since 1 June 2000, requires all remittance agents and money changers to identify customers and keep record of transactions of HK\$20,000 (US\$2,560) or more. The new legislation also requires remittance agents and money changers to register with the Narcotics Bureau of the Hong Kong Police Force. Following the amendment of the Guideline in December 2000, the banking industry has also adopted the same record-keeping threshold for conducting money exchange and remittance transactions for non-accountholders.

Further amendments to the OSCO and the DTROP are undergoing legislative procedures. The Drug Trafficking and Organized Crimes (Amendment) Bill 2000 proposes, among other things, a new offence for a person to deal with property if he has "reasonable grounds to suspect" that the property in whole or in part represent proceeds of drug trafficking or an indictable offence. This is aimed at lowering the burden of proving the mental element of "knowing" or having "reasonable grounds to believe" in prosecution as contained in the current legislation. A similar amendment in relation to the obligation to report suspicious transactions is also proposed.

The HKMA has always attached particular importance to the maintenance of internal controls by AIs to combat money laundering. Such controls are necessary to maintain confidence in both individual AIs and the banking system as a whole and to protect the reputation of Hong Kong as an international financial centre. Controls against money laundering is the subject of regular discussion with the senior management of AIs and their auditors. In addition, special teams have been set up to conduct focussed examinations on AIs in respect of the prevention of money laundering, including compliance with the Guideline. If necessary, the MA may commission under the Banking Ordinance an auditor's report to review the effectiveness of an AI's internal control systems for this purpose.

Apart from requiring AIs to observe the relevant FATF recommendations as set out in the Guideline, the MA keeps AIs closely informed of other FATF initiatives. In particular, the HKMA has asked AIs to give special attention to businesses and transactions with persons, including companies and financial institutions, from the Non-Cooperative Countries and Territories ("NCCTs") designated by the FATF. Where additional counter-measures are recommended by the FATF against a specific NCCT due to its failure to address the deficiencies in its anti-money laundering regime, the HKMA has also issued prompt specific guidance to AIs. The HKMA will take into account the fact that an institution is from a NCCT in considering its application to become an AI.

Following the terrorist attacks in the US in September 2001, the FATF extended its scope of work to include the fight against terrorist financing. The HKMA pledges full support to the FATF efforts, and has pointed AIs to lists of designated terrorist suspects available in the public domain. AIs are required to check if they have or have had dealings with those designated persons, and if so report immediately to the HKMA as well as the relevant financial intelligence unit.

In addition, the HKMA is undertaking work to enhance its supervisory approach in the prevention of money laundering (including terrorist financing). This will involve introducing a self-assessment framework for AIs and further revising the Guideline. The latter exercise aims to incorporate recommendations contained in the Basel Committee paper “Customer Due Diligence for Banks” issued in October 2001 and also the relevant FATF special recommendations to counter terrorism financing. The HKMA will also conduct more in-depth examinations on selected AIs in this aspect.

Chapter 13 - Recent developments in the financial system and supervisory regime

(a) Banking reform

Having carefully evaluated the recommendations arising from a consultancy study and the response from public consultation, the HKMA announced in July 1999 a reform programme to further develop the banking sector in Hong Kong. The objectives of the reform programme were two-fold: firstly, to encourage market liberalisation and enhance competitiveness in the banking sector; and secondly, to strengthen banking infrastructure with the objective of enhancing the safety and soundness of the sector. Since the reform programme was announced, a number of policy initiatives have been implemented.

(i) Market reform and liberalisation measures

Three-building condition

The three-building condition which restricted foreign banks licensed after 1978 to operate from not more than three buildings was completely relaxed in November 2001. From then onwards, these banks are allowed to set up an unlimited number of offices in an unlimited number of buildings. The relaxation has provided foreign banks with greater flexibility in doing business in Hong Kong.

Access to Real Time Gross Settlement

RLBs have been allowed access to the Real Time Gross Settlement system, the interbank payment system, since May 2000, to which access was restricted only to licensed banks in the past. This measure allows RLBs to provide more efficient settlement services to their customers and enables them to compete with licensed banks on a more equal footing.

Interest rate deregulation

Retail deposit rates offered by banks in Hong Kong have been subject to the Interest Rate Rules (“IRRs”) of the Hong Kong Association of Banks (the industry association for licensed banks). Some of these Rules were first relaxed during 1994/95. To promote greater competition in the banking sector, the HKMA undertook in 1999 to deregulate the remaining IRRs in two phases. The first phase of deregulation which covered time deposits with a maturity of less than seven days and the prohibition on benefits for all deposits (except HK\$ savings and current accounts) took effect in July 2000. The remaining IRRs covering savings and current account deposits were removed in July 2001. Following this, interest rates on all types of deposits are determined by competitive market forces.

Review of market entry criteria and three-tier system

A review of the existing market entry criteria for licensed banks and the three-tier authorization system was undertaken in the fourth quarter of 2001. In view of the ongoing consolidation in the banking sector and the strengthening of the banking supervisory system over the years, the HKMA believes that some of the existing market entry criteria can

be relaxed without compromising banking stability. The proposals arising from the review include:

In relation to the market entry criteria

- replacing the US\$16 billion asset size criterion for foreign bank applicants by the much lower size criteria applicable to local bank applicants which are at present HK\$3 billion for deposits and HK\$4 billion for assets respectively;
- increasing the minimum paid-up capital requirement for local bank applicants from HK\$150 million to HK\$300 million and extending this requirement to foreign bank applicants (in respect of the bank as a whole);
- reducing the period of operation as a RLB or DTC from ten to three years and dispensing with the “association with Hong Kong” requirement for locally incorporated applicants seeking to upgrade to full licensed bank status;
- allowing existing foreign incorporated banks to subsidiarise their Hong Kong operations if such banks have been established in Hong Kong for at least three years and their Hong Kong operations meet the deposit and asset size criteria applicable to local bank applicants as set out above;
- removing the general requirement that a foreign bank should maintain a local representative office in Hong Kong for at least one to two years before it can be considered for authorization;

In relation to the three-tier authorization system

- maintaining the current three-tier authorization system until the proposed changes to the market entry criteria have bedded down and worked their way through the system; and
- allowing locally incorporated RLBs to use the names of their banking parents in the names or descriptions under which they carry on business in Hong Kong.

It is expected that the implementation of the above proposals will be completed in the first half of 2002.

(ii) **Safety and soundness enhancement measures**

Clarify the MA's role as lender of last resort

In June 1999, the MA issued a policy statement on his role as lender of last resort to the banking sector. The policy statement clarified the circumstances in which the MA would provide emergency funding support to banks with short-term liquidity problems and the types of funding support that would be available to them.

Enhancing deposit protection

The Consultancy Study on enhancing deposit protection was completed. The Study critically assessed the effectiveness of the current deposit protection arrangements vis-à-vis other options like an explicit insurance system or alternative means of deposit protection. It recommended that the best protection for small depositors would be achieved by introducing a DIS in Hong Kong. A full public consultation in respect of the recommendations took place in the fourth quarter of 2000. In view of the broad public support received, the Government approved in principle the proposal to introduce a DIS in Hong Kong and requested the HKMA to undertake more detailed work with a view to producing a set of final recommendations on how the scheme should be structured. This detailed design work has substantially been completed and a public consultation on how the Scheme should be structured was initiated in March 2002. After receiving the public's views on the proposed design features of the scheme, relevant legislation to put it into effect will be prepared. (Please see Chapter 11 for details.)

Commercial credit reference agency (CCRA)

A public consultation on the establishment of a CCRA in Hong Kong was concluded in September 2000. The results indicated broad support from banks and the corporate sector for the idea. There was also general agreement that a CCRA would help enhance banks' credit risk management and, at the same time, help improve companies' access to bank funding, particularly in respect of small and medium enterprises ("SMEs"). In view of the general support received for the proposal, the HKMA convened in 2001 a Working Group comprising cross-industry representatives from the banking and other sectors to take the initiative forward. The Working Group has completed consideration of how the scheme should be structured and, following consultation with the industry Associations, recommended a CCRA scheme targeting at SME customers based on the voluntary participation by AIs. The industry Associations will form a Working Party to follow up on the implementation of this market-based scheme.

Sharing of positive consumer credit data

It is also important to develop a full-fledged credit reference agency at the personal level to bridge the information gap between banks and borrowers. At present, information sharing at the personal level is restricted to mainly negative (default) data under the privacy legislation in Hong Kong. The HKMA and the banking industry are working with the Privacy Commissioner for Personal Data to pursue full sharing of positive consumer credit data while ensuring that privacy concerns are appropriately addressed.

Corporate governance

The MA issued a Guideline on “Corporate Governance of Locally Incorporated Authorized Institutions” in May 2000 to enhance corporate governance standards in the banking sector. The Guideline was updated and incorporated into the HKMA’s Supervisory Policy Manual in September 2001. In addition to describing the responsibilities and obligations of the board of directors, the Guideline sets out a number of specific requirements to which the boards of all locally incorporated AIs are expected to adhere. The main requirements include:

- the board should ensure that the AI establishes policies, procedures and controls to manage the various types of risk the AI faces;
- the board should maintain an appropriate level of checks and balances against the influence of the management or the shareholder controllers. To this end, it is recommended, in the case of banks, that the board should include at least three independent non-executive directors;
- the board should establish an audit committee which should be made up of non-executive directors, the majority of whom should be independent;
- board meetings should be held preferably on a monthly basis but in any event no less than once every quarter; and
- individual directors should attend at least half of board meetings held in each financial year.

The Guideline also requires the HKMA to meet the full board of directors of each local bank every year to communicate major supervisory concerns and provide an assessment of the performance of the bank in the previous financial year, current financial position of the bank and the quality of the bank’s risk management and internal control systems.

The Guideline is currently subject to review in the light of recent developments such as changes in the rules of the Hong Kong Stock Exchange on corporate governance and lessons to be learnt from recent corporate failures.

With a view to further enhancing corporate governance among AIs, the HKMA has proposed in the Banking (Amendment) Ordinance 2001 to add a new authorization criterion in the Banking Ordinance that AIs should maintain adequate systems of control to ensure that persons appointed to hold senior managerial positions within the organisation (referred to as “managers” under the Banking Ordinance) are fit and proper. This recognises that “managers” could play an important role in ensuring the safety and soundness of AIs. A guideline setting out the key elements of such systems has been developed and will be issued upon the commencement of the Banking (Amendment) Ordinance 2001.

(b) Banking supervisory policies

(i) Supervisory Policy Manual

In July 2000, the HKMA commenced development of a Supervisory Policy Manual to reflect its latest banking supervisory standards and practices. The Manual will support the risk-based supervisory approach by promoting proper standards of business conduct and prudent risk management practices among AIs so that they operate in a safe and sound manner.

In developing the Manual, the HKMA is drawing on its existing guidelines, circulars, examiners' manuals and the supervisory experience of its staff. In addition, reference is being made to international standards, particularly those promulgated by the Basel Committee on Banking Supervision, guidelines of overseas banking regulatory authorities and suggestions from the banking industry.

The Manual comprises 66 modules, covering inter alia, the HKMA's risk-based supervisory approach, credit management, capital adequacy, corporate governance, internal controls, interest rate risk management, liquidity management, trading activities, technology risk management and financial disclosure. It is being rolled out in stages, as batches of modules are finalised. Up to December 2001, a total of 30 modules have been issued. In order to enhance the transparency of the HKMA's supervisory policies, readers are able to access the Manual on-line through the HKMA's website.

(ii) New Capital Accord

The Basel Committee on Banking Supervision completed the second round of consultation on the New Capital Accord at the end of May 2001. The HKMA has written to the Committee to reflect a number of views and comments on the New Accord, including those of the local banking industry. It will continue to monitor closely developments in relation to the New Accord and take part in the quantitative impact study and the next consultation to be conducted by the Committee in due course. It will also reflect views on the revised proposals through participation in international forums or meetings. In line with its policy of adopting international best practices and standards, the HKMA will aim to implement the New Accord in Hong Kong in 2005 (i.e. the timetable set by the Committee). While it is expected that most locally incorporated AIs will, initially at least, use the standardised approach to calculate capital requirements, some may wish to use the internal ratings-based ("IRB") approach. The HKMA will endeavour to facilitate banks using this approach provided they can demonstrate their readiness and capability to meet the supervisory standards set out by the Committee.

In the case of AIs that do not wish to formally use the IRB approach (which may be inappropriate for smaller banks), the HKMA will nevertheless encourage them where appropriate to adopt some elements of the IRB approach with a view to improving risk management. In particular, they should try to develop or enhance their internal rating systems to enable greater risk differentiation among borrowers of different quality. This will mean developing an internal rating system which has multiple grades for loans that are not yet irregular (i.e. those under the "pass" grade) and which is able to track the migration of individual loans through the various grades. The HKMA is also reviewing how the existing

loan classification system should be enhanced to bring it more in line with the Committee's requirements for internal ratings under the IRB approach.

To facilitate the implementation process, the HKMA issued for industry consultation in October 2001 its preliminary proposals on the introduction of the New Accord in Hong Kong. There was general support for the proposals. The HKMA will continue to consult the industry on its policy intentions for implementing the New Accord. Besides, it will keep the industry informed of developments of the New Accord and consult and reflect its views where appropriate.

(c) Consumer protection

The HKMA has undertaken a number of initiatives over the last year or so to improve protection for bank customers, despite the fact that it does not have an explicit mandate in relation to consumer protection.

The Code of Banking Practice was subject to a comprehensive review in 2001 and the revised Code became effective in December 2001. As a result of the review, substantial improvements have been made to the Code to further increase the transparency of banking services and to afford customers broader and more specific protection. In order to enhance the enforcement of the Code, the HKMA has introduced a new self-assessment framework and banks are required to provide an annual assessment report to the HKMA starting in September 2002. Moreover, a new Code of Banking Practice Committee, on which the HKMA is represented, has been formed by the industry to provide guidance on the interpretation of the Code and undertake future review of the Code.

The HKMA has formalised a guideline on AIs' complaint handling procedures which was issued in February 2002. The guideline recommends all AIs to have in place complaint handling procedures in order to provide an accessible, efficient and fair mechanism for resolving customer complaints.

In respect of how banking consumer protection should be further enhanced in Hong Kong, the HKMA has identified a number of issues, such as the role of the HKMA and the industry Associations in consumer protection and whether there is a need for a Banking Ombudsman Scheme in Hong Kong. The HKMA has an open mind on these issues and will continue to consult the relevant organisations on how consumer protection in the banking sector can be further enhanced without imposing too heavy a regulatory burden on AIs. In general, however, the current view of the HKMA is that the current arrangements are working reasonably well, and that an explicit statutory responsibility for the HKMA in consumer protection is probably not necessary at this stage.

(d) Business continuity planning

In the light of the events of 11 September, the HKMA conducted a business continuity planning readiness self-assessment of 25 banks in Hong Kong. It also organised an informal discussion forum to share experiences among seven banks, the Financial Services Bureau and the Hong Kong Interbank Clearing Limited in dealing with large scale disasters. A number of valuable lessons have been learned and they have been conveyed to AIs through a circular letter in early 2002. The HKMA will continue its research in this area, taking into

account guidance being developed by the international regulatory community and issue more detailed guidelines on business continuity planning in 2002. Moreover, the HKMA is liaising with the Government and other financial regulators in Hong Kong on what further steps should be taken to develop sector-wide contingency procedures and crisis management arrangements.

(e) US dollar clearing system

Hong Kong's US dollar clearing system was introduced in 2000 to facilitate the efficient settlement of US dollar transactions in Hong Kong during Asian hours. In March 2000, the HKMA appointed The Hongkong and Shanghai Banking Corporation Limited to be the settlement institution for the US dollar clearing system for a franchise period of five years starting from 1 August 2000. Hong Kong Interbank Clearing Limited is the clearing operator for both the Hong Kong dollar and US dollar interbank payment systems.

**Hong Kong Monetary Authority
April 2002**

**Authorized institutions with overseas branches for which the Monetary Authority
is the home supervisor (as at 26.6.2001)**

Banks incorporated in Hong Kong

1. Asia Commercial Bank Limited
2. Bank of East Asia, Limited (The)
3. Chekiang First Bank Limited
4. Chiyu Banking Corporation Limited
5. CITIC Ka Wah Bank Limited
6. Dah Sing Bank Limited
7. Dao Heng bank Limited
8. Hang Seng Bank Limited
9. Hongkong & Shanghai Banking Corporation Limited (The)
10. Hongkong Chinese Bank Limited (The)
11. HSBC Investment Bank Asia Limited
12. Hua Chiao Commercial Bank Limited
13. Industrial & Commercial Bank of China (Asia) Limited
14. Jardine Fleming Bank Limited¹
15. Liu Chong Hing Bank Limited
16. Nanyang Commercial Bank Limited
17. Overseas Trust Bank Limited
18. Po Sang Bank Limited²
19. Shanghai Commercial Bank Limited
20. Wing Hang Bank Limited
21. Wing Lung Bank Limited

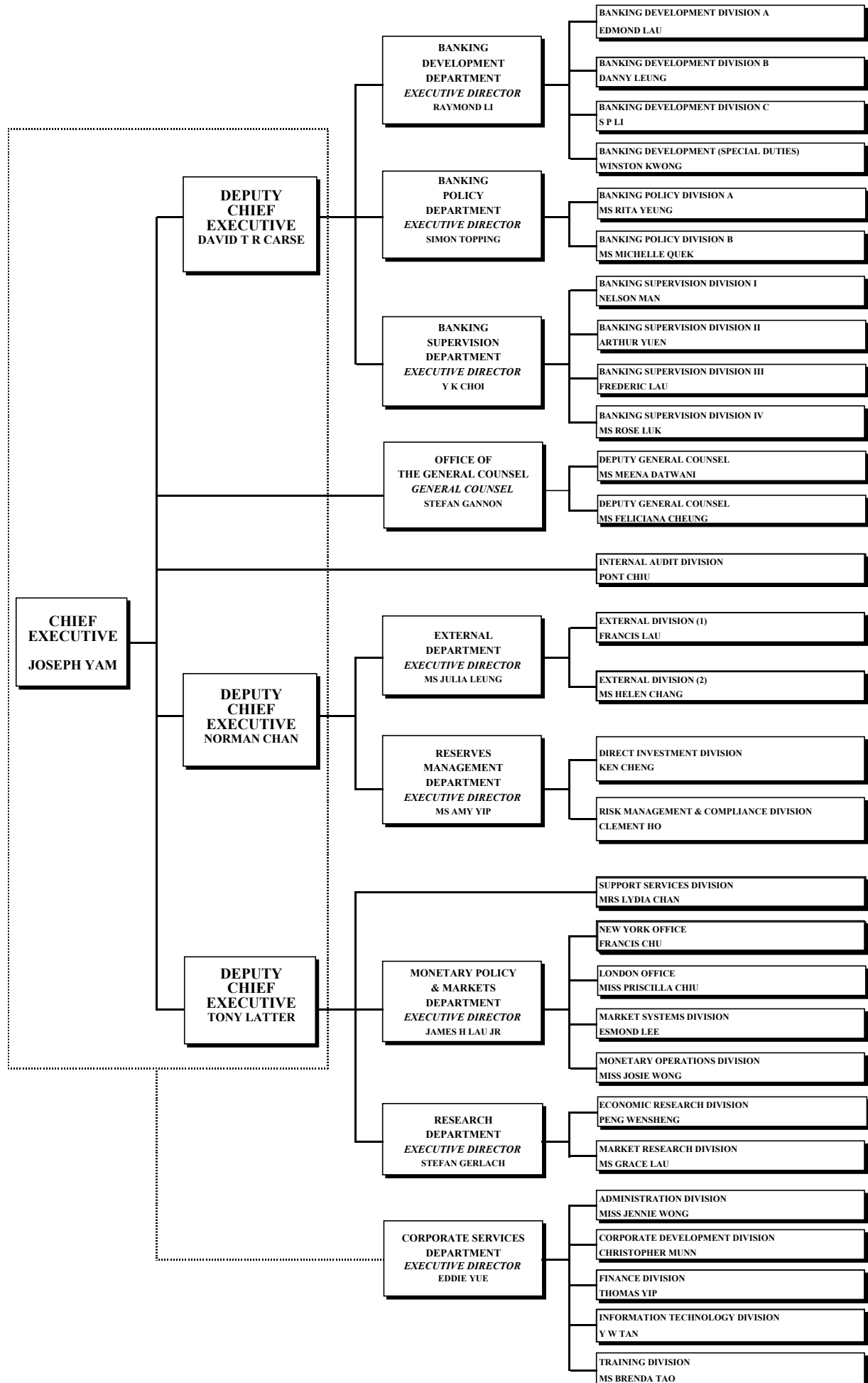
¹ Name changed to Standard Bank Asia Limited with effect from 3 July 2001.

² Name changed to Bank of China (Hong Kong) Limited upon its merger with nine other member banks of the Bank of China Group on 1 October 2001.

**International banking groups for which the Monetary Authority
is the home supervisor (as at 26.6.2001)**

<u>Name of banking group</u>	<u>Name of overseas subsidiaries which undertake banking activities</u>
1. Bank of America (Asia) Ltd.	Bank of America (Macau) Ltd.
2. Bank of East Asia, Ltd. (The)	The Bank of East Asia (BVI) Ltd. The Bank of East Asia (Canada) FP Bank (Vanuatu) Ltd. United Chinese Bank (BVI) Ltd.
3. Chekiang First Bank Ltd.	Chekiang First Bank (Luxembourg) S.A.
4. Dao Heng Bank Ltd.	Dao Heng Bank (London) Plc
5. Hongkong & Shanghai Banking Corporation Ltd. (The)	Hang Seng Bank (Bahamas) Ltd. Corebridge Bank Ltd. HSBC Bank Australia Ltd. HSBC Bank Kazakhstan HSBC Finance (Australia) Pty Ltd. Midland Australia Ltd. XDP, Inc.
6. International Bank of Asia Ltd	IBA Bank Ltd.
7. Liu Chong Hing Bank Ltd.	Liu Chong Hing Banking Corporation
8. Wing Hang Bank Ltd.	Banco Weng Hang S.A.R.L. Wing Hang Bank (Cayman) Ltd.

Hong Kong Monetary Authority Organisation Structure



SEVENTH SCHEDULE

[ss. 16(2) & (10),
17, 29(2) & 135(1)
& 8th Sch.]

MINIMUM CRITERIA FOR AUTHORIZATION

1. (1) In this Schedule—
- “adequate” (足夠), in relation to systems of control, includes operating effectively;
- “controller” (控權人) includes a minority shareholder controller;
- “net debit balance” (借方淨差額), in relation to a company, means the aggregate of the excess of accumulated losses over accumulated profits disclosed in the profit and loss account, and other reserves separately disclosed in the balance sheet, of the most recent audited accounts of the company;
- “share premium account” (股份溢價帳)—
- (a) in relation to a company incorporated in Hong Kong, means a share premium account referred to in section 48B(1) of the Companies Ordinance (Cap. 32) maintained in respect of the company;
 - (b) in relation to a company incorporated outside Hong Kong, means an account having the same characteristics of a share premium account referred to in section 48B(1) of the Companies Ordinance (Cap. 32) irrespective of its name; (*Added L.N. 130 of 2001*)
- “systems of control” (管控制度) includes procedures.
- (2) For the purposes of the calculation of the paid-up share capital of a company required by this Schedule, there shall be deducted from such share capital any net debit balance.
- (3) For the avoidance of doubt, it is hereby declared that where pursuant to the provisions of this Schedule the Monetary Authority holds an opinion, or is satisfied, in relation to any matter, his holding that opinion or being so satisfied, as the case may be, shall not of itself bind the Monetary Authority—
- (a) to continue to hold that opinion or to be so satisfied, as the case may be, whether before, on or after the authorization, if any, of the company to which the matter directly or indirectly relates (including any case where that company is seeking a different authorization); or

- (b) to hold any similar opinion or to be similarly satisfied, as the case may be, in respect of any similar matter which directly or indirectly relates to any other company seeking or having the same or a different authorization from that first-mentioned company.
- (4) Without prejudice to the generality of subparagraph (3), the Monetary Authority may regard himself as being satisfied in relation to any matter in respect of which he may be satisfied pursuant to the provisions of this Schedule where—
- (a) the matter directly or indirectly relates to a company incorporated outside Hong Kong;
 - (b) the relevant banking supervisory authority informs the Monetary Authority that it is satisfied in relation to that matter; and
 - (c) the Monetary Authority is satisfied as to the scope and nature of the supervision exercised by that authority.
- (5) For the avoidance of doubt, it is hereby declared that subparagraph (4) shall operate before, on and after the authorization, if any, of the company to which any matter referred to in that subparagraph directly or indirectly relates.
- (6) For the purposes of paragraph 13(b)(ii)(A)(VI) and (VII), a company is an associated company of any other company where that second-mentioned company may—
- (a) by means of the holding of shares or the possession of voting power in or in relation to that first-mentioned company or any other body corporate; or
 - (b) by virtue of any powers conferred by the memorandum or articles of association or other document regulating that first-mentioned company or any other body corporate,
- significantly influence the conduct of the affairs of that first-mentioned company.
2. If the company is incorporated outside Hong Kong, it is a bank—
 - (a) as defined in section 46(9); and
 - (b) in respect of which the Monetary Authority is satisfied that it is adequately supervised by the relevant banking supervisory authority.
 3. The Monetary Authority is satisfied that he knows the identity of each controller of the company.
 4. If the company is incorporated in Hong Kong, the Monetary Authority is satisfied that each person who is, or is to be, a director, controller or chief executive of the company is a fit and proper person to hold the particular position which he holds or is to hold.
 5. If the company is incorporated outside Hong Kong, the Monetary Authority is satisfied that each person who is, or is to be—
 - (a) a chief executive of the business in Hong Kong of the company;
 - (b) a director, controller or chief executive of the business of the company in the place where it is incorporated,
 is a fit and proper person to hold the particular position which he holds or is to hold.
 6. The Monetary Authority is satisfied that the company presently has, and will if it is authorized continue to have, adequate financial resources (whether actual or contingent) for the nature and scale of its operations and, without prejudice to the generality of the foregoing—
 - (a) in the case of a company incorporated in Hong Kong seeking authorization to carry on banking business in Hong Kong, the aggregate amount of its paid-up share capital and the balance of its share premium account is not less than \$150,000,000 or an equivalent amount in any other approved currency; (*Amended L.N. 130 of 2001*)
 - (b) in the case of a company seeking authorization to carry on a deposit-taking business as a deposit-taking company, the aggregate amount of its paid-up share capital and the balance of its share premium account is not less than \$25,000,000 or an equivalent amount in any other approved currency; (*Amended L.N. 130 of 2001*)
 - (c) in the case of a company seeking authorization to carry on a deposit-taking business as a restricted licence bank, the aggregate amount of its paid-up share capital and the balance of its share premium account is not less than \$100,000,000 or an equivalent amount in any other approved currency; (*Amended L.N. 130 of 2001*)

- (d) in the case of a company incorporated in Hong Kong, the company, if it is authorized, will on and after authorization have and maintain a capital adequacy ratio which complies with the provisions of Part XVII applicable to it; (*Amended L.N. 431 of 1997*)
- (e) in the case of a company incorporated in Hong Kong, the company presently has, and will if it is authorized continue to have, adequate capital to support any positions held by the company—
- (i) for trading purposes in debt securities, interest rate-related contracts, equities and equity-related contracts; and
 - (ii) in foreign exchange, exchange rate-related contracts, commodities and commodity-related contracts,
- having regard to any potential loss arising from fluctuations in the value of those positions. (*Added L.N. 431 of 1997*)
7. The Monetary Authority is satisfied that the company—
- (a) presently maintains, and will if it is authorized continue to maintain, adequate liquidity to meet its obligations as they will or may fall due; and
 - (b) without prejudice to the generality of subparagraph (a), if it is authorized, will on and after authorization have and maintain a liquidity ratio which complies with the provisions of Part XVIII applicable to it.
8. The Monetary Authority is satisfied that the company, if it is authorized, will on and after authorization comply with the provisions of Part XV applicable to it.
9. The Monetary Authority is satisfied that the company presently maintains, and will if it is authorized continue to maintain, adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.
10. The Monetary Authority is satisfied that the company presently has, and will if it is authorized continue to have, adequate accounting systems and adequate systems of control.
11. If the company is incorporated in Hong Kong, the Monetary Authority is satisfied that it presently discloses, and will if it is authorized continue to disclose, adequate information—
- (a) in relation to the state of its affairs and its profit and loss; and
 - (b) in—
 - (i) its audited annual accounts within the meaning of section 60(11);
 - (ii) any supplementary information to those audited annual accounts;
 - (iii) the report of the directors under section 129D(1) of the Companies Ordinance (Cap. 32); and
 - (iv) the institution's cash flow statement, together with any notes thereon, where the statement does not already form part of those audited annual accounts.
12. The Monetary Authority is satisfied that the business of the company is presently, and will if it is authorized continue to be, carried on—
- (a) with integrity, prudence and the appropriate degree of professional competence; and
 - (b) in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors.
13. Where the company is seeking authorization to carry on banking business in Hong Kong—
- (a) in the case of a company incorporated outside Hong Kong—
 - (i) either—
 - (A) the total assets (less contra items) of the whole banking group of which the company is a part are more than US\$16,000,000,000 or an equivalent amount in any other approved currency; or
 - (B) that, in the opinion of the Monetary Authority, authorizing the company to carry on banking business in Hong Kong would help to promote the interests of Hong Kong as an international financial centre; and
 - (ii) either—

- (A) there is, in the opinion of the Monetary Authority, an acceptable degree of reciprocity in respect of banks incorporated in Hong Kong seeking to carry on banking business in the place where that company is incorporated; or
 - (B) the place where that company is incorporated is, or is part of the territory of, a member of the World Trade Organization; (*Replaced L.N. 70 of 1996*)
- (b) in the case of a company incorporated in Hong Kong—
- (i) it is, in the opinion of the Monetary Authority, closely associated and identified with Hong Kong;
 - (ii) it has—
 - (A) total deposits from the public of not less than \$3,000,000,000, or an equivalent amount in any other approved currency, excluding any deposits by—
 - (I) any authorized institution;
 - (II) any bank incorporated outside Hong Kong which is not an authorized institution;
 - (III) any controller or director of the company;
 - (IV) any relative, within the meaning of section 79, of any such controller or director;
 - (V) any firm, partnership or body corporate in which the company, any controller or director of the company or any relative, within the meaning of section 79, of any such controller or director, is interested as director, partner, manager or agent;
 - (VI) any holding company, subsidiary or associated company of the company;
 - (VII) any subsidiary or associated company of any such holding company; and
 - (B) total assets (less contra items) of not less than \$4,000,000,000 or an equivalent amount in any other approved currency; and
 - (iii) it has been a deposit-taking company or a restricted licence bank (or any combination thereof) for not less than 10 continuous years.
(*Seventh Schedule added 49 of 1995 s. 52*)

Regulatory returns

<u>Frequency of submission</u>	<u>Name of return</u>
Weekly	Weekly Statement of Certain Assets and Liabilities
Monthly	Assets and Liabilities (Hong Kong Offices) External Liabilities and Claims Foreign Currency Position HKD Interbank Transactions Liquidity Position
Quarterly	Assets and Liabilities (Combined) Assets and Liabilities (Overseas Branches) Capital Adequacy Ratio Market Risk Exposures Certificate of Compliance Interest Rate Risk Exposures Large Exposures Loans and Advances and Provisions Maturity Profile Profit and Loss Account
Half-yearly	Cross-Border Claims Mandatory Provident Fund Related Activities Securities Related Activities

©2002 Hong Kong Monetary Authority

Hong Kong Monetary Authority

30/F, 3 Garden Road, Hong Kong

Tel: (852) 2878 8222

Fax: (852) 2878 2010

E-mail: hkma@hkma.gov.hk

Website: <http://www.hkma.gov.hk>