

CHAPTER 3

THE LEGAL AND SUPERVISORY FRAMEWORK

- 3.1 This chapter describes the legal and policy framework of the supervisory regime of Hong Kong, and the administration of supervision within that framework.

Legal framework

- 3.2 The Ordinance provides the legal framework for banking supervision in Hong Kong. The objectives of the Ordinance are set out in its long title -

“To regulate banking business and the business of taking deposits; to make provision for the supervision of authorized institutions so as **to provide a measure of protection to depositors; to promote the general stability and effective working of the banking system**; to make provision for the supervision of money brokers; and to provide for matters incidental thereto or connected therewith.”

- 3.3 Promoting the general stability and effective working of the banking system is specified in section 7(1) of the Ordinance as the principal function of the MA under the Ordinance. In this connection, section 7(2) further provides that the MA shall -
- (a) be responsible for supervising compliance with the provisions of the Ordinance;
 - (b) take all reasonable steps to ensure that the principal places of business, local branches, local offices, overseas branches and overseas representative offices of all authorized institutions and local representative offices¹ (LROs) are operated in a responsible, honest and business-like manner;
 - (c) promote and encourage proper standards of conduct and sound and prudent business practices amongst authorized institutions and money brokers;
 - (d) suppress or aid in suppressing illegal, dishonorable or improper practices in relation to the business practices of authorized institutions;
 - (e) 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 Ordinance or any other Ordinance;
 - (f) consider and propose reforms of the law relating to banking business and the business of taking deposits; and

¹ For definition of local representative office, please see paragraph 2.13.

- (g) take all reasonable steps to ensure that any banking business, any business of taking deposits, or any other business, carried on by an authorized institution is carried on -
 - (i) with integrity, prudence and the appropriate degree of professional competence; and
 - (ii) in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors.

3.4 In fulfilment of its objectives, the Ordinance contains a number of detailed provisions, including those which relate to -

- (a) banking business and business of taking deposits to be carried on by authorized institutions only (Part III);
- (b) authorization (Part IV and the [Seventh Schedule](#));
- (c) revocation and suspension of authorization (Part V, Part VI and the [Eighth Schedule](#));
- (d) powers of control over authorized institutions (Part X);
- (e) audits and publication of audited accounts (Part XI);
- (f) disclosure of information by authorized institutions (Part XII);
- (g) ownership and management of authorized institutions (Part XIII);
- (h) limitations on loans by and interests of authorized institutions (Part XV);
- (i) advertisements, representations and use of title “bank” (Part XVI);
- (j) capital requirements (Part XVIA); and
- (k) liquidity requirements (Part XVIB).

A number of these provisions are described in greater detail in subsequent chapters.

3.5 It should be noted that the MA is concerned with the entire business of an authorized institution, rather than only the banking or deposit-taking business. In particular, the MA has a significant role to play in the co-operative supervisory regime set out in the Securities and Futures Ordinance (SFO), in relation to the securities business of authorized institutions. Under the regime the MA acts as the front-line supervisor of authorized institutions, conducting day-to-day supervision of their securities business. The MA adopts regulatory standards equivalent to those applied by the Securities and Futures Commission (SFC) to the licensed corporations, and where necessary issues circulars and prescribes additional benchmarks to authorized institutions to facilitate

their compliance with the SFC's standards in the banking environment and may prescribe, as may be necessary in the exercise of his functions, additional benchmarks.

- 3.6 Authorized institutions intending to carry on any of the following securities and futures activities (defined as "regulated activities" in [Schedule 5](#) of the SFO): dealing in and/or advising on securities, dealing in and/or advising on futures contracts, advising on corporate finance, providing automated trading services, asset management and providing credit rating services² are required to register with the SFC as registered institutions under the SFO. If an applicant intends to conduct Initial Public Offering activities, it is expected to do so through Type 6 licensed corporations within the same group.
- 3.7 Meanwhile, the MA is the frontline regulator of Insurance and Mandatory Provident Fund (MPF) intermediaries in the banking sector under the relevant statutory regimes. In supervising authorized institutions' insurance and MPF intermediary activities, the MA monitors the institutions' compliance with the applicable regulatory requirements promulgated by the MA and other relevant regulatory authorities.
- 3.8 In addition, the MA cooperates with the SFC in the regulation of the over-the-counter (OTC) derivative market in Hong Kong. The regulatory framework is set out in the SFO, encompassing mandatory reporting, clearing and trading obligations in respect of specified OTC derivative transactions, and related record keeping obligations. The precise provisions relating to such obligations (which are implemented in phases) are set out in subsidiary legislation (i.e. in the form of rules) under the SFO. Under this framework, the MA is the principal supervisor of the OTC derivative activities of authorized institutions and approved money brokers.

Statutory rules, guidelines and codes of practice

- 3.9 The legal framework under the Ordinance is supplemented by statutory rules, codes of practice and guidelines issued by the MA where necessary under various sections of the Ordinance.
- 3.10 Section 60A(1) of the Ordinance provides that the MA may, after consultation with the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks and The DTC Association, make rules prescribing the information to be disclosed to the general public by authorized institutions relating to their state of affairs, including their profit and loss and their financial resources (including capital resources and liquidity resources), and prescribing the manner in which, times at which and periods during which such information shall be so disclosed. (Banking (Disclosure) Rules – see paragraph 4.95)

² [Schedule 5](#) of the SFO excludes certain types of activities from the definition of "providing credit rating services", including the provision of private ratings and credit data collection. For more details, please refer to [Schedule 5](#) of the SFO and a series of [Credit Rating Agencies-specific Frequently Asked Questions](#) on the SFC's website.

- 3.11 Section 97C(1) of the Ordinance provides that the MA may, after consultation with the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks and The DTC Association, make rules prescribing capital requirements for authorized institutions incorporated in Hong Kong, taking into account the risks associated with the institutions. (Banking (Capital) Rules – see paragraph 4.45)
- 3.12 Section 97H(1) of the Ordinance provides that the MA may, after consultation with the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks and The DTC Association, make rules prescribing liquidity requirements for authorized institutions, taking into account the liquidity risks associated with the institutions. (Banking (Liquidity) Rules – see paragraph 4.57)
- 3.13 Section 97M of the Ordinance provides that the MA may, after consultation with the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks and The DTC Association, approve and issue codes of practice for the purposes of providing guidance in respect of any rules made under section 60A(1), 97C(1) or 97H(1) of the Ordinance. (To date, the MA has issued a Banking (Liquidity Coverage Ratio – Calculation of Total Net Cash Outflows) Code to provide guidance on the calculation of “total net cash outflows” (denominator of the Liquidity Coverage Ratio (LCR)) under the Banking (Liquidity) Rules.)
- 3.14 In respect of guidelines -
- section 7(3) of the Ordinance provides that the MA may from time to time cause to be prepared and published by notice in the Gazette guidance indicating the manner in which he proposes to exercise functions conferred or imposed by or under the Ordinance upon him.
 - section 16(10) of the Ordinance provides that the MA may from time to time cause to be prepared and published by notice in the Gazette, for the guidance of companies seeking to be authorized, guidelines not inconsistent with the Ordinance, indicating the manner in which he proposes to exercise functions conferred or imposed by the [Seventh Schedule](#) upon him.
 - section 82(1) of the Ordinance provides that the MA may, after consultation with the Financial Secretary, by notice in the Gazette from time to time publish for the guidance of authorized institutions, guidelines, not inconsistent with the Ordinance, specifying business practices which should not be engaged in by authorized institutions because, in his opinion, such business practices will or may cause the soundness of the financial position of authorized institutions to be dependent upon the soundness of the financial position of a single party.
 - section 118C(7) of the Ordinance provides that the MA may from time to time cause to be prepared and published by notice in the Gazette, for the guidance of companies seeking approval to act as money broker, guidelines not inconsistent with the Ordinance, indicating the manner in which he

proposes to exercise functions conferred or imposed by the [Eleventh Schedule](#) upon him.

- 3.15 In addition to these statutory guidelines, the MA regularly issues non-statutory guidance notes, setting out recommendations in respect of standards which authorized institutions should aim to achieve, and non-statutory technical notes, clarifying the MA's interpretation of regulatory and reporting matters.

Policy framework

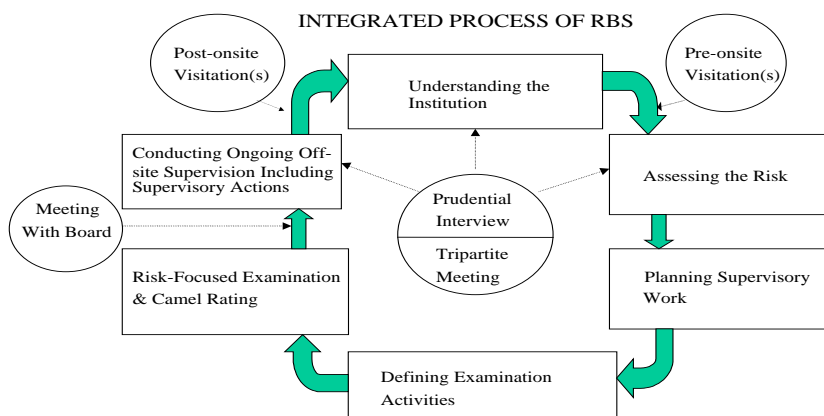
- 3.16 The primary responsibility for the prudent management of an authorized institution is regarded as resting with its board of directors and management. The objective of the MA's supervision is to reinforce the discipline and control exercised by management by laying down and enforcing a framework of minimum prudential standards. This is intended to keep in check competitive excesses which might threaten the stability of the banking system or the interests of depositors, while giving management the flexibility to take commercial decisions.
- 3.17 The Hong Kong Monetary Authority³ is a member of the Basel Committee on Banking Supervision and, in keeping with the position of Hong Kong as an international financial centre, it is the policy of the MA that the supervisory framework in Hong Kong should generally conform with international supervisory standards recommended by the Basel Committee and by other international standard-setting bodies, including the Financial Stability Board.
- 3.18 In supervising banks with international operations, the MA follows international practice as embodied in the principles of the standards issued by the Basel Committee. These include the international standards on capital adequacy and liquidity, the Core Principles for Effective Banking Supervision and the Concordat on cross-border banking supervision. The MA has taken these standards into account in establishing the manner in which the authorization criteria are applied to overseas applicants.
- 3.19 The supervisory policy framework of the MA utilises the CAMEL system for evaluating the safety and soundness of authorized institutions by reference to an institution's Capital, Asset quality, Management, Earnings and Liquidity. The MA has issued a number of guidelines and circulars to authorized institutions which set out expectations and requirements in the areas covered by the CAMEL rating. These are available on-line for downloading at <http://www.hkma.gov.hk/eng/key-information/guidelines-and-circulars>. The policy framework contained in these guidelines also underpins the MA's interpretation of the statutory authorization criteria as described in Chapter 4.

³ The MA heads an Office known as the "Hong Kong Monetary Authority" of which he is the Chief Executive.

Supervisory framework

- 3.20 The objective of the supervisory framework of the MA is to provide an effective process to monitor and assess the safety and soundness of authorized institutions on a continuing basis. The process follows a risk-based approach. It consists of a structured methodology designed to establish a forward-looking view on the risk profile of authorized institutions. This permits a direct and specific focus on the areas of greatest risk to an authorized institution. It also enables the MA to be more proactive and better positioned to pre-empt any serious threat to the stability of the banking system from any current or emerging risks.
- 3.21 The risk-based supervisory approach puts emphasis on the evaluation of the quality of risk management systems and internal controls for the various types of risk faced by authorized institutions. The 8 major types of inherent risk identified by the MA are: credit, interest rate, market, liquidity, operational, legal, reputation and strategic risk. The risk profile of an institution is ascertained by balancing the level of inherent risk against the quality of risk management systems at the institution. A risk management rating is then assigned and factored into the management and other relevant components of the CAMEL rating system.

Supervisory process



- 3.22 The diagram above shows how the risk-based supervisory methodology has been integrated into the MA's overall supervisory process in a way that provides an enhanced level of continuous supervision. The risk-based approach, which by design is circular and conducted on as current a basis as possible in a continuing cycle, is complemented and strengthened by on-site visitations, prudential interviews, tripartite meetings and annual supervisory meetings with the board of directors of locally incorporated banks. In addition, in the case of locally incorporated authorized institutions, the risk-based supervisory approach feeds into the CAMEL rating system via a Supervisory Review Process, which is designed to assist the MA in setting the minimum capital adequacy requirements applicable to the institution (see paragraph 4.48.)
- 3.23 On-site visitations to authorized institutions may be conducted at any phase of the cycle but are more likely to take place during the updating of the risk assessment process prior to the start of, or subsequent to, the on-site examination. The purpose of

the “pre-on-site” visitation is usually to obtain a current picture of recent developments, which may have an effect on the risk profile of the authorized institution, such as the introduction of new products or any significant changes in the risk management systems. The “post-on-site” visitation is usually conducted to follow up on the status of any significant examination findings or supervisory actions instituted.

- 3.24 As part of the continuous supervisory process, an annual prudential meeting is held with the senior management of an authorized institution. The MA attaches great importance to this regular dialogue as it enables the banking supervisors to understand better how senior management views and controls the authorized institution’s risks and how it views the current business situation and future prospects. The meeting also provides the supervisors with an opportunity to clarify specific issues and discuss prudential concerns which have arisen during any phase of the cycle.
- 3.25 For authorized institutions belonging to a banking group, prudential meetings may be held both at group level and with individual authorized institutions of the group. In addition, the MA may hold discussions with overseas head offices of foreign banks, either through MA staff calling on them or during their visits to Hong Kong.
- 3.26 Tripartite meetings may be held with authorized institutions and their external auditors, normally following the completion of the annual audit. Matters discussed typically include any issues arising out of the audit such as weaknesses identified in internal controls, the adequacy of provisions and compliance with prudential standards and the various requirements of the Ordinance. The MA will also wish to see the auditors’ management letter to the authorized institution and discuss any matters of prudential concern contained in the letter.
- 3.27 As a further enhancement to the continuous supervisory approach, the MA will hold an annual meeting with the board of directors of each locally incorporated bank. This meeting will generally be conducted after the completion of the risk-focused on-site examination and updating of the composite CAMEL rating of the authorized institution. The purpose of this meeting is generally to discuss the examination findings, particularly any significant deficiencies in the risk management systems or any other matters of prudential concern. The meeting is also a forum for the board members and the banking supervisors to discuss other matters of mutual interest.

On-site examinations

- 3.28 At the core of the Hong Kong risk-based supervisory approach is the on-site examination of authorized institutions. On-site examinations provide the MA with the opportunity to assess at first hand how an institution is managed and controlled, and are particularly useful for assessing asset quality and the adequacy of internal controls. The MA conducts on-site examinations of both locally incorporated and overseas incorporated authorized institutions. In respect of those institutions incorporated in Hong Kong, on-site examinations may be extended to cover overseas branches and subsidiaries.

- 3.29 The scope of on-site examinations is determined by the risk assessment process which is designed to establish the degree of risk by business activity. The MA will discuss the main conclusions of the examination with management of the institution and consider their comments before issuing a formal examination report. The examination report identifies areas of weaknesses or concerns and makes recommendations for remedial action. The MA will closely monitor the implementation of the recommendations by the institution. A copy of an examination report may be sent to an overseas bank's home supervisory authority for information.
- 3.30 The frequency of examination varies from institution to institution, depending on the size, financial standing and internal control systems of the institution concerned. For institutions incorporated outside Hong Kong, the extent and frequency of examination by its home banking supervisory authority and head office will be taken into account in determining the frequency of examination by the MA. Normally, the minimum frequency of on-site examinations will be once every year for major locally incorporated institutions and once every 4 to 5 years for overseas incorporated institutions.
- 3.31 In addition to the above, co-operation with external auditors, off-site reviews and the sharing of information with other supervisors are also supervisory tools used in Hong Kong.

Co-operation with external auditors

- 3.32 Co-operation with external auditors plays an important role in the supervisory process. Tripartite discussions may be held with institutions and their auditors, normally following the annual audit. Matters discussed typically include the annual audit, adequacy of provisions and compliance with prudential standards and the Ordinance.
- 3.33 Section 61 of the Ordinance provides the basis for the external auditor to be involved in the process of prudential supervision. It makes clear that an auditor may communicate in good faith to the MA, whether or not in response to a request made by the MA, 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 Ordinance. This section provides the basis for the MA to meet with an institution's external auditors, and to discuss with them and their clients matters of common interest.
- 3.34 Under section 63(3A), the MA may require an authorized institution to submit a report prepared by an auditor appointed by the institution on all or any of the following -
- (a) whether or not, during a specified period, the institution had in place systems of control which were adequate to enable, as much as is practicable -
 - (i) the correct compilation of prudential returns;
 - (ii) compliance with the requirements under the Ordinance in relation to disclosure of information, limitation of exposures, and adequacy of capital and liquidity; and

- (iii) if the institution is incorporated in Hong Kong, maintenance of adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), and for actual or potential liabilities and losses;

and, if the opinion is that those systems were not adequate, the nature and extent of any inadequacies;

- (b) whether or not, during that period -
 - (i) there appears to the auditor to be any material contravention by the institution of its duties under the Ordinance referred to in (a)(ii) above; and
 - (ii) if the institution is incorporated in Hong Kong, it appears to the auditor that the institution has failed to maintain adequate provision as referred to in (a)(iii) above.

3.35 Apart from the recurring reports commissioned under section 63(3A), the MA may also require the institution to submit ad hoc reports prepared by its auditors under section 59(2) on such matters as the MA may reasonably require for the exercise of functions under the Ordinance, including such a report -

- (a) on the state of affairs or profit and loss, or both, of the institution based on an audit of the accounts carried out in respect of a specified period; or
- (b) on whether or not the institution has in place systems of control which are adequate to enable, as much as is practicable, the affairs, business and property of the institution to be prudently managed and the institution to comply with its duties under the Ordinance.

3.36 It is not envisaged that this type of report would be recurring. Rather, a report will be commissioned where more comfort is required in particular areas, such as controls to prevent money laundering, contingency planning, specific controls relating to major functional areas of institutions' operations and internal audit functions. Circumstances which may lead to a decision to commission an ad hoc report under section 59(2) include the revelation of significant weaknesses in internal controls, repeated errors detected in prudential returns, the occurrence of adverse events or transactions which affect the business of the institution, and significant exposure to certain business activities.

Off-site reviews

3.37 In order to achieve "continuous supervision", on-site examination is supplemented by ongoing off-site analysis of the financial condition of individual institutions 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

institutions and detect emerging problems that can be followed up immediately with on-site examinations or prudential meetings.

- 3.38 The scope of off-site analysis varies from regular analysis of statistical returns covering various aspects of the operations of authorized institutions to an extensive annual review of the performance and financial position of individual institutions. Analysis is made on an institutional, peer group and systemic basis. There are three main sources of information - statistical returns, internal management accounts and other management information, and published financial information.
- 3.39 The MA's powers to collect prudential data on both a routine and ad hoc basis are provided by Section 63 of the Ordinance. At present, statutory returns cover information on assets and liabilities, profit and loss, capital adequacy, liquidity, interest rate risk, large exposures, analysis of advances and loan classification, foreign exchange position, as well as securities, insurance, MPF related activities and Renminbi business activities. Some of these returns are required to be completed on both a solo and consolidated basis. A full list of the current statutory returns and their completion instructions is available on-line for downloading at <http://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/regulatory-framework.shtml#periodic-returns>. In addition, surveys are used to collect information on residential mortgage lending, credit card receivables, taxi loans and exposure to non-bank Chinese entities, as well as selected debt securities and off-balance sheet exposures to derivatives and securitisations.
- 3.40 The MA may also require institutions to provide supplementary information for off-site reviews. This may include internal management information such as financial budgets and forecasts, and bad and doubtful debt reports. In addition, requests may be made for non-financial information such as institutions' internal policy statements on particular areas of operations, and information on institutions' subsidiaries.
- 3.41 The prompt and accurate reporting of prudential information and statistics is of central importance to the effectiveness of banking supervision. Non-compliance with information requirements, statutory or non-statutory, will be seen as a warning sign requiring close investigation by the MA. Failure to provide information of a material nature required under the Ordinance, or provision of false, misleading or inaccurate information are both grounds for revocation of authorization as described in Chapter 5.
- 3.42 To preserve confidentiality, prudential information obtained from institutions during the course of supervision is subject to the official secrecy requirements set out in section 120 of the Ordinance and may not be disclosed by the MA to third parties except in the circumstances set out in sections 120 and 121.

Sharing information with other supervisors

- 3.43 The MA maintains regular contacts with other local and overseas supervisors to exchange views on supervisory matters. In relation to institutions incorporated outside Hong Kong, the contact 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.

- 3.44 Section 68 of the Ordinance provides that the appropriate recognized banking supervisory authority of a place outside Hong Kong may, with the approval of the MA, examine the books, accounts and transactions of the Hong Kong operations of an authorized institution which is under its primary supervisory responsibility or which is the subsidiary of a company for which it has that supervisory responsibility. An overseas supervisor may similarly inspect the documents of an LRO in Hong Kong.
- 3.45 Under section 121 of the Ordinance, the MA may disclose information to an overseas authority which exercises functions corresponding to those of the MA, the SFC, the Insurance Authority (IA), the Mandatory Provident Fund Schemes Authority (MPFA) or the Financial Reporting Council (FRC), where in the opinion of the MA -
- (a) the relevant overseas authority is subject to adequate secrecy provisions; and
 - (b) it is desirable or expedient that information should be disclosed in the interests of depositors or potential depositors or the public interest; or
 - (c) such disclosure will enable or assist the recipient of the information to exercise his functions and it is not contrary to the interests of depositors or potential depositors or the public interest that the information should be so disclosed.
- 3.46 Sharing of information with other local supervisors is also important given the growing linkages among different types of financial institution - problems in one institution may spread to others, particularly when they belong to the same financial conglomerate. The MA and the SFC have signed a Memorandum of Understanding which sets out the agreed framework for supervisory cooperation between the two regulatory bodies. The aim of the Memorandum is to strengthen cooperation between the two authorities in respect of entities or financial groups in which both parties have supervisory interest, and also to avoid the duplication of supervisory effort. Pursuant to section 7(2) and section 120(5)(fa) of the Ordinance, the MA is also empowered to share with the SFC (without any barrier) information relating to authorized institutions' conduct of activities that are regulated under the Securities and Futures Ordinance. The MA and the IA have also signed a Memorandum of Understanding which aims to enhance the co-operation, exchange of information and mutual assistance between the two authorities. A Memorandum of Understanding Concerning the Regulation of Regulated Persons with Respect to Registered Schemes under the Mandatory Provident Fund Schemes Ordinance has been signed by the MA, the IA, the SFC and the MPFA. This Memorandum sets out certain administrative and operational arrangements among the four regulators regarding the exercise of their respective functions under the Mandatory Provident Fund Schemes Ordinance concerning the regulation of MPF intermediaries. The FRC is a statutory body established by the Financial Reporting Council Ordinance. The MA and the FRC have entered into a Memorandum of Understanding, which aims to elaborate on the mechanisms for communication and information exchange between the two entities, as well as to enhance ongoing cooperation and mutual assistance.

Sharing information with the Financial Dispute Resolution Centre

- 3.47 The MA together with the SFC has signed a Memorandum of Understanding with the Financial Dispute Resolution Centre (FDRC) under which the FDRC will provide information relating to systemic issues and/or suspected serious misconduct cases to the two regulators. This information will assist the MA in identifying systemic and/or misconduct issues as soon as practicable, so that appropriate supervisory actions can be taken on a timely basis.

Consolidated supervision

- 3.48 The MA supervises locally incorporated institutions on a consolidated basis in respect of areas such as capital adequacy, concentration of exposures and liquidity. The main objective of consolidated supervision is to enable the MA to assess any weaknesses existing within a banking/financial group which may impact on the authorized institution itself, and if possible, to initiate defensive or remedial action.
- 3.49 Under section 63(2A), the MA may require the holding company, subsidiary and fellow subsidiary of an authorized institution to submit such information as the MA may reasonably require for the exercise of functions under the Ordinance. In the case where the request for information is made to the holding company or fellow subsidiary of the authorized institution, the MA must also be satisfied that such information is necessary in the interests of depositors or potential depositors of the institution.
- 3.50 As set out in paragraph 4.36, it is generally the MA's policy that a person who intends to hold more than 50% of the share capital of an authorized institution incorporated in Hong Kong should be a well-established bank or other supervised financial institution in good standing in the financial community and with appropriate experience. In the case of applications from persons who do not fulfill this requirement, the MA will generally impose conditions on such applicants and require the establishment of a holding company incorporated in Hong Kong, which will also be subject to conditions imposed by the MA.