

Process Review Committee

Annual Report to the Financial Secretary 2004-2005

I. GENERAL INFORMATION

Background of establishment

1.1 The Clearing and Settlement Systems Ordinance (CSSO), which became effective on 4 November 2004, empowers the Monetary Authority (MA) to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre. The purpose of the CSSO is to promote the general safety and efficiency of designated clearing and settlement systems.

1.2 Since enactment of the CSSO, five clearing and settlement systems have been designated. They are:

- (a) the Central Moneymarkets Unit (CMU)
- (b) the Hong Kong Dollar Clearing House Automated Transfer System (HKD CHATS)
- (c) the Continuous Linked Settlement (CLS) System
- (d) the Euro Clearing House Automated Transfer System (Euro CHATS)
- (e) the US Dollar Clearing House Automated Transfer System (USD CHATS)

1.3 The system operator (SO) and settlement institution (SI) of each designated system are set out in the following table:

Table 1:

	Designated System				
	CLS System	CMU	HKD CHATS	USD CHATS	Euro CHATS
System operator	CLS Bank	HKMA	HKICL*	HKICL*	HKICL*
Settlement institution	CLS Bank	Nil	HKMA	HSBC	Standard Chartered Bank (Hong Kong) Ltd

* The Hong Kong Monetary Authority (HKMA) and the Hong Kong Association of Banks each owns 50% of the Hong Kong Interbank Clearing Limited (HKICL)

1.4 Of the five designated systems, the CLS system is the only one in which the HKMA does not have any interest. The CLS system is subject to the supervision of the Federal Reserve Bank of New York and is exempted under section 11 of the CSSO from the HKMA's oversight. In other words, the HKMA exercises ongoing oversight of four designated systems, namely, the CMU, HKD CHATS, USD CHATS and Euro CHATS, in all of which the HKMA has an interest in one way or another. To address the potential or perceived conflict of roles thus arising, the HKMA has implemented a number of measures. These included a clear segregation of duties within the HKMA and the promotion of transparency in the designation and oversight processes. In addition, the Process Review Committee (PRC), an independent, non-statutory committee, was established by the Chief Executive of the Hong Kong Special Administrative Region in December 2004 to review the processes and procedures adopted by the HKMA in applying oversight standards. It seeks to, among other things, ensure that the same set of standards is applied to all designated systems, whether or not the HKMA has an interest in them.

Scope of work and terms of reference

1.5 The terms of reference of the PRC are:

- (a) to review and advise the HKMA upon the adequacy of the HKMA's internal operational procedures and guidelines for applying the standards set under the CSSO to those designated systems in which the HKMA has a legal or beneficial interest;
- (b) to receive and consider periodic reports from the HKMA on all completed or discontinued files in respect of alleged non-compliance of the CSSO by those designated systems in which the HKMA has a legal or beneficial interest; and
- (c) to submit annual reports and, if appropriate, special reports on designated systems in which the HKMA has a legal or beneficial interest, to the Financial Secretary.

1.6 In the first meeting of the PRC, members agreed that, in discharging its functions, the PRC would focus on whether there were any discrepancies in the HKMA's oversight of systems in which the HKMA has an interest, as compared to other systems. In other words, the PRC would review the processes and procedures adopted by the HKMA to ensure that the same set of oversight standards was applied to all designated systems. This was consistent with the policy intention for the establishment of the PRC.

1.7 The PRC is required to submit annual reports, and, if appropriate, special reports to the Financial Secretary. The Financial Secretary may cause the reports to be published subject to relevant confidentiality requirements.

Membership of the PRC

1.8 Members of the PRC are appointed by the Chief Executive of the Hong Kong Special Administrative Region in their personal capacity on a three-year term from 1 December 2004 to 30 November 2007. The membership of the PRC is:

Chairman

Dr Eric KC Li, GBS, JP

Senior Partner

Li, Tang, Chen & Co

Members

Mr Eddy Fong Ching, SBS, JP

Senior Advisor

Tricor Services Limited

Mr Ling Chung Yan

Chief Operating Officer

Citic Ka Wah Bank

Professor Tsang Shu Ki

Department of Economics

Hong Kong Baptist University

Ms Maria Xuereb

Financial Services Partner

Deloitte Touche Tohmatsu

Mr Lim Peng Khoon

Partner & Executive Consultant

Chinfosys Limited

(until 14 September 2005)

II. HIGHLIGHTS OF THE WORK OF THE PRC

2.1 This report covers the work of the PRC from its establishment on 1 December 2004 to 30 November 2005.

Meetings held and major deliberations of the PRC

2.2 The PRC held three meetings during its first year of operation. At the inaugural meeting in January 2005, members noted the terms of reference of the Committee and agreed on the focus and objectives of the Committee's work in future (see para. 1.6 above). To facilitate the work of the PRC, it was agreed that the HKMA would produce a complete *Internal Operating Manual* ("the *Manual*") for review by the Committee. The *Manual* would set out the internal operational procedures adopted by the HKMA for evaluating the compliance with the oversight standards by designated systems. It would also act as the benchmark against which the PRC would review on an on-going basis whether the HKMA had applied the same set of procedures to all designated systems. Members further agreed that a set of management reports summarising the oversight activities adopted by the HKMA during the reporting period should be submitted to the PRC.

2.3 The second meeting in April was mainly devoted to discussions on the internal operational procedures and control mechanisms laid down in the *Manual*. Members also made suggestions on improving the format of quarterly report and management reports submitted to the PRC. (see para. 2.10 below).

2.4 At the third PRC meeting held in October, Members commented on a draft of the annual report (covering period from December 2004 to September 2005) and discussed issues in relation to the publication of the annual report. Members were briefed on the work of the PRC in the coming year.

2.5 Four quarterly reports were circulated to Members for review in 2005 and Members noted the performance benchmarks were met by the HKMA.

Comments and recommendations of the PRC

2.6 The PRC has reviewed and commented on the *Manual* and the associated management reports. The *Manual* contains ten chapters. Various control mechanisms such as the appropriate supervisory review levels, escalation procedures to higher levels, and proper documentation procedures were incorporated in the *Manual* where appropriate to ensure that the oversight process is fair and objective. Members were generally satisfied with the control mechanisms. They, however, suggested that the steps to be taken by the HKMA in response to an occurrence of an abnormal event such as delays in operation should be set out more clearly and that the handling procedures of contraventions should be refined to better reflect the decision flow of handling different types of contraventions. The relevant parts of the *Manual* have been revised accordingly.

2.7 When discussing the on-site examination procedures, members were informed that examinations would be conducted on a need basis. Proper documentation and approval process would be put in place to ensure that variation in the scope and frequency of examination among systems were justified. To facilitate the PRC's review of examination frequencies, the relevant management report was revised to include the date of the last on-site examination for each designated system.

2.8 Members also suggested that there should be proper procedures for the HKMA to handle complaints lodged by SOs and SIs of designated systems if they were aggrieved by the way in which the HKMA conducted its oversight activities. The HKMA agreed to the suggestion. The relevant complaint handling procedures are now set out in the *Manual*. The procedures clearly define what constitute "complaints" and ensure that such complaints would be handled promptly, independently and fairly. A management report has also been developed to keep the PRC informed of the complaint handling process. Following the advice of the Committee, the HKMA informed the SOs and SIs of designated systems of the complaint handling mechanism during the annual meeting with their management in November 2005.

2.9 As one of the control mechanisms to ensure procedural fairness, the process

and date of every step of oversight activities conducted by all HKMA staff are recorded in the management reports accompanying the quarterly report submitted to the PRC. Members suggested that benchmarks on the target processing time of certain oversight activities should be added where appropriate to impose some discipline on the staff concerned. The HKMA agreed and target processing time has been indicated for two oversight activities, namely, the approval of changes to operating rules and the processing of changes to particulars of system operator and settlement institution. These two oversight activities require a formal response and therefore time is of essence. For other activities, the processing time has less impact on the designated systems. Indicative processing time has been provided for these activities. Members have no objection to this approach.

2.10 The PRC reviewed the first quarterly report submitted at the second meeting and suggested that a brief summary should be put under each management report, highlighting summary statistics such as the mean or the range of processing time taken. These should be compared with the relevant benchmarks, if any, and any irregularities should be explained. The quarterly report for the quarter ended March 2005 was revised accordingly and endorsed by the PRC subsequently.

2.11 A draft of the annual report was discussed at the third meeting in October. The PRC had no comment on the draft and agreed to propose to the Financial Secretary that the annual report be published in its entirety and be posted on the website of the HKMA for the wider circulation to the public in the interest of transparency and accountability.

2.12 When reviewing the third quarterly report, Members suggested adding a new column of actual processing time of monthly returns to the summary table for comparison purpose. The suggested new column was subsequently added in the fourth quarterly report.

2.13 Five on-site examinations on SOs and SIs were conducted in the third quarter and the whole process was completed in October. As stipulated in the *Manual*, the letter informing SO/SI of the examination would be issued at least two weeks before the commencement of the field work and the internal examination report

would be prepared within two weeks after the completion of field work. Apart from these benchmarks, Members discussed if an overall benchmark for the total processing time of on-site examination should be introduced. It was explained to Members that a longer duration would be needed if issues of supervisory concerns were found during the examination, so it would be more appropriate to establish benchmark on some processes rather than the overall lead-time of on-site examination. Members agreed to this suggestion.

III. CONCLUSION AND WAY FORWARD

3.1 As there is no alleged non-compliance case with the CSSO received during the period, the PRC has not received or considered any report in this aspect.

3.2 The PRC has reviewed four quarterly reports and 21 accompanying oversight activities management reports covering the period from December 2004 to November 2005. The review covered, among other things, submission by the HKMA on its processing of 80 monthly returns and 38 cases of changes in particulars, granting approval to 11 changes in operating rules, handling of 7 abnormal events, reviewing of 106 submissions of ad-hoc information, conducting of 5 on-site examinations on the designated systems and holding of 5 meetings with management of SOs and SIs. No complaint was received from SOs and SIs. The PRC was not aware of any issues or matters that suggested that the HKMA has not followed duly the internal operational procedures and has not been procedurally fair in carrying out its oversight activities across different designated systems.

3.3 The PRC will continue to review the processes and procedures adopted by the HKMA in overseeing the existing designated systems and, where appropriate, additional systems that will be overseen by the HKMA under the CSSO in the coming year.