

Process Review Committee

Annual Report to the Financial Secretary 2005-2006

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 (EUR 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	EUR 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 EUR 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 The PRC agreed that, in discharging its functions, the Committee 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

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

II. HIGHLIGHTS OF THE WORK OF THE PRC

2.1 This is the second Annual Report of the PRC, which covers the work of the Committee from 1 December 2005 to 30 November 2006.

Meetings held and major deliberations of the PRC

2.2 The PRC held two meetings during its second year of operation. At the first meeting in May 2006, Members reviewed the quarterly report covering the oversight activities of the HKMA from December 2005 to March 2006 and examined the handling of contravention cases by the HKMA (see paragraphs 2.8-2.9 below). Members discussed and made suggestions on the proposed revisions to the *Internal Operating Manual* (“the *Manual*”) submitted to the Committee for review and endorsement (see paragraphs 2.10-2.11 below).

2.3 As agreed by Members, quarterly reports covering HKMA’s oversight activities would be sent to Members for review by circulation on a regular basis in between meetings. If Members had questions about the quarterly reports, Members would raise them with the Secretary of the Committee. Subject to the agreement of the Chairman, the questions would be discussed at the next meeting or, if needed, a special meeting would be held. The quarterly report ended June 2006 was sent to Members in July for review and Members had no comment on the report. The quarterly report ended September 2006 was sent to Members in October for review.

2.4 At the second PRC meeting held in November 2006, Members reviewed the quarterly report covering the period from July to September 2006, commented on a draft of the second annual report 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. At the request of the Chairman and some Members, a technical presentation on the clearing and settlement systems in Hong Kong was made to explain to Members the system design and operations, as well as the planned major developments, of the four designated systems (i.e. HKD/USD/EUR CHATS and CMU) and the Renminbi Settlement Systems. Members were also briefed on the clearing arrangements

following the introduction of 5-Day Clearing Week implemented on 4 September 2006 and noted that the implementation of 5-Day Clearing Week was smooth.

2.5 Members noted that there were various liquidity management tools in place to facilitate smooth and efficient settlement of payments during active IPO periods. During the day when the turnover of HKD CHATS reached a record high of about HK\$1.3 trillion because of heavy IPO activities, the system was functioning properly with sufficient liquidity. Members were informed that, in addition to the liquidity management tools, the HKMA would also closely monitor the liquidity position of individual banks during the IPO period.

2.6 Four quarterly reports were circulated to Members for review in 2006 and Members noted the performance benchmarks were met by the HKMA.

Comments and recommendations of the PRC

2.7 The format of the quarterly report and the accompanying oversight activities management reports was revised and developed based on the suggestions from Members. During the year, Members had reviewed four quarterly reports and 22 accompanying oversight activities management reports covering the period from December 2005 to November 2006. In particular, Members would focus on how the abnormal events and contravention cases, if occurred, were handled. The number of oversight activities contained in each quarterly report under the review of the PRC are summarised below:

Table 2: Oversight activities of HKMA under the review of PRC from Dec 2005 to Nov 2006

HKMA's oversight activities conducted during the quarter	1st Quarterly Report (Dec- Mar)	2nd Quarterly Report (Apr-Jun)	3rd Quarterly Report (Jul-Sep)	4th Quarterly Report (Oct-Nov)
Processing of monthly return submitted by SO/SI	28	21	21	14
Vetting of change in	13	14	2	0

particulars of SO/SI				
Reviewing of ad-hoc information submitted by SO/SI	48	35	21	18
Granting approval to change in operating rules	7	6	4	5
Handling of abnormal event	5	1	4	3
Handling of contravention case	1	1	0	0
Holding of meeting with management of SO/SI	0	0	0	5

Note: On-site examination on designated systems is conducted on a need basis, using a risk-based approach. 5 on-site examinations were conducted in 2005. No on-site examination was conducted in 2006.

2.8 At the meeting in May 2006, Members noted that a contravention case occurred in the first quarter of 2006, which was the first contravention case since the CSSO had come into force in November 2004. The contravention was related to the late reporting of change to the particulars to the Monetary Authority under section 6(2) of the CSSO. Members were briefed on the relevant handling procedures: the case was reviewed by different levels, following a set of procedures, within the HKMA and escalated to the Chief Executive of the HKMA.

2.9 Members were informed of another contravention case of similar nature in the second quarter of 2006. Contravention handling procedures were duly followed and the case was again escalated to the Chief Executive of the HKMA. These two cases were minor in nature and had no adverse implication on the safety and efficiency of the system concerned. Members suggested that the HKMA could consider measures to reduce the non-compliance cases. Subsequently, the HKMA, after consultation with the SOs and SIs concerned, introduced measures aiming to reduce the non-compliance cases while maintaining oversight effectiveness of the HKMA on the designated systems. The PRC was informed of such changes.

2.10 When the *Internal Operating Manual* was first developed in April 2005,

Members had reviewed, commented and endorsed the draft. The *Manual* serves 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. Various control mechanisms such as supervisory review at different levels, escalation procedures to senior management on important issues, and proper documentation procedures were incorporated in the *Manual* to ensure that the oversight process is as fair and objective as possible. Based on HKMA's oversight experience in the first year, revisions to the *Manual* were proposed at the PRC meeting held in May 2006 along the following guidance for Members to review:

- (a) to set out more explicitly the role of the PRC in the *Manual* and the various management reports to be submitted to the PRC for review on a quarterly basis;
- (b) to minimise unnecessary report compilation burden without affecting oversight effectiveness and to standardise the management reports submitted to senior management of the HKMA and the PRC;
- (c) to insert samples or templates of correspondences and reports for oversight activities such as on-site examination, meeting with management and annual assessment, which were completed in the second half of 2005;
- (d) to update and fine tune the procedures taken, where appropriate, based on actual experience; and
- (e) to explain in clearer terms the steps taken and make them consistent with the internal authorisation regime.

2.11 Members agreed to the above mentioned guidance and went through the proposed amendments of the *Manual* chapter by chapter at the meeting. Members' comments were all incorporated in the revised *Manual*. In view of the increasing occurrence of minor or technical contravention cases under the CSSO, consideration was given to streamline the escalation procedures after seeking approval from the Chief Executive of the HKMA. The PRC agreed with the arrangement, reviewed and endorsed the proposed amendments to the contravention handling procedures set out in the *Manual*. A complete set of the revised *Manual*, incorporating all the proposed amendments and comments from the Members, was sent to Members for retention in July.

2.12 Following the introduction of 5-day Clearing Week for HKD/USD/EUR CHATS and CMU; and subsequent changes on the Throughput Guideline of HKD/USD/EUR CHATS initiated by the respective SIs in September 2006, the monthly returns (attached as annex to the *Manual*) were amended to reflect these changes, after consultation with the SOs and SIs concerned. These amendments to the *Manual* were discussed and reviewed by Members in the November's meeting. The PRC had endorsed the proposed amendments to the *Manual*. A complete set of the revised *Manual*, incorporating all necessary amendments, was sent to Members for retention in November.

2.13 A draft of the annual report was discussed at the second meeting in November 2006. The PRC had no comment on the draft and agreed to adopt the same publication approach of the first annual report, that is, 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 promoting transparency and accountability.

III. CONCLUSION AND WAY FORWARD

3.1 Two contravention cases with the CSSO occurred during the period. The PRC reviewed the handling procedures of these cases and confirmed that they were in line with the contravention handling procedures set out in the *Internal Operating Manual*.

3.2 The PRC has reviewed four quarterly reports and 22 accompanying oversight activities management reports covering the period from December 2005 to November 2006. The review covered, among other things, submission by the HKMA on its processing of 84 monthly returns and 29 cases of changes in particulars, granting approval to 22 changes in operating rules, handling of 13 abnormal events, reviewing of 122 submissions of ad-hoc information, 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 cases where the HKMA had not followed duly the internal operational procedures, or where the HKMA had 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.