

Process Review Committee

Annual Report to the Financial Secretary 2006-2007

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, all of which the HKMA has an interest in one way or another. Some of these designated systems have established linkages with overseas payment or securities settlement systems to facilitate cross-border transactions, for example, the RENTAS-USD CHATS payment-versus-payment and delivery-versus-payment link. Although these overseas systems are not overseen by the HKMA, the HKMA oversees these external linkages in coordination with their home overseers.

1.5 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

1.6 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.

1.7 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 with 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 of the establishment of the PRC.

1.8 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

1.9 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 as at 30 November 2007 was:

Chairman

Dr Eric KC Li, GBS, JP

Senior Partner

Li, Tang, Chen & Co

Members

Mr Eddy Fong Ching, SBS, JP

Certified Public Accountant

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 third Annual Report of the PRC, which covers the work of the Committee from 1 December 2006 to 30 November 2007. This is also the last annual report for the first term of the PRC.

Meetings held and major deliberations of the PRC

2.2 The PRC held two meetings during its third year of operation. At the first meeting in May 2007, Members reviewed the quarterly report covering the oversight activities of the HKMA from December 2006 to March 2007 and examined the handling of one contravention case by the HKMA during the quarter (see paragraph 2.9 below). Members discussed the procedures adopted by the HKMA in handling abnormal events and production incidents reported by the system operator and settlement institution; and they noted the classification between “abnormal event” and “production incident”.

2.3 Members were briefed on the progress of including bulk items (such as paper cheque and CCASS) into HKD CHATS and USD CHATS in the first half of 2007 and its implications on the work of the PRC. At the request of Members, an explanatory note on the definition of bulk items was prepared and sent to Members in June.

2.4 In response to Members’ interest in the payment flows related to the issuance of RMB bonds later in the year, the HKMA explained to Members about the set up of RMB CHATS and its relationship with the RMB bond issuance arrangements. An explanatory note on this subject was prepared and circulated to Members in June.

2.5 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 for the period ended June 2007 was sent to Members for review in early August. Members had comments on the June quarterly report and the report was subsequently amended and re-circulated to Members in late August.

2.6 At the second PRC meeting held in November 2007, Members reviewed the quarterly report covering the period from July to September 2007, examined the handling of one contravention case in the third quarter, commented on a draft of the third annual report and agreed on the publication of the annual report. Members discussed issues in relation to the external link of designated systems and its impact on the local systems.

2.7 Four quarterly reports were circulated to Members for review in 2007 and Members noted that the performance benchmarks were met by the HKMA.

Comments and recommendations of the PRC

2.8 The format of the quarterly report and the accompanying oversight activities management reports was designed based on the suggestions from Members. During the year, Members reviewed four quarterly reports and 25 accompanying oversight activities management reports covering the period from December 2006 to November 2007. In particular, Members focused on how the abnormal events and contravention cases 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 2006 to Nov 2007

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 particulars of SO/SI	8	6	9	8
Reviewing of ad-hoc information submitted by SO/SI	42	18	19	24
Granting approval to change in operating rules	10	10	7	10
Conducting on-site examination	0	0	1	0
Handling of abnormal event/production incident	6	12	9	3
Handling of contravention case	1	0	1	0
Holding of meeting with management of SO/SI	0	0	0	5

2.9 At the meeting in May and November 2007, Members noted that contravention occurred in the first quarter and the third quarter of 2007. The two contravention cases were both related to the late reporting of a change to the particulars to the Monetary Authority under section 6(2) of the CSSO. Members were briefed on the relevant handling procedures: both cases were reviewed by different levels within the HKMA following the procedures set out in the Internal Operating Manual, and were classified as a “minor contravention” because they had minimal impact on the safety and efficiency of the system concerned.

2.10 The HKMA classified the problems of the designated systems into “abnormal event” or “production incident” based on their nature and different impact on the system participants. Members noted the relatively high number of abnormal events and production incidents in the June quarterly report and requested the HKMA

to elaborate on the assessment process and handling procedures of these events/incidents. The quarterly report was revised according to Members' suggestions and submitted to Members for review in late August. Members had no further questions on the revised quarterly report.

2.11 Members discussed the handling of a number of production incidents and abnormal events in the two PRC meetings and noted that a number of these incidents/events were caused by external systems or linkages. They enquired about the proper monitoring arrangements of these linkages, the oversight structure of the relevant central bank overseas and the underlying intention of establishing these linkages. Members were briefed on the detailed handling procedures when problems occurred in the external linkages. Members noted that remedial actions had been taken to handle the incidents and the HKMA would continue to be vigilant about these external linkages and work with relevant central banks under the co-operative oversight arrangements.

2.12 A draft of the annual report was discussed at the second meeting in November 2007. Members made some suggestions on the content of the report and the report was revised accordingly. Members agreed to adopt the same publication approach of the previous two annual reports. The PRC proposed 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 During the period, the PRC reviewed the handling procedures of two contravention 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 25 accompanying oversight activities management reports covering the period from December 2006 to November 2007, while no complaint was received from SOs and SIs. The review

covered, among other things, submission by the HKMA on its processing of 84 monthly returns and 31 cases of changes in particulars, granting approval to 37 changes in operating rules, handling of 30 abnormal events and production incidents, reviewing of 103 submissions of ad-hoc information, conducting of one on-site examination and holding of 5 meetings with management of SOs and SIs.

3.3 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.

3.4 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.