

Process Review Committee

Annual Report to the Financial Secretary 2008-2009

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, six 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 US Dollar Clearing House Automated Transfer System (USD CHATS)
- (d) the Euro Clearing House Automated Transfer System (EUR CHATS)
- (e) the Renminbi Clearing House Automated Transfer System (RMB CHATS)
- (f) the Continuous Linked Settlement (CLS) System

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	RMB CHATS
System operator	CLS Bank	HKMA	HKICL*	HKICL*	HKICL*	HKICL*
Settlement institution	CLS Bank	Nil	HKMA	HSBC	Standard Chartered Bank (Hong Kong) Ltd	Bank of China (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 six 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 U.S. Federal Reserve and is exempted under section 11 of the CSSO from the HKMA's oversight. In other words, the HKMA exercises ongoing oversight of the remaining five designated systems, namely, the CMU, HKD CHATS, USD CHATS, EUR CHATS and RMB 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 RENTAS¹ - USD CHATS payment-versus-payment and delivery-versus-payment links. 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 interest thus arising from HKMA both being the system operator or settlement institution of certain systems on

¹ RENTAS is the RTGS clearing and settlement system for inter-bank fund transfer and scripless securities trading in Malaysia.

the one hand and the overseer of designated systems on the other, the HKMA has implemented a number of measures. These include 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 The PRC is in its second term of service. 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 2007 to 30 November 2010. The membership of the PRC as at 30 November 2009 was:

Chairman

Dr Eric KC Li, GBS, JP

Senior Partner

Li, Tang, Chen & Co

Members

Mr Nicholas Peter Etches

Certified Public Accountant

Mr Mervyn Robert John Jacob

Financial Services Leader, Hong Kong and China

PricewaterhouseCoopers

Mr Ling Chung Yan

Alternate Chief Executive 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 fifth Annual Report of the PRC, which covers the work of the Committee from 1 December 2008 to 30 November 2009.

Meetings held and major deliberations of the PRC

2.2 The PRC held two meetings during 2009. At the first meeting in June, Members reviewed the regular report covering the oversight activities of the HKMA from December 2008 to March 2009. In particular, Members discussed how the HKMA handled the abnormal events encountered by the designated systems.

2.3 Among other things, Members were updated on (a) the readiness of the RMB CHATS to handle the new RMB trade settlement business launched in July and (b) the progress of the migration of Hong Kong's payment systems from a proprietary platform to a SWIFTNet platform (phase 1) on 25 May 2009. At the meeting, Members noted that technically it was feasible for the RMB CHATS to take on the new trade settlement business and that system testing had already been completed in June. Once the policy green light was granted, the RMB CHATS should be able to handle the new RMB trade settlement business. Members also noted the plan of the HKMA to conduct on-site examination on the RMB CHATS in July 2009, following the designation of the system in July 2008.

2.4 It was agreed in November 2008 that the HKMA would share its internal audit report on the work of its Payment System Oversight Section with PRC Members to assist Members in ascertaining whether the HKMA had been adhering to the established procedures set out in the Internal Operating Manual in conducting their oversight activities. Members were briefed on the findings of the internal audit report on the payment systems oversight function carried out by the HKMA at the June meeting and noted that no significant issue was identified in the audit.

2.5 At the second meeting held in November, Members reviewed the regular report covering the period from July to September 2009. In particular, they discussed the handling of one abnormal event relating to SWIFTNet and the drafting of the

Committee's fifth annual report to the Financial Secretary.

2.6 As agreed by Members, regular reports covering the HKMA's oversight activities would be sent to Members for review by circulation in between meetings. If Members had questions about the 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.

2.7 A total of four regular reports were circulated to Members for review in 2009 and Members noted that the performance benchmarks for oversight activities were met by the HKMA.

Comments and recommendations of the PRC

2.8 The format of the regular report and the accompanying oversight activities management reports were designed based on suggestions from Members. During the year, Members reviewed 4 regular reports and 22 accompanying oversight activities management reports covering the period December 2008 to November 2009. The statistics showing the oversight activities contained in each regular report under the review of the PRC are summarised below:

Table 2: Oversight activities of HKMA under the review of PRC from Dec 2008 to Nov 2009

HKMA's oversight activities conducted during the quarter	1st Regular Report (Dec- Mar)	2nd Regular Report (Apr-Jun)	3rd Regular Report (Jul-Sep)	4th Regular Report (Oct-Nov)
Processing of monthly return submitted by SO/SI	36	27	27	18
Vetting of change in particulars of SO/SI	6	12	6	0
Reviewing of ad-hoc information submitted by SO/SI	60	55	29	23

Granting approval to change in operating rules	5	9	17	8
Conducting on-site examination	0	0	1	0
Handling of abnormal event/production incident	10	6	2	2
Handling of contravention case	0	0	0	0
Holding of meeting with management of SO/SI	3	0	0	3

2.9 At the meetings of June and November 2009, Members discussed the handling of a number of abnormal events and production incidents. In June, they discussed three abnormal events caused by malfunctioning of the cross-currency payment matching processor (CCPMP), a system processor for validating and matching of transactions on a PvP basis. The root cause of the first incident and the remedial measures taken by the HKICL were explained to Members. On the other two incidents where the cause was still unknown, Members noted that the HKICL had already, using their best effort, engaged the system vendor to look into the problem. But since the same problem did not occur again, the root cause of it remained unknown despite tracers were applied with a view to tracking the problems if re-emerged. It was explained to Members that although the root cause of the problem was yet to be identified, the HKICL was able to deal with the problem to minimise the impact, if any, on the participants.

2.10 Members noted the successful launch of SWIFTNet project phase 1 on 25 May 2009, apart from a few minor hiccups and teething problems, when all designated payment systems in Hong Kong migrated from a proprietary operating platform to a widely accepted SWIFTNet operating platform for sending out payment instructions.

2.11 At the November meeting, Members discussed the handling of one abnormal event which was caused by a software problem of a SWIFTNet Server. Members noted that the relevant CHATS system was operating normally after the application of a provisional fix, pending an upgrade of the server in 2010. Members

also noted the completion of on-site examination on the RMB CHATS in August 2009 as scheduled.

2.12 A draft of the annual report was discussed at the second meeting in November 2009. Members made some suggestions on the content of the report which was revised accordingly. Members agreed to adopt the same publication approach as for the previous 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 4 regular reports and 22 accompanying oversight activities management reports covering the period December 2008 to November 2009. There was no complaint received from the SOs and the SIs and no alleged contravention event noted during the period. The review covered, among other things, the submission by the HKMA on its processing of 108 monthly returns and 24 cases of changes in particulars, granting approvals to 39 changes in operating rules, handling of 20 abnormal events and production incidents, reviewing of 167 submissions of ad-hoc information and holding of 6 meetings with the management of the SOs and the SIs.

3.2 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.