

Process Review Committee

Annual Report to the Financial Secretary 2009-2010

I. GENERAL INFORMATION

Background of establishment

1.1 The Clearing and Settlement Systems Ordinance (CSSO), which came into effect 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 its functioning 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 (PvP) and delivery-versus-payment (DvP) links, and the BI-RTGS² – USD CHATS PvP link. Although these overseas systems are not overseen by the HKMA, the HKMA oversees these external linkages in coordination with the respective home overseers.

1.5 To address the potential or perceived conflict of interest thus arising from

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

² BI-RTGS is the RTGS clearing and settlement system for inter-bank fund transfer in Indonesia

HKMA both being the system operator or settlement institution of certain systems on 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 is

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 for a three-year term from 1 December 2007 to 30 November 2010. The membership of the PRC as at 30 November 2010 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

Senior Research Fellow

Institute for Enterprise Development

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 sixth Annual Report of the PRC, which covers the work of the Committee from 1 December 2009 to 30 November 2010. This is also the last annual report for the second term of the PRC.

Meetings held and major deliberations of the PRC

2.2 The PRC held two meetings during 2010. At the first meeting in June, Members reviewed the regular report covering the oversight activities of the HKMA from December 2009 to March 2010. 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 extension of operating days of foreign currency payment systems in Hong Kong, (b) the establishment of a new PvP link between the USD CHATS in Hong Kong and the BI-RTGS in Indonesia in January 2010 and (c) the planned migration of Hong Kong's payment systems from a proprietary platform to the open platform of SWIFTNet on 12 July 2010. At the meeting, Members noted that cooperative oversight arrangements of the PvP link were established between the payment system oversight team of the HKMA and that of Bank Indonesia. The cooperative oversight arrangements were later proved to be useful to deal with the incidents of the USD CHATS – BI-RTGS PvP link. Members also noted the Internal Operating Manual was revised to reflect (a) the re-organisation of banking departments within the HKMA in April 2010 and (b) various changes in system requirements and addition of payment services in the past two years.

2.4 At the second meeting held in November, Members reviewed the regular report covering the period from July to September 2010. In particular, they discussed the handling of incidents relating to SWIFTNet migration on 12 July and the USD CHATS – BI-RTGS PvP link. They enquired about the operations of the RMB CHATS in the light of the expansion of the RMB trade settlement business in Hong Kong in July 2010. They also commented on the drafting of the Committee's sixth annual report to be submitted to the Financial Secretary.

2.5 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 have 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.

2.6 A total of four regular reports were circulated to Members for review in 2010 and Members noted that the performance benchmarks for oversight activities were met by the HKMA.

Comments and recommendations of the PRC

2.7 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 from December 2009 to November 2010. 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 2009 to Nov 2010

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	7	7	9	2
Reviewing of ad-hoc information submitted by SO/SI	48	28	44	40
Granting approval to change in	8	5	18	5

operating rules				
Conducting on-site examination	0	0	0	0
Handling of abnormal event/ production incident	2	8	18	7
Handling of contravention case	0	0	0	0
Holding of meeting with management of SO/SI	3	0	0	0

2.8 At the meetings of June and November 2010, Members discussed the handling of a number of abnormal events and production incidents relating to the USD CHATS – BI-RTGS PvP link. Members noted that the smooth operation of the PvP link relied on the robustness of Hong Kong’s and Indonesia’s respective payment systems, and all the incidents resulted from problems originating from the Indonesian side. On further investigation, most of the problems occurred in the BI’s PvP gateway which is designed to protect the BI-RTGS system from unauthorised accesses. The Payment Systems Oversight team of the HKMA had held a number of teleconferences with its BI’s oversight counterparts in August and September to discuss ways to step up co-operative oversight of the link and remedial actions taken. Colleagues from BI’s IT Department and the HKICL were involved in the teleconferences to identify the root cause of the problem. During the teleconference on 17 September, BI informed the HKMA that the root cause of the problem was found to be related to a minor deficiency in their database server (for storing incoming PvP payment instructions), that resulted in disconnection of the PvP link. Prompt remedial actions were taken by the BI in early September to re-adjust the design of the system to handle the problem.

2.9 Members noted the successful migration of Hong Kong’s payment systems to run on the SWIFTNet open platform on 12 July 2010. Apart from a few minor hiccups and teething problems which have subsequently been resolved, the migration was generally smooth.

2.10 Members noted the increasing turnover of the RMB CHATS since July 2010 after the expansion of RMB trade settlement business in Hong Kong.

Members were informed that the PSO team had visited the People's Bank of China payment systems counterparts to brief them on how the HKMA conducted oversight on the RMB CHATS and discussed co-operative oversight matters.

2.11 A draft of the annual report was discussed at the meeting in November 2010. Members made some suggestions on 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 activity management reports covering the period from December 2009 to November 2010. No complaints were 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 25 cases of changes in particulars, granting approvals to 36 changes in operating rules, handling of 35 abnormal events and production incidents, reviewing of 160 submissions of ad-hoc information and holding of 3 meetings with the management of the SOs and the SIs.

3.2 The PRC was not aware of any case 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 is expected to 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.