

The work of banking supervision formerly carried out in the Office of the Commissioner of Banking is now in the hands of two Departments of the Monetary Authority: the Banking Supervision Department, which is responsible for the day-to-day supervision of authorised institutions, and the

Banking Policy Department, which is responsible for the development of the policy framework within which supervision is carried out.

GROWTH OF THE BANKING SECTOR

The banking sector in Hong Kong enjoyed another stable and prosperous year in 1993: profit growth remained strong; capital ratios remained healthy; and bad debts remained low. All this occurred against the background of the continuing economic expansion in China which provided many profitable business opportunities for authorised institutions in Hong Kong. The resultant attractions of Hong Kong as an international financial centre are illustrated by the growth in the number of authorised institutions, from 367 to 371.

Within the total, the number of licensed banks rose by eight to 172. Two of the new licences were granted to locally incorporated institutions (previously restricted licence banks), the first full licences to be awarded to local companies since 1983. Another noteworthy feature was the granting of the first two banking licences to banks from Taiwan.

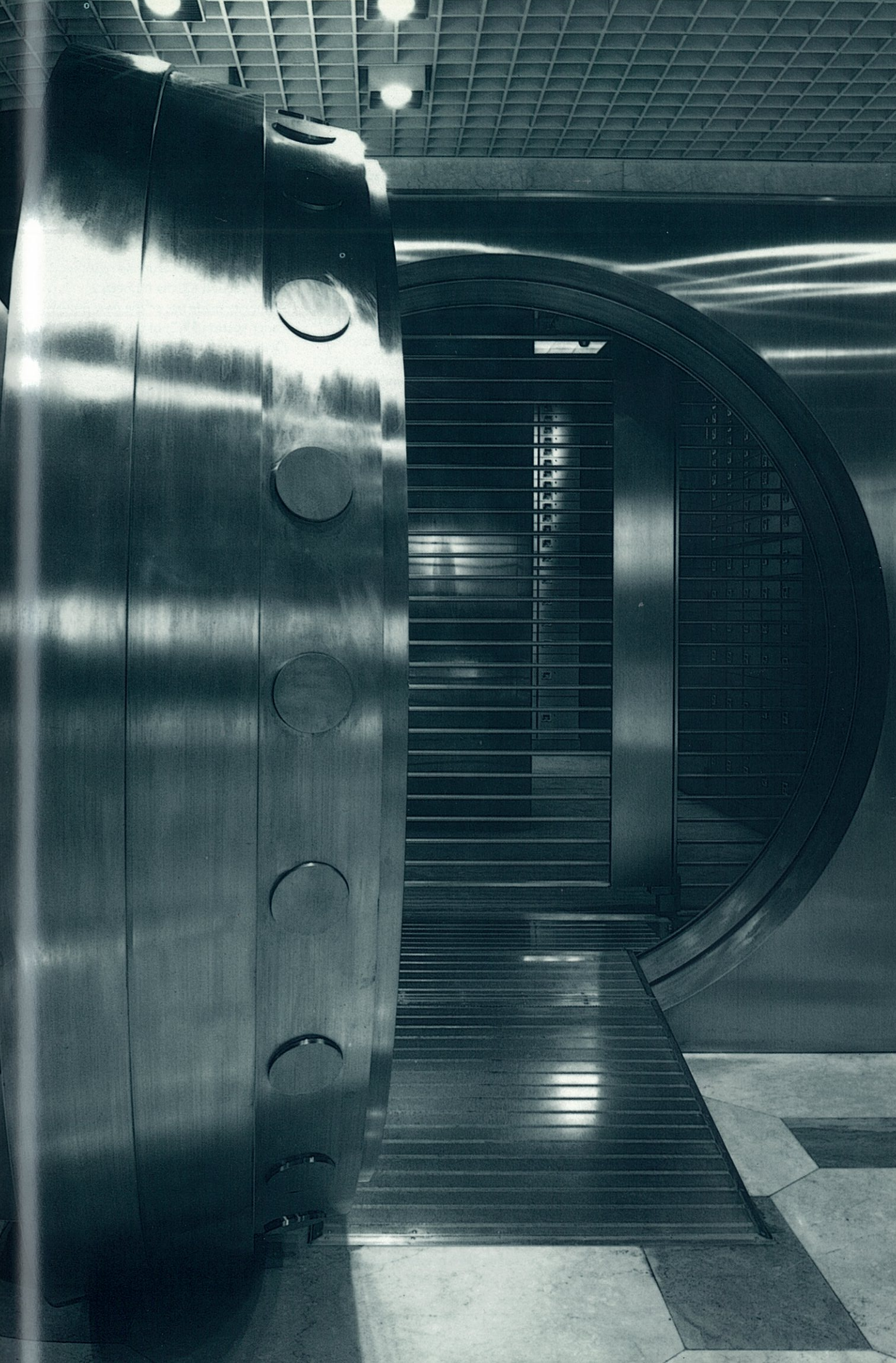
The number of restricted licence banks continued to increase (by one to 57), while there was further rationalisation in the deposit-taking companies sector. The drop in the number of dtcs (by five to 142) was however much less than in recent years.

Looking further ahead, the banking population is likely to be increased further by local representative offices which wish to upgrade to branch status; 15 banks opened representative offices in 1993. This included an office opened by one of the specialised banks in China, another sign of the trend towards internationalisation by these banks and of the growing links between the banking systems of China and Hong Kong.

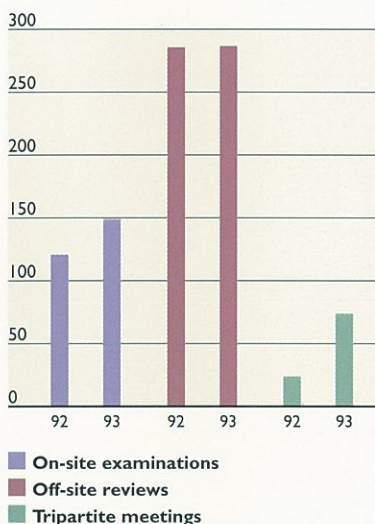
The interest in the Hong Kong market is not however confined to the Asian region. Banks from further afield – Europe and the United States – are also becoming more aware of the opportunities which Hong Kong offers. This is a trend which the Monetary Authority welcomes and supports, providing that new entrants meet the strict criteria for licensing or registration. The Monetary Authority can play its part by helping to provide an environment within which foreign banks will wish to do business, including the maintenance of an effective supervisory system.

OPERATIONAL SUPERVISION

The supervisory approach of the Monetary Authority is based on what the Office of the Comptroller of the Currency in the US has termed “continuous supervision”. This involves the on-going monitoring of institutions, through a variety of techniques, aimed at detecting any problems at an early stage.



WORK ASSIGNMENTS



On-site examinations and off-site reviews

At the core of this approach is the on-site examination. The value of this technique rests on the opportunity it offers to examine at first hand how the institution is managed and controlled. It is particularly useful for verifying the asset quality of institutions. The Monetary Authority has made it a priority to increase the number of on-site examinations which it carries out each year. The total increased from 121 in 1992 to 149 in 1993.

On-site examination does suffer from the disadvantage that it can only provide a "snapshot" of the condition of an institution at the time it is carried out. Thus, in order to achieve "continuous supervision" it is necessary also to carry out off-site analysis of the financial condition of each institution and of the quality of its management. The scope of off-site analysis varies from regular analysis of statistical returns to a more extensive annual review, usually followed by a prudential interview with senior management. A total of 287 such reviews was held in 1993, about the same as in 1992.

Reports by external auditors

Co-operation with both internal and external auditors is another aspect of the supervisory process. During the course of 1993, the Monetary Authority made use of the new powers introduced in the Banking (Amendment) Ordinance 1992 to commission reports from auditors under section 63(3A) on the adequacy of institutions' systems to compile prudential returns (this is in addition to the existing reports commissioned under section 63(3) of the Banking Ordinance on the accuracy of the returns themselves). A total of 358 such reports were commissioned in 1993; in all but a few cases the reports indicated that the relevant systems were adequate.

The work of the auditors will be extended in 1994 to cover the systems

used to ensure compliance with certain provisions of the Ordinance and to maintain adequate provisions for bad debts.

In addition to the recurring reports under section 63, the Monetary Authority made use of the new powers under section 59(2) of the Banking Ordinance to commission auditors' reports on other aspects of institutions' internal controls. After the new legislation became effective in September 1992, 17 such reports had been commissioned by end-1993 on such aspects as credit controls, EDP systems, "high level" controls and controls against money laundering.

The introduction of the new system for reports by auditors has made it necessary to increase the level of contact with them. As a result, a total of 74 tripartite meetings with institutions and their auditors were held in 1993, compared with 24 in 1992.

Use of major powers under the Ordinance

An on-site examination or an adverse auditors' report may indicate serious problems in an institution, which could lead the Monetary Authority to exercise the powers of intervention under section 52 of the Banking Ordinance. These include the power to take control of the business of a troubled institution. No such instances arose in 1993. Nor was it necessary to object to the appointment of any controllers, directors or chief executives of institutions, although on a number of occasions conditions were set for the approval of controllers. A total of 670 approvals was given in 1993.

APPROVALS UNDER THE BANKING ORDINANCE

Controllers	134
Directors	317
Chief Executives	107
Alternate Chief Executives	112

Discussions on inner reserves

The tripartite meetings with locally incorporated banks in 1993 were used as a forum for discussion on inner reserves. This reflected the new approach adopted at the beginning of the year which required banks to establish written policy statements on inner reserves and to consult with the Monetary Authority prior to finalising any transfer to or from inner reserves. The aim is to achieve consistency of approach to the use of inner reserves by institutions, both individually and as a group, and to avoid unnecessary distortions in the trend of published profits. A particular feature of the Monetary Authority's approach is that it believes that transfers *from* inner reserves should be an exceptional event. The Monetary Authority was generally content with the results of its discussions with banks on inner reserves in 1993 and is repeating the exercise in 1994.

Notwithstanding the above policy, the maintenance of inner reserves remains a controversial issue because it is thought to run counter to the trend towards greater accountability and transparency. This is part of a more general concern about the level of financial disclosure by banks in Hong Kong. As a result, the Monetary Authority initiated discussions with the locally incorporated banks at the end of 1993 on whether there was scope for them to provide more financial information in their annual accounts.

The initial reaction of the banks was receptive and it was agreed that a working party of representatives of the banks and chaired by the Monetary Authority should be formed to review the options for more disclosure. The working party met for the first time in January 1994. There was general agreement that more financial disclosure is desirable. Towards this end, the working party is considering the question of more disclosure and how quickly this might take place. The working party hopes to be able to

produce recommendations by mid-1994.

Despite the attention which inner reserves attract, it is important to realise that they account for only a minor part of the total capital base of the locally incorporated banks. By far the major part consists of Tier 1 capital (mainly paid up share capital and *published* reserves and profits). Tier 1 capital grew significantly in 1993, reflecting the rise in profits and new share issues, and the consolidated capital adequacy of the banking system rose to 17%, a level which is high by international standards. No institution fell below the statutory minimum ratio set for it during the course of the year.

Residential mortgage lending

The Monetary Authority continued to monitor carefully the growth in mortgage lending, using its regular monthly survey of 28 institutions which together account for about 87% of such lending in Hong Kong. As in 1992, the growth in lending showed a clear cyclical pattern, with the three-month moving average rising from March onwards to reach a peak of 34% (annualised) in August. Thereafter, the rate of growth fell back reflecting a further tightening of institutions' lending criteria and a reaction to higher prices.

If the peaks and troughs in mortgage lending over the last two years are evened out through use of a 12-month moving average, it appears that the underlying rate of growth in mortgage lending has remained in the range of 13-15% (annualised). This is roughly in line with the growth of nominal GDP during the period and suggests that the 70% loan to value ratio which the banking sector has voluntarily applied since November 1991 has been successful in keeping the underlying increase in mortgage lending within tolerable limits as well as providing a safety margin for individual institutions in case property prices fall. The Monetary Authority continues to

believe that the 70% ceiling should be regarded as a sound prudential measure which the banking industry should maintain on a long-term basis. This does not preclude individual banks adopting even tighter policies, as a number have done.

However, the restraint in residential mortgage lending has not been similarly reflected in lending for property development and investment which rose by 26% during the year. As a result, the overall growth in property lending rose by 19% in 1993 and accounted for 38% of total loans for use in Hong Kong at the end of the period. Against this background, the Monetary Authority wrote to all institutions in February 1994 urging them to keep their overall lending to the property sector within prudent limits.

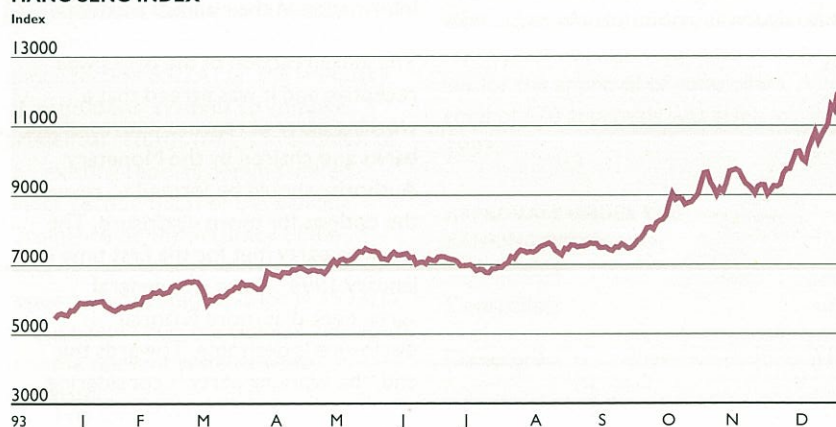
Working party on new share issues

The tendency in Hong Kong towards asset price inflation manifested itself in the stock market as well as the property market during 1993. This was reflected not only in the rise in the Hang Seng Index but also in the massive over-subscription of a number of new issues. The large volume of subscriptions generated by such issues threatened at times to disrupt normal money market conditions, as well as giving rise to concern about the risk exposure of those institutions financing the subscriptions.

Following the particularly heavy over-subscription of the Denway issue in February, the Chief Executive (Designate) of the Monetary Authority established a working party to examine the monetary and supervisory implications. The working party completed its report in March and put forward a number of recommendations. These were directed primarily at ensuring that institutions keep their credit exposures to other institutions and to individual brokers and customers within prudent limits. Among other things, it recommended that institutions apply a 10% margin on new share financing loans to individual brokers and customers.

Following a short period for consultation with the industry, the recommendations were finalised as guidelines at the end of May. Since then, although the scale of the Denway over-subscription has not been repeated, sentiment in the stock market generally remained very positive in 1993, and a number of issues attracted a heavy volume of funds. At times this led to unwelcome upward pressure on overnight interest rates. As a result, the Monetary Authority has recommended further measures, including that the deadline for applications to be submitted should be advanced from noon to 10.00 a.m. on closing day (which would give the receiving bank more time to count the cheques) and that institutions should make prior

HANG SENG INDEX



funding arrangements with the receiving banks before lending substantial amounts to customers.

Survey of China exposure

In the wake of the measures taken by the Chinese authorities at the beginning of July to tighten monetary conditions in China, the Monetary Authority introduced a monthly survey of transactions between the Hong Kong banking system and China. The intention was to try to detect any repatriation of funds to China in order to meet liquidity needs there. The survey covers 24 institutions with significant business with China. It includes information about deposits from and lending to Chinese banks and non-banks. It also covers loans to local and foreign institutions for use in China. The survey revealed some reduction in net HK dollar liabilities of Hong Kong banks to banks in China in the second half of the year, but this was absorbed without any difficulty by the banking sector.

Relationship with other supervisors

The Monetary Authority continued to develop its working relationship with the People's Bank of China, building on the framework for bilateral co-operation in banking supervision which was agreed in 1992. In particular, both authorities consulted one another on applications submitted by banks from their respective territories for cross-border expansion. During the year, four members of the People's Bank were attached to the Monetary Authority on a four-month training secondment.

Closer relationships were also developed with other supervisors, including those in South Korea and Indonesia. A formal Memorandum of Understanding on co-operation in banking supervision was concluded with Bank Indonesia, the central bank of Indonesia. The Monetary Authority also continued to participate in multilateral gatherings of supervisors, including the

SEANZA Forum which met in Tokyo in July.

Regular discussions were also held with other supervisory authorities in Hong Kong, such as the Securities and Futures Commission.

Bank of Credit and Commerce Hong Kong Ltd (in liquidation)

Further dividend payments of 10% and 7% were made to large creditors on 30 April and 8 October 1993 respectively, and a further payment of 6% was made on 28 January 1994. This brought to 64% the total dividends paid to this group. Small creditors (those owed HK\$100,000 or less) had already been paid in full in September 1992, following approval by creditors of a Scheme of Arrangement to this effect. Based on certain assumptions, the Liquidator continues to believe that a total dividend in the region of 70-75% might ultimately be possible.

SUPERVISORY POLICY

The Monetary Authority continued its efforts during 1993 to improve the supervisory and legal framework within which it conducts its supervision. Its guiding principle is to ensure that the system in Hong Kong remains in line with international standards. Equally, however, it recognises that this approach should not be applied slavishly and that the costs and benefits of new supervisory policies and their relevance to the particular circumstances of Hong Kong need to be carefully assessed.

Liquidity

The primary focus during the year was to finalise a revised approach to the supervision of liquidity. This proved difficult to achieve in view of the wide variety of institutions based in Hong Kong and their different liquidity requirements. In particular, it was necessary to give due weight to the view that the liquidity of international banks with branches in Hong Kong is managed (and supervised) on a global basis while at the same time recognising

the need for a level playing field with locally incorporated institutions in Hong Kong.

Proposals on liquidity were developed during the first half of the year, with the help of a working party of industry representatives, and were embodied in two consultative papers. The second of these gained general acceptance from HKAB and DTCA.

The objectives of the new regime are to ensure, as far as possible, that institutions can meet their obligations under normal circumstances and that they have a breathing space in the event of a liquidity crisis. The latter objective can best be met by ensuring that institutions have a pool of liquefiable assets which they can draw upon to raise cash in an emergency. This is the main function of the liquidity ratio. However, the first objective requires that regard be given to a wider range of factors, both qualitative and quantitative, which determine whether or not an institution's liquidity is "adequate". These include its maturity mismatch profile; ability to borrow in the interbank market; diversity and stability of the deposit base; loan to deposit ratio; and intra-group claims. Institutions have been asked to prepare liquidity policy statements setting out their approach to the management of liquidity, taking account of the factors mentioned above.

If the liquidity ratio is to achieve the purpose stated above, it is necessary that the assets that qualify for inclusion should be capable of producing genuine liquidity in a crisis. Revisions to the definition of liquefiable assets will therefore be introduced to try to meet this criterion: these affect such items as marketable securities, export bills and loan repayments. The eligibility criteria for "back-to-back" transactions between a branch in Hong Kong and its head office will also be tightened. These changes will be incorporated in a revised statistical return which it is planned to introduce (on a monthly rather than quarterly basis) in mid-1994.

Interest rate risk and market risk

Apart from liquidity risk, institutions are also subject to the risk that their financial position might be adversely affected by the impact of interest rate changes on their assets and liabilities, both on-balance sheet and off-balance sheet (interest rate risk). There is also the risk of price changes which affect the value of holdings of debt securities, equities and foreign exchange (market risk). The Basle Committee issued consultative papers on these subjects in April 1993 and invited comments from supervisory authorities including Hong Kong. In order to prepare its response, the Monetary Authority in turn consulted HKAB and DTCA and also conducted two surveys in order to assess the degree of the two types of risk presently being incurred by institutions in Hong Kong.

The survey on interest rate risk was conducted on the basis of the "current earnings" approach. This measures the impact on earnings in different currencies of a 1% rise in interest rates in various maturity bands over a 12-month period. This compares with the more complicated "economic value" approach favoured by the Basle Committee.

The results of the survey indicated that the bulk of institutions' interest bearing assets (75%) and interest bearing liabilities (80%) reprice within a short period (three months); and it does not appear that the interest rate risk being run by the industry as a whole is too substantial. Some foreign institutions do, however, appear to be exposed to interest rate losses which are large in relation to their net interest income in Hong Kong, though not necessarily in relation to their worldwide income.

The survey has proved valuable in terms of both improving the Monetary Authority's knowledge about the degree of interest rate risk in Hong Kong and increasing the level of awareness about this type of risk among institutions in Hong Kong.

The market risks survey was used to ascertain the amount of the instruments covered by the Basle proposals held in institutions' trading portfolios. The survey indicated that most locally incorporated institutions do not have substantial positions, particularly in derivatives and in equity-related instruments. The Monetary Authority has therefore advised the Basle Committee that it will need to consider carefully whether and to what extent it introduces the proposals in Hong Kong. This takes into account concern expressed by institutions about the complexity of the proposals and the system implications.

Netting

The Basle Committee has also issued proposals which define the conditions under which banks would be permitted to net, on a bilateral basis, the credit risks arising from trading in off-balance sheet instruments such as swaps. In particular, it would be necessary to demonstrate that the netting arrangements were legally enforceable in each of the relevant jurisdictions involved in a transaction. If the Basle conditions could be satisfied, bilateral netting would reduce the credit exposure in off-balance sheet transactions and thus require less capital to be held against such transactions. It is therefore important that the legal position with regard to netting in Hong Kong can be clearly established. The Monetary Authority is presently engaged in this process, drawing on experience in the UK, whose legal system is similar to that of Hong Kong.

Money laundering

A revised guideline had been prepared in 1992 setting out in greater detail the standards and procedures expected of institutions in their record keeping, customer identification and reporting procedures. The guideline also took account of the recommendations of the Financial Action Task Force on Money Laundering, of which Hong Kong is a member. The issue of the guideline was

however forestalled by a High Court ruling in a court case in August 1992 which repealed certain sections of the Drug Trafficking (Recovery of Proceeds) Ordinance on the grounds that they were inconsistent with the Hong Kong Bill of Rights Ordinance. This removed the legal compulsion on institutions to report to the authorities suspected cases of drug-related money laundering.

The Government appealed against this ruling to the Privy Council, which decided in favour of the Government in May 1993. The relevant sections of the Drug Trafficking (Recovery of Proceeds) Ordinance were reinstated with immediate effect. Following this clarification of the legal position, the Monetary Authority issued its revised guideline in July 1993.

The Monetary Authority has made checking of the arrangements for compliance with this guideline a regular feature of its on-site examinations. Money laundering has also been a subject for discussion with institutions at prudential interviews and tripartite meetings and has so far given rise to five section 59(2) reports by auditors.

Letters of comfort

In 1992 a review was carried out of the policy whereby locally incorporated institutions are allowed to enter into credit exposures in excess of the statutory limit of 25% of capital base if they are supported by a letter of comfort from their parents. After consultation with the BAC and DTCAC, it was decided that the limits for credit exposures covered by letters of comfort should be reviewed and, if necessary, tightened on a case-by-case basis. A revised guideline was issued in July 1993 which sets out the criteria which the Monetary Authority will apply in assessing the acceptability of a comfort letter and the factors that it will take into account in setting the limit for an exposure covered by a comfort letter. In both cases, the issuer's financial strength and status, and the extent to which its large exposures are

managed (and supervised) on a consolidated basis, will be key factors.

Since the issue of the guideline, the Monetary Authority has been conducting a review of existing limits granted to individual institutions.

Loan classification

Poor asset quality is a major cause of bank failures. Supervisors therefore need to be in a position to monitor the asset quality of institutions and to be satisfied that adequate provisions have been maintained against bad and doubtful debts. This is, and will remain, a major focus of the Monetary Authority's periodic on-site examinations. But it is considered that a standard system of loan classification would help provide the Monetary Authority with a clearer picture of the asset quality of individual institutions on a regular basis and would facilitate peer group comparisons. It is therefore proposed to introduce such a system in Hong Kong, along the same lines as those which exist in a number of other countries in the region. A consultative paper setting out the Monetary Authority's proposals was issued in October 1993.

Under the proposed loan classification framework, loans and advances would be classified into the categories of Performing, Special Mention and Non-performing. Non-performing loans would be subdivided into Substandard, Doubtful and Loss. Institutions would be asked to report the provisions held against each of the non-performing categories, but it would not be the intention of the Monetary Authority to mandate the level of provisions which should be held.

The initial reaction of HKAB and DTCA to the proposals has generally been positive, although concern has been expressed about the interface between the proposed system and institutions' internal loan classification systems where these exist. The Monetary Authority will wish to discuss with institutions which maintain internal

systems how they would propose to map their classified loans into the categories set out above. It is planned to introduce the new system during 1994.

Country debt provisioning

The Monetary Authority monitors the adequacy of provisions made by institutions for country risk by reference to the matrix developed by the Bank of England as a guide for UK banks. The matrix was revised during 1993 in order to simplify the scoring system and to enable provisions to be adjusted more swiftly to changing circumstances. The changes were incorporated in a revised guideline on country debt provisioning which was issued to institutions in December 1993. The revised matrix took effect with respect to provisioning decisions made as at the end of 1993.

Legislative changes

The Banking (Amendment) Ordinance 1993 came into operation on 31 December 1993. The Ordinance makes a number of changes which are designed to improve the effectiveness of the legal framework within which supervision is conducted. In particular, it introduced a new section 51A whereby the consent of the Monetary Authority is required for an institution or its locally incorporated holding company to establish or acquire an overseas banking subsidiary. (Such consent was already required in respect of overseas branches and representative offices.) This change brings Hong Kong fully into line with the Basle minimum standards relating to the establishment of overseas banking operations.

A guideline was issued to the banking industry in December setting out how the Monetary Authority proposed to exercise its new powers. A further change in the 1993 Ordinance has reduced the period for locally incorporated institutions to publish their annual accounts in the newspapers from six months to four months after the end of the financial year.

It is intended to bring forward further legislative proposals in 1994 to give the responsibility for the authorisation, revocation and suspension of all three types of authorised institution to the Monetary Authority (the Monetary Authority presently has these powers only in relation to deposit-taking companies). The opportunity would also be taken to clarify and standardise the criteria on which the relevant decisions would be taken.

Authorisation criteria

The existing authorisation criteria are set out in Annex A. A review of these was begun at the end of 1993 and was not complete at the time of writing. The major area for review has been whether there is scope to relax the condition which has applied to all bank licences granted after 1978 (and all restricted bank licences) that the bank should maintain offices to which customers have access for any business in only one building. Given the shortage of office space in Hong Kong and high rental values, there is concern that this condition may have become unduly restrictive.

ONE	1200	HKD	DEPOS
	0301	HSBB	3.69
	0300	BBHJ	3.75
	0300	BNPH	3.75
	0245	HSHK	4.00
	0240	BBHJ	4.06
	0245	HSHK	4.12
	0245	HSHK	4.50
	0000		
	0033	CAHL	4.62
	0251		7.7275

NG MONETARY AUTHORITY

EXCHANGE FUND		
ERN	ISSUE	COUPON
8M	2508	4.625
1M	2511	4.15
4M	2602	4.40