



Banking Supervision

The Monetary Authority's objective is to have a supervisory system that helps preserve the general stability and effective working of the banking system, but which at the same time provides sufficient flexibility for authorised institutions to take commercial decisions. In 1994, a number of policy initiatives were introduced to keep the regulatory framework and regime fully in line with international standards.

Growth of the banking sector

As an international financial centre, Hong Kong continues to attract banks and other financial institutions looking to access the Asian markets, in particular China. During 1994, the number of authorised institutions supervised by the Monetary Authority rose from 371 to 380.

The number of licensed banks rose by eight to 180. New licences were awarded to banks from Europe, United States, Japan and Taiwan, demonstrating the international nature of the banking sector in Hong Kong. The number of restricted licence banks increased by six to 63, mainly through institutions upgrading their deposit-taking company status to expand business activities. As a result, the number of deposit-taking companies continued to decrease, from 142 to 137, although three new companies were registered in 1994.

The banking population is likely to increase in the coming years with banks that have established local representative offices in Hong Kong wishing to upgrade their status. In 1994, 39 banks opened

representative offices, including two specialised banks in China. This indicated a continuing trend towards internationalisation by these banks and the closer links between the banking systems of China and Hong Kong.

Operational supervision

The Monetary Authority's main objectives in 1994 were to perform more on-site examinations and to implement a number of supervisory policy initiatives. The number of on-site examinations rose by 39 to 188, mainly achieved through the formation of two additional examination teams in August and by recruiting more support staff. By the end of 1994, 30 examination teams were in place, almost all of them fully staffed. A standard feature of all on-site examinations performed in 1994 was a review of procedures and controls to prevent money laundering (see table).

Off-site analysis of prudential returns, including an extensive annual review followed by a prudential interview with an authorised institution's senior management, continued to complement the on-site examination

Table: Work Assignments

	1993	1994
On site exam	149	188
Off site review	287	288
Tripartite	74	88

process. The number of prudential interviews was 288, around the same as in 1993. It is the longer term objective to increase the number of these meetings so that an annual prudential interview is held with every institution.

Tripartite meetings involving authorised institutions and their external auditors rose by 14 to 88. These meetings were used to discuss matters arising from the external audit and reports commissioned under the Banking Ordinance. The scope of the reports under section 63(3A) of the Ordinance was 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. Further use was also made of auditors' reports under section 59(2). In total, 25

reports were commissioned on aspects of internal control systems ranging from money laundering prevention to high level controls.

The Monetary Authority did not have to use any of its major powers under the Banking Ordinance in 1994. It did not object to 494 applications to become controllers, directors or chief executives of authorised institutions, although on some occasions conditions were set in relation to controllers. All authorised institutions met their minimum capital adequacy and liquidity ratios at the year end.

Relationship with other supervisors

A working party was established by the Monetary Authority and the Securities and Futures Commission to consider ways of enhancing and co-ordinating the supervision of institutions and financial conglomerates where the two regulators have a common interest. One of the main recommendations was that a "co-ordinator" should be appointed for every institution and financial group where there was such a common interest. While each supervisory authority would retain its statutory responsibilities, the co-ordinator's role would be to ensure that information is shared promptly. Ways of reducing the supervisory burden for those institutions that are subject to dual supervision were also explored. A Memorandum of Understanding is being drafted to

formalise the working party's recommendations.

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

The liquidation of BCCHK progressed well in 1994, with four further dividend payments to the remaining creditors. The announcement of a further dividend payment in January 1995 brought to 83% the total dividends paid to such creditors. Small creditors (those owed HK\$100,000 or less) were repaid in full in September 1992, following approval by creditors of the Scheme of Arrangement. The banking licence of BCCHK was revoked on 28 February 1995. The revocation will not affect the liquidation of BCCHK and future dividend payments.

Property related lending

Property prices, both residential and commercial, rose strongly in the first quarter of 1994. In February 1994, the Monetary Authority wrote to all authorised institutions whose property related lending was in excess of 40% of their loans for use in Hong Kong and to those who had expanded their property lending by more than 20% over the previous year. These institutions were requested to provide the Monetary Authority with a policy statement, setting out their lending procedures and limits for this type of lending. Those institutions in excess of the 40% threshold were encouraged to reduce or at least stabilise their

exposure to the property market.

Authorised institutions continued to maintain the 70% loan to value ratio for mortgage lending, which has been voluntarily applied since November 1991. Indeed, with the sharp rise in property prices in the early part of the year, some institutions lowered their lending ratios for higher value properties. In the latter part of the year when property prices fell and there was a contraction in the rate of growth in mortgage lending, the Monetary Authority re-affirmed its view that the maximum 70% loan to value ratio should be maintained.

Financial disclosure by Authorised Institutions

An industry working party, chaired by the Monetary Authority and comprising representatives of seven local banks and the Chairman of the DTCA, was set up in January 1994 to consider proposals for greater financial disclosure by authorised institutions in their annual accounts. This followed recognition that Hong Kong had fallen behind international practice in this respect.

The working party recommended that there should be full disclosure of banks' profits and more detailed information on the breakdown of assets and liabilities, bad debt provisions and off-balance sheet items.

At the same time the SEHK and SFC were also preparing their own

proposals in respect of listed banks. It seemed sensible therefore that the Monetary Authority, SEHK and SFC should adopt a joint approach. This co-operation worked well and led to an agreed package of disclosures for the 1994 accounts. These were embodied in a "Best Practice Guide on Financial Disclosure" issued by the Monetary Authority in September.

Under the 1994 measures, banks have revealed much more information than previously about their actual profits, the structure of their balance sheets and the quality of their assets. It is intended that further disclosure will take place in the 1995 accounts. An initial package has already been agreed. Major items under continuing discussion include segmental analysis, off-balance sheet exposures and cash flow statements. It is also intended that the question of disclosure of balance sheet inner reserves should be reviewed by the Monetary Authority in mid-1995.

Money laundering

In early 1994, the Financial Action Task Force conducted an evaluation on the effectiveness of the anti-money laundering measures in Hong Kong. It concluded that while the Hong Kong Government had shown sincere commitment in addressing the problems of money laundering, there were certain areas, such as staff training, where greater effort could be made by authorised institutions.

In responding to these comments, HKAB released in October a training package, including a video, to promote banking employees' awareness of money laundering and their obligations to report suspicious transactions. Preliminary indications are that this initiative had an immediate impact in increasing the numbers of reports of suspicious transactions made to the Joint Financial Intelligence Unit. This, together with the more intensive supervisory effort made by the Monetary Authority in this area, resulted in the number of suspicious transaction reports made by institutions to the Joint Financial Intelligence Unit rising from 364 in 1993 to 549 in 1994.

The Monetary Authority will revise the guideline it has issued on money laundering to take account of the Organised and Serious Crimes Ordinance, which came into effect in December. This has extended the anti-money laundering provisions to cover funds derived from all indictable offences rather than, as previously, from drug trafficking only.

Supervision of liquidity

The Monetary Authority finalised the review of its approach to the supervision of liquidity and issued a policy paper in January 1994. The new approach, which came into effect on 1 August, looks at a variety of quantitative and qualitative factors to assess the adequacy of an authorised institution's liquidity, such

as the statutory liquidity ratio, maturity mismatch profile, ability to borrow in the interbank market, diversity and stability of the deposit base, loan to deposit ratio, and intra-group transactions.

In order to introduce the new regime, the frequency of the liquidity return was increased from quarterly to monthly and the Fourth Schedule to the Banking Ordinance was amended to implement changes to the statutory liquidity ratio. As the Monetary Authority believes that the primary responsibility for the prudent management of liquidity rests with the board and management of authorised institutions, each institution was asked to draw up its own liquidity policy statement and submit it to the Monetary Authority. During the year, the Monetary Authority discussed the liquidity policy statements with institutions and will continue this process on an on-going basis. A relatively small number of institutions could not immediately meet the 25% minimum liquidity ratio under the new definition. However, after making balance sheet adjustments, all institutions were able to comply quickly.

Loan classification

The consultation paper issued in October 1993 on the proposal for a loan classification system received general support from the industry associations. The only major concern was how to correlate the Monetary

Authority's framework, which classifies loans into categories of performing, special mention, substandard, doubtful and loss, with the systems already established by a number of authorised institutions.

During the year, the Monetary Authority had discussions with all such institutions on their internal loan classification systems. Whilst most institutions already had systems which were generally compatible with the Monetary Authority's framework, it was necessary to agree with some institutions on how their internal loan classifications would be "mapped" into the Monetary Authority's system.

The new loan classification return should help to give the Monetary Authority better information about the quality of institutions' loan books. In particular, it should give an early warning of any deterioration, as loans proceed through the various categories. A standard reporting system will also enable the Monetary Authority to judge better the adequacy of provisions in relation to problem loans and to make peer group comparisons among different institutions.

Netting

The Basle Committee issued a paper in July to amend the Basle Capital Accord to recognise the effect of bilateral netting on off-balance-sheet transactions, such as interest rate swaps. As a result, banks would be

able to measure the credit exposure on such instruments on a net rather than gross basis for capital adequacy purposes. This is subject to certain conditions, in particular that the bilateral netting agreement must be enforceable in all relevant jurisdictions and should be able to withstand a challenge in court by the liquidator of a defaulting party.

At the request of the Monetary Authority, the Company and Financial Law Committee of the Law Society has produced a Statement of Law on netting. This confirms that Hong Kong law is generally sympathetic to the concept of netting. On this basis, the Monetary Authority felt able to implement the Basle proposals in Hong Kong subject to certain conditions which are set out in a policy paper which was issued in January 1995. To give formal effect to the recognition of bilateral netting for capital adequacy purposes, the Third Schedule to the Banking Ordinance will be amended.

The Monetary Authority also participated with the Foreign Exchange and Money Market Practices Committee to help develop a Hong Kong version of the IFEMA. This master agreement covers foreign exchange transactions and forms a basis for bilateral netting. The Monetary Authority has accepted that the Hong Kong IFEMA complies with its policy paper on netting.

Derivatives

In responding to the rapid growth of derivatives activities, the Basle Committee and the Technical Committee of the International Organisation of Securities Commissions issued a joint statement in July, providing guidance on the sound risk management of derivatives activities. Drawing on this work, the Monetary Authority issued its own guideline in December. This guideline stressed the importance of oversight by the board of directors and senior management, the establishment of adequate risk management processes, and proper internal controls and audits. A "Questionnaire on Derivative Risk Management Practices" was also sent out to authorised institutions who actively engage in derivatives activities to ascertain the extent of their business and their existing control procedures. In early 1995, the Monetary Authority conducted a series of treasury visits to further increase its understanding of best practice in this area. It is intended that a more detailed guideline which will focus on the operational aspects of risk management will be issued during 1995.

Authorised institutions have been requested to provide information on the volume of their derivatives business in Hong Kong as part of the BIS global survey on foreign exchange and derivatives activities which is being conducted in 1995.

Interest rate and market risks

Following a survey conducted in 1993, the Monetary Authority decided to collect information on the interest rate risk exposure of authorised institutions on a regular basis. In early 1995, a new quarterly return was issued that adopts the "current earnings" approach which measures the impact on earnings in different currencies of a 1% rise in interest rates. The rise in interest rates in Hong Kong during 1994, in line with that in the United States, has emphasised the need for institutions to measure and manage their interest rate exposure.

The Monetary Authority has also continued to keep in touch with progress on the Basle Committee's proposal to incorporate "market risk" into the capital adequacy framework. Under these proposals, authorised institutions would be required to hold capital against the risk arising from price fluctuations in the market value of equities, debt securities and foreign exchange positions (including their derivatives) held in trading portfolios. The main problem has been how to reconcile the standard "building block" approach recommended by the Basle Committee with the more sophisticated internal pricing and valuation models used by major market participants.

It is likely that the Basle recommendations will be finalised during the course of 1995. The

Monetary Authority will then need to consider how and to what extent they should be introduced in Hong Kong, bearing in mind that most locally incorporated institutions are not yet heavily involved in trading securities, derivatives or foreign exchange.

Asset Securitisation

Three authorised institutions issued mortgage backed securities in 1994 totalling HK\$2.35 bn, and one institution securitised US\$200 mn of credit card receivables. The renewed interest in asset securitisation prompted the Monetary Authority to re-examine its guidelines on this subject, which were originally issued in 1991. With the assistance of a working party formed by the Monetary Authority to consider the development of the secondary mortgage market, new guidelines have been developed. These guidelines set out the principal requirements for securitised mortgages to be removed from the balance sheet for capital adequacy purposes and the criteria for obtaining the 50% concessionary weighting under the capital adequacy regime for holdings of mortgage backed securities. In order to reflect these new requirements, minor amendments to the Third Schedule of the Banking Ordinance will be introduced.

Legislative changes

New legislative proposals were developed during 1994 which have

been embodied in the Banking (Amendment) Bill 1995. The principal feature of the Bill is to give the Monetary Authority the responsibility for the authorisation, suspension and revocation of all three types of authorised institution. The opportunity has also been taken to standardise and expand the statutory criteria for authorisation and revocation and to set these out in schedules to the Ordinance. It is considered that these new arrangements will improve the checks and balances in, and transparency of, the authorisation regime.

In addition, amendments to the provisions of the Banking Ordinance relating to the Monetary Authority's power to take control of authorised institutions are also set out in the Bill. These include new provisions that will clarify the scope, objectives, duties and powers of a Manager, appointed by the Monetary Authority, to take control of the affairs, business and property of an institution in difficulties. A number of other provisions in the Ordinance have also been revised in the light of practical experience gained in its operation.

Authorisation Criteria

The existing authorisation criteria are set out in Annex A.

The "one building condition", which has been attached to the licences of all overseas incorporated banks and

restricted licence banks since 1978, was relaxed during the year. The condition required the relevant institutions to confine their business to offices in only one building in Hong Kong. The relaxation was in response to the acute shortage of office space and escalating rents in Central District, and requests made by some institutions to move their regional office and back office operations to cheaper locations. Foreign banks are now allowed to open, in addition to their existing office, not more than one regional and one back office in separate buildings. A guideline setting out the activities that can be conducted at regional and back offices was approved by the Governor in Council and was issued in September.



◆
*A series of \$1,000 gold coins
commemorating the Chinese New
Year commenced in 1976.*

*The designs depict the Chinese
zodiac animal for each year
from 1976 to 1987.*

◆

