

THE HONG KONG MONETARY AUTHORITY CONTINUES TO TAKE THE NECESSARY STEPS TO PRESERVE THE STABILITY OF THE HONG KONG BANKING SECTOR AND TO ENSURE THAT THE SUPERVISORY REGIME REMAINS FULLY IN LINE WITH INTERNATIONAL STANDARDS. DURING 1995 THESE INCLUDED THE INTRODUCTION OF A NUMBER OF LEGISLATIVE CHANGES AND FURTHER POLICY INITIATIVES.

GROWTH OF THE BANKING SECTOR

Hong Kong maintained its position as an international financial centre in 1995 despite strong competition from other Asian banking centres. Few, if any of these, can match Hong Kong's combination of attributes: a strategic geographical position with close ties to China; a reliable legal system; sound infrastructure; a professional workforce; freedom from unnecessary regulation; freedom of entry for companies and freedom to do business; and a "critical mass" of other financial institutions. While the overall number of authorised institutions remained unchanged at 380, the core of licensed banks continued to expand, offset by further rationalisation in the deposit-taking company sector.

The net number of licensed banks rose by five to 185. In all, eight banks were granted licensed bank status, seven of which upgraded from representative offices and one from a restricted licence bank. Three of the eight were from China, reflecting a further stage in the commercialisation of these banks. The others were from Japan, the United States and Belgium. Two licensed banks gave up their

licences, and the licence of Bank of Credit and Commerce Hong Kong Limited was revoked, during the year.

The net number of restricted licence banks was unchanged at 63. Two banks were granted restricted licence bank status, one from South Korea and the other, which upgraded from a deposit-taking company, from France. One gave up its licence, and the licence of Bishops court (BB & Co.) Limited (formerly Baring Brothers & Co. Limited) was revoked. The net number of deposit-taking companies fell by five to 132, continuing the trend of recent years.

Twenty new representative offices were established in 1995, including banks from the United States, Europe, Asia and South America. A number of these offices are likely to be upgraded to authorised status in due course.

OPERATIONAL SUPERVISION

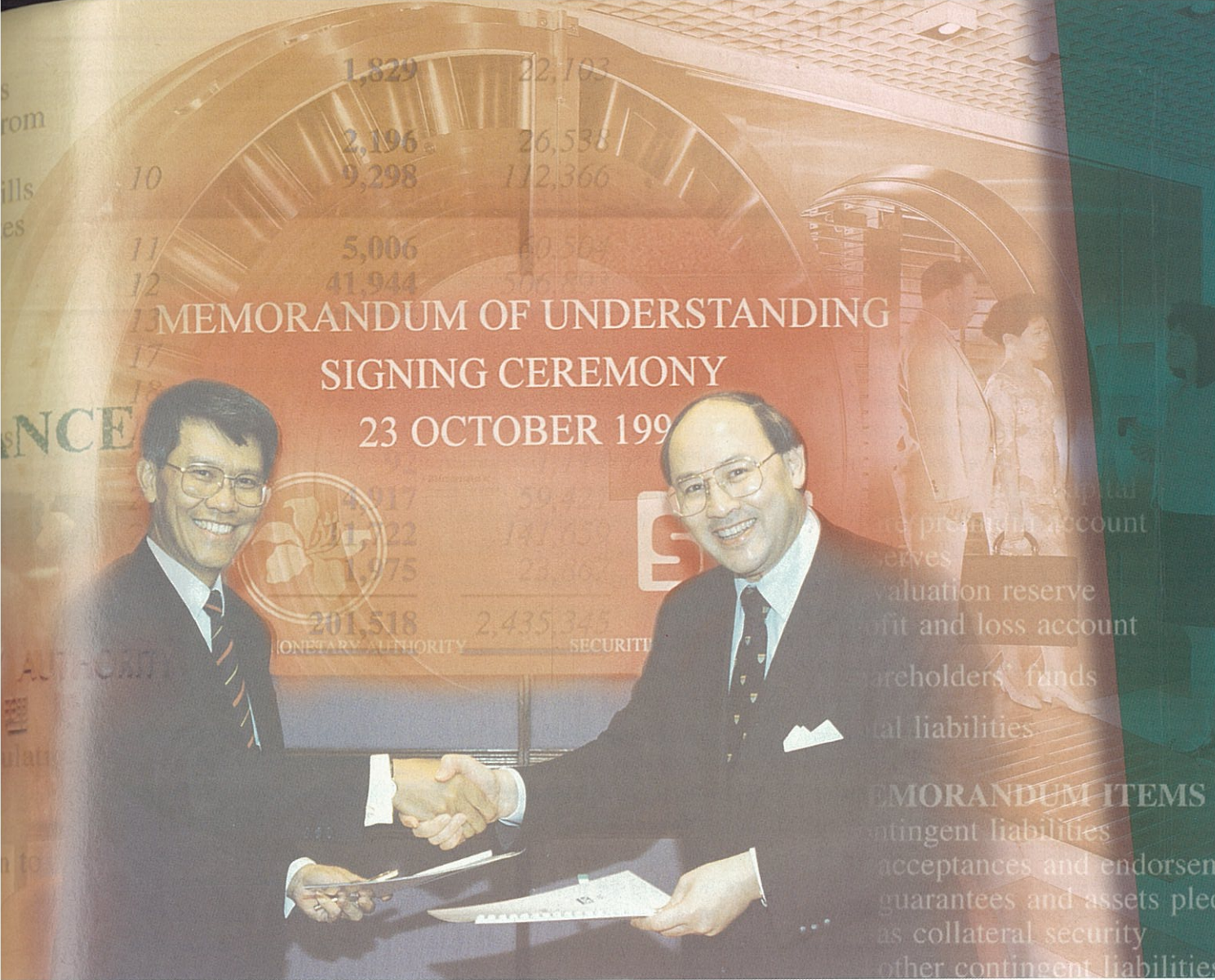
The HKMA's main priorities for 1995 were firstly to increase the number of off-site reviews, and secondly, in the light of the Risk Management Guidelines for Derivatives issued by the HKMA in December 1994, to review the treasury and derivatives



trading activities of those authorised institutions most active in these areas. Both objectives were met satisfactorily.

The number of off-site reviews - which comprise an extensive review of an institution's activities, followed by a prudential meeting with the institution's senior management - increased by more than 30% to 378, with virtually every institution subject to a review within the calendar year. An annual cycle is proposed for such reviews and prudential meetings henceforth.

In March 1995, following the collapse of Barings, the HKMA requested all authorised institutions to commission a review, by either



their internal or external auditors, of the controls over their derivatives trading in Hong Kong. These reviews revealed that 101 institutions had operations in derivatives, of which 46 could usefully strengthen their controls. The HKMA has been keeping closely in touch with the management of these institutions to ensure that appropriate improvements are implemented. Parallel to this, the HKMA formed a specialist team on derivatives which conducted treasury visits to 14 institutions during the year. The objectives of these visits were firstly to review the institutions' control systems, focusing in particular on possible areas of weakness identified by the "Barings" reports, and

secondly to increase the HKMA's understanding of institutions' derivatives activities and the related internal controls. These visits have proved to be very useful. It is envisaged that the HKMA will continue to conduct such visits in 1996.

The number of on-site examinations of institutions conducted in 1995 increased by 8% to 203. The HKMA adopts a prioritised or "risk-based" approach to the scheduling and content of such examinations, ensuring that supervisory resources are employed in the most relevant and effective manner.

Tripartite meetings with institutions' management and external auditors

have become an increasingly important element of the supervisory process. In 1995 the number of such meetings increased by more than 50% to 135, and it is anticipated that there will be further growth in 1996. In addition, contact with institutions' internal audit functions will be increased.

**TABLE: WORK ASSIGNMENTS**

	1994	1995
On-site exam	188	203
Off-site review	288	378
Tripartite	88	135
Treasury visit	—	14
<b>TOTAL</b>	<b>564</b>	<b>730</b>

During the course of 1995 the HKMA commissioned eight reports under Section 59(2) of the Banking Ordinance, on specific aspects of institutions' control systems, such as those designed to combat money laundering.

The HKMA had on one occasion to exercise its major powers under the Banking Ordinance in 1995. On 27 February 1995, the HKMA took action against Baring Brothers & Co. Limited under Section 52 of the Ordinance. This had the effect of requiring the bank to keep its branch in Hong Kong closed for normal business. The requirement was lifted on 4 April 1995. The business of the bank (whose name was changed to Bishops Court (BB & Co.) Limited) was subsequently transferred to a new company, Baring Brothers Limited; and its licence was revoked on 5 July 1995.

The HKMA approved 520 applications under the Banking Ordinance to become controllers, directors or chief executives of authorised institutions, a slightly higher number than for 1994. All authorised institutions met their required capital adequacy and liquidity ratios at the year end.

#### **ORGANISATION OF THE BANKING SUPERVISION DEPARTMENT**

Some important organisational changes and changes in work practices were introduced during the year, to enhance the efficiency, consistency and effectiveness of the Banking Supervision Department.

Standardised formats were introduced for the Department's

internal off-site reviews and external on-site examination reports. These formats will be revised on an ongoing basis to reflect best supervisory practices. Changes were also made to the allocation of work responsibilities. Before introduction of these changes in August 1995, the members of a three-person examination team, under the guidance of a more senior member of staff, worked jointly on the group of institutions assigned to them. Under the new arrangement, each member of a team is designated the "case officer" for a number of institutions and works primarily on those institutions. The expectation is that staff members will build up a more in-depth knowledge under the new system of the institutions assigned to them, and will develop closer contacts with those institutions. It is hoped that this will also improve those staff members' job satisfaction. Staff will continue to be rotated from time to time to ensure that they develop a broad-based experience of different types of institutions.

#### **RELATIONSHIP WITH OTHER SUPERVISORS**

In October 1995 a Memorandum of Understanding ("MOU") between the HKMA and the Securities and Futures Commission ("SFC") was signed, with a view to formalising co-ordination and co-operation between the two. The MOU provides for the appointment of a co-ordinator for each institution or financial group in which both regulators have an interest. There will also be improved exchange of information; greater consultation on staff training and the formulation of

policy; and regular meetings to discuss policy matters and supervisory issues relating to institutions in which both have an interest.

Such agreements between regulators are an increasingly important means of guarding against supervisory "overlap" (i.e. duplication of supervision) and supervisory "underlap" (i.e. gaps in supervision), thereby ensuring that the supervisory approach of banking and securities regulators is as consistent as possible and that the regulatory burden on institutions is minimised. For example, under the MOU the HKMA will, pending the rationalisation of the securities legislation administered by the SFC, be responsible for the supervision of the securities business of authorised institutions that are exempt dealers. The HKMA has issued a letter informing such institutions of the principles governing the supervision of their securities business. In general, these exempt dealers are expected to comply with all relevant legislation and regulations and conduct their business in a responsible, honest and business-like manner. The SFC's Code of Conduct for securities dealers will be used as a guide to the standards which these institutions should maintain. The HKMA will monitor compliance in its on-site examinations of these institutions.

The HKMA has also established relationships with a large number of overseas supervisory agencies, particularly the home country supervisors of the many foreign banks to which Hong Kong plays

host, and the local supervisors in overseas countries in which Hong Kong banks are represented. In addition, supervisory matters are regularly discussed in the bilateral meetings which are held with central banks and monetary authorities of other countries in the region.

### LEGISLATIVE CHANGES

A key task for 1995 was to secure the passage of the Banking (Amendment) Ordinance 1995. This was enacted on 29 June 1995 and came into effect on 15 November 1995. The Ordinance enhances the HKMA's central banking role by establishing the HKMA as the licensing authority responsible for the authorisation, suspension and revocation of all three types of authorised institutions. Decisions relating to these matters will be taken on the basis of transparent and clearly defined authorisation and revocation criteria set out in Schedules of the main Ordinance. The Ordinance also improves checks and balances in the authorisation procedures by requiring the HKMA to consult the Financial Secretary on important authorisation decisions, such as suspension and revocation, and retaining the Governor-in-Council as the appellate body for hearing appeals against decisions made by the HKMA.

The Ordinance also strengthens the HKMA's ability to deal with a banking crisis by defining more clearly the scope, objective and powers of a Manager appointed under the Banking Ordinance to take control of a problem authorised institution. Appropriate checks and balances have also been included to

safeguard against unreasonable use of the new powers vested in the Manager.

Concurrent with the commencement of the Banking (Amendment) Ordinance, the HKMA published a Guide to Applicants setting out the HKMA's interpretation of the authorisation criteria and the grounds for revocation contained in the Ordinance and the procedures for processing applications for authorisation. In addition to providing instruction to institutions seeking authorisation under the Banking Ordinance, the Guide is also relevant to existing authorised institutions as the authorisation criteria are of a continuing nature. The publication of the Guide further increases the transparency of the HKMA's approach in regulating authorised institutions and represents an important step in the development of the banking supervisory system in Hong Kong.

During discussion with the Bills Committee of the Legislative Council (LegCo) on the Ordinance, the HKMA undertook to establish a Banking Supervision Review Committee to strengthen internal checks and balances in order to reduce the risk of negligence and misuse of power. The Review Committee, which comprises senior officers of the HKMA, will consider, advise and make recommendations to the Chief Executive of the HKMA on major authorisation decisions under the Banking Ordinance and important policy and supervisory issues.

Work on the Banking (Amendment) Bill 1996 has already commenced. The scope of the Bill includes legislative changes for regulating the issue of multi-purpose stored value cards ("smart cards") and money brokers operating in the wholesale foreign exchange and deposit market. The opportunity may also be taken to consolidate the Banking Ordinance by streamlining some of the existing provisions.

### FINANCIAL DISCLOSURE

The Working Party on Financial Disclosure chaired by the HKMA has continued discussion on further disclosure for the 1995 accounts. Phase I of the 1995 disclosure package, which covers the relatively straightforward items, was released to the industry in December 1994. The Phase II package, which covers off-balance sheet exposures, segmental reporting and non-performing loans, was issued in August 1995.

The HKMA completed its review on the question of the disclosure of balance sheet inner reserves in October 1995. The review concluded that the disclosure of transfers to inner reserves in the 1994 accounts had not caused any major adverse impact on the banks and that the disclosures in the 1994 accounts had already prepared the way for disclosure of balance sheet inner reserves. The banks consulted by the HKMA raised no objection to making the disclosure in their 1995 accounts.

In light of the above, the HKMA recommended the disclosure of balance sheet inner reserves in the 1995 accounts of banks. The Best

Practice Guide was updated in October 1995 to incorporate this and other recommendations included in Phases I and II of the 1995 disclosure package. The HKMA has, however, made it clear that the significance of balance sheet inner reserves should not be over-played. In particular, in considering the capital strength of a bank, it is more important to look at the capital adequacy ratio, as recommended by the Basle Committee, which has been adopted in Hong Kong since the end of 1989.

The HKMA will continue work on further proposals for the 1996 accounts, covering areas such as cash flow statements and market risk exposure.

#### **CONTINUAL MONITORING OF PROPERTY RELATED LENDING**

Authorised institutions continued to maintain the 70% loan to value ratio for mortgage lending, which was voluntarily adopted by the banking sector in 1991 and has since become the industry standard.

Notwithstanding the relatively subdued property market in 1995, the HKMA believes that the ceiling has served authorised institutions well during the peaks and troughs in the market and should not be adjusted in response to what may be short-term changes in market conditions. While the default rate on residential mortgage loans is very low in Hong Kong, it is important that banks maintain an adequate cushion to guard against a significant downturn in property prices. The Government therefore supports maintenance of the 70% ceiling as a long-term policy important for

promoting stability in the banking system.

There is, however, flexibility in applying the guideline. The HKMA has not opposed the introduction of co-financing schemes which enable borrowers to obtain financing in excess of 70% of the value of new properties through the provision of "top-up" loans by property developers. Such innovation should not, however, go too far. Conscious of the importance of maintaining the basic integrity of the 70% ceiling, the HKMA has issued a further guideline requesting authorised institutions to adhere to certain basic principles relating to co-financing schemes, in particular: institutions should not advance more than 70% of the value of the property; the top-up loan should not be provided by another authorised institution; and the institution providing the residential mortgage loan should assess carefully the ability of the borrower to service the total debt, including the payments on the top-up loan.

In February 1994, when both property prices and property lending grew rapidly, the HKMA advised those institutions with property exposures in excess of 40% of loans for use in Hong Kong, to consider how that percentage could be stabilised and, if necessary, reduced. Following a review of the 40% guideline, the HKMA clarified in September 1995 that the industry average of 40% should be regarded as a benchmark rather than an upper limit. It is accepted that some institutions (particularly local banks with large residential mortgage portfolios) may have percentages in

excess of 40%. However, such institutions should generally exercise additional restraint and caution in expanding their property lending.

#### **DERIVATIVES AND RISK MANAGEMENT**

The HKMA continues to take a proactive approach to the supervision of authorised institutions' derivatives activities. A number of the steps taken, such as the "Barings" internal control reviews and treasury visits, have already been discussed.

Further to the issue of a guideline on risk management for derivatives in December 1994, the HKMA issued a more detailed operational guideline in March 1996. Among other things, this draws on observations from the internal control reviews, the treasury visits and the lessons from the Barings and Daiwa Bank incidents.

The Basle Committee and the Technical Committee of the International Organisation of Securities Commissions issued a joint paper in 1995 on the Framework for Supervisory Information on Derivatives Activities. The HKMA is studying the recommendations in the paper to determine how best to improve access to comprehensive and timely information on institutions' derivatives activities.

The staff resources of the specialist team on derivatives mentioned earlier were strengthened during the year with the recruitment of additional expertise on derivatives products and financial models. The objectives of this team are to

conduct treasury visits and examinations, review authorised institutions' risk management and pricing models, formulate supervisory policies and guidelines on derivatives, and provide training to the staff of the HKMA.

#### **NETTING AND CAPITAL ADEQUACY**

The Third Schedule to the Banking Ordinance was amended in June 1995 to recognise, for capital adequacy purposes, the effect of bilateral netting of credit exposures arising from off-balance sheet transactions. A policy paper setting out the conditions under which the HKMA would be prepared to recognise netting arrangements, and the method of calculating the resulting credit exposures for capital adequacy purposes, was issued in February 1995.

The broader recognition of bilateral netting for capital adequacy purposes was implemented by the Basle Committee in two phases. The first phase, implemented in July 1994, recognises the netting of current credit exposures; the second phase, implemented in April 1995, recognises the netting of potential future credit exposures. While the 1995 amendments to the Third Schedule incorporate the first phase, further legislative amendments will be implemented during 1996 to reflect the second phase.

Also included in the April 1995 Basle amendments is an expansion of the coverage of off-balance sheet contracts to include derivatives relating to equities, precious metal and other commodities. Such changes will also be featured in the

1996 Third Schedule amendments.

#### **MARKET RISKS**

In April 1995, the Basle Committee issued a set of consultative proposals to amend the Capital Accord of 1988 to take account of market risks. Such risks are defined as the risk of losses in on and off-balance sheet positions arising from movements in market prices. The Basle proposals set out a framework for applying capital charges to the market risks incurred by banks in their trading book of debt and equity instruments and in their foreign currency and commodities positions. Firm proposals incorporating a detailed Amendment to the Capital Accord were released by the Committee in January 1996. The amendments will take effect by end 1997 at the latest.

The HKMA has been following the progress of the development of the Basle proposals with a view to introducing similar capital requirements in Hong Kong. Reference has also been made to the Capital Adequacy Directive - the market risk framework implemented in January 1996 by the European Union.

The HKMA provisionally intends to adopt a three-tier approach in the market risk regulatory framework. Sophisticated institutions with in-house financial models to measure and manage their market risks will be allowed to use such models as the basis to calculate their market risk capital charge, subject to assessment by the HKMA of the models and the surrounding risk management procedures. Institutions with minimal trading activity in treasury products and financial

derivatives will be exempted from the framework - a *de minimis* exemption. The remaining institutions will adopt the Basle Committee's "standardised method" to arrive at their market risk capital charge. It is intended that reporting by authorised institutions in respect of their market risk exposures will be implemented by the end of 1996, with minimum capital requirement to carry statutory effect at a later date.

The HKMA participated in the BIS triennial survey of foreign exchange and derivatives activities in 1995. The results of the survey provided useful information for the general assessment of the market risk exposures of authorised institutions in Hong Kong. Further data on local institutions' market risk exposures is required to assist the development of the supervisory regime and to assess the appropriate *de minimis* exemption criteria. To this end, institutions have been asked to participate in a market risk survey in the first quarter of 1996.

#### **GUIDELINE ON LEVERAGED FOREIGN EXCHANGE TRADING AND UNSOLICITED CALLS**

Under the Leveraged Foreign Exchange Trading Ordinance ("LFETO"), authorised institutions have been granted an exemption from the licensing requirements in relation to leveraged foreign exchange trading. However, under the LFETO, they are prohibited from making unsolicited (i.e. "cold") calls. The HKMA has reached agreement with the SFC to exempt such calls by authorised institutions seeking to sell leveraged foreign exchange contracts

where the calls comply with guidelines issued by the HKMA.

The Guideline on Leveraged Foreign Exchange Trading, published in July 1995, sets out the parameters within which authorised institutions may make unsolicited calls. The contents of the Guideline were subsequently considered by the LegCo Sub-committee. Some members expressed concern about an exemption that allows authorised institutions to make cold calls by phone to customers with deposits in excess of \$500,000 with the institution or assets in excess of \$500,000 under management by the institution. Having regard to the LegCo Sub-committee's preference for a more conservative approach, the HKMA raised the thresholds concerned to \$750,000. The HKMA has recently issued a further guidance in respect of the conduct of making unsolicited calls.

## **MONEY LAUNDERING**

To promote the reputation and credibility of Hong Kong as a financial centre, it is the policy of the HKMA to reinforce professional conduct among authorised institutions and ensure that their staff take effective measures to guard against money laundering. Following efforts made by the HKMA and HKAB, there are clear signs that the level of awareness of the problem of money laundering in the banking sector has improved as evidenced by the increasing number of suspicious transactions reported to the Joint Financial Intelligence Unit. The number of reports rose by 226% to 1,787 in 1995 compared with 549 in 1994. It should be emphasised that

this increase does not imply that the scale of money laundering has increased. Rather, more suspected cases are now being reported partly because of the efforts described above, and partly because of the now wider definition of the money laundering offence. This follows the passage of the Organised and Serious Crimes Ordinance which has extended the money laundering offence to cover the proceeds of indictable offences other than drug trafficking.

The HKMA's Guideline on Money Laundering is being revised to take account of the passage of the Organised and Serious Crimes Ordinance. In addition, amendments to both this Ordinance and the Drug Trafficking (Recovery of Proceeds) Ordinance came into effect in September 1995, which make it an offence to fail to report, within a reasonable period, knowledge or suspicion of money laundering transactions to the Joint Financial Intelligence Unit. This has imposed a specific requirement on banks and other financial institutions to make such reports and thus corrected a deficiency in the previous arrangements. The revised Guideline will spell out this statutory reporting obligation.

Compliance with the Guideline is also a regular agenda item for on-site examinations and prudential meetings. If necessary, the HKMA will also require authorised institutions under section 59 of the Banking Ordinance to commission reports from their external auditors on the effectiveness of their internal control systems for the prevention of

money laundering. In 1995, the subject of money laundering was covered in 196 on-site examinations and 365 prudential meetings, and five auditors' reports were commissioned.

## **CAMEL RATING SYSTEM**

During 1995, refinements were made to the "CAMEL" rating system adopted by the HKMA. The five components of CAMEL are: Capital, Asset quality, Management, Earnings, and Liquidity. The main focus was to improve consistency in the rating of individual institutions by establishing a set of qualitative factors and quantitative measurement yardsticks as reference points for our examiners.

The CAMEL rating system helps identify those institutions whose weaknesses in financial condition, compliance with laws and regulations, and overall operating soundness require special supervisory attention. Under the system, each authorised institution is assigned a composite rating based on a performance evaluation of the five CAMEL components. The composite rating is expressed through the use of a numerical scale of "1" through "5" in ascending order of supervisory concern; "1" indicates the highest rating and least degree of concern, while "5" is the lowest rating and the highest degree of concern.

Informing authorised institutions of their composite rating is an important feature of the revised rating system. Once the HKMA has completed a review of the CAMEL ratings of an authorised institution

(usually after an off-site review or an on-site examination), the chief executive of the institution will be informed of the composite rating. The HKMA will finalise the composite rating after taking into account comments from the chief executive. The chief executive is expected to communicate the composite rating and HKMA's assessment to the board of directors of the institution (or head office in case of a foreign bank branch). In the case of a rating of 3 or below, the chief executive is expected to provide the HKMA with an action plan to rectify the problems identified.

At present, the CAMEL rating system applies to both locally incorporated institutions and branches of foreign banks. The HKMA is currently reviewing the ROCA/SOSA rating system recently introduced by the US supervisory agencies for evaluating foreign bank branches. The ROCA/SOSA rating system evaluates the Risk management, Operations, Compliance, and Asset quality of a foreign bank. It also includes a Strength Of Support Assessment assessing the strength of the parent company and the supervisory adequacy of the home country. While this review is ongoing, all authorised institutions will be evaluated under the CAMEL rating system.

#### **LIQUIDITY**

The new supervisory regime for liquidity has operated smoothly during 1995. All authorised institutions were able to comply with the statutory minimum liquidity ratio

of 25%, albeit by differing margins. The HKMA continues to discuss with individual institutions their internal liquidity policy statements. By the end of 1995, more than 90% of the authorised institutions had agreed their policies with the HKMA.

#### **PRIORITY PAYMENT TO SMALL DEPOSITORS**

The failure of Bank of Credit and Commerce Hong Kong Limited in July 1991 prompted discussion on whether or not a deposit insurance scheme should be introduced. A full scale public consultation was carried out in 1992. Taking into account the result of the consultation, the Government decided in January 1993 that such a scheme should not be introduced. Instead, an alternative scheme, whereby small depositors would receive priority treatment in the event of a bank liquidation, should be put in place.

Details of the scheme were developed and embodied in the Companies (Amendment) Ordinance 1995 which was enacted in July 1995. Section 16, which was put into operation in August 1995, requires that upon the winding up of a bank, the aggregate amount held on deposit, up to a maximum of \$100,000 to each depositor, be paid as priority debt together with other priority claims defined by the Companies Ordinance.

#### **CODE OF BANKING PRACTICE**

In December 1995, the Banking Advisory Committee and the Deposit-Taking Companies Advisory Committee (DTCA) endorsed the proposal of the HKMA to develop

with the banking sector a Code of Banking Practice (the "Code") in Hong Kong. The Code is expected to cover such areas as the provision to customers of information about the terms and conditions of banking services and the relevant fees and charges as well as the procedures for handling customer complaints.

The introduction of such a Code will help to promote good banking practices and a fair and transparent relationship between authorised institutions and their customers. This should enhance customer loyalty and confidence thus contributing to the stability of the banking system. A working group comprising representatives of the HKMA and the two industry associations has been formed to undertake the drafting of the Code.

#### **WORKING GROUP ON REGULATORY REPORTING**

In May 1995, the HKMA set up a working group to review the statistical returns which authorised institutions are required to submit under the Banking Ordinance and the Monetary Statistics Ordinance. The membership of the working group includes representatives from HKAB, the DTCA and the Hong Kong Society of Accountants. The purpose of the review is to identify possible areas of improvement to the design and content of returns and the related reporting instructions, the method of collation of statistics and, where possible, to reduce the reporting burden on authorised institutions. Once agreed, the final proposals are expected to be implemented in 1997.