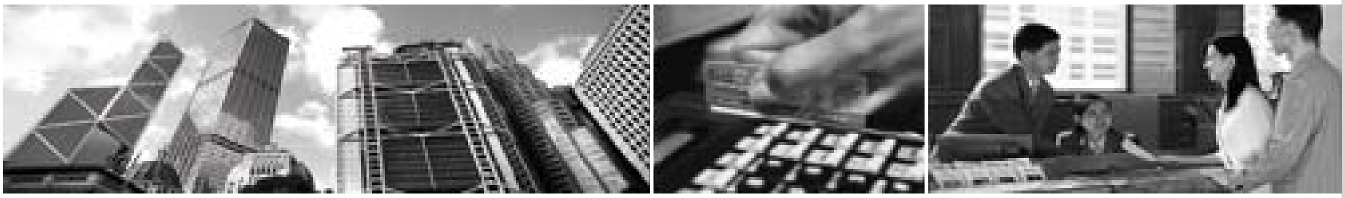
# Banking Stability



One of the main policy objectives of the HKMA is to promote the safety and stability of the banking system through the regulation of banking and deposit-taking business and the supervision of authorized institutions. 2001 saw the final phase of interest rate deregulation, a milestone in the programme of banking sector reforms progressively introduced since mid-1999 to enhance the competitiveness, safety and soundness of the banking system. A review of the *Code of Banking Practice* was undertaken, and the planned deposit insurance scheme and commercial credit reference agency came closer to fruition. The regulatory regime for authorized institutions' securities business was also developed.

## Objectives

The objective of promoting the safety and soundness of the banking system is shared among three departments within the HKMA:

- *The Banking Supervision Department* is responsible for the day-to-day supervision of authorized institutions (AIs)[1]
- *The Banking Policy Department* is responsible for the formulation of supervisory policies to promote the safety and soundness of the banking sector
- *The Banking Development Department* is responsible for the formulation of policies to promote the development of the banking industry.

## Progress and achievements in 2001

### Operational supervision

The HKMA conducted 221 on-site examinations of AIs' Hong Kong operations in 2001, including 44 risk-focused examinations, 58 money laundering, 10 treasury and 17 securities examinations. The HKMA has created six specialist teams: two for money laundering, one for derivatives and three for securities. The HKMA also conducted 11 on-site examinations of locally incorporated AIs' overseas operations. The number of off-site reviews and tripartite meetings was slightly less than in the previous year due to the reduced number of institutions as a result of mergers and acquisitions. Details of the operational supervisory work performed in 2001 are set out in Table 1.

[1] Institutions authorized under the Banking Ordinance to carry on banking business or the business of taking deposits. Authorized institutions are divided into three tiers: licensed banks, restricted licence banks (RLBs) and deposit-taking companies (DTCs).

TABLE 1

**Operational supervision**

| | 2000 | 2001 |
|---|---|---|
| 1. On-site examinations[1], including those on: | 261 | **232** |
| – money laundering | (44) | **(58)** |
| – treasury | (10) | **(10)** |
| – securities | (25) | **(17)** |
| – money brokers | (2) | **(–)** |
| 2. Off-site reviews and prudential interviews | 257 | **238** |
| 3. Tripartite meetings | 87 | **78** |
| 4. Meetings with Board of Directors of AIs | 6 | **19** |
| 5. Applications to become Controllers, Directors, Chief Executives, Alternate Chief Executives of AIs | 418 | **440** |
| 6. Reports commissioned under Section 59(2) of the Banking Ordinance | 1 | **5** |
| 7. Cases considered by the Banking Supervision Review Committee | 16 | **9** |

[1] These include overseas on-site examinations.

On five occasions in 2001, the HKMA used powers under Section 59(2) of the Banking Ordinance to require AIs to commission external auditors to review internal control issues and report their findings to the HKMA.

As part of its efforts to enhance the corporate governance of locally incorporated banks, the HKMA started to meet with the board of directors of individual banks in 1999. Both the HKMA and the board of the banks concerned have found this arrangement very useful in enhancing understanding of the financial position and state of affairs of the banks. In 2001, this arrangement was extended to cover selected RLBs and DTCs. A total of 19 meetings (13 with banks, two with RLBs and four with DTCs) were held during the year.

The Banking Supervision Review Committee considered a total of eight cases during 2001 relating to the licensing of AIs and money brokers, and one case concerning the fitness and propriety of an individual applying to become the Chief Executive of an institution under Section 71 of the Banking Ordinance. In addition, 440 applications to become Controllers, Directors, Chief Executives and Alternate Chief Executives of AIs were processed.

During 2001, no AI breached the requirements of the Banking Ordinance relating to liquidity or the capital adequacy ratio. However, there were seven breaches of the requirements relating to large exposures under Section 81 and 17 breaches of the requirements relating to connected lending under Section 83. All these breaches, technical in nature, were promptly rectified by the institutions concerned, and did not result in any risk to the interests of depositors or creditors. No use was made of formal powers under Section 52 of the Banking Ordinance.

## Asset quality

Loan demand continued to be weak by historical standards during 2001, and the business environment remained very competitive, especially in consumer loans. A major priority of the HKMA in 2001, therefore, was to monitor AIs' efforts to reduce their non-performing loans and ensure that credit standards were not compromised during the course of competition.

## Competition for mortgage business

In the light of the weak loan demand, many banks continued to compete aggressively for mortgage business in 2001. While the market norm for the mortgage rate stayed at 2.5% below the best lending rate (BLR) for most part of the year (down from 2.25% below the BLR at the end of 2000), some banks offered to lend at a preferential rate as low as 2.6% below the BLR for selected customers. The HKMA was concerned about the interest rate risk on such loans and held discussions with the banks concerned to establish that they had followed prudent lending policies; that their mortgage pricing was reasonable having regard to their funding and operating costs; and that adequate risk management measures were in place to guard against the interest rate risk associated with such business.

## Negative equity

The situation of homeowners whose property is worth less than the value of the outstanding mortgage on the property (so-called "negative equity homeowners") became an issue of concern in 2001. A particular complaint was that such homeowners had generally been unable to benefit from the sharp reduction in lending margins enjoyed by other homeowners.

To remove a potential obstacle to AIs offering relief to homeowners in negative equity through refinancing, in October 2001 the HKMA indicated that it would not object to AIs refinancing residential mortgage loans (RMLs) in negative equity up to 100% of the current market value of the mortgaged properties.

In November, the HKMA wrote to the two industry Associations to encourage their members to set up centralised units or hotlines (such as those established by some major banks) to handle enquiries about the restructuring of RMLs in negative equity. Based on the results of a survey with banks active in mortgage financing, the total number and value of RMLs in negative equity in the banking sector at the end of December 2001 were estimated to be 73,000 (or 16% of total mortgage borrowers) and $125 billion (or 23% of total outstanding mortgage loans) respectively. About 56% of RMLs in negative equity was priced at below the BLR and the average interest rate of all RMLs in negative equity was 0.57% below the BLR. This suggests that banks have been increasingly willing to refinance or restructure loans for homeowners in negative equity.

## Credit card business and bankruptcies

Credit card business was another area of strong competition in 2001. Some institutions have adopted aggressive strategies in soliciting new customers. Because of the economic downturn and rising personal bankruptcies, the delinquency and charge-off ratios of credit card receivables rose sharply during the year, in particular in the last quarter. The delinquency ratio (i.e. the value of credit card receivables overdue for more than 90 days as a percentage of total credit card receivables) stood at 1.28% at the end of 2001 compared to 0.76% at the end of 2000 and the annual charge-off ratio was 5.47% compared to 3.88% for 2000. In view of this, the HKMA issued a circular to all AIs in June 2001 requesting them to critically review their policies and controls in the area of credit card lending. As a follow-up action, the HKMA held discussions with AIs active in credit card lending to ensure that they complied with the various prudential recommendations set out in the circular. In addition, special on-site examinations of the credit card operations were conducted for seven institutions whose charge-off ratios were higher than the market average to ensure that their lending policies were prudent.

A number of AIs have experienced increased bankruptcy-related write-offs for credit card receivables. The HKMA believes that a number of measures can be taken by institutions to address this problem, including review of lending policies and procedures, enhanced monitoring of bankruptcy cases and greater use of debt counselling and debt relief plans to help customers in financial difficulties. In addition, the HKMA is working with the banking industry on a proposal to allow greater sharing of customer credit data among institutions (see the section on "Consumer credit data sharing" on page 47).

## Taxi loans

The HKMA is concerned about the fall in the income of taxi owners in the light of the economic slowdown and has been monitoring the quality of the taxi loan portfolio closely. Because of lower interest costs and an improvement in licence value, the quality of the portfolio has so far held up quite well. The proportion of overdue and rescheduled taxi loans (for both urban and New Territories taxis) declined from 9.04% to 2.88% during the year. Despite this improvement, the HKMA is concerned that the ratio may go up in 2002 if the income of the taxi owners remains low and interest rate trends reverse. It will therefore continue to monitor the situation closely.

In competing for taxi loans, many institutions have adopted the practice of offering cash rebates to borrowers. At one point, such cash rebates reached 18% of the loan amount in some cases. The usual practice of institutions is to amortise the cash rebates over a long period of time. The HKMA was concerned about the high level of cash rebates, which was not sustainable in the long run, and the impact of the unamortised cash rebates on the financial position of individual institutions if they were required to write off such cash rebates in the event of increased delinquencies. The HKMA therefore discussed this issue with the AIs concerned and requested them to review their policies on the issue of cash rebates. The AIs responded to the HKMA's concerns by reducing the level of cash rebates to 12% of the loan amount or below and by setting an internal limit on the maximum amount of unamortised cash rebates to limit the impact on their profitability should there be a need to write off the unamortised cash rebates. The HKMA considers that cash rebates at 12% are still high. It is therefore monitoring closely the position of individual AIs to ensure that the internal limit on unamortised cash rebates agreed with the HKMA is observed.

### Risk-based supervisory approach

The HKMA continued its efforts to develop and implement its risk-based approach in 2001. Major achievements during the year included:

(a) extension of the newly adopted approach in supervising locally incorporated institutions to cover foreign banks with significant operations in Hong Kong;

(b) risk-focused on-site examinations at 37 locally incorporated institutions and seven foreign bank branches;

(c) the development of a centralised database for the electronic storage, retrieval and updating of all risk-based supervision documentation and all relevant guidance notes;

(d) the development of standard work papers to provide a more structured and efficient methodology for completing risk-focused examination reports; and

(e) the issue of a supervisory framework document describing the entire supervisory process, including the integration of the risk-based supervisory approach with the CAMEL rating system, to the banking industry as part of the new Supervisory Policy Manual.

### Industry consolidation

Consolidation of the banking industry gained momentum during 2001. The HKMA welcomes this development and believes that consolidation is desirable to help maintain the long-term competitiveness of the industry. In 2001 a number of merger cases were effected through the enactment of private ordinances by the Legislative Council:

(a) the merger between the Bank of East Asia Ltd and United Chinese Bank Ltd – the merger Ordinance was enacted on 20 July 2001;

(b) the merger of nine member banks of the Bank of China Group into a locally incorporated bank, the Bank of China (Hong Kong) Ltd (formerly known as Po Sang Bank Ltd) – the merger Ordinance was enacted on 20 July 2001;

(c) the merger between the Bank of East Asia Ltd and First Pacific Bank Ltd – the merger Ordinance was enacted on 19 December 2001; and

(d) the merger of the Hong Kong branches of The Fuji Bank Ltd, The Dai-ichi Kangyo Bank Ltd and The Industrial Bank of Japan Ltd – the merger Ordinance was enacted on 19 December 2001.

In addition, the HKMA processed two other acquisitions during 2001: the acquisitions of Dao Heng Bank Ltd by the Development Bank of Singapore and of the Hong Kong Chinese Bank by CITIC Ka Wah Bank. For merger and acquisition cases, the HKMA's policy is to facilitate the process and ensure that the relevant supervisory issues are tackled expeditiously.

### The Hong Kong Approach

The number of corporate workouts that required the HKMA's mediation dropped significantly from seven in 2000 to one in 2001. While this indicates that there were fewer major corporate restructurings during 2001, it also suggests that the Approach is being adhered to, and fewer cases need to be discussed with the HKMA. The HKMA remains prepared, on request, to assist in corporate workouts in accordance with the terms of the *Hong Kong Approach to Corporate Difficulties.*

### Regulatory regime for authorized institutions' securities and Mandatory Provident Fund activities

In 2001 the HKMA worked closely with the Government and the Securities and Futures Commission (SFC) in assisting the Legislative Council Bills Committee in vetting the Securities and Futures Bill and the accompanying Banking (Amendment) Bill 2000. The two bills seek to enhance the regulatory framework for the securities and futures industries. As far as the securities business of AIs is concerned, it is proposed that the HKMA should remain the front-line regulator responsible for the day-to-day supervisory work, using standards and approaches applied by the SFC to registered securities dealers.

The HKMA attended 25 meetings of the Bills Committee during the year to explain the policy intention behind the proposed regime for supervising the securities business of AIs. Taking into account the views of the Bills Committee, the Government put forward some fundamental changes to the proposed supervisory arrangements, including the extension of the same range of disciplinary sanctions applicable to persons regulated by the SFC to the securities operations of AIs.

During the year, the HKMA continued to conduct close supervision of AIs' securities business. The specialist securities examination teams conducted on-site examinations to assess whether AIs' internal control systems were adequate to ensure compliance with the relevant legal and regulatory requirements in this area. Information on AIs' securities business was also collected on a regular basis through a special return.

The HKMA, in supervising AIs' securities business, applies standards that are equivalent to those imposed by the SFC on registered securities dealers. Following revision of the SFC Fit and Proper Criteria in March, the HKMA issued a circular reminding the relevant AIs of their obligation to ensure that their securities dealing staff meet the SFC's requirements on initial competence and continuous professional training.

In view of the increased prominence of equity-linked instruments in the retail market and the inherent risks of such products to investors, the HKMA issued a circular to relevant AIs in December emphasising the need to comply with the Code of Conduct issued by the SFC and to adopt fair dealing best practices when marketing equity-linked instruments to investors and dealing in such instruments. The HKMA also increased its focus on institutions' conduct in selling these products as well as investment funds in general, when performing securities examinations during the year.

The HKMA is also responsible for supervising the MPF-related activities of AIs. During 2001, these activities were monitored primarily through on-site examinations. The examinations focused on the assessment of whether AIs' internal control systems were sufficient to achieve compliance with the standards prescribed in the Code of Conduct for MPF Intermediaries issued by the Mandatory Provident Fund Schemes Authority (MPFA). To facilitate effective supervision, information on these activities of AIs was also collected through regular returns.

Apart from their intermediary role, some AIs provide a guarantee for the investment return of MPF products. The HKMA monitors their adherence to its provisioning and capital charge requirements in respect of such guarantees on an on-going basis.

### Relationship with other supervisors

The HKMA continued to maintain a close working relationship with other supervisors both in Hong Kong and abroad. During the year, overseas visits or bilateral meetings were arranged with regulators from the USA, the UK, Japan, Malaysia, Singapore, Thailand, Taiwan, and Macau. Regular meetings were also held with the People's Bank of China to discuss supervisory matters of common interest.

Apart from co-operation with overseas supervisory authorities, the HKMA maintains close working relationships with other regulators in Hong Kong, including the SFC, the Insurance Authority and the MPFA. As specified in the Memorandum of Understanding, the HKMA meets with the SFC monthly to exchange information on matters of common interest. The HKMA also meets with the Commercial Crime Bureau regularly to discuss commercial crimes relating to the banking industry and to consider measures which can help institutions to prevent such crimes from taking place.


From left: Executive Director (Banking Supervision) Y K Choi and Executive Director (Banking Development) Raymond Li at the International Seminar on Banking Supervision co-organised with the People's Bank of China.

## Banking reform

2001 saw significant progress in implementing the policy initiatives contained in the banking sector reform programme announced in July 1999. These initiatives are aimed at promoting market liberalisation and competitiveness in the banking sector and strengthening banking infrastructure with a view to enhancing the safety and soundness of the sector.

### *Measures to enhance competitiveness*

#### *(a) Interest rate deregulation*

The final phase of interest rate deregulation took place in July 2001. This involved the removal of the interest rate cap on savings accounts and the prohibition of the payment of interest on current accounts. With the removal of these last remaining controls, the objective of making all deposit interest rates subject to competitive market forces was achieved.

In response to the deregulation, a number of banks launched new products such as combined savings and checking accounts and HIBOR-linked savings products. Some also revised fees and charges and minimum balance requirements, and introduced tiered structures of interest rates. However, given the ample liquidity in the banking system during the period, banks generally did not bid aggressively for deposits. In consequence, no significant migration of funds among banks was observed, nor was the cost of deposits "bid up".

#### *(b) Removal of the three-building condition*

The condition restricting the number of buildings from which foreign banks licensed since 1978 and foreign restricted licence banks licensed since 1990 could operate was removed in November. The removal is intended to provide foreign institutions with greater flexibility in doing business and to enhance Hong Kong's position as a free and open financial centre.

#### *(c) Review of market entry criteria and the three-tier authorization system*

A review of the existing market entry criteria for licensed banks and the three-tier authorization system was undertaken in the fourth quarter. The conclusion was that, in view of the ongoing consolidation in the sector and the fact that the banking supervisory system had been further strengthened, the existing market entry criteria could be relaxed without compromising banking stability. The main proposals arising from the review are:

(i) replacing the US$16 billion asset size criterion for foreign bank applicants with the much lower asset and deposit size criteria applicable to local bank applicants (which are currently set at HK$4 billion for total assets and HK$3 billion for customer deposits);

(ii) reducing the requisite period of operation as an RLB or DTC from ten to three years and dispensing with the "association with Hong Kong" requirement for locally incorporated RLBs and DTCs to upgrade to licensed banks; and

(iii) maintaining the current three-tier authorization regime until the proposed changes have worked their way through the system.

These proposed changes, which have been the subject of consultation with the banking industry, are aimed at attracting a broader range of domestic and international institutions to carry on banking business in Hong Kong, which is conducive to maintaining Hong Kong's status as a leading international financial centre.


A variety of new products are launched by banks in response to the interest rate deregulation.

### *Measures to enhance safety and soundness*

#### *(a) Deposit insurance scheme (DIS)*

In April, having considered the results of the public consultation carried out in late 2000, the Chief Executive in Council approved in principle the establishment of a DIS in Hong Kong and requested the HKMA to work out the detailed design features of the scheme.

Further to this, the HKMA carried out two focused consultations on technical issues relating to, firstly, the netting arrangements in the event of reimbursing depositors and, secondly, the funding approach of the DIS.

A key consideration in the design of the scheme has been to keep the cost low and to minimise the potential moral hazard. It is proposed, therefore, that the target fund size for the scheme should be kept to $1.5 billion and the annual premium (of an average of around 8 basis points) should be structured using a differential premium system based on the supervisory ratings of institutions. In order to reduce the cost of the scheme and avoid possible duplication of work with the regulator, it is proposed that the DIS should act as a "paybox", with its functions limited to the assessment and collection of premium, the investment of funds and the making of any payouts.

#### *(b) Commercial credit reference agency (CCRA)*

A working group, comprising representatives from the banking and corporate sectors as well as relevant public organisations, has considered a number of important issues relating to the establishment of the CCRA. These included the form of participation in the scheme, the types of commercial enterprises that should be covered and the requisite data protection standards.

One of the group's conclusions was that, as there seemed to be an increasing willingness on the part of AIs to share credit information through a credit reference agency, a market-oriented approach, with participation on a voluntary basis, might be viable. If so, this would be easier and quicker to implement than a scheme established by legislation.

Following up on this recommendation, the HKMA wrote to the industry associations in March 2002 suggesting that the industry should form a working party to take this forward as quickly as possible.

### Consumer credit data sharing

One feature of the sharp rise in personal bankruptcies and consumer delinquencies in the year was that many bankrupts had often borrowed large amounts from multiple institutions. This highlighted the limitations on AIs sharing "positive" data under the existing framework for personal data protection in Hong Kong. Consequently, in December the Hong Kong Association of Banks submitted a proposal on the sharing of full positive consumer credit data on all new and existing accounts for all types of consumer lending. Implementation of positive data sharing would require amendment to the Code of Practice on Consumer Credit Data issued by the Privacy Commissioner for Personal Data. The HKMA will continue to work with the banking industry and the Privacy Commissioner in addressing the privacy issues related to sharing of positive data.

From left: Deputy Chief Executive David Carse, Hong Kong Association of Banks Chairman Peter Wong and Secretary for Financial Services Stephen Ip address the issue of soaring personal bankruptcies.

## Code of Banking Practice

The first comprehensive review of the Code was successfully completed in November. The main objective of the review was to update the Code in the light of experience and to keep up to date with the latest developments in the banking industry. The major revisions were in relation to:

- making terms and conditions of banking services more transparent and consumer-friendly
- standardising the calculation of annualised percentage rates for credit card borrowing and personal loans
- enhancing the transparency of new or revised charges of AIs
- bringing the approach to card services in Hong Kong more in line with that in other financial centres
- promoting the proper use of debt collection agencies by AIs
- raising the standards in relation to newer banking services such as e-banking and stored value cards.

The revised Code became effective on 1 December. AIs were asked to implement the recommended practices as soon as practicable. To ensure compliance with the new provisions, AIs will be required to submit to the HKMA an annual assessment of their compliance with the Code.

From left: Hong Kong Association of Banks Chairman Peter Wong, HKMA Executive Director (Banking Policy) Simon Topping and the DTC Association Chairman Clifford Forster announce the launch of the revised *Code of Banking Practice*.

## Prevention of terrorist financing and money laundering

The terrorist attacks in the US focused attention on the subject of money laundering including terrorist financing. Following the attacks, the HKMA issued a number of circulars to AIs asking them to search for any suspicious accounts that might relate to terrorists and pointing them to information in the public domain on persons who might be involved. AIs were reminded of their statutory obligation under the Organised and Serious Crimes Ordinance to report suspicious accounts to the Joint Financial Intelligence Unit run by the Police and the Customs and Excise Department.

Meanwhile, the Government issued Regulations to implement two United Nations Security Council Resolutions which, among other things, required the freezing of funds of the Taliban, Taliban undertakings and Osama bin Laden and his associates. The HKMA issued circulars to advise AIs of these Regulations and of the need to take appropriate measures to achieve compliance. The Government is also working towards giving effect to another UN Security Council Resolution on the fight against terrorism in general. This provides, among other things, for the freezing of funds of those who commit or intend to commit terrorist acts. The HKMA is closely involved in the process.

The HKMA also issued circulars to AIs to reiterate the importance of prevention of money laundering in general. AIs were reminded of the potential consequences of shortcomings in this area, as well as the key control requirements, including the application of the "know your customer" principle, on-going monitoring of accounts and transactions, ensuring a proper role of the compliance officer, and coverage by internal audit.

## Consumer protection

Since consumer issues in the banking sector have come increasingly to the fore, the HKMA has undertaken to review its role in this area and to consider whether it should be given an explicit statutory responsibility for consumer protection.

As a first step, the HKMA conducted a comparative study of how banking consumer protection and competition arrangements in Hong Kong compare with those in the UK and

Australia. A number of issues were identified for further consideration. These included the role of the HKMA in consumer protection, the monitoring of compliance with, and enforcement of, the *Code of Banking Practice*, the handling of complaints by AIs, and the question of whether there was a need for a Banking Ombudsman scheme in Hong Kong.

With a view to guarding against "financial exclusion" – the possibility that certain groups within society might be priced out of access to banking services – the HKMA monitored market developments to check that basic banking services remain generally available to customers. It was observed that, following deregulation, some banks continued to offer free banking services, while others exempted from increased fees and charges certain members of the community, such as the elderly and recipients of social benefits.

In addition to promoting self-regulation of market conduct through the review of the *Code of Banking Practice,* the HKMA formalised a new guideline on Complaint Handling Procedures. The guideline sets out recommendations on the operation of AIs' internal complaint handling procedures so as to ensure that customer complaints are fully and promptly investigated and resolved in a satisfactory manner.

During 2001, the HKMA received 880 complaints relating to banking services, a 42% increase over 2000. More than half of these complaints were lodged through the debt collection hotline set up by the HKMA, while most of the other complaints were related to credit card services. The HKMA referred these complaints to the AIs concerned for their attention and followed up with them to ensure that the complaints had been properly dealt with.

## Electronic banking and technology risk management

In view of the continued development by AIs of electronic banking (e-banking) services, the HKMA has implemented a comprehensive e-banking and technology risk management supervisory framework to ensure a secure and sound control environment for e-banking development in Hong Kong. Under this framework, the HKMA has developed an on-site examination programme focusing on the e-banking and general technology risk management of AIs, having regard to the practices of other bank supervisors in advanced economies and the guidance on e-banking risk management issued by the Basel Committee on Banking Supervision. Three pilot examinations were successfully conducted in 2001.

## Business continuity planning

In the light of the events of 11 September, the HKMA initiated a business continuity planning readiness self-assessment of 25 AIs in Hong Kong. It also organised an informal discussion forum to share experiences among seven banks, the Financial Services Bureau and Hong Kong Interbank Clearing Limited in dealing with large-scale disasters. Lessons learned were conveyed to AIs through a circular letter in early 2002.

## Legal and regulatory framework

The Banking (Amendment) Ordinance 2001 was enacted in December 2001 to:

- re-define the definition of "manager" to ensure that only those senior executives who are in charge of key businesses or affairs will be regarded as "managers"; add a new authorization criterion to require AIs to maintain adequate systems of control to ensure the fitness and propriety of their managers; and introduce a new notification requirement for the appointment of managers;
- broaden the definition of "local branch" to require AIs to seek the HKMA's prior approval for establishing, in addition to full service branches, any place of business in Hong Kong at which they can enter into commitments on the assets side of the balance sheet. A new term "local office" was introduced to allow AIs to use new delivery channels, e.g. sales and service centres, in Hong Kong to promote their business; and
- update the relevant provisions on regulation of advertisements for deposits to ensure that advertisements issued through the Internet or other new technological means will be covered and to make clear that only advertisements that target members of the public in Hong Kong will be caught.

The above legislative amendments will come into operation in mid-2002.

## Development of supervisory policies

More than 30 policy guidelines and guidance notes were issued during the year as modules of the *Supervisory Policy Manual,* which is accessible through the HKMA's public website. These included the following:

### *Risk-based supervisory approach*

With a view to enhancing the transparency of the risk-based supervisory approach, this guidance note sets out the structure of the approach, the key steps involved in the process, the inherent risks assessed, the key elements of a risk management system and the way in which the risk management system is assessed.

### *General principles of credit risk management*

This statutory guideline summarises the main principles that AIs are expected to follow in managing credit risk. Specific risk controls and systems are covered in other modules, such as *Credit management,* which covers, among other things, credit approval and administration, interest recognition, collateral and guarantees, and problem credit management. Together, these modules form the core set of guidelines on the essential elements of a sound credit risk management system.

### *Large exposures and risk concentrations*

This statutory guideline describes the minimum standards that AIs should maintain in relation to the control of large exposures and risk concentrations, as well as the HKMA's approach to supervising such risks. The requirements include the establishment of an internal clustering limit to control the aggregate of an institution's large exposures that are not currently exempted from statutory limitations under the Banking Ordinance.

### *Country risk management*

Following the withdrawal of the Bank of England's country risk provisioning matrix, this guidance note sets out the HKMA's latest supervisory approach and provides guidance on country risk management and provisioning.

### *Connected lending*

This statutory guideline specifies the systems and controls that AIs should have to identify, measure, monitor and control their financial exposure to connected parties. In particular, the role of the board of directors in monitoring controls over connected lending is emphasised.

### *Credit derivatives*

The HKMA's supervisory approach to credit derivatives, particularly in relation to capital requirements and the reporting of large exposures, is set out in this statutory guideline. This expands on an earlier circular by elaborating on risk management standards and the treatment of transactions with a maturity mismatch, currency mismatch or multiple obligors.

### *Term subordinated debt and paid-up term preference shares for inclusion in supplementary capital*

This statutory guideline specifies the HKMA's approach to recognising term subordinated debt and paid-up term preference shares as supplementary capital, including those instruments that carry special features such as call options and step-ups.

### *Supervision of Mandatory Provident Fund intermediaries*

The HKMA's approach to the supervision of authorized institutions that are Mandatory Provident Fund (MPF) intermediaries is described in this guidance note. The guidance note also incorporates the major principles laid down in the *Code of Conduct for MPF Intermediaries* issued by the MPFA.

### *Systems of control for the appointment of managers*

Ancillary to the legislative amendments in relation to the managers of AIs, this statutory guideline provides guidance on the new definition of "manager" and specifies the systems of control that AIs should have for ensuring the fitness and propriety of individuals appointed as managers.

### *Outsourcing*

In the light of increasing use of outsourcing by AIs as a result of globalisation and technological advance, this revised guidance sets out the HKMA's supervisory approach to outsourcing. It also highlights the areas – particularly customer data confidentiality and contingency planning – that AIs should address when outsourcing their activities.

## Review of financial disclosure

The HKMA has continued its efforts to improve the standards of financial disclosure by AIs. In November, updated guidelines were issued in relation to annual and interim disclosures by locally incorporated AIs and half-yearly disclosures by overseas incorporated AIs. A feature of recent updates has been to seek to enhance credit risk disclosures, taking into account international best practices and recent papers issued by the Basel Committee.

## International supervisory developments

### *New Capital Accord*

A main preoccupation for the HKMA during 2001 was the monitoring of developments in relation to the Basel New Capital Accord, which underwent a second round of consultation in 2001. The key features of the New Accord are: (i) an increase in risk sensitivity of capital requirements through greater differentiation of obligor risk; (ii) an increase in the types of risk covered by capital requirements (e.g. operational risk); (iii) the focus on banks developing better risk management systems; and (iv) the move towards more financial disclosure to help enhance market discipline.

To assess the implications of the New Accord for the local banking sector, the HKMA conducted a detailed quantitative impact study on a representative sample of banks and consulted the industry extensively on the new capital proposals. Based on the results of the impact study and the feedback received from the industry, a submission was prepared for consideration by the Basel Committee. In particular, the Committee was requested to address various issues relating to the calibration of the New Accord and potential problems arising from cross-border implementation.

Given the complexity of the New Accord and the tight schedule involved, the HKMA has already started planning for implementing the New Accord in Hong Kong in 2005 (i.e. the timetable set by the Basel Committee). In October 2001, the HKMA issued for industry consultation preliminary proposals on its implementation strategy and detailed guidance notes on the Basel requirements for internal rating systems. There was general support for the proposals.

### *International co-operation*

The HKMA continues to participate actively in various regional and international forums for banking supervisors. These include the Core Principles Liaison Group (CPLG) and the associated Working Group on Capital and Task Force on Weak Banks established by the Basel Committee, the EMEAP Working Group on Banking Supervision, the Offshore Group of Banking Supervisors and the SEANZA Forum of Banking Supervisors. The HKMA has since 1996 chaired the EMEAP Working Group on Banking Supervision, which has played an increasing role in the region on supervisory matters. The HKMA also participates in supervisory seminars organised by the BIS Financial Stability Institute (FSI). In October, the HKMA, in association with the FSI, hosted an EMEAP Workshop on Credit Risk under the New Accord in Hong Kong, which attracted 22 representatives from ten supervisory authorities in the EMEAP economies.

In April 2001, the HKMA co-operated with the BIS and 47 other economies in the *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity.* The results of the survey showed that Hong Kong continued to retain its position as the seventh largest foreign exchange market in the world and eighth largest taking into account over-the-counter derivative transactions.


From left: Stefan Hohl of the BIS, Jason George and Roland Raskopf of the FSI, and HKMA Executive Director (Banking Policy) Simon Topping at the EMEAP Workshop on Credit Risk in the New Capital Accord co-hosted by the FSI and the HKMA.

Deputy Chief Executive David Carse reviews performance of the banking sector in 2001 and explains prospects and priorities in 2002.

## Plans for 2002 and beyond

### Asset quality

The sluggish economy and the deterioration in the quality of consumer lending portfolios may lead to some worsening in the asset quality of AIs. A major supervisory priority of the HKMA in 2002 is therefore to monitor closely AIs' asset quality. Specifically, given the rising trend in bankruptcy cases, special focused examinations will be conducted in respect of the types of lending business most affected, such as credit card lending and personal loans, to ensure that AIs continue to adopt prudent lending policies and strategies.

### Interest rate risk

Interest rate risk is another major supervisory focus of the HKMA in 2002 in the light of continued market competition. The full deregulation of interest rate in July 2001 imposes a stronger requirement on AIs to manage properly their interest rate risk. In addition to the need to guard against the potential for interest rate fluctuations, a possible reversal of recent interest rate trends and the narrowing net interest margin call for extra caution to be exercised by AIs in 2002 in managing their interest rate risk. AIs will be required, where necessary, to conduct stress tests to ascertain the extent to which they would be affected by interest rate fluctuations and further narrowing of their interest margins. A guidance note on the management of interest rate risk will also be developed.

### Industry consolidation

The challenges posed by increased competition, globalisation, technological change and greater demands for sophisticated services, coupled with the sluggish business environment locally, are likely to intensify the pressure on AIs, and the smaller banks in particular, to consider consolidation. Such changes will safeguard the industry's long term competitiveness and potential for future growth. It has been the HKMA's view that consolidation of the banking industry is inevitable and the HKMA will continue to handle merger and acquisition cases expeditiously. It will also keep the regulatory regime under review to ensure that it is appropriate to market conditions and does not hinder the consolidation process.

### Risk-based supervision

Enhancements to the supervisory process will continue in the coming years to keep pace with changes in the banking industry. The HKMA will update the internal guidance note on the CAMEL rating system to incorporate the changes resulting from the implementation of risk-based supervision. An automated examination work programme will be developed to assist and guide on-site examiners in conducting risk-focused examinations and enhance the overall quality of the examination process. In addition, a quality assurance unit will be established to ensure a higher level of work standardisation and consistency.

### Banking reform

In 2002, the priorities of the HKMA will be on the establishment of the DIS and the CCRA and implementing the proposals arising from the review of the market entry criteria and the three-tier authorization system.

*(a) Deposit insurance scheme*

A second consultation paper on detailed proposals on the establishment and operation of the scheme was released in March 2002.

The HKMA will take into account comments received from the second round of public consultation and prepare the relevant legislation for implementing the DIS. The intention is to prepare the relevant Bill by the end of 2002.

*(b) Commercial credit reference agency*

The industry associations have agreed to the HKMA's suggestion to form a working party to follow up on the implementation of a voluntary scheme. In the course of this year, the working party will appoint a private sector service provider to provide the CCRA service and agree with the service provider on the information and system requirements for reporting of credit data by AIs. The HKMA will participate fully in the work of this industry working party to ensure that good progress is made on establishing the scheme. The HKMA will also issue supervisory recommendations to all AIs on the sharing of commercial credit data and a formal supervisory guideline on protection of the commercial credit data being shared. This would help ensure a level playing field among AIs in the provision of credit information and enhance public confidence in the data protection arrangements for the scheme.

*(c) Market entry criteria and three-tier authorization system*

Taking account of comments received during the consultation exercise, the HKMA will implement the agreed proposals, by amending the Seventh Schedule to the Banking Ordinance and the relevant supervisory guidelines.

## Consumer credit data sharing and bankruptcy issues

The problem of rising bankruptcies and consumer defaults remains an issue of concern. The HKMA will continue to monitor closely the quality of consumer lending of AIs and to provide further supervisory guidelines as necessary. A key priority this year will be to work with the industry and the Privacy Commissioner to develop an appropriate regime for positive data sharing. This would involve examination of the detailed scope of data sharing and the necessary safeguards to protect the privacy of data subjects.

## Prevention of terrorist financing and money laundering

The HKMA guideline to AIs on prevention of money laundering is reviewed from time to time to ensure that it is in line with international standards. Another round of updating is currently underway to incorporate the recommendations in the recent Basel Committee paper on customer due diligence for banks.

The HKMA monitors compliance with requirements set out in the money laundering guideline primarily through on-site examinations. During 2002, the examination programme will be strengthened and will be conducted in a more structured manner. AIs that are regarded as more vulnerable to money laundering activities will be subject to more in-depth examination by the specialised teams. Examinations of the anti-money laundering procedures of other institutions will be performed by the general on-site examination teams as part of their regular examinations. Such examinations will focus on the review of high level controls with particular emphasis on the relevant policies and procedures. In case of need, the HKMA may use its powers under Section 59 of the Banking Ordinance to require institutions with significant weaknesses in anti-money laundering procedures to commission external auditors to conduct a special review of the procedures and to make recommendations on remedial actions to be taken.

A self-assessment framework is being developed for AIs to regularly assess the extent of their compliance with the relevant requirements. The results of this self-assessment will be reported to the HKMA to help identify risk indicators and develop supervisory response.

Continuing efforts will be made to monitor the development of initiatives in combating terrorist financing, and to ensure AIs' compliance with the related requirements, including the proposed new legislation in Hong Kong.

## Supervision of authorized institutions' securities and MPF activities

To help implement the new regime embodied in the Securities and Futures Bill and the Banking (Amendment) Bill 2000[2], the Memorandum of Understanding between the HKMA and the SFC will be revised to reflect the co-ordination between the two regulators in respect of the securities business of AIs. The HKMA will issue guidelines to AIs, revise the regular prudential return as appropriate, and set out the procedures in relation to its various functions under the enhanced regime, such as the grant of consent to executive officers of registered institutions and the maintenance of the securities staff register by the HKMA.

The HKMA will continue to conduct specialised on-site examinations of the securities business of AIs. These will focus on the quality of securities dealing staff, the marketing and dealing practices in respect of securities, especially investment funds and equity-linked instruments, as well as regulatory compliance with the new regime.

In respect of MPF business, the new requirements set out in the *Guide to Continuing Professional Development (CPD) for MPF Intermediaries* issued by the MPFA have taken effect since 1 January 2002. The HKMA will continue to monitor the MPF business of AIs with a view to ensuring that these CPD requirements are followed in addition to the standards set out in the *Code of Conduct* issued by the MPFA.

[2] These two bills were enacted in March 2002, with implementation to take place later in the year.

## Consumer protection

The HKMA will continue to monitor closely the issue of financial exclusion. So far this is not a major problem in Hong Kong and basic banking services are generally available to more vulnerable members of the community. However, if the market fails to address this concern, the HKMA will consider options on how the provision of basic banking services at a reasonable cost can be ensured.

With respect to regulation of market conduct and practice, the HKMA will continue to monitor compliance with the *Code of Banking Practice*. To step up the enforcement of the Code, the HKMA has introduced a self-assessment mechanism under which AIs are required to file an annual assessment report to the HKMA starting in September 2002. The HKMA will evaluate the effectiveness of this mechanism in enforcing compliance. If necessary, the HKMA will conduct focused on-site examinations of AIs for any identified problem areas.

In addition, the industry associations have recently established a Code of Banking Practice Committee in order to assume more proactive ownership of the future development of the Code. One of the major responsibilities of the Committee is to provide guidance to AIs on interpreting the Code. This should help to improve compliance by specifying how provisions of the Code should be implemented in practice. By participating in the Committee, the HKMA will also be able to bring any compliance issues to the attention of the industry more promptly.

The HKMA will assess the effectiveness of the new Guideline on Complaint Handling Procedures for AIs in resolving customer disputes. The HKMA will also continue its efforts in handling customer complaints against AIs. Notwithstanding the existing role played by the HKMA in processing customer complaints, some complainants may remain dissatisfied with the response from the AIs and in such cases, the HKMA has no power to arbitrate between the two parties. This in turn leads to the question of whether an alternative dispute resolution mechanism, such as a Banking Ombudsman scheme, might be appropriate for resolving bank customer disputes in Hong Kong.

The HKMA remains open minded on this issue, though the benefits of a Banking Ombudsman scheme have to be carefully weighed against the costs. The HKMA will continue to keep this question under review, taking into account developments such as the state of compliance with the Code and the new Guideline, the effectiveness of the Code of Banking Practice Committee, and developments in the overall consumer protection regime in Hong Kong. The HKMA will continue to consult the relevant organisations on how consumer protection in the banking sector can be further enhanced without imposing too heavy a regulatory burden on AIs. In general, however, the view of the HKMA is that the current arrangements are working reasonably well, and that an explicit statutory responsibility for the HKMA in consumer protection is probably not necessary at this stage.

## Electronic banking and technology risk management

As part of the implementation of the e-banking and technology risk management supervisory framework, the HKMA will develop and update its existing guidance notes on general principles for information technology controls and general approach to supervision of e-banking. As regards the supervision of e-banking and technology risk management of AIs, the HKMA plans to complete approximately 40 on-site examinations, focusing on all major banks and selected AIs with higher risk exposure to technology. To help the HKMA in prioritising its supervisory resources, the HKMA will compile technology risk profiles of all AIs and implement a technology risk control self-assessment mechanism for AIs.

## Business continuity planning

The HKMA will continue the initiatives on business continuity planning taking into account guidance being developed by the international regulatory community and will step up the review of AIs' business continuity plans as part of the on-site examination programme on e-banking and information technology controls in 2002. The HKMA will issue a more detailed guidance note on business continuity planning based on the lessons learned from the events of 11 September and the results of on-site examinations. The HKMA will also liaise with other financial regulators, exchanges and clearing houses through the Financial Services Bureau on sector-wide efforts to develop contingency procedures and crisis management arrangements.

## Development of supervisory policies

### *Supervisory policies*

Key policies and guidelines to be developed in 2002 will cover the following areas:

- General Risk Management Controls
- Interest Rate Risk Management
- Liquidity Risk Management
- Market Risk Management
- Technology Risk Management

### *Core Principles Assessment*

The Basel Committee published the *Core Principles for Effective Banking Supervision* in September 1997 to provide banking supervisors with a set of minimum standards for prudential regulation and supervision of banks. The HKMA conducted a self-assessment of the Hong Kong supervisory regime based on the *Core Principles* in 1997, after which legislative amendments in a few areas were enacted in 1999 to address deficiencies identified. Following the issue of further documents by the Committee to provide the latest criteria for conducting self-assessment (*Core Principles Methodology* in 1999 and *Conducting a Supervisory Self-Assessment – Practical Application* in 2001), the HKMA will conduct another review of the current supervisory regime against the detailed criteria with a view to identifying areas for further improvement.

## Review of financial disclosure and regulatory reporting

### *Financial disclosure*

The HKMA will endeavour to keep its disclosure standards in line with international best practice. Regular contacts with professionals such as the Panel of Banking Experts of the Hong Kong Society of Accountants will be maintained so as to keep abreast of accounting and disclosure developments. Nevertheless, major changes are not expected in 2002 pending finalisation of Pillar 3 of the New Basel Capital Accord, which is likely to entail some significant changes in disclosure requirements.

### *Regulatory reporting*

A Working Group on Regulatory Reporting (comprising representatives from the two industry Associations, the Hong Kong Society of Accountants and the HKMA) established in December 2001, will review the statistical returns submitted by AIs under the Banking and Monetary Statistics Ordinances. The objectives of the review are to update the statutory returns in the light of policy changes and increased demand for data by international organisations such as the IMF and the BIS, and to look for opportunities to reduce the reporting burden of AIs. Industry consultation will be sought on all proposed changes endorsed by the Working Group. To allow time for system enhancements, it is expected that implementation is likely to be in early 2003.

## International supervisory developments

### *New Capital Accord*

In December 2001, the Basel Committee announced that a comprehensive quantitative impact assessment on the New Accord would be undertaken prior to conducting the third consultation. The HKMA will participate in the Basel quantitative impact study and the next consultation, assess in detail the implications of any revised proposals on AIs in Hong Kong and consult the industry on these proposals. To facilitate the implementation process, the HKMA will further develop plans for implementing the New Accord in Hong Kong and consult the industry on its policy intentions as soon as practicable.

Recognising that the implementation of an internal ratings system and the lack of historical data are major issues for banks in relation to adopting the internal ratings based (IRB) approach under the New Accord, the HKMA will explore with external parties the possibility of data sharing among banks to facilitate credit management and the estimation of default probabilities. In addition, the HKMA will review how the existing loan classification framework can be enhanced, for example by expanding the performing category into multiple grades, to bring it more into line with the Basel requirements for internal ratings under the IRB approach.

### *International co-operation*

To promote Hong Kong's status as an international financial centre, the HKMA will continue to take an active role in international and regional supervisory forums. Apart from participating in such forums as the CPLG and the EMEAP Working Group on Banking Supervision, the HKMA will assume the chairmanship of the SEANZA Forum of Banking Supervisors for two years from 2002. A supervisory workshop to be jointly hosted by the HKMA and the FSI will be held in late 2002 in Hong Kong for members of the SEANZA Forum.