



Windsurfers compete in the Hong Kong Windsurfing Circuit in Sai Kung. The Circuit attracted around 100 competitors from Hong Kong and overseas.

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. A priority of banking supervision in 2003 was to ensure authorized institutions had adequate risk management procedures and contingency measures to deal with the impact of the SARS epidemic on their operation and asset quality. On the policy side, the main focus was to develop a road map for the implementation of Basel II. Good progress was also made in preparing the legislation for the Deposit Protection Scheme Bill and the establishment of a Commercial Credit Reference Agency in Hong Kong.

OBJECTIVES

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

- the *Banking Supervision Department* handles the day-to-day supervision of authorized institutions (AIs)¹
- the *Banking Policy Department* formulates supervisory policies to promote the safety and soundness of the banking sector
- the *Banking Development Department* formulates policies to promote the development of the banking industry.

REVIEW OF 2003

Operational supervision

The HKMA conducted 247 on-site examinations on AIs' operations in 2003, including 76 risk-focused, nine treasury and 18 securities examinations. The on-site examinations also included 21 focused

examinations of AIs' equitable mortgage loan, credit card and public light bus financing operations in the light of the weak economic conditions in the first half of 2003; and 10 special examinations on AIs' lending policies and practices. The decrease in on-site examinations (down from 285 in 2002) mainly reflected the precautionary measures taken by AIs and the HKMA during the SARS outbreak in the second quarter of the year to reduce physical interaction. With the increasing popularity of electronic banking (e-banking) services, the HKMA continued with its efforts to review the controls on AIs' e-banking activities and the specialised examination teams conducted 28 e-banking and IT related examinations and 20 on-site reviews of AIs' business continuity planning during the year.

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).

Pending the issuance of the revised *Supplement to the Guideline on the Prevention of Money Laundering* and a set of guidance notes to assist AIs in implementing the requirements, the HKMA focused primarily on tier-one examinations covering high-level reviews of AIs' controls on prevention of money laundering during the year. In 2003 the regular teams and specialised money laundering examination teams together conducted 74 tier-one examinations as part of the routine inspections, and five tier-two examinations covering more thorough checking of the implementation and effectiveness of the laid down procedures.

The number of off-site reviews and tripartite meetings conducted in 2003 remained largely the same as in 2002, despite the reduced number of AIs resulting from mergers and acquisitions (224 AIs at the end of 2002 and 215 AIs at the end of 2003).

TABLE 1 Operational supervision*

	2002	2003
1. On-site examinations including those on	285	247
- treasury	(11)	(9)
- securities	(10)	(18)
- e-banking	(30)	(28)
- review of business continuity plans	(20)	(20)
- overseas examinations	(12)	(9)
2. Off-site reviews and prudential interviews	215	216
3. Tripartite meetings	78	77
4. Meetings with boards of directors of AIs	21	16
5. Approval of applications to become controllers, directors, chief executives, alternative chief executives of AIs	318	310
6. Reports commissioned under Section 59(2) of the Banking Ordinance	0	5
7. Cases considered by the Banking Supervision Review Committee	10	12

* Further details on the banking supervisory approach of the HKMA are given in *HKMA Background Brief No.2 – Banking Supervision in Hong Kong*.

The HKMA continued to maintain regular dialogue with the board of directors of locally incorporated AIs and met the boards of 11 banks and five deposit-taking companies. Both the HKMA and the boards found this arrangement useful in strengthening their communication and improving their understanding of the state of affairs, financial position and strategic direction of the AIs.

The Banking Supervision Review Committee considered 12 cases during 2003 relating to the licensing of AIs and money brokers. A total of 310 applications to become controllers, directors, chief executives and alternate chief executives of AIs were approved. Details of the operational supervisory work performed in 2003 are set out in Table 1.

On four occasions in 2003, the HKMA used the 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. A total of five such reports were submitted by the AIs concerned.

During 2003 no AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio and liquidity ratio. There were two breaches of the requirements relating to large exposures under Section 81 and 15 breaches of the requirements relating to connected lending under Section 83. All these breaches, which were technical and unintentional in nature, were promptly rectified and did not result in any risk to the interests of depositors or creditors. No use was made of the powers under Section 52 of the Banking Ordinance during the year.

Special examinations

A series of events in May 2003 connected with a certain loan made by a large bank to a Mainland-based borrower raised public concerns about the effectiveness of the bank's risk management procedure. As banking supervisor, the main concern of the HKMA was to understand the nature and scope of the problem, to ascertain whether any irregularity had been committed by any of the bank

staff, to identify remedial action that the bank should take to rectify any weaknesses revealed in the incident, and to ascertain whether other Als might have similar weaknesses in their lending practices.

Under Section 59(2) of the Banking Ordinance, the HKMA required the bank to appoint two independent external auditors to separately review and report on the bank's exposures to the borrower in question and the bank's high level controls, credit approval processes, credit risk management, internal control mechanism and asset quality. At the same time, the board of the bank took the initiative to set up a Special Committee to review, among other things, the credit approval, credit risk management and related internal control mechanisms for the bank's corporate lending. The board also commissioned a full audit of the bank's interim results for the first half of 2003.

On 5 September the board of the bank released the full Special Committee's Report, the major findings of the two Section 59(2) reports and the bank's interim results for the six months to 30 June 2003. In the Report, the bank announced that it would implement a series of measures to improve its management capability, credit approval procedures, risk management function and high level controls.

The HKMA conducted specialised examinations on 10 Als during June and July to ascertain whether prudent lending policies, practices and procedures were being followed by these institutions. They were selected for examination based on the HKMA's assessment of their business operations and associated risks. Apart from some minor deficiencies which were correctable in the normal course of business, the examinations did not reveal any material exceptions.

Impact of the SARS epidemic on the banking sector

A major challenge confronting the banking industry in 2003 was the SARS epidemic, which began affecting Als, particularly the retail banks, towards

the end of the first quarter. During the SARS outbreak, the demand for bank loans, which was already quiet, declined further; credit card spending fell sharply as consumers cut back on shopping and entertainment, and tourism declined. Branch traffic slowed, hampering the efforts of the banks to market their products.

During this period, the HKMA kept in close touch with Als and provided guidance on contingency measures to ensure continuity of their operations in the event of confirmed or suspected cases of infection among their staff. In helping Als to draw up their contingency measures, the HKMA issued a circular in April, sharing with them the measures generally adopted by most institutions. Recognising that the SARS outbreak was having adverse effects on both corporate and personal customers, the HKMA issued another circular to all Als in May urging them to adopt a sympathetic attitude towards requests for relief arrangements made by borrowers who had encountered repayment difficulties as a result of SARS. Als were generally co-operative in this area. The HKMA also maintained frequent contacts with bank management to ascertain the impact of SARS on banks' asset quality and profitability. Fortunately, the impact receded by mid-May, when SARS was brought under control. The economic environment and consumer sentiment after the outbreak improved quickly and Als generally reported that the overall impact on the 2003 results was mild.

 [Information Centre](#) > [Guidelines and Circulars](#)

Risk-based supervision

The HKMA achieved full implementation of the risk-based supervisory approach in 2003. The approach now encompasses all off-site reviews and on-site examinations of both local and foreign Als. Under this approach, risk-based documentation is produced through off-site reviews. This in turn helps define the scope of on-site examinations depending on the assessment of the specific risk areas to which individual Als are exposed. The latest development

is to devise a database to capture information about the risk management systems of each AI, further facilitate the preparation and updating of risk-based documentation, and the identification of focused areas in on-site examinations.

During the year the Quality Assurance Unit completed the first cycle of review of risk-based documentation to ensure a high level of work standardisation and consistency. The Unit also updated the internal guidance to staff throughout the risk-based review cycle.

Industry consolidation

The global trend of consolidation in the banking industry continued in 2003. Locally, the merger of Dao Heng Bank Limited, Overseas Trust Bank, Limited and DBS Kwong On Bank, Limited into DBS Bank (Hong Kong) Limited, and the merger of East Asia Credit Company Limited and East Asia Finance Company, Limited with the Bank of East Asia, Limited, were completed during the year. In September 2003, Wing Hang Bank Limited acquired the entire share capital of Chekiang First Bank Limited from Mizuho Corporate Bank, Limited. The number of locally incorporated banks dropped from 26 at the end of 2002 to 23 at the end of 2003.

Taxi loans and public light bus loans

The HKMA continued to monitor closely the market situation for taxi financing and the asset quality of Als' taxi loan portfolio. In accordance with the arrangement set out in the Guidance Note on Taxi Financing issued in December 2000, the HKMA conducted quarterly surveys covering a group of active lenders and two taxi associations regarding the taxi licence value, the income level of taxi operators and the problem loan level of taxi financing. It was noted that the operating income of taxi operators and the taxi licence value were adversely affected by SARS during the second quarter of the year. However, the situation stabilised quickly after the outbreak subsided and the market rebounded to the pre-SARS level in the

third and fourth quarters. The overdue and rescheduled loan ratio of the taxi loan portfolio (for both urban and New Territories taxis) of the surveyed lenders followed a similar pattern: the ratio deteriorated during the SARS outbreak, but started to ease from the third quarter of the year. At the end of December 2003, the ratio stood at 3.30%, which was higher than the level at the end of 2002 (1.68%).

Using the experience gained during the SARS period, the HKMA commenced a review of the operation of the Guidance Note. The major problem was that any adjustments to the cap on taxi licence loan amounts, based on the income of taxi operators, would be procyclical in terms of its impact on the taxi licence value. The HKMA therefore consulted the banking industry on proposals to improve the situation, including the removal of the Note or the replacement of the loan cap with a maximum loan-to-value ratio requirement. The industry, however, failed to reach a consensus and the HKMA decided to maintain the status quo for the time being.

During the year, the HKMA also conducted special on-site visits to Als that were active in public light bus financing to ascertain whether the market continued to adopt prudent lending practices. The outcome showed that the Als concerned had established appropriate internal lending policies and procedures for this line of business.

Personal renminbi business

It was formally announced in November 2003 that the People's Bank of China had agreed to provide clearing arrangements for licensed banks in Hong Kong to conduct personal renminbi business. To enable effective monitoring of these activities, the HKMA consulted the banking industry in December on the introduction of a new return to collect the requisite data from the banks concerned on a monthly basis. The HKMA also made plans to cover personal renminbi business in its ongoing off-site review and on-site examinations of the banks offering these services to customers.

Insurance-related activities of Als

Als in Hong Kong have become more active over the past few years in selling insurance products to customers. While the volume of insurance-related business of the banking industry remains low, it is likely to increase in the years ahead. In light of this, the HKMA discussed with the Insurance Authority (IA) ways to improve the supervisory co-ordination and co-operation between the two agencies in relation to the insurance business of Als.

These efforts culminated in the signing of a Memorandum of Understanding (MoU) between the HKMA and the IA in September. The MoU addressed one of the recommendations arising from the Financial Sector Assessment Programme² (FSAP) Report on Hong Kong conducted by the International Monetary Fund earlier in the year. The recommendation called for increased supervisory co-operation among financial regulators in supervising the cross-market activities of financial institutions.

The HKMA, after consultation with the Hong Kong Association of Banks (HKAB) and the DTC Association, introduced a new return in December 2003 to collect information half-yearly about the insurance intermediary activities of Als. The HKMA will also conduct on-site examinations of Als that are active in insurance related business to check their compliance with the codes of conduct governing the sale of insurance products to their customers.

Co-operation with other supervisors

The HKMA continues to maintain a close working relationship with other regulators in Hong Kong, including the Securities and Futures Commission (SFC), the IA, and the Mandatory Provident Fund Schemes Authority (MPFA). The HKMA also co-operates closely with law enforcement authorities in Hong Kong in preventing or handling fraud cases affecting the banking industry or potential bank customers, and with other

government agencies in countering money laundering and terrorist financing activities.

The HKMA also continues to maintain a close working relationship with supervisors outside Hong Kong. The newly established China Banking Regulatory Commission and the HKMA signed a Memorandum of Understanding on 25 August 2003, which establishes a formal framework for supervisory co-operation and sharing of supervisory information. On 7 July 2003 the HKMA also formalised a similar arrangement with the Commission Bancaire of France. During the year meetings were held in Hong Kong and overseas with regulators from the Mainland, the USA, the UK, Singapore, India, Taiwan, Iran and Macau to discuss supervisory issues of common interest.

Equitable and building mortgages

The Gold-Face incident, in which the developer failed to complete and deliver flats to home buyers who financed their purchase by taking out equitable mortgages, raised concerns about the adequacy of banks' controls over equitable and building mortgages. As a result, the HKMA conducted special visits to a number of Als to review their practices and measures for managing the risks associated with equitable and building mortgages. The results of the review indicated that the risk management and internal controls adopted by the selected Als for this type of lending were in general acceptable although there was room for improvement in the case of some of the Als visited.

Following the visits, the HKMA held discussions with the Als to remind them of the need for adequate controls to mitigate the risks associated with these types of business. In particular, Als are expected to fully evaluate the developer's ability to complete the development project before participating as an equitable mortgage lender. Als are expected to establish appropriate caps to limit their exposure to individual projects and those commenced by the same developer. They are also expected to implement proper measures to ensure that equitable mortgage loan proceeds are paid to

² A joint IMF-World Bank initiative designed to promote financial stability and assess compliance with key international codes and standards covering various financial sectors.

a stakeholder approved by the lending banks that provide the building mortgage loan. Als engaging in building mortgage financing are expected to take appropriate steps to ensure that the loan proceeds are properly applied to finance the project. They should also have adequate control procedures to monitor the construction cost disbursement and the progress of the construction, and to ascertain that sale proceeds arising from pre-completion sales are paid into designated accounts.

Asset quality

Credit card business and personal bankruptcies

The recovery in the domestic economy and the improvement in the unemployment rate helped to reduce the level of bankruptcies in 2003. The number of petitions for bankruptcy fell from 26,922 in 2002 to 22,092 in 2003. Credit card delinquency and annualised charge-off ratios also improved from 1.28% and 13.25% in 2002 to 0.92% and 10.02% respectively in 2003. Apart from the general economic recovery, the improvement in the quality of the credit card portfolio was also helped by banks' willingness to help cardholders in financial difficulties to restructure their card liabilities. With the introduction of the sharing of positive credit data in June 2003 and the prospects for continuing economic recovery, the quality of the credit card portfolio is expected to improve further.

In a follow-up to the special on-site examinations in 2002 on 23 card issuing Als, the HKMA conducted another round of short examinations of 14 small-to-medium size credit card issuers in the first quarter of 2003. These were designed to check that the recommendations arising from the 2002 examinations had been implemented, and to ensure that Als continued to adopt effective risk management procedures and to safeguard the quality of their card portfolios.

 > [Information Centre > Press Releases > Credit Card Lending Survey Results category](#)

Residential mortgage lending

Residential mortgage loans by Als shrank in the first three quarters of 2003 as a result of the

economic impact of the SARS outbreak. Moderate growth was recorded in the fourth quarter alongside the economic recovery close to the end of the year. However, the total outstanding value of residential mortgages at the end of 2003 was still less than at the end of 2002, by 2.4%.

Despite the weak economic environment in the first nine months of the year, the asset quality of Als' mortgage portfolio was stable, with the mortgage delinquency ratio hovering around 1% and finally dipping to 0.86% at the end of the year. The problem of negative equity in the mortgage portfolio also eased considerably with the pick-up in property prices in the final quarter of the year.

For a detailed analysis of the asset quality of the banking sector, please refer to the chapter on Economic and Banking Environment on page 33.

 > [Information Centre > Press Releases > Residential Mortgage Survey Results category](#)

CEPA

The full implementation of the Closer Economic Partnership Arrangement (CEPA) on 1 January 2004 has taken the economic relationship between the Mainland and Hong Kong into a new phase. CEPA offers greater market access and flexibility for qualifying Hong Kong incorporated Als to conduct business on the Mainland and increase their growth potential.

Under CEPA, Hong Kong's banking sector can enjoy a number of benefits:

- the asset requirement for Hong Kong banks setting up branches on the Mainland is reduced from US\$20 billion to US\$6 billion. Up to seven small to medium-sized banks are expected to benefit immediately from the relaxed asset size requirement.
- the criteria for qualifying Mainland branches of Hong Kong incorporated banks to conduct renminbi business have been relaxed. The minimum number of years of operation has been reduced from three to two and assessment of profitability will be based on the overall position

of all branches of the same bank on the Mainland instead of only the branch that makes the application to conduct such business.

By the end of 2003, four Hong Kong banks had taken advantage of CEPA and submitted applications to set up branches on the Mainland. The HKMA is also aware that some foreign banks are considering turning their branches in Hong Kong into subsidiaries.

Initial public offerings (IPOs)

With the revived public interest in the IPO market in the fourth quarter of 2003, the HKMA issued a circular to all AIs in December reminding them to have appropriate procedures to ensure compliance with all relevant regulatory requirements for IPO business. In particular, AIs were reminded to observe prudent credit standards in financing subscriptions for new share issues and to limit total lending for individual IPOs to an amount which was well within the AI's ability to obtain funding to meet its obligations on the day of settlement. AIs acting as receiving banks for individual IPOs were reminded to have appropriate contingency plans and adequate systems and human resources to cope with any unexpected level of interest in the issue. The HKMA also wrote to a number of AIs active in serving as IPO receiving banks drawing their attention to lessons learnt from a couple of heavily over-subscribed IPO cases in late 2003.

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Banking reform

During the year, the HKMA continued to implement the remaining policy initiatives contained in the banking sector reform programme: the establishment of a deposit protection scheme (DPS) and a commercial credit reference agency (CCRA) in Hong Kong.

(a) Deposit protection scheme

With the endorsement of the Executive Council, a Bill for implementing the DPS was introduced into the Legislative Council in April. The first reading took place on 30 April and a Bills



*Executive Director (Banking Development)
Raymond Li attends a meeting of the Legislative
Council Bills Committee on the Deposit Protection
Scheme Bill.*

Committee was formed in May to scrutinise the Bill. During the year, the Bills Committee held nine meetings. It completed its deliberation of the policy issues underlying the Bill and proceeded to examine the individual clauses. The Bills Committee generally supported the HKMA's recommendations in relation to the key features of the scheme, such as the establishment of an independent Deposit Protection Board to oversee the management of the scheme and the setting of the coverage limit at HK\$100,000 per depositor per bank. With the assistance of the Department of Justice, some refinements to the Bill were made to take into account comments received from Committee Members and other interested parties, including the Consumer Council, the Law Society of Hong Kong and the Hong Kong Bar Association.

(b) Commercial credit reference agency

Progress was made in 2003 towards the establishment of a CCRA in Hong Kong. The industry working party reached consensus on the key features of the scheme. In June the HKMA, the Hong Kong Association of Banks and the DTC Association jointly announced the scheme. In August the HKMA issued a circular letter requiring all AIs engaged in lending to small and medium-sized enterprises (SMEs) to participate in the scheme and setting out the ground rules to be followed by AIs in seeking SME customers' consent to disclosure of their

data to the CCRA. A supervisory guideline to Als on the use and protection of commercial credit data was also developed and is being refined to take into account the comments of the industry associations. The industry working party has appointed a service provider to operate the CCRA and, together with the company, is finalising the implementation details.

Consumer credit data sharing

In June 2003 the Privacy Commissioner relaxed the Code of Practice on Consumer Credit Data to extend the scope of credit data to be shared among credit providers to cover more positive data. In conjunction with this, the HKMA issued a supervisory guideline requiring Als to participate fully in the sharing of positive data and to maintain adequate controls to safeguard customer data privacy. With all the preparations in place, credit providers started sharing positive consumer credit data in August. To check Als' compliance with the guideline, the HKMA began a round of special on-site examinations covering Als that were active in consumer credit business in December 2003.

The HKMA believes that the sharing of positive data will contribute to the creation of a healthier credit environment. It will help to avoid the problem of multiple indebtedness, which underlies the sharp increase in personal bankruptcies in the past few years. In fact, there are increasing signs that the benefits of positive data sharing are being realised.



New products offered by Als in response to the launch of positive data sharing: interest is charged based on individual customers' creditworthiness.

Since August, a number of Als have introduced new products that charge interest based on the creditworthiness of individual customers. This will benefit borrowers with good credit standing.

In addition, a number of Als active in consumer lending say that positive data sharing has helped to strengthen their credit risk management systems so that they can offer more competitive products to customers.

Consumer protection

(a) Code of Banking Practice

The HKMA continued to participate in the Code of Banking Practice Committee convened by the Hong Kong Association of Banks. Following a detailed review, the Committee introduced new provisions to the Code requiring Als to provide a prospective surety with an option to choose whether the guarantee or third party security should be limited or unlimited in amount. Where the guarantee or third party security is unlimited in amount, Als are required to give notice to the surety as soon as practicable when further facilities are extended to the borrower. These new provisions came into effect in February.

The overall state of compliance with the *Code of Banking Practice* improved further in 2003, as shown in the second self-assessment conducted by Als covering the period between June 2002 and May 2003. Virtually all Als (99%) reported either full or almost full compliance (i.e. less than five instances of non-compliance) with the Code, compared with 90% in 2002. Where non-compliant areas were identified, Als were required to take prompt action to rectify the situation.

(b) Customer complaints

In 2003 the HKMA received a total of 536 complaints in relation to banking services. Compared with the second half of 2002, when the HKMA's complaint handling procedures were streamlined, the number of cases received

in 2003 was slightly higher (Chart 1). The rise was mainly due to an increased number of complaints in relation to credit card borrowing, ATM frauds and new deposit products.

Starting from March 2002, all AIs have been required to submit a quarterly return on the number of complaints received against the debt collection agencies (DCAs) that they employ. Since the survey was introduced, the number of

DCA related complaints received by AIs has continued to decline, from 374 cases in the second quarter of 2002 to 139 cases in the fourth quarter of 2003 (Chart 2). The results suggest that AIs have tightened their monitoring of DCAs to ensure they comply with the standards specified in the *Code of Banking Practice*.

 [Consumer Information](#)

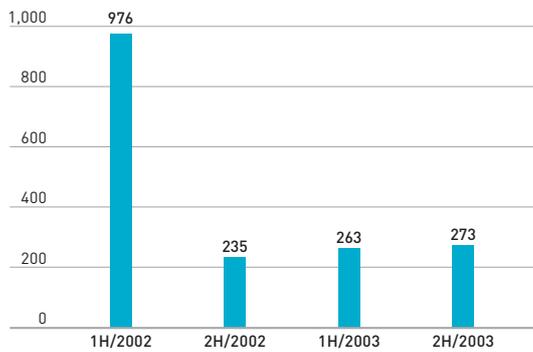
Supervision of AIs' securities and MPF activities

The commencement of the Securities and Futures Ordinance (SFO) and the accompanying Banking (Amendment) Ordinance 2002 on 1 April 2003 brought a new securities supervisory regime into operation. The role of the HKMA as front-line supervisor in relation to AIs' securities activities was reinforced with new responsibilities and powers. An on-line register containing the names and relevant particulars of AIs' securities staff was launched for public inspection on 1 April 2003 on the HKMA website. AIs have started to migrate to the new regime, as required under the law. During April to December 2003, the HKMA processed six applications from AIs for registration under the SFO and granted consent to 15 executive officers (responsible for supervising securities activities) of AIs under the Banking Ordinance. To fulfil its commitment under the new supervisory framework, the HKMA expanded the size of its specialised securities teams and arranged for them to attend SFC training programmes.

 [HKMA Register of Securities Staff of Authorized Institutions](#)

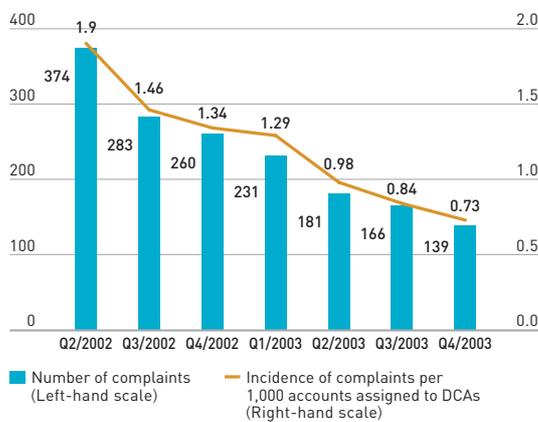
Under the new regime, the HKMA is vested with disciplinary powers to suspend or withdraw the registration of AIs' securities staff and to recommend that the SFC exercise other disciplinary powers over AIs or their securities staff. Since 1 April 2003 the HKMA has put in place procedures to deal with and, if necessary, to investigate matters concerning AIs' securities activities that may trigger disciplinary sanctions. Two separate internal committees, each chaired by

CHART 1 Customer complaints received by the HKMA



Note: In July 2002 the HKMA streamlined its complaint handling procedures. Since then, complainants have been encouraged to resolve their disputes through AIs' internal procedures before reporting to the HKMA. These procedures have resulted in a substantial reduction in the number of complaints received by the HKMA.

CHART 2 Debt collection agency complaints received by AIs



Note: Starting from the second quarter of 2002, all AIs have been required to submit a quarterly return on the number of complaints received against the DCAs that they employ.

a member of the senior management of the HKMA, were established to decide whether to open cases for disciplinary investigation and to make recommendations on the exercise of disciplinary powers. These procedures are similar to those of the SFC. Between April and December 2003, 18 incidents with potential grounds for discipline were reviewed by the responsible committee, which decided to open four cases for investigation. Another case was referred to the SFC for further action.

Specific guidance on compliance with the new statutory and regulatory requirements was provided by the HKMA through a number of circulars to Als in 2003. These covered a range of issues, including restrictions on unsolicited calls, the HKMA public register on Als' securities staff, and applications under the SFO. A module of the HKMA *Supervisory Policy Manual* on the approach towards the supervision of Als' securities business was issued in March 2003. Practical guidance to Als was also provided throughout 2003 in the *HKMA Quarterly Bulletin*. The HKMA revised the prudential return on Als' securities-related activities to reflect the relevant changes under the new regime and collect additional information to facilitate the HKMA's supervision.

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In order to maintain an open market with a level playing field for all intermediaries in the securities industry of Hong Kong, the HKMA and the SFC maintained close supervisory co-operation within the framework set out in the revised MoU between the two regulators. In all, five meetings were held in 2003 under the MoU's established mechanism. The HKMA also refined its on-site examination approach on Als' securities activities to achieve

coherence with the SFC's approach towards other securities intermediaries. Another area of co-operative effort in 2003 was the development of the disclosure regime for fees and charges of securities-related services, which will be finalised by the SFC in 2004. The two regulators also set up a working group in the final quarter of 2003 to start reviewing the implementation of the SFO and studying the need for amendments to the law and regulatory requirements in light of experience.

 > [Policy Areas > Banking Stability > Banking Policy and Supervision > Supervisory Co-operation](#)

The HKMA is also responsible for supervising the MPF-related activities of Als. Regular on-site examinations were carried out to ascertain the adequacy of Als' internal control systems for compliance with regulatory requirements and ensuring the fitness and propriety of staff engaged in MPF intermediary activities. The HKMA also monitored Als' adherence to provisioning and capital charge requirements for the guarantees they provide for the investment return of MPF products.

Electronic banking and technology risk management

In view of the growing acceptance of e-banking services and the increasing dependence of Als on the use of technology to deliver their banking services, the HKMA continued to improve its e-banking and technology risk management supervisory framework. The HKMA introduced an automated control self-assessment process to 40 Als and completed 28 on-site specialist examinations on e-banking and technology risk assessment in 2003. We also issued a guidance note on general principles for technology risk management and a series of circulars to Als to help strengthen their information technology (IT) control environment.

In early 2003 the HKMA noted a spate of fake bank website and e-mail cases overseas. In anticipation of possible similar fraudulent schemes targeting Hong Kong, the HKMA issued a circular in May recommending that AIs take certain preventive and detective measures against similar fraud cases. The HKMA, the Hong Kong Police Force and the HKAB have been co-operating since February 2003 to launch a multi-channel consumer education programme to promote awareness of e-banking security precautions among the general public.

 [Consumer Information](#) > [Internet Banking](#)

In the second half of 2003 ten schemes were detected deploying fake websites and e-mails attempting to defraud Hong Kong bank customers. The HKMA, the police and the banking sector responded quickly to these incidents. Press releases were issued to warn members of the public. Fortunately, no bank customers reported any financial loss through these schemes.

The HKMA received a number of reports of suspected ATM fraud cases in the second half of 2003. In response, the HKMA issued a circular in October setting out its expectations on the precautionary measures that should be undertaken by AIs and the way in which customer complaints should be handled. By the end of 2003 AIs had settled most reported cases and had also made satisfactory progress in improving precautionary measures for their ATMs.

Business continuity planning

The HKMA reviewed the business continuity plans of 20 AIs in 2003. In helping AIs to handle the outbreak of SARS in March and to prepare for another possible outbreak later in the year, the HKMA issued two circulars in April and October on business continuity planning considerations relating to SARS. These circulars recommended certain best practices to AIs in handling an outbreak of SARS or any similar communicable diseases.

Prevention of money laundering and terrorist financing

In 2003 the HKMA further strengthened its supervisory efforts in the prevention of money laundering and terrorist financing. A forum comprising representatives of the industry associations and the HKMA was formed early in the year to further the work on the *Supplement to the Guideline on the Prevention of Money Laundering*. A set of *Interpretative Notes* was produced to provide practical guidance on implementing the requirements of the *Supplement* and explains the risk-based approach to be adopted. The revised *Forty Recommendations* were finalised and issued by the Financial Action Task Force on Money Laundering in June. The revised *Supplement* was issued together with the accompanying *Interpretative Notes* for industry consultation in December 2003.

During the year, the HKMA continued to issue a number of circulars to update the list of Non-cooperative Countries and Territories and to alert them to the new lists of terrorist suspects published in the Gazette under the relevant local legislation, as well as those designated under the US President's Executive Order.

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Hong Kong's anti-money laundering and terrorist financing regime was assessed by the International Monetary Fund (IMF) in early 2003 as part of its FSAP on Hong Kong. The report, issued in April, indicated that the general regulatory framework for the prevention of money laundering and terrorist financing in the banking sector was adequate, and that the relevant requirements on customer identification and ongoing monitoring of accounts and transactions had been implemented effectively.

Development of supervisory policies

The following policy guidelines were developed during the year as modules of the *Supervisory Policy Manual*.

Reporting requirements relating to authorized institutions' external auditors under the Banking Ordinance

This guidance note specifies on the reporting obligations of Als' external auditors under the Banking Ordinance. It covers, among other things, requirements on auditors to report on the accuracy of banking returns, the adequacy of systems of control and any matter that, in their opinion, adversely affects an AI's financial position to a material extent or constitutes, on the part of a registered AI, a failure to comply with certain provisions or rules made under the Securities and Futures Ordinance.

The sharing and use of consumer credit data through a credit reference agency

This statutory guideline sets out the minimum standards the HKMA expects Als to observe in the sharing and use of consumer credit data through a credit reference agency. It requires all Als involved in consumer lending business to participate fully in the sharing and use of consumer credit data within the limits laid down by the *Code of Practice on Consumer Credit Data* and to maintain adequate controls to safeguard customer data privacy.

The sharing and use of commercial credit data through a commercial credit reference agency (under consultation)

This statutory guideline sets out the minimum standards Als should observe in sharing and using commercial credit data through a commercial credit reference agency (CCRA).

The guideline requires all Als involved in lending to SMEs to participate in the scheme and to have adequate systems of control to protect the data of their SME customers. It also requires Als to only use the services of a CCRA which has taken appropriate steps to safeguard the security and accuracy of the data it holds.

General principles for technology risk management

As Als increase their dependency on technology to deliver banking services, improper use of technology resources may have significant risk implications. This guidance note sets out the general principles that Als are expected to consider in managing technology-related risks.

Supervision of e-banking

The development of e-banking services brings considerable benefit to consumers as well as significant challenges to Als. The HKMA has been issuing a series of guidance notes and circulars since 1997 to cover various aspects of risk management and operations of e-banking. In order to provide a better organised and structured supervisory framework for e-banking, the HKMA has consolidated and updated its guidance notes and circulars issued on e-banking into a new guidance note "Supervision of e-banking". This note sets out the HKMA's supervisory approach to Als' e-banking services and provides Als with guidance on the general principles for e-banking risk management.

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Financial reporting and disclosure and regulatory reporting

Financial reporting and disclosure

As a result of the harmonisation of the Hong Kong and international accounting standards, two standards, modelled on International Accounting Standard (IAS) No.39 on *Financial Instruments: Recognition and Measurement* and IAS No.32 on *Financial Instruments: Disclosure and Presentation* are expected to take effect in Hong Kong for annual financial statements of periods beginning on or after 1 January 2005, subject to the final decision of the Hong Kong Society of Accountants. The two standards will introduce, among other things, greater use of fair values in accounting for financial instruments, stringent requirements on the use of hedge accounting and the use of expected cash flow discounting for loan provisioning. They are expected to have significant implications on the accounting and financial reporting by financial institutions and, in particular, the banks. Because of the complexity of the two standards and the time constraint for implementation by the banks, the HKMA conducted a survey of the locally incorporated licensed banks in the fourth quarter of 2003 to raise their level of awareness and to understand the potential impact of the standards on them. The survey results showed that many banks are still studying the requirements, with only a few in the process of developing plans for implementing the standards. It was evident that much more work would have to be done to educate the users to prepare them for implementation.

The HKMA continued to keep abreast of accounting and disclosure developments for areas of improvement. Pending the finalisation of Pillar 3 of the New Basel Capital Accord and the finalisation of the Hong Kong Accounting Standards, which are expected to entail significant changes in disclosure requirements, no revisions were made in 2003 to the financial disclosure guidelines issued by the HKMA.

Regulatory reporting

Further to the comprehensive review of the regulatory returns in 2002, the revised regulatory returns, together with the completion instructions, will become effective for the reporting of positions at the end of March 2004. Work on preparing the systems for the revised reporting was done in 2003.

International supervisory developments

New Basel Capital Accord

In April 2003 the Basel Committee released for comments the third consultative paper on the New Capital Accord (CP3). After considering the comments received, the Committee announced in October its commitment to resolve the outstanding issues for the finalisation of the New Accord by no later than mid-year 2004. The target implementation date of the end of 2006 remained unchanged.

The HKMA completed the third Quantitative Impact Study (QIS 3) on a number of selected local banks to gauge the potential impact of CP3 on the local banking sector. Based on the results of QIS 3 and the capital requirements under the CP3, the HKMA issued in July 2003 for industry consultation preliminary proposals for implementing the New Accord in Hong Kong. The HKMA will take into account comments received subsequently from the industry, and any further changes in the New Accord to be firmed up by the Basel Committee, when finalising the implementation proposals.

In recognition of the fact that the flexibility available to banks and their national supervisors under the New Accord could potentially give rise to inconsistencies in application and level playing-field issues, the HKMA has stepped up contacts with other overseas supervisors for the sharing of views and experience in an attempt to harmonise the implementation process in a cross-border setting.

International co-operation

The HKMA continued to play an active role in promoting interaction among regional banking supervisors, principally through chairing the South-East Asia, New Zealand and Australia (SEANZA) Forum of Banking Supervisors for 2002 and 2003. In December 2003 the HKMA hosted a workshop on the practical application of the New Accord in Asia for the SEANZA Forum in collaboration with the BIS Financial Stability Institute. Altogether, 35 participants from 19 supervisory authorities in the SEANZA economies attended the workshop. The HKMA also continued to participate in other regional and international forums for banking supervisors, which include the Core Principles Liaison Group established by the Basel Committee, the EMEAP Working Group on Banking Supervision, and the Offshore Group of Banking Supervisors.

Core Principles assessment

The FSAP country report on Hong Kong confirmed that the banking regulatory system and supervisory practices in Hong Kong are strong, with a high degree of observance with the *Basel Core Principles for Effective Banking Supervision*. Based on the results of the assessment, the HKMA has devised an internal work plan to address the relevant issues identified for further improvement.



Deputy Chief Executive William Ryback (second from left) reviews the banking sector's performance in 2003 and outlines the HKMA's work for 2004. With him are (from left) Executive Directors Raymond Li, Y.K. Choi and Simon Topping.

PLANS FOR 2004 AND BEYOND

Risk-based supervision

The HKMA will continue to develop the risk-based supervisory process to keep pace with changes in the banking industry and new activities undertaken by AIs. The HKMA will devote more effort to further improving the on-site examination procedures by establishing checklists for new banking products, such as those for AIs' insurance-related activities, private banking activities and personal renminbi business. Special on-site examinations will be conducted in 2004 on AIs that are involved in these areas.

The Quality Assurance Unit will review examination reports and working papers prepared by on-site examiners. The purpose of the review is to ensure consistency of standards and quality of examination reports among supervisory staff. Appropriate guidance will be issued to staff, where necessary, to further improve the quality and efficiency of the risk-based approach. A series of training and refresher programmes, some with the help of the Federal Reserve Bank of New York, will also be arranged in 2004 to improve the skills of supervisory staff in carrying out their work in this field.

Asset quality

Asset quality will remain a main supervisory focus for 2004. The HKMA will seek to ensure that banks' underwriting standards for loans will continue to be prudent. In particular, the HKMA will monitor carefully with the aim of seeking to ensure that banks do not lower their underwriting standards in order to expand their loan portfolio and reduce their surplus liquidity and that they make appropriate use of positive credit data in their consumer credit business.

Interest rate and market risk

There is a general market expectation that interest rates will rise in 2004. This would have an impact on banks with significant portfolios of fixed income securities. A major supervisory focus of the HKMA in 2004 is, therefore, to ensure that AIs have

adequate controls to manage their interest rate risk and market risk arising from adverse changes in interest rate movements and to monitor the impact of such movements on their profitability.

Banking reform

The establishment of the deposit protection scheme and the CCRA will remain a key focus of the HKMA in 2004.

(a) Deposit protection scheme

The HKMA will continue to assist the Legislative Council Bills Committee in its examination of the DPS bill. If the Bill is enacted in the first half of 2004, the Deposit Protection Board will be established to oversee the progress of the whole project. Since there is still a large volume of preparatory work to be completed, it is expected the scheme will only be ready to provide protection towards the end of 2005, at the earliest. The Government will take into account all relevant factors, including the prevailing interest rate environment, in determining the appropriate time to start the scheme.

(b) Commercial credit reference agency

The HKMA will participate in the industry working party to ensure the smooth implementation of the CCRA. The supervisory guideline which sets out the minimum standards to be observed by AIs in the sharing and use of commercial credit data will be finalised prior to the launch of the scheme. If everything goes smoothly, the CCRA is expected to be running in the second half of 2004.

Consumer credit data sharing

As agreed with the Consumer Council, the HKMA will monitor a set of indicators to assess the benefits from the sharing of positive consumer credit data, including greater differentiation in interest rates, reduction in default rates and reduced level of over-indebtedness. To ensure that AIs have put in place adequate controls to

safeguard customer data privacy, the HKMA will conduct a series of on-site reviews covering all AIs active in consumer lending. The reviews were started in December 2003 and will be completed in 2004.

Legal and regulatory framework

The HKMA plans to introduce a Banking Amendment Bill in 2005. The main purpose of the bill will be to implement the new Basel Capital Accord in Hong Kong, but the opportunity will also be taken to improve the working of the Banking Ordinance in some areas in the light of latest market developments. The preparatory work for the bill will commence in 2004.

Consumer protection

The HKMA will continue to promote self-regulation and improvement in the standard of banking practices through participation in the Code of Banking Practice Committee. It will monitor AIs' compliance with the Code through the annual self-assessment exercise and the handling of customer complaints against AIs.

Supervision of AIs' securities and MPF activities

The HKMA will continue to maintain a close working relationship with the SFC in accordance with the MoU between the two regulators. The HKMA will provide input as the AIs' front-line supervisor and consult the banking industry throughout the process of any formulation of new or revised legal and regulatory requirements as well as good industry practices that are applicable to AIs' securities activities. Relevant items include the SFC Guidelines on Good Disclosure of Securities Services-Related Fees and Charges (to be effective in 2004), amendments to the SFO as well as related rules, codes and guidelines (where the need arises), and the possible introduction of measures to improve the refund process in initial public offerings. The HKMA will also co-ordinate with the SFC to extend the Commission's annual survey on fund management activities to cover AIs.

The HKMA will process Als' applications for migration under the SFO, and monitor the schedule for such applications to ensure they will be lodged with the SFC by the end of the two-year transitional period – the end of March 2005.

A reciprocal secondment programme between the SFC and the HKMA commenced in 2004 with the aim of improving staff training. The programme currently covers officers in the area of supervision but will be extended to enforcement functions. The secondment programme will help improve the understanding of the two regulators of each other's supervisory practices, as well as facilitate knowledge and experience transfer between them.

The HKMA will maintain its current supervisory efforts of Als' MPF business. The supervision will be in line with the framework underpinned by the revised MoU signed by the HKMA, the MPFA, the SFC and the IA in January 2004. The HKMA will work with the other financial regulators in developing a uniform regulatory approach to MPF intermediaries.

Electronic banking and technology risk management

The HKMA will continue to review and monitor the rapid development of e-banking services and technology, improve its supervisory framework, and issue further guidance to Als when necessary. The HKMA plans to extend the control self-assessment on e-banking and technology risk management from 40 to 50 Als. The HKMA will also continue its on-site specialist examination programme and conduct approximately 20 such examinations in 2004.

Through the Electronic Banking Working Group of the HKAB, the HKMA, the banking industry and the Hong Kong Police Force will review and monitor the increasing number of reported cases of fake

bank websites and e-mails in Hong Kong. The Working Group will focus on improving measures to detect the operations of fake bank websites and e-mails and also prevent members of the public from being deceived (for example by disclosing their personal information to fraudsters). These measures will include improved consumer education and better security controls over e-banking services.

The HKMA will work with the banking industry to monitor and ensure that Als fully and adequately implement appropriate precautionary measures in relation to their ATMs in the first quarter of 2004. The HKMA will continue to explore with the industry, the ATM network service provider, the vendors of ATM machines and the police other possible measures to prevent similar frauds from happening in Hong Kong.

Prevention of money laundering and terrorist financing

The HKMA will further improve its supervisory efforts in combating money laundering and terrorist financing and keep in line with the international standards.

The HKMA aims at finalising and issuing a revised *Supplement* and its *Interpretative Notes* in the second quarter of 2004. Following that, we shall conduct examinations on Als' systems of controls over the prevention of money laundering and terrorist financing based on the revised requirements.

As a supplement to the on-site examinations, the HKMA intends to develop a structured self-assessment framework to facilitate Als' regular assessment of the extent of their compliance with the relevant regulatory requirements. This will also help the HKMA identify risk indicators and develop supervisory guidance in the longer term.

Development of supervisory policies

Key policies and guidelines to be developed in 2004 will cover the following areas:

- foreign exchange risk management
- liquidity risk management
- internal risk rating systems
- credit cards
- internal audit, legal and compliance functions.

Foreign exchange risk management

The HKMA's supervisory guideline on foreign exchange risk was issued in 1990. Since 2003, the HKMA has been considering an improved foreign exchange risk supervisory framework to incorporate the latest international standards and best practices. We intend to issue a revised guideline to Als in 2004. This will help Als evaluate the adequacy and effectiveness of their foreign exchange risk management, including effective systems for monitoring market risk, settlement risk and credit risk arising from foreign exchange transactions. In developing the revised guideline, the HKMA will also take into account relevant recommendations in the FSAP report and the experience from the Asian financial crisis.

Review of liquidity regime

The HKMA has undertaken a review of the existing liquidity regime, first introduced in 1994, and is in the process of developing a new *Supervisory Policy Manual* module on liquidity risk management that will incorporate the latest international standards and best practices. In particular, more supervisory emphasis will be placed on Als' liquidity risk management systems and controls, including their ability to adequately manage cash-flow positions and conduct scenario analysis. The HKMA will consult the industry about the new module by mid-2004.

Financial reporting and disclosure

The HKMA will continue to keep abreast of accounting and disclosure developments. We shall also work, in collaboration with the banks to understand the impact of International Accounting Standard No.39 and No.32 on the banking industry.

International co-operation

New Capital Accord

A key priority in 2004 is to decide on the legislative process for translating the lengthy and complex capital requirements under the New Accord into legislation, as well as the approach for implementing the New Accord in Hong Kong having regard to the costs and benefits various options will involve. Where necessary, the HKMA will undertake further consultations with the industry when finalising the relevant proposals, to make them both practicable and appropriate for all types of Als. These will take into account the particular features of the Hong Kong market. In addition, given the importance of cross-border supervisory co-operation to the implementation of the New Accord, the HKMA will continue to maintain dialogue with other overseas supervisors on relevant practical issues. The HKMA also intends to release revised banking returns on capital adequacy and associated guidelines for industry consultation by stages from 2004 onwards.

International co-operation

In promoting Hong Kong's status as an international financial centre, the HKMA will continue to participate in international and regional supervisory forums, including the Core Principles Liaison Group, the EMEAP Working Group on Banking Supervision and the SEANZA Forum of Banking Supervisors. As in previous years, the HKMA will co-host with the Financial Stability Institute a supervisory workshop for the SEANZA Forum in late 2004.