Banking Stability

The HKMA maintained its supervisory focus on authorized institutions' management of liquidity and credit risks and Mainland China-related business as risks of spill-over from the European sovereign debt crisis persisted, and credit growth continued at a fast, although moderating, pace. A further round of countercyclical measures was applied to mortgage lending to mitigate the risk that rising property prices could affect the stability of the banking sector. Further steps were taken to strengthen investor and consumer protection.

REVIEW OF 2011

Risk-based supervision

The European sovereign debt crisis led to volatile financial-market conditions in 2011. The rapid credit growth and expansion of Mainland operations by authorized institutions (AIs) continued, albeit at a slightly slower pace than previously. In view of these factors, the HKMA maintained its supervisory focus on AIs' management of liquidity and credit risks; funding strategy; Mainland-related business (including renminbi business); and other emerging areas of concern.

During the year the HKMA carried out 198 on-site examinations, while resources were re-allocated to more frequent meetings with senior management and the heads of risk management of individual AIs to address emerging prudential concerns, including the potential threats to risk management arising from the fast pace of credit growth and the European sovereign debt crisis. Stress tests conducted by the HKMA internally were strengthened to assess the capital and liquidity positions of retail banks, detect possible vulnerabilities under severe but plausible scenarios, and formulate corrective actions.

The HKMA did not receive any new applications from AIs to use the internal ratings-based (IRB) approach for credit risk calculation. The number of IRB reviews declined as a result to four (from 10 in 2010), focusing on changes to previously-approved IRB models. Five on-site examinations were also conducted on AIs using the internal models (IMM) approach for market risk calculation, mainly driven by the implementation of enhanced market risk capital framework in line with the requirements set by the Basel Committee on Banking Supervision. The HKMA also conducted examinations on the internal capital adequacy assessment process (CAAP) of eight AIs which have substantially established CAAPs.

The specialist teams conducted on-site examinations on market risk management and treasury activities of seven AIs and assessed six AIs' firm-wide stress testing and liquidity risk management. The specialist teams also performed 30 on-site examinations on AIs' sale of investment and insurance products, and other areas relating to their securities business, following a pick-up in business volume during the year. In July on-site examinations of AIs' compliance with the Deposit Protection Scheme Representation Rules for 2011 commenced. Seven such examinations were completed by the end of the year and the remainder will continue in 2012. Other areas examined by the specialist teams included anti-money-laundering (AML) and counter-terrorist-financing (CFT) controls as well as technology and operational risk management. In addition, a round of thematic examinations was conducted to assess 10 AIs' progress in the implementation of the HKMA's "Guideline on a Sound Remuneration System".

The HKMA's supervisory teams conducted 193 off-site reviews of AIs' financial positions and business operations. Other regular supervisory activities included analysis of prudential returns, review of AIs' new business initiatives and dealing with incidents of regulatory non-compliance. The supervisory teams met the boards or members of board-level committees of eight AIs and held a tripartite meeting with the management and external auditors of one AI. The reduction in tripartite meetings was mainly because meetings with senior management and board-level committees of AIs had already covered issues normally discussed in such meetings. The Banking Supervision Review Committee considered 10 cases relating to authorization of AIs in 2011. Details of the operational supervisory work performed in 2011 are set out in Table 1.

During the year the HKMA commissioned four reports under section 59(2) of the Banking Ordinance requiring four AIs to appoint external auditors to review internal control issues and report their findings to the HKMA. One of these reports concerned systems of compliance, risk management controls and incident-escalation mechanisms. Another covered the accuracy of documentation provided to investors in relation to the issuance of structured products. The other two reports covered AML/CFT controls.

No AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio or liquidity ratio in 2011. There was one breach of the approval requirement under section 44(1) relating to the establishment of a local branch, three under section 71D on the appointments of Executive Officers, two under section 74(1) on the appointment of Chief Executives and one under section 87A on the acquisition of share capital in companies. All of the breaches were assessed to be unintentional. They were rectified promptly by the relevant AIs and did not affect the interests of depositors.

Table 1 Operational supervision

		2011	2010
1	On-site examinations	**198**	216
	Regular examinations	**39**	69
	– risk-based	**30**	49
	– overseas	**9**	20
	Basel II – Reviews of the IRB and IMM approaches	**9**	14
	– Follow-up examinations of the IRB approach	**4**	10
	– Internal model recognition assessment and review of the IMM approach	**5**	1
	– IT aspects of the IRB approach	**–**	3
	Internal capital adequacy assessment process and economic capital	**8**	–
	Credit risk management and asset quality	**40**	49
	Market risk and treasury activities	**7**	15
	Firm-wide stress testing and liquidity risk management	**6**	–
	Securities, investment and insurance products-related conduct examinations	**30**	11
	Compliance with the Deposit Protection Scheme Representation Rules and Guideline on Representation on Full Deposit Guarantee#	**7**	19
	Consumer protection	**1**	–
	AML/CFT controls	**11**	14
	IT, Internet banking and operational risk	**18**	19
	Remuneration system	**10**	–
	Mainland-related business	**9**	–
	Renminbi payment system	**1**	–
	Renminbi business	**2**	6
2	Off-site reviews and prudential interviews	**193**	190
3	Tripartite meetings	**1**	12
4	Meetings with board of directors or board-level committees of AIs	**8**	7
5	Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs	**223**	241
6	Reports commissioned under section 59(2) of the Banking Ordinance	**4**	3
7	Cases considered by the Banking Supervision Review Committee	**10**	5
8	AIs that were subject to the exercise of powers under section 52 of the Banking Ordinance	**1**	1

Examinations conducted in 2011 covered the compliance with the Deposit Protection Scheme Representation Rules only as the Full Deposit Guarantee expired at the end of 2010.

Powers under section 52 of the Banking Ordinance

Melli Bank Plc continues to be subject to the exercise of powers under section 52 of the Banking Ordinance. The directions imposed by the Monetary Authority (MA) on 25 June 2008 under section 52(1)(A) of the Banking Ordinance on the affairs, business and property of the Hong Kong Branch of Melli Bank Plc remained in force during 2011. The HKMA will continue to communicate regularly with the relevant authorities to monitor developments related to the branch and its head office in the UK and will review the supervisory measures taken to protect the interests of the AI's depositors.

CAMEL rating review

The CAMEL Approval Committee reviewed and determined the composite CAMEL ratings[1] of 195 AIs. The AIs were notified of the ratings and were given the opportunity to request a review, although none did so.

The CAMEL ratings of licensed banks on 20 October 2011 were used as the supervisory ratings provided to the Hong Kong Deposit Protection Board for the purpose of determining the contributions to be paid by Scheme members in 2012 under the Deposit Protection Scheme.

Specialised supervisory work

Supervision of technology risk

The use of Internet banking services continued to grow: the number of personal Internet banking accounts increased to 7.7 million (from 7.0 million in 2010), and there were 658,000 corporate Internet banking accounts (up from 573,000 in 2010). Among the 67 AIs offering Internet banking services, 59 AIs, including all of the 42 that offer high-risk transactions (such as fund transfers to unregistered third-party accounts) through Internet banking, have implemented two-factor authentication and some 4.1 million customers have registered for this service.

1 Comprising the **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity components.

The HKMA issued a circular on 1 June 2011 requiring AIs to implement chip-based technology on all Automatic Teller Machine (ATM) services in Hong Kong as part of an on-going effort to enhance the security for ATM services. AIs are expected to upgrade their ATM terminals by the end of February 2013. Card replacement should be completed by March 2014 for debit cards and credit cards linked to cardholders' bank accounts, and by the end of 2015 for remaining credit cards.

To address the potential risk to Internet banking security arising from the introduction of SMS forwarding services by the telecommunications industry, the HKMA and the banking industry worked with the mobile telephone operators to implement additional controls to prevent fraudsters from using such services to forward one-time SMS passwords from a customer's registered mobile phone to the fraudster's mobile phone. The measure was implemented on 30 October.

The HKMA conducted regular on-site examinations and off-site surveillance of AIs' controls over Internet banking, technology risk management and business continuity planning. Separately, the HKMA extended the coverage of the supervisory control self-assessment process for Internet banking, technology risk management and business continuity planning to 78 AIs (from 73 in 2010).

The HKMA continued to participate in the International Information Technology Supervisors Conference to share supervisory experience and knowledge with overseas banking supervisors in e-banking, technology risks and emerging fraudulent techniques.

Supervision of operational risk

In 2011 the HKMA enhanced its existing operational risk profiling system for analysing information gathered from the annual self-assessment on operational risk management. The self-assessment covered 77 AIs (compared with 76 in 2010). This exercise revealed that the selected AIs had in general established an operational risk management framework in line with the supervisory requirements. In addition, the operational risk management specialist team conducted on-site examinations on three AIs to review their policies and controls for operational risk.

Benchmarking stress-testing practices of AIs

The HKMA conducted a benchmarking exercise to assess and compare the effectiveness of selected AIs' firm-wide stress-testing practices, focusing on practical aspects of the effective implementation of risk management techniques and control procedures. The exercise found that the majority of the selected AIs had adopted reasonable policies and procedures to guide their stress-testing exercises. Some deficiencies were noted in a few areas where stronger governance, stricter control processes, more prudent business assumptions and greater discipline in taking risk-mitigating actions would ensure more effective implementation of the policies and procedures. The HKMA issued a circular on 4 August 2011 to share the observed sound practices with the industry.

Supervision of securities, investment products, insurance and Mandatory Provident Fund-related businesses

The HKMA co-operated closely with the Securities and Futures Commission (SFC), the Office of the Commissioner of Insurance (OCI) and the Mandatory Provident Fund Schemes Authority (MPFA) on the supervision of AIs' securities, insurance and Mandatory Provident Fund (MPF)-related businesses. Regular contact was maintained through bilateral and multilateral meetings, and under the auspices of the Council of Financial Regulators.

The HKMA engaged, jointly with the SFC, a service provider to undertake a mystery shopping programme to assess retail banks' compliance with regulatory requirements covering sales of unlisted securities and structured deposits in 2010. The HKMA published the findings of the exercise in May 2011. AIs were required to give due regard to the issues identified and were encouraged to adopt the good practices set out in the report.

The HKMA worked closely with the SFC and the Stock Exchange of Hong Kong Limited to help the industry ensure its operational readiness for the listing of products denominated in renminbi. In this connection, the HKMA issued three circulars to AIs in February and March.

In view of the popularity of investment-linked assurance scheme (ILAS) products and their salient features and risks, the HKMA issued guidance to the industry on 14 March to strengthen the regulation of AIs' sales of such products.

Following the introduction of the pilot scheme for streamlining the sales of renminbi retail bonds and the implementation of new investor protection measures for less experienced investors, including a pre-investment cooling-off period, the HKMA issued guidance in April to streamline AIs' sales processes for plain vanilla investment products and to allow vulnerable investors to choose whether to have a companion as witness and/or to have a second front-line staff member to handle the sales process.

In view of the popularity of currency-linked instruments and interest-rate linked instruments issued by AIs and the exemption of such instruments from the authorization requirements under the Securities and Futures Ordinance, the HKMA developed templates for Important Facts Statement to enhance the disclosure of key features and risks of such products for distribution to retail customers. Guidance was issued to AIs in April to implement this requirement.

The HKMA issued guidance in October to further elaborate the standards of conduct expected of AIs selling accumulators. In particular, the selling of accumulators should be justified with specific grounds acknowledged by the customer.

The HKMA also stepped up its efforts in investor education, issuing *inSight* articles to highlight key features and risks of exchange-traded funds and accumulators in August and September respectively.

The HKMA allocated additional resources to on-site examinations related to securities, investment and insurance products. The specialist teams conducted 30 on-site examinations, up from 11 in 2010, covering the distribution of accumulators and decumulators as well as investment products not regulated under the Securities and Futures Ordinance, sponsorship activities for initial public offerings (IPOs), private placements, compliance with the enhanced regulatory requirements for selling of investment products, ILAS and non-linked long-term insurance products. The HKMA published a report in November on common deficiencies and key areas of concern identified in the thematic on-site examinations of IPO sponsorship activities. In addition, the HKMA issued a circular drawing the report to the attention of all bank IPO sponsors and reminding them of the regulatory standards required of them in performing these activities.

The HKMA processed three applications to become registered institutions (RIs) and five applications from RIs to engage in additional regulated activities. It also granted consent to 261 Executive Officers, who are responsible for supervising the securities activities of RIs, and conducted background checks on 9,578 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

During the year the HKMA continued to work with the Financial Services and the Treasury Bureau (FSTB) and the OCI to engage the banking industry and other stakeholders in formulating the future regulatory framework governing the distribution of insurance products after the proposed independent Insurance Authority is established. The HKMA also continued to co-operate with the FSTB and the MPFA to formulate the statutory regime to regulate MPF intermediaries, in preparation for the implementation of the Employee Choice Arrangement.

Supervision of treasury activities

Of the 13 treasury examinations conducted on selected AIs during 2011, seven mainly covered AIs' control framework for managing market risk and counterparty credit risk arising from their treasury and derivatives activities. The remaining six focused on firm-wide stress testing, liquidity risk management and interest rate risk management.

In addition to the on-site examinations and the benchmarking exercise on stress-testing practices, the HKMA continued to devote considerable resources to monitoring emerging financial market and treasury product trends with potential material market risk or systemic implications, and providing specialist opinion on material or emerging risks in relation to AIs' treasury and derivatives operations.

Credit risk management and asset quality

Credit growth

The banking sector's total lending increased by 20.2% in 2011, although the pace of growth moderated in the second half. Overall, the growth in bank lending for use in and outside Hong Kong, and for trade finance was slower than in 2010 (Table 2).

Table 2 Growth in loans and advances

% change	**2011**	2010
Total loans and advances	**20.2**	28.6
of which		
– for use in Hong Kong	**12.8**	20.9
– trade finance	**26.9**	56.7
– for use outside Hong Kong	**41.2**	50.3

The HKMA has been closely monitoring the credit growth of AIs because of the potential stress on credit quality and liquidity risk management. Early in the year, AIs were required to submit their business plans and funding strategies to the HKMA for review. Where considered appropriate, the HKMA requested AIs to revise their business plans having regard to the sustainability of stable funding to support their lending activities. More frequent on-site examinations were conducted to review the loan portfolios of AIs whose credit growth, including Mainland-related businesses, had grown significantly. Overall, the results showed no apparent deterioration in the credit underwriting standards and credit risk management of AIs. To build a stronger buffer against possible deterioration in asset quality, the HKMA also discussed with the retail banks the need to increase the level of their regulatory reserves by the end of 2011. As a result, the relevant retail banks' regulatory reserves (including their collective impairment allowances) are expected to reach 1.4% of their total lending once the agreed levels are attained, compared with 0.85% at the end of 2010.

Prudential supervision of mortgage loans

The HKMA remained vigilant towards AIs' property mortgage business, which constitutes a significant portion of their lending portfolios. As property prices continued to rise in the first half of 2011, the risk of a property bubble, which might potentially undermine the stability of the banking system, persisted. Against this background, the HKMA introduced on 10 June the fourth round of countercyclical macro-prudential measures. The measures were:

(1) Lowering the maximum loan-to-value (LTV) ratios to:

- 50% for residential properties valued at $10 million or more
- 60% for residential properties valued at $7 million or more but below $10 million, subject to a loan cap of $5 million
- 70% for residential properties valued at less than $7 million, subject to a loan cap of $4.2 million.

(2) Lowering the maximum LTV ratio for properties under net worth-based mortgage lending from 50% to 40%.

(3) Lowering the applicable maximum LTV ratio by at least 10 percentage points for mortgage loans from applicants whose principal income is derived from outside Hong Kong.

(4) Requiring AIs to consider the need to apply more stringent credit underwriting standards when lending to borrowers with multiple outstanding mortgages.

These macro-prudential measures have strengthened the risk management standards and practices of AIs in their mortgage lending business. This also enables AIs to build up a larger safety cushion to absorb potential losses arising from a property market downturn. The LTV ratio for new residential mortgage loans reduced to around 53% in December 2011 from 64% in September 2009 before the first round of measures was introduced.

To monitor AIs' compliance with the prudential requirements on property mortgage lending, the HKMA undertook a round of thematic on-site examinations in 2011. The results indicated that AIs generally complied with the requirements.

The HKMA will continue to monitor the property and mortgage markets closely and introduce appropriate measures to safeguard banking stability as and when necessary.

European sovereign debt crisis

Although AIs do not have significant exposures to the European countries facing sovereign debt problems, the banking sector may suffer from spill-over if the fiscal problems of some European countries lead to heightened risk aversion and trigger capital outflows from emerging markets or a liquidity squeeze in the interbank market. In the light of the volatile market conditions in the second half of 2011 and as part of our on-going supervisory process, the HKMA has been closely monitoring the funding and liquidity positions of foreign AIs, particularly those from Europe, including their access to the interbank market and deposit movements. These AIs have also been asked to step up their contingent funding plans and to maintain sufficient high-quality liquefiable assets to meet any unexpected developments. In addition, the HKMA has stepped up its communication with the home supervisors of some European AIs on matters concerning the latest financial conditions of their head offices and market developments.

Mainland-related business

Renminbi banking business

Since April, AIs participating in renminbi business have been able to place renminbi funds in excess of their day-to-day business and settlement needs in a segregated Fiduciary Account with the People's Bank of China through the Renminbi Clearing Bank. With the introduction of the Fiduciary Account, the HKMA allows the outstanding balance maintained in it to be included when calculating the renminbi risk management limit, which requires a participating AI to maintain the sum of its renminbi cash, its settlement account balance with the Renminbi Clearing Bank and the balance maintained in the Fiduciary Account at not less than 25% of its renminbi customer deposits. The HKMA also allows the exposure under the Fiduciary Account to be exempt from the large exposure framework prescribed by the HKMA.

Having considered the need for orderly development of renminbi business and industry comments, the HKMA issued a circular on 28 July introducing some refinements to the management of AIs' renminbi net open positions. This allows a de minimis exemption of RMB50 million to the principal requirement that an AI's renminbi net open position should not be larger than 10% of its renminbi balance sheet. The HKMA also allows AIs to exclude their actual amount of investments under the Qualified Foreign Institutional Investors (QFII) regime on the Mainland and positions arising from renminbi bond market-making activities if their net open positions exceed the 10% limit. The excess can also be offset against net renminbi deliverable forward positions in the opposite direction. Notwithstanding these refinements, the HKMA has requested AIs not to leverage on the refinements in ways that might undermine the orderly development of renminbi business in Hong Kong and proper risk management by AIs regarding their renminbi positions.

Under the same circular, participating AIs handling cross-border trade settlement business in renminbi are allowed to consolidate the renminbi trade positions of banks outside Hong Kong that are part of the same bank group as the AI concerned with its own renminbi trade position for the purpose of position squaring with the Renminbi Clearing Bank on a net basis.

To ensure the proper use of the supplementary renminbi conversion channel for position squaring, the HKMA issued a circular on 8 November to clarify the requirements on position squaring in respect of renminbi trade settlement transactions with the Renminbi Clearing Bank and to elaborate on the HKMA's supervisory expectations in that regard. The circular gave additional guidance on how to determine which cross-border trade transactions are eligible for position squaring with the Renminbi Clearing Bank. Participating AIs were requested to be vigilant to cross-border merchandise trade transactions that are artificially structured to "round-trip" through Hong Kong or other locations into the Mainland. The HKMA also reiterated its requirements for adequate know-your-customer and due diligence procedures and the need to request third-party supporting documents from customers where necessary to substantiate the flow and genuineness of trade transactions. To ensure adequate monitoring of compliance with the requirements, participating AIs are required to conduct reviews of their top 10 renminbi cross-border merchandise trade transactions or renminbi remittances to verify compliance with the relevant requirements if a net total of RMB200 million or above is squared with the Renminbi Clearing Bank within a month.

The HKMA continued to conduct on-site examinations of AIs' renminbi banking business during the year and the results were generally satisfactory.

Tapping the Mainland market

There were 13 locally incorporated banks with business operations on the Mainland during the year, of which eight were operating through subsidiary banks incorporated on the Mainland. They continued to expand their branch network, maintaining over 330 Mainland branches or sub-branches, either directly or through subsidiary banks.

The industry's aggregate on-balance-sheet non-bank exposures to the Mainland amounted to the equivalent of HK$2,021.0 billion at the end of 2011, or 13.0% of total assets. These included exposures of HK$546.6 billion booked at the Mainland subsidiaries of Hong Kong banks. Compared with 2010, the aggregate exposures grew by 44.8%.

In view of the increasing Mainland-related business conducted by AIs, in September the HKMA clarified its supervisory expectations in relation to these activities. The HKMA requested AIs to ensure compliance with Mainland legal and supervisory requirements when conducting Mainland-related activities. Thematic examinations on AIs active in these areas of business were conducted.

With the increasing importance of the Mainland market to AIs, the HKMA has enhanced communication with the China Banking Regulatory Commission to ensure effective cross-border supervisory co-operation and co-ordination.

Prevention of money laundering and terrorist financing

The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance was gazetted on 8 July 2011 and came into operation on 1 April 2012. The Ordinance codifies customer due diligence and record-keeping requirements, and provides for supervisory and criminal sanctions when breaches occur. Following consultation with the banking industry, a guideline on the new legislative and regulatory requirements had been issued and became effective on 1 April 2012.

The AML/CFT specialist teams continue to monitor AIs' compliance with the HKMA's regulatory requirements. The teams completed 11 on-site examinations during the year, including 10 Tier-2 examinations and one thematic examination.

Co-operation with supervisors outside Hong Kong

During the year the HKMA participated in college-of-supervisors meetings organised by the home supervisors of 14 banking groups with significant operations in Hong Kong. Issues of common interest were discussed, including market trends, key areas of supervisory attention, stress testing, credit, liquidity, market and other types of risk management and Basel II implementation.

Bilateral meetings were held within and outside Hong Kong with banking supervisory authorities from Australia, France, Indonesia, Japan, Liechtenstein, Macau, the Mainland, the Netherlands, the Philippines, Singapore, South Africa, South Korea, Sweden, Switzerland, Taiwan, Thailand, the UK and the US. There were also regular exchanges with overseas banking supervisory authorities on institution-specific issues and developments in financial markets.

The HKMA is a member of the crisis management groups of three major banking groups organised by the relevant home authorities to discuss and oversee the production of a Recovery and Resolution Plan for each banking group in accordance with the relevant principles established by the Financial Stability Board (FSB). Through its membership, the HKMA also contributed its views on the cross-border resolution framework in the FSB Cross-Border Crisis Management Working Group.

Remuneration practices

A round of thematic examinations on the remuneration systems and practices of 10 selected AIs was conducted in the first quarter of 2011 to assess their compliance with the HKMA's "Guideline on a Sound Remuneration System" issued in March 2010. In general, the results indicated that the AIs' progress in implementing the HKMA's Guideline was satisfactory and their remuneration policies and practices broadly complied with the established principles and standards.

Enhancement to management information system

A project to revamp the HKMA's management information system of statistical data collected from AIs was initiated in 2011 to better assist the supervisory teams in performing their duties.

Basel II

Enhancements to Basel II

The HKMA, in collaboration with the FSTB and the Department of Justice, amended the Banking (Capital) Rules (BCR) and the Banking (Disclosure) Rules to implement the enhancements to the Basel II regulatory capital framework issued by the Basel Committee in July 2009.[2] The package of measures involves the following enhancements:

- raise capital requirements substantially for securitisation transactions (particularly for complex securitisation transactions) held in the banking book, and extend the enhanced securitisation framework to securitisation exposures held in the trading book
- introduce additional market risk capital charges to better capture price changes due to issuer default and changes in the credit ratings of credit-sensitive products, as well as incorporating stress elements into market risk calculations based on historical experience
- strengthen valuation requirements to ensure prudent and reliable valuation of fair-valued exposures held in both the trading and banking books, taking into account the liquidity of the exposures
- enhance disclosure requirements with respect to securitisation and market risk activities.

In amending the Rules, the HKMA took the opportunity to introduce some refinements to address practical issues and ambiguities identified in the course of implementing the Rules since their introduction in 2007; and to include additional credit rating agencies as external credit assessment institutions for the purpose of calculating regulatory capital.

The amended Rules were the subject of several rounds of industry consultation during the year, prior to submission to the Legislative Council in October 2011 for negative vetting. The negative vetting process was completed in November 2011 and the amended Rules came into effect on 1 January 2012.

The regulatory return relating to AIs' capital adequacy ratio (CAR) and the accompanying completion instructions were revised to reflect the amendments made to the BCR. Other relevant supplementary guidance was also updated to assist AIs incorporated in Hong Kong in complying with the amended Rules.

[2] The enhancements to Basel II are set out in the Basel Committee papers, *Revisions to the Basel II Market Risk Framework, Guidelines for Computing Capital for Incremental Risk in the Trading Book,* and *Enhancements to the Basel II Framework,* originally released in July 2009 and, in the case of the first paper, updated in February 2011.

Implementation of advanced approaches

During the year the HKMA granted approval to another AI to adopt the IMM approach under the market risk capital framework of the BCR, after assessing the AI's internal models and market risk management systems against the minimum requirements set out in the BCR.

Those AIs that had already obtained the MA's approval to use the IMM approach prior to 1 January 2012, when the amended BCR took effect, were required to obtain additional approvals from the MA to continue using this approach on and after that date. The HKMA conducted reviews to assess the compliance of these AIs with the revised minimum requirements for adopting the IMM approach (including the calculation of the newly introduced additional market risk capital charges). The results of these reviews were generally satisfactory, and form the basis for granting approval for the AIs to continue using the IMM approach.

Several AIs previously approved by the MA to use the IRB approach for the calculation of regulatory capital for credit risk changed their internal rating systems during the year to reflect the availability of more comprehensive data and refinements to the existing methodology. The HKMA reviewed the changes to ascertain the AIs' continued compliance with the requirements for the use of the IRB approach, taking into account both the extent of the changes made and their materiality in terms of impact on the AIs' regulatory capital.

Supervisory review process

The supervisory review process (SRP) which forms Pillar 2 to the Basel II capital framework (Pillar 1 being the calculation of capital requirements for credit, market and operational risks and Pillar 3 being disclosure) provides the HKMA with a comprehensive framework for assessing the capital levels and risk profiles of AIs incorporated in Hong Kong, including in respect of non-credit-related risks such as interest rate risk in the banking book as well as liquidity, reputation and strategic risks.

In 2011 the HKMA completed a round of SRP assessments on Hong Kong-incorporated AIs, which included a review of their progress in establishing or enhancing their CAAPs. The SRP Approval Committee within the HKMA reviewed the assessment results for the purpose of considering both the appropriate minimum CARs to be required of the AIs and whether there were other supervisory issues warranting attention. The AIs were notified of the results, and were given the opportunity to request a review of their minimum CAR, although none did so.

Under CAAP, AIs assess internally whether their overall capital adequacy is commensurate with the risk profile of their operations and formulate a strategy for maintaining adequate capital levels. Since the implementation of Basel II, a number of AIs have substantially established their CAAPs and have been submitting the results to the HKMA for review. Notable progress has also been observed among some other AIs in that the policies and procedures for their CAAPs are now largely in place. In addition to its regular SRP reviews, the HKMA has started a round of more focused thematic reviews of selected AIs to identify sound practices for conducting CAAP, having regard to their risk profiles and the sophistication of their operations. These reviews will continue in 2012.

Basel III

Implementation of Basel III in Hong Kong

Following the issue of the Basel III reform package by the Basel Committee on Banking Supervision in December 2010[3], the HKMA issued a circular in January 2011 informing AIs of its intention to implement Basel III in Hong Kong in accordance with the Basel Committee's timetable (i.e. between 1 January 2013 and 1 January 2019) and of the need to introduce legislative amendments to give effect to the new capital, liquidity and disclosure requirements.

In essence, Basel III strengthens the global capital framework by improving the quality of the regulatory capital base; raising the minimum regulatory capital requirements (with greater emphasis on common equity); introducing two capital buffers (a "Capital Conservation Buffer" and "Countercyclical Capital Buffer") to reinforce the resilience of banks and reduce the impact of economic downturns on their credit intermediation activities; introducing a supplementary leverage ratio as a backstop to risk-weighted capital measures; and enhancing the transparency of the capital base.

Basel III also introduces two global liquidity standards to achieve two separate but complementary objectives to make the banking sector more resilient to liquidity stress:

- *Liquidity coverage ratio (LCR)*: to promote short-term liquidity resilience by ensuring that banks have sufficient high-quality liquid assets to survive for at least 30 days under an acute stress scenario

- *Net stable funding ratio (NSFR)*: to promote longer-term resilience by requiring banks to hold minimum amounts of funding expected to be "stable" over a one-year time horizon under an extended stress scenario.

In addition, a set of liquidity monitoring tools is proposed for supervisors' on-going monitoring of banks' liquidity risk exposures in order to further strengthen and promote global consistency in liquidity risk supervision.

Banking (Amendment) Bill 2011

For the purpose of implementing Basel III in Hong Kong, a Banking (Amendment) Bill was introduced into the Legislative Council in December. The Bill builds upon the existing rule-making powers in the Banking Ordinance and provides for the capital, liquidity and disclosure requirements applicable to AIs to be set out in rules to be made by the MA. This legislative approach balances the need for clear binding requirements with the need to be able to amend regulatory standards swiftly and proactively to address changing business practices and environments. The rules will be subsidiary legislation subject to statutory consultation under the Banking Ordinance and negative vetting by the Legislative Council. To provide further guidance in respect of the rules, the MA will be able to issue, or approve, codes of practice. The Bill also broadens the remit of the Capital Adequacy Review Tribunal to cover specified decisions under the future liquidity rules, as well as appeals against decisions by the HKMA to issue remedial action notices in respect of, or to vary, individual AIs' capital and liquidity requirements, and renames it the Banking Review Tribunal.

The Bill was passed by the Legislative Council on 29 February 2012 and became the Banking (Amendment) Ordinance 2012. This should allow

[3] The Basel III reform package comprises two Basel Committee papers, *Basel III: A Global Framework for More Resilient Banks and Banking Systems,* and *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring,* setting out the details of the new global regulatory standards on bank capital adequacy and liquidity designed to strengthen the resilience of the global banking system and reduce the probability and severity of future banking crises.

Basel III (continued)

sufficient time for the development of the rules, and for AIs to introduce the necessary system changes in advance of the deadlines in the Basel Committee's timetable.

The HKMA will issue detailed policy proposals for the contents of the rules during 2012.

The HKMA will also monitor the approaches of other jurisdictions to the implementation of Basel III including, particularly, the adoption of more stringent standards (both in terms of minimum requirements and/or implementation timelines), and will assess any potential impact on Hong Kong, having regard to factors such as competitive issues, local circumstances and overall global economic conditions.

Capitalisation of exposures to central counterparties

The Basel Committee followed the release of its first consultative paper *Capitalisation of Bank Exposures to Central Counterparties* in December 2010 with a second consultative paper in November 2011 setting out revised proposals for the capital treatment of banks' counterparty credit risk exposures to central counterparties (CCPs). Most of the revisions related to the methodology for calculating the capital requirement for default fund exposures (generally speaking, this capital requirement addresses the risk of a clearing member of a CCP losing its contribution to the CCP's loss sharing arrangements if another clearing member of the CCP defaults). Given the potential implications for the banking sector, the HKMA encouraged the two industry associations to consult their members on the revised proposals and to send a co-ordinated response to the Basel Committee. The Basel Committee is finalising the proposals. The HKMA will work with the industry to adopt the new standards in Hong Kong in accordance with the Basel Committee's timetable once the finalised proposals are released.

Global systemically important banks and capital buffers

During the year the Basel Committee and the Financial Stability Board (FSB) made significant progress in their work related to the risks posed by global systemically important banks (G-SIBs) and in particular the means by which both the likelihood and the impact of the failure of such an institution may be reduced. The text of the rules on *Global systemically important banks: assessment methodology and the additional loss absorbency requirement* was published by the Basel Committee in November 2011, setting out the framework and methodology for assessing the systemic importance of G-SIBs and the additional loss absorbency to be required of G-SIBs. The FSB concurrently announced an initial group of 29 G-SIBs (none of which is incorporated in Hong Kong), identified on the basis of the Basel Committee's assessment methodology.

Requirements for G-SIBs' additional loss absorption capacity, to be met by common equity, have been set within a range of 1% to 2.5% of their risk-weighted assets (although the upper limit can extend to 3.5% to discourage banks from becoming even more systemically important). Attributes for national resolution regimes and standards for more intensive supervision of G-SIBs have been agreed. As the higher loss absorbency requirements for G-SIBs will form part of their capital conservation buffers under Basel III, the requirements will be introduced in parallel with the relevant Basel III timeline (i.e. between 1 January 2016 and the end of 2018, to become fully effective on 1 January 2019).

Basel III (continued)

The Basel Committee issued guidance on the operation of the countercyclical capital buffer in December 2010. The HKMA is currently analysing the technical aspects of, and the options for the institutional arrangements underlying, the operation of the countercyclical capital buffer in Hong Kong.

Application of Pillar 2 under Basel III

Basel III focuses primarily on Pillar 1 requirements and does not provide specific guidance on how the Pillar 2 SRP process should be integrated into the new capital framework. The HKMA is currently considering the appropriate integration approach for Hong Kong, taking into account local circumstances and the approaches adopted in some major jurisdictions. The overarching principles guiding the HKMA's current thinking are that (i) amid international efforts to strengthen banking resilience through higher capital standards, the fundamental concept of Pillar 2 should remain as important under Basel III as it is under Basel II; and (ii) any approach to integration should not result in a disproportionate capital impact on AIs. The work in this area will continue into 2012.

Liquidity standards and monitoring tools

As noted above, the HKMA intends to follow the Basel Committee's timetable to implement the LCR on 1 January 2015 and the NSFR on 1 January 2018. Some banks will be required to report, in a fashion similar to that adopted by the previous quantitative impact studies (QIS) conducted by the Basel Committee on implementing enhancements to the Basel II framework, on their position vis-à-vis the two standards from 2012 to facilitate the HKMA's monitoring of behavioural changes and other consequences of the standards during the observation period set by the Basel Committee. The HKMA also intends to adopt the Basel Committee's proposed liquidity monitoring tools in its on-going liquidity risk supervision by 2015. The new liquidity standards will be set out in rules to be made by the MA under the Banking (Amendment) Ordinance 2012, supplemented where necessary by codes of practice and guidelines.

In developing its implementation proposals, the HKMA has taken into account the results of a series of liquidity QIS and other surveys conducted in 2010 and 2011, as well as issues raised during bilateral discussions with selected AIs. The information collected has better enabled the HKMA to assess the impact of the liquidity standards on different types of AI and obtain insight into the likely behavioural changes of AIs in response to the standards.

Major policy issues under consideration

The HKMA started consulting the industry on its initial policy proposals in early 2012 including issues such as:

- *25% minimum liquidity ratio*: Whether the existing statutory ratio under the Banking Ordinance should be retained and, if so, whether it needs to be modified. The extent to which the existing ratio differs from, or interacts with, the LCR (e.g. in terms of policy objective and impact) is relevant here

- *Scope of application*: Whether the LCR and NSFR should apply uniformly to all AIs; or whether they should only apply to a class (or classes) of AIs. A particular issue is whether the standards should apply to branches of foreign banks, which may be subject to comparable standards in their home jurisdiction on a consolidated basis

- *Discretionary items within the liquidity standards*: These include items specifically subject to national discretion under Basel III and a range of definitional issues.

Basel III (continued)

HKMA's participation in Basel III working groups

As a member of the Basel Committee and its governing body, the Group of Governors and Heads of Supervision, the HKMA has continued to participate in the Committee's work on the development of the Basel III framework, including through its membership of the Committee's working groups, including the Working Group on Liquidity, the Definition of Capital Subgroup, and the Quantitative Impact Study Working Group (QIS Working Group). These working groups have been tasked with addressing important outstanding issues relevant to the application of the Basel III standards. Some of these are of particular relevance to Hong Kong, such as the development of a framework to allow jurisdictions with an insufficient supply of high-quality liquid assets denominated in their local currency to adopt an alternative treatment under the LCR to cover their banks' potential liquidity needs. The HKMA has contributed actively to the discussions in these areas.

Basel III implementation monitoring process

In 2011 the HKMA continued to contribute data from selected Hong Kong-incorporated AIs to the Basel Committee's QIS Working Group to facilitate both the assessment of the impact of the Basel III requirements and the monitoring of banks' implementation progress in member jurisdictions. This implementation monitoring is expected to be repeated semi-annually during the transitional period before full implementation of the Basel III framework.

The HKMA has also carried out a similar implementation monitoring exercise locally on a broader sample of AIs. Based on the results to date, AIs in Hong Kong appear generally well placed to meet the new capital standards, given that they tend to be well capitalised and rely mainly on common equity to meet their regulatory capital requirements. AIs are also not expected to encounter major difficulties in complying with the new liquidity standards over the transition period. Nevertheless, some AIs may need to adjust their liquidity profiles or liquid asset composition to satisfy the relevant requirements.

Improving the supervisory policy framework

Revision of liquidity regime

In April the HKMA issued a supervisory guideline "Sound Systems and Controls for Liquidity Risk Management" to provide detailed guidance on how AIs are expected to comply with the enhanced risk management standards set out in the *Principles for Sound Liquidity Risk Management and Supervision* published by the Basel Committee in September 2008 (Liquidity Sound Principles). AIs are required to agree an implementation plan with the HKMA, which will monitor implementation progress. Internally, the HKMA has also enhanced aspects of its supervisory process with regard to those of the Liquidity Sound Principles specifically applicable to supervisors. Among other things, significant progress was made in developing intraday liquidity monitoring indicators for supervisory purposes.

Competence and ethical behaviour

In July the HKMA issued a new supervisory guideline "Competence and Ethical Behaviour", taking into account comments received from the industry in an earlier consultation. The guideline sets out supervisory expectations regarding measures to be adopted by AIs to monitor and maintain the competence and ethical behaviour of their staff. AIs have been requested to review their existing arrangements against the new guideline and take steps to address any deficiencies as soon as practicable.

Stress testing

The HKMA consulted the industry on the revision of the supervisory guideline "Stress-testing", incorporating the *Principles for Sound Stress Testing Practices and Supervision* issued by the Basel Committee in May 2009 together with recommendations from other international organisations to address deficiencies in stress-testing practices revealed by the global financial crisis.

Corporate governance

To strengthen its supervisory guidance on corporate governance, the HKMA released for industry consultation in October a revision of its existing guideline "Corporate Governance of Locally Incorporated Authorized Institutions" to bring it into line with international standards and best practices set out in the *Principles for Enhancing Corporate Governance* issued by the Basel Committee in October 2010. The draft revision focuses, among other things, on board and senior management oversight (including their understanding of the group structure and business), the functioning, organisation and evaluation of the board, and the disclosure of key corporate governance and risk management information. The HKMA will take into account comments received from the industry in finalising the revised guideline.

Improving the supervisory policy framework (continued)

Remuneration practices

The HKMA issued a circular letter in November encouraging AIs to make disclosure in line with the paper *Pillar 3 Disclosure Requirements for Remuneration* issued by the Basel Committee in July 2011, in addition to the disclosures set out in the HKMA's existing "Guideline on a Sound Remuneration System". The Basel Committee paper contains more specific requirements for the disclosure of qualitative and quantitative information, further to the requirements in its supplemental Pillar 2 guidance issued in July 2009. AIs are encouraged to make disclosures at least annually with effect from the financial year 2011, and on a proportionate basis, having regard to the extent to which they use incentive-based compensation and the size, scope, nature and complexity of their business.

Prudent valuation

Following industry consultation, the HKMA issued the guideline "Financial Instrument Fair Value Practices" in December superseding its previous guideline "Use of the Fair Value Option for Financial Instruments". The new guideline incorporates the Basel Committee's *Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices*, issued in April 2009 (and reflected in the Basel Committee's July 2009 enhancements to Basel II) designed to strengthen and promote transparency of banks' prudent valuation of exposures that are measured at fair value. The scope of the guidance has been extended to cover all positions that are accounted for at fair value, whether in banking book or trading book. The guidance also clarifies that regulators should retain the ability to require adjustments to the current value of relevant exposures beyond those required by financial reporting standards, in particular, where there is uncertainty about the current value. In developing its guideline, the HKMA closely followed the Basel Committee's guidance, taking into account comments from the banking industry and the Hong Kong Institute of Certified Public Accountants.

Other policy development work

A new Research and Development Unit was created within the HKMA's Banking Policy Department. This unit includes a number of policy experts with experience from overseas regulatory organisations. The Unit will analyse international policy developments and support the HKMA's contribution to policy formation at the international level.

A working group was established by the Basel Committee during the year to develop global standards for the regulation of banks' large exposures. While many jurisdictions, including Hong Kong, impose restrictions on large exposures, typically in the form of percentage limits measured against capital base, there is a lack of international harmonisation in this area. The working group is considering a range of microeconomic and systemic issues and analysing calibration and data needs. It will also focus on intra-group as well as shadow banking exposures. The working group is expected to issue a consultative document in 2012.

Accounting and disclosure

Accounting standards

In 2011, the International Accounting Standards Board (IASB) issued a number of new and revised International Financial Reporting Standards as part of its programme to enhance global accounting standards following the global financial crisis. Many of these will have implications for banks in Hong Kong. These include enhancements to fair-value measurement standards addressing valuation uncertainty when markets become less active and accounting requirements for consolidation and joint arrangements, and disclosure standards for off-balance sheet vehicles. The Hong Kong Institute of Certified Public Accountants (HKICPA), in turn, issued updated Hong Kong Financial Reporting Standards in line with the IASB's new requirements.

In addition, to enhance current accounting standards for impairment, the IASB has been working closely with the US Financial Accounting Standards Board to finalise a joint expected loss provisioning approach, with a re-exposure draft expected in 2012. The approach incorporates more forward-looking information about credit losses into impairment measurements and provides for earlier recognition of expected losses.

During the year the HKMA maintained a regular dialogue with the HKICPA's Banking and Regulatory Liaison Group on developments in global accounting standards, including their implications for AIs' financial reporting and the HKMA's supervisory framework, as well as on key supervisory policy developments.

Thematic review on risk disclosures

The FSB launched a thematic peer review in June 2010 on the implementation of the recommendations concerning risk disclosures by market participants set out in its April 2008 report "Enhancing Market and Institutional Resilience". The HKMA participated as a member of the review team. The review was completed in early 2011 and the final review report published on 18 March, setting out recommendations on the areas of risk disclosure mainly related to Special Purpose Entities and off-balance sheet exposures where further improvement is needed.

As far as Hong Kong is concerned, locally incorporated AIs' disclosures in these respects were generally in compliance with the recommendations of the Senior Supervisors Group Report, where applicable.

As a first step towards taking forward the recommendations, the FSB organised a Roundtable on Risk Disclosure on 9 December, in which the HKMA participated, alongside other regulators, standard setters, audit firms and market practitioners. The objective was to foster a constructive dialogue among key parties (including those from the private sector) for the purpose of enhancing the transparency and relevance of risk disclosures, having regard to prevailing market conditions.

Consumer protection

Code of Banking Practice

As part of its continuing efforts to strengthen consumer protection in the banking industry, the HKMA commenced on-site examinations to review AIs' compliance with the Code of Banking Practice, supplementing the regular self-assessments conducted by AIs. In the industry's self-assessment covering the period from 1 January to 31 December 2010, all AIs reported full, or almost full, compliance[4], with the Code. At the HKMA's request, the Code of Banking Practice Committee started a review of the Code to further enhance the standard of banking practices. The review will continue in 2012 with the HKMA participating as a member of the Committee.

Enhanced credit card practices

The HKMA has been working with the Hong Kong Association of Banks (HKAB) to introduce enhanced credit card practices, with reference to enhancements adopted recently in the UK and US, to promote fair and responsible business practices by credit card issuers. Some of the measures will reduce cost to customers, while increased disclosure will enable customers to compare products and services among AIs and make better-informed decisions. HKAB announced the first two batches of 22 practices in the first half of 2011. Most of them have already been implemented while some, which require significant systems enhancement, are scheduled to be implemented

[4] With five or fewer instances of non-compliance.

in 2012. The third (and last) batch of nine practices was announced in March 2012 for implementation in 2012 and 2013.

Proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre

The HKMA has been assisting the FSTB on the proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre (FDRC). The FDRC is expected to come into operation in mid-2012. During 2011 the HKMA continued to participate in the working group set up by the FSTB to provide advice on the operational details of the FDRC.

G20 High-level Principles on Financial Consumer Protection

The HKMA served as a member of the FSB Consultative Group and the Task Force on Financial Consumer Protection of the Organisation for Economic Co-operation and Development (OECD), which are tasked with developing High-level Principles on Financial Consumer Protection and preparing a report setting out additional international work that could help advance such protection and financial stability. The *G20 High-level Principles on Financial Consumer Protection* were published in October.

Credit data sharing

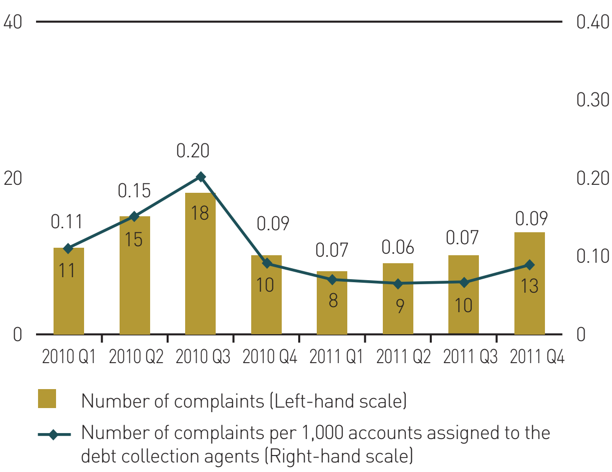
At the end of 2011, 118 AIs and AIs' subsidiaries were sharing commercial credit data through the Commercial Credit Reference Agency (CCRA). The scheme contained the credit data of more than 120,600 business enterprises, about 18% of which were sole proprietorships and partnerships. The continued development of the CCRA has helped to strengthen the credit risk management capacity of AIs and improve access to credit for small and medium-sized enterprises.

The HKMA continued to work with the industry and the Office of the Privacy Commissioner for Personal Data on the industry's proposal to expand consumer credit data sharing to include positive mortgage data. Following public consultation in January, the Privacy Commissioner for Personal Data amended the Code of Practice on Consumer Credit Data (the amended Code took effect on 1 April 2011), to allow the sharing of mortgage data among credit providers through the Credit Reference Agency to include positive mortgage data. This involves sharing of information on the number of mortgage loans held for residential and non-residential properties. The HKMA issued a circular to all AIs on 31 March setting out the steps they need to take to implement the scheme. The HKMA believes that the sharing of positive mortgage data will further strengthen credit risk management and is therefore conducive to the general stability of the banking system, which is crucial to the interests of depositors as well as the financial stability and economic development of Hong Kong.

Customer complaints relating to debt collection agents employed by AIs

The number of complaints received by AIs about their debt collection agents fell to 40 from 54 in 2010 (Chart 1). The HKMA will continue to ensure that AIs remained vigilant in monitoring the performance of their debt collection agents.

Chart 1 **Complaints received by AIs about their debt collection agents**



Enforcement

Re-engineering of the enforcement process

The complaint handling and enforcement process of the Enforcement Department on banking services and products was overhauled to make it more efficient and to improve communication with complainants. The processing cycle has been shortened and a single case team is made responsible for a complaint from inception to imposition of sanctions, if any. The Complaint Processing Centre has been established as the initial contact point for complainants. Where no further action is taken on a complaint, the reasons will be explained to the complainant to the extent allowed by applicable legislation.

In conjunction with these changes, the Banking Enforcement Management System was launched to enhance management information, facilitate record keeping and retrieval and guide users through the essential steps to ensure procedural compliance.

Several sound-proof interview rooms were installed with audio recording to make the interview process more efficient.

Investigation interview facilities.

Banking complaints

The HKMA received 2,326 complaints about banking services or products in 2011, compared with 1,675 in 2010 (Chart 2). The services or products concerned included credit cards, investment products, savings and deposits, and loans and credit facilities (Chart 3).

Chart 2 **Number of banking complaints received by the HKMA**

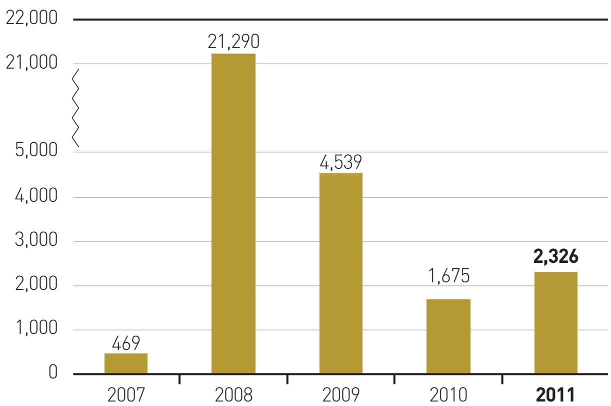
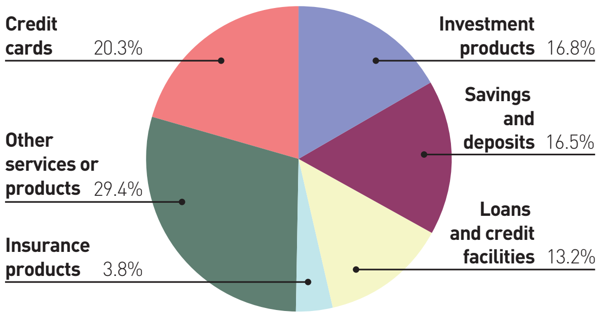


Chart 3 **Types of service or product concerned in banking complaints received by the HKMA**



Lehman-Brothers-related investigation

The HKMA and the SFC reached settlement agreements with two more banks in relation to their distribution of Lehman-Brothers-related equity-linked notes and market-linked notes, entitling 3,458 eligible customers to repurchase offers from the banks.

By the end of the year, over 99.6% of the 21,835 complaints received by the HKMA on Lehman-Brothers-related products had been dealt with. In particular, over 86.6% had been resolved by settlement agreements under section 201 of the Securities and Futures Ordinance (15,756 cases) or through the banks' enhanced complaint-handling procedures (3,174 cases). Investigation of the remaining 72 Lehman-Brothers-related complaints was underway at the end of the year. The majority of these cases were received in 2011.

Non-Lehman-Brothers-related investigations

The HKMA completed the handling and assessment of 414 complaints involving products not related to Lehman Brothers. Among them, 25 were opened for investigation. Investigations of 77 cases were completed by the end of the year. The MA took disciplinary action under section 58A of the Banking Ordinance to suspend the particulars of two Relevant Individuals from the HKMA's register for one month. On the basis of the HKMA's recommendations, the SFC banned a former Relevant Individual from re-entering the industry for two years by exercising its disciplinary power under the SFO.

Deposit Protection Scheme

The enhanced Deposit Protection Scheme (DPS) providing a higher protection limit of HK$500,000 per depositor per bank came into operation on 1 January following the expiry of the Government's Full Deposit Guarantee on 31 December 2010. In addition to the increase in the protection limit, coverage of the DPS has been expanded to include deposits pledged as security for banking services. Measures to make the determination of compensation payments more efficient also became effective at the beginning of the year.

The enhanced DPS Representation Rules, which require Scheme members to make proper representations on their DPS membership and the protection status of their financial products, also took effect at the beginning of 2011. Various mechanisms were applied to monitor compliance, including a requirement for Scheme members to conduct a self-assessment of their compliance for the first half of 2011. In addition, in July the HKMA began a series of on-site examinations to ascertain the level of Scheme members' compliance with the Rules in greater detail. So far, the results have been generally satisfactory and no significant incidence of non-compliance was identified.

The FSB launched a peer review of FSB member jurisdictions' deposit insurance schemes, using the *Core Principles for Effective Deposit Insurance Systems* (Core Principles) issued jointly by the Basel Committee and the International Association of Deposit Insurers as the benchmark. The review also seeks to draw lessons from members' experience of the effectiveness of reforms implemented in response to the recent financial crisis. Taking into account the results of the peer review, the design of the DPS will be thoroughly reviewed against the Core Principles in 2012.

Oversight of clearing and settlements systems

Oversight of designated systems

The Clearing and Settlement Systems Ordinance (CSSO) empowers the MA to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial centre. Its purpose is to promote the general safety and efficiency of the designated systems: the Central Moneymarkets Unit (CMU), Hong Kong dollar Clearing House Automated Transfer System (CHATS), US dollar CHATS, Euro CHATS, Renminbi CHATS and the Continuous Linked Settlement (CLS) System. Except for the CLS System, the HKMA oversees the designated systems through off-site reviews, continuous monitoring, on-site examinations and meetings with management.

All designated systems continued to comply with the safety and efficiency requirements under the CSSO in 2011. In addition to meeting CSSO requirements, the systems are encouraged to comply with international standards for payment and settlement. During the year the HKMA assessed the Euro CHATS and US dollar CHATS against the *Core Principles for Systemically Important Payment Systems* issued by the Bank for International Settlements (BIS). The assessments took account of the existing policies regarding payment and settlement systems of the European Central Bank and the US Federal Reserve under the principles for international co-operative oversight. The assessment reports were published to promote transparency.

Co-operative oversight arrangements

The CLS System is operated by CLS Bank, which is primarily regulated by its home supervisor, the US Federal Reserve. The HKMA participates, through the CLS Oversight Committee, in the international co-operative oversight of the CLS System. In 2011 the HKMA participated in various meetings and telephone conferences of the Committee and reviewed documents related to the operations and developments of the CLS

System to ensure that the System continued to meet the safety and efficiency requirements under the CSSO.

The HKMA also co-operates with other central banks in the oversight of foreign currency payment systems in Hong Kong. In particular, co-operative oversight arrangements are maintained with other central banks for payment-versus-payment (PvP) links established between payment and settlement systems in Hong Kong and those in other jurisdictions. Such arrangements exist for the US dollar/Malaysian Ringgit PvP link and the US dollar/Indonesian Rupiah PvP link.

Independent tribunal and committee

An independent Clearing and Settlement Systems Appeals Tribunal was established in 2004 to hear appeals against decisions of the MA on designation and related matters under the CSSO. There has been no appeal since the establishment of the Tribunal.

An independent Process Review Committee reviews processes and procedures adopted by the HKMA in applying standards set under the CSSO to systems in which the HKMA has a legal or beneficial interest. The Committee evaluates the designated systems' compliance with the oversight standards and assesses whether the HKMA has applied the same procedures to all designated systems. The Committee met twice in 2011 and reviewed four regular reports and 24 accompanying oversight activities management reports. The Committee concluded that it was not aware of any case where the HKMA had not duly followed the internal operational procedures, or where the HKMA had not been procedurally fair in carrying out its oversight activities. Under its terms of reference, the Committee submitted its annual report to the Financial Secretary, which is available on the HKMA website.

Informal oversight of retail payment systems

Compared with large-value interbank payment systems, the retail payment systems generally carry minimal systemic risks and, at this stage, are not considered systemically significant enough to be designated under the CSSO. However, the HKMA encourages the retail payment industry to adopt a self-regulatory approach by issuing codes of practice to promote safety and efficiency.

The HKMA monitors the compliance of Octopus Cards Limited (OCL) with the Code of Practice for Multi-purpose Stored Value Card Operation issued by OCL and endorsed by the HKMA in 2005. In 2011 OCL completed its sixth annual self-assessment against the Code and reported its full compliance.

The Code of Practice for Payment Card Scheme Operators, issued by eight credit and debit card scheme operators and endorsed by the HKMA in 2006, sets out the principles covering operational reliability, data and network security, and the efficiency and transparency of payment card operations in Hong Kong. The HKMA monitors the operators' compliance with the Code and operators are required to perform an annual self-assessment and report to the HKMA any incident which may have material adverse impact on Hong Kong cardholders. In the fourth annual self-assessment report covering 2010, the eight card scheme operators reported full compliance with the Code. Since June 2010, the HKMA has published quarterly aggregate payment card data collected from the card operators to promote transparency of the payment card industry.

Licensing

At the end of 2011, Hong Kong had 152 licensed banks, 20 restricted licence banks, 26 deposit-taking companies and 15 approved money brokers. During the year the HKMA granted seven bank licences and one restricted bank licence to eight foreign banks, and upgraded one overseas restricted licence bank to a licensed bank. Two licensed banks, two restricted licence banks (including the one which was upgraded to a licensed bank) and one money broker revoked their authorization during the year.

The HKMA released a consultation paper on the review of the market entry criteria for banks seeking authorization in Hong Kong in January 2012. The aim of the review is to introduce refinements to the criteria so as to bring them more in line with international practices and to ensure that they do not put Hong Kong at a disadvantage compared with other financial centres.

International co-operation

The HKMA continues to participate in various international and regional forums for banking supervisors and is currently a member of both the Basel Committee and its governing body, the Group of Governors and Heads of Supervision. The HKMA also participates in various Basel Committee working groups, including the Standards Implementation Group, the Working Group on Liquidity, the Definition of Capital Sub-Group and the QIS Working Group. The Basel Committee established a number of new working groups in 2011. Among these, the HKMA is a member of the Core Principles Group, the Large Exposures Group, and the Capital Planning Workstream. The HKMA also participates in the newly established joint BCBS-IOSCO-CPSS-CGFS Working Group on Margining Requirements.

The HKMA is a member of the FSB Standing Committees on Supervisory and Regulatory Cooperation and on Assessment of Vulnerabilities, and participates in the former's Cross-border Crisis Management Working Group and the newly established Mortgage Underwriting Principles Working Group. Regionally, the HKMA is a member of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and continues to be the leader of the Interest Group on Liquidity under the EMEAP Working Group on Banking Supervision. The HKMA is also a member of the South East Asia, New Zealand and Australia Forum of Banking Supervisors.

In addition, the HKMA participates in committees and working groups under the BIS and EMEAP related to payment systems oversight. It is a member of the joint working group under the BIS Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) and participated in the review of the existing standards for financial market infrastructures (large-value payment systems, securities settlement systems and central counterparties). In March the CPSS-IOSCO issued for market consultation a report "Principles for Financial Market Infrastructures", which contains a comprehensive set of principles designed to apply to all systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories. The HKMA performed an initial assessment in mid-2011 on how well the local designated systems would meet the proposed new standards and provided its comments to the BIS, and continued to discuss with the settlement institutions and systems operators of the designated systems areas where further enhancement may be needed to meet the new requirements. During the year the HKMA met with the European Central Bank and the UK Financial Services Authority to discuss oversight issues of common interest.

PLANS FOR 2012 AND BEYOND

Supervisory focus

Credit growth

While growth in bank lending showed some moderation in the second half of 2011, it remains a key area of supervisory attention because of the potential impact it may have on the credit quality, liquidity and other risk management aspects of AIs. Given the uncertainties in the global economic outlook, the HKMA will continue its monitoring and surveillance of AIs' asset quality, funding strategies and other areas of prudential concern and may consider adopting further supervisory measures to address any further build-up of risks to banking stability. The HKMA's internal stress tests are also being enhanced to take into account the latest developments.

Credit risk management and asset quality

The outlook for the global economy remains uncertain given the increased volatility in financial markets and the European sovereign debt crisis. The HKMA will continue to enhance its prudential supervision on AIs to ensure that they remain vigilant in their conduct of banking business through on-going on-site examination, off-site prudential supervision and enhanced communication and cross-border co-operation with overseas supervisors. The HKMA will conduct thematic examinations to ensure AIs have exercised extra caution in their lending business and maintained a high degree of vigilance in their underwriting standards and adequate provisioning, and have effective contingency funding plans.

For European banks affected by the sovereign debt crisis and with a presence in Hong Kong, the HKMA will also continue to monitor market developments including the compliance of European banks with Europe's new capital requirements by the end of June 2012, and keep track of the potential impact of recapitalisation and deleveraging of European banks on Hong Kong.

Supervision of technology risk

A round of thematic examinations is planned for 2012 to assess AIs' security controls over transaction services conducted through Internet banking, mobile banking and phone banking services, as well as controls over IT problems and change management processes.

The HKMA will monitor the implementation of the chip-based ATM security controls and will work with the industry to promote public awareness of the new measures.

Supervision of operational risk

The HKMA will continue to identify and address emerging operational risks of AIs through on-site examinations and off-site reviews. To ensure that material operational losses incurred by business lines are properly captured and monitored by AIs, the HKMA plans to conduct in 2012 a round of thematic examinations to review their operational loss data collection processes.

Supervision of securities, investment products, insurance and MPF-related businesses

The HKMA will:

- work closely with the SFC and the banking industry to enhance the regulatory regime governing the sale of investment products, while striving to maintain an appropriate balance between investor protection and market development

- continue to conduct off-site and on-site surveillance of AIs' business conduct in respect of the sales of securities, other investment and insurance products

- continue to co-operate with the FSTB and other financial regulators in enhancing and implementing the regulatory regimes for insurance and MPF-related intermediary activities in Hong Kong.

Supervision of treasury activities

The HKMA will continue to give priority and resources to on-site examinations of AIs' treasury and derivative activities and surveillance of potentially important emerging risks. Given the increasing importance of firm-wide stress testing and liquidity risk management under the current regulatory and market conditions, the treasury examinations will cover these two areas for selected AIs where necessary to enhance supervision in these areas.

Mainland-related business

With the rapid expansion of the Mainland operations of Hong Kong banks, the HKMA will strengthen its surveillance to ensure that the associated risks are assessed and managed appropriately. In addition to more frequent data collection for off-site review and increasing on-site examinations of Mainland operations, the HKMA will step up supervising communication with the China Banking Regulatory Commission to further enhance home-host supervisory co-operation.

Against the background of increasing Mainland-related business conducted by AIs, the need to ensure compliance with legal and regulatory requirements on the Mainland and in Hong Kong will be a key focus in the HKMA's on-site examinations. Consideration will also be given to collecting more frequent prudential data for analytical purposes. In addition, with the substantial development of renminbi banking business during 2011, the HKMA will conduct intensive on-site examinations on AIs' compliance with the HKMA's requirements and will step up monitoring of how AIs manage the risks arising from this line of business.

Prevention of money laundering and terrorist financing

The HKMA will continue its co-operation with the FSTB and other financial regulators to ensure the smooth implementation of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance on 1 April 2012. The HKMA will also work closely with the banking industry to ensure a smooth transition to the regime under the Ordinance.

The Financial Action Task Force will conclude its revision of the prevailing international anti-money laundering standards in 2012. Following promulgation of the revised international anti-money laundering standards, the HKMA will assist the FSTB to review and where necessary implement the changes in Hong Kong.

The HKMA will continue to conduct institution-specific and thematic examinations to ensure AIs remain vigilant against money laundering and terrorist financing.

Enhancement to management information system

The project to revamp the internal management information system to process data collected from AIs will continue until 2013. In 2012 detailed data and system requirements will be determined and the relevant enhancements will be worked out.

Co-operation with supervisors outside Hong Kong

The HKMA will continue its communication and co-operation with supervisors outside Hong Kong and actively participate in college-of-supervisors meetings organised by the home supervisors of banking groups with significant operations in Hong Kong and participate in crisis management groups to shape the policy outcomes. This will facilitate improved supervision of the local operations of banks that are regarded as Systemically Important Financial Institutions. Efforts will also continue to ensure the timely sharing of bank-specific prudential information and other issues of mutual interest, such as European banks' latest financial condition and implementation of recapitalisation plans.

Basel II

Amendments to Banking (Capital) Rules and Banking (Disclosure) Rules

The Banking (Capital) (Amendment) Rules 2011 and Banking (Disclosure) (Amendment) Rules 2011, which incorporate the Basel Committee's July 2009 enhancements to the Basel II framework, came into effect on 1 January 2012. The HKMA will continue to assist the industry in complying with these Rules through the development of supervisory guidance on aspects of their application. The HKMA will continue to monitor individual AIs' capital positions as part of its on-going supervisory assessment of the impact of the Rules.

Implementation of advanced approaches

The HKMA will conduct model validations and reviews against the requirements in the revised Banking (Capital) Rules, for those AIs that seek to use, or to continue using, the IMM approach for market risk on and after 1 January 2012.

Under Basel II, there are three methods for banks to calculate capital requirements in respect of their counterparty credit risk (CCR) exposures arising from OTC derivatives transactions: the current exposure method (CEM); the standardised method (SM); and the IMM subject to prior supervisory approval. In the initial phase of Basel II implementation in Hong Kong, only the CEM was introduced, given AIs' limited appetite and state of readiness for the adoption of the more advanced methods (the SM and IMM). Based on the results of two follow-up surveys in 2007 and 2008, the HKMA concluded that the strengthening of supervisory guidance on the systems and control standards for CCR management should take precedence over the introduction of the more advanced CCR calculation methods. As a result, a supervisory guideline "Counterparty Credit Risk Management" was issued in June 2009. Subsequently, in developing its proposals for implementing the strengthened CCR requirements under Basel III (which are particularly relevant to the IMM), the HKMA has revisited the issue and proposes to make the IMM available in Hong Kong (there remains little apparent demand for the SM). The HKMA therefore intends to implement the IMM on 1 January 2013, along with the CCR enhancements under Basel III.

Capital adequacy assessment process

The thematic reviews of selected AIs to identify sound practices for conducting CAAP will continue in 2012. After the reviews, the HKMA plans to share these sound practices, as well as any common inadequacies observed, with AIs.

Revision of liquidity supervisory framework

The HKMA's focus in 2012 will be on monitoring AIs' progress in complying with the standards in the guideline "Sound Systems and Controls for Liquidity Risk Management" issued in April 2011. This will include a review of AIs' deliverables in the areas of enhanced liquidity risk management policies, liquidity stress-testing, and cash-flow approaches to the management of liquidity risk.

The HKMA will also begin the preparatory work to enhance the existing liquidity reporting framework so that it can support the HKMA's plans to implement the Basel III liquidity standards and enable the HKMA to make more use of liquidity monitoring tools and metrics, thereby facilitating supervisory monitoring of AIs' liquidity risk profiles and positions.

Basel III

Capital standards

Legislative amendments

The HKMA has started to consult the banking industry on its policy proposals which will form the basis for rule making under the enabling provisions introduced by the Banking (Amendment) Ordinance 2012 gazetted on 9 March 2012. The definition of capital, minimum risk-weighted capital ratios, and enhanced counterparty credit risk (CCR) capital requirements will be the first set of standards to take effect from 1 January 2013 according to the Basel Committee's timetable. The industry will therefore be consulted in the second half of 2012 on the text of the draft amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules to bring these requirements into effect, with a view to submitting the draft amendment rules to the Legislative Council for negative vetting in the fourth quarter of 2012.

Industry consultations

The first Basel III consultative package issued in January 2012 covers proposals in relation to the definition of capital, the CCR framework and Pillar 2:

- *Definition of capital:* As a general principle, the HKMA proposes to follow the Basel III requirements, except in certain areas where there are strong reasons to retain an existing policy or practice. Areas which require consideration from this perspective include the capital treatment of unrealised gains arising from the fair valuation of assets in the banking book (such as securities classified as "available for sale" or "designated at fair value" and properties held for investment or own-use); the treatment of collective impairment allowance and regulatory reserve; and certain regulatory adjustments or deductions to the capital base (such as capital holdings in other financial entities)

- *Counterparty credit risk framework:* The HKMA proposes to implement both the strengthened CCR requirements (including the new capital charge for credit valuation adjustments) and the Basel III central counterparty framework

- *Pillar 2:* The HKMA proposes to retain substantially its existing approach to Pillar 2 and outlines in the consultation package the options for integrating Pillar 2 capital requirements into the Basel III framework. A separate review will be undertaken to identify any overlap between risk factors considered within the Pillar 2 framework and the new Basel III capital requirements (particularly the new capital buffers), in order to avoid any "double-charging" of regulatory capital. The HKMA will also continue to monitor international developments, including the Pillar 2 approaches adopted by other major supervisors, and will assess their implications for Hong Kong. The HKMA intends to finalise its approach to the application of Pillar 2 under Basel III and update the relevant supervisory guideline "Supervisory Review Process" by the end of 2012.

Basel III (continued)

Consultation on other aspects of the Basel III capital standards (such as disclosure requirements relating to constituent elements of capital base) will be conducted in subsequent phases.

Liquidity standards

In 2012 the HKMA will continue with the development of its policy proposals for implementing the Basel III liquidity standards in Hong Kong, taking into account international developments and the implementation approaches of major overseas regulators, and start the preparatory work for the rule-making process under the Banking (Amendment) Ordinance 2012.

It is envisaged that consultation on the liquidity implementation proposals will begin in 2012, as a basis for drafting a set of Banking (Liquidity) Rules during 2013 and 2014 (in anticipation of the Basel Committee's timetable which provides for the liquidity coverage ratio to become effective from 2015 and the net stable funding ratio from 2018). Thereafter, attention will turn to development of the accompanying regulatory reporting requirements, monitoring tools, and supplementary codes of practice and guidelines. The legislative process for the Banking (Liquidity) Rules in respect of the liquidity coverage ratio is targeted to be completed within 2014 while that in respect of the net stable funding ratio is targeted to be completed within 2017.

The HKMA believes that continued dialogue with the industry is crucial for the smooth and effective implementation of the new liquidity standards and will continue to seek industry input on market practices and issues affecting implementation.

Transitional arrangements

During the observation and supervisory monitoring periods set by the Basel Committee as part of the transitional arrangements for implementation of Basel III, the HKMA will continue contributing data, collected from the local banking sector, to the Basel Committee's QIS Working Group. The HKMA will also continue with its own monitoring process for the local banking sector, formalising the local QIS reporting arrangements for this purpose, until the new requirements are formally implemented. The main objective underlying these reporting arrangements is the monitoring of AIs' readiness to comply with the new standards. They are not a tool for de facto accelerated implementation of the standards.

Systemically important banks

The work related to systemically important banks (SIBs) will continue, particularly on two fronts: the extension of the global systemically important banks (G-SIBs) framework to domestic SIBs (D-SIBs) and the establishment of a Peer Review Council within the Financial Stability Board (FSB) to ensure the full and consistent implementation of measures for systemically important financial institutions across jurisdictions. As Hong Kong plays host to all of the 29 G-SIBs identified to date by the Basel Committee and the FSB, the HKMA will actively participate in the shaping of policies in these areas, and enhance co-operation with international organisations and home supervisors in regulating G-SIBs.

Another key area of focus in respect of systemically important banks (both G-SIBs and D-SIBs) is the development of a policy framework for drawing up recovery and resolution plans (RRPs) (often referred to as "living-wills") to promote the resolvability of such institutions as part of the overall supervisory process. The requirement for robust and credible RRPs is one of the *Key Attributes of Effective Resolution Regimes for Financial Institutions* identified by the FSB. The HKMA intends to consult the industry on proposals for drawing up RRPs for systemically important banks during 2012.

Development of supervisory policies

Corporate governance

The HKMA intends to finalise the revisions to its supervisory guideline "Corporate Governance of Locally Incorporated Authorized Institutions" in the first half of 2012, taking into account the comments received in the industry consultation. Since most of the major Hong Kong-incorporated AIs are listed on the Stock Exchange of Hong Kong, the HKMA, in finalising the revised guideline, will have regard to the results of the Stock Exchange's recent consultation exercise on proposed changes to its *Code on Corporate Governance Practices* and certain of the Listing Rules relating to corporate governance.

Credit risk transfer

The HKMA intends to issue supervisory guidance on credit risk transfer for industry consultation in 2012. This guidance will incorporate recommendations and best practices proposed by international standard setters (including the Financial Stability Board, the Joint Forum[5], the Basel Committee and the International Organization of Securities Commissions) in the light of lessons from the global financial crisis, and will seek to promote sound risk management for credit risk transfer activities conducted by AIs. The new guideline is intended to supersede the existing supervisory guideline "Credit Derivatives".

Guideline on the application of the Banking (Disclosure) Rules

Amendments to the Banking (Disclosure) Rules to incorporate the July 2009 enhancements to the Basel II disclosure requirements came into effect on 1 January 2012. To facilitate AIs' compliance with the new disclosure requirements, the HKMA intends during 2012 to update its existing "Guideline on the Application of the Banking (Disclosure) Rules".

Market risk management

The HKMA also intends to issue a new supervisory guideline on market risk management to help strengthen AIs' management of market risk, taking into account the lessons of the global financial crisis and the latest recommendations and best practices issued by international organisations. A consultation document is expected to be issued to the industry associations in the second half of 2012.

Stress testing

Having considered the industry's comments on the draft revised supervisory guideline "Stress-testing", the HKMA issued a further revised draft for industry consultation early this year. The HKMA will endeavour to finalise the revised guideline in the first half of 2012 after addressing any further comments from the industry.

Supervisory review process

The HKMA plans to complete its review of the Pillar 2 framework in the first half of 2012 to cater for Basel III implementation. Thereafter, the industry will be consulted on the changes proposed to the existing framework, with a view to updating the supervisory guideline "Supervisory Review Process" by the end of 2012.

Guideline on over-the-counter derivative market reforms

When margining standards for non-centrally cleared derivatives are agreed internationally, the HKMA will

[5] The Joint Forum is under the aegis of the Basel Committee, the International Organization of Securities Commissions and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.

Development of supervisory policies (continued)

update its prudential framework for AIs as appropriate to align with the new international standards.

Once the over-the-counter (OTC) derivatives market regulatory regime is finalised in Hong Kong, the HKMA intends to issue a supervisory guideline to outline the key requirements of the new regime and the HKMA's approach to supervising AIs' OTC derivatives activities. The draft guideline is expected to be released for industry consultation in the second half of 2012.

Use of internal models approach to calculate market risk

The supervisory guideline "Use of Internal Models Approach to Calculate Market Risk" is being updated to align with the enhancements to the IMM approach for market risk set out in the Banking (Capital) (Amendment) Rules 2011. A draft revised guideline was issued for industry consultation in March 2012.

Accounting and disclosure standards

The HKMA will monitor accounting developments emanating from the IASB work plan to enhance global accounting standards (particularly in relation to a new impairment accounting standard) and will maintain its regular dialogue with the HKICPA and the banking industry on these developments.

International co-operation

The HKMA will continue participating in the on-going work of the Basel Committee and the FSB, including through participation in the thematic peer reviews on risk governance and on resolution regimes which the FSB proposes to conduct in 2012.

Consumer protection

The HKMA will continue to work to improve the standards of banking practices through participation in the Code of Banking Practice Committee. It will also continue monitoring AIs' compliance with the Code through regular self-assessments, on-site examinations and the handling of complaints about products and services provided by AIs.

In relation to the proposed Investor Education Council and Financial Dispute Resolution Centre, the HKMA will continue to work with the FSTB, the SFC and the industry to prepare for their establishment and operation.

The HKMA will jointly host with the OECD and the SFC a regional seminar on financial consumer protection and education in Hong Kong in the second half of 2012.

Credit data sharing

The HKMA will review AIs' implementation of the positive mortgage data sharing scheme through on-site examinations on their compliance with the regulatory requirements.

During the review leading to the expansion of credit data sharing to include positive mortgage data, the Privacy Commissioner for Personal Data (PCPD) required that a threshold be set for non-mortgage-related credit facilities, above which AIs would be allowed to access the number of mortgages held by a customer when considering the grant, renewal or review of non-mortgage-related credit facilities. The HKMA will work with the industry to set an appropriate threshold, for which the PCPD's endorsement will be sought.

Enforcement

Following the completion of the vast majority of the Lehman-Brothers-related complaints, the remaining work of the HKMA in that regard is mainly to:

- continue to handle individual cases excluded by the settlement schemes under section 201 of the Securities and Futures Ordinance and cases of customers who rejected the settlement offers under the schemes
- investigate the 72 outstanding cases
- handle enquiries from customers whose cases were closed.

On the other hand, the HKMA will accelerate the handling of 1,197 outstanding non-Lehman-Brothers-related complaints, the progress of which has been affected by the need to accord priority to Lehman-Brothers-related complaints in the past few years.

The HKMA supervisory guideline "Complaint Handling Procedures" will be revised to take account of recent developments.

Under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance which took effect on 1 April 2012, the HKMA is the relevant authority for conducting investigations and taking disciplinary action under the Ordinance in respect of AIs.

Under legislative proposals to enhance regulation of the sale and marketing of insurance products and MPF schemes, the HKMA is expected to take an active role in enforcement and will continue to work closely with the FSTB and the relevant financial regulators on the related legislation and standard setting.

Deposit protection

The HKMA will continue to assist the Hong Kong Deposit Protection Board in implementing and operating the enhanced DPS. As the Global Financial Crisis continues with intensified concerns on the European sovereign debt problems, it is important that the Board stands ready to execute a payout effectively and efficiently at any time should there be a bank failure. Efforts will therefore be made to further upgrade and test the payout readiness of the Board. Simulation tests, compliance reviews and payout rehearsals will continue to be conducted by the Board to ensure its readiness to handle a payout. In respect of monitoring Scheme members' compliance with the representation requirements, the annual self-assessment review will continue and the HKMA will assist the Board to conduct on-site examinations. Further advertising campaigns will be held in 2012 to maintain the public's awareness of the DPS and new initiatives to carry out public education and outreach campaigns to reach specific target groups will be explored.

Taking into account the results of the Peer Review on Deposit Insurance Systems, a thorough review of the design of the existing DPS in Hong Kong against the Core Principles will be undertaken using the Methodology for Compliance Assessment. The objective is to evaluate the standard of compliance with the Core Principles and identify areas that may require further enhancements.

Payment systems oversight

As the overseer of designated systems under the CSSO, the HKMA will continue to be involved in promoting and ensuring the safety and efficiency of these systems; and will continue to monitor the performance of the operators of retail payment systems under their self-regulatory codes of practice, keep abreast of global trends and improve the current regime where necessary.

The BIS is expected to finalise and publish *The Principles for Financial Market Infrastructures* in 2012. The HKMA will work with the system operators and settlement institutions of the designated systems on how best to comply with the new international standards.

A local trade repository, which provides a central registry for collecting and maintaining records of OTC derivatives transactions, will be set up in Hong Kong as part of the CMU service in 2012. The HKMA will oversee the local trade repository and develop an oversight regime, taking into account the international standards and oversight practices, which are still evolving.