Banking Stability

The long-running European sovereign debt crisis and uncertainty over the recovery in the US continued to adversely impact on global financial markets in 2012, while low interest rates and fund inflows raised the risk of an asset-price bubble in Hong Kong. As a result, the HKMA maintained its supervisory focuses on the management of liquidity and credit risks by authorized institutions (AIs). The implementation of new automatic teller machine (ATM)-card technology to improve security was making good progress, and the supervision of AIs' compliance with anti money-laundering requirements was stepped up. Legislation to implement the first phase of the strengthened Basel standards was enacted; and efforts continued to enhance investor and consumer protection and education.

REVIEW OF 2012

Overview

Volatile financial market conditions continued into 2012 amid the prolonged European sovereign debt crisis, uncertain US economic recovery and slower growth in China. On the other hand, low interest rates and fund inflows increased the risk of an overheating property market. Against this backdrop, the HKMA continued to monitor closely AIs' management of liquidity and credit risks, funding strategy, mortgage lending, Mainland-related business (including renminbi business) and other areas of supervisory concern to ensure the banking sector remained resilient to any abrupt deterioration in the macroeconomic environment.

The HKMA continued to work closely with the industry towards the introduction of chip-based technology in ATM services by AIs in an effort to enhance ATM security. After the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO) came into effect on 1 April 2012, and following widely reported incidents overseas involving international banks with significant presence in Hong Kong, the HKMA increased its supervision of AIs' compliance with the Ordinance and the HKMA's Guideline on Anti-Money Laundering and Counter Terrorist Financing.

Operational supervision

After resumption of the usual examination cycle and with a slight increase in staff, the HKMA carried out 288 on-site examinations, compared with 198 in 2011 and 216 in 2010. Regular examinations covered areas such as corporate governance framework, compliance monitoring, credit-related issues and remuneration systems, while thematic and specialist examinations focused on selected AIs' credit and liquidity risk management, stress testing and regulatory compliance of Mainland-related business, including renminbi business. The number of reviews on AIs' internal ratings-based (IRB) models increased given their wider usage and the need to ensure that such models remained robust. Separately, 27 on-site examinations were conducted on AIs' sale of investment and insurance products as well as other areas of securities business.

The supervisory teams conducted 192 off-site reviews of AIs' financial position and business operations. Greater attention was paid to liquidity risk management, funding strategy and analysing the impact of the planned Basel III implementation on capital adequacy. The supervisory teams met the boards or board-level committees of 19 AIs and held tripartite meetings with the senior management and the external auditors of 13 AIs.

The Banking Supervision Review Committee considered seven cases, six of them concerning the authorization of AIs, and one relating to the investigation of an AI's practices in handling documents involving customer data.

The HKMA commissioned a report under section 59(2) of the Banking Ordinance, requiring the AI to appoint external auditors to review its anti-money laundering (AML) controls and report the findings to the HKMA.

No AI breached the requirements of the Banking Ordinance relating to capital-adequacy or liquidity ratios. There were 13 breaches of the requirements under section 20(4)(b) to notify the HKMA of changes to information recorded in the register maintained by the HKMA, six breaches of the requirements under section 72B to notify the HKMA of the appointment of managers and five breaches under section 85 regarding unsecured lending to AIs' employees. All the breaches were assessed to be unintentional. They were rectified promptly by the AIs and did not affect the interests of depositors.

Banking Stability

Details of the operational supervisory work performed in 2012 are set out in Table 1.

Table 1 Operational supervision

		2012	2011
1	On-site examinations	**288**	198
	Regular examinations	**73**	39
	– risk-based	**58**	30
	– overseas	**15**	9
	Basel II — Reviews of the internal ratings-based approach (IRB approach) and internal models approach (IMM approach)	**22**	9
	– Follow-up examinations of the IRB approach	**15**	4
	– Internal model recognition assessment and review of the IMM approach	**7**	5
	Internal capital adequacy assessment process and economic capital/capital planning	**7**	8
	Credit risk management and asset quality	**34**	40
	Market risk and treasury activities	**9**	7
	Firm-wide stress testing and liquidity risk management	**13**	6
	Securities, investment and insurance products-related conduct examinations	**27**	30
	Compliance with representation requirements in the Deposit Protection Scheme Ordinance and Deposit Protection Scheme Representation Rules	**12**	7
	Code of Banking Practice/Consumer protection	**2**	1
	Positive mortgage data sharing	**3**	–
	Anti-money laundering and counter-terrorist financing controls	**14**	11
	IT, Internet banking and operational risk	**20**	18
	Remuneration system[@]	**–**	10
	Mainland-related business	**15**	9
	Renminbi payment system	**–**	1
	Renminbi business	**37**	2
2	Off-site reviews and prudential interviews	**192**	193
3	Tripartite meetings	**13**	1
4	Meetings with board of directors or board-level committees of AIs	**19**	8
5	Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs	**199**	223
6	Reports commissioned under section 59(2) of the Banking Ordinance	**1**	4
7	Cases considered by the Banking Supervision Review Committee	**7**	10
8	AIs subject to the exercise of powers under section 52 of the Banking Ordinance	**1**	1

[@] In 2012, examinations of remuneration systems formed part of the risk-based examinations of the selected AIs.

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 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 2012. 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 keep in view 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 AIs. The AIs were notified of the ratings and given the opportunity to request a review, although none did so.

Specialised supervisory work

Supervision of technology risk

The growth in the use of Internet banking services continued. By the end of the year, the number of personal Internet banking accounts reached 8.4 million (from 7.7 million in 2011), and there were 764,000 corporate Internet banking accounts (up from 658,000 in 2011). Among the 71 AIs offering Internet banking services, 63 (including all of the 46 that offer high-risk transactions through Internet banking such as fund transfers to unregistered third-party accounts), have implemented two-factor authentication and some 4.3 million customers have registered for this service.

The HKMA continued to work with various parties to promote public security awareness of Internet banking. This included participating with the Hong Kong Association of Banks in a "Build a Secure Cyberspace" promotion campaign organised by the Hong Kong Police Force, the Office of the Government Chief Information Officer and the Hong Kong Computer Emergency Response Team Coordination Centre to raise the public awareness of cyber threats and the importance of information security.

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

The HKMA continued to work closely with the industry on the implementation of chip-based ATM technology to strengthen security controls for ATM services. The HKMA also worked with the industry to promote public awareness of the enhanced technology and security measures. Regular on-site examinations and off-site surveillance of AIs' controls over Internet banking, technology risk management and business continuity planning were conducted. Coverage of the supervisory control self-assessment process for Internet banking, technology risk management and business continuity planning was extended to 79 AIs (from 78 in 2011).

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

The annual self-assessment on operational risk management covered 74 AIs (77 in 2011). The exercise revealed that the selected AIs had in general established operational risk management frameworks in line with the supervisory requirements. The operational risk management specialist team conducted on-site examinations at five AIs to review their policies and controls on operational risk.

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 in supervising 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.

In response to market developments and observations from our supervisory work, the HKMA issued a series of circulars providing further guidance to AIs on the sale of investment products to bank customers to ensure adequate investor protection. These covered new investment products or services, such as Renminbi Qualified Foreign Institutional Investor (RQFII) funds and Hong Kong Exchanges and Clearing Limited's "Dual Tranche, Dual Counter" model.

Because of the special features and risks of debentures that are extendable, exchangeable, convertible or with non-viability loss absorption features, and funds primarily investing in high-yield bonds, the HKMA required AIs to audio-record face-to-face sales of such products to retail customers and to apply the pre-investment cooling-off period to these debentures.

In addition, the HKMA strengthened the regulation of sales by AIs of structured products not regulated by the Securities and Futures Ordinance (SFO), such as investment products linked to currencies and interest rates, by requiring AIs to apply the regulatory measures of the SFC (restriction on the use of gifts, investor characterisation, pre-sale disclosure of monetary and non-monetary benefits and disclosure of sales-related information) to the sale of such products. The HKMA also issued guidance in September reminding AIs to comply with the regulatory requirements in conducting MPF intermediary activities and to ensure that the sale, marketing and selection of constituent funds of MPF schemes in branches take place in the investment corner, and that cases involving risk mismatch are audio-recorded.

Because of the unique features of investment-linked assurance scheme (ILAS) products and to better protect the interests of potential policyholders, the HKMA has been working with the OCI and the SFC to formulate a proposal for enhanced disclosure requirements.

To facilitate the development of the private wealth management industry in Hong Kong, the HKMA has tried to provide a regulatory environment that is user-friendly for private banking customers while ensuring adequate investor protection. Through circulars issued to AIs, the HKMA introduced a flexible version of its enhanced measures for the sale of investment products to private banking and corporate banking customers, taking into account the differences in the clientele and mode of operations of these businesses and retail banking business. In close co-operation with the SFC, the HKMA also provided guidance and clarification to facilitate the adoption of a "portfolio-based" approach in assessing the suitability of investment solicitation and recommendation for private banking customers.

To encourage the adoption of common competency standards among industry practitioners, and to cater for the evolving demand of the industry for professional talent, the HKMA has been providing advice and assistance to the private wealth management industry, the Hong Kong Institute of Bankers (HKIB), the Hong Kong Securities and Investment Institute (HKSI) and the Treasury Markets Association (TMA) to develop an enhanced competency framework for private wealth management practitioners.

The HKMA specialist teams conducted 27 on-site examinations in 2012 covering areas including the sale of RQFII funds, accumulators and decumulators, ILAS and non-linked long-term insurance products; the selling process, product due diligence and training regarding investment products regulated under the SFO; the private banking "portfolio-based" approach to suitability assessment; error trade controls and private placements; and compliance with new or enhanced regulatory requirements for the sale of investment products.

The HKMA processed nine applications to become registered institutions (RIs) and four applications from RIs to engage in additional regulated activities. It also granted consent to 255 Executive Officers, who are responsible for supervising the securities activities of RIs, and conducted background checks on 8,452 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

During the year, the HKMA continued to work closely with the Financial Services and the Treasury Bureau (FSTB) and other financial regulators to prepare for the introduction of the statutory regime for regulating MPF intermediaries, which was implemented on 1 November along with the Employee Choice Arrangement. The HKMA also worked with the FSTB and the OCI to engage the banking industry and other stakeholders in formulating the future regulatory framework governing the distribution of insurance products under the proposed independent Insurance Authority.

Supervision of treasury activities

Given the increasing importance of liquidity risk management and firm-wide stress testing and the unstable market conditions, the HKMA concentrated its thematic on-site examinations for selected AIs in these areas. Of the 22 treasury examinations conducted, 13 covered liquidity risk management and firm-wide stress testing with the remaining nine focused on AIs' control frameworks for managing market, counterparty credit and interest-rate risks arising from their treasury and derivatives activities.

In addition to the on-site examinations, 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.

Supervisor-driven stress testing programme

To better understand the resilience of locally incorporated retail banks to extreme adverse economic conditions, the HKMA initiated a bottom-up supervisor-driven stress testing programme in late 2012. The forward-looking programme was designed to encourage AIs to develop plans to address potential problems in case economic conditions come under stress. The HKMA will analyse the stress test outcome prepared by individual AIs and discuss them with the participating AIs.

Credit risk management and asset quality

Credit growth and asset quality

The banking sector's total lending increased by 9.6%, compared with 20.2% in 2011 (Table 2). The overall loan-to-deposit ratio was stable, increasing slightly to 67.1% at the end of 2012, from 66.9% a year ago.

Table 2 Growth in loans and advances

% change	**2012**	2011
Total loans and advances	**9.6**	20.2
of which		
– for use in Hong Kong	**7.1**	12.5
– trade finance	**9.3**	27.9
– for use outside Hong Kong	**16.0**	41.9

Despite the moderation in credit growth, the HKMA continued to closely monitor AIs' lending practices to ensure that they remained prudent. The banking sector's overall asset quality remained sound with the classified loan ratio standing at 0.58% at the end of the year.

Prudential supervision of mortgage loans

With continuing signs of overheating in the property market and additional quantitative easing by the major developed economies, the risk of property-price bubbles in Hong Kong increased further. The HKMA remained vigilant towards AIs' property lending, particularly over the risk that borrowers with multiple outstanding mortgage loans might pose to AIs, and introduced on 14 September the fifth round of countercyclical macroprudential measures. Measures applicable to these borrowers included:

(1) lowering the maximum debt servicing ratio (DSR) from 50% to 40% and the maximum stressed DSR from 60% to 50%;

(2) lowering the maximum loan-to-value (LTV) ratio of property mortgage loans granted to net worth-based mortgage applicants by 10 percentage points to 30%; and

(3) lowering by 20 percentage points the maximum LTV ratios for property mortgage loans granted to mortgage applicants with income derived mainly from outside Hong Kong.

Besides, the HKMA required AIs to limit the maximum loan tenor of all new mortgage loans to 30 years as longer loan tenors would increase AIs' credit risk and weaken borrowers' ability to withstand interest rate risk. These measures apply to both residential and non-residential properties.

The HKMA also conducted a review of major AIs' underwriting policies for car park mortgages. The review identified a number of prudent underwriting practices for these loans including limits on LTV ratio, DSR and loan tenor. AIs were asked to ensure their underwriting policies are in line with such good practices.

The countercyclical measures introduced since 2009 on property mortgage loans have made banks more resilient to potential credit losses in a property market downturn. The average LTV ratio for new residential mortgage loans (RMLs) declined to 52% in December 2012 from 64% in September 2009 before the first round of measures was introduced. The average DSR for new RMLs decreased to 36% in December 2012 compared with 41% in August 2010, when the DSR requirement was tightened.

European sovereign debt crisis

The HKMA continued to closely monitor the funding and liquidity positions of foreign AIs, particularly those from Europe, to ensure the effectiveness of their liquidity risk management and contingent funding arrangements. Close communication was maintained with the home supervisors of some European AIs through regular teleconferences, attending supervisory colleges and participating in the work of crisis management groups.

Mainland-related business

Renminbi banking business

In view of the orderly and healthy development of renminbi business with greater market depth and breadth and improvements in AIs' risk management capability, the HKMA introduced several refinements to facilitate further business development.

First, adjustments in the calculation of the statutory liquidity ratio were introduced in February to allow for the inclusion of more renminbi liquefiable assets. Secondly, AIs were allowed to set their own internal renminbi net open positions in consultation with the HKMA from May. Thirdly, the 25% renminbi risk management limit, which required AIs to hold five specific types of liquid renminbi assets against their customer deposit liabilities, was replaced by a 25% supervisory renminbi liquidity ratio to bring the liquidity risk management framework for renminbi more in line with that for other major currencies. This also facilitated more accurate matching of maturity of renminbi liquid assets with short-term renminbi liabilities. In addition, the HKMA launched in June a renminbi liquidity facility to provide renminbi liquidity to AIs to address possible short-term renminbi liquidity tightness.

In August, the HKMA requested all AIs to have in place proper renminbi liquidity risk management policies and renminbi liquidity contingency plans to further consolidate the appropriate management of renminbi liquidity risk. All the policies and plans received from AIs are considered to be generally satisfactory.

Tapping the Mainland market

Thirteen locally incorporated banks have established business operations on the Mainland, of which eight operated through subsidiary banks incorporated on the Mainland. These banks continued to expand their branch networks during the year, maintaining over 400 Mainland branches or sub-branches, either directly or through subsidiaries. The HKMA conducted on-site examinations of these Mainland operations of Hong Kong banks.

The industry's aggregate on-balance-sheet non-bank exposures to the Mainland amounted to the equivalent of HK$2,415.3 billion at the end of 2012, or 14.3% of total assets. These included exposures of HK$620.8 billion booked at Mainland subsidiaries of Hong Kong banks. Compared with 2011, the aggregate on-balance sheet exposures grew by 18.8%.

With the increasing Mainland-related business conducted by AIs, the HKMA stepped up surveillance of these activities and requested the AIs concerned to report more detailed information on their non-bank Mainland exposures. As part of this initiative, the HKMA consulted the banking industry associations on the introduction of a new return on Mainland activities in 2013. Thematic examinations on AIs active in these areas were also conducted.

The HKMA continued to maintain close contact 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 AMLO and a guideline on the new legislative and regulatory requirements came into effect on 1 April. To help AIs meet the legal and regulatory requirements and provide guidance on how anti-money laundering and counter-terrorist financing (AML/CFT) systems and controls can be strengthened, the HKMA conducted a number of seminars, covering the implementation of the AMLO and common findings of on-site examinations.

To ensure AIs' systems and controls are effective and comply with the regulatory and legal requirements, the AML specialist teams completed 14 on-site examinations during the year, including four Tier-2 examinations and 10 thematic examinations.

Co-operation with supervisors outside Hong Kong

The HKMA participated in college-of-supervisors meetings organised by the home supervisors of 24 banking groups with significant operations in Hong Kong. Issues of common interest were discussed, including market trends, key areas of supervisory focus, stress testing, credit, liquidity, market and other types of risk management and supervisory issues relating to megabanks.

Bilateral meetings were held with banking supervisory authorities from Australia, France, Germany, India, Indonesia, Italy, Japan, the Mainland, the Netherlands, Singapore, South Korea, Switzerland, Taiwan and the UK. There were also regular exchanges with authorities outside Hong Kong on institution-specific issues and developments in financial markets.

The HKMA is a member of the crisis management groups of eight 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 principles established by the Financial Stability Board (FSB). As an FSB member, the HKMA also contributed its views on the cross-border resolution framework in the Cross-Border Crisis Management Working Group.

Basel Accord

Enhancements to Basel II

The Basel Committee on Banking Supervision's "Basel 2.5" enhancements to the regulatory capital framework were implemented in Hong Kong on 1 January through the Banking (Capital) (Amendment) Rules 2011 and Banking (Disclosure) (Amendment) Rules 2011. Under Basel 2.5, AIs are required to hold more regulatory capital for their market risk exposures and their exposures to securitisation transactions, particularly those with complex structure, to better capture the risks inherent in these exposures.

Implementation of advanced approaches

Approvals were granted during the year for another two AIs to adopt the internal models approach (IMM approach) for calculating market risk, following assessment of their internal models and market risk management systems against the minimum requirements in the Banking (Capital) Rules, as amended by the Banking (Capital) (Amendment) Rules 2011, which became effective on 1 January 2012. A review was also conducted into the compliance of AIs already using the IMM approach with the revised requirements. Following the review, all AIs concerned were granted approval to continue using the IMM approach except one AI which reverted to the standardised (market risk) approach upon the commencement of the amended Rules.

The HKMA conducted a thematic review of the approaches adopted by AIs using the internal ratings-based approach (IRB approach) for credit risk to the recognition of non-contractual support from related entities of borrowers in devising internal ratings for those borrowers and, specifically, the extent to which such ratings are enhanced by the perceived potential for such non-contractual support. The HKMA reviewed the robustness of the approaches to ensure that credit risk was not under-estimated.

Several AIs with approval to use the IRB approach for credit risk made changes to their internal rating systems during the year to reflect the availability of more comprehensive data and refinements to their methodology. The HKMA reviewed the changes to confirm the AIs' continued compliance with the requirements for the use of the IRB approach, taking into account both the extent of the changes and the materiality of their impact on the AIs' regulatory capital.

Supervisory review process

The supervisory review process (SRP) under Pillar 2 of the Basel II capital framework[2] provides the HKMA with a comprehensive framework for assessing the capital levels and risk profiles of Hong Kong-incorporated AIs. The SRP covers both credit and non-credit-related risks such as interest rate risk in the banking book as well as liquidity, reputation and strategic risks.

A round of SRP assessments on Hong Kong-incorporated AIs was completed and the SRP Approval Committee reviewed the results to consider both the appropriate minimum capital adequacy ratio (CAR) that individual AIs should maintain and whether there were other supervisory issues warranting attention. AIs were notified of the results, and were given the opportunity to request a review of their minimum CAR, although none did so.

[2] The Basel Committee's regulatory capital framework has three mutually reinforcing Pillars, respectively dealing with the calculation of capital requirements for credit, market and operational risks (Pillar 1), the institution of a supervisory review process for determining the capital adequacy of banks (Pillar 2) and the associated disclosure standards (Pillar 3).

Basel III

Implementation of Basel III in Hong Kong

A major focus for the HKMA in 2012 was the completion of the legislative process for the introduction in Hong Kong of the first phase of the Basel Committee on Banking Supervision's Basel III standards.

In February 2012, the Banking (Amendment) Bill 2011 (the Bill) was passed by the Legislative Council (LegCo), and became the Banking (Amendment) Ordinance 2012 (BAO 2012), to empower the Monetary Authority to make rules prescribing the capital, liquidity and disclosure requirements for AIs and to approve and issue codes of practice to provide guidance for such rules.

In December, the Banking (Capital) (Amendment) Rules 2012 (BCAR 2012), made under powers introduced by the BAO 2012, completed the LegCo's negative vetting to bring into effect the first phase of Basel III from 1 January 2013, in accordance with the Basel Committee's transition timeline.

Capital standards

Pillar 1

The first phase of Basel III focuses on capital standards. The regulatory capital framework is strengthened by: improving the quality of the regulatory capital base, focusing on the ability of capital instruments to absorb losses as a going concern and recognising the pre-eminence of common equity for this purpose; raising the minimum regulatory capital requirements by requiring banks to meet three risk-weighted ratios (of Common Equity Tier 1 Capital, Tier 1 capital and Total capital respectively against risk-weighted assets); and broadening the risk coverage of the framework on counterparty credit risk (CCR) exposures of banks. The HKMA undertook extensive consultation with the banking industry on its policy proposals for implementing these standards, culminating in the third quarter with a formal statutory consultation involving the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks, and the DTC Association pursuant to section 97C of the Banking Ordinance.

The HKMA took the opportunity of the passage of the BCAR 2012 to introduce an internal models calculation approach for CCR (IMM CCR approach) as an alternative method for authorized institutions (AIs) to calculate their CCR exposures arising from over-the-counter derivatives transactions. AIs using the internal models approach to calculate their market risk capital charge may apply to the HKMA for approval to use the IMM CCR approach instead of the existing "current exposure method" to calculate their CCR exposures for capital adequacy ratio purposes.

Pillar 2

Basel III focuses primarily on the Pillar 1 requirements of the regulatory capital framework (the calculation of regulatory capital for credit, market and operational risk). It does not provide specific guidance on the application of Pillar 2 (the supervisory review process (SRP) and any resulting additional capital requirements which may be imposed to cover risks not adequately covered in Pillar 1) and how any Pillar 2 capital add-on relates to the new Basel III risk-weighted capital ratios and capital buffers. Therefore, to integrate Pillar 1 and Pillar 2, the HKMA has revised its supervisory guideline "Supervisory Review Process" to introduce changes to the local Pillar 2 framework necessitated by the implementation of Basel III, and explain how the revised Pillar 2 framework will operate under Basel III. The approach taken reflects the underlying philosophy of Pillar 2 as well as local circumstances and the approaches adopted in other major jurisdictions.

Basel III (continued)

The basic concept and principles underlying the SRP are retained and consequently the Pillar 2 capital add-on will continue to form a constituent part of an AI's minimum capital requirements to ensure that sufficient capital is held by the AI against both Pillar 1 and Pillar 2 risks. However, the SRP assessment framework is adjusted to address any potential overlap between Pillar 2 capital and the Basel III capital buffers when the latter come into effect in 2016.

After industry consultation, the revised SRP guideline was formally issued on 28 December for implementation from 1 January 2013.

Pillar 3

In November, the HKMA issued draft Banking (Disclosure) (Amendment) Rules for formal statutory consultation with industry bodies pursuant to section 60A of the Banking Ordinance. The Rules primarily implement disclosure requirements associated with the first phase of the Basel III capital standards and reflect the *Composition of capital disclosure requirements* released by the Basel Committee in June.

Capital buffers

The two capital buffers introduced by Basel III are scheduled to be implemented from 2016. The capital conservation buffer requires a bank to hold additional Common Equity Tier 1 Capital equal to 2.5% of its risk-weighted assets if it is to avoid having restrictions placed on its ability to make distributions such as dividend payments, or share buybacks or discretionary staff bonus payments. The countercyclical buffer, which is also composed of Common Equity Tier 1 Capital can vary between 0% and 2.5% of a bank's risk-weighted assets. The countercyclical buffer should be activated (set at a level in excess of 0%) in times of excessive credit growth with systemic implications.

National authorities will, therefore, require frameworks for the surveillance of the build-up of systemic risk and for the activation (and release) of the countercyclical buffer at appropriate times. The HKMA is currently working to identify specific indicators that may be good predictors of system-wide risk build-up in Hong Kong for the purpose of "switching on" the buffer, and also the metrics that may indicate the "turning point" in the economic cycle and signal the need for a buffer release to allow AIs to continue lending into a downturn.

Liquidity standards and monitoring tools

In addition to strengthening regulatory capital requirements, Basel III introduces two new global liquidity standards, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), to improve banks' resilience to liquidity stress.[3] A complementary set of liquidity monitoring tools has also been developed for supervisors' surveillance of banks' liquidity risk exposure to further strengthen and promote consistency in liquidity risk supervision globally.

The HKMA intends to follow the Basel Committee timetable and implement the LCR on 1 January 2015 and the NSFR on 1 January 2018. The HKMA also proposes to adopt the liquidity monitoring tools recommended by the Basel Committee as part of its ongoing supervisory process from 1 January 2015.

[3] The LCR is designed to promote banks' short-term liquidity resilience by ensuring that they have sufficient high-quality liquid assets (HQLA) to survive for at least 30 days under an acute stress scenario. The NSFR promotes 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.

Basel III (continued)

Ultimately, the liquidity standards will be set out in the Banking (Liquidity) Rules to be made by the Monetary Authority under the power conferred by the BAO 2012, supplemented where necessary by codes of practice and supervisory guidelines.

In 2012, the HKMA began consulting the banking industry on initial policy proposals for implementing the Basel III liquidity standards in Hong Kong. This included consultation on, among other proposals, a two-tier approach for applying the liquidity standards, under which larger and more sophisticated AIs of greater significance to the Hong Kong banking system will be required to observe the LCR, while others will observe a modified version of the existing 25% minimum liquidity ratio in the Banking Ordinance.

The HKMA's industry consultation on the liquidity standards will continue in 2013 taking into account the Basel Committee's revisions to the LCR published in January 2013.

SIFI framework

The Financial Stability Board and the Basel Committee continued to work on the implementation of the policy framework for systemically important financial institutions (SIFIs) to address the systemic and moral hazard risks associated with such institutions. The FSB issued its first annual update to the list of globally systemically important banks (G-SIBs) in November and, for the first time, allocated the G-SIBs to "buckets" corresponding to a required level of additional loss absorbency (in essence, an additional capital requirement levied on G-SIBs). The level of additional loss absorbency currently ranges from 1% to 2.5% of the relevant G-SIBs' risk-weighted assets, with an empty top bucket of 3.5%. The additional loss absorbency requirements for G-SIBs will be phased in from 2016 (initially for banks identified as G-SIBs in November 2014).

Work also progressed on extending the SIFI framework beyond G-SIBs to other systemically important financial institutions. In October, the FSB endorsed a set of principles drawn up by the Basel Committee for a domestic systemically important bank (D-SIB) framework. The 12 principles focus primarily on a methodology for assessing whether a bank is a D-SIB and on the higher loss absorbency requirement (in terms of additional capital) which a D-SIB should hold. National authorities should begin applying the requirements to banks identified as D-SIBs from January 2016. Preliminary work is now underway at the HKMA to devise a D-SIB framework, and industry consultation will be undertaken during 2013.

Supervisory reporting

In December, the HKMA released proposed revisions to the regulatory banking return relating to capital adequacy to reflect the changes made by the BCAR 2012 and enable AIs to report their capital positions by reference to the new capital requirements. AIs are expected to report their capital positions as at the end of March 2013 using the revised return.

Basel III (continued)

HKMA's participation in Basel III working groups

As a member of the Basel Committee, the HKMA has continued to participate in the Committee's work on the implementation of the Basel III framework. The HKMA is represented on the Committee's Working Groups on Liquidity, Capital[4] and Disclosure[5] as well as its Quantitative Impact Study Working Group, which have been tasked with addressing outstanding issues relevant to the application of the Basel III standards. Some of these issues are of particular relevance to Hong Kong, such as the development of a framework to allow jurisdictions with an insufficient supply of HQLA denominated in their local currency to adopt an alternative treatment under the LCR to cover their banks' potential liquidity needs.

Basel III implementation monitoring process

The HKMA contributed data from selected Hong Kong-incorporated AIs to the Basel Committee's quantitative impact studies to facilitate the assessment of the impact of the Basel III requirements and the monitoring of banks' progress in implementation. This monitoring is expected to be repeated semi-annually during the transition period prior to full implementation of the Basel III framework in 2019.

The HKMA also carried out a similar implementation monitoring exercise locally covering a broader sample of AIs. The results to date indicate that AIs in Hong Kong should be generally well placed to meet the new capital standards, given their tendency historically to maintain capital levels above the regulatory minimum and to rely principally on common equity to meet 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 requirements. The information collected in the quantitative impact studies has enabled the HKMA to better assess the effects of the liquidity standards on different types of AIs (such as those that are incorporated outside Hong Kong, wholesale-oriented in their business, or predominantly retail-based in their focus) and obtain some insight into the likely behavioural changes of AIs in response to the standards.

HKMA's participation in the Basel Committee's Regulatory Consistency Assessment Programme

The HKMA led the international expert team that assessed the consistency of existing and proposed banking regulations in the United States with the Basel II and Basel III standards as part of the Basel Committee Regulatory Consistency Assessment Programme (RCAP). Similar assessments were conducted by other teams for the European Union and Japan. The three assessment reports were published by the Basel Committee in September. Ultimately, all of the Basel Committee's member jurisdictions, including Hong Kong, will be assessed under the RCAP. The RCAP assessment for Singapore began in the last quarter of 2012, and will be followed by assessments of Switzerland, China, Australia, Brazil and Canada in 2013 and 2014.

[4] The Working Group on Capital is a new working group formed in 2012 by the merger of the former Definition of Capital Subgroup and the former Contingent Capital Working Group.

[5] The Working Group on Disclosure is a new working group formed in 2012 by the Basel Committee, principally to review and co-ordinate disclosure initiatives by the Committee and other relevant bodies, to ensure a single and coherent package of Pillar 3 disclosure requirements.

Improving supervisory policy framework

Stress testing

A revised module "Stress-testing" in the Supervisory Policy Manual was issued in May, following industry consultation. The module incorporates the *Principles for Sound Stress Testing Practices and Supervision* issued by the Basel Committee on Banking Supervision in May 2009.

Corporate governance

Revised supervisory guideline "Corporate Governance of Locally Incorporated Authorized Institutions" was issued following industry consultation in August. The guideline sets out the HKMA's supervisory expectations for the corporate governance of Hong Kong-incorporated authorized institutions (AIs), reflecting the *Principles for Enhancing Corporate Governance* issued by the Basel Committee in October 2010. The guidance focuses on board and senior management oversight (including their respective roles in risk governance), the functioning, organisation and evaluation of the board, and the disclosure of key corporate governance and risk management information.

Large exposure limits

A working group of the Basel Committee is developing proposals for global standards regulating banks' large exposures. Although many jurisdictions, including Hong Kong, currently apply restrictions on large exposures, there is at present no internationally harmonised standard. A consultation document was issued by the Basel Committee in March 2013. Once the regime is finalised, the HKMA will update the regulations for AIs to align them with the new international standard.

Use of internal models approach to calculate market risk

Revised supervisory guideline "Use of Internal Models Approach to Calculate Market Risk" was issued in October, following industry consultation, to reflect the enhancements to the IMM approach for market risk set out in the Banking (Capital) (Amendment) Rules 2011.

Other policy development work

Additional policy development work undertaken by the Basel Committee during the year included consultation on proposals to reform the regulatory capital framework for banks' trading book exposures, following a fundamental review; the development of a set of indicators for monitoring banks' intraday liquidity risk to complement the relevant guidance in the Basel Committee's 2008 *Principles for Sound Liquidity Risk Management and Supervision*; and updating the guidance on the management of risks associated with the settlement of foreign exchange transactions. The HKMA provided comments during the development of these proposals, taking into account local circumstances and practices.

The global financial crisis drew attention to the need to focus on risk at both the system-wide and individual institution levels. The HKMA has, therefore, been examining the systemic risk issues that may be most relevant to Hong Kong and the range of existing and potential macroprudential policy options to most effectively address them. Areas where further and more in-depth work is needed have been identified.

Accounting standards

In response to the call by the Group of Twenty (G20) for a single set of global accounting standards to be adopted to strengthen financial supervision and regulation, the International Accounting Standards Board and the US Financial Accounting Standards Board have continued their efforts to develop convergent and improved standards. Improving accounting standards for the classification and measurement of financial instruments and loan loss provisioning are of significant importance to the banking industry and of particular interest to prudential regulators.

The HKMA and the Banking Regulatory Liaison Group of the Hong Kong Institute of Certified Public Accountants (HKICPA) held regular discussions during the year on topics of common interest. These included developments in international accounting convergence, new accounting and financial reporting standards issued by the HKICPA and their implications for the banking industry, and key supervisory policy developments domestically and internationally.

Consumer protection

Code of Banking Practice

The industry's overall compliance with the Code of Banking Practice remained satisfactory. In the industry's self-assessment covering the period from 1 January to 31 December 2011, all AIs reported full, or almost full, compliance.[6] The HKMA also conducted thematic examinations on two AIs to review their compliance with the Code and related policies and controls. The Code of Banking Practice Committee, on which the HKMA is represented, began a review of the Code to further enhance practices. The review will continue in 2013.

Establishment of the Investor Education Centre and the Financial Dispute Resolution Centre

The HKMA contributed towards the establishment of the Investor Education Centre (IEC) and the Financial Dispute Resolution Centre (FDRC). The FDRC commenced operation in June to provide financial consumers with an independent and affordable mediation and arbitration avenue to resolve monetary disputes with financial institutions. The IEC, established as a wholly-owned subsidiary of the SFC, is a cross-sectoral investor education body which aims to improve financial literacy and the public's ability to make better financial decisions. It was officially launched in November.

G20 High-level Principles on Financial Consumer Protection

The HKMA continued to participate in the Task Force on Financial Consumer Protection of the Organisation for Economic Co-operation and Development (OECD) to develop effective approaches to support the implementation of the *G20 High-level Principles on Financial Consumer Protection*.

Credit data sharing

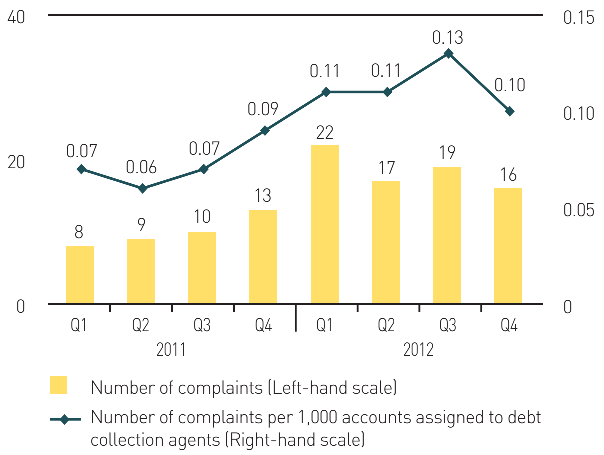
At the end of 2012, 116 AIs and AIs' subsidiaries were sharing commercial credit data through the Commercial Credit Reference Agency (CCRA). The scheme contained the credit data of more than 126,000 business enterprises, about 19% of which were sole proprietorships and partnerships. The continued development of the CCRA has helped to strengthen the credit risk management capacity of AIs. With regard to consumer credit data sharing, the HKMA conducted three on-site examinations to review AIs' compliance with the regulatory requirements in relation to the positive mortgage data sharing scheme and related policies and controls.

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

Customer complaints relating to debt collection agents employed by AIs

The number of complaints received by AIs about their debt collection agents increased to 74 from 40 in 2011 (Chart 1). The HKMA will continue to ensure that AIs properly monitor the conduct of their debt collection agents.

Chart 1 Complaints received by AIs about their debt collection agents



Financial consumer education

The HKMA, jointly with the OECD and the SFC, hosted an Asian Seminar on financial consumer protection and education and an Asia Financial Consumer Protection Roundtable on 13 and 14 December. The Seminar attracted over 120 local and overseas participants, including representatives of regulatory authorities, financial industry practitioners, consumer and investor education bodies and academics. Around 30 senior representatives of local and overseas supervisory authorities and public bodies responsible for financial consumer protection attended the Roundtable. Participants discussed the key lessons from the global financial crisis and recent developments to support financial consumer protection, and exchanged views on challenges in developing and implementing financial consumer protection policies in their jurisdictions.

To promote consumers' understanding of their rights and obligations, the HKMA, in December, launched a "Consumer Corner" on its website providing information on local banking consumer issues and the HKMA's role in banking conduct regulation.

Enforcement

Enforcement work

Apart from a small number of outstanding cases, some of which were lodged only recently, the handling of Lehman Brothers-related complaints was largely completed. Some 88% of the complaints were resolved and the remaining 12% closed because of insufficient evidence or grounds on which to proceed. With the majority of cases completed, the HKMA has begun redeploying resources to accelerate the handling of other complaints.

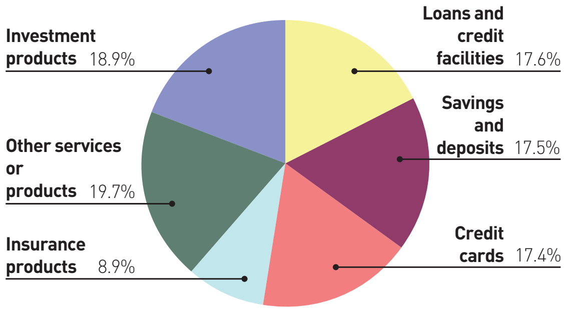
The HKMA received 916 formal banking complaints during the year (Table 3). The services or products concerned mainly included investment products, loans and credit facilities, savings and deposits, and credit cards (Chart 2).

Table 3 Banking complaint cases received by the HKMA

	2012			2011
	Conduct issue	Service quality issue/ commercial dispute	Total	Total
In progress on 1 January	1,509	418	**1,927**	3,281
Received during the year	273	643	**916**	834
Completed during the year	(1,067)	(463)	**(1,530)**	(2,188)
In progress on **31 December**	715	598	**1,313**	1,927

Note: These cases include both Lehman Brothers-related and non-Lehman Brothers-related formal banking complaints, as well as other cases referred by the HKMA's banking departments and other regulators.

Chart 2 Types of service or product concerned in banking complaints received by the HKMA



Assessments of 984 cases and investigations of 546 cases were completed, and 58 cases were opened by the Event Review Committee for further investigation. At the end of December, 1,313 cases were in progress (Table 3).

Investigations and recommendations by the HKMA have contributed towards the SFC taking the following enforcement action in 2012 under the SFO:

- reprimanded a bank, with the bank agreeing to repay more than US$11 million to customers, under a settlement agreement relating to more than 3,000 secondary market transactions of over-the-counter bonds, options and structured notes
- exercised its disciplinary power to ban a former relevant individual from re-entering the industry for three years.

The Ombudsman's Awards 2012

The HKMA was the runner-up in the Ombudsman's Awards 2012, following the overhaul of the Enforcement Department's banking complaint handling and enforcement process in 2011 to improve the efficiency and transparency of the complaint handling procedures. The award recognised the HKMA's effective internal administrative systems, professionalism in handling complaints, and commitment to improving its quality of service to the public. The Ombudsman also appreciated the HKMA's co-operative attitude in response to his Office's inquiries, its openness to recommendations and proactive attitude to introducing improvements.

Commencement of new legislation

The AMLO which came into effect on 1 April empowers the HKMA to investigate, discipline and prosecute contraventions of specified provisions by banks. The HKMA, following consultation with the banking industry, issued the guideline "Exercising Power to Impose Pecuniary Penalty", which took effect on 1 July. In October, the Anti-Money Laundering Regulatory Enforcement Co-ordination Group was established to provide a regular forum for the four relevant authorities under the AMLO (the HKMA, the Customs and Excise Department, the OCI and the SFC) to exchange views and observations and share the outcome of investigations and enforcement work in relation to the AMLO. The forum facilitates the performance of regulatory functions under the Ordinance and helps ensure consistency in enforcement outcomes.

Following the enactment of the Mandatory Provident Fund Schemes (Amendment) Ordinance 2012, a statutory regime for MPF intermediaries came into effect on 1 November. The HKMA, as frontline regulator, is vested with powers to investigate suspected contraventions in relation to the MPF intermediary activities of banks. The HKMA has worked closely with the Mandatory Provident Fund Schemes Authority and will enter into a memorandum of understanding in the first half of 2013 setting out, among other things, operational arrangements for handling complaints against banks concerning MPF products. The operational arrangements are designed to assist the public in lodging complaints, while ensuring regulatory consistency.

Deposit Protection Scheme

The Deposit Protection Scheme (DPS) continued to provide protection for deposits of up to $500,000 per depositor per bank. Taking into account the results of the Peer Review on Deposit Insurance Systems commissioned by the Financial Stability Board over its 24-member jurisdictions, a thorough self-assessment was conducted of the design of the DPS against the *Core Principles for Effective Deposit Insurance Systems* jointly issued by the Basel Committee and the International Association of Deposit Insurers. The assessment concluded that the DPS was largely well positioned against the Core Principles, although certain areas for possible further enhancement were identified, such as improving payout efficiency.

A full-scale rehearsal was conducted in the fourth quarter to test the ability of the Hong Kong Deposit Protection Board (HKDPB) and its network of payout agents to handle a payout in case of a bank failure. The rehearsal covered processes from the triggering of a payout to the delivery of compensation payments. The results confirmed that the HKDPB and its payout agents were able to operate in a co-ordinated and efficient manner to effect compensation payments in accordance with the established policies and procedures. A plan is being formulated to further improve payout efficiency following the review against the Core Principles and based on recommendations arising from the rehearsal. These include setting out an overpayment risk management process to support a faster payout, studying payment methods other than cheques, closer co-ordination between the HKMA, the HKDPB and other relevant government departments in a payout, and some fine-tuning of the payout system and procedures.

To monitor compliance with the DPS Representation Rules by DPS member banks, Scheme members' disclosures to depositors of their DPS membership and the protection status of their financial products were subject to an annual self-assessment by Scheme members and on-site examinations by the HKMA. The results were generally satisfactory and no significant non-compliance was identified.

Efforts were made to increase public awareness of the DPS, including a new multi-media publicity campaign. The results of an independent opinion survey indicated that public awareness rose to a record high of 78% after the campaign, with respondents' understanding of the $500,000 protection limit reaching 76%. There were also further initiatives to promote the DPS to target demographic groups, including a series of consumer events at the community level.

Oversight of clearing and settlement systems

Oversight of designated systems

The Clearing and Settlement Systems Ordinance (CSSO) empowers the Monetary Authority 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, 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 addition to meeting the CSSO requirements, designated systems are expected to comply with the international standards for clearing and settlement systems. In April, the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the International Organization of Securities Commissions (IOSCO) published a report *Principles for Financial Market Infrastructures*, setting out new international standards for financial market infrastructures (FMIs), including systemically important payment systems, securities settlement systems, central securities depositories, central counterparties and trade repositories. The HKMA considers all designated systems as meeting the definition of FMI and has adopted the PFMIs into its oversight framework for designated systems by amending the "Guideline on the Oversight Framework for Designated Systems".

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. The HKMA participated in various meetings and teleconferences of the CLS Oversight Committee during the year and reviewed documents related to the operations and developments of the CLS system to ensure it continued to meet the safety and efficiency requirements under the CSSO.

In 2012, the HKMA became a member of the SWIFT Oversight Forum. SWIFT is a major global message carrier for financial institutions and market infrastructures. The Forum, chaired by the National Bank of Belgium and comprising member economies that are major users of SWIFT's services, discusses SWIFT oversight matters and shares SWIFT-related information. The HKMA has an interest in SWIFT's operations because AIs and designated systems in Hong Kong use, and rely on, the services of SWIFT and may be exposed to risks in the event of any disruption to its operations. The HKMA attended meetings of the Forum in May and November.

The HKMA also co-operates with other central banks in the oversight of foreign currency payment systems in Hong Kong. In particular, arrangements are maintained with other central banks for payment-versus-payment (PvP) links 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 Monetary Authority 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 2012 and reviewed four regular reports and 21 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 to fulfil the designation criteria of 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 2012, OCL completed its 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 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 and adverse impact on Hong Kong cardholders. In the annual self-assessment report covering activities in 2012, 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 2012, Hong Kong had 155 licensed banks, 21 restricted licence banks, 24 deposit-taking companies and 14 approved money brokers. During the year the HKMA granted four bank licences to four foreign banks and one restricted bank licence to a locally incorporated subsidiary of a foreign bank. One licensed bank, two deposit-taking companies and one money broker revoked their authorizations during the year.

The HKMA conducted a review of the market entry criteria for banks in the first half of 2012 and introduced changes to put the licensing requirements of Hong Kong on a par with those of other international financial centres. The requirements that an applicant for a banking licence must have total customer deposits of not less than $3 billion and total assets of not less than $4 billion were removed as was the requirement that a bank wishing to enter the Hong Kong market by establishing a locally-incorporated entity must previously have operated in Hong Kong as a branch, restricted-licence bank or deposit-taking company for at least three years.

The HKMA introduced in August face-to-face meetings with selected candidates applying for appointment as director, chief executive and alternate chief executive of locally incorporated AIs. The HKMA considers the arrangement a useful way to raise the standards of governance in locally incorporated AIs, and to help ensure that directors and senior management are fit and proper for their roles. The HKMA will continue to conduct meetings with selected candidates as part of the assessment process.

International co-operation

The HKMA continues to participate in various international and regional forums for banking supervisors. The HKMA is currently a member of both the Basel Committee and its governing body, the Group of Governors and Heads of Supervision and is represented on various Basel Committee working groups, including the Policy Development Group, the Standards Implementation Group, the Working Group on Liquidity, the Working Group on Capital, the Quantitative Impact Study Working Group, the Large Exposures Group, and the Working Group on Disclosure. The HKMA also participates in the Basel Committee and IOSCO joint 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 FSB Resolution Steering Group and the Cross-border Crisis Management Working Group. Regionally, the HKMA is a member of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and the South East Asia, New Zealand and Australia Forum of Banking Supervisors.

The HKMA also participates in committees and working groups under the Bank for International Settlements and EMEAP related to payment systems oversight. During the year, it participated in discussions with the CPSS and IOSCO to develop the PFMIs and the related disclosure framework and assessment methodology for FMIs.

PLANS FOR 2013 AND BEYOND

Supervisory focus

Against the background of continuing low interest rates and uncertain global economic conditions, property mortgage lending will remain a key focus of the HKMA's supervisory agenda in 2013. Separately, while credit growth in the banking sector moderated in 2012, it will remain an area of supervisory attention, particularly in ensuring AIs are well prepared for any sharp adverse change in economic conditions that may have a material impact on their asset quality. In addition, supervisory focus on AIs' Mainland-related business will be further strengthened in 2013.

Supervision of technology risk

The HKMA will maintain its regular on-site examinations and off-site surveillance of AIs' controls over Internet banking, technology risk management and business continuity planning to ensure the sound implementation of chip-based ATM security controls, while working with the industry to promote public awareness of the new security measures.

Supervision of operational risk

The HKMA's operational risk management specialist team will conduct on-site examinations and off-site reviews to identify and address emerging operational risks, and ensure that AIs have the requisite systems and controls to identify and manage their operational risk exposures. Supervision will continue to focus on assessing the effectiveness of AIs' operational risk governance frameworks and related risk-management tools.

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

The HKMA will:

- continue to work closely with the SFC and the banking industry to provide further guidance on the standards the HKMA expects institutions to observe in the sale of investment products

- continue to assist the private wealth management industry, the HKIB, HKSI and TMA to develop a structured framework covering competency requirements and continuing professional development for private wealth management practitioners

- continue to work closely with the OCI, the SFC and the banking industry to enhance the disclosure requirements relating to the sale of ILAS to ensure an appropriate degree of policyholder protection

- continue to co-operate with the FSTB and the OCI in enhancing the regulatory regime for insurance intermediary activities under the proposal to establish an independent Insurance Authority

- continue off-site and on-site surveillance of AIs' business conduct in selling securities, MPF and other investment and insurance products

- introduce a mystery shopping exercise on AIs' sale of investment and insurance products.

Supervision of AIs' compliance with guidance on liquidity risk management and stress testing

To assess AIs' compliance with the standards and guidance set out in the new module "Sound Systems and Controls for Liquidity Risk Management" in the Supervisory Policy Manual, issued in April 2011, and the revised module "Stress-testing", issued in May, the HKMA will conduct another round of thematic on-site examinations on these areas for selected AIs. In addition, the HKMA will continue to give priority to on-site examinations of AIs' treasury and derivative activities and surveillance of potentially important emerging risks.

Supervisor-driven stress testing programme

The HKMA will devote adequate resources to further developing the supervisor-driven stress testing programme.

Mainland-related business

In light of the rapid growth in AIs' Mainland-related business, the HKMA will strengthen its surveillance to ensure that the associated risks are assessed and managed appropriately. In particular, on-site examinations of AIs' Mainland-related activities will focus on credit underwriting standards and regulatory compliance. In addition, the HKMA will further strengthen its supervisory co-operation with the China Banking Regulatory Commission.

Prevention of money laundering and terrorist financing

The Financial Action Task Force promulgated the revised international anti-money laundering standards in 2012. The HKMA is now assisting the FSTB to review Hong Kong's AML/CFT regime and will implement appropriate changes where necessary.

The HKMA will continue to conduct institution-specific and thematic examinations to ensure that AIs' AML/CFT systems and controls meet legal and regulatory requirements and can effectively counter the risk of money laundering and terrorist financing.

Co-operation with supervisors outside Hong Kong

A key item on the HKMA's supervisory agenda will be to work with the relevant crisis management groups for international banks on formulating recovery and resolution plans in accordance with the timetable set by the Financial Stability Board. Every effort will be made to ensure the timely sharing of bank-specific prudential information and other issues of common interest, such as the latest financial condition of European banks and the implementation of recapitalisation plans.

Basel III

Capital standards

Policy development

The second phase of implementation of the Basel III capital standards will focus on introducing the capital conservation and countercyclical buffers designed to reinforce banks' resilience and reduce the impact of any economic downturn on their lending and other credit intermediation activities.

The capital conservation buffer will be phased in between 2016 and 2018 in accordance with the transition timeline of the Basel Committee on Banking Supervision.

The countercyclical buffer, when triggered, operates as an extension of the capital conservation buffer and, therefore, its framework should be established to coincide with the introduction of the capital conservation buffer. The countercyclical buffer will be set at 0% in normal times but, where excessive credit growth in a given jurisdiction is judged by the relevant authority in that jurisdiction to be associated with a build-up of system-wide risk, that authority may set a countercyclical buffer requirement above 0% for its own banks. Other regulators are then expected to follow suit for their banks' activities in that jurisdiction on a reciprocal basis. Since banks will need a period of notice (the Basel Committee suggests 12 months) to enable them to build up their capital once the countercyclical buffer is triggered, the operational framework for the countercyclical buffer should be in place from 2015 (i.e. 12 months before the buffers come into effect). Therefore, amendments to the Banking (Capital) Rules will be introduced in 2013/2014 to provide for the operation of the buffers.

Authorized institutions (AIs) assessed by the HKMA to be domestic systemically important banks (D-SIBs) will be subject to additional loss-absorbency requirements (additional capital requirements) reflecting the standards set out in *A Framework for Dealing with Domestic Systemically Important Banks* issued by the Basel Committee in October. The additional loss-absorbency requirement will be applied through an extension of the capital conservation buffer.

The HKMA expects to consult the industry during 2013 on the proposed amendments to the Banking (Capital) Rules to cater for the operation of the buffers and on the detailed policy proposals for the application of the D-SIB and countercyclical buffer frameworks.

Supplementary guidelines

The Banking (Capital) (Amendment) Rules 2012 (BCAR 2012) will necessitate consequential changes to existing supervisory guidance, including:

- **Counterparty credit risk** — the supervisory guideline "Counterparty Credit Risk Management" will be reviewed to bring it into line with the BCAR 2012 (including, in particular, the introduction of the internal models calculation approach for counterparty credit risk (IMM CCR approach)) and to reflect the enhanced counterparty risk management practices introduced by Basel III. The revised guideline will also provide guidance on credit valuation adjustment, i.e. adjustment for potential mark-to-market losses on derivative contracts due to changes in counterparty creditworthiness

Basel III (continued)

- **Overview of capital adequacy framework** — the HKMA is updating its "Overview of Capital Adequacy Regime for Locally Incorporated Authorized Institutions" to reflect the new capital adequacy regime introduced by the Banking (Amendment) Ordinance 2012 and BCAR 2012. The revised guidance will be issued for industry consultation in 2013

- **Financial instrument fair value practices** — similarly, the HKMA will update its guideline "Financial Instrument Fair Value Practices" to reflect the new definition of capital introduced under Basel III. The HKMA expects to issue a draft of the revised guidance for industry consultation in the first half of 2013

To address the technical issues which inevitably arise on the implementation of complex rules such as the BCAR 2012, the HKMA will issue "Frequently Asked Questions" as a swift and responsive measure to clarify interpretation and facilitate consistency in the application of the Rules.

Disclosure

To enable the Banking (Disclosure) (Amendment) Rules to take effect from 30 June 2013 in accordance with the Basel Committee's implementation timetable, it is planned to gazette and table the Rules before Legislative Council (LegCo) for negative vetting in April 2013. AIs will be required to observe the new standards for disclosures relating to a balance sheet date on or after 30 June 2013. To facilitate compliance and comparability between AIs, the HKMA will issue a set of standard disclosure templates within the first half of 2013.

Leverage ratio

Basel III introduces a simple non risk-based leverage ratio as a complementary measure to the risk-based capital requirements to limit excessive leverage on the part of banks. The Basel Committee's implementation timetable provides for a "parallel run" of the leverage ratio from 2013 until 2017, with the ratio becoming a binding requirement from 2018. The HKMA is developing a reporting template for all Hong Kong-incorporated AIs to submit their leverage ratio positions during the parallel run period. Basel III requires disclosure of the leverage ratio from 1 January 2015 and the HKMA will participate in the development of the relevant disclosure standard in the Basel Committee. Once it is binding, the Banking (Disclosure) Rules will be amended at the appropriate time to incorporate the new standard.

Liquidity standards

The Basel Committee issued a package of revisions to the liquidity coverage ratio (LCR) in January 2013 to address a variety of issues identified since the original publication of the LCR standard as part of the Basel III reform package. The major changes –

- *expand the range of assets eligible as high-quality liquid assets (HQLA) to include (subject to national discretion):*

  — non-financial corporate debt securities rated A+ to BBB-, subject to a 50% haircut;

  — listed common equity shares of non-financial corporates included in a main index, subject to a 50% haircut; and

Basel III (continued)

— certain high-quality residential mortgage-backed securities, subject to a 25% haircut

provided relevant qualifying criteria are met and the aggregate amount of such assets does not exceed 15% of a bank's total HQLA

- *reduce the outflow rates for certain retail and corporate deposits* to (i) 3% (from 5%) for certain insured retail deposits backed by a deposit insurance scheme that meets specified criteria; (ii) 40% (from 75%) for non-operational non-financial corporate deposits; and (iii) 20% (from 40%) for fully insured non-operational corporate deposits

- *reduce the drawdown rate for certain committed credit and liquidity facilities* to 40% (from 100%) for facilities extended to banks subject to prudential supervision

- *adopt a more granular treatment for derivatives risks* to ensure the LCR adequately captures the liquidity risk inherent in collateral substitution, the holding of excess collateral and customer short positions in client servicing brokerage

- *reduce the outflow rate for repos with central banks* to 0% (from 25%) to equalise the treatment with that for funding obtained from central banks via outright sale of assets.

The text regarding banks' ability to use their HQLA in times of stress has also been clarified. Furthermore, a phase-in arrangement has been introduced so that the minimum LCR requirement will begin at 60% on 1 January 2015 and then rise by 10 percentage points a year to reach 100% on 1 January 2019.

The HKMA is reviewing its strategy for implementing the LCR in light of these changes and will consult the industry in the second quarter of 2013 on proposed methodologies for the calculation of the LCR, based on the Basel Committee's revised standard. The consultation will form the basis for a set of Banking (Liquidity) Rules which is expected to be tabled in LegCo in 2014. The HKMA will endeavour to finalise its proposed two-tiered approach to the implementation of the LCR and the terms of the minimum liquidity ratio (to be observed by AIs not made subject to the LCR) in the first half of 2013.

The HKMA will augment the existing liquidity reporting framework so that it can both support the Basel III liquidity standards and enable the HKMA to make better use of liquidity monitoring tools and metrics in the supervision and oversight of AIs' liquidity risk profiles and positions.

In developing liquidity rules and reporting frameworks, the HKMA will maintain its dialogue with the industry and take account of the implementation approaches adopted by major overseas regulators.

Recovery and resolution

As part of its package of policy measures to reduce the risk posed by systemically important financial institutions, the FSB issued the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes) in November 2011. All member jurisdictions of the FSB and G20 are expected to meet these new international standards to ensure that both public authorities and financial institutions will be better placed to respond effectively to shocks that threaten to undermine the financial soundness of individual financial institutions (or financial market infrastructures).

During 2012, the FSB co-ordinated a self-assessment by jurisdictions of how far their existing arrangements for contingency planning and dealing with distressed firms meet the new standards in the Key Attributes. This work confirmed that although the statutory and regulatory framework in Hong Kong was relatively well-developed before the global financial crisis, further strengthening is now needed to reflect the latest best practices for effective resolution regimes. The HKMA is working with the FSTB and other regulators to develop the necessary enhancements and will engage key stakeholders during 2013.

An important aspect of the Key Attributes is the requirement for robust and credible recovery and resolution planning, at a minimum, for all global systemically important financial institutions (G-SIFIs) and for any other firm that its home authority assesses could have an impact on financial stability. The HKMA participates in the crisis management groups of a number of globally systemically important banks (G-SIBs) where work is underway to develop firm-specific group-level recovery and resolution plans. In addition, the HKMA has begun consulting the industry on policy proposals for local recovery and resolution planning requirements covering:

- key elements to be included in recovery plans prepared by AIs, such as governance, trigger events, stress scenarios, recovery options, implementation and communication plans

- a "top-down" and iterative approach to resolution planning beginning with a resolution strategy based on core information and analysis of key components of AIs' structures and operations, such as the critical functions performed by the AI or its corporate group; significant legal entities within the AI's corporate group; the AI's business lines and operating models; and dependencies between the AI and other members of its group and third parties. The resolution strategy can then be further developed into an operational plan

- a proportionate application across AIs, focused on ensuring initially that recovery and resolution planning is undertaken for AIs considered to be the most systemically significant or critical to the functioning of the Hong Kong banking sector.

Development of supervisory policies

Credit risk transfer

The HKMA is developing a supervisory guideline on credit risk transfer to reflect recent international developments in securitisation regulation (such as disclosure and alignment of incentives between originators and investors) and the reduction of reliance on ratings produced by credit rating agencies (such as more stringent requirements in respect of banks' internal credit assessment of securitisation exposures).

Market risk management

The HKMA intends to issue a new supervisory guideline on market risk management taking into account the lessons of the global financial crisis and observed best practices. Consultation with the industry associations is expected in the second quarter of 2013.

Guideline on over-the-counter derivatives market reforms

Once the margining standards for non-centrally cleared derivatives are agreed internationally, the HKMA will update its prudential framework in line with the new standards. After the over-the-counter (OTC) derivatives market regulatory regime is introduced in Hong Kong, the HKMA will issue supervisory guidance outlining the key requirements and its approach to supervising the OTC derivatives activities of authorized institutions (AIs).

Internal audit function

The supervisory guideline "Internal Audit Function" of AIs will be updated to reflect latest guidance in *The Internal Audit Function in Banks* issued by the Basel Committee on Banking Supervision in June, particularly in relation to the approach to internal audit across banks within a banking group or holding company structure and the communication between supervisory authorities and banks' internal auditors.

Management of risks associated with settlement of foreign exchange transactions

The Basel Committee issued updated *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions* in February 2013, reflecting lessons from the global financial crisis. The HKMA's supervisory guidance on foreign exchange risk management will be revised accordingly.

Financial Sector Assessment Program

The International Monetary Fund (IMF) will lead a Financial Sector Assessment Program (FSAP) for Hong Kong in 2013. The IMF and the World Bank established the FSAP in 1999 as a comprehensive in-depth analysis of a country's financial sector. The last FSAP for Hong Kong was conducted in 2003. The two main components of the FSAP will be a macro-financial stress test of the banking system and a detailed assessment of the compliance of Hong Kong's banking regulations with the Basel Committee's *Core Principles for Effective Banking Supervision*, which were substantially revised in 2012. The FSAP for 2013 will also cover, among other things, financial safety-net arrangements, of which the DPS is a key part. The HKMA will work with the FSAP review team to facilitate their assessment. Any recommendations arising from the review will be followed up.

Accounting and disclosure standards

The HKMA will continue to monitor developments in international accounting convergence, particularly in the area of loan loss provisioning, and will maintain its regular dialogue with the HKICPA and the banking industry on these developments and their implications for the supervisory framework.

International co-operation

The HKMA will continue its involvement in the work of the Basel Committee and the FSB, including through the thematic peer review on the implementation of the FSB *Principles for Reducing Reliance on Credit Rating Agency Ratings* being conducted by the FSB in 2013.

Consumer protection

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

The HKMA will enhance its efforts on banking consumer education. Initiatives will be launched to improve product knowledge and consumers' understanding of their rights and obligations. The HKMA will also continue to have an active role in the work of the IEC and co-operate with it on investor education initiatives.

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 and work with the industry to promote credit data sharing. Continued development of the credit data sharing arrangements will help strengthen the credit risk management capacity of AIs.

Enforcement

The HKMA will expedite the handling of outstanding complaint cases not related to Lehman Brothers, the progress of which has been affected by the need to accord priority to Lehman Brothers-related complaints in the past few years. Without materially affecting the timely handling of new complaints, the HKMA aims to clear the bulk of this backlog in 2013.

Priority will also be given in 2013 to the handling of cases under the new enforcement regimes relating to anti-money laundering and MPF intermediaries, to uphold industry standards.

The HKMA will continue its co-operation with other financial regulators through enhancing working contacts, participating in inter-regulator working groups such as the Anti-Money Laundering Regulatory Enforcement Co-ordination Group and organising experience-sharing sessions with other financial regulators upon request.

Deposit protection

The HKMA will continue to assist the HKDPB in implementing and operating the DPS. As the external environment is expected to remain volatile, it is important for the HKDPB to maintain its readiness to execute a payout effectively. Efforts will be made to further enhance payout efficiency, including tightening the timing and format of depositor information to be submitted by a Scheme member in the event of a bank failure, as well as refinements to the payout policies and procedures to shorten the time required to calculate and disburse compensation payments. The banking industry and other relevant parties will be consulted on the proposals.

Self-assessment and on-site examinations will be conducted to monitor Scheme members' compliance with the representation requirements on DPS membership and protection status of financial products. Riding on the encouraging improvement in public awareness of the DPS, new educational and outreach initiatives will be undertaken for specific target groups such as senior citizens and youth.

Payment systems oversight

As overseer of designated systems under the CSSO, the HKMA will continue to promote and ensure the safety and efficiency of these systems, monitor the performance of the operators of retail payment systems under their self-regulatory codes of practice, and develop the current regime based on the new international standards.

The HKMA will work with the system operators and settlement institutions of the designated systems to achieve observance of the *Principles for Financial Market Infrastructures* (PFMIs). The local designated systems will be required to conduct self-assessments against the PFMIs based on the related disclosure framework and assessment methodology for FMIs. The HKMA will also be involved in external assessments of Hong Kong's observance of the PFMIs, including the FSAP review.

A regime for overseeing the trade repository, a central registry for collecting and maintaining records of over-the-counter derivatives transactions, will be formulated by the HKMA and incorporate the requirements under the PFMIs.

Licensing

The revised supervisory guideline "Corporate Governance of Locally Incorporated Authorized Institutions", issued in August 2012, sets out the HKMA's expectations in relation to induction training and continuing development to be provided to directors of AIs. The HKMA conducted a survey on training for directors of locally incorporated AIs in September 2012, to gather information on how the AIs assess the training needs of directors and the training currently being provided. The information collected will enable the HKMA to identify whether there are any gaps in the availability of training resources, and whether a degree of co-ordination in the provision of such training will be beneficial.

The HKMA will consider measures to help further enhance the development of directors. In the meantime, all locally incorporated AIs are encouraged to identify gaps and take steps to bring their practices in relation to board development in line with the HKMA's guidance.