Banking Stability

In 2017, the HKMA continued to place its supervisory focus on the effectiveness of authorized institutions' risk governance framework, including credit and liquidity risk management systems. During the year, another round of countercyclical macro-prudential measures was introduced to strengthen the resilience of the banking sector to cope with any downturn in the property market. With cyber threats on the rise, the HKMA stepped up the supervision of authorized institutions' technology risk management. At the same time, the HKMA launched seven initiatives that prepare Hong Kong to move into a New Era of Smart Banking. The effectiveness of authorized institutions' anti-money laundering and counter-terrorist financing controls remained a key supervisory focus of the HKMA as part of its efforts to combat financial crimes. On conduct supervision, the HKMA took further steps to promote a customer-centric corporate culture, foster financial inclusion, and address difficulties encountered by small and medium-sized enterprises and start-up companies in opening and maintaining bank accounts in Hong Kong. Efforts were also made to enhance the supervision of authorized institutions' sales practices for investment and insurance products to further strengthen customer protection.

Substantial progress was made on the local implementation of international supervisory and accounting standards, including capital adequacy standards, disclosure standards, the Net Stable Funding Ratio, large exposure limits, recovery planning and International Financial Reporting Standard 9. In support of the need for capacity building amid an ever-changing banking environment and evolving risk landscape, the HKMA co-ordinated with the industry to develop director empowerment programmes and the Enhanced Competency Framework for banking practitioners.

The Financial Institutions (Resolution) Ordinance came into operation on 7 July 2017, making Hong Kong one of the few Financial Stability Board member jurisdictions with a fully cross-sectoral resolution regime for financial institutions. The Ordinance, establishing a new line of defence for financial stability, confers necessary powers on the Monetary Authority to manage, in an orderly manner, failure of a financial institution in circumstances where such failure could have adverse systemic consequences.

OBJECTIVES

The HKMA has a general objective to promote the safety and stability of the banking system. Achieving this objective is contingent upon the financial system being highly resilient and capable of providing the critical financial services the Hong Kong economy needs.

Banks can affect the stability of the system through the way they carry out their business and, in extremis, by failing in a disorderly manner. The Monetary Authority, as a supervisory authority, plays a key role in safeguarding financial stability by ensuring banks are resilient to shocks and are able to recover their positions in response to crises, which ultimately helps prevent failures. The Monetary Authority is responsible for the prudential supervision of banking business, which includes the business of taking deposits, in Hong Kong. It is tasked with the authorization of licensed banks, restricted licence banks and deposit-taking companies in Hong Kong, which are collectively known as authorized institutions (AIs). The Monetary Authority is also responsible for the designation and oversight of certain financial market infrastructures (FMIs).

However, the Monetary Authority cannot ensure, nor is the Hong Kong prudential regulatory framework designed to ensure, a zero-risk financial system. Instead, the Monetary Authority, as a resolution authority, seeks to ensure that in the event of an AI's failure, resolution may be conducted in an orderly manner such that continuity in critical financial services provided by AIs to their customers can be maintained. To this end, a resolution regime for financial institutions in Hong Kong is established, under which the Monetary Authority is the resolution authority for AIs, amongst other financial institutions.

REVIEW OF 2017

Overview of supervisory activities

In 2017, 192 off-site reviews were conducted covering a broad range of issues, including CAMEL ratings[1], corporate governance, business operations and risk management of AIs. As part of the HKMA's continued efforts to promote stronger risk governance at AIs, 30 meetings were held with the boards of directors or board-level committees of AIs, with the discussions focused on important risk management issues. The HKMA also conducted a survey to monitor the adoption of its recent guidance on corporate governance. 27 tripartite meetings among the HKMA, AIs and their external auditors were also held.

Conducted
192 off-site reviews

Conducted
401 on-site examinations and **thematic reviews**

Apart from off-site activities, the HKMA continued to conduct regular on-site examinations supplemented with thematic reviews on areas assessed to be of higher risk. This approach has allowed the HKMA to prioritise its supervisory resources to focus on emerging and more significant risks faced by AIs. The HKMA conducted 401 on-site examinations and thematic reviews during the year. Credit risk management and controls remained the key focus of these examinations and reviews. Another major focus was technology risk and operational risk management. The HKMA also increased the number of overseas examinations and the number of on-site examinations and thematic reviews targeted at liquidity and market risk management as well as anti-money laundering and counter-terrorist financing (AML/CFT) controls. On-site examinations of AIs' activities in securities, investment products, insurance and Mandatory Provident Fund (MPF)-related businesses were also conducted by specialist teams.

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

Banking Stability

Table 1 contains an overall summary of the HKMA's supervisory activities in 2017.

Table 1 Summary of supervisory activities

		2017	2016
1	Off-site reviews and prudential interviews	192	188
2	Meetings with boards of directors or board-level committees of AIs	30	30
3	Tripartite meetings	27	27
4	On-site examinations	121	164
	Credit risk management and controls	8	71
	Technology risk and operational risk management	21	20
	AML/CFT controls	20	17
	Liquidity risk management	12	8
	Implementation of Basel capital adequacy framework	5	6
	Capital Planning	3	–
	Market risk, counterparty credit risk and treasury activities	8	4
	Securities, investment products, insurance and MPF-related businesses	18	20
	Deposit Protection Scheme-related representation	12	12
	Overseas examinations	14	6
5	Thematic reviews	280	213
	Credit risk management and controls	84	62
	Technology risk and operational risk management	61	64
	AML/CFT controls	55	30
	Implementation of Basel capital adequacy framework	5	4
	Sale of investment products	3	3
	Consumer protection	60	50
	Liquidity risk	8	–
	Market risk	4	–
Total number of off-site reviews and prudential interviews, meetings, on-site examinations and thematic reviews		**650**	622

Supervision of credit risk

Credit growth and asset quality

Total bank lending grew by 16.1%, compared with a growth of 6.5% in 2016. As shown in Table 2, the loan growth was broad-based.

Table 2 Growth in loans and advances

% change	2017	2016
Total loans and advances	**16.1**	6.5
Of which:		
– for use in Hong Kong	16.1	8.0
– trade finance	8.7	0.2
– for use outside Hong Kong	17.5	4.5

Specifically, Mainland-related lending grew by 17.5% to HK$4,188 billion at the end of 2017 (Table 3). This included HK$644 billion of loans booked with Mainland subsidiaries of banks incorporated in Hong Kong.

Table 3 Growth in Mainland-related lending

% change	2017	2016
Total Mainland-related lending	**17.5**	7.0
Of which:		
– Mainland-related lending (excluding trade finance)	17.8	7.7
– trade finance	13.6	–1.2

The asset quality of AIs remained healthy in 2017. Retail banks' classified loan ratio edged down from 0.72% at the end of 2016 to 0.54% at the end of 2017, well below the long-run historical average of 2.2% since 2000. For the banking industry as a whole, the classified loan ratio decreased from 0.85% to 0.67%. As regards Mainland-related lending, retail banks' classified loan ratio of such lending edged down to 0.75% in 2017 from 0.82%. For the banking industry as a whole, the ratio decreased to 0.67% from 0.80% a year ago.

Retail banks' classified loan ratio

All loans: **0.54%**

Mainland-related lending: **0.75%**

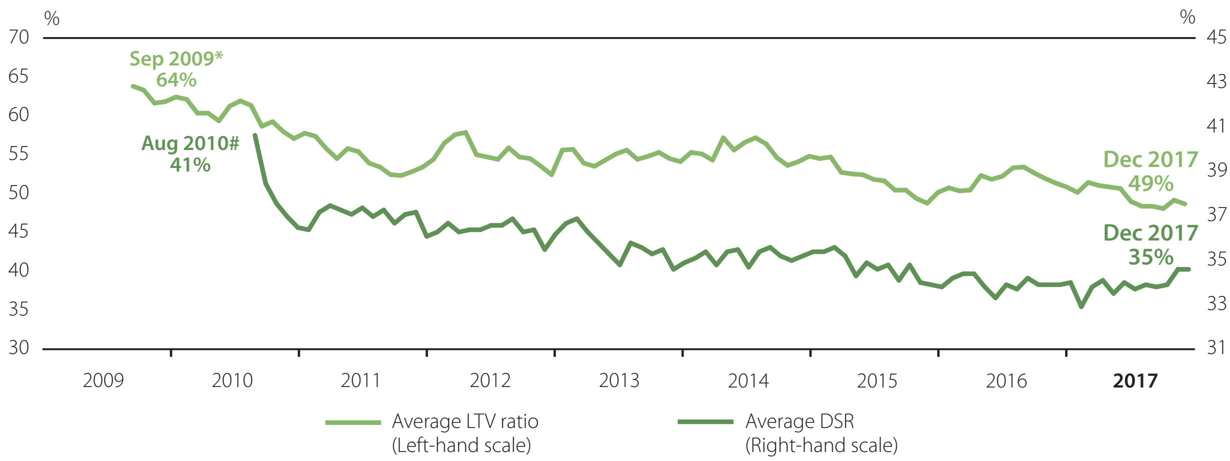
During the year, the HKMA stepped up its supervisory efforts to ensure that AIs continued to adopt prudent credit risk management standards. In particular, the surveillance of AIs' exposures to major corporates was enhanced. Targeted thematic examinations were conducted, focusing on key credit risk management controls such as loan underwriting standards, the loan classification and provisioning system, credit risk governance framework and risk management for lending to property developers, asset-backed financing and insurance premium financing.

Property mortgage lending

Property prices continued to rise in 2017. There were more loans extended by AIs involving borrowers with multiple mortgages or with income derived from outside of Hong Kong. In view of these developments, the HKMA introduced another round of countercyclical macro-prudential measures on 19 May. The eighth round of measures included raising the risk-weight floor for the calculation of capital charges for new residential mortgage loans granted by AIs, lowering the applicable loan-to-value (LTV) ratio cap for property mortgage loans extended to borrowers with pre-existing mortgages, and lowering the applicable debt servicing ratio (DSR) limit for property mortgage loans extended to borrowers whose income is derived mainly from outside of Hong Kong.

The HKMA's macro-prudential measures on property mortgage loans, introduced since 2009, have enhanced banks' resilience to risks associated with the property market. The average LTV ratio of new residential mortgage loans fell to 49% in December 2017 from 64% in September 2009, before the countercyclical measures were first introduced. The average DSR also decreased to 35% in December 2017 from 41% in August 2010, when a cap on DSR was first applied (Chart 1).

Chart 1 Average LTV ratio and DSR of new residential mortgage loans



* Before the introduction of the first round of the HKMA's countercyclical measures on property lending
\# Introduction of a cap on DSR

The HKMA observed that some developers financed their property development projects with high gearing and some of them provided mortgages with high LTV ratios to buyers of properties. To address the risks associated with these developments, the HKMA introduced new risk management measures for lending to property developers on 12 May. These included requiring AIs to lower the financing caps for construction financing; requiring AIs to set aside more capital for their lending to property developers with a higher proportion of mortgage loans relative to equity; and performing a round of thematic examinations to ensure that banks continue to follow prudent underwriting standards in their lending to property developers.

Separately, the HKMA worked with the Land Registry in launching an e-Alert service in February. The e-Alert service provides a notification to the AI concerned whenever a further mortgage in respect of the mortgaged property is lodged with the Land Registry for registration, so that the mortgagee bank can take appropriate risk mitigating actions as appropriate.

Supervision of operational and technology risks

Cybersecurity threats continued to increase over the year. The HKMA stepped up its supervisory efforts in a bid to enhance the cyber resilience of the banking sector. As part of the Cybersecurity Fortification Initiative (CFI) rolled out by the HKMA in 2016, 30 AIs completed an assessment of the maturity of their cyber defences. Separately, the HKMA and the Securities and Futures Commission (SFC), after extensive consultation with the banking and securities industry, jointly decided to introduce a mandatory two-factor authentication for online share trading. A round of on-site examinations focused on banks' cybersecurity controls and operational resilience was also conducted. The HKMA further completed a round of discussions with the senior management of major banks to assess how the banks were managing strategic risks posed by potential new market entrants powered by technological advancement.

Smart Banking

In September, the HKMA announced a package of measures to assist Hong Kong's banking sector in migrating to a new era of Smart Banking. On the supervisory front, the HKMA enhanced the Fintech Supervisory Sandbox to version 2.0, with new features including a Chatroom facility accessible by both banks and technology firms and the establishment of linkages among the sandboxes of the HKMA, the SFC and the Insurance Authority (IA), so as to provide a single point of entry for conducting trials of cross-sector fintech products.

The HKMA also launched a Banking Made Easy initiative to identify and minimise regulatory frictions with the aim of further improving customers' experience in using fintech and digital banking services. A taskforce has been set up with the current focus on remote onboarding and account maintenance, online finance and online wealth management.

A review of the existing Guideline on Authorization of Virtual Banks has commenced to facilitate the introduction of virtual banking in Hong Kong.

Supervision of treasury activities and liquidity risk

As the US continued to normalise its monetary policy, global fund flows might become increasingly volatile. In consideration of this, the HKMA placed increased focus on the supervision of liquidity risk during the year. The HKMA enhanced its supervisory liquidity stress testing with additional scenarios, including a more stressful but plausible scenario of fund outflows and a short-term, confidence-driven bank run scenario. The HKMA also stepped up the monitoring and analysis of individual AIs' liquidity profiles and required selected AIs to strengthen their liquidity risk management capability.

Separately, the HKMA conducted more on-site examinations of AIs' market risk management in respect of their debt securities portfolios. A round of thematic reviews were carried out to evaluate potential risks arising from AIs' increased investment activities in foreign currency bonds and to assess the effectiveness of the corresponding risk management, including hedging practices.

Prevention of money laundering and terrorist financing (ML/TF)

The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) (Amendment) Bill 2017 was gazetted on 23 June and will come into operation in 2018. The amendment is intended to update Hong Kong's regulatory regime for AML/CFT in line with the latest international requirements as promulgated by the Financial Action Task Force (FATF). These changes, together with updates to the statutory guideline on AML/CFT, will help clarify and implement the risk-based approach in customer due diligence (CDD) processes for account opening and the maintenance of bona fide customers, and encourage innovation where such processes are carried out remotely.

In 2017, the HKMA's risk-based AML/CFT supervisory programme included 22 on-site examinations and 55 off-site reviews to assess the effectiveness of AIs' controls over ML, TF and/or financial sanctions risks. This included thematic reviews on the role of internal audit in AML/CFT work as well as the engagement of an external consultant specialising in the assessment of AIs' automated screening systems. The HKMA also encouraged the greater use of new technology, including a Know-Your-Customer Utility (KYCU), and promoted closer collaboration with the industry to share useful practices that some AIs had used to increase the effectiveness of AML/CFT measures.

Reflecting the global nature of ML, effective domestic and international co-operation in addressing the risks is important. Domestically, the Fraud and Money Laundering Intelligence Taskforce, a public-private partnership among the Hong Kong Police Force, AIs, the Hong Kong Association of Banks (HKAB) and the HKMA, was established on 26 May to enhance the detection, prevention and disruption of serious financial crimes and ML threats. Internationally, the HKMA continues to participate actively in the AML/CFT Expert Group of the Basel Committee on Banking Supervision (Basel Committee) and the FATF, contributing experienced assessors and reviewers to the evaluations of other members' AML/CFT regimes.

Supervision of wealth management and MPF-related businesses

The HKMA co-operated closely with other financial regulators in Hong Kong to provide guidance and supervise AIs' sales practices of securities, investment products, insurance products and MPF schemes. The HKMA also maintained regular dialogue with regulators through bilateral and multilateral meetings, as well as under the auspices of the Council of Financial Regulators, to ensure co-ordinated and effective supervisory actions. In 2017, the HKMA and the SFC conducted a joint review of a financial group's controls and management over possible conflicts of interest arising from the sale of in-house investment products. Based on the findings from the joint review, the HKMA and the SFC issued a joint circular in November to share with the industry some key observations and good practices.

During the year, the HKMA conducted 18 on-site examinations, 3 thematic reviews and 13 industry analyses of AIs, covering the sale of investment products, settlement of securities transactions and safe custody of client securities, and the sale of non-investment-linked long-term insurance (NLTI) products and MPF products, which involved retail, private and corporate banking customers. In February, a circular was issued to all AIs to provide practical guidance in respect of the sale of investment products and handling of client securities, drawing reference to the HKMA's supervisory observations and discussions with the industry on the interpretation and implementation issues of certain regulatory requirements and standards.

To further promote a customer-centric culture, the HKMA worked with the Private Wealth Management Association (PWMA) in developing a Treat Customers Fairly Charter for the private wealth management industry. A circular was issued in June to elucidate the HKMA's expectations for private banks in following the principles of the Charter. The HKMA and the PWMA have also made collective efforts to implement several initiatives, such as the enhancement to the PWMA Code of Ethics and Conduct, to support the Charter.

In July, the HKMA introduced a half-yearly survey on AIs' sale of insurance products, with the first reporting period starting from 1 July 2018. This survey will provide further information on the insurance intermediary activities of AIs and facilitate the HKMA's supervision in this regard. Meanwhile, the HKMA started to co-operate with the newly established IA to prepare for the implementation of a new statutory regime under the Insurance Ordinance to regulate insurance intermediaries, including a collaboration framework for the inspection and investigation of AIs' insurance intermediary activities.

The HKMA consulted banking industry associations on proposed disclosure requirements to enhance point-of-sale transparency and to better address potential conflicts of interest in the sale of structured investment products that are not regulated by the Securities and Futures Ordinance (SFO). A circular was subsequently issued in January 2018 to provide guidance and remind AIs to continue to demonstrate consistently high standards.

During the year, the HKMA processed two applications to become Registered Institutions (RIs) and four applications from RIs to engage in additional regulated activities. It granted consent to 172 executive officers responsible for supervising the securities activities of RIs, and conducted background checks on 9,142 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

Other supervisory activities

The Banking Supervision Review Committee considered six cases in 2017. Five of these cases concerned the authorization of an AI and the approval of money brokers. The remaining one was about the transfer of authorization of a licensed bank to another bank (see Table 4 for details).

Banking Stability

During the year, the HKMA commissioned nine reports under section 59(2) of the Banking Ordinance (BO). The AIs were required to appoint external auditors to report on the effectiveness of their controls over a specified area of operation. Three of the reports covered AML/CFT controls, another three covered the distribution of financial products, and the remaining reports were related to areas including mortgage financing and financial risk management.

In 2017, no AIs breached the requirements of the BO relating to capital adequacy or liquidity ratio. There were, however, 23 breaches under various sections of the BO, but none affected the interests of depositors and these breaches were rectified promptly by the AIs concerned.

As in the past years, the CAMEL ratings of AIs were reviewed and determined by the CAMEL Approval Committee. The AIs were notified of the ratings and given the opportunity to request a review. There was no request for a further review of approved CAMEL ratings from AIs during the year.

Table 4 Summary of other supervisory activities

		2017	2016
1	Cases considered by the Banking Supervision Review Committee	**6**	6
2	Reports commissioned under section 59(2) of the BO	**9**	2
3	Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs	**203**	193

International co-operation

Co-operation with overseas supervisors

The HKMA participated in 32 college-of-supervisors meetings organised by the home supervisors of 26 banking groups with significant operations in Hong Kong. A broad range of issues were discussed at these meetings, covering areas such as financial soundness, corporate governance, recovery and resolution planning, and risk management controls. During the year, the HKMA assisted the home supervisors of two global systemically important banks (G-SIBs) in organising supervisory college meetings in Hong Kong.

Bilateral meetings were held during the year with banking supervisors from Australia, Brazil, Brunei, the European Union, India, Japan, Liechtenstein, Macao, Mainland China, Malaysia, Singapore, Switzerland, Taiwan, Thailand, the United Arab Emirates, the UK and the US. There were also regular exchanges with overseas authorities on institution-specific issues and developments in financial markets.

Participation in international and regional forums

The HKMA continued to participate in a range of international and regional forums for banking supervisors. It is a member of 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 (PDG), the Macroprudential Supervision Group, the Supervision and Implementation Group (SIG) and the AML/CFT Expert Group. The HKMA is also a member of several sub-groups under (i) the PDG, including the Working Group on Capital, the Market Risk Group, the Working Group on Liquidity, the Working Group on Disclosure, the Credit Risk Group and the Large Exposures Working Group; and (ii) the SIG, including the Working Group on Supervisory Colleges, the Task Force on Impact and Accountability, the Working Group on Stress Testing and the Workstream on Future Regulatory Consistency Assessment Programme. In addition, the HKMA chairs the Risk Data Network under the SIG to monitor the implementation progress of the *Principles for effective risk data aggregation and risk reporting* by G-SIBs. The HKMA also participates in the Joint Working Group on Margining Requirements formed by the Basel Committee and the International Organization of Securities Commissions (IOSCO).

As regards participation in the Financial Stability Board (FSB), the Chief Executive of the HKMA chairs the Standing Committee on Supervisory and Regulatory Co-operation. In addition to serving as a member of the Plenary Meeting and Standing Committee on Assessment of Vulnerabilities, the HKMA also participates in several FSB working groups, including the Over-the-counter (OTC) Derivatives Working Group, the Compensation Monitoring Contact Group, the Working Group on Governance Frameworks, and the Workstream on Other Shadow Banking Entities. In the area of resolution, and in addressing the problem of "Too Big To Fail", the HKMA is a member of the FSB Resolution Steering Group and Cross-Border Crisis Management (CBCM) Working Group for banks.

At the regional level, the HKMA is a member of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)[2]; the South East Asia, New Zealand and Australia Forum of Banking Supervisors and the South-East Asian Central Banks group. As part of its work in the EMEAP Working Group on Banking Supervision, the HKMA is the Champion of the Interest Group on Liquidity (IGL). During the year, the IGL exchanged views and shared experience regarding the implementation of Basel III liquidity standards in the EMEAP jurisdictions.

Financial Stability Board Peer Review

The FSB conducts a regular programme of country and thematic peer reviews of its member jurisdictions, including Hong Kong. In 2017, the FSB conducted a peer review that focused on steps taken by the relevant authorities in Hong Kong to implement reforms in the OTC derivatives market and to strengthen the framework for the resolution of financial institutions. In its Peer Review Report published in February 2018, the FSB testified to the good progress Hong Kong made in both areas, reflecting Hong Kong's strong commitment to implementing international standards, driven by its status as an international financial centre.

During the year, the HKMA also participated as a member of an international expert team in the FSB Peer Review that focused on assessing the macro-prudential policy framework in Singapore.

2 EMEAP is a cooperative organisation of central banks and monetary authorities in the East Asia and Pacific region.

Implementation of Basel standards in Hong Kong

Capital standards

On 27 January 2017, the HKMA announced a jurisdictional Countercyclical Capital Buffer (CCyB) for Hong Kong at a rate of 1.875% (reflecting the Basel III phase-in provisions), effective from 1 January 2018. On 10 January 2018, the HKMA increased the CCyB rate for Hong Kong to 2.5% with effect from 1 January 2019. In line with the Basel Committee's framework for dealing with domestic systemically important banks (D-SIBs), the HKMA announced in December an updated list of D-SIBs for 2018, together with their corresponding higher loss absorbency capital requirements, to take effect from 1 January 2019.

Countercyclical Capital Buffer

1.875% effective from 1 January 2018

2.5% effective from 1 January 2019

The Banking (Capital) (Amendment) Rules 2017 were introduced to implement three capital standards of the Basel Committee scheduled to take effect on 1 January 2018. These cover a revised securitisation framework, the Basel III leverage ratio, as well as an interim treatment of expected loss provisions by banks under the International Financial Reporting Standard 9 (IFRS 9), which was implemented on 1 January 2018 locally as the Hong Kong Financial Reporting Standard 9.

To align with the implementation progress of other major markets, the HKMA considered it appropriate to defer the local implementation of three other capital standards of the Basel Committee, tentatively to not earlier than 1 January 2019, as opposed to the original target date of 1 January 2017. These include the standardised approach for measuring counterparty credit risk exposures, the capital requirements for bank exposures to central counterparties and the capital requirements for banks' equity investments in funds. The HKMA will continue to engage the industry with the preparatory work for implementing these standards.

Interest rate risk in the banking book

In April 2016, the Basel Committee issued new standards on interest rate risk in the banking book, fundamentally updating its earlier 2004 principles on this important risk category. The new standards continue to follow an "outlier-based" Pillar 2 approach, but include a more sophisticated and comprehensive set of measures to identify banks with significant exposures to interest rate risk in their banking books. The HKMA consulted the industry on its planned approach for local implementation of the standards in June 2017, and decided to revise the original implementation date of 1 January 2018 in order to allow banks more time to update their systems. The local implementation of the standards is expected to be finalised in 2018.

Disclosure standards

Further to the implementation of the first phase of the Basel Committee's revised Pillar 3 disclosure requirements earlier in 2017, the HKMA took steps to prepare for the implementation of the second phase of the revised requirements, as set out in the *Pillar 3 disclosure requirements – consolidated and enhanced framework* issued by the Basel Committee in March. These revised disclosure requirements seek to promote market discipline through enhanced disclosure of banks in terms of user-relevance, consistency and comparability of disclosed information. The HKMA consulted the industry on its policy proposals for implementing the second phase of the revised requirements and undertook preparatory work for the amendment of the Banking (Disclosure) Rules (BDR) to incorporate the requirements.

Liquidity standards

The Banking (Liquidity) (Amendment) Rules 2017 were introduced to implement the Net Stable Funding Ratio (NSFR). Effective from 1 January 2018, AIs designated as "category 1 institutions" under the Banking (Liquidity) Rules will be required to observe the NSFR requirements. AIs designated as "category 2A institutions" will be required to observe a local Core Funding Ratio (CFR), which is a modified version of the NSFR.

Exposure limits

The HKMA is working on the local implementation of the Basel Committee's *Supervisory framework for measuring and controlling large exposures* (April 2014), which consists of a comprehensive minimum standard for internationally active banks and is designed as a simple backstop to complement the Basel III risk-based capital standard. In this regard, the Banking (Amendment) Bill 2017 was passed by the Legislative Council (LegCo) in January 2018 to implement the latest international standards on exposure limits. Taking the opportunity, outdated provisions on exposure limits in the BO will also be revised to keep pace with market developments and the contemporary risk management practices of the industry. During the year, the HKMA conducted quantitative impact studies to calibrate the revised limits to be set out in the new rules.

Improving Supervisory Policy Framework

Corporate governance and risk controls

In October, the HKMA issued three revised Supervisory Policy Manual (SPM) modules relating to corporate governance and risk controls, namely "Corporate Governance of Locally Incorporated Authorized Institutions", "Risk Management Framework" and "Internal Audit Function", to reflect the latest international standards.

Regulation of OTC derivatives transactions

On 1 March, a new SPM module, "Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards", took effect to introduce global margin and risk mitigation standards for AIs involved in non-centrally cleared OTC derivatives (NCCD) transactions. These global standards, developed by the Basel Committee and IOSCO, are designed to reduce counterparty credit risk and limit contagion by ensuring collateral is available to offset losses following the default of a derivatives counterparty, promote legal certainty over the terms of derivatives contracts, and facilitate the timely resolution of disputes.

Following a six-month transitional period, the margin requirements under the new SPM module were fully implemented on 1 September. Based on a subsequent survey conducted by the HKMA, the results showed that a vast majority of the AIs experienced a smooth transition to the new regime and did not face any notable difficulties to comply with the required margin exchange.

One key element of the regime is "substituted compliance". This allows AIs to follow foreign margin standards instead of those set out in the HKMA's SPM module, thereby ensuring that cross-border transactions are not subject to duplicative or inconsistent requirements. As a general principle, substituted compliance is available if the HKMA has issued a comparability determination in relation to a foreign jurisdiction's margin and/or risk mitigation standards. However, all other member jurisdictions of the Basel Committee-IOSCO Working Group on Margin Requirements are deemed comparable from the day the respective standards entered into force in their jurisdictions, because of their implementation of, or general intention to implement, the Basel Committee-IOSCO margin framework.

Other jurisdictions have also introduced substituted compliance in their regimes, some of which required the issuance of formal comparability determinations for overseas rules. In 2017, the Australian Prudential Regulation Authority and the Japanese Financial Services Agency announced the comparability of the HKMA's margin framework, allowing Australian and Japanese covered entities to avail themselves of substituted compliance in respect of the HKMA's margin requirements.

Counterparty credit risk management

In September, the HKMA consulted the industry on revisions to the SPM module on "Counterparty Credit Risk Management". The primary objective of the revisions is to bring the guidance in line with the latest capital treatment and risk management practices of counterparty credit risk arising from derivatives contracts and securities financing transactions.

Recovery planning

The Monetary Authority used to rely on information-gathering powers under the BO to require AIs to prepare recovery plans. To provide for greater transparency and certainty in respect of the recovery planning requirements, and to better align with international standards set by the FSB in its "*Key Attributes of Effective Resolution Regimes for Financial Institutions*", the Banking (Amendment) Bill 2017, which was passed by LegCo in January 2018, added a new Part XIIA to codify the recovery planning requirements.

During the year, the HKMA also published further guidance on the application of the HKMA's recovery planning requirements for overseas incorporated AIs with branch operations in Hong Kong and smaller locally incorporated AIs.

Updating other supervisory policies and risk management guidelines

The HKMA updated the SPM module on "Competence and Ethical Behaviour" in December to reflect the latest developments in enhancing training programmes for banking practitioners in Hong Kong as well as to update the guidance on promoting good ethical behaviour. Furthermore, the HKMA consulted the industry on a technical update of the SPM module on the validation of risk-rating systems under the internal ratings-based (IRB) approach for credit risk.

Banking Stability

Compliance with regulatory regime for OTC derivatives market

The HKMA monitors AIs' and approved money brokers' (AMBs) compliance with the mandatory reporting and related record keeping requirements on OTC derivatives transactions stipulated in the SFO. The Phase 2 mandatory reporting requirements commenced on 1 July, expanding the reporting scope to cover transactions in product types under five asset classes, namely interest rate, foreign exchange, equities, credit and commodities; as well as post-trade events and daily valuations of all reported transactions. AIs also commenced mandatory clearing of specified OTC derivatives transactions on the same day. The HKMA had been closely monitoring AIs' and AMBs' compliance with the relevant regulatory requirements and will follow up with AIs and AMBs on matters of compliance concern.

Balanced and responsive supervision

In response to challenges faced by the industry due to fast-evolving market circumstances and new international standards, the HKMA launched a Balanced and Responsive Supervision Programme in order to further enhance the supervisory interface with the banking sector. The aim is to drive a more effective supervisory outcome as well as establish a more conducive environment for banking development as underpinned by a proportionate and risk-based supervisory approach.

Under this Programme, the HKMA conducted a review to optimise the supervisory processes and to build more effective communication with banks on supervisory and compliance practices. A plan was also drawn up to collect feedback from the banking industry regularly to identify possible enhancements to supervisory policies and requirements as well as emerging risks and market trends warranting supervisory attention.

Accounting standards

In response to the implementation of IFRS 9 *Financial Instruments* in 2018, the Basel Committee issued standards on the interim approach and transitional arrangements for the regulatory treatment of accounting provisions in March 2017. The Basel Committee will continue to work on the longer-term approach, taking into account further analysis based on quantitative impact assessments. Domestically, the HKMA finalised the interim regulatory capital treatment of IFRS 9 provisions after consulting the industry in March 2017. The interim approach covers the categorisation of expected credit losses made by AIs under IFRS 9 as general or specific provisions for the purposes of the regulatory capital framework, as well as the interaction between the regulatory reserve requirement and the expected credit losses under IFRS 9.

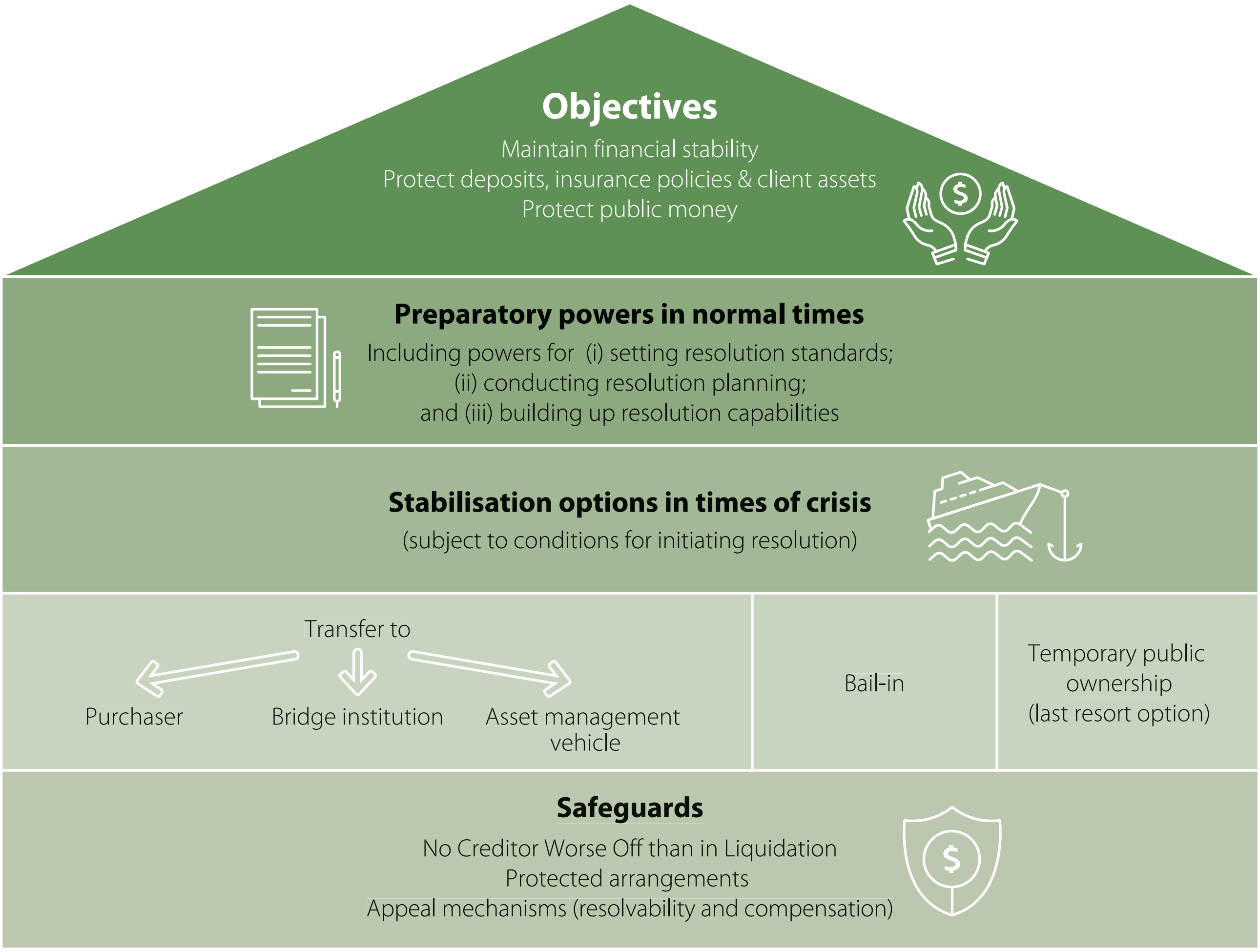
Further to a survey on IFRS 9 implementation conducted with selected AIs in June 2016, the HKMA carried out additional rounds of surveys during 2017 to assess AIs' progress in adopting the new IFRS 9 requirements and the potential impact of IFRS 9 on AIs' key financial figures and regulatory capital ratios. Several rounds of discussions were also held with auditors on AIs' preparation for the implementation of IFRS 9.

During the year, the HKMA continued its regular dialogue with the Banking Regulatory Advisory Panel of the Hong Kong Institute of Certified Public Accountants on topics of common interest. These included international and domestic developments in relation to new or revised accounting, auditing and financial reporting standards and their implications for banks, as well as major international and domestic banking regulatory developments.

Resolution

The Financial Institutions (Resolution) Ordinance (FIRO) came into force on 7 July[3]. It is designed to meet international standards set by the FSB in its *"Key Attributes of Effective Resolution Regimes for Financial Institutions" (Key Attributes)*. The FIRO establishes a cross-sectoral resolution regime in Hong Kong[4], under which the Monetary Authority is the resolution authority for banking sector entities, including all AIs[5]. The FIRO confers statutory powers and responsibilities on the Monetary Authority to manage the failure of a financial institution in an orderly manner in circumstance where such failure could have adverse systemic consequences (Chart 2).

Chart 2 Overview of powers and safeguards under the FIRO



The resolution regime establishes a new line of defence for financial stability, guarding against risks posed to the stability and effective working of the financial system of Hong Kong in the event of the failure of an AI. It also implements an important part of the G20 financial reform package agreed after the global financial crisis and represents a significant addition to Hong Kong's financial safety net and crisis management tools (Chart 3).

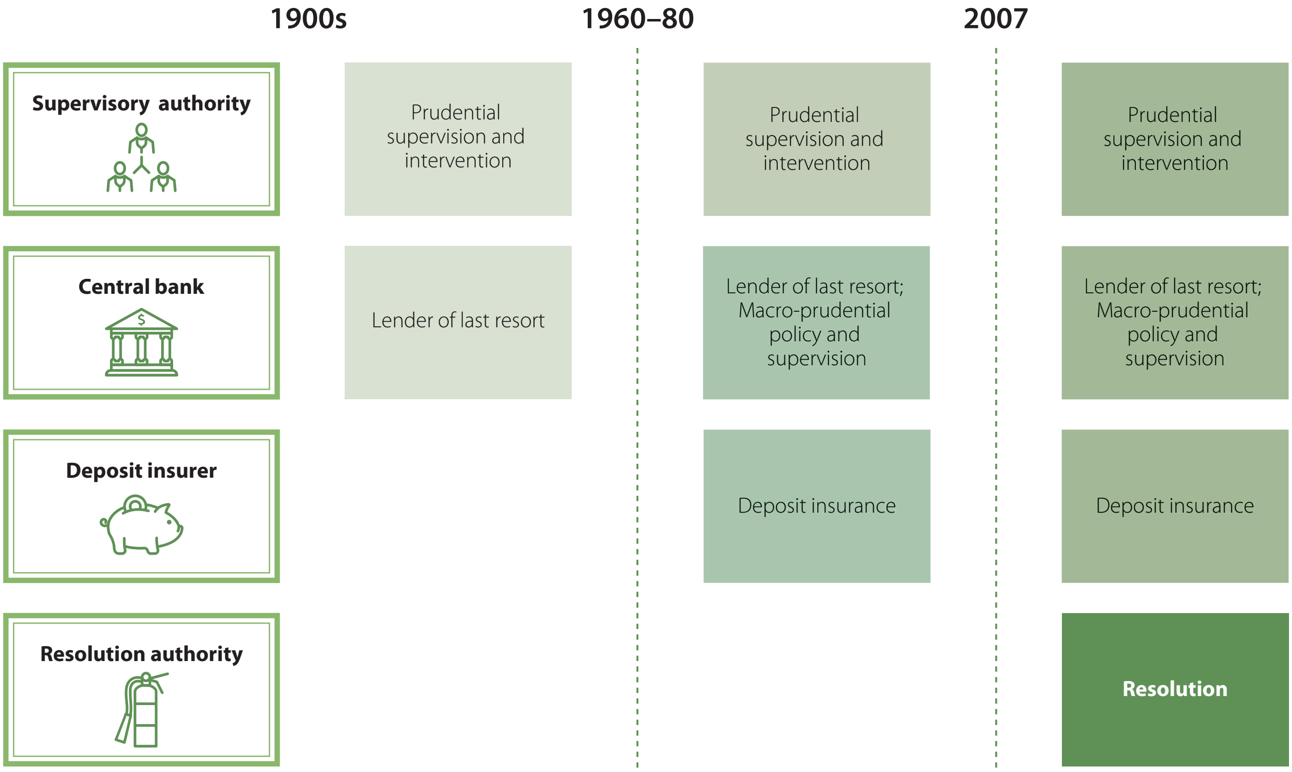
[3] All provisions of the FIRO, except for certain provisions in relation to the clawback of remuneration, the winding-up petition process and consequential amendments to the Insurance Companies Ordinance, came into operation on 7 July. The consequential amendments to the Insurance Companies Ordinance did not come into operation as they were rendered inapplicable owing to the commencement sequence of certain provisions of the Insurance Companies (Amendment) Ordinance 2015 and the FIRO.

[4] Under the FIRO, the Monetary Authority, the SFC and the IA are the resolution authorities for within scope financial institutions under their respective purview.

[5] In addition, the Monetary Authority is the resolution authority for a small number of FMIs which are designated by the Monetary Authority as designated clearing and settlement systems under section 4(1) of the Payment Systems and Stored Value Facilities Ordinance (PSSVFO), other than those which are wholly owned or operated by the Government.

Banking Stability

Chart 3 International evolution of safety net and crisis management tools



This progress has been recognised by the FSB as part of its 2017 peer review of Hong Kong's framework for the resolution of financial institutions. The FSB Peer Review Report[6] confirmed that Hong Kong has legal powers and safeguards related to resolution that are consistent with the requirements of the *Key Attributes* and noted that Hong Kong is *"one of the few FSB jurisdictions with a fully cross-sectoral resolution regime"*.

The Monetary Authority's function as a resolution authority

Under the FIRO, the Monetary Authority is the resolution authority for all AIs. In addition, the Monetary Authority is designated by the Financial Secretary as the lead resolution authority for each of the existing cross-sectoral groups[7] in Hong Kong that include banking sector entities within the scope of the FIRO. Accordingly, the Monetary Authority has lead responsibility for resolution planning and, if needed, resolution execution of these groups in Hong Kong.

The resolution authority function of the Monetary Authority is supported by an operationally independent Resolution Office which was established within the HKMA on 1 April 2017.

Resolution Office

was established within the HKMA on 1 April 2017.

[6] The report of the FSB Peer Review of Hong Kong was published on 28 February 2018.

[7] There is presently a list of 25 cross-sectoral groups of which the Monetary Authority is designated as the lead resolution authority. See the HKMA website.

Since its establishment, the Resolution Office has been working to operationalise the resolution regime in Hong Kong through developing resolution policies, undertaking resolution planning for AIs, building up its resolution capability and communicating actively with the market. The following four sections elaborate on this work to date in more detail.

Resolution policy, standards and guidance

In order for resolution to be both feasible and credible, each financial institution needs to be organised and managed during normal times in a way that facilitates effective use of the stabilisation options in the event of its failure. Pursuant to the FIRO, the Monetary Authority may publish guidance about any matter relating to the functions given to it as a resolution authority by the FIRO, including the communication of resolution standards which AIs are expected to meet.

To this end, on the same day that the FIRO came into operation, three Code of Practice (CoP) chapters under the FIRO were published, namely 1) Core Information Requirements for Resolution Planning, 2) The HKMA's Approach to Resolution Planning, and 3) Operational Independence of the Monetary Authority as Resolution Authority. See *"Development of resolution standards and guidance in Hong Kong"* below for more details.

Development of resolution standards and guidance in Hong Kong

Core information requirements for resolution planning

Following two rounds of industry consultations, the HKMA issued a CoP chapter under the FIRO entitled *Core Information Requirements for Resolution Planning (CI-1)*, which specifies the core information for resolution planning that AIs will be expected to provide. The HKMA has since requested core information from AIs in phases, starting with those AIs which are considered to have more significant potential impact on financial stability in Hong Kong should they fail.

Operational independence of the Monetary Authority as resolution authority

The *Key Attributes* set out a number of attributes that a resolution authority should have, one of which is "operational independence" consistent with its statutory responsibilities, transparent processes, sound governance and adequate resources. The CoP chapter entitled *Operational Independence of the Monetary Authority as Resolution Authority (RA-1)* describes the measures that have been taken to ensure the Monetary Authority is operationally independent as a resolution authority under the FIRO.

The HKMA's approach to resolution planning

The development of a feasible and credible resolution strategy is needed to facilitate effective use of resolution powers in the event of an AI's failure. To this end, resolution planning is carried out to determine a preferred resolution strategy for an AI, which will then be developed into an operational plan for the AI. The CoP chapter entitled *The HKMA's Approach to Resolution Planning (RA-2)* provides guidance to the industry on the HKMA's approach in this respect in relation to AIs.

Banking Stability

In developing future resolution standards for AIs to address barriers to resolvability, the Monetary Authority will have regard to the resolution guidance and standards published by the FSB and international standard-setting bodies (Chart 4).

Chart 4 Common barriers to resolvability of systemic banks – international policy development

Barrier to resolvability	International policy development
1. Insufficient external and internal loss-absorbing capacity	◉ FSB Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution & TLAC Term Sheet ◉ FSB Guiding Principles on the Internal TLAC of G-SIBs
2. Inability to maintain operational continuity in resolution	◉ FSB Guidance on Arrangements to Support Operational Continuity in Resolution
3. Inability to avoid early termination of financial contracts	◉ ISDA Universal Resolution Stay Protocol ◉ ISDA Jurisdictional Modular Protocol
4. Inability of valuation systems to meet resolution valuation requirements	◉ FSB Principles on Bail-in Execution Consultation
5. Inability to meet funding need in resolution	◉ FSB Guiding Principles on the Temporary Funding Needed to Support the Orderly Resolution of a G-SIB ◉ FSB Funding Strategy Elements of an Implementable Resolution Plan Consultation
6. Inability to maintain access to payment, clearing and settlement services from FMIs & banks	◉ FSB Guidance on Continuity of Access to FMIs for a Firm in Resolution
7. Bail-in execution preparedness	◉ FSB Principles on Bail-in Execution Consultation

The HKMA has been actively involved in the formulation of many of these international resolution standards through its membership of the FSB – see "*HKMA's contribution to international resolution policy development*" below for more details on the HKMA's participation in FSB-related policy work during 2017.

HKMA's contribution to international resolution policy development

The significant presence of global and regional banking groups in Hong Kong and the continued expansion of some locally incorporated AIs in the region mean that effective resolution relies heavily on internationally harmonised resolution policies and standards.

As a result, through its membership of the FSB, the HKMA continued its active involvement in the formulation of international resolution standards focused on solving the "Too Big To Fail" problem. The HKMA is a member of the FSB Resolution Steering Group and the FSB CBCM Group for banks, which are responsible for overseeing and developing resolution standards and monitoring their implementation by systemically important financial institutions.

The HKMA chaired the FSB Legal Experts Group and co-chaired the FSB CBCM Internal Total Loss-Absorbing Capacity (TLAC) Workstream, both of which completed their agreed mandates and objectives in 2017. The HKMA also participated in expert working groups under the CBCM Group on bail-in execution, funding and public disclosure, and contributed to the work of CBCM workstreams on the continuity of access to FMIs and solvent wind-down.

The HKMA attended ten international meetings of the aforesaid FSB groups in 2017, a number of which were organised by the HKMA and took place in Hong Kong. A range of guidance and consultation papers were published by the FSB in the year, including on internal TLAC, bail-in execution, funding strategy, continuity of access to FMIs and central counterparty resolution and resolution planning. These continued to facilitate consistent implementation of measures by authorities to address the "Too Big To Fail" problem and informed the development of resolution standards and guidance in Hong Kong.

The HKMA's policy priorities were informed by the FSB's resolution standards. Following the HKMA's finalisation of core information requirements for resolution planning, the HKMA prioritised work on addressing two barriers to resolution in 2017: insufficient loss-absorbing capacity (LAC) and disorderly exercise of early termination rights.

On the first barrier, the HKMA has been working to develop policy proposals in relation to LAC requirement rules for AIs under the FIRO. Ahead of launching a public consultation in January 2018, the HKMA published a *Quarterly Bulletin* article in 2017 to explain the importance of making LAC requirements and set out some of the key policy design questions. A quantitative impact study and bilateral discussions with relevant stakeholders were conducted as part of the LAC policy development process.

On the second barrier, the HKMA has been developing its policy thinking on regulating stays on early termination rights and working with the International Swaps and Derivatives Association, Inc. (ISDA) on addressing this barrier locally. To this end, an important step towards removing this barrier locally was achieved with ISDA's publication of the *Hong Kong Country Annex* to the *ISDA 2015 Universal Resolution Stay Protocol (ISDA Protocol)* in December 2017. The *Hong Kong Country Annex* extends the coverage of the *ISDA Protocol* to the Hong Kong resolution regime and represents an important step towards meeting an international commitment to reducing the risks associated with the disorderly early termination of certain financial contracts of G-SIBs in resolution.

The *ISDA Protocol* (and the *Country Annex*) will not, however, eliminate entirely the risk to orderly resolution of a disorderly exercise of early termination rights in financial contracts. To this end, the HKMA expects to develop rules pursuant to the relevant rule-making power under the FIRO to require broader adoption of contractual recognition of stays, and intends to consult on the relevant policy proposals in 2018.

Resolution planning for authorized institutions

In 2017, the HKMA continued to advance its structured bilateral resolution planning programmes with certain D-SIBs that could pose the greatest systemic risk in Hong Kong should they fail. This work is carried out in close co-ordination with the relevant home and host authorities. Considerable progress was made by these AIs to implement structural changes to their legal, financial and operational arrangements in order to enhance the feasibility and credibility of the authorities' preferred resolution strategies. Examples include changing legal holding structure, issuing debt instruments, setting up dedicated service companies and incorporating resolution-proof clauses into internal and external service agreements.

Further to the publication of the aforesaid CoP chapter on *CI-1*, the HKMA began rolling out the requirements to AIs by phases, starting with the D-SIBs at the time the requests were made in 2017.

On cross-authority co-ordination, the HKMA led regional resolution planning for a G-SIB which has its Asia Pacific headquarters in Hong Kong, including through the organisation of an annual Asian crisis management group (CMG) meeting for the relevant home and host authorities in the region.

In addition, the HKMA continued to participate in cross-border resolution planning of 12 G-SIBs through its membership of CMGs, critically assessing the progress made by these G-SIBs in addressing impediments to resolvability and ensuring local specificities were taken into account.

Operational capacity

Substantial progress was made in 2017 to build up the HKMA's operational capacity as a resolution authority. For instance, a cross-departmental organisational governance structure and framework has been developed to co-ordinate the management of systemic crises involving failure of an AI. A framework to provide early warning signals to trigger contingency planning for at-risk AIs was established between banking supervision and resolution functions. In addition, an operational framework for assessing the conditions for the initiation of resolution of AIs was developed. Finally, the HKMA will continue to use drills and simulation exercises to further strengthen its operational readiness for managing failure of an AI in an orderly manner.

Banking Stability

Resolution Office's engagement with the industry and regional authorities

The HKMA maintained close communication with the banking industry in relaying and explaining resolution standards and its approach to resolution planning, through meetings with the management of AIs and joint workshops with industry associations. The HKMA is also committed to promoting the understanding of AIs' counterparties of the implications of the entry into resolution of an AI should it fail and the impact of resolution standards and resolution planning on AIs during normal times. Similar engagement with investors would also facilitate their understanding of risks underlying their financial investments and the safeguards available under the resolution regime.

The HKMA has also employed various communication channels to raise awareness of the resolution regime in Hong Kong more widely. In August, further to the commencement of the FIRO, a workshop was held with the press on the resolution regime in Hong Kong. In addition, the Chief Executive of the HKMA published an *inSight* article in the same month which explained the importance of the resolution regime to banking stability.

The HKMA took part in and spoke at various industry events, such as conferences of RiskMinds, ISDA and the Financial Stability Institute. In addition, the HKMA has continued its focused bilateral engagements with relevant market stakeholders, including rating agencies, law firms, industry bodies and LegCo members, in relation to the resolution regime in Hong Kong.

Roundtable discussion with the press about resolution.

Regulator's Dialogue with the industry on resolution.

To facilitate the development of harmonised resolution regimes in the Asia Pacific region, the HKMA also continued to strengthen its relationship with authorities in the region on resolution policies and firm-specific resolution planning matters. In 2017, these included bilateral dialogue, knowledge sharing and co-operation with authorities from a number of jurisdictions, including Indonesia, Mainland China, Malaysia, Singapore, South Korea and Thailand. On a multilateral level, the HKMA participated in regional forums, such as the EMEAP, and shared its experiences in establishing a *Key Attributes*–compliant resolution framework.

Bank consumer protection

Code of Banking Practice

The industry's overall compliance with the Code of Banking Practice (the Code) remains satisfactory. The industry has completed a self-assessment exercise covering the period from 6 February to 31 December 2016, which was the first self-assessment conducted by AIs since the revised edition of the Code became effective on 6 February 2015. AIs' subsidiaries and affiliated companies controlled by them, which are not AIs and are not licensed, regulated or supervised by any financial regulators in Hong Kong, should also observe the revised Code when providing banking services in Hong Kong, where applicable. According to the self-assessment results, almost all AIs as well as their subsidiaries and affiliated companies reported full or nearly full compliance[8], while a few AIs have taken prompt remedial action, mainly to improve their policies and procedures.

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

In February, the HKMA issued a circular to all AIs amending the relevant sections of the Code on legal expenses in preparing mortgages and fire insurance for mortgaged properties and clarifying the supervisory expectations in relation to these provisions, as enquiries and complaints indicated that some AIs may not fully appreciate the policy intention, which is to enhance transparency of the legal expenses and maintain flexibility in providing options of the insured amount.

In December, AIs on the Code of Banking Practice Committee, with the support of HKAB and the Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies, submitted an application to the Competition Commission for a decision to exclude compliance with the Code from the ambit of the First Conduct Rule of the Competition Ordinance, so as to seek clarity and legal certainty that the customer protection objective of the Code provisions is consistent with that of competition requirements. Meanwhile, the HKMA reminded all AIs that they were still required to fully comply with the Code, which was important for customer protection.

Financial inclusion

The HKMA has been encouraging the banking industry to put the spirit of financial inclusion into practice when developing their banking networks. The industry responded positively with a plan to establish a total of ten branches and three mobile branches in remote areas and public housing estates. Six of the branches and all three mobile branches were set up by the end of the year. The industry has also worked out an arrangement with EPS Company and a convenience store chain to launch in early March 2018 a pilot initiative that allows the elderly to withdraw cash via EPS at any of the 34 convenience stores of the chain in remote areas, without the need to make purchases. Subject to the effectiveness of the pilot scheme, the target is to expand the service to most of the outlets of the convenience store chain by the end of 2018.

6 physical branches and
3 mobile branches launched in remote areas and public housing estates.

HKMA Chief Executive, Mr Norman Chan, tries out a video teller machine.

HKMA Chief Executive, Mr Norman Chan, presents a bank counter specially designed at a lower height to facilitate access by people with disabilities.

As part of its efforts to promote financial inclusion, the HKMA has been encouraging retail banks, in providing basic banking services to the public, to pay special attention to customers in need. During the year, the HKMA worked with the banking industry to further enhance accessibility of basic banking services to customers with disabilities, and hosted a sharing session in October for representatives of disabled groups and retail banks to exchange views on barrier-free banking services. In addition, the HKMA worked together with HKAB and the Equal Opportunities Commission to enhance the transparency of information to help ethnic minority customers better understand their rights and responsibilities when using banking services, as well as to jointly publish information on banking services in seven languages commonly used by the ethnic minority community in December.

Opening and maintaining bank accounts

The progressive tightening of international standards to combat ML and TF has led to a strengthening of banks' AML/CFT systems and controls over the past few years. It is important that banks' AML/CFT controls operate effectively and efficiently, and do not pose an unreasonable barrier to bona fide businesses and the public when seeking access to banking services. To achieve this objective, the HKMA continued to work closely with the banking industry and the business community on the issue of account opening and maintenance, providing guidance and clarity around the expectation that banks should manage both their risks and their customer relationships effectively and that CDD requirements should be proportionate with respect to a customer's background, circumstances and likely ML/TF risk, rather than apply a "one-size-fits-all" approach.

In order to provide more comprehensive information relating to bank account opening and maintenance, and to collect views as well as to answer related enquiries from the public, business communities as well as other stakeholders, the HKMA set up a dedicated webpage on its website in March and launched a dedicated email account (accountopening@hkma.gov.hk) to facilitate bank customers' submission of enquiries and feedback to the HKMA. The HKMA webpage contains information about account opening and maintenance procedures, documentation and information requirements, and the contact details of banks. It also features a "What's New" section that provides information on the latest initiatives of banks, what banks should not do, in addition to other useful tips. Since the launch of the HKMA's dedicated webpage and email account, useful feedback and comments have been received and followed up by a dedicated team at the HKMA.

Dedicated email account

accountopening@hkma.gov.hk

To enhance communication with the business community and other stakeholders, the HKMA jointly organised with InvestHK and the Trade and Industry Department two rounds of briefing and networking sessions in April and June respectively. The sessions provided useful platforms for sharing with chambers of commerce, local small and medium-sized enterprise (SME) associations and professional organisations on the changing international landscape and various improvement measures introduced by banks, and for gathering customer feedback. HKAB also reached out to the business community, for example, by taking part in a seminar on SME banking services in April to promote banking services available for SMEs. A number of banks reached out to the chambers of commerce to share their policies and practices on account opening and maintenance.

Positive feedback has been received from chambers of commerce and the local business community about the efforts in addressing the account opening and maintenance issue. In addition to the improvement measures introduced last year, banks have taken further steps to enhance the account opening process and customer experience. For example, all retail banks provide a "pre-vetting" service, in which banks accept applicants' submissions of account opening documents via email, fax or mail for initial pre-screening or pre-assessment by the banks before arranging face-to-face meetings with the applicants, with a view to providing greater convenience to applicants. Some banks have also set up dedicated hotlines and dedicated branches resourced with properly trained front-line staff members to handle account opening related matters, so as to improve customer experience. As front-line staff members are the first point of contact with customers, the HKMA requires banks to properly train their front-line employees to equip them with sufficient technical knowledge and experience in dealing with the account opening process and in communicating with potential customers in a user-friendly manner. Some banks have made changes to how they interpret AML/CFT requirements to better reflect the risk-based approach.

Opening and maintaining bank accounts (continued)

On average about **10,000** new business accounts were opened per month, of which some **60%** to **70%** relating to SMEs and start-up companies.

The retail banking sector opens on average about 10,000 new business accounts per month, of which some 60% to 70% relating to SMEs and start-up companies. Of the successful cases, on average some 50% to 60% were able to open accounts within two weeks, and that some accounts could even be opened as quickly as within a few days. The actual timeframe would naturally depend on the complexity of individual cases and the availability of the necessary information required of the applicants. In fact, the average unsuccessful rate of account opening applications excluding an outlier, is below 5%, representing a substantive improvement in customer experience.

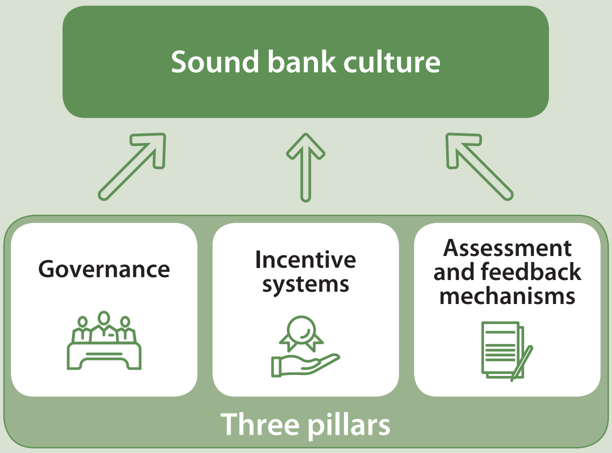
While there are indications that customer experience has improved, the HKMA sees the need to sustain its work in this area. It has commenced a mystery shopping programme relating to the account opening processes of banks in Hong Kong, to assess the effectiveness of measures adopted by AIs in improving customer experience. The HKMA is also conducting a round of thematic reviews on the application of AML/CFT requirements during the customer on-boarding process of SME segment with a view to identifying issues and good practices for sharing with the industry. Meanwhile, the HKMA continues to encourage the banking industry to utilise new technology, such as remote onboarding and KYCU, which may introduce greater efficiency to CDD processes, reduce unnecessary compliance burden and, as a result, improve the customer experience.

The HKMA will continue to work with the banking industry, business community and relevant stakeholders to deal with this global and complex issue. The HKMA's aim is to maintain a robust AML/CFT regime in Hong Kong that does not undermine access by legitimate businesses and ordinary citizens to basic banking services.

Bank culture

In recent years, while considerable efforts have been made globally by banking supervisors and senior management of banks in enhancing standards and practices in respect of governance and the risk management framework, it is increasingly recognised that much more needs to be done to promote a sound culture at all levels of banks. In particular, although banks have generally adopted practices to promote a proper culture, cases involving undesirable behaviour of staff, which very often affects the interests not only of the institutions concerned but also of customers, continue to happen in various places round the world. This signifies the need for banks to further improve the effectiveness of culture enhancement initiatives so that banks put their safety and soundness as well as the interests of depositors and customers at the centre stage in the pursuit of commercial interests.

The HKMA initiated a bank culture reform in March to develop and promote a sound corporate culture that supports prudent risk management and contributes towards incentivising proper staff behaviour that will lead to positive customer outcomes and high ethical standards in the banking industry. While there is no "one-size-fits-all" approach, the HKMA expects AIs to adopt a holistic and effective framework to foster a sound culture within the institution. Particular attention should be given to the three pillars for promoting a sound bank culture, namely governance, incentive systems as well as assessment and feedback mechanisms.



On governance, the HKMA expects board and senior management to set an appropriate "tone from the top" and lead by example to ensure that the AI's desired culture is understood and shared by all levels of staff. An AI and its staff must internalise good culture and values in such a way that they behave properly not because they are afraid of being caught and punished, but because they believe it is unethical to do otherwise. In practice, AIs should have a dedicated board-level committee chaired by an independent non-executive director (INED) to focus on culture-related matters.

A good incentive system, covering staff recruitment, performance management, remuneration and promotion, should not only reward good business performance but also take into account adherence and non-adherence to the institution's cultural and behavioural standards, with a view to avoiding incentivising short-term business performance at the expense of the interests of customers and the safety and soundness of the institution. It should also promote the alignment of the interests of owners, managers, customers and public stakeholders.

At the same time, the "tone from the top" should go hand in hand with an "echo from the bottom". The HKMA expects AIs to put in place an interactive feedback loop and different metrics, such as customer surveys and mystery shopping programmes, to assess the actual behaviour of management and staff on the ground. There should be an effective escalation policy within the institution, including a whistle-blowing mechanism, to allow timely reporting of any illegal, unethical or questionable practices observed by staff and stakeholders in a confidential setting without the risk of reprisal. Results from such assessment and feedback mechanisms provide useful feedback which should be reported to senior management and the board-level committee to help them consider whether further enhancements are necessary.

AIs are required to review their governance arrangements as well as policies and procedures in relation to corporate culture and implement the necessary enhancement measures.

Engagement of intermediaries by authorized institutions

Various measures were introduced to help further protect the interests of bank customers and reduce the potential risks to the reputation of the banking industry arising from possible malpractices by fraudulent lending intermediaries. In particular, following the HKMA's reminders to the public to stay alert to bogus phone calls, retail banks' hotlines have been widely and effectively used by the public to verify callers' identities, with a total of about 1,400 to 2,200 enquiries received each month. Retail banks have also implemented the improvement measure of showing the educational message of responsible borrowing – "To borrow or not to borrow? Borrow only if you can repay!" – on all advertisements in relation to their lending business to retail customers and SMEs.

Enhancing customer communication regarding Automatic Exchange of Financial Account Information in Tax Matters (AEoI)

In the light of the implementation of the AEoI regime in Hong Kong, which also requires the co-operation of bank customers, particularly in terms of information collection and updating, the HKMA has worked with and closely guided the banking industry in developing an AEoI fact sheet which aims at addressing likely questions that bank customers may raise. The AEoI fact sheet can be found on the respective websites of HKAB, the PWMA and the HKMA.

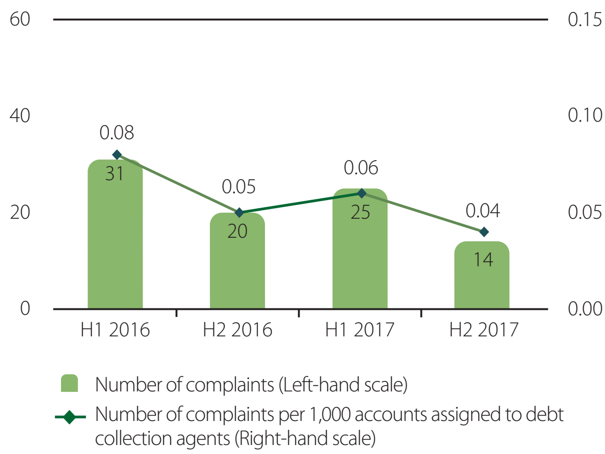
Credit data sharing

At the end of 2017, 112 AIs and AI subsidiaries shared commercial credit data through the Commercial Credit Reference Agency. The scheme contains the credit data of more than 118,100 business enterprises, about 14% of which were sole proprietorships and partnerships. In the light of market development and practical experience, the commercial credit database was expanded in December to cover more non-listed limited companies with an annual turnover of up to HK$100 million, from the previous threshold of HK$50 million. The expanded coverage of the database would further enhance its comprehensiveness and relevance, which helps strengthen the credit risk management capacity of AIs.

Customer complaints relating to debt collection agents employed by authorized institutions

The number of complaints received by AIs about their debt collection agents decreased to 39 from 51 in 2016 (Chart 5). The HKMA will continue to monitor AIs' engagement with debt collection agents.

Chart 5 Complaints received by AIs about their debt collection agents



Deposit protection

The Deposit Protection Scheme (DPS) continued to provide protection to each depositor up to a limit of HK$500,000 per bank.

A full-scope payout rehearsal was conducted in the fourth quarter of 2017 to test the capability of the Hong Kong Deposit Protection Board and its network of service providers in meeting the new target payout timeframe under a gross payout approach. The results illustrated that the target of making compensation payments to the majority of eligible depositors within seven days could be met. The Board has also commenced a two-year payout system modernisation project to further improve the resilience and performance of the payout system and expects to complete the project by the end of 2018.

To reinforce public awareness and understanding of DPS protection, a multi-media publicity campaign with a new thematic TV commercial, *Everyone Can Save with Confidence*, was launched. An integrated communication campaign with advertisements on various media and channels was conducted to reach audiences from different walks of life.

Banking Stability

Licensing

At the end of 2017, Hong Kong had 155 licensed banks, 19 restricted licence banks, 17 deposit-taking companies and 16 AMBs. During the year, the HKMA granted a banking licence to one foreign bank. Two licensed banks and three restricted licence banks had their authorizations revoked.

Enforcement

Banking complaints

The HKMA received 1,786 complaints about AIs and their staff members in 2017 and completed the handling of 1,885 cases, a 9% year-on-year increase. At the end of the year, the total number of outstanding cases was 456 (Table 5).

Table 5 Banking complaints received by the HKMA

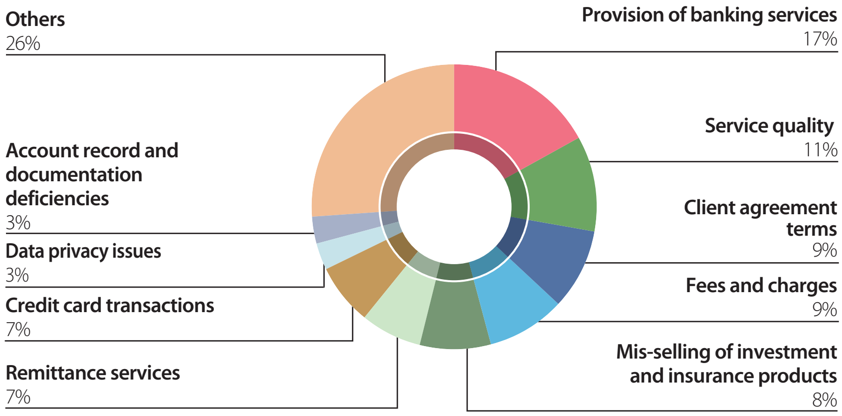
	2017			2016
	Conduct-related issues	General banking services	**Total**	Total
In progress on 1 January	243	312	**555**	539
Received during the year	237	1,549	**1,786**	1,745
Completed during the year	(380)	(1,505)	**(1,885)**	(1,729)
In progress on 31 December	100	356	**456**	555

Complaints concerning the provision of banking services increased by 29% over the year to 299 cases in 2017. The majority of complaints in this category concerned the freezing and closure of accounts. In a number of these cases, banks decided to close the accounts because suspicions were aroused during ongoing monitoring processes, or because the customers were not able to provide adequate information for account maintenance purposes. There were also cases in which the accounts were subsequently maintained after relevant information was provided by customers to address banks' concerns. Information suggests that the situation is not an industry-wide phenomenon and that most complaint cases are related to individual international banking groups. The HKMA has required the banking groups concerned to review their policies and procedures as well as undertake measures to improve the execution and customer communication issues revealed by the cases.

Complaints concerning remittance services also rose by 93%, from 68 cases in 2016 to 131 cases in 2017. The major allegations in these complaints included delays due to the more comprehensive CDD measures taken by originating or beneficiary banks, processing errors and issues related to counterparty banks.

Complaints related to the mis-selling of investment and insurance products decreased by 11% to 146 cases, mainly due to a drop in complaints about the mis-selling of investment products, including foreign exchange accumulators (Chart 6).

Chart 6 Types of services or products concerned in banking complaints received by the HKMA



Enforcement actions

Enforcement of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO) continued to be a priority, with a number of cases under investigation during the year. In April, the HKMA issued a public reprimand and imposed a pecuniary penalty of HK$7 million on a bank for contraventions of the AMLO. The investigation found deficiencies in the bank's AML/CFT systems and controls for managing business relationships with politically exposed persons (PEPs)[9].

Enforcement work has also reflected and reinforced the HKMA's efforts in promoting bank culture reform and high ethical standards in the banking industry. In September, the HKMA suspended the registration of a relevant individual (Rel) following an investigation which found the Rel had completed six sets of Individual Financial Statements for two personal guarantors of a corporate client without their consent and without verifying the accuracy of all the information therein, and had forged the signatures of the two personal guarantors on the relevant Individual Financial Statements. The matter was also reported to the relevant law enforcement agency for appropriate follow-up. Separately, following investigation and referrals by the HKMA, the SFC imposed disciplinary sanctions during the year on seven former RelS, ranging from suspension to a life ban, for cases including forgery of customers' signatures and concealment of trading error.

After the HKMA's investigation into the systemic failures of a bank and its referral of the findings to the SFC in relation to the sale of Lehman Brothers-related Notes and Leveraged Forward Accumulators, the bank was fined HK$400 million by the SFC. In addition, the bank's registration for Type 4 regulated activity (advising on securities) was suspended for a period of one year, whilst its registration for Type 1 regulated activity (dealing in securities) was also suspended partially for a period of one year. This followed the decision of the Securities and Futures Appeals Tribunal in November to uphold the SFC's disciplinary actions against the bank.

The HKMA has continued to investigate or otherwise follow up on issues arising from banking complaints or examinations during the year that raised possible concerns regarding compliance with laws and regulatory requirements and fitness and properness. This has resulted in the referral of 39 cases to the relevant financial regulators for appropriate action, the issuance of 101 compliance advice letters to AIs and their staff members who were found not to have acted in full compliance with the relevant regulatory requirements, and other supervisory outcomes. In 2017, the HKMA also collaborated with the SFC in relation to investigation work and continued its close co-operation and dialogue with other local financial regulators on issues of mutual interest.

9 PEPs are individuals whose prominent positions in public life may make them vulnerable to corruption and they therefore pose a higher risk of ML.

Banking Stability

The Ombudsman's Grand Award

The HKMA received the Grand Award of The Ombudsman's Awards 2017, after receiving a runner-up prize in the Ombudsman's Awards 2012. The Award is a recognition of the HKMA's positive and pragmatic approach in formulating an effective complaint handling mechanism which has improved complaint management. The Ombudsman also recognised the HKMA's good efforts in rendering assistance to the Ombudsman in its investigations, including the provision of timely and comprehensive information despite the volume of documents and the complexity of issues involved. The HKMA will continue to use its best endeavours to handle customer complaints against banks, with a view to enhancing investor protection and ensuring that customers are treated fairly by banks.

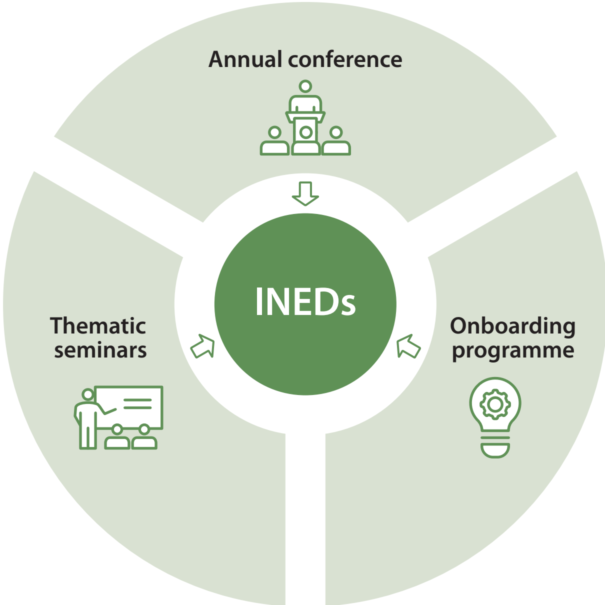
HKMA Chief Executive, Mr Norman Chan (right), receives the Grand Award on behalf of the HKMA from the Ombudsman, Ms Connie Lau.

Complaints Watch

As a continuing initiative to promote proper standards of conduct and prudent business practices among AIs, two issues of *Complaints Watch* were published in 2017, drawing AIs' attention to trends in banking complaints and emerging topical issues. The topics included: determination of the insured amount for fire insurance on mortgaged property; proper and efficient handling of customer complaints by banks; provision of annualised percentage rate of unsecured personal loans by banks; and collection of information in CDD processes.

Capacity building in the banking sector

Director empowerment programme



In March, the HKMA hosted an inaugural conference themed *Cultivating Culture in the Banking Industry in Hong Kong* for INEDs. It was well received by over 100 INEDs from 34 locally incorporated AIs. Distinguished supervisors and market experts joined the conference to share insights on bank culture development.

During 2017, thematic seminars were organised regularly to keep INEDs updated on topical issues in the banking sector and to provide a channel for INEDs to exchange views with industry experts and the HKMA. Examples of topics of mutual interest covered in the seminars included bank culture reform, board practices, banking risks and trade-based AML.

In October, the HKMA launched a new Onboarding Programme for INEDs. The programme provided newly appointed directors with essential practical knowledge about the financial services industry, with a special focus on the evolving landscape and regulatory environment of the banking industry.

The HKMA worked with Hong Kong's Independent Commission Against Corruption (ICAC) to organise a case sharing seminar in November with a special focus on the latest modus operandi and effective detection of corruption cases. Through sharing by senior ICAC officials, bank directors were better equipped to take up a more active role in combating potential corruption and, more importantly, in maintaining a sound value system in the banks they serve.

The HKMA also organised meetings with Hong Kong Interbank Clearing Limited and the Mandatory Provident Fund Schemes Authority to share its views and experiences in empowering INEDs. These authorities were invited to sit in on the seminars for INEDs, to better understand the HKMA's work in director empowerment.

HKMA Deputy Chief Executive, Mr Arthur Yuen (right), discusses with Chief Executive of Financial Conduct Authority, Mr Andrew Bailey, in the First Annual Conference for INEDs.

Talent development for banking practitioners

During the year, the HKMA continued to work closely with the banking industry and relevant professional bodies to develop various modules under the Enhanced Competency Framework (ECF) for capacity building and talent development purposes. Two ECF modules on treasury management and retail wealth management were launched in 2017 after the completion of industry consultations. With support from the working group, comprising seasoned banking practitioners, the development of competency standards for the professional level module of the ECF on AML/CFT was also making good progress.

Since the launch of the core level of the ECF on AML/CFT and the ECF on cybersecurity at the end of 2016, a total of 3,000 banking practitioners had obtained recognised certifications to meet ECF benchmarks under these two workstreams by end-December 2017. This could help enhance the core competency and ongoing professional development of banking practitioners to meet the needs of a continuously changing business environment.

The HKMA organised a Senior Bankers' Seminar jointly with the China Banking Regulatory Commission in Beijing and Langfang in September, with the participation of over 70 senior banking executives. The seminar provided banking executives insights over the developments of Mainland China in areas such as the economy, financial regulations, fintech and international relations.

As a regular training programme, the HKMA has been keeping banking practitioners at all levels updated on the regulatory requirements and the policy intention through Regulator's Dialogue sessions and sharing seminars. In 2017, six seminars were organised on topics such as AML, bank culture reform, banking risks, international standards and resolution regime.

The HKMA is also mindful of developing future talent for the banking sector. During the year, the HKMA and the PWMA launched an apprenticeship programme for private wealth management and organised two rounds of recruitment in April and November. The programme is the first initiative offering full-time students of tertiary institutions funded by the University Grants Committee a multi-year experience dedicated to training in private wealth management, potentially leading to a job offer from the same firm after graduation. Some 80 apprentices were recruited to work in a range of functions such as client services, product design, risk management and compliance.

Enhanced Competency Framework

2016	☑ Anti-money laundering and counter-financing of terrorism
	☑ Cybersecurity
2017	☑ Treasury management
	☑ Retail wealth management
Upcoming	☐ Credit risk management
	☐ Risk management and compliance

Banking Stability

Consumer education

In 2017, the HKMA continued its Consumer Education Programme focusing on how to be smart and responsible financial consumers. The infotainment programme *Financial Wisdom Fighters* on TV was a prelude, highlighting smart tips on using various banking and financial services through artistes competing in a simulated digital battle game.

A poster featuring the infotainment programme "Financial Wisdom Fighters".

As it is common for consumers to use credit cards to make prepayment for services, a thematic campaign was conducted to enhance public awareness and understanding of the credit card chargeback protection, and to remind the public to think carefully before making prepayment. Cross-media promotion via TV, radio, print, internet (including the HKMA website and the HKMA Smart Tips Channel on YouTube), as well as mobile and out-of-home platforms were arranged to disseminate the messages to the public.

A thematic campaign to raise awareness of credit card chargeback protection.

Under the theme of digital financial services, videos regarding online and mobile payment and peer-to-peer fund transfer via smartphones were produced to convey the relevant tips on using these services in a humorous manner. Online and offline promotion were rolled out to reach the public through popular websites and smartphone apps, public transport, cinemas, outdoor TV walls, as well as print media and radio stations.

A video on digital financial services.

During the year, seasonal promotions were conducted to provide timely tips on using different banking and financial services, for example, the smart use of credit cards and ATM cards during festive holidays, and reminders on assessing individual borrowing needs and product suitability before committing to a loan in the tax season. Other initiatives to reinforce public security awareness in using internet banking services and advocate responsible borrowing were also carried out.

An online game to bring out educational messages interactively.

On youth programmes, the HKMA co-organised the "Hong Kong Liberal Studies Financial Literacy Championship" with various stakeholders, to enhance the financial knowledge of secondary school students through an online quiz, a financial experiential game and a live competition. In addition, talks were organised to promote responsible spending and the smart use of banking and related services among senior secondary school and university students.

The HKMA also continued to support the Investor Education Centre in promoting financial literacy in Hong Kong.

Students' financial knowledge is tested via an online quiz and a live competition.

Banking Stability

Oversight of financial market infrastructures

The policy objectives of the HKMA in overseeing FMIs are to promote their general safety and efficiency, limit systemic risk and foster transparency. The aim is to make the FMIs more resilient to financial crises and protect the monetary and financial systems in Hong Kong from possible destabilising effects arising from disruption to the FMIs. The approach taken by the HKMA in overseeing the FMIs under its purview is set out in a policy statement published on the HKMA website.

The PSSVFO 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. The purposes of the PSSVFO include promoting the general safety and efficiency of the designated clearing and settlement systems: the Central Moneymarkets Unit (CMU), the Hong Kong dollar Clearing House Automated Transfer System (CHATS), the US dollar CHATS, the Euro CHATS, the Renminbi CHATS and the Continuous Linked Settlement (CLS) System.

One of the functions of the Monetary Authority is to maintain the stability and integrity of the monetary and financial systems of Hong Kong, including the maintenance and development of Hong Kong's financial infrastructure. In this connection, the HKMA is responsible for overseeing the OTC Derivatives Trade Repository (HKTR). While the HKTR is not a clearing or settlement system and thus not designated as such under the PSSVFO, the Monetary Authority shall ensure that the HKTR is operated in a safe and efficient manner. It is the policy intention of the HKMA to oversee the HKTR in the same way, and applying, where relevant, the same standards as the other designated clearing and settlement systems under its purview. All the designated clearing and settlement systems and the HKTR are treated as FMIs in Hong Kong.

The HKMA adopts international standards in its oversight framework for FMIs. The Committee on Payments and Market Infrastructures (CPMI) of the Bank for International Settlements and the IOSCO Technical Committee published the Principles for Financial Market Infrastructures (PFMI) in 2012. The PFMI constitutes the latest international standards for the oversight of FMIs, including systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories. The HKMA and the SFC jointly issued a policy statement in March 2013 on the adoption of the PFMI for systematically important FMIs in Hong Kong. The requirements under the PFMI are incorporated in the relevant guidelines on designated clearing and settlement systems and trade repository issued by the HKMA.

The HKMA oversees local FMIs under its purview through off-site reviews, continuous monitoring, on-site examinations and meetings with management. All the FMIs continued to comply with the relevant requirements.

International participation

The HKMA is a member of the CPMI and participates in meetings, working groups and forums on FMI oversight matters. It also participates in the CPMI-IOSCO Implementation Monitoring Standing Group, which is responsible for monitoring and assessing the implementation of the PFMI by different jurisdictions.

In addition to participating in the monitoring and assessment of other jurisdictions, the HKMA is also one of the parties being assessed. During the year, the HKMA continued to work with FMIs under its purview to ensure observance of the PFMI. The HKMA has completed the PFMI assessments on FMIs under its oversight. All the FMIs have also published Disclosure Frameworks, which is a key requirement under the PFMI to improve transparency by disclosing system arrangements principle by principle. The PFMI assessment results and Disclosure Frameworks are available on the HKMA website. The level 2 assessment report published by the CPMI-IOSCO in 2017 confirmed that the HKMA had duly implemented the PFMI in its oversight framework, and obtained the highest rating in all relevant principles for the FMIs under its purview.

The HKMA is also a member of the Oversight Forum of the global message carrier SWIFT, which discusses relevant oversight matters and shares SWIFT-related information. Hong Kong's AIs and FMIs use and rely on SWIFT's services and may be exposed to risks in the event of any disruption to SWIFT's operations. During the year, the HKMA attended forum meetings and teleconferences to discuss matters of interest, in particular the customer security framework developed by SWIFT and cybersecurity issues.

The HKMA participates in the international co-operative oversight of the CLS System through the CLS Oversight Committee. The CLS System is a global clearing and settlement system operated by the CLS Bank for cross-border foreign exchange transactions. It enables foreign exchange transactions involving CLS-eligible currencies, including the Hong Kong dollar, to be settled on a payment-versus-payment (PvP) basis. During the year, the HKMA attended various meetings of the CLS Oversight Committee to discuss operational, development and oversight matters.

The HKMA has established co-operative oversight arrangements with the relevant authorities both at domestic and international levels to foster efficient and effective communication and consultation, in order to support one another in fulfilling their respective mandates with respect to FMIs. On the domestic front, the HKMA has signed a Memorandum of Understanding with the SFC. Internationally, the HKMA held discussions with the relevant overseas authorities to further strengthen the co-operative oversight of links between the FMIs in Hong Kong and those overseas. In particular, the HKMA has established co-operative oversight arrangements with overseas regulators for the PvP links between the US dollar CHATS and the Malaysian ringgit, Indonesian rupiah and Thai baht Real Time Gross Settlement systems; and for the various cross-border links between the CMU and its overseas counterparts.

Independent tribunal and committee

An independent Payment Systems and Stored Value Facilities Appeals Tribunal has been established to hear appeals against decisions of the Monetary Authority on licensing and designation matters under the PSSVFO. There has been no appeal since the establishment of the tribunal. An independent Process Review Committee, whose members are appointed by the Chief Executive of the Hong Kong Special Administrative Region, reviews processes and procedures adopted by the HKMA in applying standards under the PSSVFO to systems in which the HKMA has a legal or beneficial interest. The Committee assesses whether the HKMA has applied the same procedures to all designated clearing and settlement systems. The Committee met twice in 2017 and reviewed four regular reports and 36 accompanying oversight activities management reports. The Committee concluded that it was not aware of any case where the HKMA had not duly followed 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, and the report is available on the HKMA website.

PLANS FOR 2018 AND BEYOND

Supervisory focus

Supervision of operational and technology risks

The HKMA will continue to step up its supervision of technology risk in response to growing cyber threats and the continued adoption of new technology by banks. In 2018, the HKMA will monitor AIs' implementation of the CFI and update its supervisory guidance on business continuity planning and e-banking, so as to keep pace with market development. The HKMA will also step up its supervision of AIs' outsourcing arrangements in response to an increasing use of external service providers.

Smart Banking

In 2018, the HKMA will complete a review of the existing Guideline on Authorization of Virtual Banks to facilitate the introduction of virtual banking in Hong Kong, and improve digital customer journeys as part of its Banking Made Easy initiative. The HKMA will also continue to clarify legal and regulatory expectations as needed to facilitate AIs' launch of remote onboarding for customers. In addition, it will work closely with the industry in its efforts to use technology to streamline account opening and maintenance without compromising customer protection and the prudent business practices of AIs, including preventive measures against ML and TF. The HKMA will continue to work with relevant financial regulators and the banking industry to facilitate the use of technology in online finance and online wealth management through the formulation of risk-based regulatory standards.

Supervision of credit risk

In respect of credit risk, the HKMA will continue to refine its surveillance system for the banking sector's exposures to major corporates. It will undertake thematic reviews and examinations focused on loan underwriting practices and lending to property developers which grew significantly in 2017. Separately, to prepare for international banks transferring the booking and management of derivatives trading activities to Hong Kong, the HKMA will strengthen its capital model review capability and streamline the approval processes.

Supervision of liquidity risk and market risk

The HKMA will remain vigilant in the supervision of liquidity risk and market risk. Global US dollar liquidity may tighten amid the continued normalisation of US monetary policy. Accordingly, the HKMA will assess AIs' preparedness for a possible tightening of US dollar liquidity.

Following the Basel Committee's implementation timeline, the NSFR requirement will come into effect in 2018. The HKMA will monitor AIs' compliance with this new liquidity requirement. The HKMA will also conduct thematic reviews to assess AIs' internal liquidity stress testing capability, given its importance as a liquidity risk management tool.

As regards market risk, the HKMA plans to evaluate AIs' compliance with new international standards in treasury activities, including the FX Global Code, and the margining and risk mitigation standards on NCCD, with a view to strengthening the industry's market risk management practices.

Prevention of money laundering and terrorist financing

In the coming year, the HKMA will continue its efforts to increase the effectiveness of its AML/CFT work. The HKMA will strengthen the legislative framework for AML/CFT through amendment of AMLO, which will come into effect in 2018, and work with the Government, industry associations and other financial regulators to bring these amendments into effect, including, for example, updating the statutory guideline.

The publication of Hong Kong's first jurisdiction-wide ML/TF risk assessment will help strengthen collective efforts to focus on higher ML/TF risks. The HKMA will also continue to work closely with the Government and other agencies in preparation for the evaluation of Hong Kong's AML/CFT regime by the FATF, which will take place in late 2018. Given its size and importance in Hong Kong's economy, the banking sector is expected to be a major focus in the assessment.

In parallel, the HKMA will continue to encourage the industry to utilise new technology, including KYCU, to enhance effectiveness in AML/CFT work and reduce unnecessary compliance burden.

Supervision of wealth management and MPF-related businesses

The HKMA will:

- continue to communicate closely with other regulators and the banking industry to provide guidance on regulatory standards in relation to the sale of investment and insurance products;
- continue to collaborate with the SFC on the supervision of financial groups consisting of RIs and licensed corporations;
- continue to conduct on-site examinations and off-site surveillance of AIs' conduct in the sale of securities, MPF and other investment and insurance products, including accumulators, debt securities, investment funds and NLTI products, as well as AIs' compliance with new regulatory requirements;
- continue to co-operate with the IA on the preparatory work for the implementation of the new statutory regime for regulating insurance intermediaries; and
- maintain close dialogue with, and provide guidance to, the industry to promote a customer-centric culture and good conduct of the banking sector.

Implementation of Basel standards in Hong Kong

Capital standards

The Basel Committee issued a standard in October 2016 to specify the regulatory capital treatment of banks' holdings of TLAC instruments issued by G-SIBs. Scheduled to come into effect on 1 January 2019, the standard aims to reduce contagion risk within the financial system if a G-SIB, as an issuer of TLAC instruments, were to fail. The HKMA intends to consult the industry on the relevant policy proposals, with a view to implementing the standard in accordance with the Basel Committee timetable through appropriate amendments to the Banking (Capital) Rules (BCR).

At the same time, the HKMA will continue to work on a set of amendments to the BCR for the implementation of a standardised approach for measuring counterparty credit risk exposures, the capital requirements for bank exposures to central counterparties and the capital requirements for banks' equity investments in funds (deferred from the original target date of 1 January 2017 to tentatively no earlier than 1 January 2019 in the light of the implementation progress in other major markets), while assessing the appropriate timing for bringing these standards into effect. The HKMA intends to issue the draft amendments for industry consultation in 2018 to allow more time for AIs to better prepare for the implementation.

In view of the comments received during a consultation on the revised securitisation framework in 2017, the HKMA has reconsidered its initial proposal of not making available the Internal Assessment Approach (IAA) (designed for unrated securitisation exposures to asset-backed commercial paper programmes) in Hong Kong. The HKMA intends to consult the industry in 2018 on policy proposals for implementing the IAA.

In December 2017, the Basel Committee published "*Basel III: Finalising post-crisis reforms*" (Basel 2017 package) in furtherance of the Basel III framework issued in December 2010 and revised in June 2011. Scheduled for implementation from 1 January 2022 with certain transitional arrangements, the Basel 2017 package aims to enhance the robustness and risk sensitivity of the standardised approaches for credit risk and operational risk, to constrain the use of internally modelled approaches, and to complement the risk-weighted capital ratio with a finalised leverage ratio and a revised and robust capital floor. The HKMA will conduct local quantitative impact assessments of the Basel III reforms with all or selected AIs, and develop policy proposals for implementing the Basel 2017 package in consultation with the industry.

With regard to market risk, the Basel Committee issued revised standards on the minimum capital requirements for market risk in January 2016 following the completion of its fundamental review of the trading book. In December 2017, the Basel Committee announced an extension of the original implementation timeline by three years to 1 January 2022. The HKMA decided to align its local implementation of the new market risk standards with the revised Basel Committee's timeline and expects to initiate industry consultation on its implementation proposals in 2019.

Disclosure standards

Implementation of the second phase of the Basel Committee's revised disclosure requirements of March 2017 will require appropriate amendments to the BDR, together with the issuance of standard templates and tables (based on those prescribed by the Basel Committee) and interpretative guidance to facilitate AIs' disclosures under the BDR. The amendments to be introduced in 2018 are intended to be applicable to the first interim disclosure of AIs in respect of their 2018 financial year.

Liquidity standards

The HKMA is updating the SPM module, "Regulatory Framework for Supervision of Liquidity Risk", to provide more guidance on the implementation of the NSFR and the CFR. A new return will be used to facilitate the reporting of the NSFR and the CFR by different categories of AIs.

Exposure limits

Following the passage of the Banking (Amendment) Bill 2017, the HKMA intends to implement new rules to replace the existing section 87 of the BO, about limitation on shareholdings, in 2018.

The HKMA expects to consult the industry on its proposed rules for local implementation later in 2018.

To supplement the planned implementation of the large exposures regime, the HKMA will review and as appropriate update the relevant SPM modules during 2018, including "Large Exposures and Risk Concentrations", "Consolidated Supervision of Concentration Risks under Part XV: §79A", "Exemption of Financial Exposures: §81(6)(b)(i)", "Letters of Comfort: §81(6)(b)(ii)", "Underwriting of Securities: §§81 and 87" and "Major Acquisitions and Investments: §87A".

Development of Supervisory Policies

Counterparty credit risk management

Following an industry consultation in 2017, the HKMA intends to finalise and issue the SPM module on "Counterparty Credit Risk Management" in 2018.

Recovery planning

The new provisions relating to recovery planning under the BO have come into operation since February 2018. The HKMA will update the SPM module on recovery planning accordingly, taking into account developments in international standards and practices on recovery planning.

Other supervisory policies and risk management guidelines

The HKMA also plans to finalise revisions to the SPM module on "Validating Risk Rating Systems under the IRB Approaches", and to update a selection of other modules to incorporate the latest guidance issued by the Basel Committee as well as other local and international standard-setters. These include the SPM module on the "Supervisory Review Process", "Foreign Exchange Risk Management", "Guideline on a Sound Remuneration System" and "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance". The HKMA also intends to consult the banking industry on the local implementation of new guidelines for the identification and management of step-in risk issued by the Basel Committee in October 2017.

Compliance with regulatory regime for OTC derivatives market

The HKMA will continue to monitor AIs' and AMBs' compliance with the regulatory regime for the OTC derivatives market in accordance with the statutory requirements.

Balanced and responsive supervision

The HKMA will engage the banking sector through roundtable discussions to facilitate the setting of key priorities and themes for the implementation of Balanced and Responsive Supervision Programme. The engagement process will also enable the HKMA to have better insights into the development needs of the industry and achieve a more optimal and sustainable supervisory outcome.

Accounting standards

In respect of IFRS 9, the HKMA will update its prudential framework for AIs as appropriate, taking into account the related standards and guidance issued by the Basel Committee, such as the longer-term standards on the interaction between the regulatory capital framework and expected credit losses under IFRS 9. The HKMA will continue to monitor the implementation of IFRS 9 by AIs in Hong Kong and maintain regular dialogue with their external auditors. The HKMA will also assess the implications of other impending accounting standards, such as IFRS 16 "Leases", on the prudential requirements.

Resolution Office

Whilst the HKMA made substantial progress in 2017 in the establishment of an operational resolution regime in Hong Kong for AIs, as echoed in the FSB Peer Review Report and similar to other key jurisdictions, further work is needed to fully implement the regime and enhance the credibility and feasibility of resolution measures.

The priorities for the Resolution Office in 2018 will include developing further resolution policies, advancing resolution planning and enhancing its resolution capabilities, reflecting the recommendations from the FSB Peer Review and international best practice (Table 6).

Table 6 HKMA's forward priorities on resolution in 2018

I. Resolution Policy	II. Resolution Planning	III. Resolution Authority Functions
Formulate LAC requirement rules for AIs and related CoP chapter	Roll out *CI-1* to, and develop preferred resolution strategies for, locally incorporated AIs with systemic impact should they fail	Operationalise resolution funding arrangement under the FIRO by establishing the levy framework and planning options for the design of facilities for funding in resolution for AIs
Consult on CoP chapter on operational continuity in resolution	Advance resolution planning with D-SIBs further to implementation of *CI-1*, conduct resolvability assessments and work with D-SIBs on removal of barriers to resolvability	Develop crisis management memorandum of understanding with other local resolution authorities
Consult on policy proposals for imposing contractual requirements regarding stays on early termination rights of financial contracts	Strengthen cross-border coordination	Facilitate cross-border information sharing by conducting secrecy provisions assessment
Review FMI scheme rules in light of the FIRO and make appropriate updates		Strengthen institutional framework and resolution arrangements, e. g. bail-in mechanics
Contribute to international policy development of standards on funding in resolution and bail-in execution as well as engage Asia Pacific regional forums on resolution issues		Conduct resolution drills and simulation exercises
		Establish processes for timely appointment of external professional advisors

Bank consumer protection

The HKMA will continue to promote good banking practices through participating in, and providing advice to, the Code of Banking Practice Committee of HKAB. It will continue to monitor AIs' compliance with the Code through various means, including AIs' self-assessment, mystery shopping programmes and the handling of relevant complaints against AIs.

The HKMA will continue its effort to develop a customer-centric culture among AIs and foster financial inclusion by retail banks, especially in securing reasonable access to basic banking services by the public. The HKMA is working with the banking industry on a practical guideline on barrier-free banking services. The HKMA will monitor the industry's implementation of enhancement measures in fostering a sound bank culture and driving positive customer outcomes. The HKMA will also continue to participate in international efforts to drive better protection for financial consumers through participation in the Organisation for Economic Co-operation and Development Task Force on Financial Consumer Protection.

Opening and maintaining bank accounts

The HKMA will continue to work with the banking industry, business community and relevant stakeholders to further enhance customer experience in account opening and maintenance. The HKMA will take into account the findings from the mystery shopping programme in respect of account opening by AIs in Hong Kong in considering further follow-up actions. The HKMA is also working with the industry association to seek to increase efficiency and effectiveness of CDD processes through innovation and technology, including the use of KYCU in account opening and maintenance processes.

Deposit protection

Continued efforts will be made to ensure and improve the readiness for payout under the DPS. The payout system modernisation project will continue in 2018, with a new application system to be developed to further enhance payout efficiency. The compliance programme for monitoring DPS members' readiness in submitting the data and information in accordance with the Information System Guideline will continue. Annual self-assessments and on-site examinations will continue to be conducted to ensure that DPS members make appropriate representations to depositors in respect of the protection status of deposits. In addition to publicity and community education campaigns, direct engagement with specific segments who might not be easily reached by mass communications will be undertaken to reinforce their understanding of the DPS.

Enforcement

The HKMA is developing electronic complaint forms as an additional channel for lodging complaints against banks. Useful insights from complaint cases and timely feedback will continue to be shared with AIs to help promote robust business practices and a customer-centric culture among AIs.

In addition to focusing on cases involving misconduct and dishonesty that affect the interests of the investing public, the HKMA will continue to deploy resources to enforce compliance with the AMLO and other regulatory regimes, such as the statutory framework for regulating OTC derivatives and the regime for stored value facilities and retail payment systems. With respect to the latter, the HKMA will issue, after consultation with the industry, a fining guideline to set out the manner in which the power to order a pecuniary penalty under the PSSVFO is to be exercised.

Following the enactment of the Insurance Companies (Amendment) Ordinance 2015, the HKMA will continue to work closely with the IA on the arrangements for the delegation of investigation powers to the Monetary Authority in relation to AIs' regulated activities under the Insurance Ordinance and other operational matters for enforcing the new statutory regime.

Capacity building in the banking sector

Director empowerment

Director empowerment is a broad topic and many of the initiatives of the HKMA contribute to it either directly or indirectly. The HKMA aims at co-ordinating these activities in a manner such that INEDs will be better equipped to support the banking sector to develop its business, protect the reputation of the industry and enhance Hong Kong's status as an international financial centre. The HKMA will also continue to organise seminars on various topics for INEDs and publish a knowledge kit to help equip newly appointed INEDs.

Talent development for banking practitioners

The HKMA will review the effectiveness of the ECF in raising professional competence and enlarging the talent pool of banking practitioners through an industry survey. Going forward, the HKMA will continue to collaborate with the banking industry and relevant professional bodies to develop two new ECF modules on risk management and compliance and credit risk management.

Apart from the ECF, the HKMA will also continue its efforts in the ongoing talent development of banking practitioners, such as organising Regulator's Dialogue sessions to keep them abreast of banking sector developments.

Consumer education

Further publicity initiatives, including videos and other educational materials, will be launched under the HKMA's Consumer Education Programme to promote smart and responsible use of banking and other financial services under the HKMA's supervision. In addition, the HKMA will further collaborate with other stakeholders to promote financial literacy and maximise the impact of consumer education.

Oversight of financial market infrastructures

The HKMA will continue to promote the safety and efficiency of the FMIs under its oversight in accordance with the PSSVFO and the PFMI, including the Faster Payment System scheduled for launch in 2018.

The HKMA will work with the FMIs on their observance of the PFMI. Assessments will be conducted and updated as required, and the HKMA will continue to participate in the CPMI-IOSCO PFMI implementation monitoring and assessment exercise. Where appropriate, oversight requirements will be strengthened to reflect international practices or in response to market developments. The HKMA will continue to work with relevant authorities to further strengthen co-operative oversight arrangements where appropriate.