The Hong Kong Monetary Authority issued on 28 September 1994 a Best Practice Guide on Financial Disclosure by Authorised Institutions. The Guide is based on recommendations jointly developed by the HKMA, the Stock Exchange of Hong Kong and the Securities and Futures Commission. Implementation of the recommendations will substantially increase the transparency of authorised institutions' performance and financial strength. It will also bring the standard of financial disclosure in Hong Kong substantially into line with that in other major international financial centres.

Introduction

Banks and deposit-taking institutions play a significant and influential role in the efficient running of an economy and its monetary system. Most individuals and corporate bodies have an interest in them either as depositors, borrowers or investors. There is considerable interest in their well-being, especially in their financial strength, solvency, liquidity and the relative degree of risk to which they are exposed. There has been increasing public interest in the adequacy of the financial information institutions disclosed in their published annual accounts i.e. whether such information sufficiently reflects the performance and financial strength of the institution in the reporting period.

By virtue of an exemption from the disclosure requirements set out in the Tenth Schedule of the Companies Ordinance, banks incorporated in Hong Kong are permitted to disclose less than other companies. In essence, the exemption means that:

(a) banks need only provide limited balance sheet information;

(b) banks do not need to provide a breakdown of income, operating expenses and charge for bad and doubtful debts in their profit and loss account; and

(c) banks are able to maintain inner reserves and can make undisclosed transfers to or from them.

The exemption does not apply to restricted licence banks (RLBs) and deposit-taking companies (DTCs). Nonetheless, the disclosure made by these institutions is still modest relative to most other international financial centres.

The exemption under the Companies Ordinance was originally introduced in recognition of the special nature of banks. They are heavily reliant on external funding from customer deposits or interbank borrowing and their capital and earnings are vulnerable to fluctuations in asset values, the creditworthiness of their borrowers, the business cycle and monetary conditions. The exposure of banks to such fluctuations means that they are vulnerable to a loss of confidence on the part of depositors. Banking problems can quickly spread, calling into question the stability of the system as a whole. This led to the view, in some countries as well as in Hong Kong, that it was preferable for banks not to disclose full information about their performance and business so as to prevent bad news from causing a loss of confidence. In particular, it was felt that banks should be allowed to maintain inner reserves as a means of "smoothing" profits.

The need to maintain the stability of the banking system should be given considerable weight in considering the appropriate extent of financial disclosure by banks. However, the Hong Kong banking system is now well-capitalised and profitable, and the supervisory regime has been strengthened. Moreover, the international trend is towards greater transparency and accountability, and the present level of disclosure by banks in Hong Kong is very limited. This could become counterproductive as it may lead to a lower than justified perception of authorised institutions in Hong Kong by depositors, counterparties, overseas regulators and rating agencies. This may affect their ability to conduct international business or to raise capital.

A Common Approach for both Listed and Non-Listed Banks

The HKMA has been working closely with the banking industry since December 1993 to develop proposals to increase the scope of financial disclosure by authorised institutions in Hong Kong. A Working Party on Financial Disclosure comprising representatives of seven local banks and the Chairman of the Deposit-taking Companies Association was formed in January 1994 under the chairmanship of HKMA to consider the issue.

The Working Party formulated a set of recommendations which were embodied in a consultation paper issued in mid-May to the banking industry and the accounting profession. The Working Party's recommendations represent substantially greater financial disclosure by banks in Hong Kong, including full disclosure of banks' profits and much more detailed information on the breakdown of assets and liabilities of the balance sheet, segmental reporting, cash flow statements and off-balance-sheet items.

The Stock Exchange had also been conducting its own consultation exercise on increased financial disclosure by listed companies, including listed banks. It presented its own proposals for greater financial disclosure by listed banks in a discussion paper issued in March 1994.

Comments received from the banking industry and the accounting profession were generally supportive of the broad direction of the Working Party's recommendations. A number of institutions asked for more time to prepare for the disclosure of certain items such as segmental analysis and off-balance-sheet items. There was also general support for the HKMA and the Stock Exchange to develop a common framework for disclosure by banks, which should apply to both listed and non-listed banks.

On the basis of the comments received, the HKMA held discussions with the Stock Exchange and the Securities and Futures Commission on disclosure by authorised institutions. It was agreed that a common set of proposals was desirable. A technical working group involving the three regulatory bodies has therefore developed joint recommendations on additional disclosures to be included in the accounts of authorised institutions for accounting periods ending on or after 31 December 1994.

The joint disclosure package has adopted most of the recommendations of HKMA's Working Party. To take account of institutions' concern about the time constraint, certain items such as segmental analysis and off-balance sheet exposures have been deferred to the 1995 accounts. The Hong Kong Association of Banks, the Deposit-taking Companies Association and the Hong Kong Society of Accountants have endorsed in principle the joint recommendations.

Joint Disclosure Package for 1994 Accounts

Table 1 compares the key items recommended for disclosure in the Best Practice Guide with the existing level of disclosure in a typical bank's accounts in Hong Kong.

The joint disclosure recommendations are applicable to all authorised institutions, listed or non-listed, incorporated in Hong Kong in respect of the annual accounts for their financial years ending on or after 31 December 1994. Those RLBs and DTCs which have total assets of less than HK$1 billion and total customer deposits (excluding interbank placements) of less than HK$300 million are however exempted pending a further review by the HKMA. The HKMA will discuss with the Deposit-taking Companies Association the future applicability of the disclosure recommendations (both the Joint Package for 1994 and any further recommendations for 1995) to all RLBs and DTCs.

The Stock Exchange intends to require listed banks to comply with the joint recommendations as part of their continuing listing obligations. The Listing Rules will be amended to apply the recommendations to listed banks.

While it is recognised that the Best Practice Guide is not a statutory document, the HKMA expects non-listed locally incorporated authorised

Table 1

Comparison of the Joint Package with the Present Position

JOINT PACKAGE	PRESENT DISCLOSURE
Profit and loss statement	
Interest income	
Interest expense	
Net interest income	
Other operating income	
– foreign exchange dealing income	
– other dealing income	
– net fee & commission income	
– dividend income	
– others	
Operating income	
Operating expenses	
– staff	
– premises & equipment	
– depreciation	
– others	
Operating profit before provisions	
Charge of bad and doubtful debts	
Operating profit	
Gains less losses from disposal of tangible fixed assets and long-term investments	
Exceptional item	
Profit on ordinary activities before taxation	
Taxation charge	
Profit after taxation	Profit after tax and inner reserve
Extraordinary items	
Profit attributable to shareholders	Profit attributable to shareholders
Appropriations:	Appropriations:
Transfers to/from inner reserves	
Dividends	Dividends
Profit for the year retained	Profit for the year retained
Balance Sheet	
Assets	**Assets**
Cash and short-term funds	Cash and short-term funds
Placements with banks maturing between one and twelve months	
Trade bills	Trade bills
Certificates of deposit	Certificates of deposit
Securities held for dealing purposes	
Advances and other accounts	Advances to customers, banks and other accounts
– Advances to customers	
– Advances to banks	
– Accrued interest and other accounts	
– Provisions (general and specific)	
Investment securities	Investments
Investments in associated companies	Investments in associated companies
Tangible fixed assets	Fixed assets
Liabilities	**Liabilities**
Deposits and balances of other banks	Current, deposit and other accounts including inner reserves
Current fixed, savings & other deposits of customers	
Certificates of deposit	
Issued debt securities	
Other accounts and provisions including inner reserves	
Capital Resources	**Capital Resources**
Loan capital	Loan capital
Minority interests	Minority interests
Share capital	Share capital
Reserves (analysed by type of reserves)	Reserves (no analysis required)
Shareholders' funds	Shareholders' funds

institutions to which the Guide is applicable to adopt the recommendations on a voluntary basis in drawing up their accounts for their financial years ending on or after 31 December 1994. Authorised institutions are recommended to include a statement in the directors' report on the extent of compliance with the Best Practice Guide and the reason(s) for any non-compliance. The HKMA is considering an amendment to the Banking Ordinance to include adequate disclosure of financial information in the annual audited accounts as a condition of authorisation.

The Effects of the Joint Package

The joint disclosure package represents a big step taken by authorised institutions in Hong Kong towards improving the transparency of their financial reporting. It will bring Hong Kong's standard of disclosure substantially into line with that of other major financial centres. The HKMA believes that the disclosure recommendations are in the best interests of both individual institutions and Hong Kong's position as an international financial centre. The additional disclosures will improve the perception of authorised institutions in Hong Kong by the international financial community. It will also assist banks in Hong Kong to tap into the international capital markets in a cost effective manner.

Fuller disclosure imposes additional market discipline on bank management. They have more incentive to ensure that their institution is prudently managed and does not make losses or is seen to be taking excessive risks. With fuller disclosure, risky positions will not only attract supervisory attention as always, but may also attract a higher cost of funds as lenders would have a better basis for assessing the risk of lending to such an institution. Authorised institutions are therefore more accountable to their depositors and other creditors. To that extent, more disclosure helps the banking supervisor in ensuring the prudent management of authorised institutions.

In specific terms, the Joint Package will provide greater transparency on the following areas:–

- **actual profitability**

  For the first time in Hong Kong, all banks will be asked to disclose their actual level of profits (some banks have already done so voluntarily). Presently, little information is given by most banks in their profit and loss statement other than the profit after tax and inner reserve transfers. This has caused users of financial statements difficulty in assessing the actual performance of banks. Under the new recommendations, transfers to and from inner reserves will be separately disclosed.

- **the nature and quality of earnings**

  The sources of income will be analysed into interest income, fee-based income and dealing profits. Readers will have a better understanding of the extent to which a bank's profits rely on recurrent and non-recurrent income and of the business strategy of the bank.

- **the cost structure**

  Operating expenses are to be disclosed and analysed into staff costs, depreciation, other premises and equipment expenses and other operating expenses. Analysts will be in a better position to assess the performance and the cost efficiency of a bank, by way of certain key performance measures such as net interest margin and cost/income ratio.

- **the nature and quality of assets**

  Presently, the amounts of advances to customers and banks are not separately disclosed but are grouped under one item "loans, advances and other accounts". Under the joint recommendations, assets will be grouped by type and maturity. In particular, loans and advances to customers and general and specific provisions are to be separately disclosed. Securities are to be analysed according to the purpose for which they are held. Disclosure of market values of listed investment securities will reveal latent reserves of the banks. Hence, readers will have more information on how assets have been deployed, and how they are valued.

- **sources of funding**

  Presently, customer deposits and interbank borrowings are not separately disclosed but are grouped into a single item "current, deposit and other accounts". Under the joint recommendations, liabilities will be analysed into their various main constituents, namely, customer deposits, interbank deposits, and other accounts (including inner reserves). Accordingly, the extent of reliance on different funding sources will be more apparent.

- **inner reserves**

  Although balance sheet inner reserves will not be disclosed at this stage, the mystique that surrounds this item will be removed to a significant extent by:

  (a) the breakdown of "current, deposit and other accounts" into its main constituents. Although inner reserves will still be grouped under "other accounts", the upper limit of balance sheet inner reserves will be significantly reduced by the separate disclosure of customer deposits and interbank borrowings; and

  (b) the separate disclosure of property revaluation reserves which form part of the inner reserves for some banks. Banks' inner reserves will henceforth consist of accumulated realised profits.

The 1995 Disclosure Package

The HKMA will have further discussions with the Stock Exchange and the SFC on additional disclosures to be included in authorised institutions' 1995 accounts. These include items which the HKMA Working Party on Financial Disclosure recommended for implementation in the 1995 accounts and certain items originally recommended for implementation in the 1994 accounts by the Working Party that had been deferred in response to institutions' request for more time to prepare for their disclosure. The major items under consideration include segmental analysis, off-balance sheet exposures, cash flow statement, movements in provision for bad and doubtful debts, maturity profile of investment securities, assets pledged as security, the capital adequacy ratio and the liquidity ratio.

The HKMA will undertake a review in mid-1995 on the disclosure of balance sheet inner reserves in the light of the experience of the additional disclosures in the 1994 accounts. It will share and discuss the conclusions of the review with the Stock Exchange and SFC before a decision is made on whether or not to recommend disclosure of balance sheet inner reserves in the 1995 accounts.

– Prepared by the Banking Policy Department