

The Banking (Amendment) Bill 1996, which was published in the Gazette on 24 May 1996, proposes to introduce a legal framework in the Banking Ordinance for the regulation of the issue of multi-purpose stored value cards and the authorization and regulation of foreign exchange and deposit brokers. This paper describes the policy framework of the issues covered by the Bill. It should be stressed that the Bill is now being scrutinized by a Bills Committee of the Legislative Council which has been formed for that purpose. As is normally the case with the legislative process, this may result in amendments to the current proposals.

Introduction

The HKMA has prepared a Banking (Amendment) Bill 1996, which was introduced into the Legislative Council in early June. The main purpose of the Bill is to introduce a legal framework for the regulation of the issue of multi-purpose stored value cards and the authorization and regulation of foreign exchange and deposit brokers operating in the wholesale foreign exchange and deposit market (money brokers). The Bill also seeks to improve the working of individual provisions of the Ordinance in the light of experience; and consolidate the Ordinance by streamlining the appeal and penalty provisions.

Stored value cards

Development of stored value cards

A stored value card is an instrument which contains prepaid monetary value stored in a magnetic strip or an electronic device embedded onto the card. Stored value cards have developed first as a single-purpose payment instrument issued by the entities providing the services which the instrument may be used to purchase. Existing single-purpose cards in Hong Kong include the phone cards issued by Hong Kong Telecom.

With the development of smart card technology, an integrated circuit chip consisting of a memory and processing component can now be embedded onto a plastic card that allows multi-purpose applications, including use of the card to pay for a variety of goods and services provided by third parties. There are two major stored value card systems being developed, the Mondex system and the Visa/MasterCard system.

Issue of multi-purpose cards need to be regulated

The HKMA has reviewed the implications of multi-purpose cards and concluded that the issue of such instruments should be regulated for the following reasons:

- (a) the money received by the issuer of multi-purpose cards is akin to a deposit, thus the reasons which justify limiting deposit-taking to authorized institutions, i.e. protection of depositors, also apply to the issue of multi-purpose cards;
- (b) alternatively, the creation of value to be stored in certain types of multi-purpose cards, such as Mondex is very similar to the issue of bank notes. The issue of conventional bank notes, and the backing for these, are subject to careful controls and it is logical that similar safeguards should apply to the creation of "electronic" bank notes;
- (c) multi-purpose cards represent a new payment system and the default of an issuer could disrupt financial system stability if the cards are very widely used;
- (d) the importance of security for the multi-purpose card systems and the potential of multi-purpose cards being exploited for money laundering purposes support restricting the issue of multi-purpose cards to regulated entities;
- (e) the regulatory inclination of other overseas countries including the UK and Singapore, and the recommendation of

the European Monetary Institute is that the issue of multi-purpose cards should be restricted to authorized financial institutions.

The issue of multi-purpose cards involves the origination of value and the distribution of the multi-purpose cards to end-users. These two functions may be performed by the same entity or different entities (e.g. under the Mondex scheme, Mondex will be the originator of value and will hold the central pool of funds which back the stored value in circulation but the Mondex cards will be distributed by member banks). It is considered that both the issuer and the entity that facilitates the issue of multi-purpose card through the creation of value (the facilitator) should be subject to the regulatory framework.

It is, however, considered that there is no need to regulate the issue of single-purpose cards. These are similar to prepayments for specific goods and services which are currently not subject to regulation. However, single-purpose cards will not include stored value cards issued by a joint venture company comprising several service providers. (The broader the range of goods and services in respect of which a stored value card can be used, the closer it is to "money".)

Whilst it might be possible to rely on existing restrictions in the Ordinance to limit the issue of multi-purpose cards to AIs, it is not clear that the storing of value on a card would in all cases amount to the "taking of deposits" as defined in the Ordinance. It is considered therefore that amendments to the Ordinance are required to bring the issue of multi-purpose cards clearly within its scope.

The proposed legal framework

The question of who should be eligible to issue multi-purpose cards is central to the legal framework. We need to strike the right balance between the broad public interest of product innovation and convenience that may be served by the application of the smart card technology and the need to maintain the stability of the payment system. Stability of the payment system is now protected by the legal restrictions on the operation of checking accounts and the issue of bank notes. Allowing non-bank entities to issue multi-purpose cards has the effect of opening up parallel payment

systems which, if allowed to proliferate, would have significant systemic implications. While it is desirable to provide some flexibility in the legal framework to allow certain classes of non-bank entity to issue multi-purpose cards, such extension of the payment system needs to be carefully controlled. Having regard to this and the business restrictions applicable to authorized institutions under the current three-tier structure of authorization under the Ordinance, the HKMA proposes that –

- (a) licensed banks should be deemed to be approved to issue multi-purpose cards (i.e. they will not require specific approval under the Ordinance). This reflects the fact that at present they are not, in general, subject to specific approval in respect of the various banking activities in which they may engage;
- (b) existing restricted licence banks and deposit-taking companies should not be eligible to apply for approval to issue multi-purpose cards. This is consistent with the existing three-tier structure which confines access to the payment system and the operation of demand deposits (the value embedded in multi-purpose cards is similar to demand deposits) to licensed banks;
- (c) however, special purpose vehicles whose principal business consists, or will consist, of the issue of multi-purpose cards should be allowed to apply for authorization as a deposit-taking company for the principal purpose of being approved to issue multi-purpose cards. This would provide an avenue for non-bank issuers (such as transport operators) to issue more specialized types of card;
- (d) flexibility should also be allowed by giving the Monetary Authority the power to declare a stored value card not to be a multi-purpose card (for example, where the card is very similar to a single-purpose card).

The exceptions in relation to items (c) and (d) above are intended to be applied sparingly. A special purpose vehicle applicant will need to satisfy the general authorization criteria set out in the

Seventh Schedule to the Ordinance, including those relating to the fitness and propriety of controllers (although the non-statutory criterion of 50% ownership by a bank will be waived).

The cards to be issued by an authorized special purpose vehicle would be more limited in scope than those issued by banks under guidelines to be developed by the HKMA in consultation with the various interested parties. These will take account of the relationship between the range of goods and services to be purchased and the core business of the issuer and also the value to be stored on the card. Any deposit-taking by such special purpose vehicles should only be ancillary to their main business of issuing multi-purpose cards and they should not engage in other types of commercial banking activities such as the granting of loans.

As regards the regulatory framework, the provisions in the Banking Ordinance will apply to the multi-purpose card issuers by virtue of their status as authorized institutions. Detailed regulatory requirements for multi-purpose card schemes, such as the use of the funds received from card holders and the separation of such funds from other funds maintained by the issuer, the internal control and system requirements to guard against forgery and money laundering, will be imposed through the new power in the Bill to attach conditions to approval to issue multi-purpose cards and through statutory guidelines to be issued by the HKMA.

It is proposed that all non-bank multi-purpose card issuers at the time of the commencement of the Amendment Ordinance should be given a grace period of three months (which may be varied by the HKMA) to apply for approval or exemption.

Foreign exchange and deposit brokers

Industry background

There are at present 10 money brokers providing broking services for interbank foreign exchange and deposit transactions. These brokers are members of the Hong Kong Foreign Exchange and Deposit Brokers Association (HKFEDBA). Their role is primarily that of a matchmaker, bringing together two independent counterparties (these include authorized institutions and banks overseas) to a transaction. Deals arranged through them are settled directly between the principals.

The need for a formal legal framework

At present, the money brokers are not subject to a formal authorization system. Both the brokers and the banks which use them have suggested to the HKMA that such a system should be introduced and that the HKMA should take up the role of authorization authority.

The HKMA supports the proposal. It accepts that an orderly and efficient interbank foreign exchange and money market is important to Hong Kong as an international financial centre and that a formal authorization regime will help to ensure that the highest standards of integrity and fair dealing are observed by the brokers.

It is, however, not considered justified to introduce an elaborate regulatory regime similar to that for authorized institutions: the number of brokers is small and they act as name-passers and therefore do not pose significant "systemic" risks to the interbank foreign exchange and deposit market or raise consumer/depositor protection issues.

The proposed legal framework

The proposed legal framework includes provisions to prohibit any person to act as a money broker unless he is authorized by the Monetary Authority under the Ordinance and empower the Monetary Authority to authorize or revoke the authorization of a broker on the basis of criteria set out in schedules to the Ordinance. The authorization criteria will be those necessary to ensure that only fit and proper companies can be authorized as brokers. The main criteria include the following:

- (a) the directors, controllers and the chief executive of the company must be fit and proper persons;
- (b) the company should be financially sound;
- (c) it should maintain adequate accounting systems and systems of control; and
- (d) its business should be conducted with integrity, prudence and competence.

The authorization criteria would be of continuing nature. This means that it would be a ground for revocation if the Monetary Authority is

no longer satisfied that the company is fit and proper to continue the brokerage business (i.e. if the company were not presently authorized and were to make an application for authorization, the authorization criteria would prohibit the Monetary Authority from authorizing it). Other grounds of revocation include the following:

- (a) failure to provide information or the provision of false, misleading or inaccurate information of a material nature;
- (b) cessation to carry on the business of a money broker;
- (c) contravention of conditions attached to its approval; and
- (d) voluntary revocation.

The Monetary Authority is empowered to attach conditions to the authorization, and to vary, add or delete such conditions. This should give the Monetary Authority the necessary powers to impose regulatory measures on individual brokers. It is therefore unnecessary to specify detailed regulatory measures in the Ordinance. There would also be powers to obtain information and to conduct examinations.

There is an appeal avenue to the Governor in Council for persons who are aggrieved by the Monetary Authority's decision to refuse or revoke authorization, or to impose or vary conditions attached to an authorization. Existing money brokers would be required to apply for approval within a specified period after the commencement of operation of the Bill.

Other amendments

Definition of "banking business"

Section 2 of the Banking Ordinance defines "banking business" as:

"the business of either or both of the following –

- (a) receiving from the general public money on current, deposit, savings or other similar account repayable on demand or within less than 3 months or at call or notice of less than 3 months;
- (b) paying or collecting cheques drawn by or paid in by customers."

Following the deregulation of time deposits fixed for seven days or more, the DTC Association has requested the HKMA to, among other things, relax the restrictions on the maturity of the deposits that could be taken by deposit-taking companies (maturity restriction) from 3 months to 7 days.

The HKMA is considering this proposal in the wider context of its review of the three-tier structure of authorized institutions. Any decisions arising from the review which result in the need to revise the maturity restriction require amendments to the minimum maturity period specified in the First Schedule (currently 3 months) and the definition of "banking business" in the Banking Ordinance. The former can be amended by the Governor in Council but the latter requires an amendment to the principal Ordinance.

While the HKMA has not reached any conclusion on the review, it is proposed that the definition of "banking business" should be amended by replacing "3 months or at call or notice of less than 3 months" with "the period specified in item 1 of the First Schedule or with a period of call or notice of less than that period". This amendment will not alter the substance of the definition but will provide the flexibility for implementing any changes to the maturity restriction arising from the review of the three-tier system by simply amending the First Schedule.

Grounds for exercising section 52 powers to deal with problem authorized institutions

Past experience in dealing with banking crises, such as in the cases of BCCI and Barings, has indicated that evidence and information may sometimes be available to the Monetary Authority to enable him to form an opinion on whether any one of the circumstances specified in section 52(1)(c)(i) to (iv) exists without the need to undertake the examination or investigation currently required under that section. Indeed, it is usually difficult, because of the urgency of the matter, for the Monetary Authority to have completed the relevant examination, investigation or report before he exercises the section 52 powers in emergency cases.

To provide flexibility for the Monetary Authority to take urgent and immediate action to

deal with banking crises, it is proposed that section 52(1)(c) should be amended to delete the need to make such examinations, investigations, or reports, as the case may be, before the Monetary Authority can form an opinion on whether any of the grounds specified in section 52(1)(c)(i) to (iv) exists. It is considered that the proposed amendment will not reduce the checks and balance of the system as the Monetary Authority will still need to have strong grounds for deciding to take action and will still need to consult the Financial Secretary before exercising any of the section 52 powers.

Also, the Monetary Authority's powers under section 52 to take control of an AI, including a direction made under section 52(1)(A) to require an AI to cease to carry on its normal business, is similar to the suspension powers under sections 24 or 25, which become exercisable when the Monetary Authority's power to revoke an authorization becomes exercisable. However, this ground for invoking the suspension powers, i.e. when the power to revoke becomes exercisable, is not generally available for exercising the similar powers under section 52. For consistency, it is proposed that amendments should be introduced to enable the Monetary Authority to exercise the powers under section 52 when his powers to

propose to revoke an authorization under section 22(1) become exercisable. This amendment will give the Monetary Authority a wider range of options to deal with a banking crisis.

Consolidation

As a result of the various Banking (Amendment) Ordinances enacted in previous years, similar provisions, such as those relating to appeals and penalties, are dispersed in different parts of the Ordinance making the Ordinance bulky and sometimes difficult to refer to. There are a total of 25 appeal provisions, 24 of which relate to appeals to the Governor in Council and one to the Financial Secretary. The formulation of these provisions are broadly similar. It is intended that these appeal provisions should be consolidated into one section.

The penalty provisions in the Ordinance will also be rationalized by specifying the amount of fines in a tier structure in a new Schedule to the Ordinance. It is also proposed to double the amounts of fines for all penalties under the Ordinance (which have not been revised since 1986) to retain their deterrent effect which has been eroded over the years by inflation. ☛

— Prepared by the Banking Development Division