

*The Hong Kong Monetary Authority (HKMA) is committed to improving the financial disclosure by authorised institutions in Hong Kong. Hong Kong banks are now regarded as having the best financial disclosures in Asia. To keep up the momentum, the HKMA has issued the 1997 financial disclosure package for authorised institutions in respect of information to be disclosed in their annual accounts for financial years ending on or after 31 December 1997. This article reports on the new recommendations contained in the 1997 disclosure package.*

### Introduction

The implementation of the recommendations embodied in the Best Practice Guide first issued in 1994 resulted in a rapid and significant improvement in the level of disclosure by authorised institutions in Hong Kong. In the space of three years, the level of disclosure by banks in Hong Kong has been raised from being one of the worst to one of the best in Asia.

The HKMA is however committed to reviewing developments in disclosure requirements of major international financial centres to ensure that Hong Kong maintains its leading status in the region.

The latest review has resulted in new recommendations aimed at improving disclosure on asset quality such as counterparty analysis, maturity profile and a more detailed and standardised breakdown of the loan portfolio. In addition to quantitative information, it is also recommended that institutions provide qualitative type disclosures on their risk management policies in respect of various types of risk in addition to similar disclosures made on market risk management in the 1996 accounts. Authorised institutions would also be required to disclose their capital adequacy ratios adjusted for market risk and a reference has been provided to assist institutions in determining whether market risk arising from its trading book is material. Last but not least, authorised institutions would also be required to disclose information on the Year 2000 problem as part of the accompanying information to their financial statements.

The 1997 disclosure package was issued on 23 October 1997 and the recommendations have been agreed by the Hong Kong Association of Banks, the Deposit-Taking Companies Association and the Hong Kong Society of Accountants. The

Stock Exchange of Hong Kong has also advised that Appendix 15 of the Listing Rules, which deals with accounts disclosure by banks, will be revised to bring it largely in line with HKMA's 1997 disclosure package.

### The 1997 Disclosure Package

The salient features of the 1997 disclosure package are as follows:

#### Counterparty analysis of securities held

Authorised institutions will be required to disclose securities held both for dealing and investment purposes classified into those issued by:

- Central governments and central banks
- Public sector entities
- Banks and other financial institutions
- Corporate entities
- Others

#### Maturity profile

Authorised institutions will be required to disclose the maturity profile of the following assets and liabilities:

- Advances to customers
- Placements with banks and other financial institutions
- Certificates of deposit held
- Debt securities held for both dealing and investment purposes
- Customer deposits
- Deposits from banks and other financial institutions
- Certificates of deposit issued
- Debt securities issued

classified into the following maturity bands:

- On demand
- 3 months or less (except those due on demand)

- 1 year or less but over 3 months
- 5 years or less but over 1 year
- Over 5 years
- Undated

At present, authorised institutions are already required to disclose the maturity profile of their investment securities and there is some other limited balance sheet information on maturity. As such, the recommendations above are just a logical extension of the current requirements. Disclosure of more information concerning the maturity of major balance sheet items should provide a clearer picture as to how banks' assets and liabilities are managed and further encourage conservative management of risks.

### **Analysis of advances to customers by industry sector**

At present, authorised institutions are required to disclose information on their advances by broad industry categories. While some major industry categories are specified in the Best Practice Guide, individual institutions have the discretion to classify such advances as considered appropriate. This has resulted in variations in the definition of disclosures and has made comparison between institutions difficult (for example, in respect of property exposures). Therefore, it is considered desirable for the information to be disclosed on a more standardised and consistent manner.

It is recommended that the existing analysis of institutions' loan books by broad industry sectors be replaced with a more detailed and standardised analysis of advances to customers which would continue to be included under the supplementary financial information section of the Best Practice Guide.

Accordingly, institutions will be required to disclose a breakdown of their advances to customers classified into the following industry categories:

#### **Loans for use in Hong Kong**

##### *Industrial, commercial and financial*

- Property development
- Property investment
- Financial concerns
- Stockbrokers
- Wholesale and retail trade
- Manufacturing
- Transport and transport equipment
- Others

#### *Individuals*

- Loans for the purchase of flats in the Home Ownership Scheme and Private Sector Participation Scheme
- Loans for the purchase of other residential properties
- Credit card advances
- Others

#### **Trade finance**

##### **Loans for use outside Hong Kong**

The above categories have been derived from the return of "Quarterly Analysis of Loans and Advances and Provisions (MA(BS)2A)" (the "return") that authorised institutions use for prudential reporting purposes. In order to achieve consistency in reporting, all institutions would be required to use these categories but they may also break items down into more detailed sub-categories if they so wish. The aggregate of the above categories should reconcile with total advances to customers figure reported in the audited accounts.

#### **Discussion of risk management policies**

Under the new recommendations, authorised institutions should provide a description of the main types of risk arising out of their business, including, where appropriate, credit, liquidity, interest rate, foreign exchange and market risks arising out of its trading book. They should also provide a description of the policies, procedures and controls used for measuring, monitoring and controlling those risks and for managing the capital required to support them. This would include, for example, discussion of:

- board and senior management oversight of risk management;
- identification and measurement of the various forms of risk;
- approval of the entering into transactions;
- monitoring and control of risks (eg through independent risk control units);
- the use of limits for controlling risks;
- operational controls; and
- the role of internal audit.

#### **Materiality of market risk arising from the trading book**

Where market risk arising from the trading book is regarded as material for the authorised institution, the institution should also provide



quantitative information about the amount and volatility of the risk. Market risk arising from an authorised institution's trading book would be regarded as *immaterial* if an institution meets all of the *de minimis* exemption criteria for reporting market risk as set out in the new market risk regime. The institution, however, should state the fact that it has relied on such criteria in considering the materiality of market risk arising from its trading book.

### **Capital adequacy ratio adjusted for market risk**

The capital adequacy requirements of the Banking Ordinance will be amended to reflect the introduction of the market risk regime based on the Basle Committee's framework. As a result, authorised institutions will be required to report their capital adequacy ratio computed in accordance with the Third Schedule and also an adjusted ratio to reflect market risk.

It is recommended that both the adjusted and unadjusted ratios be disclosed to enable a comparison with prior period figures to be made and to reflect the new market risk regime. The two ratios, however, should be clearly distinguished from each other for disclosure purposes. The difference between the two is that the unadjusted ratio measures only credit risk while the adjusted ratio measures both credit risk and market risk.

### **The Year 2000 problem**

Resolving the Year 2000 (Y2K) problem will be one of the major challenges facing all industries which rely on computers over the next few years. As banks rely heavily on their information technology systems, this problem has particular relevance to the banking sector. The HKMA is concerned that there should be no disruptions in bank operations as a result of systems not being able to process transactions beyond the year 2000. It is also important to emphasise that the HKMA does not regard this to be a routine internal control issue since the problem affects not only the individual institutions but also their counterparties,

customers, depositors and the banking sector as whole. It is therefore a matter of wide public interest. Accordingly the HKMA is of the view that disclosure of information will enable members of the public and bank counterparties to be kept informed of the progress made by authorised institutions in this regard. This will have a positive effect on the stability of the banking system.

It is recognised that the proposed disclosure requirement is not of a conventional type. It is therefore recommended that authorised institutions include information on the Y2K problem as part of the supplementary information to their financial statements. It is also recognised that the way individual institutions might choose to address this issue is likely to vary. Therefore, the nature and scope of disclosure should be determined at the discretion of the institution. However, an authorised institution is encouraged to consider the following items for disclosure in respect of the Y2K problem:

- the degree of the institution's Y2K problem;
- the progress of work performed to date;
- the institution's definition of Y2K compliance; and
- the date on which the institution expects to be Y2K compliant.

### **Applicability**

The 1997 package will be applicable to all licensed banks incorporated in Hong Kong and those locally incorporated restricted licence banks and deposit-taking companies with total assets of HK\$1 billion or more or total customer deposits of HK\$300 million or more.

### **Future Developments**

The HKMA intends to continue its work on refining the disclosure framework in line with developments in financial reporting elsewhere around the world. ☛

– Prepared by the Banking Development Division