# Banking Policy And Supervision

**The three-tier banking system**

Hong Kong maintains a three-tier system of deposit-taking institutions, namely, licensed banks, restricted licence banks and deposit-taking companies. They are collectively known as authorised institutions (AIs) under the Banking Ordinance.

Only licensed banks may operate current and savings accounts, and accept deposits of any size and maturity. Restricted licence banks are principally engaged in merchant banking and capital market activities. They may take deposits of any maturity of HK$500,000 (approximately US$64,103) and above.

Deposit-taking companies are mostly owned by, or otherwise associated with, banks. They engage in a range of specialised activities, including consumer finance and securities business. These companies may take deposits of HK$100,000 (approximately US$12,821) or above with an original term to maturity of at least three months.

Hong Kong has one of the highest concentrations of banking institutions in the world. At the end of June 1999, there were 166 licensed banks, 59 restricted licence banks and 86 deposit-taking companies in business. Between them, these 311 authorised institutions operate a comprehensive network of 1,583 local branches. Of these 311 AIs, 279 are beneficially owned by interests from over 30 countries. There are, in addition, 131 representative offices of overseas banks in Hong Kong. A local representative office is not allowed to engage in any banking business. Its role is confined mainly to liaison work between the bank and its customers in Hong Kong.

**Authorisation**

The authorisation criteria for licensed banks, restricted licence banks and deposit-taking companies seek to ensure that only fit and proper institutions are entrusted with public deposits. The Hong Kong Monetary Authority (HKMA) conducts periodic reviews of the authorisation criteria and, when necessary, introduces amendments to reflect the changing needs of the regulatory environment and to meet new international standards.

Under the Banking Ordinance, the HKMA is the licensing authority responsible for the authorisation, suspension and revocation of all three types of authorised institutions. Checks and balances are provided in the Ordinance with the requirement that the HKMA consult the Financial Secretary on important authorisation decisions, such as suspension or revocation. The Chief Executive-in-Council is the appellate body for hearing appeals against decisions made by the HKMA.

Authorised institutions have to comply with the provisions of the Banking Ordinance which, among other things, require them to maintain adequate liquidity and capital adequacy ratios, to submit periodic returns to the HKMA on required financial information, to adhere to limitations on loans to any one customer or to directors and employees, and to seek approval for the appointment of controllers, directors and senior management.

Overseas-incorporated banks licensed in and after 1978 and overseas-incorporated restricted licence banks authorised in and after 1990 were previously subject to the one-building condition, which effectively restricts these institutions to operate out of one branch. The original intention of imposing branching restriction on foreign banks was to avoid over-crowding in the retail banking market. Having regard to the latest developments in the banking market, the HKMA is now of the view that this policy has outlived its usefulness and is becoming less relevant to the banking development in Hong Kong. Accordingly, the one-building condition was relaxed in September 1999, and from that time onwards, foreign banks are allowed to carry out their business in not more than three buildings. In addition, the restriction on the number of regional and back offices that overseas-incorporated institutions can maintain was lifted at the same time. The HKMA will review the situation and consider further relaxation of this policy in 2001.

In view of the increasing interest in the issue of multi-purpose stored value cards with the potential to substitute to a significant degree for cash and cheques, the Banking (Amendment) Ordinance 1997 was enacted to empower the HKMA to regulate the issue of these cards. The Ordinance provides that only licensed banks should have the ability to issue multi-purpose cards that are unrestricted in terms of the goods and services which they can be used to purchase. The objectives are to maintain the stability of the payment system and provide a measure of protection to cardholders. A non-bank service provider may, however, be authorised as a deposit-taking company whose principal business is to issue or facilitate the issue of multi-purpose cards which are more limited in scope of usage. Furthermore the new legislation provides for the HKMA to grant exemption from the approval process to certain types of multi-purpose cards where the risk to the payment system and to cardholders is considered to be slight.

The Banking (Amendment) Ordinance 1997 also established the legal framework for the authorisation of money brokers operating in the wholesale foreign exchange and deposit markets. Only persons who satisfy the fit and proper criteria set out in a Schedule to the Ordinance will be approved as money brokers. Among other things, approved money brokers will be required to comply with relevant codes and guidelines on the conduct of business.

## Regulatory framework

The Banking Ordinance provides the legal framework for banking supervision in Hong Kong. The HKMA seeks to establish a regulatory framework which is fully in line with international standards, especially those recommended by the Basle Committee on Banking Supervision (Basle Committee). The objective is to devise a prudential supervisory system to help preserve the general stability and effective working of the banking system, while at the same time providing sufficient flexibility for authorised institutions to take commercial decisions.

In response to the Basle Committee's paper on the Core Principles for Effective Banking Supervision, the HKMA carried out a self-assessment of the position of Hong Kong in 1997. The assessment revealed that Hong Kong's supervisory framework substantially complies with the Core Principles. The enactment of the Banking (Amendment) Ordinance 1999 in July 1999 brings Hong Kong's framework of banking supervision fully in line with the Core Principles.

## Approach to supervision

The supervisory approach of the HKMA is based on a policy of 'continuous supervision'. This involves the on-going monitoring of institutions using a wide variety of techniques which are aimed at detecting any problem at an early stage.

At the core of this approach is the on-site examination of individual institutions. Depending on the risk assessment of the institution concerned, the scope of an examination may range from an investigation of specific areas to a comprehensive review of an institution's operations. On-site examinations provide a valuable opportunity to assess at first hand how an institution is managed and controlled. They are particularly useful for verifying asset quality. However, they are periodic in nature and, to achieve 'continuous supervision', on-site examination is supplemented by on-going off-site analysis of the financial condition of individual institutions and the assessment of the quality of their management, including the systems for controlling exposures and limiting risk. The scope of off-site analysis varies from regular analysis of statistical returns covering various aspects of the operations of individual institutions to an extensive annual review of their performance and financial position. Off-site reviews may be followed by a prudential interview with senior management. Frequent contacts are also made with individual institutions at various levels of management as specific issues arise.

In the continuous assessment of the performance of individual institutions, close attention is paid to capital, liquidity, earnings, asset quality, loan loss provisioning, concentration of risks, interest rate risk, risk management systems and internal controls.

Discussion with both internal and external auditors is another important aspect of the supervisory process. Annual tripartite discussions are held with institutions and their auditors, normally following the annual audit. Matters discussed typically include the annual audit, adequacy of provisions and compliance with prudential standards.

The HKMA regularly makes use of its powers under the Banking Ordinance to commission reports from auditors on the accuracy of prudential returns and the adequacy of institutions' systems to compile prudential returns. Additionally, the HKMA may commission reports from auditors on the internal control systems of individual institutions.

Given the evolving financial and economic environment, there is an on-going need for the HKMA to enhance the supervisory process for maintaining the stability of the banking system. To ensure the effectiveness of its supervisory framework, the HKMA is developing a more formalised risk assessment approach and quality assurance programme.

## Risk-based supervision

The HKMA continues to refine its risk-based supervisory approach, which is similar to that found in the advanced economies that are used for benchmarking purposes. These include a more systematic risk assessment framework and organisational changes designed to increase staff capabilities and provide more comprehensive career development. The HKMA has initiated work on mapping out a plan for implementing the recommendations in the Banking Sector Consultancy Study report (see the last section), including the establishment of the Licensing and Compliance Division. This will enable the HKMA to focus more clearly its attention on risk areas of individual institutions as well as the sector as a whole. The HKMA expects to adopt a fully-fledged risk-based supervision approach within two years.

## Capital adequacy

The internationally accepted capital adequacy framework proposed by the Bank for International Settlements (BIS) in 1988 has been applied in Hong Kong since the end of 1989, against the Basle Committee's deadline for full implementation before the end of 1992. The consolidated capital adequacy ratio for locally incorporated institutions as a whole was 19.5% at end-June 1999, well in excess of the minimum international standard of 8% set by the BIS. The HKMA has developed a market risk capital adequacy regime in Hong Kong based on the Amendment to the Capital Accord to incorporate market risks issued by the Basle Committee in January 1996. The market risk capital adequacy regime has been in effect since 31 December 1997. The HKMA has adopted a three-tier approach in implementing the regime, namely the standardised approach, the models approach (the use of which is subject to the HKMA's approval) and a de minimis exemption.

## Supervision of liquidity

The HKMA assesses the adequacy of an institution's liquidity by examining a number of criteria, including the institution's liquidity ratio, maturity mismatch profile, ability to borrow in the interbank market, diversity and stability of the deposit base, loan-to-deposit ratio and intra-group transactions. This approach aims to ensure, as far as possible, that institutions can meet their obligations when they fall due in normal circumstances and that an adequate stock of high quality liquid assets is maintained to provide them with a breathing space in the event of a liquidity crisis.

### Financial disclosure

In line with the international trend towards greater transparency and accountability, the HKMA supports greater disclosure by authorised institutions in Hong Kong. The standard of financial disclosure in Hong Kong has been brought substantially in line with that of other major financial centres following institutions' adoption in 1994 of the Best Practice Guide on Financial Disclosure issued by the HKMA. Authorised institutions incorporated in Hong Kong (except for the smaller restricted licence banks and deposit-taking companies) are required to disclose adequate financial information, including profit and loss accounts, balance sheets, cash flow statements and off-balance sheet exposures in their audited annual accounts and their annual reports.

Further steps were taken by the HKMA in 1998 to increase the transparency of the financial position of AIs and hence to enhance market discipline among these institutions. For local banks, the focus of the 1998 disclosure package was on the quality of banks' loan portfolios. Institutions are required to disclose more detailed information on overdue and rescheduled assets. Disclosure requirements in relation to the Year 2000 problem have also been enhanced. Overseas incorporated AIs are required to disclose on a half-yearly basis selected key financial information drawn from the Best Practice Guide on Financial Disclosure by AIs. Local institutions are required to make interim disclosures with effect from June 1999. This brings the frequency of disclosure by non-listed local institutions in line with that for listed local institutions and institutions incorporated outside Hong Kong.

### Interest rate deregulation

Historically, interest rates paid to depositors on all Hong Kong dollar deposits of up to HK$500,000 (approximately US$64,103) and with a maturity of less than 15 months were governed by the Interest Rate Rules (IRR) of the Hong Kong Association of Banks (HKAB) of which all licensed banks are members. The IRR were partially liberalised in phases starting from 1 October 1994. With the implementation of the final phase of deregulation on 1 November 1995, all small time deposits fixed for 7 days or more have been deregulated. The IRR now apply only to current accounts, savings accounts and time deposits with a maturity or call period below seven days. In July 1999, the HKMA announced a plan to remove the remaining IRR by a two-phase approach (see the last section).

### Electronic banking

The Banking Sector Consultancy Study has advised that technology will be one of the major driving forces for longer-term changes in the financial services industry globally and in Hong Kong. It has also revealed that a high proportion of local banks has plans to launch internet banking services in the next five years. In fact, the HKMA has issued a series of circulars on its supervisory policy with respect to internet banking and a number of banks are now offering internet banking services of various kinds. Meanwhile, the Government is establishing a safe and secure environment for the conduct of electronic transactions over the internet, in the form of a local public key infrastructure and the necessary legal framework in Hong Kong. The HKMA will continue to keep abreast of technological developments and will refine as appropriate its regulatory framework to continue to provide a sound and secure basis for the development of internet banking in Hong Kong.

**Derivatives and risk management**

The HKMA continues to take a proactive approach in the supervision of authorised institutions' derivatives activities. The HKMA adopts a three-pronged approach in developing its supervisory framework for managing the risks of AIs' derivatives activities. They are:

- controls (to ensure that AIs have adequate internal control systems to manage the risks of their derivatives activities);
- capital (to ensure that AIs have adequate capital to support possible losses in their derivatives business); and
- capability (to ensure that there is adequate expertise within the HKMA to develop risk management policies and to supervise AIs' derivatives activities).

In December 1994, the HKMA adopted as an industry guideline the Basle recommendation on risk management of derivatives, which focuses on high level controls by board and senior management. In March 1996, a more detailed operational guideline on financial derivatives was issued which drew on, among other things, observations from internal control reviews, treasury visits to AIs, and the lessons from the Barings and Daiwa Bank incidents. Since 1994, a specialised team has been formed to examine the derivatives and trading activities of institutions which are active in this business, as well as the adequacy of their risk management systems.

**Supervisory co-operation**

To ensure supervisory co-operation the HKMA entered into a Memorandum of Understanding (MOU) with the Securities & Futures Commission (SFC) in October 1995. In 1996, with the assistance of the SFC, the HKMA developed an on-site examination guide on the securities activities of AIs and formed a specialised team to conduct examinations of institutions active in securities activities. The HKMA and the SFC currently meet once a month to discuss supervisory issues and cases of mutual interest.

The exposure of banks to new types of risk around the world has increased the need for supervisors to co-operate with one another, both geographically and functionally. To enhance the exchange of supervisory information and co-operation, the HKMA has entered into MOUs with supervisory authorities in Thailand, Indonesia, Macau, the United States and the United Kingdom. The HKMA continues to participate in this process by extending its bilateral co-operation with banking supervisors in other countries. The HKMA also holds regular meetings with the People's Bank of China to discuss matters of common interest.

The HKMA plays an increasingly active role in international and regional forums of banking supervision. It currently chairs the Executives' Meeting of East Asian-Pacific Central Banks' (EMEAP) Study Group on Banking Supervision and was one of the participants in a working group formed by the Basle Committee to draft the Core Principles for Effective Banking Supervision.

**Further development and reform of the banking sector**

Early in 1998, the HKMA commissioned a consultancy study on the Hong Kong banking sector aimed at developing an appropriate strategy to effectively supervise and regulate the sector for the next five years. The study was completed in December 1998.

Given the new emerging financial environment, the consultancy study suggested four strategic mandates for the HKMA in promoting future developments of the banking sector. These are:

- to ensure that the regulatory and supervisory framework for Hong Kong remains appropriate;
- to improve the competitive environment to ensure the positive benefits of global and local trends are developed in the Hong Kong market;
- to ensure that increasing levels of risk associated with global and local trends are prudently managed; and
- to increase the level of transparency allowing the forces of market discipline to work more effectively.

Having regard to the recommendations of the study and the views received from a three-month public consultation exercise, the HKMA will undertake a package of policy initiatives, as set out below, to reform and further develop Hong Kong's banking system:

**(a) Overall approach:**

- encourage market liberalisation and enhance the level of competitiveness of the Hong Kong banking sector in order to promote greater efficiency and innovation in the market;
- in parallel with the item above, strengthen the banking infrastructure with a view to enhancing the safety and soundness of the sector; and
- by gradual elimination of regulatory barriers, allow market forces to play a greater role in determining the appropriate number of institutions in the banking sector.

**(b) Market reform and liberalisation measures:**

- subject to a monitoring process, adopt a two-phased approach to deregulate the remaining Interest Rate Rules with the first phase to begin on 1 July 2000 with the remaining regulated time deposits with a maturity of below seven days. The second phase is expected to begin on 1 July 2001 with deregulation of savings and current account deposits;
- relax the one branch policy in the second half of 1999 by allowing foreign banks currently subject to the one building condition to open up to three branches initially to which customers have access (full relaxation of this policy will be considered upon a review in 2001);
- subject to appropriate contractual arrangements being agreed with Hong Kong Interbank Clearing Limited, allow access by restricted licence banks to the Real Time Gross Settlement system in the second half of 1999 for the purpose of settling CHATS payments;
- conduct a detailed review in the second half of 2000 on ways to reform the three-tier authorisation system into a two-tiered system and review the minimum paid-up capital requirements for different tiers of authorised institutions at the same time; and
- review the existing market entry requirements for a local banking licence towards the second half of 2001.

**(c) Safety and soundness enhancement measures:**

- conduct a detailed study in the first half of 2000 on the issue of establishing an explicit depositor protection scheme in Hong Kong and review the desirability of setting an asset maintenance requirement for banks in Hong Kong in relation to the Priority Payment Scheme for small depositors under the Companies Ordinance;
- clarify HKMA's role of lender of last resort for banks in Hong Kong;
- continue the efforts to improve the financial disclosure requirements for banks in line with international best practices;
- develop a more formal risk-based supervisory system in Hong Kong;
- conduct a detailed feasibility study in the first half of 2000 on a commercial credit register for the banking system in Hong Kong; and
- promote high standards of corporate governance within the banking system.

This package of policy initiatives has been endorsed by the Government. The overall timetable would envisage these policy initiatives to be completed over a period of around three years.