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FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2021

TECHNICAL NOTE—BANKING SECTOR: SUPERVISION AND REGULATION

This Technical Note on Banking Sector: Supervision and Regulation for the People's Republic of China–Hong Kong Special Administrative Region FSAP was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in June 2021.

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June 7, 2021

TECHNICAL NOTE

BANKING SECTOR: SUPERVISION AND REGULATION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in the People's Republic of China – Hong Kong Special Administrative Region, led by Ananthakrishnan Prasad. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

AI	Authorized (deposit-taking) Institution
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
AT1	Additional Tier 1
BCP	Basel Core Principles for Effective Banking Supervision
BCBS	Basel Committee on Banking Supervision
BO	Banking Ordinance
BCD	Banking Conduct Department
BCR	Banking (Capital) Rules
BDR	Banking (Disclosure) Rules
BSD	Banking Supervision Department
BELR	Banking (Exposure Limits) Rules
BPD	Banking Policy Department
CAMEL	Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity
CBIRC	China Banking and Insurance Regulatory Commission
CE	Chief Executive
CET1	Common Equity Tier 1
CLS	Continuous Linked Settlement
CM	Case Management
CNH	Chinese Yuan in the offshore market
CNY	Chinese Yuan
CP	Core Principle
DTC	Deposit-Taking Company
D-SIB	Domestic Systemically Important Authorized Institutions
ED	Executive Director
EFO	Exchange Fund Ordinance
FBB	Foreign Bank Branch
FRC	Financial Reporting Council
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FX	Foreign Exchange
G-SIB	Global Systemically Important Bank
HSBC	Hong Kong and Shanghai Banking Corporation Limited
HKMA	Hong Kong Monetary Authority
HKSAR	Hong Kong Special Administrative Region

IA	Insurance Authority
ICT	Internal Capital Target
IFFO	Infrastructure Financing Facilitation Office
IHC	Immediate Holding Company
INED	Independent Non-Executive Director
LAC	Loss-Absorbing Capacity
LE	Large Exposure
MA	Monetary Authority
MLO	Money Lenders Ordinance
MOU	Memorandum of Understanding
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
NDFC	Non-deposit taking finance company
NED	Non-Executive Director
RLB	Restricted License Bank
RML	Residential Mortgage Loan
RPT	Related Party Transaction
PBS	Portfolio-based supervision
PRA	Prudential Regulation Authority at the Bank of England
PvP	Payment versus Payment
RCAP	Regulatory Consistency Assessment Program
RTGS	Real Time Gross Settlement
SFC	Securities and Futures Commission
SPM	Supervisory Policy Manual
SRP	Supervisory Review Process
UHC	Ultimate Holding Company

EXECUTIVE SUMMARY[1]

Banking supervision and regulation by the Hong Kong Monetary Authority (HKMA) remain strong. This assessment confirms the 2014 Basel Core Principles assessment that the HKMA achieves a high level of compliance with the BCPs. The Basel III framework (and related guidance) and domestic and cross-border cooperation arrangements are firmly in place. The HKMA actively contributes to the development and implementation of relevant international standards. Updating their risk based supervisory approach helped the HKMA optimize supervisory resources. The HKMA's highly experienced supervisory staff is a key driver to achieving one of the most sophisticated levels of supervision and regulation observed in Asia and beyond.

In recent years, the work of the HKMA has undertaken a variety of initiatives to keep pace with changes in the banking sector and technological advancements. Key priorities include ensuring that regulations support innovation like Smart Banking initiatives and strengthening the cyber resilience of banks. A stronger degree of regulatory oversight is required as the HKMA's supervisory environment continues to become more challenging with geopolitical headwinds. Recent increases to supervisory staff have been mostly devoted to newly identified areas of responsibility, resulting in challenges in managing supervisory resources with competing priorities. It is noteworthy that HKMA's use of independent reviews by external auditors more than doubled from 2017 to 2018. The HKMA has responded well to the diverse challenges associated with an increasingly dynamic financial environment. Continued attention and review is needed in regard to the adequacy of supervisory resources, having regard to operational needs and changes in the range of responsibilities.

Staff reiterates the 2014 FSAP's recommendation to provide de jure operational independence to HKMA. Although the HKMA enjoys de facto operational autonomy, reflecting such position in the law would provide greater legal certainty to the HKMA's operational independence. The Banking Ordinance (Cap. 155) (BO) gives the Chief Executive (CE) of the HKSAR a reserve power to give directions to the Monetary Authority (MA) and the MA shall comply with any direction given. This reflects the HKSAR Government's responsibility for the formulation of monetary and financial policies and supervision of financial markets as enshrined in the Basic Law. While such power has never been invoked and any such exercise of the power would be limited to furthering the objectives of the BO, its existence in principle may undermine the HKMA's de jure operational independence. It would be desirable for it to be removed or clarified by specifying the circumstances under which the CE may give directions to MA. In addition, as in the case with other international financial centers, on-going diligence is needed to ensure that developmental/competitive considerations, particularly connected with new initiatives, are not in conflict with prudential mandates. The HKMA is recommended to review checks and balances on a regular basis to ensure that the objective of maintaining monetary and financial stability is not undermined by developmental initiatives.

The HKMA needs to further strengthen the supervisory framework for bank governance and related party transactions. The HKMA has strengthened its regulatory framework with emphasis on

[1] This technical note was prepared by Hee Kyong Chon (IMF/MCM). The FSAP mission took place in September 2019.

the roles and responsibilities of the Board and independent non-executive directors since the last FSAP. Effective implementation should be the focal point. For instance, the HKMA needs to review the cases where individuals hold a large number of director/management positions in financial and non-financial entities in terms of potential conflicts of interests and time commitment to the role. Supervision on related party transactions should be intensified by strengthening analysis of motivations behind intragroup transactions and closely monitoring banks' implementation of the new connected party definition.

The HKMA should continue to closely monitor concentrated exposures to non-bank Mainland Chinese entities, especially of banking groups that have both foreign banking branches (FBBs) and subsidiaries; focus should be on the potential for regulatory arbitrage. In cases where banks are taking excessive risks, circumventing more rigorous credit risk assessment or bypassing regulatory oversight, more transparent and direct discipline approaches may need to be considered. The group-wide supervisory approach needs to be updated to be more responsive to the evolution in the risks for the banks. Supervisory focus should be placed on risk concentration, group-wide corporate governance, and intra-group transactions and exposures. Exempted exposures from the large exposure (LE) rules, and banks' non-self-use property investment should be closely monitored. Limited scope onsite examination of the large FBBs that have not had an onsite presence for long intervals is also recommended.

The HKMA has stepped up its supervisory efforts on real estate lending over the past years. The HKMA has imposed risk-weight floors on residential mortgage loans, and raised risk weights for credit exposures to property developers offering high LTV mortgages. The HKMA has sophisticated monitoring systems in place to oversee AIs' exposure to real estate lending. Non-deposit taking finance companies (NDFC) in the HKSAR are regulated under the Money Lenders Ordinance and licensed by the Licensing Court, instead of being regulated by the sectoral financial regulators. While the size of the NDFC industry remains small, these finance companies are disbursing residential mortgages and consumer loans for marginal borrowers. The regulatory parameters should be adjusted for more timely recognition of risk. The HKMA should also continue to closely monitor whether macroprudential policies have spurred household exposures to NDFCs and property developers.

Further refinement of the HKMA's supervisory and regulatory approach will make supervision more effective. The framework for the use of external auditor should be strengthened with a view to managing the associated potential conflicts of interest and supervisory objectivity risks, considering HKMA's increased use of independent reviews. Information sharing mechanisms with other supervisors need to be enhanced given the growing linkages among different types of financial institutions. Domestic sectoral regulators are encouraged to conduct joint examinations on the cross-sectoral business to promote consistency.

Table 1. Hong Kong SAR: Main Recommendations on Banking Regulation and Supervision

Recommendations	**Responsible Authorities**	**Timing**
Supervisory Responsibilities, Objectives, and Powers		
Establish a framework to review checks and balances on a regular basis to ensure that the objective of maintaining monetary and financial stability is not undermined by developmental initiatives.	HKMA	C
Reassess the need for amending regulatory parameters by including NDFCs to ensure more timely recognition of risk in the lending space and monitor potential spill-over effect of its macroprudential policy.	HKSAR authorities	MT
Independence and Resourcing		
Update the legislation to reflect the HKMA's de facto operational independence in the law. • Remove the CE's reserve power in the BO to direct the MA or to specify the circumstances under which the CE may give directions to MA	HKSAR authorities	MT
Continue to review the adequacy of supervisory resources and appropriately respond to changes in complexity, range of responsibilities, and desired supervisory activities. • Allocate more staff to large bank supervision and technology risk supervision.	HKMA	C
Cooperation and Collaboration		
Formalize the process of requesting relevant information from other domestic sectoral regulators before its on-site examination on non-banking activities of AIs.	HKSAR sectoral regulators	ST
Continue to proactively identify information that may be of common interest and develop a more effective information sharing mechanism.	HKSAR sectoral regulators	ST
Supervisory Approaches and Techniques		
Strengthen communication with AIs by further articulating the CAMEL supervisory ratings in its notification process and/or clearly communicating its qualitative assessment criteria to provide stronger incentives for AIs to meet the supervisory expectation.	HKMA	ST
Strengthen the supervisory framework on the use of external auditor with a view to managing the associated potential conflicts of interest and supervisory objectivity risks.	HKMA	ST

Table 1. Hong Kong SAR: Main Recommendations on Banking Regulation and Supervision (concluded)

Recommendations	**Responsible Authorities**	**Timing**
Conduct targeted and/or limited scope inspections on FBBs that have not had an onsite examination for long intervals; give special attention to systemically important FBBs.	HKMA	MT
Update group-wide approach to supervision of AIs having regard to the evolution in the risks for the banking groups. • Increase supervisory focus on the areas of risk concentration, group-wide corporate governance, intra-group transactions and exposures, and financial entities' aggregate exposures to non-financial entities.	HKMA	ST
Review and examine the cases where individuals hold a large number of directors/ management positions in other financial and non-financial entities.	HKMA	ST
Prudential Regulations and Requirements		
Continue to closely monitor AIs' concentrated exposures to non-bank Mainland Chinese entities, particularly of banking groups that have both FBBs and subsidiaries with focus on potential opportunities for regulatory arbitrage.	HKMA	C
Minimize exemptions to LE limits as far as practicable in line with Basel framework and closely monitor the exposures that are exempted from the BELR.	HKMA	MT
Closely supervise changes of the AI's non-self-use property.	HKMA	C
Consider the need to improve the prudential reporting template on related party transaction for more effective monitoring (e.g., internal exposure limits, value of non-exposure transactions, types of exposures, RP's relationship to bank, collateral type and amount, and asset classification, etc.)	HKMA	ST
Strengthen analysis on the nature of intragroup transactions.	HKMA	ST
* C= continuous; ST = Short Term (within 0- 2 years); MT = Medium Term (within 3-5 years)		

INTRODUCTION

A. Scope and Approach

1. **This technical note was prepared in the context of the FSAP mission to the HKSAR from September 10–24, 2019.**[2] This note was derived from the Basel Core Principles for Effective Banking Supervision (BCPs) assessments that were completed in the 2014 FSAP. This FSAP focuses on emerging issues and new developments in the areas of banking supervision and regulation that have occurred since the last assessment. This note references the BCP issued by the Basel Committee on Banking Supervision (BCBS) in September 2012 but does not provide grades on compliance nor does it revisit the grades given in the 2014 BCP assessment.

2. **The 2014 FSAP assessment recognized the HKSAR's high level of compliance with the BCP.** In view of the broadly compliant assessment in the 2014 FSAP, this note focuses on five priority areas covered by BCPs[3]:

a. **Progress with 2014 FSAP recommendations:** The 2014 BCP assessment questions relative to (i) de jure independence of the HKMA; (ii) expanding the definition of connected parties; and (iii) giving more explicit power to the HKMA regarding dismissal of inadequate auditors.

b. **Breadth and depth of risk supervision and regulation:** With respect to the deepening economic and financial linkages between Mainland China and the HKSAR and the rapid growth in lending to property developers, it is critical to ensure that the HKMA's regulatory requirements and supervisory approach remain relevant and risk appropriate.

c. **Cross-border and consolidated supervision:** The HKSAR's financial system has large cross-border exposures and significant participation of foreign banks. The arrangements that the HKMA has in place are reviewed through an assessment of the home-host relationship and the consolidated/group-wide supervision.

d. **Coordination and collaboration with other regulatory authorities**: The HKSAR maintains a traditional sectoral regulatory structure. Supervisory cooperation to ensure cross-sectoral issues of mutual concern should be dealt with in an effective manner.

e. **Mandates and resourcing of banking supervisory function in the HKMA**: Like other international financial centers, pursuing dual mandates (i.e. safety and soundness vs competitiveness) requires sufficient checks and balances.

3. **The IMF team extends its gratitude to the authorities and private sector participants for their excellent cooperation.** The authorities updated their self-assessment of the BCP and provided responses to a comprehensive FSAP questionnaire with examples of actual supervisory

[2] This note was prepared by Hee Kyong Chon, a senior financial sector expert of the IMF.

[3] The structure of this note does not follow the sequence of the bullet points in paragraph 2, and the scope of the note also covers conduct risk supervision as well.

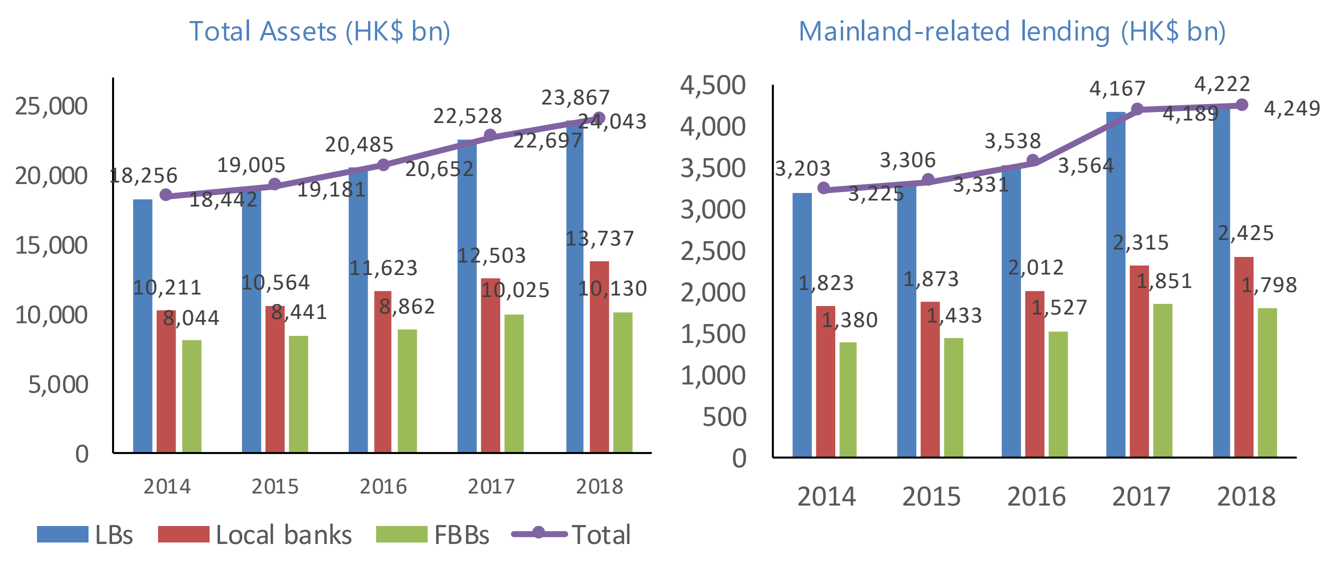
practices. The FSAP had access to supervisory files, staff, and systems, and held extensive meetings with the HKMA staff. The FSAP team also met bank officials, auditing firms, credit rating agencies, the Hong Kong Association of Banks, and other stakeholders. The FSAP team is appreciative of the authorities for their utmost professionalism, cooperation, attention, and hospitality.

B. Banking Sector Structure

4. **The HKSAR has a large and advanced financial system dominated by banks.** The banking sector includes 189 institutions—155 licensed banks, 18 restricted license banks, and 16 deposit-taking companies (as of March 2019) —with assets equivalent to over 822 percent of GDP. The assets of the four largest banks[4] account for almost half of the total consolidated assets of the banking system. Domestic lending to the corporate sector represents around half of the banking system's total lending, while property-related lending accounts for about 30 percent.

5. **The banking system experienced significant asset growth in the past 5 years.** Key trends since the last FSAP include rapid increases in asset size (30 percent), property development lending (141 percent in 2014-2018) and Mainland China related lending (32 percent). Banks' profitability has been strong with double digit return on equity from high fee and commission income and stable net interest margin. Since 2014, banking assets in subsidiaries and branches of Mainland banking groups have increased substantially by 50 percent.

Figure 1. Hong Kong SAR: Total Asset and Mainland-related Lending Growth



Source: HKMA.

6. **HKSAR has a diverse banking sector.** There are three tiers of deposit-taking institutions. These institutions, collectively referred to as authorized institutions (AIs), are (i) licensed banks that

[4] The Hongkong and Shanghai Banking Corporation Limited (HSBC), Hang Seng Bank Limited (a subsidiary of HSBC), Bank of China (Hong Kong) Limited, and Standard Chartered Bank (Hong Kong) Limited.

can carry out the full range of banking business; (ii) restricted licence banks (RLBs) that may take deposits of no less than HK$500,000 (or an equivalent amount in any other currency) without limit on term; and (iii) deposit-taking companies (DTCs) that may take deposits of no less than HK$100,000 (or an equivalent amount in any other currency) of a tenure of not less than three months. Retail deposits are dominated by the three largest banks (all local subsidiaries of overseas banking groups). Indigenous local banks that are medium to small in size play an important role in SME lending. A few FBBs are integral players in the private banking and derivatives market, while some others mainly serve clients of their respective nationalities. More than half of FBBs have relatively simple operations.

Table 2. Hong Kong SAR: Overview of the Structure of the Banking System
(As of end-June 2019)

Authorized institutions (AIs) supervised by the HKMA	Number of AIs	Market share (total assets)	Total assets growth rate since 2014
Licensed banks (LBs)	160	99.2%	31.2%
• Local banks	30	59.1%	39.7%
- Subsidiaries of foreign banks and bank holding companies	15	31.9%	43.8%
o Subsidiaries of Mainland Chinese banking group	7	20.3%	49.5%
- Virtual banks*	8	n.a.	n.a.
• Foreign bank branches (FBBs)	130	40.2%	20.5%
- Branches of Mainland Chinese banking group/banks	13	13.2%	47.8%
Restricted licence banks (RLBs)	18	0.7%	14.8%
Deposit taking companies (DTCs)	16	0.1%	-53.8%
Total	194	100%	30.9%

Source: HKMA.

*All virtual banks have not commenced business.

7. **There is a strong presence of global systemically important banks (G-SIBs) in the HKSAR.** All 29 G-SIBs identified by the Financial Stability Board (FSB) in November 2018 undertake banking activities in the HKSAR. Accounting for about 40 percent of the banking system's total assets, foreign branches demonstrate a diversity of business models in the HKSAR. Some of these branches act as group liquidity hubs, some conduct investment banking activities, and others are active in corporate lending or the local interbank market.

8. **Hong Kong banks are well capitalized and maintain low levels of nonperforming loans.** Banks' capital adequacy remains robust at around 20 percent, with a Tier 1 capital ratio around 18 percent. Solvency stress tests conducted by the HKMA suggest that banks' capital adequacy is resilient to both domestic and external shocks, including sharp increases in interest rates. Profitability is supported by steady improvements in net interest income. Banks' funding continues to be dominated by customer deposits with their share of funding making up close to 57 percent of liabilities. The classified loan ratio of the banking sector stands at 0.56 percent, well below the long-run historical average of 2 percent since 2000. The loan to deposit ratio increased from 51.5 percent as of end 2009 to 73.4 percent as of end March 2019.

9. The stability of the system is reinforced by the Exchange Fund. The Exchange Fund's assets reached HK$4 trillion at end-2018. It is largely comprised of a Backing Portfolio (fully backed by high-quality, highly liquid US dollar-denominated assets to cover the Monetary Base), an Investment Portfolio (invested in bond and equity markets in both developed and emerging market economies with a view to preserving the Exchange Fund's value and long-term purchasing power), and a Long-Term Growth Portfolio (invested in private equity and overseas real estate to help diversify risks and enhance medium-to-long term returns). While the primary objective of the Fund is to maintain currency stability (through the Linked Exchange Rate System), it can also be used for maintaining the stability and integrity of the HKSAR's monetary and financial systems. Specifically, it can be used to provide liquidity and capital to the banking system when there are issues with systemic stability, and provide a backstop for the Deposit Protection Scheme.

C. Preconditions for Effective Banking Supervision

10. The 2014 BCP assessment determined that the preconditions for effective supervision are well established in the HKSAR. The HKSAR is a common law jurisdiction. When Hong Kong became a Special Administrative Region of the People's Republic of China in 1997, the Basic Law, which sets out the constitutional framework of the HKSAR, came into effect. Under the principle of "one country, two systems" enshrined in the Basic Law, the laws previously in force in Hong Kong (the common law, rules of equity, ordinances, subordinate legislation and customary law) shall be maintained, except for any that contravene the Basic Law and subject to any amendment by the legislature of the HKSAR. The Basic Law further provides that the HKSAR courts, when adjudicating cases, may refer to precedents of other common law jurisdictions.

11. Maintaining a transparent legal system with an independent judiciary is one of the critical components of the HKSAR's success as an international financial center. The HKSAR's rule of law is directly related to public confidence in its financial sector. The distinct and unique legal status of the HKSAR should be maintained by upholding transparent rules and its judicial independence. Doing so will ensure that the HKSAR's banking system stays central to the world and the Asian continent.

INSTITUTIONAL SETTING

A. Supervisory Responsibilities, Objectives, and Powers

Supervisory Objectives

12. Under the BO, the HKMA's principal function as a bank supervisor is to promote the general stability and effective working of the banking system. The MA is the Chief Executive of an organization, referred to as the HKMA, which works to enable the MA to fulfill his statutory responsibilities and functions set out in the BO.[5] The BO regulates the banking business and the

[5] Legally, the MA is a person appointed by the FS under EFO section 5A.

business of taking deposits, makes provision for the supervision of AIs to provide a measure of protection to depositors, promotes the general stability and effective working of the banking system, etc. AIs operating a banking business and/or a business of taking deposits in the HKSAR are subject to regulation and supervision by the MA under the BO.

13. The HKMA has four main functions: (i) maintaining currency stability within the framework of the Linked Exchange Rate System (Section 3(1) of the Exchange Fund Ordinance (Cap. 66) (EFO)), (ii) promoting the stability and integrity of the financial system including the banking system (BO Section 7(1), etc.), (iii) managing the Exchange Fund (EFO Section 3(2)), and (iv) helping to maintain Hong Kong's status as an international financial center, including the maintenance and development of Hong Kong's financial infrastructure (EFO Section 3(1A)).

14. As observed by the 2014 FSAP and in many other jurisdictions, the HKMA's developmental function can potentially conflict with the stability objective. The HKMA may use the Exchange Fund to maintain the stability and integrity of the monetary and financial systems of Hong Kong, with a view to maintaining the HKSAR's status as an international financial center. In 2016, for instance, the HKMA established the Infrastructure Financing Facilitation Office, which facilitates infrastructure investment and financing by working with a cluster of key stakeholders[6].

15. The mission acknowledged, however, that there is a clear operational demarcation of roles and responsibility within the HKMA to ensure the separation of regulatory/supervisory functions and market development functions. The banking departments within the HKMA, namely the Banking Supervision Department (BSD), the Banking Policy Department (BPD), the Banking Conduct Department (BCD), the Enforcement and Anti-Money Laundering Department, and the Resolution Office, are responsible for promoting the safety and soundness of banks and the stability of the banking system in the HKSAR. Development of the HKSAR as an international financial center is primarily led by the Market Development Division under the External Department of the HKMA. Each function has its own Deputy Chief Executive / Senior Executive Director. It is important to provide an independent and authoritative voice on what is considered prudent where the work of developmental/competitive mandate touches the regulatory boundary. Staff noted that a strong commitment exists in the HKMA in recognizing that stability in this area is a prerequisite for maintaining HKSAR's position as an international financial center.

16. Nevertheless, on-going diligence is needed to ensure that developmental/competitive considerations connected with new initiatives do not impair the HKMA's prudential mandates. The HKMA has undertaken various initiatives in recent years to help the banking sector prepare for the challenges arising from the rapid development of technology, the new era of Smart Banking,[7] the

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[6] Besides the management team (https://iffo.org.hk/about-us/iffo-management), there are currently seven staff members supporting the work of IFFO.

[7] To strengthen the HKSAR's position as a financial hub in Asia, the HKMA established the Fintech Facilitation Office in 2016, which has played a pivotal role in driving the implementation of the seven Smart Banking Initiatives aimed at facilitating the development and use of fintech in the banking and payment industries.

Green and Sustainable Banking Initiative[8], and facilitating infrastructure investment and financing.[9] The authority indicated that its institutional arrangements (e.g., the Risk Committee chaired by the Chief Executive of the HKMA) are able to ensure that sufficient checks and balances are put in place within the HKMA to assess such operational risk. While supporting banks and innovation is important, ensuring the safety and soundness of the HKSAR banking system needs to remain the top priority of the HKMA's prudential mandate. Where there is a conflict between the prudential supervisory objective and other objectives, the prudential objective should prevail. It is important to ensure that the HKMA's corporate-wide resource allocation will not be affected by any conflict.

Recommendations

- Establish an internal framework to review checks and balances on a regular basis to ensure that the objective of maintaining monetary and financial stability is not undermined by developmental initiatives.
- Ensure the HKMA's mandate for prudential supervision is not compromised by its developmental mandates/competitive considerations through institutional safeguards, especially, in planning resource allocation and in setting supervisory and regulatory priorities.

Supervisory Responsibilities

17. The HKSAR maintains a traditional sectoral regulatory structure. Responsibilities for prudential supervision of the HKSAR's financial sector are split among four principal financial regulators. The banking, securities and insurance industries, and the operation of the Mandatory Provident Fund (MPF) schemes and occupational retirement schemes are primarily regulated by four financial regulators: The MA, the Securities and Futures Commission (SFC), the Insurance Authority (IA) and the Mandatory Provident Fund Schemes Authority (MPFA). Each of the financial service sectors is subject to a licensing/registration regime and a regulatory framework for ensuring the safety and soundness of regulated entities and conducting business in a proper and prudent manner. The supervisory authorities seek to ensure effective supervisory cooperation and that cross-sectoral issues of mutual concern are dealt with in an effective manner.

18. Non-deposit taking finance companies (NDFC) are not of themselves regulated by the four principal regulators as mentioned in the preceding paragraph. They are regulated under the Money Lenders Ordinance and are licensed by the Licensing Court. The Hong Kong Police Force is responsible for enforcement work including investigations of complaints against NDFCs, and provides opinions to the Licensing Court on licensing matters, while the Registrar of Money Lenders will conduct site inspections on NDFCs and collect information from NDFCs on their loan businesses. However, where a NDFC is a subsidiary of a locally incorporated AI, the MA will exercise consolidated

[8] In May 2019, the HKMA announced the setup of the Centre for Green Finance (CGF) under the Infrastructure Financing Facilitation Office. The objectives are to promote Hong Kong as the hub for green finance in Asia and the importance of sustainability within infrastructure investment and financing.

[9] IFFO is a platform established in July 2016 by the HKMA to facilitate infrastructure investments and their financing. This has been given further impetus by the Belt and Road Initiative, a strategy by the Chinese Government to promote connectivity and long-term development in the regions spanning Asia, Africa and Europe.

supervision to ensure that the operations of the AI and the NDFC are properly conducted. While the size of the NDFC industry remains small, these finance companies are disbursing residential mortgages and consumer loans for marginal borrowers. The regulatory parameters should be adjusted for more timely recognition of risk. The HKMA should also continue to closely monitor whether macroprudential policies have spurred household exposures to NDFCs and property developers. In the future, the authorities should consider imposing the same macroprudential limits on residential mortgages granted by NDFCs.

Recommendation

- Reassess the need for amending the regulatory parameter by including NDFCs, to ensure a more timely recognition of risk in the lending space and monitor a potential spill-over effect of its macroprudential policy.

B. Independence and Resourcing

19. Overall, the HKMA performs its supervisory tasks in an operationally independent manner. The HKMA enjoys operational independence in discharging its duty.

De Jure Independence of the HKMA

20. The mission reiterates the 2014 BCP assessment recommendation that amendments to the BO (Section 10) be made to eliminate or specify the circumstances under which the legal authority of the CE to give directions to the MA may be exercised. This recommendation has yet to be addressed. Section 10 of BO gives the CE a reserve power to "give such directions as he thinks fit" adding that the MA "shall comply with any directions given." The authorities explained that the power vested in the CE to issue directions to the MA under Section 10 of the BO underpins the ultimate constitutional responsibility of the HKSAR Government to formulate monetary and financial policies, and to regulate and supervise financial markets as enshrined in the Basic Law of the HKSAR.[10] The authority noted that the power has never been invoked and any such exercise of the power would need to be in accordance with the objectives and functions of the BO, and in practice would only be used as a tool of last resort to implement specific remedial measures in the most critical and extreme circumstances. Any unreasonable use of the power would be subject to judicial review, thereby safeguarding against any arbitrary use of the reserve power. The HKMA also underlines that in the HKSAR there is a deeply embedded constitutional and political convention of restraint such that any arbitrary attempt to abuse the power would be politically untenable, and that the HKSAR Government and the legislature do not have any track record of interfering with the independent operations of the HKMA. Nevertheless, the existence of such reserve power of the CE in principle may undermine the HKMA's de jure operational independence.

21. The 2014 BCP assessment also recommended that legislative amendments be made to confirm the reasons for which the MA could be dismissed and to publicly disclose the reasons for dismissal. The HKMA explained that any person having power to make such appointment shall

[10] To provide greater transparency to the division of functions and responsibilities in monetary and financial affairs, official letters exchanged between the MA and the FS in June 2003 were made publicly available.

also have the power to remove or dismiss the appointment according to Section 42 of the Interpretation and General Clauses Ordinance. While the Financial Secretary (FS) has the power to dismiss the MA, he is required under the common law to act reasonably and consider all relevant factors in exercising such power; the FS's decision is subject to judicial review. In practice, the HKMA publicly announces all changes and reasons for the change of staff at the Executive Director (ED) level or above. The confidential appointment letter of the MA makes it clear that it is not the FS's intention to terminate the MA's employment outside of extenuating circumstances. Legally, the MA can be dismissed by the government without disclosing the reasons. The FS is the approving authority of personnel changes at the ED level and up.

22. While there is no legally specified minimum of the MA's office term after appointment, the recent practice has been in line with accepted standards. The previous MA served his position for ten years and the current MA has been appointed for a term of five years; this was determined after consultation with the Exchange Fund Advisory Committee's Governance Sub-Committee.

Recommendation

- Consideration should be given to update the legislation to reflect the HKMA's de facto operational independence in the law, so that the HKMA has de jure discretion to take any supervisory and regulatory actions as needed.
    - Eliminate the provisions allowing the CE to direct the MA or to specify the circumstances under which the CE may give directions to MA (e.g., such power may be used in the most extreme circumstances and any override should be made public).
- Legislative amendment is recommended to require the disclosure of the reasons of dismissal for MA for more transparency.

Resourcing of the HKMA

23. The mission appreciates that the BSD of the HKMA has reorganized its structure since the 2014 FSAP. The BSD consists of Case Management Teams, Risk Specialist Teams and Banking System Surveillance Teams. The Case Management Teams are responsible for the day-to-day supervision of AIs including activities like conducting annual CAMEL[11] and supervisory review process (SRP) assessments, promoting home-host supervision, formulating supervisory plans, assessing overall risk governance, and maintaining regular dialogue with the Board and senior management. The Risk Specialist Teams are dedicated to the supervision of specific banking risks, such as credit, market, liquidity, operational and technology risks. The Risk Specialist Teams conduct off-site and on-site inspections in different risk areas. The Banking System Surveillance Teams are responsible for understanding market development and trends along with identifying emerging risks

[11] CAMEL is an internationally recognized framework for assessing Capital adequacy, Asset quality, Management, Earnings and Liquidity. The overall rating is expressed through the use of a numerical scale of 1 to 5 in ascending order of supervisory concern.

in the banking sector and irregularities of individual AIs.

24. The HKMA has optimized its use of supervisory resources by further refining its risk-based approach. In the HKMA, about half of the 187 staff members of the BSD are allocated to case management[12] and the rest are credit, market, liquidity, operational and technology risk specialists and banking system surveillance. The HKMA has managed to recruit, develop, and maintain a highly competent workforce to support its policy objectives and respond to changing work priorities. The turnover rate for banking departments has remained stable over the past five years at 4.5%. With respect to case management supervision, the HKMA introduced portfolio-based supervision (PBS), which is applicable to AIs with smaller and less complex operations.

25. In recent years, the work of the HKMA has taken diverse initiatives to keep pace with changes in the banking sector and technological advancements. Additional resources have been allotted to strengthen the supervisory teams. For instance, the headcount of the BSD increased from 156 in 2016 to 176 in 2019 (13 percent) to facilitate the supervision of operational and technology risks arising from cyber-attacks and fintech development, and the supervision of virtual banks. The first batch of virtual banks is expected to launch in the near future, thus, an increased allocation of supervisory resources will be warranted for this area.

26. The HKMA staff increase was mostly devoted to new areas of responsibility in the HKMA (e.g., virtual banking and intensified cyber/IT risk supervision). In addition to the new responsibilities, banking assets have increased by 31 percent over the last five years. Higher supervisory expectations with respect to emerging risks, group-wide supervision from complex arrangements, and Basel III final package implementation have contributed to the high demand of supervisory resources. Conduct risk and anti-money laundering and combating the financing of terrorism (AML/CFT) supervision also requires significant resources for continuous supervision in the HKSAR. HKMA needs to keep in view supervisory needs and adjust resources accordingly.

27. It is important for the HKMA to expand its range of expertise in line with the broadening scope of activities, and it is equally important to manage the supervisory resources spent on traditional institutional banking supervision. For instance, human resources in the BSD appear to be stretched by increasing demands. There is dedicated case management manpower (76 staff) to conduct institution specific supervision of 194 banks. The headcounts of Case Management Division 1 (in charge of 17 local banks supervision including three D-SIBs) are 18 people in total, although large banks are supervised by a combination of CM officer(s) and a team of risk specialists.[13] Nine supervisors in the portfolio management team are tasked with handling 85 banks' CAMEL ratings and day-to-day supervision. Although no international standards exist in respect of supervisory resources and simple benchmarking appears extremely difficult, a relevant comparison could be made with supervisory agencies in other countries with significant financial sectors.

[12] The Case Management Teams are responsible for day-to-day supervision of AIs.

[13] The headcount in CM-Div 1 has decreased from 26 in 2016 to 18 in 2019 due to reshuffling and reallocation of banks that each division is in charge and sending more staff to risk specialist teams.

Table 3. Hong Kong SAR: Prudential Supervision Resources within the HKMA (As at June 2019)

Prudential Supervision Resources	HKMA
Number of full-time equivalents for banking supervision	187
Case management supervision	76
Risk supervision	111
Number of G-SIBs headquartered in the HKSAR	0
Number of AIs designated as D-SIBs	6
Number of AIs supervised	194
Market share of D-SIBs (% of banking assets)	45%
Banking assets as % of GDP	835%

Source: HKMA.

28. Optimizing supervisory resources have resulted in an increased use of external auditors to a certain degree. The number of independent reviews by external auditors more than doubled from 2017 to 2018 (See the part of "the use of external auditors" for details).

Recommendations

- The HKMA is recommended to continue to review its supervisory resources and appropriately respond to changes in complexity, range of responsibilities, desired supervisory intensity, and importance of the banking sector in the HKSAR.[14]
    - More staff may need to be allocated to large bank supervisory functions and increased supervisory activities related to technology risk.

C. Cooperation and Collaboration

Cooperation with Regulators in Foreign Authorities and the Mainland of China

29. The HKMA has strengthened home-host coordination and cooperation with home supervisors of international banks (e.g., Prudential Regulation Authority) and the regulators in the Mainland China (e.g., China Banking and Insurance Regulatory Commission). There are mutual consultations and information is shared on a range of regulatory and supervisory matters. For example, the HKMA participated in or led 32 supervisory colleges in 2018 while also cooperating with the home supervisors for their on-site examinations of banks' operations in the HKSAR. In addition to meeting with examination teams and exchanging examination reports, the HKMA may also participate in examinations.

[14] The HKMA is reviewing its headcount for 2020 for consideration by the Governance Sub-Committee in late 2019.

30. In 2016, the HKMA as an intermediate home supervisor organized a joint examination with the host supervisor in Mainland China and the European home supervisor on Mainland Chinese operations of a G-SIB. This type of joint examination provided a knowledge-sharing opportunity for home and host supervisors. As another example, in response to a home supervisor's expressed concern regarding a weakness found in the operational risk management framework of a banking group, the HKMA conducted an on-site examination on the overseas subsidiaries of a locally incorporated bank.

Box 1. Hong Kong SAR: HKMA's Interactions with Home Supervisors as a Host Supervisor

Case 1. In 2016, the HKMA closely monitored the poor asset quality of a foreign bank branch in the HKSAR for its potential impact on the parent bank's capital position. In addition to imposing supervisory arrangements on the Hong Kong branch, the HKMA considered the need to invoke the power under the BO to protect the interests of the branch's depositors in Hong Kong in relation to the bank's going-concern and possible spillover on the Hong Kong branch.

The HKMA requested the home supervisor's views on the bank's financial condition and recapitalization plan. The home supervisor shared with the HKMA on a timely basis all relevant information such as the capital and liquidity conditions of the bank, their going-concern assessment, and assessment of the recapitalization plans, including notification of approval where applicable.

The consistency and fluidity of information shared assisted in the HKMA's decision to not invoke its power under the BO.

Case 2. Between 2016 and 2017, the HKMA's on-site examinations and a foreign bank branch's internal review processes identified significant deficiencies in its credit risk management systems and compliance function. The HKMA requested immediate corrective action and reported the issue to the home regulator at supervisory college meetings and bilateral meetings for its follow-up with the bank's head office.

The interactions were effective, as shown by the additional resources allocated to the Hong Kong branch and the satisfactory progress made by the branch in implementing the rectification measures.

Cooperation Among Domestic Financial Regulators

31. The HKMA and other domestic sectoral financial regulators cooperate extensively at different levels of seniority. To do this, the HKMA has entered into MOUs with other domestic sectoral financial regulators to set out the agreed framework for supervisory cooperation and information sharing. These MOUs establish the expectation that the authorities will share with each other, as permitted by law (e.g., Section 120 of the BO), information that will assist in the exercise of their statutory functions. In practice, the HKMA holds regular MOU meetings with the SFC, IA, and MPFA to discuss common regulatory and supervisory matters.

32. The traditional sectoral regulatory structure in the HKSAR appears to be robust and MOUs are effective. For instance, the MOU between the HKMA and the IA has specified whether the HKMA or the IA will be the coordinator for supervision of a financial group with both banking and insurance entities. In general, the HKMA will be the coordinator when an AI has an authorized insurer as its subsidiary and the IA will be the coordinator if the holding company of an AI is an authorized insurer. With respect to some non-banking activities (e.g., securities, insurance and MPF intermediary activities) conducted by AIs[15], the HKMA, as the front-line supervisor of AIs, is responsible for supervising these activities in collaboration with the lead supervisors, i.e. the SFC, IA, and MPFA. AIs are required to comply with the relevant codes or standards issued by these authorities.

33. The focus, expertise, and intensity of supervision may differ by lead supervisor. In principle, supervisory and regulatory approaches should be applied to the relevant activities of the same nature to ensure that consistent regulatory standards are adopted across agencies. Supervisory activities are by and large consistent across sectors. The HKMA may adopt their supervisory approaches having regard to institution-specific considerations because adequate protection should be accorded to customers when sales of securities, insurance and MPF products are taking place in the bank environment as customers usually have special trust in banks. For instance, as part of conduct risk supervision, the HKMA runs a 'mystery shopping program' and conducts half-yearly insurance surveys on AIs, whereas the IA has not used the same program or format. In supervising AIs' insurance intermediary activities, the HKMA has been carrying out supervisory activities based on its on-going supervisory experiences whilst the IA took up the direct supervision of insurance intermediaries from the self-regulatory organizations as of September 23, 2019. The HKMA had also consulted the IA on the insurance survey template and kept the IA informed of the mystery shopping program prior to their implementation.

34. Collaboration and cooperation through information sharing is critical to achieve the desired supervisory outcome. The HKMA and SFC meet regularly to share information of common interest[16] and discuss enforcement-related matters concerning AIs and AIs' security intermediary activities to ensure consistency in interpretation of regulatory standards. Regular training sessions have been held across agencies and staff exchange programs have been made available to promote knowledge sharing. Joint HKMA and SFC thematic examinations are conducted on the sale of investment products of AIs to ensure consistency in approach and performance. Upon the implementation of the new regulatory regime for insurance intermediaries on 23 September 2019, a joint inspection between the HKMA and IA is being planned.

35. Overall, the information sharing mechanism between the HKMA and other domestic regulators is effective, but there is scope for improvement. During the course of supervision, each authority shares or may request specific information on a regular and ad hoc basis. For example, on a monthly basis, the SFC provides the HKMA with information on newly authorized retail investment products (for which the relevant lists of retail investment products authorized by the SFC from time to time are available on the SFC website). The HKMA also shares with the SFC regularly (e.g. quarterly) results of surveys on retail banks' selling of investment products. For group-wide supervision, the IA provides the HKMA, *on a yearly basis* with information compiled from returns collected from insurers that are subsidiaries of AIs. The current timing of exchange, which is

[15] For instance, as at end-June 2019, 115 AIs were registered institutions for securities businesses and 42 AIs were licensed as insurance intermediaries.

[16] For illustration, in July 2019, the HKMA and the SFC entered into a new Side Letter to further enhance the collaboration between the two agencies. The Side Letter outlines arrangements for information sharing to ensure that the HKMA and the SFC can discharge their respective statutory functions more effectively.

conducted on a need basis, may need to step up for day-to-day supervision. The HKMA indicated that they are in discussion with IA to prepare a list of information to be shared.

Recommendations

- Domestic sectoral regulators are encouraged to actively conduct joint examinations on cross-sectoral business to promote consistency in supervisory activities.
- Formalize the process of requesting relevant information from other domestic sectoral regulators before on-site examination of non-banking activities of AIs.
- Continue to proactively identify information that may be of common interest and refine the information sharing mechanism as necessary to reflect industry development.
    - The types and frequency of information to be shared should be reviewed and updated on a regular basis (e.g., yearly) to reflect industry development.

BANKING SUPERVISION

A. Supervisory Approaches and Techniques

36. The HKMA is an effective and competent supervisor. The HKMA has effectively carried out its duties in a complex and dynamic financial environment. It continues to pursue the most efficient and effective ways to utilize its supervisory resources and maintain quality performance. The rest of this note highlights areas that the assessor identified as requiring more attention to further reinforce effective banking supervision.

37. Within the HKMA, the BSD, BCD and BPD are the primary units responsible for the policy formulation and supervision of AIs for prudential and conduct risk. The BSD has six divisions, three case management divisions responsible for vertical supervision of AIs, and three specialized risk divisions responsible for horizontal supervision and on-site inspections of key risk areas of AIs. Specialized risk teams conduct on-site examinations targeting AIs that are of supervisory concern. In 2017 and 2018, the HKMA respectively performed 401 and 392 on-site examinations and thematic reviews. These divisions coordinate closely in the supervisory process of AIs. For example, the risk teams provide input for CAMEL, SRP assessments, discuss risk governance issues, and share on-site examination reports and observations from off-site supervisory work. The case management teams provide comments on risk profiling work from risk teams. The BCD is responsible for supervising AIs' conduct on the sale of investment, insurance and MPF products, and the BPD is in charge of formulating regulatory policies for the banking sector.

38. The Enforcement and AML Department consists of two Enforcement Divisions and the AML & Financial Crime Risk Division. The two Enforcement Divisions are responsible for handling customer complaints and other reporting about banking products or services and, through the process, may identify issues of supervisory or disciplinary concern that require appropriate follow-up actions including the exercise of supervisory and/or disciplinary powers against the bank and/or staff concerned to deter improper practices and behavior and promote proper standards of conduct and prudent business practices among AIs, and to provide a measure of protection to depositors and investors. The AML & Financial Crime Risk Division (AML Division) is responsible for supervising AIs' compliance with the legal and supervisory requirements set out in the Anti-Money Laundering and Counter-Terrorist Financing Ordinance. In 2015, the AML Division was moved under the purview of an Executive Director who has the dedicated responsibility of overseeing the HKMA's AML/CFT and enforcement work. Conscious effort has been made to staff the AML Division with a mixture of specialists and supervisors with various backgrounds (such as financial/banking, audit, AML/CFT compliance, law enforcement, etc.) for best results. The HKMA primarily takes a risk-based approach to AML/CFT supervision and from 2015, has expanded resources for developing a model for AML/CFT risk assessment and a thematic review of AIs' sanctions regimes.

The Process of the Risk-based Banking Supervision

39. The HKMA adopts a risk-based supervisory approach. The HKMA supervisory intensity correlates with the identified systematic risks and supervisory concerns of AIs. A detailed supervisory plan provides guidance on supervisory priorities and resource planning. For example, in accordance with the BSD's internal guide on risk profiling, the specialized risk teams conduct annual risk profiling on AIs to help prioritize supervisory work. Based on the quantitative and qualitative assessments, AIs were assigned High/Medium/Low Supervisory priority ratings. Taking into account management guidance, overall supervisory focus, and case management's comments, the risk profiling results are used to determine supervisory priorities and resources planning. Banks in the high risk category will be examined at least annually, and medium or low risk banks will be subject to less frequent on-site inspections.

40. The HKMA has further refined its approach to risk-based supervision with resources allocated according to the risk profile of AIs since the 2014 FSAP. A new framework was established to determine the type of supervisory approach for each AI based on a set of quantitative and qualitative factors such as the size and complexity of the AI's operations in Hong Kong, presence of significant supervisory concerns, etc. There are two types of supervisory approaches, institution-based and portfolio-based supervision. Traditional institution-based supervision is applicable to locally incorporated banks and major foreign branches given their systemic importance in the banking sector.

41. Portfolio-based supervision (PBS) is applicable to AIs with relatively insignificant operations and assessed to be low risk, whereby more data-driven and standardization of processes will be applied. For AIs under PBS, the HKMA places greater reliance on off-site supervision. The supervisors in the BSD monitor the financial conditions of these AIs on a monthly basis by reviewing MIS reports specifically designed for the BSD's portfolio supervision team.[17] There are no regular meetings with the Board and prudential meetings are held as needed. The HKMA also relies on the work of the internal and external auditors to complement their supervision of these AIs. AIs under PBS provide an annual update to the HKMA on their business plans and

[17] The HKMA has enhanced its macro-surveillance capability through the regular production of suite of more risk focused MIS reports, to facilitate early identification of emerging risks to the banking systems and individual AIs.

critical supervisory information. This information is taken into account in the AIs' annual CAMEL assessments.

42. Determination of proportional segments to apply PBS is one of the key challenges. A number of AIs are currently being supervised under the PBS approach, and the appropriateness of the supervisory basis adopted for AIs is reviewed at least annually. Where significant concerns are identified in any AI during off-site supervision, the AI will be moved to the institution-based supervision. However, the assessor noted the cases where the determination was not always related to its supervisory rating. For instance, the 2018 CAMEL assessment identified that a few AIs under portfolio-based supervision were rated "3" but not all were subsequently transferred to institution-based supervision.

43. The HKMA streamlined the SRP and CAMEL assessment processes in 2016. The refinement aimed to enhance the efficiency of the processes by eliminating redundancies like duplicate forms. Every year, the HKMA conducts CAMEL reviews of all AIs and SRP reviews of all locally incorporated AIs. The supervisors maintain a risk-focused approach and communicate issues of supervisory concerns to their senior management for review. The results are reviewed by CAMEL/SRP approval committees in an independent manner.[18] The composite CAMEL rating and minimum capital requirement derived respectively from the CAMEL review and the SRP review are communicated to individual AIs in writing.

44. With respect to the CAMEL/SRP notification process, there is room for improvements to ensure the AI is clear on HKMA expectations. Although the HKMA notifies the final composite rating and areas of weaknesses in risk management and controls to AI on an annual basis, there is no discussion or evaluation of each component rating (i.e., capital adequacy, asset quality, management, earning, liquidity). The HKMA elaborates when composite ratings have changed or fallen below "2." Per the mission's discussion with some AIs, nevertheless, AIs do not seem to know how the rating was decided and what qualitative criteria were used by the HKMA. CAMEL indicators and qualitative assessment criteria have not been open to the industry. AIs should see this CAMEL/SRP exercise as a valuable benchmarking opportunity. Direct assessment of each component and further articulation of CAMEL supervisory ratings in its official notification letter may increase the incentives to address the areas to be enhanced. The HKMA indicated that the template of notification was also recently revised to require an AI to inform its Board or their head office of its supervisory rating and SRP result. The SRP supervisory policy manual (CA-G-5) is also currently being revised to reflect the latest Basel standards.

Recommendations

- Strengthen communication with AIs by further articulating the CAMEL supervisory ratings in its notification process and/or clearly communicating its qualitative assessment criteria of each component to provide stronger incentives for AIs to meet the supervisory expectation.

[18] The approval committee has a quorum of three members, comprising the Executive Director of the BSD as the chairman, and two approving members (Division Heads of the BSD) who are not involved in proposing the ratings in question.

- Continue to be vigilant in determining proportional segments to apply PBS through regular review of various thresholds while considering qualitative factors.

The Process of On-site Examination

45. Specialized risk teams propose on-site examinations and reviews to be conducted for which AIs and in which areas. Factors taken into consideration include (i) prevailing and emerging risk factors faced by the industry; (ii) the result of the latest risk profiling assessment of AIs; (iii) any common and significant risk management weaknesses identified in previous examinations/desktop reviews warranting a more extensive inspection; and (iv) comments from case management teams.

46. In conducting the examinations, on-site examination teams will follow the terms of reference approved by the relevant Division Heads. The terms of reference specify objectives and scopes of the examination, key areas to be covered, and sampling methodologies. The "mandated activities" of on-site examinations include: pre-field-work assessment, field work, internal communication, preparation of draft report, issue of final examination report. A final examination report incorporates the findings, recommendations for remedial measures, and the AI's management responses. The final examination report will normally be issued to the AI within three months after the conclusion of the on-site visit. If an examination finding is classified as high severity, the HKMA will require the AI to report it to the Board of Directors or the regional head office (HO) if the AI is incorporated outside Hong Kong.

The Use of External Auditors

47. The work of external auditors is an important element of the HKMA's supervisory process. The HKMA has actively used external auditors to look into certain matters that are of prudential concerns. The legal framework for external auditors' major duties and responsibilities in relation to prudential supervision are set out in section 63(3), 63(3A) and 59(2) of the BO. An AI may also be required to appoint external auditors to commission an independent review. Major areas of control that may be covered by section 59(2) of the BO or otherwise include:

- Corporate governance; risk management system, controls relating to specific operational areas (e.g., lending or trading activities), loan classification system, information technology, business continuity planning, prevention of money laundering, internal audit function.

48. Benefits from relying on external auditors include extending the HKMA's reach and resources particularly to small banks. Using the external auditor's findings, the HKMA can discuss any identified deficiencies in the AI and seek timely rectification. The results of external auditor's work are also taken into account in the annual assessment of the AI's CAMEL ratings. In some cases, tripartite meetings between the HKMA, the bank and its internal and external auditors are held.

49. The number of independent reviews by auditors more than doubled from 2017 to 2018. The relevant auditors are appointed by AIs and approved by the HKMA (for independent reviews under section 59(2) of the BO). The auditors could be a firm that already provides a bank with other consulting services. Nevertheless, SPM IC-3 (Reporting requirements relating to AI's external auditors under the BO) emphasizes that any potential conflict of interest would be taken in account in the selection of auditors for regulatory reporting purposes. All supervisory audit costs are borne by the AIs. The auditors for the various purposes under the BO (except section 59(2)) will normally be an AI's existing auditor.

50. The HKMA should continue to pay attention to the potential conflicts of interest. With respect to the reporting on specific systems of control under section 59(2) of the BO, particular attention should be given to the interdependency between audit firms and supervised banks. Independence concerns and conflicts of interest will be prevalent where a single firm provides multiple services to regular clients subject to audits. The HKMA has the power to require AI to use another firm of auditors in commencing independent reviews under Section 59(2) and SPM IC-3. AIs are normally requested to use another firm of auditors if the subject matters of the independent reviews may give rise to potential conflict of interest. The assessor also noted several cases where the HKMA made this request. Considering the increased reliance on external auditors, ascertaining independence of review becomes a greater point of importance.

51. Previous BCP assessment recommended that the HKMA be granted the *direct power* to reject and rescind the appointment of an external auditor who is deemed to have inadequate independence. This recommendation has yet to be addressed. However, the authority explained that while the HKMA does not have a direct and explicit power to reject or rescind the appointment of an external auditor, the HKMA may request the AI to consider the appropriateness of retaining the external auditor where necessary or invoke its general supervisory power to reject or rescind the appointment. The assessor also noted several cases where the HKMA made this request effectively.

Recommendation

- The FSAP supports the HKMA's review and update of the current SPM IC-3 issued in 2003.[19] (e.g., reiterate the importance of considering potential conflict of interest in the selection of the auditors for independent reviews,[20] and explicitly require the independent review report to be submitted simultaneously to HKMA and to the AI (and its Board or relevant Committees), where necessary,[21] etc.)

Supervision of Foreign Bank Branches (FBBs)

52. Overall, the HKMA is effective in supervising the significant presence of foreign banks in the HKSAR and the cross-border issues arising from branch status. As a host authority of a large number of foreign financial institutions including all G-SIBs, cooperation and information sharing with foreign authorities is a key aspect of FBB supervision and regulation. The HKMA continues to have a high degree of engagement with foreign supervisors and parent banks.

[19] The HKMA already indicated that they are in the process of updating the SPM module IC-3.

[20] In some cases, AIs' external auditors are rotated naturally in case where the authorities of their parent entities or headquarters have such rotational rules.

[21] According to IC-3, paragraph 4.3.7, the auditors' report should normally be submitted to the AI not later than three months from the end of the review period and forwarded with the comments of the AI to the MA within a further month.

53. Foreign bank branches are not required to hold capital or observe capital adequacy requirements such as leverage ratios in the HKSAR. The responsibility for supervising the overall capital adequacy of foreign banks rests with their home supervisors. FBBs are not subject to the statutory limits on exposures and concentration of risks covering: LEs, connected lending, holding of shares, interest in land, etc. A "Certificate of Compliance" procedure requires an AI to certify its compliance with various statutory limits under the BO.

54. The regulatory monitoring and reporting framework for FBBs is similar to that of local AIs and commensurate with FBBs' nature and form of banking activities. For instance, the information collected on Mainland activities, RMB business activities, liquidity monitoring, foreign currency position, loans and advances and provisions, residential mortgage survey, etc. is sufficiently detailed. Liquidity stress testing framework of HKMA also includes large foreign bank branches. Equivalent levels of information collection support comparable monitoring to assist the risk-based supervision of FBBs and local AIs consistently. The HKMA is in the process of updating its internal guidance on FBB supervision to reflect the latest supervisory approaches and to keep pace with industry and market development.

55. Around one third of AIs in the HKSAR have not been inspected by the HKMA over the last five years. AIs with no onsite presence are mostly FBBs subject to supervision on a portfolio basis. Of the FBBs that have not been subject to HKMA examinations in the past five years, some are quite large. For such AIs, the HKMA engaged independent external parties to conduct reviews (either under section 59(2) of the BO or otherwise) on the effectiveness of the risk management systems and controls on a needs basis. Although offsite information does not indicate any material weaknesses or problems, it remains necessary for the HKMA directly to verify the banks' conditions through on-site examinations, especially for large FBBs.

Recommendation

- It is recommended that the HKMA conduct targeted and/or limited scope inspections on FBBs that have not had an onsite inspection for long intervals; give special attention to systemically important/large FBBs.

B. Financial Group Supervision

56. The 2014 FSAP assessed that the HKMA has a strong legal and regulatory framework for consolidated supervision. The HKMA analyzes AIs on a solo and consolidated basis, and carefully monitors risks across the entire group structure, placing emphasis on corporate governance and robust risk management policies and procedures. AIs typically belong to one or more of the following three common types of structure.[22] Type One is for groups comprised of an AI and its subsidiaries. Type Two is when the AI and its subsidiaries form part of an international banking group or other supervised financial group (i.e. one that is headed by an overseas bank or a regulated holding company). Type Three is when an AI and its subsidiaries are headed by an unregulated

[22] SPM CS-1 ("Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions") sets out the group-wide approach adopted by the HKMA to supervising AIs incorporated in the HKSAR.

holding company that controls entities that are involved in the wider range of financial (i.e.: banking, insurance and securities) and commercial activities (i.e.: a diversified financial group).

57. Under the sectoral regulatory regime of the HKSAR, the HKMA and other regulatory agencies take a coordinated approach on financial groups for group-level supervision. There are 25 cross-sectoral financial groups including banking sector entities and securities/futures sector entities. There are also six cross-sectoral financial groups that include insurance sector entities and securities/futures sector entities. In practice, there is "lead coordinator" arrangement to facilitate effective exercise of its functions. For example, the HKMA acts as the coordinator for local financial groups where an AI has a subsidiary that is an authorized insurer; the IA acts as the coordinator where an AI has a holding company that is an authorized insurer. The increasing complexity of its financial group structures in the HKSAR warrants the strengthened group-wide supervision.

Box 2. Hong Kong SAR: Examples of Coordinated Financial Group Supervision

- The HKMA and the SFC have jointly conducted thematic reviews on the sale of in-house products by intermediaries within the same financial group and issued a joint circular in November 2017 to share with intermediaries key observations and good practices in relation to potential conflicts of interest that may arise from the sale of in-house products.
- The HKMA and the SFC have conducted coordinated inspections focusing on complex financial arrangements and deficient lending practices of a Mainland-based bank and a licensed corporation owned by its subsidiary. Joint circular by the SFC and the HKMA was issued in April 2019 addressing their observations and recommending good practices.

58. The HKMA's general policy is that a person who holds more than 50 percent of the share capital of an AI incorporated in the HKSAR should be a bank or financial institution in good standing. If a locally-incorporated AI is not owned by a bank or financial institution, the HKMA expects the AI to be held through an immediate holding company (IHC) in the HKSAR, whose sole purpose is to hold the shares in the bank, with supervisory conditions imposed on the IHC under section 70 of the BO.[23] The pillar 2 capital add-on imposed on the IHC appears to be consistently set at the same level as the corresponding AI, without a separate Supervisory Review and Evaluation Process decision.

59. There are two cases where a local mid-sized AI, together with other sister companies, are headed by an ultimate holding companies (UHC) that is neither supervised by the HKMA nor by any other regulators. The UHC is also required, by means of conditions attached to the consent given to it under section 70 of the BO, to submit, at least on an annual basis, an assessment report by an audit firm on (i) the financial condition of the UHC group; (ii) the ability of the UHC group to provide timely capital and/or liquidity support to the IHC and the AI in case of need, etc.

60. The HKMA has formalized the process for analyzing non-financial activities of ultimate

[23] The conditions imposed on such IHCs cover requirements on capital adequacy, liquidity, large exposures, intra-group exposures and charges over assets, group structure, activities undertaken, risk management, fitness and propriety of directors and senior management and the submission of financial and other information to the MA

UHCs since the last FSAP. The HKMA issued an internal guidance note "Imposing Conditions on Holding Companies of Locally Incorporated Licensed Banks for the Purpose of Consolidated Supervision" in 2016 and has taken a consistent approach to assessing their group risks. Where an AI is part of a wider group headed by an UHC, consolidated supervision is supplemented by a review of the holding company and other companies of the group (i.e., controller group review). Where necessary, the HKMA may employ assessment tools similar to prudential standards expected of AIs. However, the internal guidance note is not legally binding nor is it publicly available.

Recommendations

- The FSAP supports the HKMA's review and update of the current SPM CS-1 issued in 2008 which sets out the group-wide approach to supervision of AIs in order to continue to be responsive to the evolution in the forms and sources of risks for the banking groups.[24]
    - For instance, consider incorporating standard conditions of the internal guideline to be observed by IHCs and UHCs into the SPM so that the relevant AIs clearly understand supervisory requirements and add enforceability.
    - It is recommended that the authorities increase focus on the areas of risk concentration, group-wide corporate governance, intra-group transactions and exposures, and financial entities' aggregate exposures to non-financial entities.

C. Corporate Governance

61. The HKMA continues to strengthen its supervisory framework on corporate governance. In October 2017, the HKMA updated supervisory guidance relating to corporate governance policies of AIs.[25] This has led to a greater emphasis on the role and expectations of the board and in particular independent non-executive directors (INEDs). Major revisions of the guidance were made to:

- Clearly outline the responsibilities of the board and senior management;
- Strengthen the composition of board members and role of INEDs to ensure effective board function (i.e.: chair of the board and its committees should be INEDs, require a minimum number of INEDs as board members); and
- Establish specific board-level committees (i.e. nomination committee, audit committee, risk committee, remuneration committee) to assist the board in discharging its responsibilities.

62. The HKMA established a new Development Program for INEDs in 2016 to better equip INEDs in performing their functions. The Program covers: (i) an experience and insight sharing

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[24] When revising the SPM, the HKMA is advised to refer to the Principles for the supervision of financial conglomerates, September 2012, BCBS.

[25] SPM module CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions"

conference between INEDs and the HKMA to be held annually; (ii) thematic seminars relevant to the work of INEDs; and (iii) on-boarding sessions to help newly appointed INEDs familiarize themselves with the evolving landscape of the banking industry and of the regulatory environment.

63. **The corporate governance supervision still has room for improvement.** Generally, in the HKSAR, there are no restrictions for individuals to hold multiple positions in different entities within the financial group. The authorities explained that it is not uncommon for a director of a foreign subsidiary to hold one or more positions in other group entities. This can help to ensure consistency in strategic direction and foster closer communications between the group entities, in particular between a subsidiary board and its parent board. However, staff also noted some examples where individuals (a Board member, Chief Executive or Alternate Chief Executive) in a local AI held multiple director/management positions in other *non-financial entities* within a wider group (albeit not within the AI group), which may compromise independent judgment and create conflicts of interest.[1] Staff is of the view that independence is crucial for the board to carry out its fiduciary duty and function in the best interests of the entity and its stakeholders. A board's ability to exercise objective judgment can be enhanced by properly vetting candidates for independence and conflicts of interest concerns.[2]

64. **While the SPM requires sufficient time commitment for directors (including NEDs and INEDs), in practice, it appears many directors in AIs hold a large number of director/management positions.** For example, one NED in an AI can have 40-50 different directorships in other financial/non-financial companies. Members of the board (including NEDs and INEDs) play a crucial role in the governance of banks. They are expected to oversee, monitor, and challenge the management function, especially in regard to the effectiveness of internal controls and the soundness of governance structures. This cannot be achieved without a sufficient time commitment on the role.

Recommendations

- Review and examine the cases where individuals hold a large number of directors/management positions in financial and non-financial entities with focus on potential conflicts of interest and time commitment on the roles.

D. Conduct Risk Supervision

65. **BCD[3] takes a proportionate approach when assessing the conduct risk of AIs based on size and complexity.** The frequency, intensity, and depth of the on-site examinations and off-site reviews is determined by the potential risk that the AI poses. The HKMA's conduct risk supervision

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[1] For instance, a Chief Executive of a local AI can also be serving as a director of a property company (which can do business with the regulated entity) within a wider group.

[2] From the perspective of conflict of interest, under Module CG-1 of the HKMA's Supervisory Policy Manual *Corporate Governance of Authorized Institutions*, AIs are required to have effective policies to identify, prevent and mitigate actual and potential conflicts of interest of their directors and employees.

[3] The BCD takes charge of oversight of financial market infrastructures, licensing, and all supervisory and development functions relating to the business conduct of AIs.

relies on the analysis of various supervisory returns, surveys, banking complaints, and thematic onsite examinations. Among other duties, the BCD is vested with the responsibility of supervising AIs' conduct on the sale of investment, insurance, and MPF products. Examination findings on conduct related issues are integrated in the annual CAMEL rating.

66. **The number of banking complaints is increasing.** The HKMA received 1,948 complaints against AIs and their staff members in 2018, a 9% increase from the previous year; 21% related to the provision of banking services. Complaints concerning the provision of banking services increased by 39% over the year to 417 cases in 2018. Other complaints are related to freezing and closing accounts arising from the risk assessment conducted by individual AIs, service quality, client agreement terms, fees and charges, mis-selling of investment/insurance products, remittance, etc. The HKMA's Enforcement & AML Department receives complaints directly from the public and handles every complaint in accordance with established procedures.

67. **The HKMA initiated a Bank Culture Reform to promote the adoption of a holistic and effective framework and foster sound culture within AIs.** More regulatory focus was put on culture as strengthening a banks' risk culture is a proactive deterrent to misconduct. The HKMA encourages AIs to foster sound culture within their institutions with particular attention to three pillars, namely governance, incentive systems, and assessment and feedback mechanisms[4]. Practical guidance on these pillars was provided to all AIs. In 2018-19, the HKMA has implemented the following supervisory measures in relation to AI's culture efforts[5]: (i) requiring AIs to conduct self-assessments; (ii) conducting focused reviews of key areas of bank culture (e.g., incentive system of front offices in retail banks); and (iii) undertaking cultural dialogues with senior management and/or board members of AIs with a focus on supervisory observations on culture and conduct issues. The HKMA is currently reviewing the self-assessment reports covering the 30 banks which were due in July 2019, with a view to drawing insights from the industry's submissions for providing a range of practices for reference by the industry, as well as having an assessment of the culture of individual banks.

Recommendation

- Under increasing competition and a weakening economy, improvements in the management of non-financial risks appear to be critical. Continue to analyze and focus on the root causes of identified misconduct and consider enforceable actions as necessary.

PRUDENTIAL REGULATIONS AND REQUIREMENTS

A. Capital Requirements

68. **The capital ratios of CET1 and AT1 of the banking sector and D-SIBs have steadily increased over the past five years.** The increase in CET1 ratios was mainly attributable to retained earnings and gains from asset disposals from some banks during the period. The level of Tier 2

[4] https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2017/20170302e2.pdf

[5] https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2018/20181219e1.pdf

capital in the banking sector and D-SIBs declined slightly over the past five years, partly due to AIs' redemption and phase-out of Tier 2 capital instruments that were non-compliant with Basel III standards.

Table 4. Hong Kong SAR: Breakdown of AIs' Capital Ratio

Breakdown of Industry's (All local AIs) Capital Ratio (In ppt)				
Consolidated basis	**CET1**	**AT1**	**T2**	**Overall**
Q1 2014	13.1	0.1	2.8	**15.9**
Q1 2019	16.1	1.9	2.4	**20.4**
Breakdown of D-SIBs' Capital Ratio (In ppt)				
Consolidated basis	**CET1**	**AT1**	**T2**	**Overall**
Q1 2014[1]	12.6	0.1	2.6	**15.3**
Q1 2019	15.9	1.9	2.3	**20.2**

[1] The capital ratios of D-SIBs as of Q1 2014 are computed based on the capital positions of AIs which were then designated by the HKMA as D-SIBs in 2015 when the D-SIB framework was implemented in Hong Kong.

69. **The capital framework adopted in the HKSAR is in line with the Basel III requirements and takes a proportionate approach.** The Regulatory Consistency Assessment Program (RCAP) of the BCBS on Hong Kong's capital framework conducted in 2014/15 concluded that the prudential risk-based capital regulation in Hong Kong is compliant with the Basel framework.[6] Leverage ratio, capital buffers, higher loss absorbency capital requirements for D-SIBs, revised securitization framework, and total loss-absorbing capacity (TLAC) holdings standards have been implemented in accordance with the BCBS implementation timetable. In terms of a proportional approach, it is permissible for very small AIs (i.e.: total asset size of not more than HK$10 billion) to use a simpler approach (i.e.: the basic approach which is a modified version of the Basel I capital accord) to calculate the capital requirements for credit risk of non-securitization exposures.

70. **The HKMA has further introduced internal capital targets (ICTs) for each of the CET1, Tier 1 and Total capital ratios since 2016.** The ICTs replace non-statutory trigger ratios to facilitate the supervision of locally incorporated AIs' capital adequacy. The HKMA also requires all locally incorporated AIs to set up internal leverage ratio targets at levels above the statutory minimum.

71. **The HKMA imposes Pillar 2 capital requirements to all locally incorporated AIs, providing incentives for AIs to address their risk management and internal control weakness.** In 2016, the supervisory policy manual regarding the Pillar 2 process has been updated. The updated manual better illustrates the operation of Pillar 2 within the revised capital adequacy framework, including the positioning of the Pillar 2 capital requirement in the capital hierarchy; the approach to allocating the Pillar 2 capital requirement amongst the CET1 capital ratio, Tier 1 capital ratio and Total capital ratio; and the differentiation between P2A and P2B and how the BCR buffer level is considered when addressing overlap.

[6] See https://www.bis.org/bcbs/publ/d313.htm for details.

72. The HKMA is in the process of amending the BCR to incorporate the Basel revised capital standards on the treatment of counterparty credit risk exposures and equity investments in funds. These standards were originally scheduled for implementation on 1 January 2017 but were tentatively deferred to sometime around end-2020 in light of the implementation progress of other major jurisdictions. Updates to the capital framework to incorporate other associated Basel standards are on-going. Those implemented include the revised securitization framework, capital treatment of expected loss provisions and the TLAC holdings standard.

B. Credit Risk

73. The capital framework for credit risk was compliant with the Basel standards based on 2014/15 RCAP. While some minor deviations were found in the treatment of commercial real estate exposures under the standardized approach for credit risk, the current practice is similar to the treatment under the revised Basel Capital Framework, which is counterparty-based and more risk-sensitive. The simple impact analysis by the HKMA also indicated that the impact from such deviations are minimal. Thus, the HKMA intends to amend/rectify these areas in accordance with the BCBS implementation timetable for the revised standards.[7]

74. With respect to the internal ratings-based (IRB) approach for credit risk, the HKMA has imposed risk-weight floors on residential mortgage loans (RML) as part of its counter cyclical macro-prudential measures. This measure together with other macroprudential measures (tightening of loan-to-value (LTV) ratio and debt servicing ratio (DSR) requirements) have enhanced banks' resilience to risks. The risk-weight floors are standardized across IRB banks without further breakdown by risk buckets such as LTV ratio and DSR. The relevant risk-weight floors are as follows:

Table 5. Hong Kong SAR: Risk-weight Floors on RMLs

Date of approval	Risk-weight floors
All new RMLs approved by IRB banks after 19 May 2017	25%
All existing RMLs approved by IRB banks on or before 19 May 2017	15%

75. The HKMA has stepped up its supervisory efforts on banks' credit risk management over the past years. The HKMA employs skilled credit risk professionals for their on-site examinations. The credit risk division within BSD primarily performs on-site examinations on credit risk related issues and provides support on credit risk monitoring and supervision of high risk profiled AIs. The HKMA has sophisticated monitoring systems in place to monitor AIs' exposure to the property market and Mainland-related lending. With respect to supervision on Mainland-related lending, the HKMA developed a database on large corporate exposures and risk assessments and has conducted more thematic examinations. It is worth noting that the classified loan ratio of this lending has remained below 1% in the past five years under the HKMA's supervision.

[7] Revisions to SA and IRB framework for credit risk implementation date are set as January 1, 2023.

Box 3. Hong Kong SAR: Examples of Credit Risk Supervision

Supervision on exposures to residential real estate

The HKMA monitors the above activities of AIs mainly through off-site surveillance. These include:

- analyzing data collected from the monthly survey on residential mortgage lending, other periodic surveys (e.g. half-yearly survey on top-up mortgages) and quarterly return on loans and advances and provisions to identify potential risks;
- monitoring data from independent sources (e.g. the Land Registry, the 'Sales of First-hand Residential Properties Electronic Platform,' and property agents) to assess the size of mortgage financing provided by non-bank entities (property developers and unregulated finance companies) and the associated risks posed to the banking sector; and
- keeping close dialogue with AIs that are active in mortgage lending to gather market intelligence, and remaining attuned to daily news on developments in the property and mortgage markets.

Supervisory actions on AI's lending to property developers

In late 2016 and early 2017, some property developers aggressively acquired land at high prices. Many developers were offering high LTV mortgages to buyers. The credit risk of the banking sector increased, as lending to property developers was one of the key drivers for domestic loan growth.

To mitigate risk, the HKMA lowered financing caps for construction loans in 2017, from 50% to 40% of the site value and from 100% to 80% of the construction cost, with an overall cap from 60% to 50% of the expected value of completed projects. The risk weight for capital charges was raised in 2017 for exposures to property developers offering high LTV mortgages.

The HKMA monitors AIs' lending to property developers as part of its ongoing supervision of AIs. For example, the HKMA conducted a round of thematic examinations from Q3 2017 to Q4 2018 to ensure that AIs follow prudent underwriting standards in their lending to property developers.

Supervision on Mainland-related lending

The HKMA monitors AIs' Mainland related lending (MRL) by collecting frequent and granular information on AIs' lending activities through return and surveys.

In view of AIs' increasing non-bank Mainland exposures, the HKMA has introduced the Return of Mainland Activities and three surveys on MRL since 2014 to collect more granular data on exposures, such as MRL by borrower type, MRL by risk mitigation type (e.g. collaterals, guarantees, etc.) and loan quality of MRL. In particular, the HKMA required selected AIs active in these activities to provide a list of exposures to mega corporates, including Mainland state-owned entities, Mainland private entities and non-Mainland entities. The collection of these data enhances the HKMA's analysis and risk identification processes of these activities.

76. **Non-bank Mainland exposures should continue to be a main focus of supervisory activities.** 41% of total outstanding Mainland related lending was lent to Mainland state-owned enterprises (mostly central state-owned enterprises), 31% to local and foreign companies investing in the Mainland, and the remaining 28% to Mainland private entities.[8] The HKMA collects breakdown of detailed Mainland-related lending data by counterparty types and closely monitors its change of exposures. Geographical concentration and concentration of exposure to non-bank Mainland entities are factors considered by the MA in determining Pillar 2 capital add-on.

77. **AIs are expected to set internal limits for monitoring concentration such as specific**

[8] See table 3.13.3 of the MSB table, https://www.hkma.gov.hk/eng/data-publications-and-research/data-and-statistics/monthly-statistical-bulletin/

counterparties, groups of counterparties, economic sectors, and geographical areas; the HKMA determines the adequacy of limits. While the HKMA may set prudential limits directly to prevent AIs from taking excessive concentration risks on these areas, no explicit supervisory limit has been imposed on sectoral or geographical concentration of exposures. Generally, FBBs have not been required to set any regulatory prudential limits on LEs or concentrated exposures.[9] Some banking groups have both subsidiaries and FBBs in the HKSAR; supervisory focus should be on the potential for regulatory arbitrage.

78. The HKMA has taken rigorous and pre-emptive supervisory actions in its supervisory review on credit risk management of AIs. For instance, the HKMA and SFC's joint on-site inspection found that an AI was involved in high risk equity financing disguised through multi-layer transactions, opaque financing structures, special-purpose vehicles or discretionary accounts. After completing the inspection of a bank, the HKMA and SFC issued a joint circular asking all relevant financial institutions to review complex financing arrangements and warn about this malpractice.[10]

79. Several other examples of pre-emptive supervisory actions taken by the HKMA confirmed its effectiveness. It is common for the HKMA to require AIs to submit an independent review by an external auditor to identify the root causes of severe deficiencies and accountable staff members, which can be either a supervisory measure or an enforcement outcome. The HKMA follows up the results of independent reviews, and where necessary, it will further step up its supervisory work. As a supervisory measure, some AIs have suspended a particular business until the HKMA is satisfied that all rectification measures have been implemented.[11]

Recommendations

- Continue to closely monitor AIs' concentrated exposures to non-bank Mainland entities, particularly of banking groups that have both FBBs and subsidiaries with focus on potential opportunities for regulatory arbitrage.

- Continue to demonstrate its willingness to act upon AIs that attempt to circumvent rigorous credit risk assessments or bypass regulatory oversight.

[9] For FBBs, their large exposures are normally managed by their head offices on a group-wide basis together with the large exposure positions of other entities of the banks, and under the consolidated supervision of the home supervisors.

[10] https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=19EC28

[11] Where warranted, the HKMA may impose sanctions directly on offending management although there are not many examples.

C. Large Exposures and Related Party Transactions

Large Exposures and Concentration Risk

80. The new Banking (Exposure Limits) Rules (BELR) that came into operation in July 2019 will likely have a large effect on corporate exposures. The rules are to implement the standards on LE issued by the BCBS in April 2014. According to the BCBS' timetable, all aspects of the LE framework should have been implemented in full by January 1, 2019. The BELR came into operation on July 1, 2019 and the HKMA has allowed an additional six-month grace period for banks to comply with them. Under the BELR, every AI (except for FBBs) is subject to a statutory limit of 25 percent of its Tier 1 capital on its financial exposure to any one person or group of related persons. Banks are expected to identify possible connected counterparties by economic dependence when the sum of all exposures to one individual counterparty exceeds 5 percent of Tier 1 capital. Exemptions are allowed for sovereign, central bank, and interbank intraday exposures. A tighter limit of 15 percent is applicable for exposures between banks that have been designated as G-SIBs. Also, the local implementation takes more conservative approaches than the Basel framework in some areas. For example, the rules apply not only to internationally-active AIs, but to all locally-incorporated AIs and the rules do not provide for an explicit window on ungrouping to prevent possible abuse. The overall intent is to tighten the regulation for more prudence.

81. Complementary to Basel LE implementation, AIs are subject to new capital charges on significant sovereign concentration risk. Capital charges for sovereign concentration risk follow a marginal risk weight add-on approach. Any exposure to sovereigns up to 100% of Tier 1 capital is free of additional charge. Exposures exceeding that percentage are subject to increasing risk weights that serve to calculate the risk-weighted assets subject to capital requirements.

82. Nonetheless, the BELR provide more exemptions than are detailed in the Basel LE standards. For instance, exposures of the receiving banks of an Initial Public Offering (IPO) to other banks for placing the IPO subscription monies received to the interbank market are exempted (rule 48(1)(l)). Exposures acquired by an AI in the course of satisfaction of debts due to an AI are exempted and have to be disposed when the earliest opportunity arises but no later than 18 months (rule 48(1)(e)). Exposures in relation to specific projects backed by the HKSAR Government (rules 48(1)(h), (i) and (j)) are exempted, although these exemptions have been granted on a case-by-case basis to ensure that the risk is low. Exposures covered by a letter of comfort are exempted (rule 57(1)(d)) – In general, a letter of comfort is provided by the parent bank of a subsidiary AI in the HKSAR expressing an undertaking to support any incurred losses of the subsidiary's exposures in excess of the ordinary statutory limits. As a letter of comfort is not a formal guarantee, the HKMA has determined to cease the acceptance of the existing letters of comfort provided to the foreign bank subsidiaries from July 1, 2020 (a one-year grace period). The HKMA explained that these local exemptions take into account some specific characteristics of the Hong Kong market, and they are designed to minimize the risk of potential side effects on financial stability.

83. AIs' property and equity investment business is restrained by statutory limits. AIs are required to monitor concentration in equity exposures and interests in land. Rule 11 of the BELR provides that an AI incorporated in Hong Kong must maintain an equity exposure ratio not exceeding 25%. Part 6 of the BELR provides that an AI incorporated in Hong Kong must maintain the value of holding of interests in land at a ratio not exceeding 50% compared to the amount of its Tier 1 capital; while for interests in non-self-use land, the ratio must not exceed 25% (AIs are also expected to set internal limits for monitoring other kinds of concentration such as economic sectors and geographical areas under SPM module CR-G-8). These are Hong Kong-specific restrictions.

84. **Although the actual investment levels of AIs are not excessive, and may also relate to a legacy issue, the current absolute regulatory limit appears to be high.** The authority also indicated that AIs on average have interests in non-self-use-land and building of around 3-4 percent of Tier 1 capital. The authority also explained that AIs' interest in land will not jeopardize AIs even in times of severe stress in real estate markets based on its own stress-test. Nevertheless, considering the role of banking as the credit intermediaries, further increases should be prevented by close supervision.

Recommendations

- Minimize exemptions to LE limits as far as possible in line with Basel LE framework and closely monitor the exposures that are exempted from the BELR rules.[12]
    - Conduct close monitoring on AIs' implementation of new rules focusing on their system change (e.g., application of economic interdependence).
- Closely supervise changes of the AI's non-self-use property.

Related Party Transactions (RPT)

85. **The SPM module on "Exposures to connected parties" was revised in November 2015 requiring AIs to adopt an expanded scope of connected parties.** The connected parties in the SPM module include in addition to those specified in Rule 85(1) if the BELR, (i) the senior management and key staff of an AI; (ii) an AI's subsidiaries, fellow subsidiaries and other entities over which the AI is able to exert control; (iii) the controllers, directors or senior management and key staff of the entities specified in (ii); (iv) the relatives of those persons referred to in (i) and (iii), etc. The exposure limit on single connected natural persons was loosened from HK$1 million to HK$ 10 million based on its quantitative impact study results. Revised provisions for connected parties' exposure limits have been in effect since July 2019 subject to a grace period of six months.

86. **The HKMA limits AIs' intragroup exposures by requiring AIs to set internal limits on aggregate exposures to their own group of companies.** The internal limit on intragroup exposures is expressed as a ratio of aggregate intragroup exposures to the amount of an AI's Tier 1 capital. There are no quantitative regulatory limits to intragroup exposures. While intragroup transactions are subject to reporting to the HKMA, the analysis of the transactions may have been

[12] Refer to the Regulatory Consistency Assessment Program Assessment (RCAP) report of Basel large exposures regulations – Hong Kong SAR (https://www.bis.org/bcbs/publ/d492.pdf).

insufficient.[13] It is important to understand the reasoning behind the transactions and such analysis will help the authorities take the necessary measures.

87. A scope for improvement on RPT supervision remains. The HKMA considers the information collected as effective for regular monitoring of the nature of connected party transactions but might not be sufficiently granular to capture the exact characteristics of RPT for in-depth assessment; there is potential room for improvement in the granularity of the information collected for in-depth assessment. For instance, the prudential reporting template could further include type of exposures, internal exposure limits, value of non-exposure transactions, RP's relationship to bank, collateral type and amount, and asset classification, etc.

Recommendations

- Intensify supervision on RPT to check whether AIs' identification of connected party, Board of Directors reporting requirements, internal limits are being properly set and observed considering the changes of rules.
    - Strengthen analysis of the nature of intragroup transaction and take appropriate actions where necessary.
- Consider the need to improve the prudential reporting template on RPT for more effective monitoring.

D. Other Prudential Requirements

88. The Basel III Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) have been implemented according to the Basel timeline since January 2015 and January 2018 respectively. AIs that are internationally active or significant to the stability of the banking sector are required to comply with relevant LCR and NSFR requirements. For other AIs to which the Basel III liquidity standards do not apply, they are required to comply with the requirements relating to the Liquidity Maintenance Ratio (LMR). On top of LMR, those AIs with considerable business size are also required to comply with the requirements relating to the Core Funding Ratio, which is a simplified version of the NSFR. A set of liquidity monitoring tools (e.g., report on intraday liquidity position) are also in place. The average LCR of major banks is 162.4%, well above the statutory minimum of 100%; while the average LMR of other banks is 54.7%, also well above the statutory minimum requirement of 25%.[14]

89. In 2019, the Banking (Liquidity) (Amendment) Rules 2019 (BLAR) expanded the scope of level 2B assets and liquefiable assets under the LCR and the LMR respectively. When the HKMA developed the local LCR policy during 2013 and 2014, it decided to adopt a more

[13] The example of "complex and opaque financing arrangement" in paragraph 79 demonstrates the need for such analysis. The new banking return capturing exposures to intragroup companies will be effective from September 2019.

[14] See the Regulatory Consistency Assessment Program Assessment (RCAP) report of Basel NSFR regulations – Hong Kong SAR (https://www.bis.org/bcbs/publ/d495.pdf).

conservative stance than Basel standards by only including single-A rated debt securities and residential mortgage-backed securities (the latter subject to case-by case pre-approval) as level 2B assets. Based on the HKMA's subsequent review of its policies, it decided to include Basel-compliant equity shares and triple-B rated debt securities as level 2B assets. This amendment will come into effect in January 2020.

90. The liquidity stress tests have been enhanced. AIs in the HKSAR largely maintain sound liquidity with low loan/deposit ratios and low reliance on wholesale funding. Potential dollar fund outflows could create liquidity management challenges for some mid-sized banks. If an AI has liabilities denominated in a foreign currency that account for 5% or more of its total liabilities, the AI is required to include that currency into its liquidity stress test program and conduct separate stress tests for that particular currency. Thematic reviews were conducted in 2018 to assess AIs' preparedness for a possible tightening of US dollar liquidity and their internal liquidity stress testing capability. The HKMA's supervisory liquidity stress test assumes that the funding of the banks would contract by an average of about 20% within one month.[15] If necessary, the HKMA has imposed specific liquidity requirements on AIs assessed to be less resilient in certain scenarios.

91. Effective from July 2019, the interest rate risk in the banking book (IRRBB) framework, adopting the 2016 BCBS standards on IRRBB, was implemented. The framework requires the use of a standardized approach (i.e.: no internal model allowed) and most FBBs continue to be subject to the previous interest rate risk framework, which is proportionate. The following points outline some of the adaptations for the local implementation that have been carried out with respect to the 2016 BCBS IRRBB framework:

- All locally incorporated AIs and their affiliated overseas incorporated AIs operating in the HKSAR are required to implement the local standardized IRRBB framework (overseas incorporated AIs covered in the local IRRBB framework are exempted from the outlier tests as they are not subject to local capital requirements);

- Most overseas incorporated AIs remain subject to the 2004 BCBS standards for management and supervision of interest rate risk locally and are expected to follow IRRBB standards of their home jurisdictions;

- Interest rates are floored at –2 percent for all shock scenarios in the local IRRBB framework;

- AIs must report all major currencies until at least 90% of relevant interest rate sensitive items are covered; and

- AIs are required to distinguish between CNY and CNH under the local IRRBB framework.

[15] The scenarios have covered the major sources of AIs' funding and incorporated severe fund outflow situations and liquidity shocks that may originate from various stresses, including massive run-off in customer deposits and squeezes in interbank and capital markets referencing the Global Financial Crisis in 2008.

Box 4. Hong Kong SAR: Foreign Exchange (FX) Settlement Risk[1] Supervision

Hong Kong is one of the world's largest FX trading hubs in terms of OTC foreign exchange turnover.[2] The 2019 BIS Triennial Central Bank Survey of FX turnover indicated that sales desks in five jurisdictions – the United Kingdom, the United States, Singapore, HKSAR, and Japan – intermediated 79% of all FX trading. Turnover in Hong Kong SAR grew at a higher rate than the global aggregate, raising its share in global turnover from 6.7 percent to 7.6 percent.

FX settlement approaches by banks

FX settlement approaches commonly adopted by banks in the HKSAR include: payment versus payment (PvP) settlement[3] through Continuous Linked Settlement (CLS); PvP settlement through the Real Time Gross Settlement (RTGS) systems[4]; settlement via "same clearer" or "on-us[5]" accounts; and settlement via nostro accounts maintained at corresponding banks. While FX settlement through PvP methods or netting are generally preferred by banks in the HKSAR to reduce FX settlement risk, not all transactions nor all currencies are covered by existing PvP systems. For example, PvP is not a feasible option for FX transactions involving CNY with banks operating outside Hong Kong. These transactions cannot be settled through the RTGS if the overseas counterparty banks are not members of the RTGS systems, and they cannot be settled via the CLS either as the CLS does not cover settlements in CNY. Also, some small banks do not prefer PvP settlement due to higher cost. According to the recent data in April 2019, a total of US$481 bn[6] was settled per day in the HKSAR (less transactions to be settled with a single payment or bilaterally netted). Around 40% of FX transactions were settled via CLS, 5% via other PVP settlement methods, 11% via "same clearer" or "on-us" accounts, and the remaining 44% were settled via non-PvP methods.

Prudential requirements on FX settlement risk

The HKMA's Supervisory Policy Manual (SPM) module TA-2 "Foreign Exchange Risk Management[7]" stipulates proper measures to monitor, control and reduce FX settlement risk (Section 6). AIs are encouraged to use PvP settlement arrangement, as well as adopting other arrangements including bilateral payment netting and improving unilateral payment cancellation deadlines. AIs are required to conduct stress tests and have contingency plans in place for dealing with settlement failures and other issues.

Certain key elements for effective risk management of FX settlement risk is also covered under dedicated risk management modules in the SPM (e.g. corporate governance in module CG-1[8], risk management framework in module IC-1[9] and counterparty credit risk management in module CR-G-13[10]). The HKMA is now reviewing and updating module TA-2 to incorporate the more granular requirements in the BCBS Supervisory Guidance for managing FX settlement risk.[11] The capital treatment for FX settlement risk adheres to the Basel capital framework.

Supervision on FX settlement risk

The HKMA monitors banks' FX settlement risk and assesses the adequacy of the relevant risk management and controls of banks through both off-site reviews and on-site examinations. As part of HKMA's off-site reviews, for example, the HKMA collected quantitative data on major banks' FX settlement activities in 2019. The HKMA also conducted an ad hoc survey on banks' risk management practices associated with FX settlement, and evaluated the adequacy of banks' FX settlement risk management practices through on-site examinations of banks' treasury and derivative activities.

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[1] FX settlement risk is the risk of loss when a financial institution in an FX transaction pays the currency it sold but does not receive the currency it bought.

[2] BIS Triennial Central Bank Survey of Foreign Exchange turnover in April 2019 (https://www.bis.org/statistics/rpfx19_fx.htm).

[3] With PvP, a payment in one currency occurs if and only if the payment in the other currency takes place, and this settlement method eliminates FX settlement risk.

[4] In the HKSAR, six cross-currency PvP links have been established among the Hong Kong dollar, US dollar, euro and renminbi RTGS systems (CHATS) through HKMA's developed Cross Currency Payment Matching Processor. USD CHATS has also established three cross-border PvP links with Malaysia's ringgit RTGS system, Indonesia's rupiah RTGS system and Thailand's baht RTGS system. The PvP links help eliminate settlement risk by enabling simultaneous settlement of related foreign exchange transactions.

[5] Both legs of FX trades are settled across the books of a single institution.

[6] Daily average turnover of FX contracts conducted in April 2019 ("gross-gross" basis).

[7] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/TA-2.pdf

[8] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CG-1.pdf

[9] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/IC-1.pdf

[10] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-13.pdf

[11] https://www.bis.org/publ/bcbs241.htm

92. Operational risks, including cyber security issues, are a key area of focus and rank high on the HKMA's list of important tasks. Considering the growing use of fintech and a challenging cyber threat landscape in recent years, the HKMA has stepped up its supervisory capacity on technology risk. In the past three years, the HKMA has conducted 23 on-site examinations in relation to technology risk. There are around 22 persons in the team currently (compared with eight in 2013). Among other things, the HKMA has paid attention to addressing the emerging risks of third-party cloud outsourcing in relation to operational risk. Reliance on external service providers and outsourcing of IT operation to overseas jurisdictions add complexity in banking system supervision. Indicative of the multi-dimensional nature of these risks, the HKMA has conducted on-site inspections of AI in the areas of technology risk management, business continuity management, outsourcing and general operational risk management.

93. The disclosure requirements related to the Basel III standards (i.e. LCR, leverage ratio, CCyB and NSFR) as well as the revised Pillar 3 disclosure requirements have been implemented. The Banking (Disclosure) Rules (BDR) were amended and associated standard disclosure templates and tables were issued. Phase I and Phase II of the Basel revised Pillar 3 disclosure requirements, which have reflected the FSB Enhanced Disclosure Task Force recommendations, have been implemented in the HKSAR from March 31, 2017 and June 30, 2018 respectively.

Appendix I. FSAP 2014: Actions Taken to Improve Compliance with the BCPs

Main recommended Actions	Action Taken
CP1-Responsibilities, objectives and powers: There is continued need to be vigilant to ensure that, in the future, developmental and even competitive considerations are not allowed to impinge upon and impair prudential standards	**Implemented/On-going.** There is a strong tradition and commitment within the HKMA, communicated publicly, of recognizing such stability as a prerequisite and cornerstone for maintaining Hong Kong's position as an international financial center. Within the HKMA, there is clear delineation of responsibilities among departments, the work of which contribute to the overall stability and development of Hong Kong's financial system. The banking departments of the HKMA are primarily responsible for the prudential supervision and conduct supervision of banks, while some other departments are undertaking macro-surveillance, liquidity support, and market operations functions to ensure monetary stability. In planning for developmental work, an overarching consideration for the HKMA is the implications of the initiatives on monetary and financial stability.
CP2- Independence, accountability, resourcing: It is recommended that amendments to the BO be made to eliminate or specify the circumstances under which the legal authority of the Chief Executive of the HKSAR to give directions to the MA may be exercised.	**Not Implemented.** The authority explained that Section 10 of the BO reserves a right to the Chief Executive (CE) of the HKSAR Government to give to the FS and the MA such directions as the CE thinks fit with respect to the exercise of their respective functions under the BO. The authority also indicated that the power vested in the CE to issue directions to the MA under Section 10 of the BO reflects the HKSAR Government's ultimate responsibility to formulate monetary and financial policies and supervise financial markets as enshrined in the Basic Law. Given that the power is included in the BO, it would have to be exercised in accordance with the objectives and functions of the BO and in practice would only be used as a tool of last resort to implement specific remedial measures in the most critical and extreme circumstances. Any unreasonable use of the power would be subject to judicial review. Such power in fact has never been exercised. There is a deeply embedded constitutional and political convention of restraint such that any arbitrary attempt to abuse the power would be politically untenable. These considerations, together with the institutional arrangements put in place to ensure a high degree of operational autonomy of the HKMA, provide strong backing for the MA to exercise his supervisory power in an independent and professional manner.

Main recommended Actions	Action Taken
It is recommended that legislative amendments be made to confirm the reasons for which the MA could be dismissed and to provide for the public disclosure of the reasons for the dismissal of the MA.	According to the HKMA, it is not a general practice in Hong Kong to prescribe in law the reasons for removing a statutory appointment and the need to publicly disclose such reasons. Section 42 of the Interpretation and General Clauses Ordinance (Cap. 1) provides that any person having a power to make such an appointment shall also have the power to remove, suspend, dismiss or revoke the appointment. The dismissal of the MA falls within the general legal framework in Hong Kong and the authorities see no need for any legislative change. The letter appointing the MA makes it clear that it is not the FS' intention to terminate the MA's employment except for cause such as the MA's inability to discharge, or not adequately carry out his functions or duties; serious misconduct; conviction of a criminal offence punishable by imprisonment; and bankruptcy.
CP7-Major acquisitions It is recommended that supervisory practices be enhanced with respect to assessing whether major acquisitions and investments by other entities in the banking group will hinder effective implementation of corrective measures in the future, in particular the resolvability of the AI.	**Implemented** In relation to assessing the resolvability of AIs, since the 2014 FSAP, significant progress has been made in establishing the domestic cross-sectoral resolution regime in Hong Kong under the Financial Institutions (Resolution) Ordinance (Chapter 628 of the Laws of Hong Kong) ("FIRO") (which commenced operation on 7 July 2017) and strengthening domestic and cross-border resolution planning for AIs. Pursuant to section 12(1) of the FIRO, the MA as the resolution authority of a within scope financial institution that is a banking sector entity may from time to time conduct a resolvability assessment to determine whether there are any impediments to orderly resolution of an AI or its holding company and, if so, the extent of those impediments. In assessing the resolvability of an AI and where relevant, the MA will take into account (amongst other matters) any major acquisitions and investments by other entities in an AI's group. Resolvability assessment is an ongoing process and is supported by the bilateral resolution planning program established between the HKMA and an AI.
CP8-Supervisory approach: It is recommended that the HKMA continues to intensify its focus on business models and strategy and providing greater consideration to cross-sectoral issues.	**Implemented** Since the last FSAP, HKMA has intensified its focus on the supervision of strategic and business model risks and given greater consideration to cross-sectoral issues, including- <u>Strategies and business models</u> • Putting more emphasis on AIs' strategic risks and business model risks during prudential interviews with senior management and meetings with the board. This facilitates the HKMA's forward-looking risk assessments on new trends and developments of the banking sector, such as the impact of digitalization and fintech development; and • Intensifying offsite reviews on AIs' business performance and projections, and emerging risks. <u>Cross-sectoral issues</u>

Main recommended Actions	Action Taken
	• Strengthening communication between the HKMA and other regulators; • Organizing joint examinations/ reviews by the HKMA and the SFC on certain business activities of a number of banking groups (which consist of registered institutions and licensed corporations). • Sharing with the other regulators diverse information (e.g.: aggregate results of a quarterly survey on banks' product distribution and certain information about banks' non-compliance with the Securities and Futures Ordinance and the guidelines of the SFC.
CP9-Supervisory techniques It is recommended that the HKMA pays close attention to the frequency of on-site review of the AIs which are incorporated overseas, i.e., the foreign branches in HKSAR.	**Partially implemented**: The HKMA adopts a risk-based approach to banking supervision. Under this approach, the frequency of on-site reviews depends on a number of factors, such as the size and risk profile of individual AIs. Since the 2014 FSAP, the HKMA has further strengthened this approach in respect of the supervision of FBBs. Specifically, FBBs with complex and sizable operations in Hong Kong are subject to supervision on an institutional basis. FBBs with small business scale and lower risk profile are supervised on a portfolio basis. Apart from conducting HKMA's own examinations, independent external parties are also engaged to conduct reviews, including reviews under section 59(2) of the BO on the effectiveness of the AIs' risk management systems and controls over specific areas of operations. Nonetheless, around one-third of AIs have not been inspected by the HKMA in over 5 years. (for details, please see the section of "supervision on FBBs")
The HKMA should consider a review and as necessary a revision of internal guidance relating to foreign branches.	**Implemented**: The HKMA has reviewed and updated the internal guidance relating to FBBs, for example: • a new internal guidance note, "Overview of Portfolio Management Teams," was developed to provide guidance on supervision of AIs, which are mostly FBBs with small business scale and lower risk profile, on a portfolio basis; and • an internal guidance note, "Refinements to SRP and CAMEL Assessment Process," was updated to provide guidance on conducting Supervisory Review Process ("SRP") and CAMEL rating review of AIs under portfolio-based supervision. The HKMA is currently updating an internal guidance on "Risk Based Supervisory Approach for Foreign Bank Branches" to bring it in line with current supervisory practice.
CP12- Consolidated supervision It is recommended that the HKMA considers formalizing its process for analyzing non-financial activities of	**Implemented:** The HKMA formalized the process for analyzing non-financial activities of UHCs through the issuance of an internal guidance note (No. 2016-001) "Imposing Conditions on Holding Companies of Locally Incorporated Licensed Banks for the Purpose of Consolidated Supervision" in 2016.

Main recommended Actions	Action Taken
Ultimate Holding Companies (UHC).	As set out in the internal guidance note (which applies to cases where none of the holding companies of a local bank is a supervised financial institution), the HKMA will- • impose conditions on the UHC Group (e.g. conditions related to financial, intra-group exposure, independent review, composition of management team and others); and • require regular submission of information and independent assessment report by the UHC Group to the HKMA.
CP13 - Home-host relationships It is recommended that the HKMA maintains momentum on establishing its domestic resolution regime so that it is able to focus on domestic resolution plans in relation to institutions that are part of international groups.	**Implemented:** The MA as the resolution authority of a within scope financial institution that is a banking sector entity is empowered by the FIRO to undertake resolution planning and resolvability assessment, and to direct an AI or its holding company to take measures reasonably required to remove or mitigate the effect of any significant impediments to orderly resolution. Accordingly, the HKMA has been conducting resolution planning for AIs at both domestic and international levels. The HKMA continues to pursue AI-specific resolution planning work in close coordination with the relevant home and host authorities. Structured bilateral resolution planning programs have been established and are being advanced for each of the six domestic systemically important banks ("D-SIBs") in Hong Kong, five of which are part of an international group. For each of these D-SIBs, a preferred resolution strategy has been determined and a resolvability assessment has been conducted to identify impediments to resolvability. The indicative LAC requirements have also been communicated to these D-SIBs to facilitate their resolution planning and necessary actions to be taken on LAC resources. Considerable progress has been made by these D-SIBs to implement structural changes to their legal, financial, and operational structure or arrangements in order to address the identified impediments to their resolvability. Examples include the build-up of LAC resources, replacement of a chain of overseas holding companies with a clean holding company in Hong Kong, and establishment of a Hong Kong service company.
CP20- Related parties It is recommended that the HKMA executes its plans to seek legal reform to expand the definition of "connected party" (or the equivalent term under the BO) to include senior management, as well as make the corresponding changes to the SPM.	**Implemented:** The SPM module CR-G-9 "Exposures to connected parties" was revised in November 2015 to require AIs to adopt an expanded scope of "connected party" for internal risk management purposes. In paragraph 3.2.1 of that module, the connected parties in addition to those specified in section 83 of the BO (recently replaced by rule 85(1) of the BELR) include:- (i) the senior management and key staff of an AI; (ii) an AI's subsidiaries, fellow subsidiaries and other entities over which the AI is able to exert control;

Main recommended Actions	Action Taken
	(iii) the controllers, minority shareholder controllers, directors, senior management and key staff of the AI's subsidiaries, fellow subsidiaries and other entities referred to in (ii); and (iv) the relatives of those persons referred to in (i) and (iii) who are natural persons. From 1 July 2019 (subject to a grace period of six months), an AI is required to report its connected party exposures determined under the expanded scope in a prudential return to the HKMA for monitoring purposes.
Current plans to incorporate the requirement that write-offs of related party exposures exceeding specific amounts are subject to prior approval by an AI's board should be completed.	**Implemented:** The relevant requirement was incorporated into paragraph 3.1.4 of SPM CR-G-9 in November 2015.
CP27- Financial reporting and external audit It is recommended that the HKMA is granted the direct power to reject and rescind the appointment of an external auditor who is deemed to have inadequate expertise or independence, or is not subject to or does not adhere to established professional standards.	**Partially implemented:** The authority explained that while the HKMA does not have a direct and explicit power to reject or rescind the appointment of an external auditor, it may achieve the same results through the following channels: • During day-to-day contacts with AIs, if the HKMA has concern over the competence or independence of the external auditors of an AI, the HKMA may request the AI concerned to critically consider the appropriateness of retaining the external auditor. • If the AI mentioned above is not responsive to the HKMA's comments without appropriate justifications, the HKMA may invoke the power under section 52(1)(A) of the BO to direct the AI to reject or rescind the appointment of its external auditor. • Having said that, the authority's experience indicates that it was not necessary to invoke any legal power for this purpose, as AIs have been responsive to the HKMA's comments.
It is recommended that a supervisor be granted the direct power to access external auditors' working papers, where necessary.	The authority indicated that there are a number of gateways for the HKMA to gain better understanding of the audit findings and/or access to working papers if the circumstances warrant: • The HKMA maintains regular dialogue with external auditors through tripartite meetings; • Under section 51 of the Financial Reporting Council (FRC) Ordinance, the FRC may disclose information including audit working papers it obtains to the HKMA.
CP28-Disclosure and transparency It is recommended that the HKMA reviews best practices in other countries and consider publication of time series data sourced from its regulatory returns, disclosed	**Implemented**: The disclosure requirements related to the Basel III standards (i.e. LCR, leverage ratio, CCyB ratio and net stable funding ratio) as well as the revised Pillar 3 disclosure requirements (both phases I and II) promulgated by the BCBS in 2015 and 2017 have been implemented in Hong Kong by amendments to the Banking (Disclosure) Rules (Cap. 155M) and issuance of the associated standard disclosure templates and tables.

Main recommended Actions	Action Taken
on an individual institution bases, that would enhance the public and financial community's understanding of AIs' operations and risk profile.	The HKMA publishes regularly supervisory data and information of interest to the market and the general public. Since the last FSAP in 2014, the following additional data have been published: • Mainland-related lending (by types of AIs, by types of borrowers and asset quality); • Basel III LCR; • Basel III NSFR; and • Basel III Leverage Ratio.